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Inflation: A Test of Stabilization Policy*

By ALFRED HAYES

President, Federal Reserve Bank of New York

This annual luncheon at the New York State Bankers Association midwinter meeting always brings a welcome opportunity to share my thoughts with you on major developments of the past year and on prospects for the new year.

As I have reflected on my comments in the last few years, I have been struck by the persistence—or recurrence—of the same old problems year after year. In early 1967, for example, while recognizing that there was a good deal of concern in the business and financial community over a possible recession, I found the forecast of a serious recession unconvincing. I was, on balance, more worried over a slippage in our efforts to combat cost and price pressures—especially in the light of the urgent need for an improved trade surplus to remedy our weak balance-of-payments position. One striking difference at that time from the present situation was the fact that credit pressures had already slackened and interest rates had declined; these factors were stimulative to domestic business, but at the same time suggested trouble with respect to international capital flows.

Today I would like to adopt a little longer perspective, and take a look at the major policy problems that have beset us ever since the overheating of the economy that was sparked by the stepped-up Vietnam war effort in mid-1965. Perhaps there are some lessons to be learned from that experience that could be useful as we face a difficult future and as the Congress faces an urgent need for decisions on fiscal policy. As background, there had long been a pervading concern—a national preoccupation—about recession. Any recession—even a mild one—was

the greatest possible evil to be avoided at all costs. On the other hand, inflation had often been looked on as an inevitable phenomenon of modern economic life that was more annoying than devastating. Doubtless because of deeply embedded memories of long years of depression, we have had a kind of national passion for rapid growth at all costs.

Of course, since 1965 the overriding problem has been how to check inflation by using the relatively impersonal stabilization weapons of monetary and fiscal policy. Apart from all the domestic implications of this problem, there always lurked in the background the nagging difficulty of our balance of payments—the problem of how to preserve the dollar's key position in the world by getting close to payments equilibrium without jeopardizing the role of the United States as a “natural” exporter of capital and without using methods that would upset the whole international financial system. Thus we were never able to take decisions for domestic reasons without regard to their international effects.

First let's have a look at the contribution of fiscal policy in the period under review, and then turn to monetary policy. By 1965 the theory of using fiscal policy as a deliberate stabilizer had become pretty well accepted—certainly in academic circles, and probably very largely in business and Government circles. But alas, theory and practice were very far apart. In the first place, timeliness would seem to be a first requisite of an effective fiscal policy. Yet from late 1965, when the need for higher tax rates to combat excessive demand first became apparent to many of us, two and a half years passed before significant action was at last taken in mid-1968. At first the Administration was reluctant to push for restraint on the fiscal front, and then an unpersuaded Congress took a year and a half to go along with the Administration's urgings. And by that time inflation was well out of hand.

The Administration's hesitation in 1966 seemed to re-

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flect a lack of awareness of the extent to which stepped-up military outlays might be expected to bring an excessive total demand in the economy, or at best an insistence on documentary proof that such influences were already being felt rather than a willingness to act on the basis of reasonable expectations. Even when the extent of the demand pressures was realized, there seemed to be a reluctance to go to the Congress for the tax increase needed to carry out a military commitment that commanded less than whole-hearted popular support.

In the Congress, one very important element was the insistence of some legislators that taxes should be raised only if adequate cuts in spending were assured. However defensible this view might be, it had a paralyzing effect on timely tax action. For one thing, it depended on the establishment of spending priorities—inevitably a long and argumentative process. And there were some who automatically opposed an increase in taxes because they thought an increase would merely permit and assure a commensurate rise in spending. This, to me, was simply a counsel of despair.

Equally damaging to effective use of the tax instrument was the later injection of the debate over tax reform. Without denying the great importance of tax reform, I find it hard to avoid the feeling that this debate diverted attention from the more pressing question of establishing income tax rates appropriate to the economic circumstances. It seems clear to me that maintenance of a 10 percent surtax rate through the present fiscal year, and perhaps longer, would have been desirable from the anti-inflation point of view.

Admittedly, questions of economic analysis and judgment also entered into the tortuous history of the tax surcharge. Even while the inflation was gathering momentum, there was much reluctance to try to slow the economy by fiscal means. My testimony before the House Ways and Means Committee in September 1967 included the following sentence: "I do not share the fear, frequently expressed in these hearings, that a 10 percent tax rise could dip the country into recession." We can all recall the misplaced fears of economic "overkill" at the time when the surtax was at last enacted in mid-1968. And lingering sentiments of a similar kind doubtless had something to do with the decision in early 1969 to propose reducing the surtax rate to 5 percent on January 1, 1970 and eliminating it as of July 1, 1970. These judgments gave too much weight to the risks of a possible recession and too little weight to the immediate problem of inflation.

Effective use of fiscal policy in these years was also weakened by a quite different line of argument—that of the monetarists who find an almost surefire mechanical

relationship between changes in the money supply (subject to some variations in definitions) and subsequent changes in gross national product. There is no doubt that the monetarist school has performed a useful service by focusing public attention on the importance of money and credit aggregates. But since the monetarist view in its most extreme form denied any significant role to fiscal policy, it is not surprising that some people who were loath to increase taxes in any case seized on this view as a sophisticated justification for inaction.

On a less sophisticated level, use of fiscal policy as a deliberate weapon against inflation has always suffered from lack of grass-roots understanding of the relationship between higher taxes and price stability. I feel strongly that we have not done a good educational job in explaining, in simple terms, how fiscal and monetary policies are expected to function. For example, there is a tendency to lump tax increases in the same boat with price increases, just as interest rate increases are also often spoken of as abetting inflation. Such views lose sight of the fact that higher taxes and interest rates are designed to dampen spending, thus bringing overall demand more in line with available supplies of goods and services.

I cannot leave the subject of fiscal policy without pointing to the severe handicap which failings in this area placed on the proper functioning of monetary policy. It has been the policy of the Federal Reserve to seek to preserve an "even keel"—that is, to avoid any significant change in policy or money market conditions—while Treasury financing operations are in progress. The constraints imposed by maintaining an "even keel", however, vary rather widely depending on the size and difficulty of the financing, with maturity a major consideration. Treasury tax bill offerings, for example, usually call for only minimal attention, whereas a large refunding may be very touchy indeed.

