FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

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The Business Situation

As had been generally expected, the advance in economic activity has slowed somewhat following the exceptional buoyancy in the first three months of the year. Two major factors in the more moderate pace of the current advance are the easing-off in automobile sales and production following all-time records in the first quarter and the postponement of the threat of a steel strike until the fall, which has led to a downward adjustment of steel production from the record levels reached in the January-April period. Underlying forces of expansion remain strong, however, and the over-all business outlook continues to be bright. In April, new orders booked by durable goods manufacturers surged to a new record, despite a decline in steel orders, and the number of housing units started was up for the second month in a row. While steel ingot production fell off in May, automobile assemblies and scattered other production indicators moved up, and retail sales apparently also advanced.

The bill currently before Congress proposing a sizable multistage cut in Federal excise taxes should, if enacted, help to sustain economic expansion during the second half of this year; it should also provide a further boost to activity at the start of 1966, just in time to offset part of the scheduled rise in social security taxes. Many businesses have already announced their intention of passing whatever tax savings are eventually enacted on to customers in the form of lower prices. Moreover, the Federal Government may possibly provide some additional direct boost to demand, at least over the near term, since expanded military commitments abroad may tend to halt the recent downtrend in defense spending. Consumer responses to the Census Bureau's mid-April survey, taken before the tax-cut proposals were announced, confirmed earlier indications that buying intentions remain high. Businessmen's own confidence in the economy is evident in the results of the Government's latest capital spending survey, which points to an increase in outlays of 12.3 per cent for 1965 as a whole with advances in each quarter. Such gains should help to offset the adverse effects on over-all activity that may occur as a result of further readjustment of steel production and should also aid in maintaining a strong demand for steel itself.

The price situation continues to bear watching. While the rate of increase in industrial wholesale prices remains mild, such prices were up once again in April and perhaps also in May, and there is evidence of some acceleration in recent months. The gain in the three-month period from January through April was at a seasonally adjusted annual rate of about 2 per cent, compared with an annual rate of about 1½ per cent over the entire period since last September. Over the first nine months of 1964, the rise in the index was at an annual rate of only 0.3 per cent. Consumer prices in April registered the largest seasonally adjusted rise since December 1963. The gain was attributable in good part to the effects of tighter supply conditions for many food items. The advances in nonfood prices, on the other hand, were more nearly in line with the moderate increases of recent months.

RECENT MONTHLY INDICATORS

Increases in production were moderate but widespread in April, and the Federal Reserve Board's seasonally adjusted index moved up by 0.3 percentage point to 140.8 per cent of the 1957-59 average. The gain was smaller than in the preceding few months, partly as a result of floods and other adverse weather conditions that curtailed workweeks in several regions. At the same time, there was some downward adjustment in the automobile assembly rate—an adjustment that came after an enormous surge in production following the strikes of last fall. Output of consumer goods other than automobiles advanced further in April, and production of television sets continued to show particular strength. Production of materials was up once again, as was the output of business equipment, paced by a record rate of truck assemblies.

The outlook for continued strength in over-all production was enhanced by a 2 per cent rise in the volume of new orders received by durable goods manufacturers in April. Orders for steel were down appreciably from the

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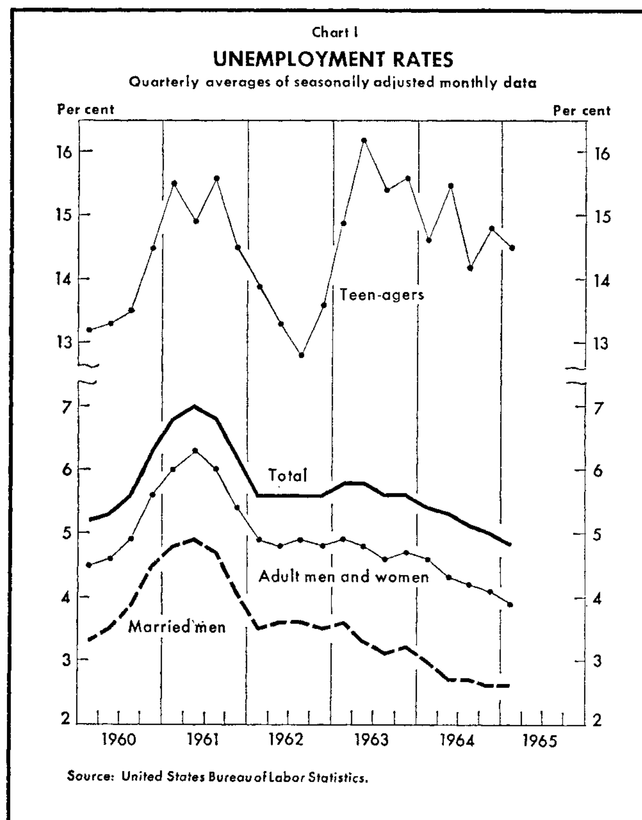
very heavy pace set earlier this year when strike-hedging efforts were in full swing, but the decline was more than offset by strength in orders for machinery and equipment, reflecting a rise in defense ordering as well as the buoyancy in businessmen's capital spending plans.

Actual production data available for May are scanty and mixed. Automobile output (seasonally adjusted) advanced a bit after dropping off in April, and preliminary schedules suggest that the May production rate will be sustained in June. In the wake of the interim settlement of the steel labor contract, however, ingot production in May fell off by about 6 per cent from the record annual rate of 146½ million tons in April (seasonally adjusted), and the industry expects some further decline in June. Nevertheless, the steel mills report that there were unexpectedly few order cancellations following the four-month extension of the labor negotiations. It has been observed that the current high rate of steel consumption will act as a brake on the downward adjustment of steel production, and trade sources have in fact expressed the opinion that there will be some further inventory accumulation over the summer months. However, it should be noted that in recent months, just as in other periods of threatened shortages, foreign steel has made substantial inroads into the United States market.

Reflecting the impact of adverse weather conditions in many parts of the country during April, payroll employment in the construction industry registered a substantial decline that slightly more than offset strength in other sectors. Employment in manufacturing—which is at the highest level in over twenty-one years—expanded somewhat further in April, with gains centered in the metal-using industries. On the other hand, most manufacturing industries reported a decline in overtime—a decline that was perhaps slightly overstated, since the survey week included important religious holidays—and the average workweek put in by manufacturing production workers was shortened to 40.8 hours in April from 41.4 hours in March. In May, the civilian labor force expanded a bit further but the volume of employment registered a larger gain. As a result the over-all unemployment rate was reduced to 4.6 per cent, the lowest reading since the fall of 1957. The over-all rate has moved down fairly steadily since early 1964, partly in response to the more rapid growth in aggregate activity that has occurred during the past year and a half (see Chart I). The improvement, which followed two years of stubbornly high rates of generally about 5½ per cent, has brought the average unemployment rate in the first five months of 1965 to 4.8 per cent, the lowest for any such extended period since 1957.

