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The Business Situation

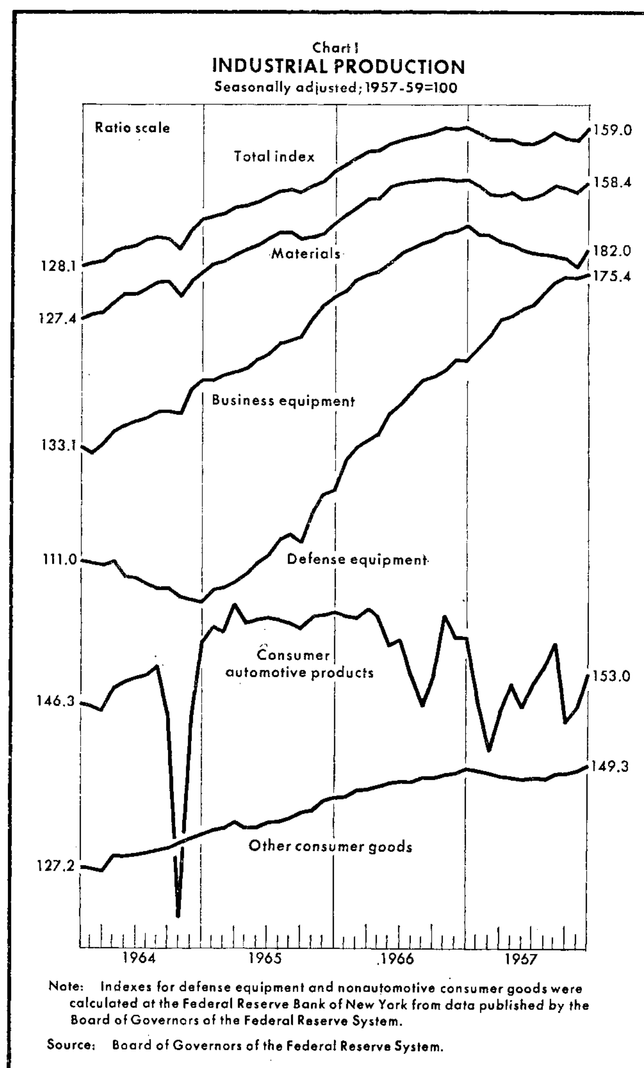
Economic activity rebounded sharply in November and December from the strike-depressed levels of the two preceding months. Auto production picked up substantially, following the October 25 settlement at the Ford Motor Company, and late-October strike settlements in other industries also contributed to the improved economic picture. November gains were widespread, however, and included many sectors not directly affected by the recent labor disputes. The strength of the November advance is evident in the sharp, broad-based rise in industrial production, the surge in new orders for durable goods, the substantial decline in unemployment, and the strong gains in personal income, retail sales, and housing starts. Reflecting mounting cost and demand pressures, consumer and wholesale prices rose sharply in November.

Recent developments point to further strong gains for economic activity in early 1968. Surveys suggest that capital spending will rise. Outlays on inventories should also increase, as the auto industry rebuilds its strike-depleted stocks and as steel users intensify inventory building in anticipation of a possible strike later in the year. Consumer spending should be stimulated by Federal pay increases, a rise in the minimum wage, a boost in social security benefits, and higher wages won in recent contract settlements. Against this background, price pressures at both the consumer and wholesale levels can be expected to heighten.

PRODUCTION, ORDERS, INVESTMENT, AND CONSTRUCTION

Industrial output posted a broad gain in November. The Federal Reserve Board's production index jumped by 2.6 percentage points to 159.0 per cent (seasonally adjusted) of the 1957-59 average (see Chart I). At that level, the index was at its 1967 high and had returned very close to the all-time peak reached in December 1966. The sharp November rise in the index was of course partly due to the recovery of production following the settlement of strikes, particularly in the auto industry. The improvement, however, also reflected increases in output across a broad range of industries, and encompassed gains in production of materials, consumer goods, and equipment.

The post-strike rise in automobile production lifted the seasonally adjusted annual rate of new car assemblies to 7.4 million units in November, up from 6.9 million units in October. Reflecting this recovery, the overall pro-



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System.

Source: Board of Governors of the Federal Reserve System.