But "even keel", inhibiting though it may be with respect to timing of monetary policy actions, is a good deal less of a handicap to effective monetary policy than is the simple fact of a huge Federal deficit that must be financed. As an arm of Government, the Federal Reserve has an obligation to avoid acting in a way that could cause the failure of a Treasury issue, although that does not mean that the central bank should, or does, assure the success of particular offerings. The essential point is that the Treasury, like any other borrower, should meet the test of the market by offering terms that make its obligations attractive to investors. However, there is at least a temporary process in which the banking system must be provided with reserves while banks and dealers underwrite the offerings of the Treasury. The reserves may be with-

drawn later to exert pressure on the banks and dealers to distribute the issues to ultimate investors. However, if these offerings come in very large size and quick succession, a substantial bulge in bank credit may be well-nigh unavoidable. For example, in the second half of 1967, when much of the enormous \$25 billion Federal deficit of fiscal 1968 had to be financed, the Treasury was almost constantly in the market, and the very rapid increase in bank credit and the money supply was partly a reflection of this fact.

As we survey the period since mid-1965, I think we must agree that monetary policy made its mistakes, though I would argue that these mistakes were a good deal less flagrant than those of fiscal policy; and, as I have just suggested, some of the failings of monetary policy were directly attributable to a very unsound fiscal environment. There were at least two occasions when, in retrospect, credit was eased too much—in late 1966 and early 1967, and in mid-1968. In both cases excessive fear of recession had much to do with the decisions made, showing that the Federal Reserve has shared to some extent the national predilection for exaggerating fears of recession as compared with those of inflation. The misjudgment in late 1966 and early 1967 was caused partly by an underestimate of the rising force of defense spending. Perhaps an extenuating factor in early 1967 was the unrealized hope that fiscal policy would make a significant contribution, and a related fear that monetary tightening might even jeopardize fiscal action. That of mid-1968 was caused by an overestimate of the dampening influence of a large Federal tax increase (and accompanying restraints on Federal spending). Contrary to expectations, consumers decided to sustain their spending in the face of higher taxes by cutting the proportion of disposable income saved. As a result, total spending and total economic activity continued to rise much faster than expected. The easing of monetary policy in mid-1968 followed six months of rather significant credit tightening. Initially the easing took the form of “accommodating the decline in market interest rates” that developed just before and during the enactment of the Federal tax and spending package. This euphemism seemed to place the Federal Reserve in a somewhat more passive and less aggressive role than if we had made an affirmative decision to ease because of fears that continued restraint plus the fiscal package would constitute too restrictive a program for the economic circumstances. But, semantics aside, the consequences were much the same as a decisive move toward ease. Money and credit grew in the last half of 1968 at a disturbingly fast pace.

Both periods of excessive easing that I have described

were followed by several months during which the System might have reversed these tendencies in the light of continuing economic strength and continuing evidence of inflation. In the fall of 1967 there were in fact a number of occasions when we would have liked to move back to greater restraint but were inhibited by several powerful factors, one of which was the Treasury financing requirements I have already discussed. Another inhibiting factor was recurrent—and probably justified—fears that tightening moves in the United States might be all that was needed to force sterling into a devaluation, a development for which the American monetary authorities would certainly not like to have been responsible. Also, financial markets were becoming increasingly skittish as the second half of 1967 produced growing evidence of strong inflationary forces in the economy, and there were times when we were genuinely fearful that a tightening move might come close to causing panicky market conditions. Finally, with the Administration at last pushing the case actively for much needed fiscal restraint—a case the monetary authorities fully supported—there was naturally some reluctance to step on the monetary brakes and thus indicate skepticism of the ability of the Congress to take timely, responsible fiscal action. Possibly we were influenced too much by all these inhibitions, but I can assure you that they loomed large at the time.

The second period when we might have tightened and failed to do so was in the autumn of 1968. This time we were free of the problem of helping the Treasury to finance an enormous deficit, and we were also free from major worries over sterling. Even concern for market conditions was not a real inhibiting influence, although interest rates were rising to new peaks. But the Federal Reserve itself was deeply split by disagreements on the business outlook, with the majority still fearful of too restrictive a stance while others were convinced that we had no alternative to tightening in view of the clear signs of unchecked and, in fact, growing inflationary pressures and expectations. This latter school of thought finally prevailed in December 1968, but not before an excessively easy policy had produced far too high growth in the major credit and money aggregates.

The monetarist school has seized on these events, which with the benefit of hindsight must be marked down as errors in Federal Reserve judgment, to argue that we would have done much better simply to have permitted a gradual and rather steady growth in the money supply, with a minimum of discretionary policy. I disagree strongly with the suggested remedy. In the summer of 1967, for example, it would have been both unwise and impracticable to ignore the fact of a huge Treasury financing

need and to strive to hold the growth of the money supply to some predetermined low rate. The result could well have been an extremely sharp run-up in interest rates, perhaps accompanied by complete disruption of financial markets. Any disruption of financial markets would, of course, seriously interfere with the flow of credit that is essential to a satisfactory performance of the economy.

Let me add a few more general comments on the monetarist approach. If one assumes a mechanical relationship between changes in the money supply and subsequent changes in gross national product, it is not hard to conclude that the only sound monetary policy is to permit the money supply to increase at some moderate steady rate, for then the economy will grow commensurately, and who could oppose such a happy outcome? But I find grave flaws in this line of argument. In the first place, the velocity of money can change sharply and unpredictably over both long and short periods, at times reinforcing but at others completely offsetting changes in the quantity of money. We are indebted to one of my associates, George Garvy, for an up-to-date review of the role of velocity published last fall under the title "The Velocity of Money". It shows, among other things, that since World War II a larger part of the requirements of our growing economy has been accommodated by increases in velocity rather than by increases in the money supply.

But an even more glaring weakness of the whole monetarist approach is the failure to spell out the process whereby money-supply changes bring about the alleged resulting changes in the economy. This whole area is usually dismissed as too complex to try any analysis of it; hence the reliance on a simple formula that has been "proved" by recorded past events. However, a close study of the alleged proof shows that it is far from conclusive and indeed seems questionable in a number of respects. Let me make clear that the Federal Reserve System does pay, and always has (at least in the postwar years) paid, a great deal of attention to the money supply. We also pay a great deal of attention to changes in total bank credit and other credit and to changes in interest rates, since all these factors can, and do on occasion, exercise a strong influence on changes in the total economy.