It is significant that this recent improvement in the labor market situation has affected the unemployment rates in all age groups, including even the teen-agers. While the absolute level of the unemployment rate among teen-agers remains about three times as high as the over-all unemployment rate, the general downtrend since mid-1963 contrasts with the increase in teen-age joblessness that occurred during late 1962-early 1963. However, the possibility of future problems in this important sector of the job market should be clearly borne in mind. An exceptionally large rise in the teen-age labor force is expected this summer as the children born in the immediate post-war years graduate from high school. Adult women have likewise come into the labor market in great numbers over the course of the current business expansion, but the unemployment rate in this category has also moved downward during the past year. For adult men, particularly those who are married and have a family to support, unemployment rates have fallen to very low levels. Indeed, the rate for married men was at 2.5 per cent in May for the third consecutive month, only 0.4 percentage point above the lowest rate since collection of such data began in 1954. At the time of that lowest recorded reading—in the latter part of 1955—there were clear signs of strain in the



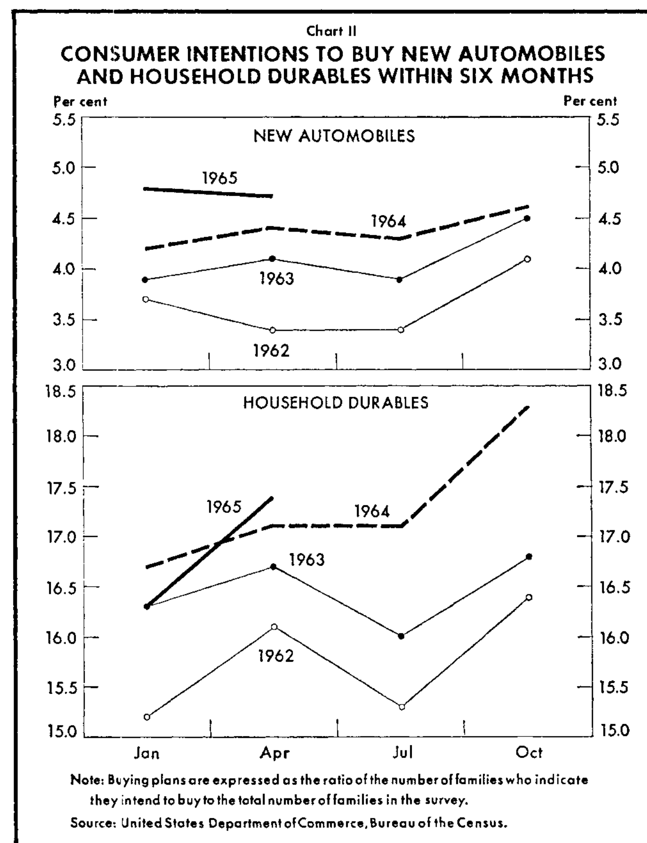
supply of skilled labor, and some such shortages have likewise been reported in recent months. A basic improvement in the employment situation is also reflected in the fact that in April the number of major labor market areas classified by the Government as having substantial unemployment was reduced from 29 to 25, the lowest number since the fall of 1957.

INDICATORS OF FUTURE CONSUMER DEMAND AND CAPITAL SPENDING

The Census Bureau's latest survey of consumer buying plans, taken in mid-April, has confirmed the earlier signs of continued underlying strength in consumer demand—which of course may be stimulated further by passage of the proposed excise tax cut. The proportion of families planning to purchase, within six months, at least one of the seven household durable goods included in the survey jumped sharply from a January figure that had been below that of 1964 to one well above the readings for 1964 and earlier years. At the same time, the proportion of families planning to buy a new car remained essentially unchanged at the high January level and was substantially above the year-ago reading (see Chart II). The lack of a significant decline since January is especially noteworthy when it is recalled that the car-buying plans reported in that month's survey may well have been inflated a bit by the responses of persons who were unable to buy during the strike-affected fourth quarter. Actual sales in January were at the extraordinary seasonally adjusted annual rate of around 9.7 million units. While some decline in auto sales has occurred in subsequent months, it is reported that the industry is increasingly optimistic over the prospects for total 1965 sales of 8.5 million domestically built units, which would of course easily surpass the previous record of 7.6 million units set last year. Data for May point to a seasonally adjusted annual sales rate in excess of 8 million units for the month; total sales for the first five months of 1965 amounted to an annual rate of about 8.9 million units. Over-all retail sales volume appears to have gone up a bit in May, reaching a level close to the record set in February.

In proposing a substantial cut in Federal excise taxes, the Administration strongly urged that the benefits of whatever reductions are enacted be passed on directly to buyers in the form of lower prices. The current bill provides that the first stage of the tax cut would amount to $1.75 billion annually, effective July 1. The reductions in taxes on automobiles and air conditioners would be retroactive to May 15, to avert possible delays by buyers waiting for lower prices after July 1. A second major round of reductions, amounting to an additional $1.75 billion, would occur on January 1, 1966. Including allowance for the eventual complete elimination of the tax on autos, written into the bill by the House Ways and Means Committee, still further cuts totaling $1.4 billion would take place at one-year intervals to January 1969. The effect of these cuts on consumer spending will depend importantly on how much of the total tax reduction is passed on to buyers in the form of lower prices.

Chart II
CONSUMER INTENTIONS TO BUY NEW AUTOMOBILES AND HOUSEHOLD DURABLES WITHIN SIX MONTHS



Note: Buying plans are expressed as the ratio of the number of families who indicate they intend to buy to the total number of families in the survey.
Source: United States Department of Commerce, Bureau of the Census.

Business spending for new plant and equipment should also provide a boost to over-all activity during the months ahead. According to the latest survey by the Commerce Department and the Securities and Exchange Commission, conducted in mid-May, capital spending plans for 1965 total $50.4 billion, or 12.3 per cent higher than the volume of outlays during 1964. The year-to-year rise is slightly larger than the 11.7 per cent increase indicated in the February Commerce-SEC survey—a change that reflects a modest step-up in planned expenditures for the second half of the year. A survey taken by McGraw-Hill in the early spring had pointed to a 15 per cent rise in capital outlays this year, but the McGraw-Hill results are more heavily weighted by

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responses from large firms and are thus not entirely comparable to the Commerce-SEC results.