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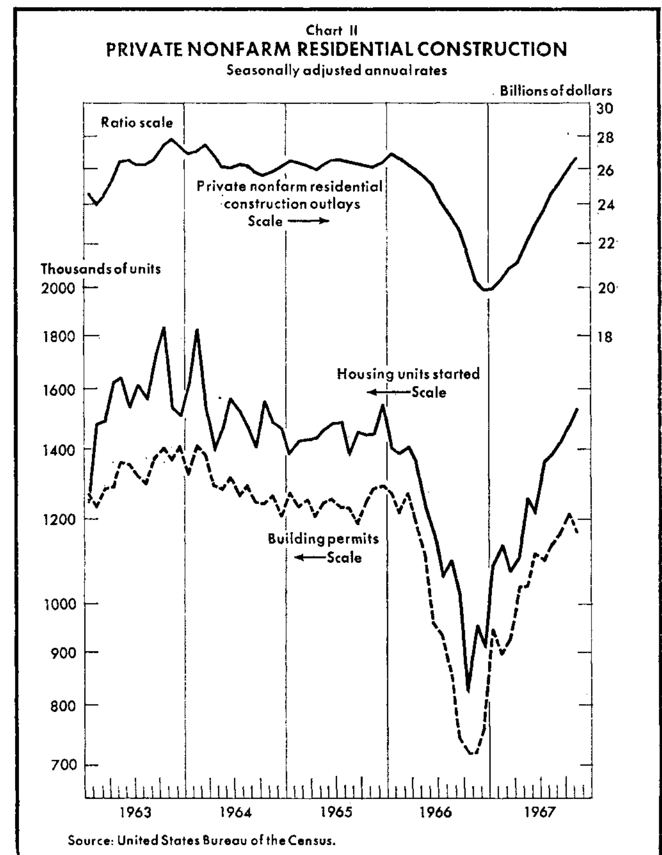
duction index for motor vehicles and parts jumped by almost 12 per cent but was still well below the midsummer level. Another factor contributing to the November rise in industrial production was the strong further advance in iron and steel output, which reached a 1967 high. This advance reflected an improved demand from the auto manufacturers as well as from a wide range of other steel users. There is some evidence, according to industry analysts, that steel users are already beginning to build inventories as a hedge against a possible steel strike next summer.

In December, the pace of auto production surged 21 per cent to a seasonally adjusted annual rate of 8.9 million units and steel output rose a strong 8 per cent. A further buoyant note was provided by the substantial November rise in the flow of new orders to manufacturers of durable goods. The volume of new orders grew by almost $500 million—the largest increase since May—with the advance occurring despite a sharp drop in the highly volatile series on orders for defense-related goods (largely aircraft). Though durables shipments reached a 1967 high in November, they were slightly exceeded by the volume of new orders and thus the unfilled orders backlog increased a bit further.

The recent quickening of the pace of business activity apparently reflects in part a strengthening of business investment spending. The latest Government survey of business plans for capital spending, taken in late October and early November by the Department of Commerce and the Securities and Exchange Commission, indicates that businessmen anticipated an upturn in such outlays in the final quarter of 1967, following modest declines in the first three quarters of the year. The survey points to a substantial further increase in the pace of business investment in plant and equipment during the first half of this year. These results must be interpreted with caution, however, since the survey historically has tended to overestimate expenditures when outlays were falling—as in 1967—and to underestimate expenditures when outlays were rising.

Inventory investment in manufacturing appears to be accelerating. Following a rise of $350 million in October, inventories of durables manufacturers rose by a substantial $600 million in November. At the same time, the gain in shipments was so large that their inventory-sales ratio fell sharply to the lowest level since August. Nondurables manufacturers' inventories edged upward in November and, with sales rising, the inventory-sales ratio for that sector dropped to a new low.

November marked another month of strong recovery in residential building, as both housing starts and construction outlays posted large gains (see Chart II). With



Source: United States Bureau of the Census.

only two interruptions, private nonfarm starts moved up throughout 1967 from a very low seasonally adjusted annual rate of only 0.9 million in December 1966 to a rate of 1.5 million in November 1967. At that level, starts were at their highest point since late 1965. While the high and rising starts pace indicates an increasing level of construction outlays over the near term, the substantial November decline in building permits issued for new housing units could point toward a moderation of the strong upswing in residential building later in 1968.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Reflecting the brisk pace of economic activity and the settlement of strikes, employment expanded vigorously in November and increased still further in December. The number of persons on the payrolls of nonagricultural establishments registered the largest increase of the year in November. The bulk of the gain was in durable goods manufacturing, with the return of striking auto workers

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responsible for a good share of the rise. Employment gains were also reported, however, by a broad range of other manufacturing industries as well as by the nonmanufacturing sectors of the economy in both November and December. A further indication of quickening in the pace of economic activity was the increase (seasonally adjusted) in the average length of the workweek of manufacturing production workers in December.

The acceleration in economic activity was accompanied by a sharp drop in the unemployment rate, to 3.9 per cent in November from 4.3 per cent in October. The decline was the largest monthly reduction in six years. The unemployment rates for adult women and teen-agers, who had accounted for much of the increase in the overall unemployment rate in the previous two months, dropped substantially in November, while the key unemployment rate for married men fell to a very low 1.7 per cent.

As a result of the rapid growth in employment, personal income in November recorded the largest advance in more than two years. This impressive showing was of course partly due to the termination of strikes, which had depressed wage and salary payments in September and October. However, the Commerce Department estimated that only about $2 billion of the nearly $6 billion November rise in the seasonally adjusted annual rate of personal income was due to the ending of strikes. The primary factor in the month's income growth was the more rapid tempo of industrial activity, which led to higher employment, longer hours, and greater earnings.

In addition to rising economic activity, a Federal pay increase covering five million employees is currently contributing to the expansion of personal income. Moreover, the sizable wage increase won in the auto industry and the scheduled February rise in the minimum wage from $1.40 an hour to $1.60 an hour are expected to boost wage and salary payments in the early months of the year. The rise in social security payments should also increase personal income in early 1968.

