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BUSINESS REVIEW

The Compact House

Defending the Dollar

FEDERAL RESERVE BANK OF PHILADELPHIA

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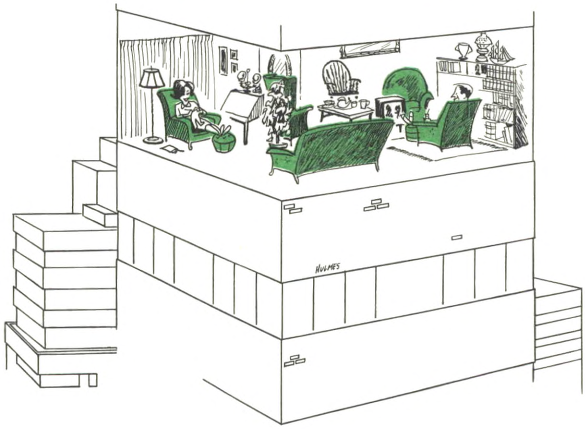
THE COMPACT HOUSE



The "dinosaur in the driveway," as George Romney called the standard-sized American car, lost much of its appeal in the late 1950's. As a result many drivers changed to the new compacts.

A similar trend developed in housing at about the same time. Disenchanted with the standard suburban house at the end of the driveway a number of people began switching to more compact apartments.

Last year apartments accounted for almost 25 per cent of all housing starts, up from only 9 per cent in 1956. In Philadelphia more building permits were issued for apartments in 1961 than for single-family homes.

The increased popularity of compact cars and apartments—compact houses—is traceable to much the same causes. Both are simplified and easy to maintain; both can satisfy a desire for economy. The wide acceptance of smaller cars and apartments stems in part from basic changes in American aspirations and status symbols. Last but not least, both may be reasons why the present rate of economic growth seems disappointing.

FEWER DOLLARS PER UNIT

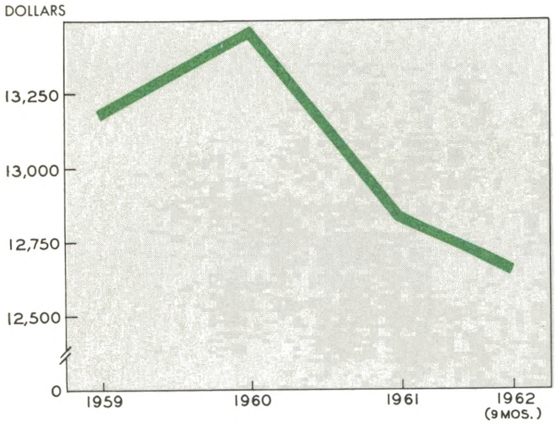
It takes considerably less steel, glass, rubber, and other materials to build a compact car. Thus its manufacture is less stimulating than a standard-sized car would be. The same thing applies to operation because a compact uses less gas, oil, and anti-freeze and is cheaper to repair.

So it is with the compact house. An apartment unit uses less concrete, wood and other materials than the standard house. In most cases less labor is required because apartments are mass produced and benefit from the use of much specialized machinery while single homes often are constructed by hand on scattered sites.

In 1961 the average construction cost for single homes was $13,900 and for apartment units it was $10,400. With apartments making up a larger proportion of housing starts the average expenditure per start declined almost 5 per cent from 1960 to 1961.

Furthermore, high-rise apartments do not require so extensive a network of roads, sewers, and utility services as housing developments do. Since apartments are likely to be constructed in built-up areas they usually do not touch off a

THE EFFECT OF THE COMPACT HOUSE
Average expenditure per nonfarm housing unit.



wave of secondary construction—schools, shopping centers, etc.

The compact house, like the compact car, costs less to operate. Apartment dwellers don't have to buy lawnmowers or invest in blue spruce trees to plant by their doorstep. They need fewer appliances; one washer and drier in the basement often serves dozens of families. Less furniture and furnishings are required in apartments because of their smaller size. Most high-rise units are centrally located and apartment people often find they can get along without a car.

The high proportion of compact cars and apartments is one reason why the numerical rise in auto sales and housing starts this year has not given the economy a more vigorous tone. The present popularity of apartments also has other implications, but before we discuss them we shall explain some of the reasons why more people are "living it up."

WHY APARTMENTS ARE SO POPULAR

The housing needs of the typical family change in a regular pattern as its members grow older. After the wedding many couples move into an apartment or other rented quarters. Often the wife works for a few years and they set aside some money that becomes a down payment on their first house. As children grow older and the husband's earning power increases, the typical family often moves to a larger house. Then after the children grow up and go out on their own the parents frequently move back to a more compact, convenient apartment.

The depression of the 1930's, postwar prosperity, medical advances, and other factors have skewed our population mix. The adult population is growing faster at both ends—young people just starting out and older people nearing retirement. A significant part of the increase in apartment construction is a response to the strong demand—both present and anticipated—from these two groups. In addition these factors are important:

Increased mobility. The average family now changes its residence every 5 years. When the breadwinner works for a large national concern moving-day may be even more frequent. Many people hesitate to buy a home when they might have to move again in a few years. Each purchase can involve a broker's commission of 6 per cent or more and settlement charges that run as high as $500. In order to avoid the trouble and expense of frequently buying and selling homes many families prefer to rent an apartment.

Playing safe. A home owner's investment can be threatened when something undesirable—people, factories, highways, etc.—comes into the neighborhood. Some families hesitate to take the risk and lease an apartment instead.

Available money. Mortgage money is relatively easy to get nowadays and this has spurred all types of residential construction. Remembering past shortages, some builders feel "better take it while I can get it." Changes in tax and zoning laws and the end of rent control have encouraged apartment building in certain areas.

Suburban slowdown. The flood tide of migration to the suburbs has slowed somewhat in recent years. Some families are electing to remain in the city and others are returning to more central locations.

We don't mean to imply that people are no longer moving to the suburbs. They are, certainly, and the total suburban population continues to grow but in some areas this growth has begun to slow. Edmund N. Bacon, Executive Director of the Philadelphia City Planning Commission, speaks of ". . . the beginning of a marked trend toward a return to city living both on the part of older people and of families with children." This may come as a surprise to those of us accustomed to thinking of suburban life as an unshakeable American institution.