It is illusory to think that the application of monetary policy can be reduced to a simple formula focusing on some one measure. To attempt to achieve a steady growth rate for the money supply over any short period would be impracticable, in the light of big random swings in the various elements having an impact on bank reserve positions, and undesirable, as it would cause wild gyrations in other monetary factors capable of affecting eco-

nomic decisions. And, on the basis of post-World War II experience, I simply cannot believe that changes in fiscal policy and in the Treasury's financing requirements can be disregarded while the Federal Reserve pursues a course of expanding the money supply at a fixed rate. In my view, effective central banking will always involve a good deal of human judgment in weighing the importance of all these and other factors in the particular circumstances prevailing at the time when policy is being determined. Undoubtedly our understanding of causation in economic processes will improve over the years, but it will, I think, be a long time before the application of monetary policy can be termed anything like a precise science.

Balance-of-payments considerations did not conflict with domestic monetary policy requirements during the years under review. This was in strong contrast to the situation in the early sixties, when we went through all sorts of contortions to find ways of stimulating the domestic economy without doing undue damage to our balance of payments. Since our payments deficit continued to be a major problem in the second half of the decade, but with inflation our greatest difficulty on the domestic front, it is obvious that the restrictive measures we were able to take were useful from both a domestic and a balance-of-payments point of view.

Since the record of fiscal and monetary policy in checking inflation after mid-1965 has been so unsuccessful, it is perhaps surprising that other means of fighting wage and price increases were not resorted to more vigorously. Direct efforts, through moral suasion, to influence wages and prices might be expected to bring at least some marginal benefits at a time when the more basic policies are laggard. It seems to me that the so-called "guideposts" in the early sixties had considerable educational value in focusing attention on the truism that wage settlements consistently higher than national productivity gains are bound to lead to lower profits or higher prices or both. When the line was broken in 1966 by an excessive settlement in the airlines industry, the Government seemed to lose interest in the guideposts and to assume that any further approach of this kind was futile. Then, with the accession of the new Administration in 1969, there was an apparent determination to rely wholly on fiscal and monetary policies and to steer clear of anything smacking of moral suasion with respect to prices or wages. To my mind this was a case of letting a "hands-off" philosophy get the better of a practical need. I believe that some kind of Government interest in this area, publicly expressed, can play a useful role.

Certainly both wages and prices soared in 1969, with the increases reaching the point where more and more

individuals began to question not only the absence of moral suasion but even the absence of compulsory wage and price controls. In the minds of businessmen, of course, compulsory controls usually mean controls on wages whereas they probably have little thought of accompanying price or profit controls. It should be stressed that rigid controls are likely to prove quite illusory and, at best, of only temporary value.

As we enter 1970, the importance of checking inflation can hardly be exaggerated, whether we think in purely domestic terms or in terms of our balance of payments and the future of the dollar as the key international currency. I have purposely focused today on domestic matters, but I think it fairly obvious that a braking of inflation, by restoring a reasonable trade surplus, provides the greatest hope of a better United States balance-of-payments position.

What are the prospects for an effective domestic stabilization program, in the light of the lessons and disappointments of the past four or five years? To form some estimate, it is useful to give attention to what has been going on in the past year, what momentums have developed, and what changes seem fairly clear in the making. First of all, it is necessary to pay tribute to a vastly improved fiscal situation, at least through 1969, as compared with, say, the huge deficit of fiscal 1968. And it is also appropriate to recognize the consistently strong backing which a firm Federal Reserve policy has received from the Administration.

But there are important qualifications on the fiscal side. The maximum restraining influence of a sounder budget policy has already been felt. The budget is now moving in the other direction, both because of sizable prospective expenditure increases—including enlarged social security outlays, higher Federal pay rates, etc.—and because of recent and prospective tax cuts. I personally think it was unwise to reduce the 10 percent surcharge until success on the anti-inflation front was at least faintly visible. In any case the Federal budget will become increasingly stimulative over the coming months, in the absence of new initiatives designed to check this trend. Secondly, a part of the budget improvement in 1969 was illusory, achieved by taking out of the budget several major Federally sponsored spending programs that were still important economic stimulants and important sources of credit demand. Another possible criticism has to do with the official public stress on gradualism and on the avoidance of recession, which helped to create the kind of belief in a perpetual boom—or a perpetual boom attenuated by only minor interruptions—that has played so big a part in strengthening widespread inflationary expectations and business-

men's capital spending plans.

It seems to me that we face a crucial test of economic policy over the coming months. Will the traditional use of monetary and fiscal policy succeed in checking the course of inflation, or will we as a nation be driven to experiment with more direct controls—a line of experiment which I very much hope we can avoid? Obviously the process by which monetary and fiscal policy can check this long and deeply seated inflation involves a substantial slowing of economic growth, perhaps over a fairly extended period. I realize, of course, that a period of relatively slow economic growth will involve some hardships, such as employment opportunities lost and income foregone. However, I strongly believe that it is better to face up to these hardships now, mitigating them with special programs to help those who are particularly hurt, than to relax our stabilization efforts prematurely, thereby making necessary a much more difficult readjustment in the future. The longer we allow inflation to run unchecked the more painful and costly will it be to bring it under control again.

The slowing of the economy has already commenced; in the fourth quarter, real gross national product was unchanged. But it is by no means clear that the slowing will be lasting enough to prove effective. Inflationary expectations have been built into the economy so strongly over the past four or five years that they cannot be changed easily. I find it hard, given these conditions, to understand the point of view of those who for some time have been clamoring for an easing of policy in order not to run the risk of recession. There is necessarily some risk of recession in the kind of policy we have been applying. If there were not, it would be wholly ineffective. But the opposite evil, inflation, is not merely a risk; it is and has been an actuality. Thus, if we weigh the conflicting risks, we find very strong reasons to hold the line. Of course there are some economists who argue that a serious recession is already assured by reason of the weak performance of the money supply over the past six months. I hope I have already made clear that I see no merit in any such mechanical view. The biggest dangers I see on the horizon are (1) the danger that fiscal policy will be a weaker and weaker ally of monetary policy in the anti-inflation effort and (2) the danger that pressures from outside the Federal Reserve and inside the System itself will prevent our maintaining a sufficiently restrictive policy for a long enough time to turn the trick. Skepticism on this point is unfortunately widespread.