While the quickening in economic activity has increased the rate of growth in income and employment, consumer demand still appears to be somewhat restrained. Recent surveys of consumer buying intentions indicate a significant downgrading of consumer plans to purchase new cars, homes, and household durables in the coming months. Though retail sales volume rose appreciably in November, reversing a substantial part of the October decline, retail sales have not shown much vigor in recent months. Thus, November sales were about even with last June's total and only a shade over sales in July and August. Sales of nondurables registered their largest advance of the year in November, but the growth of durables volume was virtually unchanged. Sales of new autos in November were about unchanged from the previous month's strike-reduced annual rate of 7 million units. While December auto sales were up over 6 per cent to a rate of 7½ million units, they were considerably below industry expectations.

PRICES

The price picture remains highly disturbing. The overall consumer price index rose sharply again in November, despite the fact that its food component continued to decline. The overall index moved up 0.3 percentage point to 117.8 per cent of the 1957-59 average, largely because of substantially higher costs of apparel, gasoline, and services. The wholesale price level edged up in November, as a decline in farm products partially offset a large 0.3 percentage point rise in the index for industrial commodities. Metal prices advanced strongly, due primarily to shortages caused by the copper strike as well as price boosts in the steel industry. Preliminary figures for December indicate that the overall wholesale index jumped 0.5 percentage point, as agricultural prices shot up 2.3 percentage points. The Bureau of Labor Statistics cautioned that the increase in food prices should not be interpreted as the beginning of a sharp upward trend, because the unusual rise may be something of a statistical fluke. Industrial prices, a key measure of inflationary pressures, also advanced at a relatively high 2.2 per cent annual rate in December. Rising demand and large wage increases practically ensure that price pressures will remain a problem in the months ahead.

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The Money and Bond Markets in December

On December 27, the Board of Governors of the Federal Reserve System announced an increase of ½ percentage point in reserve requirements against demand deposits in excess of $5 million at member banks, from 16½ per cent to 17 per cent at the reserve city banks and from 12 per cent to 12½ per cent at other member banks. The increase will take effect in two stages during January 1968, the first at reserve city banks in the reserve computation period beginning on January 11 and the second at other member banks in the computation period beginning on January 18. Required reserves are expected to rise by a total of $550 million—approximately $360 million through the first-stage increase and $190 million through the second. The increase, the first in member bank reserve requirements since September 1966 and the first against demand deposits since November 1960, was undertaken in order to further "the Federal Reserve's objectives of fostering financial conditions conducive to resistance of inflationary pressures and progress toward equilibrium in the United States balance of international payments".

The money market became gradually firmer during December. Despite a contraction in nationwide net reserve availability of member banks after midmonth, the reserve position of the major money market banks remained relatively comfortable throughout the period. Consequently, the money market accommodated without difficulty the heavy seasonal flows of funds associated with corporate tax and dividend payments and year-end portfolio adjustments by commercial banks and corporations, as well as the substantial volume of international financial transactions that developed in the wake of the mid-November devaluation of the British pound. The effective rate for Federal funds was generally at or below the 4½ per cent discount rate during the first three statement weeks, but rose to 4⅝ per cent later. Rates on most other money market instruments also moved higher over the month.

Market yields on longer term Treasury bills moved irregularly lower over most of December, reflecting a strong investment demand from both domestic and foreign sources and relative scarcities of some issues. The market for Treasury notes and bonds showed renewed strength during December, although earlier price gains were pared on the last two trading days after the announcement of the increase in reserve requirements. The better market tone reflected partly an increased willingness of investors to commit funds on a long-term basis at prevailing yields and partly a feeling of relief among market participants that international currency markets had stabilized after the November devaluation of the pound sterling. Intermediate-term issues, moreover, were in demand on a substantial volume of tax switching, while the longer term area benefited from the seasonal slack in new financing operations. At a somewhat higher pattern of yields that emerged at the start of the month, a substantial volume of new and recent offerings of corporate and tax-exempt securities was distributed by underwriters.

BANK RESERVES AND THE MONEY MARKET

Conditions in the money market firmed very gradually during December, although nationwide net reserve availability contracted sharply after midmonth. Average free reserves of all member banks fell to about $80 million in the last two statement weeks (see Table I) from the $200 million level that had prevailed during November and early December. At the same time, however, the reserve positions of major money market banks were unusually comfortable for this period of the year (see Table II), and the banking system accommodated large seasonal demands for funds around midmonth without strain. The effective rate for Federal funds rose above the discount rate in the latter part of the month.

Rates on short-term money market instruments continued to increase during December. The dealer offering rate on ninety-day bankers' acceptances rose by ½ percentage point to 5⅝ per cent, while that on prime four- to six-month commercial paper increased by ⅛ percentage point to 5⅝ per cent. Offering rates on directly placed

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finance company paper were raised by ¼ percentage point to 5½ per cent for paper maturing in one month or more. Offering rates posted by the major New York City banks on negotiable time certificates of deposit (C/D's) maturing in one to three months were raised during December to a range of 5⅜ to 5½ per cent by the end of the month. At large commercial banks throughout the country, approximately $5.9 billion of negotiable C/D's, or 28 per cent of the total amount outstanding, matured during December. In the statement week ended on December 20, when the bulk of these maturities was concentrated, the C/D runoff amounted to an estimated $731 million.

During the two statement weeks ended on December 20, the period during which seasonal demands for funds from businesses, nonbank financial intermediaries, and securities dealers were at a high point, total loans (adjusted) and investments of all weekly reporting banks expanded by $3.8 billion, almost entirely reflecting a rise in loans. The $3.5 billion loan expansion surpassed increases in loans of $2.8 billion and $3.4 billion, respectively, in the corresponding two weeks of 1966 and 1965.