The vine-covered-cottage syndrome

Until World War II the suburbs were the province of the wealthy and socially elite. Along Philadelphia's Main Line gracious stone mansions bobbed in undulating seas of blue grass and it was the same outside most large cities.

The average man lived within city limits in row houses, "brownstones," or tenements. The old city neighborhood could be a pleasant place, however. It usually was a friendly, cohesive unit. People with similar ethnic and religious backgrounds tended to live together. Boys married girls next door and families remained within a few blocks of each other. Most residents had an intimate, informal feeling of group identity.

Then after World War II the suburbs began breaking up the old gang. Government mortgage programs and increasing income made suburban home ownership possible for millions. A number of things made it seem desirable.

The soaring postwar birth rate was a factor. Most suburbanites say "we moved because we wanted better schools and a safe place for the kids to play."

Apparent economic advantages of home ownership also were important considerations. Local taxes and mortgage interest were (and still are) deductible for Federal Income Tax purposes. Since most houses were appreciating in value it seemed living was "for free." Real estate ownership also was considered a good way to hedge against the inflation of the early postwar period.

Some families felt they were forced to the suburbs by the migration of rural job seekers to the city. Others moved because the old neighborhood had deteriorated in appearance and was no longer considered safe at night. Still others moved because most of their old friends had gone.

Finally there was the desire for status and prestige. Americans have a deep-rooted desire to own land which traces back to their European origins. In days long past land was practically the only source of wealth. Royalty and a few favored families owned all the land and everybody else was forced to work it in a form of semi-bondage. This heritage helps explain why detached homes with land around them are so popular.

In order to create a supply to fill the fast-growing demand, bulldozers made broad swatches across suburbia. Asphalt was poured on land that yesterday grew alfalfa and utility poles replaced stately old trees. Row after row of ranch houses sprung up on 70′ by 100′ "ranches." Armies of split levels and colonials were drawn up in parade ranks. Picture windows stared each other down across narrow lawns.

It was a new and exciting way of life for many first-time home owners. Take the case of the Gardners, a family we know and maybe you do too. They moved to a small suburban house in the early 1950's. In the beginning there was much to learn and much to do. Yard care was fun. Bailing out the basement was good exercise. Painting and repairing were creative. Shoveling snow was invigorating in the crisp country air.

The Gardners were united with their new neighbors by a kind of frontier spirit. Brought together by the chance reading of a real estate ad, they faced common problems in making a just-finished development into a living community. A certain intimacy developed between these pioneers as they exchanged tools, ideas, and cups of coffee.

The majority of developments remained popular, pleasant communities. We heard it was different for the Gardners, however.

After a time, the initial camaraderie they enjoyed with their neighbors began to disappear. Developments are often thought to be full of people who are just as similar as their box-like houses. This notion is based on the fact that most couples are around the same age, have children, and enjoy roughly the same income. In the Gardners' case these were only surface similarities that hid more basic differences. A wide range of religions, tastes, interests, political persuasions, and educational and regional backgrounds existed in this development. Finding they had little in common, the Gardners and their neighbors began to drift apart. The Gardners longed for the solid friendships and family contacts they had known in the city. What satisfying attachments they did make in suburbia usually were broken up by job transfers to another city.

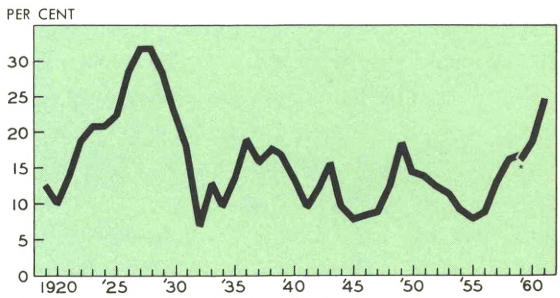
Perhaps because of the diversity and insecurity of the people involved, an unstable social order and a fluid set of values grew up in this case. The Gardners wanted status and respect but they didn't know exactly how to achieve them. For a while they tried fancy, high-powered cars, then it was velvet-carpet lawns and hi-fi, and "look what I built with my own hands." Nothing seemed to work the way it should.

The initial throw-out-your-chest pride of being a land owner diminished as the Gardners grew older and performed the duties of home ownership again and again. Yard care became a chore. Home repair and maintenance turned into drudgery and snow shoveling was a good way to strain your back.

Some of the economic advantage of suburban home ownership proved to be more illusion than fact. The Gardners found that taxes rose year after year as more and more families moved into the area demanding governmental services. Commuting became more expensive and time-consuming. Service and repair men were unavailable except at exorbitant prices. The used home market weakened and this diminished the "living-for-free" feeling. Real estate ownership became less desirable as a hedge against infla-

THE APARTMENT MIX

Multifamily units as a percentage of nonfarm starts.



* New series.

tion because the cost of living seemed relatively stable.

Such considerations led the Gardners and families like them to reassess the advantages and disadvantages of suburban home ownership. Some, particularly those with older children, or working wives, decided that the promised land of a decade ago now was going back on its promises. As we pointed out, the suburbs continue to grow just as people continue to buy standard-sized cars but enough people have become disenchanted with the vine-covered cottage to swell the demand for apartments both in more central suburban locations and near the cores of large cities.

A number of people choose to live in downtown areas because they claim the social life in the city is more interesting and stimulating. It is easier to find friends with similar tastes and interests—probably because there are so many people in a given area.

Cultural activities are more accessible to city residents and so is a wide selection of stores, restaurants, and amusements. Father's office may be a short walk from the city apartment and this can mean two or more extra hours a day for pleasure and relaxation. Mother finds that caring for an apartment is easier and less expensive than for a house and, even if it were not, domestic help is readily available in the city. Urban renewal has removed a number of slums, created parks and playgrounds, and generally made cities more appealing. Rising industrial unemployment has slowed the immigration of rural workers and relieved the overcrowding that forced many to the suburbs in the 1950's.