In this connection, provided a suitable combination of monetary and fiscal policy can be put in place, there is much to be said for greater use of Government persua-

sion to induce those who are in a position to determine wage and price levels to exercise great restraint in making these decisions. With inflationary expectations as deeply embedded as they are, this effort might be a helpful, and reasonably costless, supplement to monetary and fiscal policy in achieving acceptable price-cost stability without an excessive slowdown. It might persuade people here and abroad that the Government intends to use all its powers to brake inflation.

I am well aware that maintenance of a firm monetary stance, especially in the event of weakening fiscal support, will tend to keep markets in their highly uncertain state and may continue to cause serious problems for some financial institutions. But special facilities are available to assist the latter, and the Federal Reserve is always in a position to relieve market pressures if the need becomes acute. On the whole it has been reassuring that our financial institutions have been able to remain as viable as they have in the face of the unprecedented interest rate levels we have witnessed in the last few years.

It would not be right, in speaking to bankers, to omit mention of one area where the banks have become increasingly critical of the Federal Reserve. I am speaking, of course, of the use of deposit interest rate ceilings as an instrument of credit control, with all the complex ramifications that are so familiar to you. Let me just say that I believe the System has gone too far in this direction, although it should be recognized that all this time the Congress was exerting great pressure to go even further along this road. There was some obvious attraction in using Regulation Q to put pressure on the banks and thereby to hold down credit growth. It could also be argued that the use of Regulation Q put special pressure on large banks and that this would make credit harder to come by for big corporate borrowers; but this reckoned without the ability of large corporations to bypass the banking system and obtain funds directly in the open market. Moreover,

the Q effort did not take sufficient account of the ability of the banks to devise various escape routes and of the increasingly complex regulations designed to close these loopholes.

Large-scale exploitation of one major alternative source of funds, the Euro-dollar market, tended to intensify the effects of our tight money on foreign nations. This use of Euro-dollars had some immediate balance-of-payments advantages, but it also set the stage for what might become a difficult payments situation if American credit conditions become considerably easier than they are today. For all these reasons I believe that it is none too soon for the System to be thinking hard of ways to soft-pedal this use of rate ceilings as a policy instrument, while still maintaining a firm general policy stance through an appropriate combination of the more traditional instruments of monetary policy. I therefore welcome last week's move to modify some of these ceilings.

I am not pessimistic about the outcome of the anti-inflation campaign. Already there are a few encouraging signs. What we need, as has been true right along, is the conviction of Americans in all walks of life that inflation is a major evil that must be mastered, and the willingness to forego immediate maximum personal gain to help achieve this goal. When a labor union obtains an outrageously high settlement, or when an employing organization blithely accepts such a settlement with the firm intention of passing on the higher cost in the form of higher prices, they are jeopardizing the effectiveness of a fiscal-monetary approach and inviting some drastic, highly undesirable, and probably ineffective, direct Government control. I am hopeful that a spirit of reasonableness will prevail before it is too late. As usual, you bankers are inevitably in the forefront of the effort. I have no doubt that you will use all your powers of persuasion to help assure effective cooperation in this highly worthwhile effort by business, by labor, by Government, and indeed by all our countrymen.

The Business Situation

The nation's real output of goods and services was virtually unchanged in the fourth quarter of 1969, although price increases raised the market value of that output by more than \$10 billion. The latest monthly figures point to continued slackening of economic activity. Industrial output declined in December, maintaining its steady downtrend from the July peak, new orders for durable goods registered a third consecutive monthly decrease, and housing starts fell still lower. Total retail sales in December were essentially unchanged, while successive declines have brought new domestic auto sales to the lowest level in two years, inducing the major producers to make sharp cuts in production. The lack of growth in real gross national product (GNP) in the past quarter has been reflected in slightly higher unemployment but not in any slowing in the rate of price inflation, and wage increases continue to far outstrip productivity rises. Furthermore, consumer purchasing power has been boosted by reduction of the surtax to 5 percent, social security benefit checks will shortly be increased, and the surtax is scheduled to be eliminated in July. In addition, surveys indicate record business capital spending plans for 1970 despite falling corporate profits and tight conditions in the financial markets. A major uncertainty is the extent of fiscal restraint to be achieved this year; it will take a determined effort by the Administration and the Congress to limit the rise of Federal spending.

GROSS NATIONAL PRODUCT

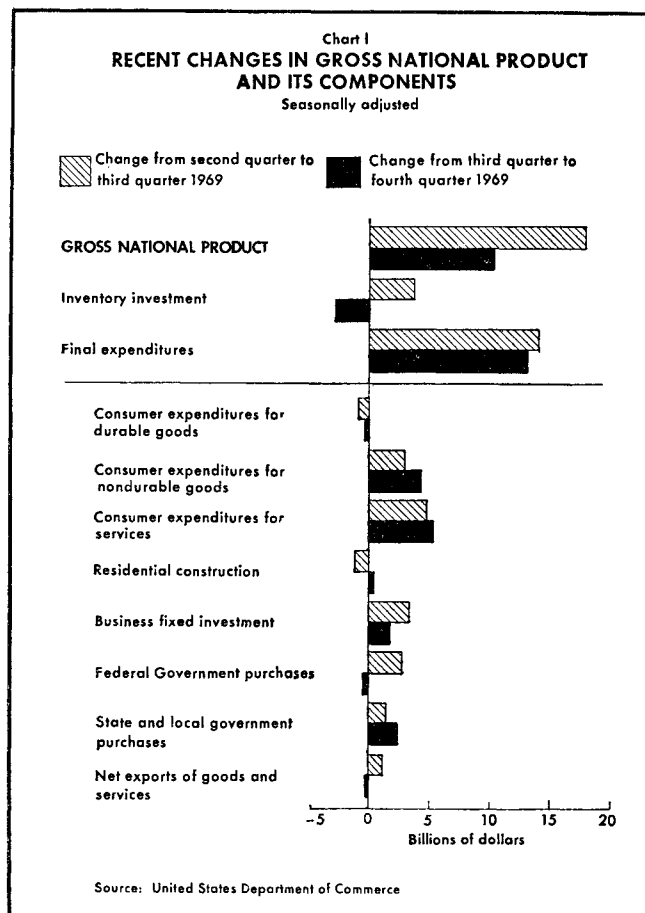
The nation's total output of goods and services as measured in constant dollars failed to rise in the fourth quarter for the first time since the mini-recession of 1967, according to preliminary estimates. The market value of GNP rose \$10.3 billion (see Chart I) to a seasonally adjusted annual rate of \$953.1 billion as the result of price increases. This was the smallest quarterly advance of the year and was partly due to the General Electric strike. In the GNP accounts, most of the slowdown was in the amount of inventory accumulation.