THE GOVERNMENT SECURITIES MARKET

The market for Treasury notes and bonds strengthened in December, after having been buffeted during November by the combined effects of the uncertainties surrounding the domestic fiscal and credit situation and the devaluation of the British pound in the middle of that month. At the beginning of December, the market suffered fairly sharp price losses in reaction to an announcement by the Chairman of the House Ways and Means Committee that no action would be taken on the Administration's income tax proposal during 1967. The heavy tone also stemmed in part from rumors of an imminent increase in the Federal Reserve discount rate and in the maximum interest rate payable on time deposits under Regulation Q. Subsequently, however, the market turned decidedly more optimistic, and prices rose irregularly until late in the period when news of the increase in reserve requirements exerted some downward price pressures.

A number of influences appeared to contribute to the favorable market tone, including the heavy demand for intermediate issues generated by investor tax-switching transactions, the seasonal contraction of financing activity in the long-term capital markets, and satisfaction among market participants over the performance of international currency markets after the devaluation of sterling. Long-term issues were in demand on outright buying by investors who seemed reluctant to wait for further increases in yields, feeling that perhaps long-term yields had reached a peak. In these circumstances, prices of Treasury coupon securities were not very sensitive to developments which might otherwise have produced a greater effect. Unusually heavy speculative buying of gold in the London market on December 14 and 15, for instance, sparked only a limited price decline in the Government securities market. The reaction in the market to this development was probably tempered by a weekend statement of Treasury and Federal Reserve officials, affirming that the gold value of the dollar would be maintained and that the operation of the London gold market would continue unchanged. Similarly, the market was relatively unaffected by a variety of unfounded rumors about exchange rates and changes in foreign monetary policies and by the publication at midmonth of weekly reserve statistics seeming to suggest that a shift in monetary policy had taken place. For the month as a whole, prices increased by as much as ¾ point in the intermediate maturity area and 1½ points in the long-term sector of the market.

Rates on Treasury bills moved irregularly during December in a pattern generally similar to that of yields on coupon issues. At the start of the month, rates were marked up sharply as a result of aggressive professional

Perspective '67

Each January this Bank publishes *Perspective,* a brief, informative review of the performance of the economy during the preceding year. This booklet is a layman's guide to the economic highlights of the year. A more comprehensive treatment is presented in our *Annual Report,* available in March.

Perspective '67 is available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045. (A copy is being mailed with this issue of the *Monthly Review.*) A Spanish version is also available upon request.

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, DECEMBER 1967

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

Factors	Changes in daily averages—week ended on				Net changes
	Dec. 6	Dec. 13	Dec. 20	Dec. 27	
"Market" factors					
Member bank required reserves*	— 285	+ 184	— 576	— 293	— 970
Operating transactions (subtotal)	— 289	— 206	+ 640	+ 81	+ 226
Federal Reserve float	+ 107	— 11	+ 504	+ 240	+ 840
Treasury operations†	+ 267	+ 516	— 54	+ 182	+ 911
Gold and foreign account	— 122	— 319	— 16	+ 8	— 449
Currency outside banks*	— 247	— 338	— 37	— 379	— 1,001
Other Federal Reserve accounts (net)‡	— 292	— 54	+ 244	+ 28	— 74
Total "market" factors	— 574	— 22	+ 64	— 212	— 744
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 372	+ 134	— 145	+ 141	+ 502
Bankers' acceptances	+ 7	+ 7	+ 2	+ 5	+ 21
Repurchase agreements:					
Government securities	+ 125	— 172	—	+ 81	+ 34
Bankers' acceptances	+ 14	+ 61	— 75	+ 39	+ 39
Federal agency obligations	+ 9	— 11	—	+ 7	+ 5
Member bank borrowings	— 32	+ 34	+ 64	+ 160	+ 226
Other loans, discounts, and advances	—	—	—	—	—
Total	+ 497	+ 52	— 154	+ 433	+ 828
Excess reserves*	— 77	+ 30	— 90	+ 221	+ 84

	Daily average levels				
Member bank:					
Total reserves, including vault cash*	24,855	24,701	25,187	25,701	25,111§
Required reserves*	24,558	24,374	24,950	25,243	24,781§
Excess reserves*	297	327	237	458	330§
Borrowings	87	121	185	345	185§
Free reserves*	210	206	52	113	145§
Nonborrowed reserves*	24,768	24,580	25,002	25,356	24,926§

	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 308	—	+ 56	+ 465	+ 829
More than one year	—	—	— 169	—	— 169
Total	+ 308	—	— 113	+ 465	+ 660

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 of four weeks ended on December 27.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS DECEMBER 1967