A house in the sky

The condominium is a new idea in apartments that is stimulating demand. A person buys a legal title to his condominium apartment which may be mortgaged, sold, rented, given away or bequeathed. It is almost the same as buying a house in the sky. Condominium owners must pay property taxes but they and mortgage interest are deductible for Federal Income Tax purposes.

Condominiums require enabling legislation and are now available in only a handful of states. Many experts, however, expect their use to spread rapidly in the next decade—"the new frontier in housing," they have been called.

THE PENDULUM EFFECT

A previous apartment boom of major proportions occurred in the 1920's. At its peak in 1927, one-third of all housing units started were apartments. In the 1930's, 1940's, and much of the 1950's the pendulum of preference had swung to single-family units. Now, of course, it's moving back to apartments again. Each time the pendulum swings it picks up something from one side and carries it to the other.

For example, the apartment boom of the 1920's had an important influence on the design of houses during the following generation. As *House and Home*, the builders' magazine points out, people who lived in apartments during the Jazz Age learned to like small, well-planned living space all on one level. When they later became home owners they wanted much the same thing—smaller, more functional homes—many of them without stairs.

Home owners of the postwar period in turn are influencing present apartment construction. Suburban living whetted the appetite for sunshine, greenery, play areas, and convenient parking, and ex-homeowners want at least a taste of these things with their new apartments.

The present emphasis on apartments no doubt will affect single homes of the future. Probably tomorrow's home owner will demand the overall airconditioning he has grown accustomed to in his modern apartment. Future housing developments may offer less private yard area and more community space and facilities. Possibly double homes and row houses which economize on construction and land cost will be more popular. Tomorrow's homes may come with more built-in and convertible furniture to make efficient use of limited space. More extras such as carpeting and refrigerator-freezers probably will be included. Quite possibly community washer-dryer-dry cleaner units will be set up. Apartment dwellers have learned such an arrangement is practical. Garages also could be centralized or they may disappear entirely. The feeling is spreading that it is a waste to devote so much indoor space to "just a car." Modern paints and construction enable cars to better withstand the elements and automobiles are no longer the love-objects they once were.

TOO MANY APARTMENTS?

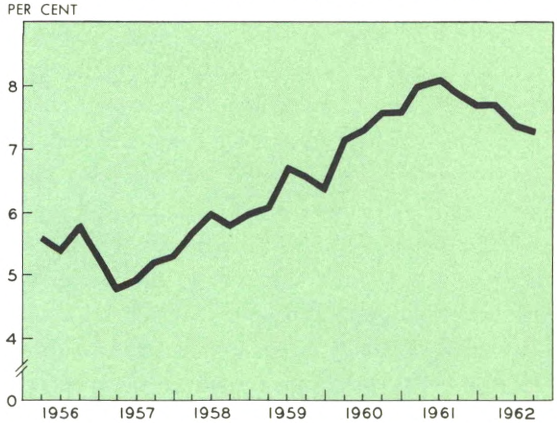
Like most things in that frantic decade, the apartment boom of the 1920's was overdone. After a few years, supply outraced demand and considerable excess capacity developed. Rents softened and apartment starts dropped 45 per cent from 1927 to 1929. The roller-coaster ride in apartment construction in the 1920's, if not a cause, undoubtedly aggravated the depression of the 1930's.

Many experts now have begun to wonder about the present boom. Are we again building too many apartments too fast so that future construction will have to mark time while the nation digests its supply?

Indeed, some claim apartments already are overbuilt. Almost 7.5 per cent of all rental units now are vacant compared with 5 per cent in 1957 and 2.5 per cent in 1950. Stories of concessions that landlords are forced to make to lure tenants are becoming commonplace. In several instances we heard about, the first months of a lease are rent free. No-charge extras such as pools, tennis courts, putting greens, dishwashers, and babysitting often are used as bait.

ROOM TO SPARE

Rental vacancies as a percentage of all rental units.



On the other hand, many experts maintain that a "vast, untapped reservoir of demand" still exists. Vacancy rates may be high but they actually declined during 1962. Furthermore, it is claimed most of the vacancies are either in new luxury units—a small segment of the market—or in dilapidated units that should be torn down anyway. The huge, middle-income market is far from saturated and should support more construction.

If, in fact, the present apartment boom results in considerable excess capacity, this is partly in the nature of the industry. It takes a good many years from the time an apartment building is planned until they finally hand out keys. Thus supply cannot be finely tuned to demand and the momentum behind a wave of construction may carry it too far.

But there are many important differences between the present apartment boom and the last major one. Here, briefly, are a few of them.

From the 1920 low to the 1927 peak, 1.3 million apartment units were begun. Since 1956, when the present boom got under way only 1.2 million units have been started. Today, however, the total population is almost twice as large as it was in the 1920's and 70 per cent of the present population lives in urban areas now compared with 50 per cent then. In other words, this boom is relatively puny compared with the previous one.

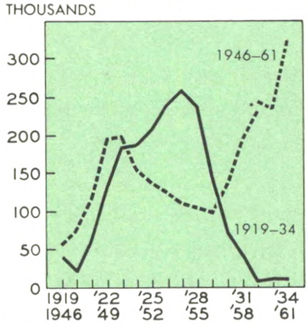
New household formation is a key demand factor because, as we mentioned, people starting out on their own usually rent apartments. Household formation is now edging up after making a trough in the 1950's and it is almost certain that the general rise will continue through the remainder of this decade and beyond. In contrast, household formation hit its top in 1923 and trended downward for ten years thereafter.

The number of births increased rapidly after both World Wars. The first time was a flash-in-the-pan, however; by 1922, births had entered a long-run decline. On the other hand, births continued to increase during most of the period from World War II to the present. Already the first bumper crop of postwar babies is 16 years old and in a few more years they will be getting married (average age: girls, 20; boys, 22) and looking for apartments themselves. Their younger brothers and sisters will continue to swell the ranks of apartment seekers in the late 1960's and 1970's.

THEN AND NOW

Apartment starts and various demand factors compared for 16-year periods after both world wars.