Actual capital outlays in the first quarter of this year reached a seasonally adjusted annual rate of $49.0 billion, about the level that had been anticipated in the February Commerce-SEC survey and up $1.25 billion from the fourth quarter of last year. A further gain of $0.6 billion is expected for the current quarter, and the May plans called for progressively larger rises in the final two quarters of the year. If these plans are realized, capital spending in the fourth quarter of this year will reach a seasonally adjusted annual rate of $52.1 billion, 9.1 per cent higher than a year earlier. This would cap off four and one-half years of rising outlays and bring to more than 50 per cent the total increase since the end of the last recession in early 1961.

Manufacturers, especially in the durable goods industries, are responsible for the bulk of this year's planned increase in capital spending. The continued growth of output has brought a number of industries fairly close to their preferred rates of capacity utilization, and the expectation of still further sales gains has increased the need for additional capacity. There are indications that firms are actually proceeding with their capital spending plans. A recent National Industrial Conference Board survey found that manufacturers' net new capital appropriations rose by 11 per cent in the first quarter.

The Money and Bond Markets in May

The money market retained a steadily firm tone in May. The reserve positions of the money market banks outside New York City remained under pressure, while the reserve positions of the major New York City banks became somewhat more comfortable. Treasury bill rates generally declined on good demand, although there was a temporary rise around midmonth.

Prices of Treasury notes and bonds rose moderately in the opening days of the month, when most activity was associated with the Treasury's refunding operation then in progress. After the subscription period came to a close, demand contracted and prices of outstanding issues moved slightly lower in dull trading. In part, the cautious atmosphere reflected developments elsewhere in the capital market, where prices of corporate and tax-exempt bonds eased after midmonth in the face of a large schedule of current and future offerings of new issues.

THE MONEY MARKET AND BANK RESERVES

Nationwide net reserve availability contracted slightly during May, and a firm tone persisted in the money market. The bulk of Federal funds transactions continued to take place in a 4 to 4⅛ per cent rate range (see top panel of the chart on page 123), while average member bank borrowings from the Federal Reserve increased slightly. During the month, rates posted by the major New York City banks on call loans to Government securities dealers were generally quoted in a 4¼ to 4½ per cent range. Offering rates for new time certificates of deposit issued by leading New York City banks were little changed in May, but the range of rates at which such certificates traded in the secondary market edged a bit higher. Fairly strong investment demand developed in the market for bankers' acceptances at the higher rate levels established toward the end of April, and dealers reduced their heavy inventories to a lower level than had prevailed in recent months. Rates on acceptances, however, held generally steady during the month.

System open market operations provided a considerable volume of reserves in the first statement period in May and offset a substantial portion of the absorption of reserves which was accounted for by market factors. Nevertheless, the money market was quite firm as the financing needs of Government securities dealers rose, mainly reflecting their acquisition of "rights" to the Treasury's May refunding. A considerable portion of the enlarged dealer needs was filled by the major banks outside New York City. This resulted in additional pressures on the reserve positions of these banks and in a strong demand for Federal funds, which traded predominantly at 4⅛ per cent

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Table I

CHANGES IN FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1965

In millions of dollars; (+) denotes increase, (—) decrease in excess reserves

Factor	Daily averages—week ended				Net changes
	May 5	May 12	May 19	May 26	
"Market" factors					
Member bank required reserves*	— 249	+ 296	+ 13	+ 42	+ 102
Operating transactions (subtotal)	— 369	— 562	+ 335	— 204	— 800
Federal Reserve float	— 126	— 84	+ 358	— 817	— 169
Treasury operations†	+ 79	— 175	— 60	+ 259	+ 103
Gold and foreign account	—	+ 14	— 46	— 22	— 54
Currency outside banks*	— 247	— 336	+ 142	+ 119	— 322
Other Federal Reserve accounts (net)‡	— 75	+ 20	— 59	— 243	— 357
Total "market" factors	— 618	— 266	+ 348	— 162	— 698
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 158	+ 64	— 19	+ 242	+ 445
Bankers' acceptances	—	— 1	— 1	— 2	— 4
Repurchase agreements:					
Government securities	+ 375	+ 232	— 328	— 105	+ 174
Bankers' acceptances	+ 48	— 36	— 9	+ 11	+ 14
Member bank borrowings	+ 133	+ 20	+ 2	— 17	+ 138
Other loans, discounts, and advances	+ 1	—	— 1	— 1	— 1
Total	+ 715	+ 279	— 357	+ 130	+ 767
Excess reserves*	+ 97	+ 13	— 9	— 32	+ 69
Daily average levels of member bank:					
Total reserves, including vault cash*	21,747	21,464	21,442	21,368	21,505§
Required reserves*	21,413	21,117	21,104	21,062	21,174§
Excess reserves*	334	347	338	306	331§
Borrowings	478	498	500	483	490§
Free reserves*	— 144	— 151	— 162	— 177	— 159§
Nonborrowed reserves*	21,269	20,966	20,942	20,885	21,015§

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended May 26, 1965.

during that period. On the other hand, the large New York City banks experienced a temporary reserve surplus with the inflow of sizable Treasury redeposits of April tax receipts, and were net sellers of Federal funds in contrast to their usual heavy net demands for such funds. Partly as a result of this situation at the New York City banks, the credit needs associated with the Treasury's refunding were accommodated without strain.

As the Treasury recalled most of the redeposited funds, reserve pressures on the money market banks both inside and outside New York City first heightened during the statement period ended May 12, and then eased moderately in the week ended May 19. Member bank borrowings from the Federal Reserve remained substantial—around $500 million—but tended to be concentrated prior to each of the two weekends, thus leading to some temporary build-up in excess reserves. Consequently, Federal funds were in relatively greater supply after the weekends and traded mainly at 4 per cent, as against the 4⅛ per cent effective rate that prevailed on each Thursday and Friday. The reserve positions of the money market banks registered some improvement in the final statement period, but the money market remained firm. Federal funds traded mainly at 4⅛ per cent, and member bank borrowings from the Reserve Banks declined only slightly.