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on Dec. 27
	Dec. 6	Dec. 13	Dec. 20	Dec. 27	
Eight banks in New York City					
Reserve excess or deficiency(—)*	30	10	25	+ 52	29
Less borrowings from Reserve Banks	—	2	37	27	17
Less net interbank Federal funds purchases or sales(—)	98	— 160	188	250	94
Gross purchases	*1,052*	*905*	*1,147*	*1,172*	*1,069*
Gross sales	*954*	*1,066*	*959*	*922*	*975*
Equals net basic reserve surplus or deficit(—)	— 68	168	— 200	— 225	— 82
Net loans to Government securities dealers	885	887	1,119	1,108	1,000
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	14	16	14	34	20
Less borrowings from Reserve Banks	21	54	43	104	56
Less net interbank Federal funds purchases or sales(—)	408	651	512	421	498
Gross purchases	*1,727*	*1,805*	*1,883*	*1,814*	*1,807*
Gross sales	*1,319*	*1,154*	*1,370*	*1,394*	*1,309*
Equals net basic reserve surplus or deficit(—)	— 416	— 688	— 541	— 491	— 534
Net loans to Government securities dealers	648	455	491	379	493

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—December 1967			
	Dec. 4	Dec. 11	Dec. 15	Dec. 22
Three-month	4.989	4.941	5.127	4.989
Six-month	5.580	5.493	5.659	5.515

Maturities	Monthly auction dates—October-December 1967		
	October 24	November 22	December 26
Nine-month	5.313	5.422	5.555
One-year	5.302	5.430	5.544

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

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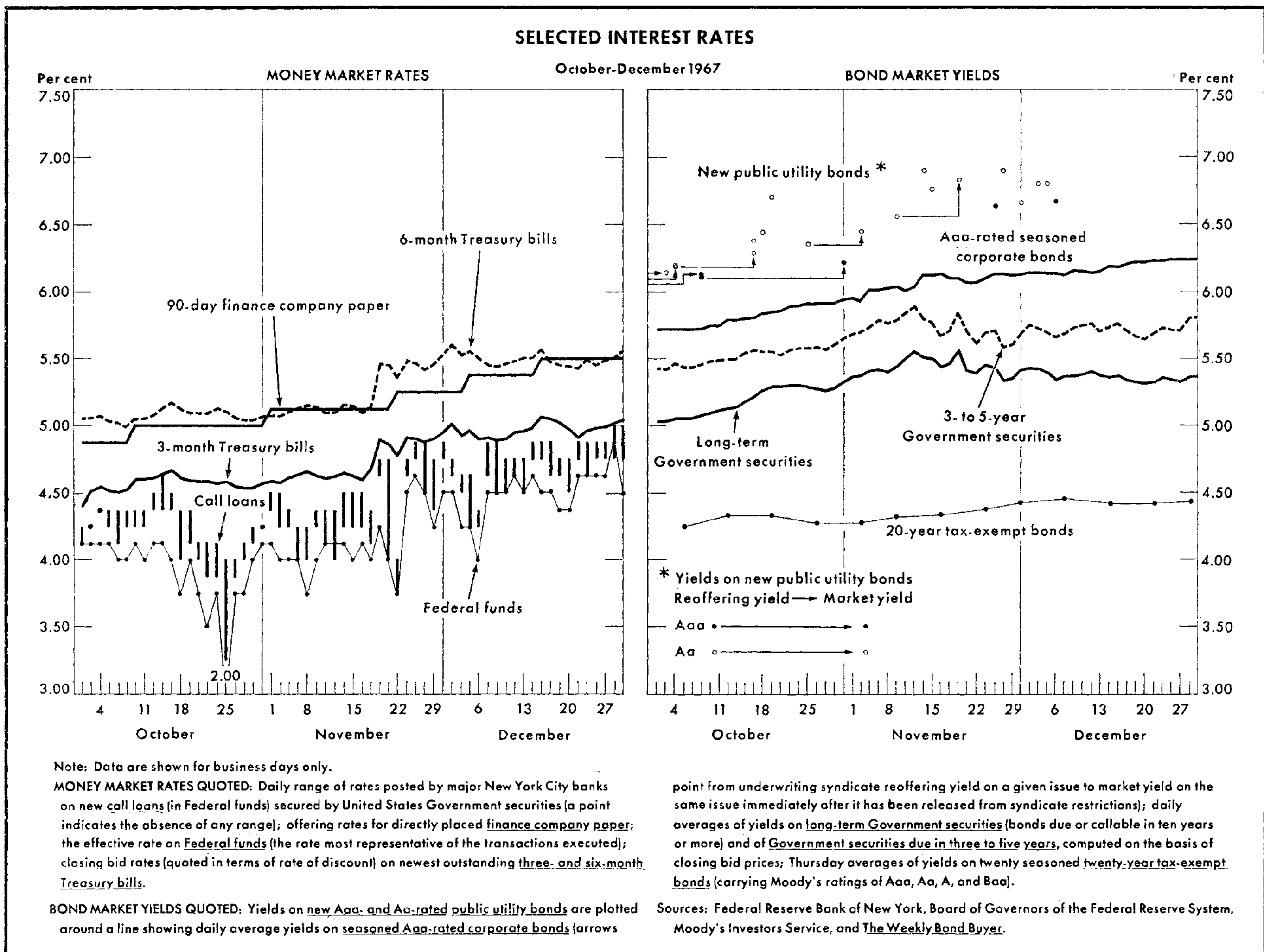

Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields on seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on 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 on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

selling of bills prompted by disappointment over the fate of the tax increase proposal in the Congress and by widespread rumors of a discount rate increase. The rise in rates generated increased investment demand, however, and bidding in the first regular weekly bill auction of the month was very strong, resulting in average issuing rates for the three- and six-month issues, respectively, of 4.989 per cent and 5.580 per cent (see Table III), only slightly higher than in the previous weekly auction. Investment buying of bills, much of it from foreign sources, held at significant levels over the remainder of the month, and scarcities of certain maturities developed frequently. For December as a whole, market yields on the nearest three- and six-month bill maturities rose by 9 and 1 basis points, respectively, to 5.04 per cent and 5.54 per cent.