The fourth-quarter decline of \$2.9 billion (preliminary) in inventory accumulation was not an unusually large drop

and was certainly nothing like the abrupt \$10.9 billion swing that marked the first quarter of 1967. (The fourth-quarter preliminary GNP inventory figure is based upon October and November inventories, since December data were not yet available.) On balance, the inventory situation toward the end of 1969 did not show broad-based excesses of the sort which preceded the 1967 mini-recession, although there is evidence of surpluses in some sectors. Durables manufacturers' inventories have been building up recently as sales growth has slackened. In November, inventories of durables manufacturers rose \$445 million, while sales fell almost \$1 billion; as a result the inventory-sales ratio jumped 3.8 percent, with both auto and nonauto durables manufacturers experiencing increases. Non-durables manufacturers experienced a modest rise in inventories and a small decline in sales, but total inventories did not appear to be excessive. At the retail level, markedly lower inventory accumulation at durables outlets resulted mainly from a reduction in inventory growth at auto dealers. Outlets for other durables and non-durables, however, experienced moderate-sized gains in November in the face of sluggish sales, and their already high inventory-sales ratios increased substantially. December data on the manufacturing sector indicate another sharp drop of \$1 billion in durables sales. Meanwhile, durable goods inventories continued to rise, although at a reduced rate, and the inventory-sales ratio increased to the highest level since 1967.

The growth of GNP less inventory change (final expenditures) in the fourth quarter amounted to \$13.2 billion, only two thirds the first quarter of 1969. The quarterly advances of final expenditures were successively less throughout 1969 and, by the end of the year, most components' growth rates were distinctly weaker.

While fourth-quarter consumption expenditures rose \$9.4 billion, compared with a \$7.0 billion advance in the third quarter, the increase was considerably less strong than in the first two quarters, mainly because of a reduction in the purchase of durables. The retail sales figures also indicate lackluster consumer demand. Retail sales, sluggish since the spring of 1969, were essentially unchanged in December. Over the twelve months of 1969,



dollar sales grew only 3.4 percent, while consumer goods prices rose 5.5 percent, suggesting about a 2 percent fall in real sales volume. Approximately half the decline occurred during the fourth quarter of the year, when dollar sales were growing more slowly and prices rising more rapidly than on average during 1969. In particular, unit sales of domestic cars have shown substantial softening. On a seasonally adjusted annual basis, unit sales fell from 8.3 million in November to 7.7 million in December, and in January declined to 6.8 million.

Business fixed investment registered only a relatively small advance in the fourth quarter, increasing \$1.9 billion as compared with \$3.3 billion in the previous quarter. This slowdown had been previously estimated by Department of Commerce and Securities and Exchange Commission surveys of business spending plans. Capital spending surveys also indicate that in the first half of 1970 the annual growth rate of plant and equipment expenditures could be 13½ percent, about the same as during 1969

on the whole and considerably above the fourth-quarter rate.

The near-term outlook for residential construction, however, is for further moderation. Although residential construction in dollar terms actually rose slightly in the fourth quarter after dropping in the second and third quarters, this reflected home repairs and modernization rather than new building. Recent monthly statistics on housing starts have shown steady declines, as individuals have found growing difficulty in obtaining mortgage financing. Private nonfarm housing starts fell 3 percent in December to a seasonally adjusted annual rate of 1.24 million—the lowest level since December 1967. On the average, starts in the fourth quarter of 1969 were at a seasonally adjusted annual rate of 1.30 million units, 23 percent below the average during the first quarter of 1969. Moreover, in November and December, declines in housing activity occurred in the western part of the country, where usury ceilings are generally higher and home building had been relatively strong. The number of newly issued building permits authorizing new private housing units has been declining, and during the last quarter averaged a full 17 percent less than in the first quarter of 1969. The fall in starts and permits took place despite substantial advances to savings and loan associations by the Federal Home Loan Bank Board (FHLBB) and purchases of insured mortgages in secondary markets by the Federal National Mortgage Association. The recent action of the FHLBB permitting savings and loan associations to raise interest rates paid on all types of accounts may reduce the rate of deposit outflow.

Although Government spending has continued to rise, the increases have tended to lessen. In total, Federal, state, and local government spending edged up \$1.9 billion in the fourth quarter, down substantially from the relatively moderate \$4.1 billion rise during the July-September period. National defense spending in the fourth quarter actually fell to a level below that of a year ago. While the growth rate of state and local expenditures was up a bit from the third quarter, the fourth-quarter rate is still considerably below rates registered in the first half. Statutory limitations on interest rates that state and local governments may pay on bonds have impeded financing of expansion in this time of tight credit.

INDUSTRIAL PRODUCTION AND ORDERS

Recent industrial production and new orders data indicate gradual slackening over the months of the fourth quarter. The Federal Reserve Board's index of industrial production fell 0.3 percent in December to 170.9 per-

cent of its 1957-59 level (see Chart II). While the current five-month decline has been the longest continuous monthly downswing in the index since the 1960 recession, the total magnitude of the decline from the July peak has been only 2.1 percent, somewhat less than from December 1966 to May 1967. Furthermore, about one third of the total fall is directly attributable to the General Electric strike, which began in late October.

Reduced auto production has been responsible for about one fourth of the decline in the total production index and is a major reason for the 3.2 percent fall in the output of consumer goods since July. Strikes at General Motors and American Motors plants held auto output down in September-October. In both November and December, Chrysler and General Motors shut down vari-