Over the month as a whole, market factors absorbed $698 million of reserves, while System open market operations provided $629 million. The weekly average of System outright holdings of Government securities rose by $445 million from the final statement week in April through the last week in May, and average System holdings of Government securities under repurchase agreements increased by $174 million. Average net System holdings of bankers' acceptances, both outright and under repurchase agreements, rose by $10 million during the month. From Wednesday, April 28, through Wednesday, May 26, System holdings of Government securities maturing in less than one year expanded by $3,400 million, while holdings of issues maturing in more than one year contracted by $2,471 million—mainly reflecting the effects of a maturity shift.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS MAY 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended				Average of four weeks ended May 26
	May 5	May 12	May 19	May 26	
Eight banks in New York City					
Reserve excess or deficiency(—)*	11	31	— 4	16	14
Less borrowings from Reserve Banks	4	29	38	—	18
Less net interbank Federal funds purchases or sales(—)	— 139	130	51	— 96	— 13
Gross purchases	*763*	*903*	*882*	*702*	*813*
Gross sales	*902*	*773*	*832*	*798*	*826*
Equals net basic reserve surplus or deficit(—)	146	— 127	— 92	112	10
Net loans to Government securities dealers	618	500	549	452	530
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	31	27	— 1	22	20
Less borrowings from Reserve Banks	144	132	131	95	126
Less net interbank Federal funds purchases or sales(—)	401	455	344	315	379
Gross purchases	*1,137*	*1,221*	*1,086*	*1,175*	*1,155*
Gross sales	*736*	*766*	*742*	*860*	*776*
Equals net basic reserve surplus or deficit(—)	— 515	— 560	— 476	— 388	— 485
Net loans to Government securities dealers	645	349	395	262	413

* Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

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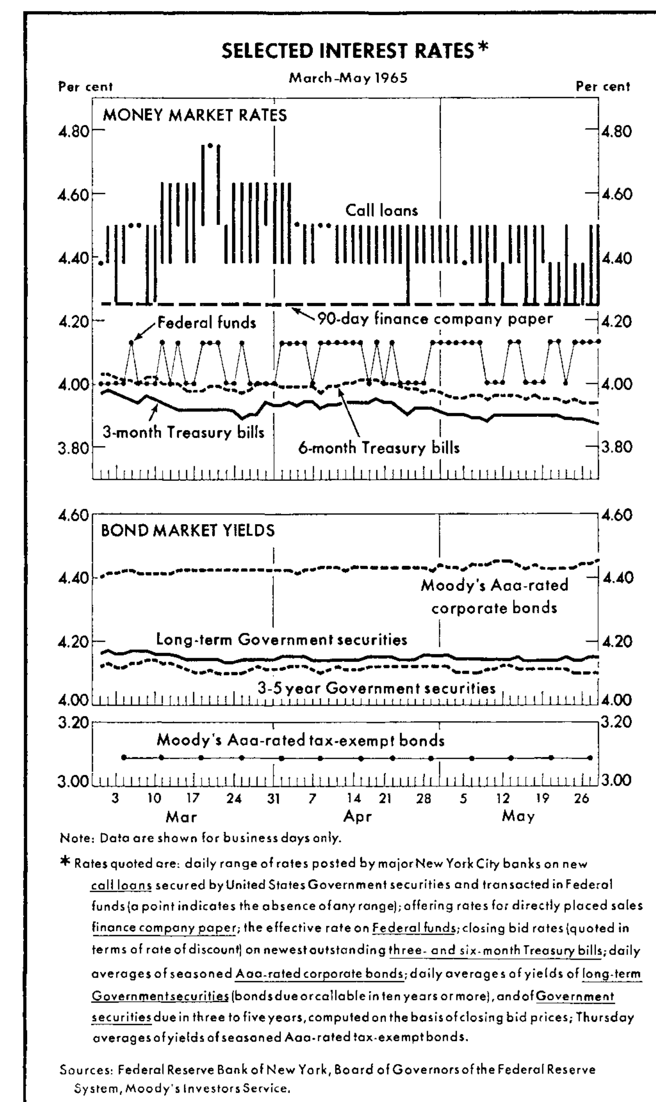
THE GOVERNMENT SECURITIES MARKET

Activity in the Government securities market in the early part of the month was largely related to the various forces set in motion by the Treasury's refunding operation (for details of the offering, see last month's *Review*). In the Treasury bill sector, there was a moderate demand from sellers of refunding rights who were seeking alternative short-term investment outlets, and this demand was augmented by continuing public fund purchases. Market supplies gradually became depleted, and bill rates generally moved lower during the first third of the month (see top panel of the chart). As the refunding approached completion, bill demand tapered off while offerings from commercial banks and dealers expanded somewhat. Therefore, rates for most issues—particularly those in the three-month maturity area—tended to move upward on limited activity from May 12 through mid-month. Subsequently, investment demand reappeared in the market—both from corporations seeking short bill maturities and from others interested in longer maturities. Rates were generally steady to lower over the remainder of the month, as the presence of this broadly based demand tended to counteract some concern about future interest rate levels.

At the last regular weekly auction of the month, held on Friday, May 28 (in advance of the Memorial Day holiday on May 31), average issuing rates were 3.870 per cent for the new three-month issue and 3.924 per cent for the new six-month bill, about 5 basis points lower in each case than the average rates at the final weekly auction in April. The May 25 auction of $1 billion of new one-year bills produced an average issuing rate of 3.954 per cent, as against 3.996 per cent on the comparable issue sold a month earlier. The newest outstanding three- and six-month bills closed the month at bid rates of 3.87 per cent and 3.94 per cent, respectively.



Note: Data are shown for business days only.

* Rates quoted are: daily range of rates posted by major New York City banks on new call loans secured by United States Government securities and transacted in Federal funds (a point indicates the absence of any range); offering rates for directly placed sales finance company paper; the effective rate on Federal funds; closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills; daily averages of seasoned Aaa-rated corporate bonds; daily averages of yields of long-term Government securities (bonds due or callable in ten years or more), and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields of seasoned Aaa-rated tax-exempt bonds.

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service.

In the market for Treasury notes and bonds, prices edged higher at the beginning of the month (as reflected in the decline in the composite yield of three- to five-year securities and of long-term bonds, shown in the bottom panel of the chart). Trading activity was moderate and consisted mainly of switching operations into and out of the issues involved in the Treasury's May refunding. There was some net investment demand for short-term and intermediate-term issues, while dealers readily absorbed limited offerings of long-term obligations. With the close of the May 3-5 refunding subscription period, investment activity contracted as participants paused to await the results of the Treasury operation. After the end of trading on Friday, May 7, the Treasury announced that approximately $8.0 billion, or about 94 per cent of the maturing Treasury notes eligible for conversion, had been exchanged for the two Treasury issues reopened in the refunding. Subscriptions totaled $5.9 billion (including approximately $1.6 billion from public subscribers) for the 4 per cent notes of August 1966, and $2.1 billion (including about $2.0 billion from public subscribers) for the 4¼ per cent bonds of May 1974.