OTHER SECURITIES MARKETS

A firmer tone emerged in the corporate and municipal bond markets during December, after an initial sharp upward adjustment of yields (see chart). One Aa-rated offering of public utility bonds, priced just before the Congressional announcement that the proposed surtax would not be enacted by the end of the year, was poorly received at a reoffering yield of 6.65 per cent. In contrast, two other similarly rated public utility offerings also carrying five-year call protection, priced shortly after the announcement, were quickly taken by investors at a reoffering yield of 6.80 per cent, a near-record high for this type of offering.

At the higher yield levels, new offerings of tax-exempt bonds were also marketed quite successfully. Among the

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largest offerings of the month was a $97 million issue of industrial revenue bonds, of which $74 million represented term bonds due in 1990. These bonds, rated Baa by Moody's, were well received at a reoffering yield of 6 per cent. Unsold balances of a number of municipal offerings, which had been overhanging the market since their initial reoffering in November, were released from syndicate price restrictions during December, with resultant upward yield adjustments of as much as 15 basis points. Nevertheless, a certain amount of congestion remained in the tax-exempt market, and at the close of the month the Blue List of dealers' advertised inventories of municipal bonds stood at $506 million, up from $478 million at the end of November.

The average yield on Moody's Aaa-rated seasoned corporate bonds rose to 6.24 per cent at the end of December from 6.13 per cent a month earlier. *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues, carrying ratings ranging from Aaa to Baa, also rose over the month to 4.44 per cent from 4.42 per cent.

Special Drawing Rights: A Major Step in the Evolution of the World's Monetary System*

A major benchmark in the evolution of the international monetary system was reached last September when the members of the International Monetary Fund (IMF) agreed on a proposal for establishing a new reserve facility to meet the possible need for a supplement to existing international reserve assets. This supplement is designed to assure an adequate supply of international liquidity for a growing world economy if, as is expected, the growth of more traditional reserve assets—gold and foreign exchange—should prove inadequate. The plan provides a means for regularly creating special drawing rights (SDR's) in the Fund, which the participating countries would accept as reserves and could use in international settlements. Although the plan contains certain provisions to ensure the attractiveness of SDR's, their value as a reserve asset rests fundamentally on the obligation of participants to accept them in exchange for a convertible currency. To be sure, the proposal places some restraints on the ability of participating countries to use these assets and limits their obligation to accept them. But, because in general SDR's could be used automatically for the settlement of international payments, they fulfill the essential function of any reserve asset.

This new facility to some extent represents a logical extension of the Fund's current operations, but it departs from the Fund's ordinary procedures in several important respects. First, SDR's will be more readily available than the credit that the IMF now provides through drawings in the credit tranches.[1] Any participating country will be able to use SDR's whenever it has a balance-of-payments or reserve need to do so. Its exercise of this right will not be subject to consultation or prior challenge nor con-

* Martin Barrett and Margaret L. Greene, Economists, Foreign Research Division, had primary responsibility for the preparation of this article.

[1] At present, a member of the Fund may purchase (or "draw") the currencies of other members by depositing with the IMF an equivalent amount of its own currency. The normal quantitative limitations on the use of the Fund's resources depend on the size of the member's quota (which equals the member's subscription in gold and in its own currency to the Fund's resources). Drawings are virtually automatic in the "gold tranche"—i.e., as long as the total amount drawn does not exceed the 25 per cent of the borrowing country's quota normally subscribed in gold. But a country can make additional drawings, in the "credit tranches", only after it has agreed to take measures to correct its balance of payments.

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tingent on the adoption of prescribed policies designed to restore balance-of-payments equilibrium. Second, the SDR's are intended to provide a permanent addition to international reserves, whereas most current IMF transactions give rise to only a temporary increase. Third, the SDR's will be distributed to all participants in proportion to their IMF quotas. On the other hand, reserves that arise as a by-product of the Fund's credit operations normally add, in the first instance, to the total reserves of the borrowing country alone and only indirectly to the reserves of other countries. Finally, the use of SDR's does not entail repayment according to a fixed schedule, as does the use of the Fund's ordinary resources, although SDR balances must be partially reconstituted following large and prolonged use. In short, the SDR's are intended to provide systematic and regular additions to international liquidity, and to be readily available to any member of the Fund which elects to participate in the project.

The plan is to be prepared as draft amendments to the Fund's Articles of Agreement not later than March 1968. These draft amendments will then be submitted to all the members of the IMF for ratification—a process that could be completed late in 1968 or early in 1969. However, for reasons discussed more fully below, an affirmative vote for adoption of the amendment does not automatically lead to activation of the mechanism, and just when the plan will be implemented is not known.