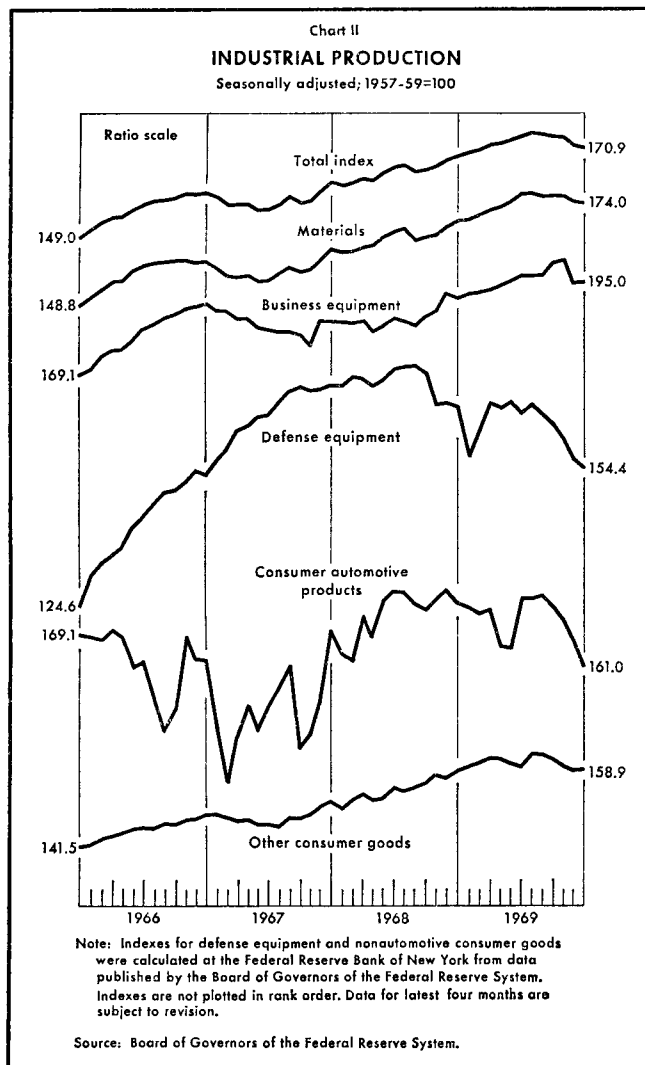
ous plants several days in an effort to cut excessive inventories. In the month of December, assemblies declined a full 8 percent from an annual rate of 7.9 million units to 7.2 million units. The latest information indicates still further cuts in auto production. In January, auto assemblies fell to 6.5 million units (annual rate) as the Ford Motor Company joined the other two major auto producers in reducing output; moreover, the big three auto producers have announced additional layoffs for February. The production of other consumer goods, which began to decline before the onset of the GE strike, was 2.4 percent below the July level at the year-end.

Other categories of output have also fallen. Business equipment production had been quite strong until November, the first full month of the GE strike, when it plunged 3.3 percent. In December, there was only a slight recovery. Decreases in defense equipment output, however, have totaled 9.2 percent since July, and account for about 10 percent of the July-December decline in the total industrial production index. After a large drop in November, materials production edged down in December, with both the iron and steel component and the other materials component reaching levels about 1.4 percent below July. Moreover, ingot production, which is about half of the iron and steel component, declined 6 percent in January.

Another indication of slowing is that new orders received by manufacturers of durable goods have dropped. The orders series fell 4 percent in December to a level that is 8 percent below the September peak. This was the third consecutive month of decline. The December fall was entirely in the transportation equipment category, reflecting slower spending on autos and national defense.

EMPLOYMENT AND PERSONAL INCOME

The aggregate unemployment rate and other labor market indicators have suggested an easing of labor market conditions. The January unemployment rate of 3.9 percent was somewhat above the revised fourth-quarter average rate of 3.6 percent and showed an increase of joblessness in most age-sex categories. Other labor market indicators have shown reduced tightness over the fourth quarter, and January data suggest further moderation. The insured unemployment rate (the percentage of covered individuals receiving unemployment insurance benefits) was up significantly in November and December. Nonagricultural payroll employment has failed to grow from November through January. Furthermore, the average factory workweek in the last quarter of 1969 was down a bit, and in January there was a particularly sizable drop: the average workweek for factory workers in January fell from 40.6 hours



to 40.2 hours, while average overtime declined from 3.5 hours to 3.2 hours, the lowest level since mid-1967.

These factors, together with the GE strike, account for much of the reduction in the growth of personal income. Personal income increased by a modest \$2.3 billion in December, bringing the average annual rate of growth during the fourth quarter of 1969 to 4.7 percent, down substantially from the annual rates of 7.8 percent in the third quarter and 8.4 percent in the first half. The more modest increases in personal income reflected a reduction in the growth rate of wage and salary disbursements, from 9.0 percent (annual rate) in the third quarter to 5.6 percent in the last three months of the year.

PRICE AND WAGE DEVELOPMENTS

Despite the current slowing of economic activity, there has been no apparent effect as yet on the rate of inflation. Wholesale industrial prices advanced at an annual rate of 4.2 percent in January, as prices of metals and metal products rose sharply. The January increase, about the same as that in December, was in line with the average price rise during the last half of 1969.

Recent increases in consumer prices belie earlier indications of slowing in the rate of inflation. It now appears that the third-quarter rate of 5.3 percent was not indicative of a downward trend in price increases: in December, consumer prices rose at a 7.4 percent annual rate, bringing the fourth-quarter annual rate of advance to 6.2 percent which is just about the same as the average rate

during the first half of 1969. Overall, consumer prices rose 6.1 percent in 1969, compared with 4.7 percent in 1968. In fact, the rise from December 1968 to 1969 was the greatest twelve-month increase since the November 1950-November 1951 Korean war period. The huge December jump reflected a sharp rise in food prices, particularly those of fresh vegetables and eggs, and a large increase in the prices of consumer services.

Wage increases have also been large and well in excess of productivity gains. The rapid rise of labor compensation accompanied by lagging productivity resulted in substantial increases in unit labor costs in the private sector during 1969. The rise was almost 7 percent, compared with 5 percent in 1968, mainly because of much smaller productivity increases. Man-hour productivity recovered somewhat over the year, however, and the annual rate of increase of unit labor cost declined from 7.3 percent in the first quarter to 6.0 percent in the fourth quarter.

Furthermore, provisions of 1969 labor contracts covering 1,000 or more workers suggest that wages will rise rapidly over the near term as well. The median per annum wage and fringe benefit increase negotiated in 1969 major labor contracts was 7.4 percent, a substantial acceleration from the 6.0 percent per year median negotiated in 1968 contracts. Moreover, most of the contracts were front loaded—as has been typical in recent years—and provide in the first year of the contract for an 8.2 percent increase in wages alone; in 1968 the median advance in wages during the first year of the contract was 7.2 percent.