Although the amount subscribed for the nine-year bonds exceeded the expectations of most market observers, the announcement of the refunding results had little initial impact on the market for outstanding coupon issues. As the month progressed, it appeared that investors had

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accomplished the bulk of their portfolio objectives while the subscription books were open, and had left little to do over the remainder of the period. For the rest of the month, prices of most issues declined irregularly—especially those in the longer term maturity area—when dealer offerings expanded in the face of general investor apathy. Investor activity was light as the market appraised the enlarged calendar of future debt offerings in other sectors of the capital markets.

OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices fluctuated narrowly in the early part of May in quiet trading. In part, this inactivity reflected the fact that attention was focused on the Treasury's May refunding, but participants were also looking ahead to the heavy calendar of impending corporate and tax-exempt flotations. When several large new corporate and tax-exempt issues did reach the market in the week ended May 12, underwriter bidding was enthusiastic at slightly lower price levels than had previously predominated. The relatively attractive reoffering yields on these issues stimulated considerable investor interest, which in turn generated a stronger undertone in both sectors. Investment demand largely centered upon the new issues, however, and dealers made only moderate headway during this period in trimming their sizable inventories of older bonds. During the latter part of the month, demand contracted and a more hesitant tone emerged in the corporate and tax-exempt markets. Dealers reduced the prices of some slow-moving issues, making upward adjustments in yields of about 2 to 10 basis points. The continuing heavy volume of private placements of corporate issues, together with announcements of large offerings soon to come in various sectors of the capital market, added to the hesitancy of these markets. In addition, the tax-exempt market reacted adversely to a Supreme Court decision upholding the formula under which the earnings of life insurance companies are taxed—a formula that limits the advantage to such companies of holding tax-exempt bonds. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 1 basis point to 4.45 per cent while the average yield on similarly rated tax-exempt bonds remained unchanged at 3.09 per cent. (These indexes, shown in the bottom panel of the chart, are based on only a limited number of issues and therefore do not necessarily reflect market movements fully.)

The volume of new corporate bonds publicly floated in May amounted to an estimated $675 million, compared with $395 million in April 1965 and $470 million in May 1964. The largest publicly offered new corporate bond issue of the month consisted of $125 million of Aaa-rated 4⅝ per cent utility company debentures maturing in 2000. The debentures were reoffered to yield 4.50 per cent and encountered considerable investor resistance. (The marketing syndicate terminated on June 1 and the bonds subsequently traded to yield about 4.59 per cent.) New tax-exempt flotations totaled about $895 million, as against $920 million in April 1965 and $625 million in May 1964. The Blue List of tax-exempt securities advertised for sale closed the month at a record level of $872 million, compared with $821 million at the end of April. The largest new tax-exempt bond flotation during the month consisted of $126 million of Aaa-rated housing authority bonds. The bonds were reoffered to yield from 2.30 per cent in 1966 to 3.35 per cent in 2005, and were accorded a fairly good investor reception. Other new corporate and tax-exempt bonds publicly offered during the period were accorded mixed investor receptions.

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International Liquidity*

By FREDERICK L. DEMING
Under Secretary of the Treasury for Monetary Affairs

Fifteen days ago, the Prime Minister of Great Britain, Mr. Harold Wilson, devoted a section of his major public speech in New York to consideration of international liquidity. He took the view that the world should push forward promptly in comprehensive planning to avoid a liquidity squeeze which might result from the disappearance of the United States balance of payments deficit.

Some weeks ago, President de Gaulle suggested that the world should return to a gold standard system, and Mr. Jacques Rueff, a well-known French economist, has recently proposed the same course of action, with the additional suggestion that the price of gold be doubled in order that reversion to a gold standard system might take place without drastic deflationary consequences for the world economy.

The President of the German Bundesbank, Karl Blessing, recently endorsed the present international monetary system but suggested the possible desirability of standardizing the composition of national reserves by agreeing on an appropriate ratio between holdings of gold and reserve currencies.

Former Secretary of the Treasury Douglas Dillon in his last press conference suggested that one of the major questions with which his successor would have to wrestle would be that of the future adequacy of world liquidity. Secretary Fowler has agreed "that the greatest challenge in this area is to work out a steadily improving international monetary system so as to facilitate a continuing expansion of trade and economic development in the Free World".

The United States position with respect to the liquidity issue has been made very clear by President Johnson, who said in his Message to Congress on the Balance of Payments:

> The measures I have proposed in this message will hasten our progress toward international balance without damage to our security abroad or our prosperity at home. But our international monetary responsibilities will not end with our deficit. Healthy growth of the Free World economy requires orderly but continuing expansion of the world's monetary reserves.
>
> During the past decade, our deficits have helped meet that need. The flow of deficit dollars into foreign central banks has made up about half of the increase in Free World reserves. As we eliminate that flow, a shortage of reserves could emerge. We need to continue our work on the development of supplementary sources of reserves to head off that threat.
>
> We must press forward with our studies and beyond, to action—evolving arrangements which will continue to meet the needs of a fast growing world economy. Unless we make timely progress, international monetary difficulties will exercise a stubborn and increasingly frustrating drag on our policies for prosperity and progress at home and throughout the world.

Today I would like to discuss with you just what it is that all of these distinguished people are talking about and why there is this general and widespread interest in international liquidity.

We might start with a very simple statement as to the purpose of international reserves. Their primary purpose is to permit a country to ride through any balance of payments deficit while making an orderly adjustment of its international and domestic policies to restore balance of

* An address at the Ohio State University in connection with "Distinguished Lectures in Monetary Policy", jointly sponsored by the University and the Ohio Bankers Association, Columbus, Ohio, April 29, 1965.

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payments equilibrium. In this, the purpose of international reserves is very similar to the purpose of individuals and businesses in setting aside and holding liquid assets for an emergency. A complication with which I shall not deal today is that international reserves in many countries play an additional role as partial determinants of the domestic money supply.

International reserves, of course, are not held in the same form as the reserves of a private business. The traditional reserves of nations are gold and reserve currencies. A reserve currency, if you will excuse the tautology, is a currency which, by general agreement, nations are prepared to hold in their reserves. The dollar is today the major reserve currency. The pound sterling is held rather widely, particularly by sterling area countries, and the French franc is regarded as a reserve currency in some parts of Africa. Each nation makes its own decision as to what it will regard as a reserve currency. It bases its decision on the extent to which that currency can be widely used in international transactions, the confidence it has in the stability of that currency in terms of gold and in terms of goods, and the ease with which it may invest and disinvest both its working balances and additional holdings of the currency in question.