THE PLAN IN OUTLINE

ALLOCATION OF SPECIAL DRAWING RIGHTS. The plan does not yet specify the criteria according to which SDR's should be provided, but the general criterion is that there must be a widely recognized need to supplement existing international reserve assets. Indeed, the procedure for the introduction of SDR's is clearly designed to ensure that there is broad support for any decision on reserve creation. Thus, the managing director of the IMF, after having satisfied himself that there is a need to supplement monetary reserves, will undertake whatever consultations may be necessary to determine whether or not there is sufficient support among the participants for the creation of SDR's in the amount he proposes. After the concurrence of the Fund's executive directors, the proposal must then be approved by the board of governors of the Fund by an 85 per cent majority of the voting power of the participants. The Common Market countries, with almost 17 per cent of the voting power in the IMF, could thus veto the creation of SDR's if they vote as a unit, as could the United States with 22 per cent of the voting power.

Since the SDR's are intended to assure the adequate long-term growth of total reserves, the amount created will not ordinarily vary from year to year, nor will it be influenced by the reserve needs of individual countries. Instead, the amount to be issued will be for a "basic" period of several years—during which predetermined allocations are to be made at specified intervals. Initially, the basic period will be five years, but the IMF may decide that any future basic period will be of a different duration. The proposal does not indicate the amount of SDR's to be issued; that will be decided on the basis of a collective judgment of global reserve needs, which will depend in part on the growth of other forms of reserve assets. If it were decided to create $1 billion to $2 billion annually in the initial basic period, for example, total reserves would expand in the first year by 1.4 per cent to 2.8 per cent—considerably less than the 3.6 per cent average annual increase in total reserves from 1960 to 1964 and not significantly greater than the 2.3 per cent growth during 1965 and 1966. All members of the IMF will be able to participate in the "special drawing account" through which all the operations relating to SDR's will be carried out, and allocations will be made to all participants in proportion to their IMF quotas. Thus, the United States would receive roughly 25 per cent, or between $250 million and $500 million a year, if $1 billion to $2 billion of SDR's were issued annually.

If unexpected developments make it desirable to change the rate at which SDR's should be issued, it will be possible, under the same consultation procedure, to increase or decrease this rate for the rest of a basic period or to adopt a new basic period with a different rate of creation. Such changes will ordinarily require an 85 per cent majority vote. However, a decision to reduce the rate of issue for the remainder of a current basic period can be taken by a simple majority of the voting power of the participating countries.

USE OF SPECIAL DRAWING RIGHTS. A participating country will be entitled to use SDR's to acquire an equivalent amount of convertible currencies to finance a balance-of-payments deficit. The user of SDR's will acquire currencies, not out of resources held by the Fund, but directly from other participants or through the intermediation of the Fund. Convertible currencies are expected to be purchased from countries with strong balance-of-payments and reserve positions, thereby following the Fund's existing criteria for the selection of currencies to be used in its lending operations. However, a reserve center may also use SDR's to purchase balances of its own currency held by another country—provided the latter agrees—by transferring SDR's directly to that country. Whether the transfers are arranged directly between participants or

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indirectly through the Fund, the countries that use SDR's will have their SDR holdings in the special drawing account reduced and those countries that receive them will correspondingly have their SDR holdings increased by an equal amount.

SDR's may not be used for the sole purpose of changing the composition of a country's reserves. In other words, a country cannot use SDR's simply to build up its foreign currency balances or gold holdings. Although the use of SDR's will not be subject to prior challenge, the IMF may make representations to any country that has failed to observe this principle and may direct transfers of SDR's to that country to restore its SDR holdings. Nevertheless, over time a participant could find the share of its reserves held in SDR's falling if it were to use SDR's when in deficit and receive other reserves when in surplus. Such changes in the composition of reserves, however, will generally be avoided through the guidance of transfers of SDR's by the IMF.

RECONSTITUTION PROVISION. Participating countries that use SDR's may incur an obligation to restore (or "reconstitute") their position to some extent, depending on the amount and duration of their use. The reconstitution provision in the plan specifies that a member's average use of SDR's over a basic period is not to exceed 70 per cent of its average cumulative allocation. Translated in terms of holdings, this obligation means that over any basic period a country's average holdings should be at least 30 per cent of its average allocation over the same period. If at any given time holdings of SDR's fall below this 30 per cent average level, it will be necessary to reconstitute and hold them for a sufficient time to establish the minimum average ratio.

The reconstitution provision is designed to prevent any tendency toward financing large and persistent payments deficits by exclusive reliance on SDR's. In fact, the reconstitution provision includes the principle that "participants will pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of special drawing rights and other reserves". However, the reconstitution provision does not prevent a country from using all its SDR's when its balance-of-payments difficulties are temporary in nature. If the balance-of-payments difficulties that give rise to the use of SDR's are in fact short-lived, then a country which had utilized all its allocation of SDR's in the early part of a basic period could reconstitute its average holdings simply by minimizing the use of its allocation or accumulating SDR's in the latter part of the period. Otherwise, a participating country would have to acquire them either directly from other participants or through the intermediation of the IMF in exchange for some of its other reserve assets. If a country began using SDR's toward the end of the period, holdings of its allocation at the beginning of the period might enable it to satisfy any reconstitution requirement.