Banking and Monetary Developments in the Fourth Quarter

The fourth quarter of 1969 rounded out a full year of sustained monetary stringency. While bank credit growth in the quarter recovered somewhat from a near halt in the previous quarter, the growth of all monetary aggregates remained severely restricted. Member bank reserve positions were under considerable pressure, and the continuation of monetary restraint and strong credit demands resulted in new short- and long-term interest rate highs. The rise of market rates in the face of unchanged deposit ceilings continued to affect time and savings deposits adversely. The Board of Governors of the Federal Reserve System took a number of regulatory steps, however, to reduce the attractiveness of nondeposit sources of funds.

INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

The strong upward movement in short-term interest rates, which characterized the first three quarters of the year, continued on balance over the final months of 1969. Although most money market rates fell in October under the impact of peace rumors and expectations of reduced inflationary pressure, they climbed again in both November and December. Over the final quarter, the discount on three-month Treasury bills rose by 73 basis points to an average of 7.81 percent in December for a new high and rates on commercial paper and bankers' acceptances also showed sizable increases. Yields on intermediate- and long-term Treasury issues rose markedly over the quarter as well. A heavy volume of Federal agency and corporate new issues in November and considerable selling for tax purposes in December contributed to the substantial rate increases, as did the \$8.3 billion new cash offerings by the Treasury. The average yield on United States Government securities maturing in three to five years jumped 40 basis points to an average of 7.98 percent in December, and yields on long-term Government bonds rose to record levels shortly before the end of the year. Rates also moved up strongly in the corporate bond market: the average rate on new issues of high-quality

corporate bonds rose by about 81 basis points over the quarter to an average of 8.83 percent in December.

These interest rate increases resulted from strong credit demands during a time of severe monetary restraint. Member bank reserve positions continued under pressure in the October-December period, and net borrowed reserves remained high. Net borrowed reserves, which are not adjusted for seasonal variation, represent the amount by which member bank borrowings at the Federal Reserve Banks exceed member bank excess reserves. The level of these reserves was close to \$1 billion in both October and November, but was allowed to move somewhat lower in December to accommodate the heavy increase in financial transactions typical of the month. The effective rate on Federal funds declined substantially in October along with most other money market rates, but it moved up again in each of the last two months of the year, averaging 8.97 percent in December.

Required reserves of member banks increased \$400 million in the week ended on October 22 because of the August 13 amendments to Federal Reserve Regulations D and M. The amendment to Regulation M established a 10 percent reserve requirement on net borrowings by member banks from their foreign branches to the extent that such borrowings exceed the daily average amounts outstanding in the four weeks ended on May 28, 1969. This marginal reserve requirement also applies to most assets which are acquired by foreign branches from their United States head-office banks. The amendment to Regulation D established an equivalent 10 percent reserve requirement on member bank direct borrowings from foreign banks.

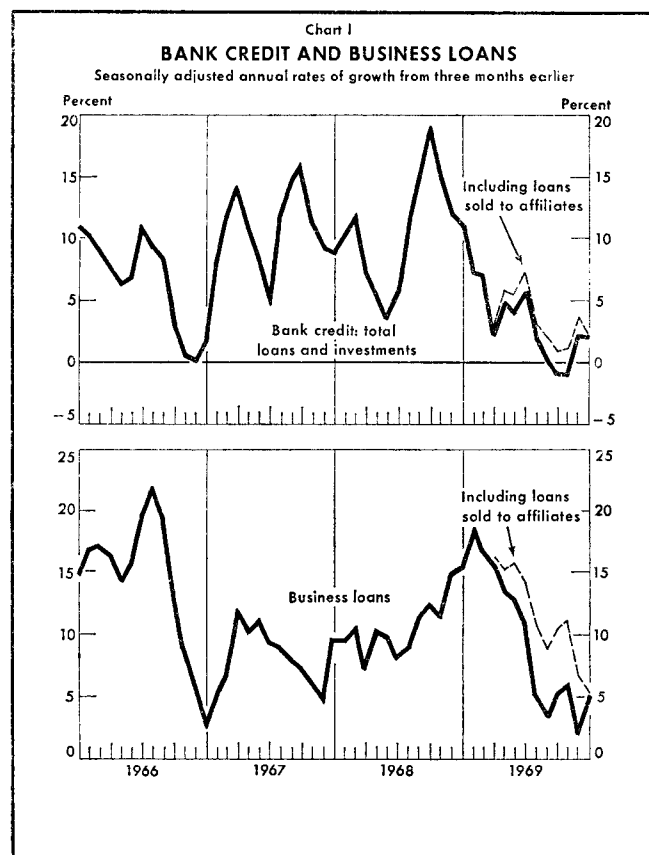
BANK CREDIT

Bank credit growth in the October-December period recovered a little from the very low level to which it had fallen in the third quarter. The fourth-quarter increase, including an adjustment for loans sold, was at a 2.3 percent seasonally adjusted annual rate, compared with a

third-quarter rate of 0.8 percent. Since expansion of bank credit had been somewhat higher earlier in 1969, the last two quarters brought the rate for the year as a whole down to 3.3 percent from the 11.0 percent gain posted in the previous year (see Chart I). Certain loans sold by the banks have been included in the figures for 1969 in order to obtain a more accurate measure of the volume of credit originating in the banking system. Loans were sold by the banks over the year primarily to their branches and affiliates in order to gain access to an additional source of funds during a period of heavy deposit losses. Although these loans no longer appear on the banks' balance sheets, their sale financed a part of the total credit extended by the banking system in 1969. In dollar terms, the annual gain in bank credit as it appears on the balance sheets of the banks totaled \$9.1 billion, while loans sold by the banks amounted to an additional \$3.9 billion of credit during the year. The resulting \$13 billion is not only far below the \$39 billion recorded in the previous year, but is also smaller than the increase in any year since 1960. In 1966, when monetary restraint sharply reduced bank credit growth in the second half of the year, the advance in bank credit totaled \$17.5 billion.

The rise in fourth-quarter 1969 bank credit consisted of a moderate increase in total loans partially offset by a contraction in total investments. This pattern, characteristic of periods of monetary restraint, had also been evident in each of the previous quarters of 1969, as banks reduced their holdings of investments in order to accommodate loan activity. Over the fourth quarter, total investments held by the banks fell at a seasonally adjusted annual rate of 9.3 percent, about equal to their decline during the third. The reduction in bank investment holdings was particularly sharp in December and may have been associated with provisions of the Tax Reform Act of 1969, signed into law at the end of December. Under the new legislation, banks may have found it advantageous to sell certain securities before the year-end.