The status of the dollar as a reserve currency developed over the years, particularly since the Second World War, from the voluntary decision of many countries that this was the currency which best met their needs as a reserve asset. The reserve currency status of the dollar is greatly buttressed by the fact that the United States is the only country which stands ready to deliver gold at the fixed price of $35 an ounce to foreign monetary authorities upon request.

But international liquidity has broader dimensions than gold and reserve currencies. When representatives of the Group of Ten leading industrial countries began a couple of years ago to study what has come to be called the "liquidity problem", they placed emphasis upon a broad liquidity spectrum which shaded from owned reserves through certain credit availabilities.

It was agreed that the first additional asset to be included in the broader liquidity concept should be the "gold tranche" position of member countries in the International Monetary Fund. The International Monetary Fund has 102 member countries, and each of these has a quota for which it has paid one-quarter in gold and three-quarters in its own national currency. As a result, one-quarter of its quota in the Fund is referred to as its "gold tranche" rights. Any member country is entitled to borrow from the Fund, virtually without question, any currency it may need up to the amount of its gold tranche position. There is general agreement, accordingly, that the aggregate of gold tranche positions in the Fund, amounting to approximately $4 billion, should appropriately be considered an element in international liquidity. I might mention parenthetically that such gold tranche positions will be increased to $5 billion when the 25 per cent increase in Fund quotas now under way has been completed.

There are other forms of international credit about as liquid as gold tranche positions in the Fund. In the last four or five years, a network of short-term credit facilities has been created among monetary authorities and central banks of the highly industrialized countries. These are generally referred to as "swap" lines. They consist of agreements that the authorities of one country will make its currency available to its swap partners up to agreed amounts, usually for an initial period of ninety days. If, for example, Italy should find itself in need of dollar currency, it could deposit lire to the account of the Federal Reserve System and the Federal Reserve System would deposit an equivalent sum in dollars to the credit of the Italian authorities. These agreements represent a highly liquid asset for the countries concerned. Swap lines can be activated on only a few hours' notice, and many of them have been so activated throughout the network in many directions in recent years. The total of swap agreements at the present time throughout the network amounts to more than $2½ billion.

Another substantial element in international liquidity is represented by special Government bonds which the United States has issued to certain of its creditors in recent years to help finance the United States balance of payments deficit. These may be denominated in the currency of the holder and are convertible at short notice by the holders into cash. Foreign currency bonds now outstanding amount to $1.1 billion. Foreign monetary authorities holding these bonds regard them either as part of their reserve assets or as an asset similar to reserves.

In considering international liquidity, it is also appropriate to take into account the availability of credit from the International Monetary Fund beyond the gold tranche positions. As I have said, one-quarter of a country's quota represents its gold tranche; the full quota itself represents the drawing rights beyond the gold tranche. These borrowing rights are not so automatic as gold tranche drawing rights and, hence, not so highly liquid. Consequently, they are not generally regarded as *reserves*. However, they are available in accordance with well understood standards and have been widely used for many years. They represent an important element in total international liquidity.

The report of the Deputies of the Group of Ten, re-

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leased in August of last year, following their study, brought out several interesting points relative to the growth of international liquidity, as the report defined it, during the ten years from 1954 to 1963. As noted, they dealt with international liquidity as being a spectrum divided into two broad categories: "reserves" and "credit facilities". The dividing line between these two closely related classifications was fixed in this manner. Credit availabilities that had not been utilized were, broadly speaking, treated as "credit facilities", and these might be available to potential deficit countries in the future, subject to individual credit arrangements. Reserve assets represented the claims of creditor countries that had been established by the extensions of credit to others in the past on their part, through the International Monetary Fund or directly, and that could readily be mobilized for their own use in case they, in their turn, needed foreign exchange resources. This latter category included also the gold tranche claims on the Fund acquired by past subscriptions of gold to the IMF.

During the ten-year period, the reserves of all the countries in the Free World rose about $17 billion or nearly a third. Gold accounted for nearly $6 billion. Foreign exchange, principally in the form of dollars and sterling, rose nearly $8 billion, and $3 billion was contributed by increased claims on the Fund and by the use of bilateral credit facilities.

You will note that only about a third of the total addition to reserves, defined broadly to include the reserve assets noted, was provided by gold. At the end of 1963, countries held in their reserves about $40 billion in gold or about 57 per cent of the total reserves of $70 billion. $25 billion was held in the form of foreign exchange, one-half in sterling, and one-half in dollars. These foreign exchange holdings were official reserves and take no account of some $15 billion in liquid assets held by non-official private entities, almost entirely as claims in dollars or sterling.

Apart from the global picture, it is useful to pause a moment to look at the regional aspects of this growth in reserves. During the ten-year period, the eight major non-reserve currency countries of the Group of Ten and Switzerland acquired $18½ billion of reserve assets, or $1½ billion more than the world as a whole. This group of countries includes the major part of a persistent surplus area in Continental Europe, which has had an unexampled prosperity and an unprecedentedly strong balance of payments position. Moreover, this group of countries acquired nearly $11 billion in gold, nearly twice the total of new gold supplies available for monetary use in the world as a whole. They were able to do so through a substantial redistribution of the gold reserves of the United States.

This was the pattern of the ten years prior to the study undertaken by the Group of Ten in 1964. Against this pattern, the Ministers and Governors concluded that, "For the international monetary system as a whole, supplies of gold and reserve currencies are fully adequate for the present and are likely to be for the immediate future. These reserves are supplemented by a broad range of credit facilities. The continuing growth of world trade and payments is likely to entail a need for larger international liquidity. This need may be met by an expansion of credit facilities and, in the longer run, may possibly call for some new form of reserve asset."

The Ministers and Governors of the Group of Ten then took several decisions looking toward the future of the monetary system. They undertook a thorough study of the measures and instruments best suited for avoiding and correcting large and persistent international imbalances, compatibly with the pursuit of essential internal objectives. They recommended a procedure for "multilateral surveillance" of the ways and means of financing balance of payments disequilibria. Looking further into the future, since there was a possibility that the supply of gold and foreign exchange reserves may prove to be inadequate for the over-all reserve needs of the world economy, they authorized a study group to examine various proposals regarding the creation of reserve assets either through the IMF or otherwise. Finally, they agreed that they would support a moderate general increase in quotas of the IMF.