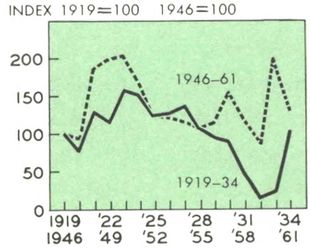
APARTMENT STARTS
THOUSANDS



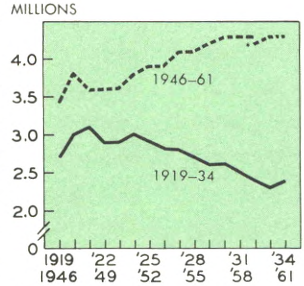
* New series.

NET HOUSEHOLD FORMATION

INDEX 1919=100 1946=100



BIRTHS
MILLIONS



* New series.

If excess capacity develops in apartments, therefore, most of it could be absorbed within a relatively short time. This assumes, of course, that prosperity will prevail. A sound, healthy economy, in the last analysis, is most important to sustain the demand for apartments.

CONCLUSION

By the year 2000 it is estimated we will need more than 40 million *additional* housing units. This means we will have to increase the present supply at least 75 per cent in the short space of 38 years. In addition, we will have to replace tens of millions of units that are now, or will become, substandard. It will be a staggering building task.

Whether or not an oversupply of apartments may be troublesome for the next few years, looking further ahead the major need will be for more housing. We must construct enough units to house an exploding adult population in decent fashion; but where will the necessary capital come from—and the land? Suburbs already sprawl 20 to 30 miles beyond our major cities and remaining open space is extremely expensive. The suburban housing development may be a luxury that we will be forced to stint in the future. Apartments are cheaper and more efficient to build than individual homes and they economize on land and utilities. The compact house may be the answer.

DEFENDING THE DOLLAR

"Defending the dollar" has recently become a topic of lively discussion. Only a decade ago a dollar shortage was of widespread concern.

This article deals briefly with two main problems: defending a country's currency against short-term outflows of funds, and achieving and maintaining equilibrium in its balance of international payments. The emphasis is on the general principles involved, with some recent United States policies being used as illustrations. The article does not attempt to give a complete description of recent steps taken to defend the dollar and remedy the deficit in the United States balance of payments.

As background, it may be helpful to note some of the marked changes that have occurred in the international financial mechanism in the past three decades. The Great Depression of the early thirties brought the final collapse of the international gold standard which had been relied on to maintain stable exchange rates. The depression was also accompanied by financial crises, rumors, and massive flights from one currency then another. In the chaotic environment that developed, currencies were devalued and many countries established exchange controls as a means of keeping foreign payments and foreign receipts in balance.

In World War II, exchange controls and trade restrictions were tightened. Wartime damage and destruction of productive capacity in many of the major industrial countries left the United States as the principal source of supply in world markets. An urgent need for United States goods for reconstruction and development, together with seriously impaired capacity and ability to produce for export, led to a widespread shortage of dollars. To conserve limited supplies of dollars, many countries imposed special controls against imports of goods from the United States. In that environment there was an acute shortage of dollars—not a problem of defending the dollar against depreciation in foreign exchange markets.

Significant changes have occurred in the past few years. The dollar shortage began to vanish over a decade ago. A continuing deficit in the United States balance of payments has put a growing volume of dollars in the hands of foreigners. Foreign holdings of dollars are currently at an all-time peak. Productive capacity of the principal countries has been restored, even increased, and most of the countries have rebuilt their international monetary reserves. Confidence in the major currencies has been reestablished. Restrictions on trade and capital flows have been relaxed, and once again the world's leading currencies are convertible into each other on current and on some capital transactions.

The dollar remains the key currency in the international payments mechanism. Except for gold, the dollar constitutes the largest portion of the free world's international monetary reserves. Members of the International Monetary Fund have declared the par values of their currencies in terms of gold or the dollar, and have agreed to maintain the market values of their currencies within a range of not more than 1 per cent above or below par. Most of the West European countries maintain the value of their currencies within the agreed limits by selling or buying dollars in foreign exchange markets. The United States maintains the foreign exchange value of the dollar by agreeing to buy or sell gold to foreign official institutions for legitimate monetary purposes at a fixed price of $35 an ounce.

DEFENSES AGAINST SHORT-RUN DISTURBANCES

Establishing defenses against temporary disturbances in foreign exchange markets and against outflows of short-term funds is an essential part of an over-all program to defend a nation's currency.

Short-term funds may flow abroad for several reasons. Extending short-term credit to foreigners purchasing United States goods is a common method of financing exports. Higher interest rates in foreign countries may stimulate an outflow of funds both by encouraging foreigners to borrow in the United States and inducing holders of dollars, both domestic and foreign, to invest abroad. Higher rates were one of the factors in the outflow of about $2 billion of private short-term capital from the United States in both 1960 and 1961.

The inducement to shift short-term funds from one international financial center to another is influenced by the spread between spot and forward rates of exchange as well as by differentials in interest rates. To illustrate: if the current yield on three-month British Treasury bills is 2 per cent above the yield on similar United States bills and if the price of spot sterling is $2.80 and the rate for sterling for 90 days future delivery is $2.79, an investor could cover the exchange risk and still get a higher return on British bills. Investors placing funds abroad in short-term earning assets usually like to cover the exchange risk involved. The United States investor could buy sterling at $2.80 to pay for his three-month British bill and simultaneously could enter into a contract to sell his sterling 90 days hence at a price of $2.79. His forward sale of the sterling he will receive when his British bills mature protects him against loss from converting his sterling back into dollars should the price of sterling decline. The cost of hedging by selling forward sterling would amount to 1.43 per cent at an annual rate $\left(\frac{\$2.80 - \$2.79}{\$2.80} \times 4\right)$. Allowing for the cost of covering the exchange risk, the United States investor would get more than ½ per cent higher yield from British than from United States Treasury bills. An increase in the cost of cover—widening the spread between the spot and forward rates—would diminish the attractiveness of British bills, while a narrower spread would increase the inducement to invest abroad. A premium on forward sterling would provide a strong inducement for short-term funds to flow to England, the investor receiving in addition to the higher yield on British bills a profit from covering the exchange risk.