The reconstitution provision may, in effect, impose a repayment obligation on part of a country's use of SDR's, but it does not seriously compromise the quality of the SDR's as a reserve asset. That portion of SDR's which is not required to be reconstituted (70 per cent of the cumulative allocations) is as absolutely at the disposal of a participating country to meet balance-of-payments deficits as any asset can be. Moreover, the reconstitution provision is less onerous than the repayment (repurchase) provisions currently applicable to drawings on the IMF. Such drawings must be completely liquidated within three to five years either directly through repayments by the debtor country to the IMF or indirectly by other members' drawings on the IMF of the debtor's currency.[2]

ACCEPTANCE OBLIGATIONS. Every participating country is obligated to provide currency in exchange for SDR's freely and to keep those it receives (so long as it does not have need to use them) until its total holdings are equal to three times the amount of its cumulative allocations. That is, if a country's initial allocation were $100 million and it used none of its SDR's, its acceptance obligation would be $200 million. If the country had transferred all its initial allocation to other countries, its acceptance obligation would be $300 million. A country could, of course, accept and hold SDR's in excess of this amount, and the plan gives surplus countries some incentive to do so. The SDR's will carry a gold-value guarantee. Moreover, holdings of SDR's will earn a moderate rate of interest, although the yield will presumably be less than that on United States Treasury bills.

The limitation on holding countries' obligations to retain SDR's would appear to reduce the facility's usability as a reserve asset, since it is essential that a country have absolute assurance that it will be able to use its SDR's to acquire convertible currencies to meet all or part of its payments deficit. In the long run, however, this limitation seems unlikely to be serious. If, after the plan has been in operation for a number of basic periods, the amount of SDR's outstanding becomes quite large, a country with

[2] Only up to the point where the Fund's holdings of a member's currency fall short of 75 per cent of the quota—as may happen when that currency is used for other countries' drawings—can that member draw from the IMF without incurring a repayment obligation.

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a balance-of-payments deficit is almost certain to find some surplus country which holds less than its obligatory limit of SDR's. Moreover, the reconstitution provision, which encourages persistent deficit countries to use other reserves in addition to SDR's, will help to avoid excessive transfers of SDR's. Finally, transfers of SDR's may be made not only to participants with a strong balance of payments but also to countries with a strong reserve position even when they have a moderate payments deficit.

For these reasons, the margin between the amounts of SDR's created and the acceptance obligations will probably be large enough to assure any participant that its holdings are fully usable. If, for example, a proposal were made to create $1 billion of SDR's annually, the United States, with about 25 per cent of IMF quotas, would receive $1,250 million over a five-year period and would not reach its acceptance limit in the fifth year until it held $3,750 million of SDR's, or 75 per cent of the SDR's outstanding. The Common Market countries as a group, with about 17 per cent of IMF quotas, would not reach their acceptance limits until they held about $2,550 million of SDR's—slightly more than half the total issue. If either the United States or the Common Market countries as a group were to have temporary deficits which were settled with the maximum transfer of SDR's, the acceptance limits would be large enough to accommodate a transfer in either direction.

SOME UNRESOLVED ISSUES

The plan appears to provide a workable mechanism for the creation of a supplement to existing reserve assets. But smooth operation of the mechanism depends not only on the provisions, guarantees, and limits contained in the proposal but also on the degree to which various countries, in particular the surplus countries, will support the plan and accept SDR's as a reserve asset.

The question immediately arises as to when the plan will be activated. The adoption of the proposal, which requires an 80 per cent majority of the voting power of IMF members, seems assured, but activation of the plan requires an 85 per cent vote. Thus, an affimative vote for the adoption of the amendment would not necessarily be sufficient to assure activation, and the Common Market countries as a group could veto any proposal to issue SDR's.

Ratification of the plan may be delayed, if creation of SDR's becomes linked to overall reform of the present provisions of the Bretton Woods Agreement. Some Common Market countries seek modification in the voting provisions of the Fund in order to require an 85 per cent vote for approval of quota increases. In effect, this reform would give the Common Market countries the same veto power on regular IMF operations that the United States now enjoys. An alternative and in many ways preferable course by which the Common Market countries could obtain a decisive voice in the IMF would be by increasing their subscription to the Fund to the point where they have just over 20 per cent of the total voting power.

Assuming that the plan is ratified by the IMF members, its activation might nevertheless be delayed until there is substantial reduction in the United States balance-of-payments deficit. The position of the French government, as stated by Michel Debré, Minister of Economy and Finance, is "that the mechanism cannot come into play until the balance-of-payments deficits affecting the countries whose currencies are designated as 'reserve currency' have disappeared". This is an extreme view which has not been taken by other countries. Moreover, as President Johnson indicated in his statement on the new United States balance-of-payments program, movement toward balance will, by curbing the flow of dollars into international reserves, limit the growth of existing reserve assets: "It will therefore be vital to speed up plans for the creation of new reserves".

Even if the plan were promptly implemented, the need to restore balance-of-payments equilibrium in this country would in no way be reduced. The amount of SDR's the United States would obtain each year is small, compared with the size of our recent deficits, and the plan does not prevent countries from converting their existing dollar holdings into gold. Consequently, continued balance-of-payments deficits would still pose a threat to our gold reserves. If the dollar is to continue to function as the principal trading and reserve currency, the United States must substantially strengthen its payments position. Changes in the workings of the world monetary system will not relieve this country of this task.

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