It might be asked why there was so much concern regarding the future of international liquidity when reserves had increased so rapidly in the previous ten years. The eight members of the Group of Ten and Switzerland nearly tripled their reserves during the ten-year period, 1954 to 1963. In fact, some of these countries consider that the growth in their reserves has been excessive and has been a contributing factor to inflationary pressures on the European Continent. Thus, they are particularly concerned that the growth in reserves not be excessive in the future, as a result of continuing deficits in the United States balance of payments.

At the same time, they join with the United States in recognizing that there may be conditions in the future, given the remarkably vigorous expansion of world trade and investment, when annual supplies of new monetary gold would alone be insufficient to provide an adequate secular growth in reserves. You will recall that new gold supplied only about one third of the ten-year growth in reserve assets.

The United States also looks forward to a changing

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situation; it is not in our interest to continue substantial balance of payments deficits, to pay out increasing amounts of dollars to the rest of the world, and then to be faced with financing a substantial part of that deficit in gold because other countries no longer wish to accumulate important amounts of dollars in their reserves. There is certainly no fixed or absolute level or ratio of our short-term dollar liabilities to our gold reserves. But officially held dollar claims of a liquid character are now just about equal to our gold reserves. They have been rising for about fifteen years, and rising quite sharply since 1958. It is quite essential that we bring this long series of balance of payments deficits to a halt. In doing so, we will also stop the process of providing gold and dollar reserves to the rest of the world.

When this happens, there may then be a question as to how to provide supplementary reserves in some form, to add to gold and the existing holdings of dollars and sterling exchange. It is, in my view, unrealistic to assume that the world can or should attempt to do away with these existing foreign exchange holdings. The gold exchange standard in itself is a useful and meritorious instrument. But, at the same time, we must exercise moderation in its use, and realize that it has been overstrained by the size and persistence of United States deficits, and the resulting supply of dollars.

It is no secret that some European countries feel that the long-continued deficit of the United States has been at best made possible and at worst encouraged and stimulated by the ability of the United States to finance a very substantial portion of its deficit during the past seven years by paying out dollars that have been added to foreign reserves. If the United States deficit had been settled entirely in gold, they assert, the United States would have taken earlier and more rigorous steps to bring its payments into equilibrium.

Accordingly, some of these countries are prepared to argue that the international monetary system at the present time is experiencing a surplus of liquidity, not a shortage. This is perhaps the basis for the suggestion of President de Gaulle that the world should return to a gold standard system. A return to a gold standard would imply a sharp curtailment of world reserves and world liquidity and would carry the threat of worldwide deflation. I need not—for this audience—spell out the detailed mechanism by which this would come about. I mentioned Jacques Rueff, who recently expressed his support for a return to the gold standard in public statements in the United States. Recognizing that this alone would create dangerous deflationary pressures, he couples his proposal with the suggestion that the price of gold be doubled and that the United States then pay off its liquid liabilities to foreign central banks in gold at the new price. That would mean redeeming some $14.5 billion of dollar reserves of foreign official holders at a rate of $70 for an ounce of gold rather than the existing $35 per ounce. The United States would be left at the end of the operation with gold reserves near the present level, according to the new valuation, and would have wiped out its official liabilities to foreign monetary authorities.

Such a proposal is thoroughly unacceptable to the United States. It combines the proposal that the world once again accept automatic regulation of its money supply according to the vagaries of world gold production with the proposal that the implied and stated commitments of the gold exchange standard be repudiated to the advantage of a few and the disadvantage of many. It is easy to see how it might be appealing to the major gold-producing countries, including the Union of South Africa and the U.S.S.R., and to some countries holding a high proportion of their reserves in gold. It would, of course, be discriminatory against countries which have kept a substantial fraction of their reserves in the form of reserve currencies. Our commitment to maintain the fixed parity of $35 an ounce between gold and dollars is basic to the stability of the world monetary system. President Johnson has reiterated our unchanging determination to maintain this parity.

We share fully, however, the European view that our balance of payments deficit should be promptly corrected. We do not believe that the existence of the present monetary system has weakened our resolve to eliminate our balance of payments deficit. We have, however, insisted that the deficit be eliminated by measures which would have a minimum impact both on the rate of economic growth in our own country and on the continued economic prosperity of the rest of the Free World. We have ruled out measures which would have denied our responsibilities in defense of the Free World or in the economic development of less developed countries—and we have done so in the interest of free men everywhere. Our deep reluctance to adopt more restrictive monetary or fiscal policies at home has derived from the unshakable conviction that a strong and growing economy in the United States is a prerequisite both to lasting correction of our balance of payments difficulties and to continued prosperity in the Western world.

I shall not digress at any length to review the extent to which our balance of payments position has, in fact, been strengthened in recent years. The splendid record of price stability which we have maintained through fifty months of steady economic growth has established for us a strong

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competitive position in world trade and our trade balance is highly favorable. We have reduced the balance of payments impact of our military and foreign aid operations without retreating from our commitments in these areas. More recently, measures have been taken to dampen the outflow of capital from the United States by means of the voluntary cooperation of the banking system and the business community. The United States will, however, continue to be an important source of productive capital.

Before I resume commenting briefly on what I think will be the principal issues to be decided as we cooperate in working out arrangements to assure that adequate world liquidity will be maintained when our deficit has been corrected, I should acknowledge that there is a school of thought—and one which appears to be quite strong in academic circles—that believes in solving the liquidity problem not by increasing liquidity but by reducing the need for liquidity. Members of that school are the advocates of floating exchange rates. They hold that fixed exchange rates alone create the need for large reserves. More importantly, perhaps, they feel that fixed exchange rates constitute a restraining influence preventing individual countries from following domestic policies which might be deemed appropriate for domestic aims. If exchange rates were free to move up and down in the market, a balance of payments deficit would be reflected in a cheapening of the country's currency rather than in a loss of reserves. The cheapening of the currency, in turn, the argument runs, would bring about adjustments in the trade pattern—lower imports and higher exports, among other changes—which would restore balance of payments equilibrium. No country would need to hold large reserves and each country could choose its internal monetary and fiscal policies according to its own system of priorities and without regard for balance of payments effects.

I am not going to try to argue the case for or against floating rates. I would admit, as any student of economics will admit, that the theoretical arguments for floating exchange rates can be presented with great precision and appeal. Operation of the system in a world of imperfect knowledge, imperfect governmental and monetary institutions, and conflicting national ambitions and policies would be something else again. I will merely express the opinion, which is shared by an overwhelming majority of commercial and financial interests, that such a system, in practice, would prove extremely disruptive to world trade and financial transactions. The Ministers and Governors of the Group of Ten have ruled out consideration of any such system and the International Monetary Fund has operated for nearly twenty years in defense of a regime of generally fixed exchange rates, with individual exchange rate adjustments regarded as appropriate from time to time when individual countries have fallen into a position of fundamental disequilibrium.