Another cause of an outflow of funds is uncertainty or fear about the future value of a currency. Upward revaluations of the mark and guilder in the spring of 1961 sparked a large-scale outflow of funds from London, especially to Germany and Switzerland. Political developments and international tension may also touch off substantial short-term capital movements. The Berlin crisis, for example, generated an outflow of funds from Germany.

Outflows of short-term funds, although a natural consequence of currency convertibility and greater freedom of capital movements, may at times cause difficulties. A substantial outflow during a period of economic slack, especially if long continued, may hamper monetary authorities in fostering as much ease as might otherwise seem appropriate to domestic economic conditions. Also, an outflow of short-term funds may at times become disruptive and cumulative. An outflow of funds from the United States, for example, tends to push up prices of foreign currencies. If the capital outflow induces expectations of a further loss of funds and depreciation of the dollar in foreign exchange markets, speculative transactions may accelerate both the outflow of funds and depreciation of the dollar. If the rate on dollars abroad drops too much, foreign stabilization authorities buy dollars to keep the rate from falling below the limit agreed upon with the International Monetary Fund. As dollar holdings rise, stabilization authorities may decide to convert some of their growing supply of dollars into gold by buying gold from the United States.

Operations in foreign exchange

An important link in the defenses established to deal with temporary disturbances and imbalances is official intervention to prevent or at least mitigate sharp swings in exchange rates and large movements of short-term funds which, by creating fear and uncertainty, may become cumulative. The Treasury, through the Exchange Stabilization Fund established in 1934, intervened in the foreign exchange market in the spring of 1961, and the Federal Reserve System began operations in the market in the spring of 1962. The principal objectives of Treasury-Federal Reserve operations are to protect the external value of the dollar, prevent disorderly conditions in the foreign exchange market, and avoid excessive outflows of short-term capital and gold.

Treasury operations have been mostly in the forward exchange market. Revaluation of the German mark and the Netherlands guilder touched off large speculative flows of funds by creating expectations that other revaluations would soon follow. As a result, some foreign central banks, notably those of Germany and Switzerland, had a heavy inflow of funds and in the process accumulated large holdings of dollars. Individuals and business firms with future contracts to pay marks tried to anticipate their payments because of the expected rise in the price of marks in terms of other currencies. The forward mark rose to a substantial premium, and in Germany there was a sharp discount on forward dollars. The premium on forward marks encouraged an outflow of funds from the United States, and the discount on forward dollars made it expensive for Germans to cover funds placed temporarily in the United States.

To help check the outflow of funds from the United States and to cushion the impact of speculative transactions on foreign exchange rates, the Treasury intervened in the forward exchange market. Under an arrangement worked out with the Bundesbank, the Treasury sold forward marks in the New York market. These sales helped reduce the premium on marks for future delivery which in turn diminished the incentive to shift short-term funds to Germany. When the forward sales contracts began to mature, the purchasers had to buy dollars to pay the United States Treasury. Such purchases tended to raise the price of dollars abroad and reduce the volume of central bank purchases to prevent the rate on dollars from dropping below the support level.

Substantial official sales of forward marks by the Treasury helped restore confidence in the foreign exchange markets, cushion the outflow of short-term funds from the United States, and diminish the accumulation of dollars in some of the foreign central banks. As conditions improved, the Treasury was able to discontinue its forward sales and by the end of 1961, all of its forward mark contracts had been liquidated.

The Treasury also intervened in the forward market for Swiss francs and Netherlands guilders. Both countries experienced substantial inflows of short-term funds, and the premiums on three-month forward francs and guilders rose (or the discount on forward dollars increased). In these cases also, the Treasury offered Swiss francs and guilders for future delivery. These sales helped reduce the forward premiums on francs and guilders, thus diminishing the incentive for short-term funds to continue to flow into Switzerland and the Netherlands.

Federal Reserve operations in foreign exchange facilitate System cooperation with foreign central banks and supplement the limited resources of the Stabilization Fund operated by the Treasury. System operations have been carefully coordinated with those of the Treasury. Thus far most Federal Reserve operations have been directly with foreign central banks. As yet the System has not executed any transactions in the forward exchange market for its own account.

The bulk of the Fed's operations has been by means of swap arrangements negotiated with foreign central banks. The initial step in these swaps usually is a standby credit in which each central bank agrees to exchange on request its own currency for the currency of the other country, up to a maximum amount for a certain period of time, commonly 90 days. If the standby credit is actually used, the Federal Reserve credits the account of the foreign central bank with a given amount of dollars and in exchange receives a credit on the books of the foreign central bank for an equivalent amount of that country's currency. Simultaneously, both central banks agree to reverse the transaction at the end of the specified period at the same rate of exchange. This agreement affords mutual protection against fluctuations in exchange rates between the two currencies.

Swap transactions negotiated by the Federal Reserve have varied somewhat as to purpose. Those with the Swiss National Bank and the Netherlands Bank were soon activated and part of the funds used to absorb dollars these institutions were acquiring in keeping their exchange rates with the dollar within the agreed limits. Had these surplus dollars not been absorbed these banks probably would have converted them into gold in the United States, resulting in a drain on our gold stock.

The System's swap of $250 million with the Bank of Canada was part of a large-scale mobilization of credit to help defend the Canadian dollar in mid-1962, when the Canadian Government declared a par value for its currency and instituted a broad stabilization program to protect it. In other cases, such as the Bank of France and the Bank of England, swaps have been negotiated and put on a standby basis. Should they be needed, these standby credits can be activated promptly and the proceeds used in foreign exchange operations.

Official intervention in foreign exchange, it should be noted, may also discourage speculation. If, for example, the prices of foreign currencies in the United States are expected to rise, speculators may buy expecting to be able to sell later at a profit. Speculators abroad might be induced to sell dollars forward expecting to profit by buying them back later at a lower price. Official operations such as those conducted in the spring of 1961 helped to restore confidence and thus temper speculative activity. The very fact that Treasuries and central banks have substantial foreign exchange resources at their command which may be used to thwart expected rate changes increases the risk and tends to discourage speculative activity.