As we consider possible methods for assuring adequate liquidity in the future, the next question is whether some new *type* of asset should be created or whether liquidity needs can be met by further development and refinement of existing credit mechanisms.

On the credit side, agreement has already been reached, in principle, on a 25 per cent increase in International Monetary Fund quotas. I say "in principle" because, while more than 80 per cent of the membership favored the increase, each member must now determine for itself, in accordance with its own legislative procedures, whether it will accept its appropriate share of such increase. The United States Administration is seeking Congressional approval for an increase of $1,035 million in the United States quota. The House of Representatives voted favorably on this bill on Tuesday of this week. We are confident that the total of aggregate quotas in the Fund will be increased from about $16 billion to about $21 billion when this operation has been completed. That will provide an appreciable addition for international liquidity in the form of credit facilities.

The most intriguing aspect of the liquidity question, however, doubtless lies in efforts to devise a new type of reserve asset. I mentioned that the Deputies of the Group of Ten, in their Report to Ministers, announced that they had established a "Study Group on the Creation of Reserve Assets" to study the problem which its name implies. The Group is meeting periodically. It is expected to present to the Deputies some time this summer a study which will "assemble the elements necessary for evaluation of the various proposals" which have been put forward.

I cannot speak in detail about the work of this Group. But its terms of reference are public information. The Deputies to the Group of Ten spoke of two types of proposals:

> One, the introduction, through an agreement among the member countries of the Group, of a new reserve asset which would be created according to appraised over-all needs for reserves;
>
> and the other based on the acceptance of gold tranche or similar claims on the (International Monetary) Fund as a form of international asset, the volume of which would, if necessary, be enlarged to meet an agreed need.

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Proposals of the first type vary substantially in detail. Essentially, however, these schemes provide that a limited group of countries, by depositing their own currencies or gold, establish a central pool of monetary resources which would provide the backing for a new reserve unit. Members would receive in exchange for their respective subscriptions an equal value of reserve units. These would represent proportionate claims upon the aggregate pool of resources and these claims or units would be transferable among the members in settlement of surpluses or deficits. The reserve unit itself would be held or used much as gold is now held in reserves or used in international settlements. By agreement among the members, it would assume the nature of gold; it would be held as reserves; its value would be fixed in terms of gold; and its acceptance by any member would be automatic according to stipulated conditions.

For example, some proposals would call for creation of a limited amount of reserve units and for the use of these units in fixed proportion with gold in making all settlements among members. The economic effect would be little different from the gold standard itself. It would operate like the gold standard with some reserve units added. Like a return to the gold standard itself, it could call into question the continuing usefulness of reserve currency holdings and would probably encourage the conversion of some holdings into gold. To the extent such conversions should occur, the world would face a decline in total world liquidity, rather than an increase.

A second important condition would be that dealing with the manner in which decisions would be made for increasing or, if necessary, decreasing the amount of units in existence. To oversimplify, it would be in the apparent interest of creditor countries to resist—and of debtor countries to favor—the creation of additional units. If new issues were to be subject to a unanimous agreement, which is to say if any country could veto an expansion or a contraction, it would hardly be accurate to say that decisions regarding the adequacy of international liquidity had been placed under international control in any meaningful way.

The importance of the conditions which might govern creation of new assets would be no less if new reserve assets should be created in the International Monetary Fund. Proposals of this type call for creation of claims on the Fund that can be drawn upon at will to meet balance of payments deficits. For example, automatic drawing rights could be accorded against some part of the existing credit tranches in the Fund. Another proposal is that the Fund might be authorized to invest some of its holdings of currencies in member countries, thereby providing those countries with assets usable internationally.

Again, a number of questions would have to be considered. Would operation of the normal weighted voting procedures in the Fund serve the interests of creditor and debtor countries equitably? Should reserve assets be created for all countries or for only those countries that might be expected to be in both surplus and deficit over a period of years?

However additional reserves are created, their use implies a credit operation. The original creation could take the form for each participating country of an equal increase in its liabilities and in its assets—the latter becoming, by terms of the agreement, an international reserve asset. There would be no real economic impact at this stage. But as soon as the newly created asset or unit began to be used, those surplus countries which accumulated the unit would be extending credit to the deficit countries. And the extension of credit from one country to another reflects the transfer of real assets. The surplus country foregoes present consumption in exchange for higher reserves—or for future potential consumption. A creditor country has, of course, considerable freedom of action in controlling the credit it will extend. There are many acceptable ways in which a balance of payments surplus can be reduced. Study of the adjustment process to determine appropriate policies to be followed—both by deficit countries to correct their deficits and by surplus countries to reduce their surpluses—is another area to which the Group of Ten is giving attention.

With respect to the deficit countries, no country can expect to receive unlimited automatic credit from its trading partners. The search for assurance that adequate international liquidity will be maintained in the future will not in any sense be a search for automatic credit for persistent debtors.

I have mentioned a few of the issues connected with the liquidity discussions without giving any clear indication of what the answers should be. The answers must await continued hard study and, at an appropriate stage, perhaps hard negotiations. I will advance only three questions for your consideration at this time.

First, how can we make certain that any new scheme will be entirely compatible with the evolution of the existing system? This will require that nations should not be penalized—nor benefited—as a result of the composition of their reserves, when and if some new liquidity asset is developed.

Secondly, how can we assure that any new system will increase and not reduce world liquidity? World liquidity would be reduced to the extent that existing reserve currency holdings are converted into gold. What, then, should be our attitude toward proposals which might stimulate

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such conversion or cast doubt upon the stability or the convertibility of existing reserve currency holdings?

Thirdly, how can we make sure that any new system will maintain machinery for giving appropriate weight to the views of both creditor and debtor countries? Should it be subject to the arbitrary control of either, or to the veto of a single country?

These are three broad questions, among many, that will need to be kept in mind as we proceed to examine most carefully the various ideas that have been or may be suggested. We are conscious that the creation of any new type of reserve asset by international agreement would be a step of profound significance. We must be sure that it is a step in the right direction. The mechanism of the international monetary system is an intricate and complicated mechanism, the successful functioning of which is of worldwide concern. We must make certain that any adjustments made in that mechanism will be the best that experience and intelligence and concern for the welfare of all nations can devise.

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