Other forms of international cooperation

The chain of defenses forged to protect the dollar, as well as other currencies, includes in addition to intervention in foreign exchange markets other types of international cooperation among Treasuries and central banks. Mobilization of credits to assist countries whose currencies are under heavy pressure, cooperative efforts to counteract speculative activity and to stabilize the price of gold in the London market, and regular meetings to discuss mutual balance-of-payments problems and policies are among the recent developments in this field.

When the German mark and Dutch guilder were revalued in the spring of 1961, there was a large-scale speculative attack on sterling and a substantial loss of reserves by the Bank of England. At one of the monthly meetings of the Bank for International Settlements in Basle (which brings together governors of the leading European central banks and, in recent years, a senior representative of the Federal Reserve System) the so-called Basle Agreement was worked out to help cope with the capital flows generated by the revaluations. Leading central banks put total credit facilities of nearly $1 billion at the disposal of the Bank of England. One advantage of central bank credit arrangements is that they can be organized and put into effect quickly.

Another important development in the area of cooperation was the establishment in the spring of 1961 of a special working group under the Organization for Economic Cooperation and Development. This particular working group deals primarily with monetary, financial, and balance-of-payments problems. Meetings of the group bring together top financial officials and afford an opportunity to explore current financial and balance-of-payments problems of the participating countries. The discussions contribute to a better understanding of each other's problems and facilitate coordination of national programs and policies so as to avoid, insofar as possible, adding to the difficulties and pressures on other countries.

Special borrowing arrangements

Cooperation among central banks, including credit arrangements, and intervention in foreign exchange markets are lines of defense that can be brought into operation quickly. These defenses may be adequate except in serious situations in which a currency is put under heavy pressure. Another part of the defense line against temporary pressures is the International Monetary Fund. Heavy drawings in recent years left the Fund with limited resources in some of the major currencies, especially now that these currencies are convertible; hence the proposal, recently adopted, to enlarge the resources available to the I.M.F.

The new supplementary borrowing arrangement adds $6 billion to the resources of the Fund. Under this arrangement, ten of the major industrial countries stand ready to lend up to specified maximum amounts of their currencies. The maximum for the United States is $2 billion, and the total for the other nine nations is $4 billion.

The purpose of the new arrangement is to establish facilities whereby surplus countries gaining reserves can lend their currencies to the Fund which in turn can lend these currencies to deficit countries needing them. Such loans to the Fund mature in five years but can be repaid sooner if the borrowing country pays its drawing before maturity. Should a lending country experience balance-of-payments problems, it can obtain prompt repayment from the Fund even though the loan has not matured.

By enlarging the resources that can be mobilized in support of the ten leading currencies, the new borrowing arrangement puts the International Monetary Fund in a much stronger position to meet the heavy pressures that may arise in the current international environment. The very fact that such large resources are available should serve as a strong deterrent to speculative activities in foreign exchange markets.

Role of liquidity

A nation's international monetary reserve influences its ability to withstand external pressures on its currency. The function of an international monetary reserve is similar to that of a working balance or reserve of a bank or business institution. It is to tide over periods when payments are temporarily larger than receipts. Even though its international transactions are basically in balance, a nation may have seasonal and other temporary deficits. It needs a reserve of gold or currencies acceptable in international payments to meet such temporary deficits, just as a bank or business firm needs a cash reserve or working balance to bridge short-term gaps between its payments and receipts.

In addition to covering temporary shortages, a reserve gives a nation some time to take the necessary steps to remedy a basic imbalance in international transactions. The size of the reserve cushion needed depends significantly on how promptly effective corrective measures are taken. An international reserve should be sufficient to meet seasonal and other temporary deficits in the balance of payments. In case of a deficit arising from a fundamental imbalance, however, the only remedy is effective action to correct the deficit. The function of a reserve in such cases is not to enable a country to avoid action but to afford reasonable time for a sound remedial program to be established and become effective. Unless remedial action is taken, a continuing deficit would eventually exhaust any reserve.

MAINTAINING BASIC BALANCE

The defense line erected against temporary disturbances and deficiencies, although helpful, is not a remedy in any sense for the longer-run problem of a persistent deficit in a nation's basic balance of payments, as United States authorities have stressed repeatedly. The root of the problem of defending the dollar is the continuing deficit in the international transactions of the United States. It is the deficit that has built foreign holdings of dollars to an all-time peak, increased potential claims on our gold reserve, and at times put a strain on the dollar in foreign exchange markets. Deficits year after year are bound to arouse doubts as to the ability of a country to maintain the value of its currency, and may lead to rumors of devaluation which in turn may touch off massive shifts of funds into currencies that are considered stronger.

The foundation of any effective program to defend the dollar or any other currency is some method of keeping foreign earnings and foreign payments in balance over a period of time. A brief look at various approaches to maintaining balance between foreign receipts and payments will help put this problem in better perspective.

Self-adjusting devices

A significant feature of a free market economy is that if some segment gets out of balance, forces tend to be set in operation to restore equilibrium. One of the great advantages claimed for the international gold standard was that in case of sizable balance-of-payments surpluses or deficits, forces were automatically set into operation to restore balance. Experience revealed, however, that this automaticity was less than often claimed.

A feature of the gold standard was that foreign exchange rates were pegged within narrow limits by the cost of shipping gold between international money centers. To illustrate: in the days of the gold standard when the par value of the English pound sterling was $4.8665, the gold export and import points were about 4.8865 and 4.8465, respectively, because the cost of shipping gold between New York and London was about 2 cents per pound sterling. If a deficit pushed the price of a foreign currency to the gold export point or slightly above, it became cheaper to use gold in making payments than to buy foreign exchange. As a result, gold flowed out and the country's gold reserve was reduced. When the price of foreign currencies dropped to the import point it was profitable to buy foreign exchange and import gold.

Under the gold standard, gold flows were the principal means of keeping foreign receipts and payments in balance. An outflow of gold and reduced reserves in deficit countries would tend to tighten credit, push up interest rates, and put downward pressure on prices, income, and production. Countries receiving gold would gain reserves which in turn would encourage an expansion of credit and the money supply and increases in prices and production. Lower prices and income in deficit countries would encourage exports and discourage imports; rising prices and income in surplus countries would reduce foreign receipts and increase payments. In short, gold flows were supposed to set into operation market forces which would restore balance between foreign receipts and payments.

Even in its heyday the gold standard never worked so smoothly as the above summary of the theory indicates. Adjustments in reserves, prices, and incomes brought about by gold flows often hampered achievement of domestic economic objectives. For example, an outflow of gold and contraction of credit in a period of recession conflict directly with policies needed to promote recovery. It was largely such conflicts that led to the so-called managed gold standard in which the central bank offset insofar as possible those gold flows that interfered with policies needed to achieve domestic objectives.

Foreign exchange rates are prices—prices of foreign currencies. Fluctuations in foreign exchange rates may also initiate forces to restore balance between foreign earnings and payments. A net deficit, for example, would put upward pressure on prices of foreign currencies, which in turn would make foreign goods and services more expensive; United States goods would become less expensive to foreigners. A reduction in payments for imports and an increase in receipts from exports would operate to eliminate the deficit and restore balance.

Although operating to maintain equilibrium between foreign receipts and payments, fluctuating exchange rates have a number of undesirable consequences. Only a few of the major disadvantages can be touched on here.

A serious disadvantage is that wide swings in exchange rates increase risk and therefore discourage international trade and financial transactions. Diminished trade in turn hampers international specialization and productivity. At times, rate changes may induce speculation and aggravate rather than mitigate balance-of-payments problems. Fluctuating exchange rates also increase the risk of holding foreign currencies as part of international monetary reserves, and as a result might impair international liquidity. Disadvantages such as these led to the provision for stable exchange rates in the establishment of the International Monetary Fund.

Exchange control

At the opposite extreme from relying on free market forces to correct imbalances in a country's balance of international transactions is direct controls imposed by Government. Severe and protracted imbalances created by the depression of the thirties and later by World War II and its aftermath led to widespread imposition of exchange controls. Although objectives and methods varied among countries, the essence of exchange control is to achieve balance between payments and receipts by channeling foreign earnings into the exchange control authority which, in turn, rations the available supply among those desiring to make foreign payments. The exchange control authority, through rationing foreign exchange, limits payments to the amount of foreign exchange available.

In an emergency such as a war, disparities in economic conditions among countries may be so serious for an extended period that exchange control is about the only feasible method of bringing foreign payments into line with receipts. Direct control also makes it possible to ration scarce foreign exchange in accordance with domestic needs for reconstruction and development.

Exchange control has serious disadvantages, however. Exchange control restricts the convertibility of the nation's currency. Such restrictions, especially if imposed by major countries, are a serious impediment to world trade and international specialization. Insulating a nation's economy against external forces deprives the country of the benefits of international specialization and the stimulus to efficiency that comes from competing in the world market. In addition, a harness of controls stifles initiative and flexibility which are so essential for economic progress and growth. The disadvantages are such that this method of maintaining international balance should be used only in time of war or some other national emergency.

The middle way

The United States approach to the problem of maintaining balance between foreign receipts and payments is an attempt to avert both extremes—sole reliance on free market forces or a blanket of controls over foreign receipts and payments. Foreign exchange rates, as already mentioned, are maintained within relatively narrow limits by countries that are members of the International Monetary Fund. Monetary policy is determined mainly in terms of domestic economic and credit conditions instead of in relation to gold reserve increases or decreases. The United States has never relied on direct exchange controls, and the trend in other countries has been toward their elimination or relaxation.

United States officials are fully aware that our balance-of-payments deficit cannot be expected to correct itself. Without going into detail, the program thus far developed embraces a number of measures designed to increase receipts and to reduce the foreign exchange drain of Government payments abroad. The foundation of the program is maintaining a stable cost-price structure so that United States producers can compete in world markets. In addition, the Government is sponsoring a drive to increase exports, including an expanded program of export credit insurance and more information about sales opportunities abroad.

Measures have also been taken to reduce foreign payments and hold down their impact on the deficit. The net drain of military expenditures in foreign countries, a large deficit item in our balance of payments, is being reduced by persuading foreign countries involved to use some of the dollars to buy more of their military equipment and supplies in the United States. Another large deficit item, foreign economic aid, is being tied more closely to the purchase of United States goods and services. The goal this year is for 80 per cent of such aid to be in the form of United States goods and services. In addition, efforts have been made to get foreign countries with continuing balance-of-payments surpluses to assume a larger share of foreign aid to underdeveloped countries.

CONCLUSIONS

Deficits and surpluses in international transactions are inevitable in a world in which money and goods can move freely among countries. Balance-of-payments deficits and surpluses may result from seasonal and other temporary factors, or they may arise from more deep-seated causes.

The fundamental problem in defending a nation's currency from speculative pressures and depreciation in foreign exchange markets is to avoid a long-continued deficit in the balance of payments. Such a deficit results in a substantial build-up in foreign holdings of the currency, depresses its value in foreign exchange markets, and renders the currency susceptible to speculative forays.

Monetary and fiscal policies directed toward maintaining cost-price stability are integral parts of any program to defend the dollar. A rising cost-price spiral would seriously impair the ability of United States producers to compete in world markets and, by reducing exports and increasing imports, would aggravate the deficit.

Monetary and fiscal policies, even though essential, should not be our sole reliance for eliminating our balance-of-payments deficit. As pointed out in the first article, Government payments to other countries are an important factor in the deficit. Even if domestic policies are successful in maintaining price stability, it is unlikely that private international transactions will usually generate a surplus sufficient to cover net Government payments abroad, which are necessarily determined largely on noneconomic grounds. It is appropriate, therefore, that monetary and other economic policies which exercise their influence on the private sector of the economy through the market place be supplemented by measures to assist in bringing our international transactions into balance.

Even though eliminating the deficit is the basic remedy, measures that are helpful in dealing with temporary disturbances are a valuable part of an over-all program for defending a nation's currency. Whether provided by the I.M.F. or central banks, credit facilities may be a suitable means of meeting temporary deficits. A subsequent surplus can then be used to repay the funds borrowed. Credit facilities also provide time for putting into operation effective measures to correct a basic deficit. Foreign exchange intervention may be used to help stabilize foreign exchange rates, temper speculative activity, and diminish an outflow of gold.

business review

FEDERAL RESERVE BANK OF PHILADELPHIA

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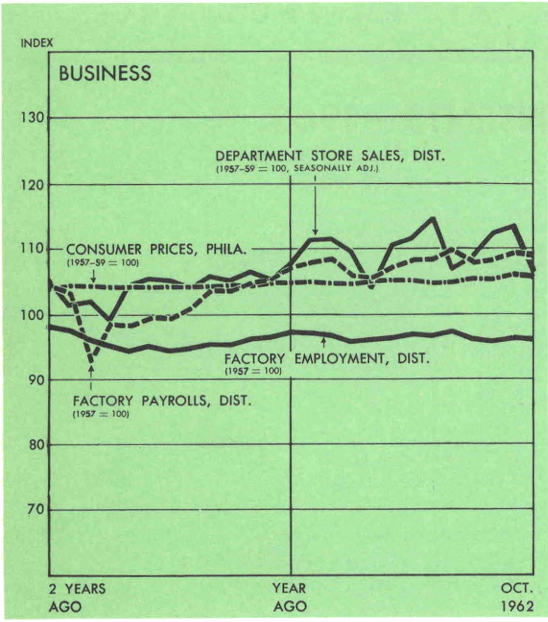
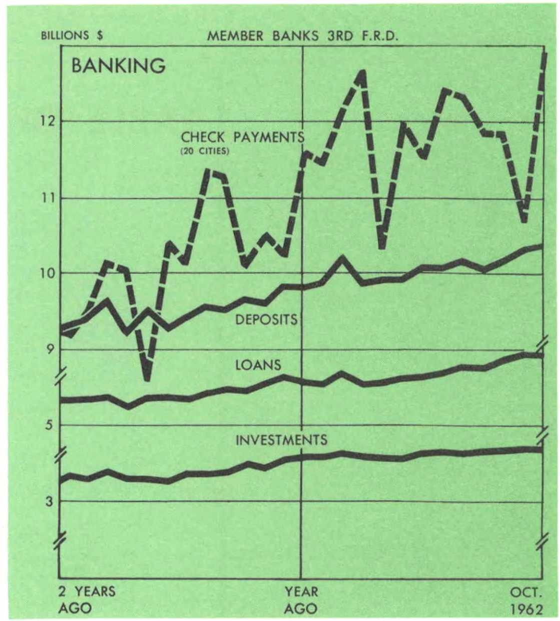
FOR THE RECORD...





SUMMARY	Third Federal Reserve District — Per cent change — Oct. 1962 from mo. ago	Oct. 1962 from year ago	10 mos. 1962 from year ago	United States — Per cent change — Oct. 1962 from mo. ago	Oct. 1962 from year ago	10 mos. 1962 from year ago
MANUFACTURING						
Production	....	....	....	+ 2	+ 5	+ 9
Electric power consumed	+ 5	+ 4	+ 8	....	....	....
Man-hours, total*	− 1	0	+ 3	....	....	....
Employment, total	0	0	+ 1	0	+ 3	+ 3
Wage income*	− 1	+ 2	+ 6	....	....	....
CONSTRUCTION**	+11	− 2	+17	+ 5	+ 4	+11
COAL PRODUCTION	+ 5	− 3	+ 5	+ 3	0	+ 7
TRADE***						
Department store sales	− 6	− 2	+ 5	− 6	+ 1	+ 5
Department store stocks	+ 2	+ 6	....	+ 2	+ 8	....
BANKING (All member banks)						
Deposits	+ 1	+ 5	+ 5	+ 3	+ 8	+ 7
Loans	0	+ 7	+ 5	+ 1	+11	+ 8
Investments	0	+ 3	+ 7	+ 2	+ 4	+ 7
U.S. Govt. securities	0	− 3	+ 6	+ 2	− 4	+ 2
Other	+ 1	+18	+ 9	+ 1	+26	+22
Check payments	+20†	+11†	+14†	+17	+12	+11
PRICES						
Wholesale	....	....	....	0	+ 1	0
Consumer	0‡	+ 1‡	+ 1‡	0	+ 1	+ 1

*Production workers only.
**Value of contracts.
***Adjusted for seasonal variation.

†20 Cities
‡Philadelphia

LOCAL CHANGES	Factory* Employment — Per cent change Oct. 1962 from mo. ago	year ago	Factory* Payrolls — Per cent change Oct. 1962 from mo. ago	year ago	Department Store† Sales — Per cent change Oct. 1962 from mo. ago	year ago	Department Store† Stocks — Per cent change Oct. 1962 from mo. ago	year ago	Check Payments — Per cent change Oct. 1962 from mo. ago	year ago
Lehigh Valley	− 1	0	− 2	0	....	....	....	....	+15	+ 8
Harrisburg	0	+ 2	− 1	+ 6	....	....	....	....	+18	− 1
Lancaster	0	+ 7	0	+10	− 6	− 1	+ 2	+ 1	+16	+15
Philadelphia	0	− 1	− 1	+ 3	− 4	0	+ 2	+ 8	+24	+ 8
Reading	+ 1	+ 2	+ 1	+ 1	− 9	− 2	+ 4	+21	+ 9	+ 9
Scranton	− 2	− 2	− 4	− 4	−10	− 6	0	+ 3	+18	+ 5
Trenton	+ 3	0	+ 3	− 2	− 9	−10	− 2	+ 3	+43	+26
Wilkes-Barre	0	+ 1	− 1	+ 9	− 9	− 2	+ 3	+ 3	+11	+ 6
Wilmington	− 1	− 3	− 1	+ 2	−11	− 4	− 2	+ 3	+ 8	+33
York	− 1	− 2	+ 1	0	−15	− 2	+ 1	+ 8	+10	+ 7

*Not restricted to corporate limits of cities but covers areas of one or more counties.
†Adjusted for seasonal variation.