All the fourth-quarter contraction in bank investments was in holdings of United States Government securities which had been built up before 1969. Holdings of Treasury bills at all weekly reporting banks had more than doubled during the second half of 1968, and holdings of short-term Treasury notes and bonds had also risen during that period. Liquidation of these investments over the first nine months of 1969 reduced their level considerably and, with the further reduction during the fourth quarter, seasonally adjusted bank holdings of United States Government securities fell to \$51.8 billion at the end of December—the lowest level since the beginning of the series in 1948. The previous low point had



occurred under similar circumstances during the second half of 1966. Bank holdings of other securities—primarily state and municipal obligations—were unchanged on balance in the fourth quarter, but over 1969 holdings of these securities dropped by \$0.8 billion for their first annual decline in ten years.

The growth of the loan component of bank credit during the fourth quarter consisted partly of a sharp increase in the volume of securities loans—credit extended to stockbrokers and securities dealers. After having shown a net decline in the third quarter, securities loans rose over the last three months of the year at a 32.6 percent seasonally adjusted annual rate. Much of this increase is associated with the fact that securities dealers were financing a higher level of inventories after rebuilding depleted inventory positions toward the end of October. Securities loans frequently show relatively large short-term fluctuations as dealer inventory positions vary. If these loans are excluded from the data, total loans including those sold grew in the fourth quarter at a seasonally adjusted annual rate of 6.6 percent.

An increase in business loans accounted for the largest part of the absolute increase in loans less securities loans over the fourth quarter. The outstanding volume of loans extended to business appearing on banks' balance sheets increased by \$1.3 billion on a seasonally adjusted basis. A substantial amount of business loans does not appear on the banks' books because these loans have been sold to affiliates and branches. The growth of business loans including those sold proceeded at a seasonally adjusted annual rate of 5.3 percent over the fourth quarter, a notable deceleration from the 10.5 percent rate of growth over the preceding three-month period (see Chart I). Indeed, throughout 1969 such business loans have shown successively smaller rates of growth in each quarter. Since business loan demand has continued to be heavy, the markedly slower growth of such loans over the last three months of the year would seem to reflect increasing restrictions on the supply of these loans as the period of monetary restraint lengthens.

Credit extended to nonbank financial institutions increased during the final quarter of the year at a 22.4 percent seasonally adjusted annual rate of growth, after having declined on balance over the previous three months. Loans to finance companies accounted for the bulk of the gain in this category, as a large volume of their commercial paper ran off at the year-end. The finance companies may have turned to the banking system as a temporary source of funds instead of issuing new paper at a time when financial markets faced heavy seasonal demands for liquidity.

The seasonally adjusted volume of real estate loans outstanding grew at a 5.8 percent annual rate over the final quarter of the year. This represents a somewhat more rapid gain than that of the preceding three-month period, but the rate of advance continued well below that seen in the first half of the year. Loans to consumers also expanded at a slightly more rapid pace relative to the preceding quarter, growing at an annual rate of 5.9 percent. On balance over the second half of the year, however, a deceleration in this category is evident as well.

MONEY SUPPLY AND TIME DEPOSITS

Over the final quarter of 1969 the narrowly defined money supply—currency held by the public plus demand deposits adjusted—continued to reflect the impact of a policy of restraint. On a seasonally adjusted basis, this aggregate grew at a rate of only about 1½ percent in the fourth quarter, slightly above its zero rate of growth over the preceding three-month period. These increases brought the rate of growth of the money supply over all of 1969

to 2.5 percent, a sharp contrast with rates of growth of approximately 7 percent in each of the two preceding years. The fourth-quarter rise resulted from moderate currency growth throughout the period and an unusual late-December bulge in demand deposits. The bulge was partly associated with the clearing of Euro-dollar transactions during the holidays, as European banks were closed from Christmas Day through the following Sunday, while United States banks were open on December 26. A similar aberration occurred in April 1969 over the Good Friday and Easter weekend.

The total volume of time and savings deposits at all commercial banks in the fourth quarter was essentially unchanged on a seasonally adjusted basis, compared with the previous quarter's 13 percent decline. Weekly reporting bank data, which are not adjusted for seasonal variation, suggest that an increase in the volume of both large certificates of deposit (CD's)—those in denominations of \$100,000 or more—and other time and saving deposits at the New York City banks partially accounts for this performance. Other time and savings deposits at New York City banks rose \$0.4 billion and CD's \$0.7 billion over the fourth quarter, while banks outside New York City lost \$0.6 billion in other time and savings deposits and \$1.6 billion in CD's. This development reversed the trend of heavy time deposit and CD losses at banks in New York City (see Chart II).

This turnaround may be linked to Federal Reserve Board regulatory changes that may have led some foreign official depositors to shift funds from the Euro-dollar market to New York City banks, where the bulk of foreign official time deposits and CD's in this country have traditionally been held. A November amendment to Regulation Q broadened the number of foreign official institutions qualifying for exemption from the interest ceilings. The August amendments to Regulations D and M subjected United States banks' Euro-dollar borrowing over a base amount to a 10 percent reserve requirement. Time deposits and CD's are subjected to a 6 percent reserve requirement, and United States banks may have found it advantageous to borrow additional funds directly from foreign official institutions rather than indirectly through their foreign branches.

Despite this fourth-quarter reversal at New York City banks, the CD runoff has been prolonged and severe. The differential between the maximum interest rates payable on large CD's and yields available on alternative investments began to widen in November 1968. From the end of that month until the end of December 1969, CD's at all weekly reporting banks declined \$13.4 billion, reducing the total volume of CD's outstanding to \$10.9

billion—their lowest level since April 1964 when such deposits were being built up. The CD runoff of 1969 was thus much larger than that of 1966, when the fall in CD's during the second half totaled \$2.6 billion. During the last half of 1966 the most frequently quoted rate on 30- to 89-day CD's was slightly above the Treasury bill rate on a monthly average basis, and was at most about 40 basis points below the rate on three- to six-month commercial paper. By mid-1969 the spread between CD's and the three-month Treasury bill rate was about 100 basis points, and by the year-end had reached about 250 basis points; the spread between the CD and commercial paper rates was even greater. While disintermediation has been a severe problem during the past year, recently announced changes in Regulation Q may help stem the outflow of time deposits from commercial banks in the future. (For details, see box on page 39.)

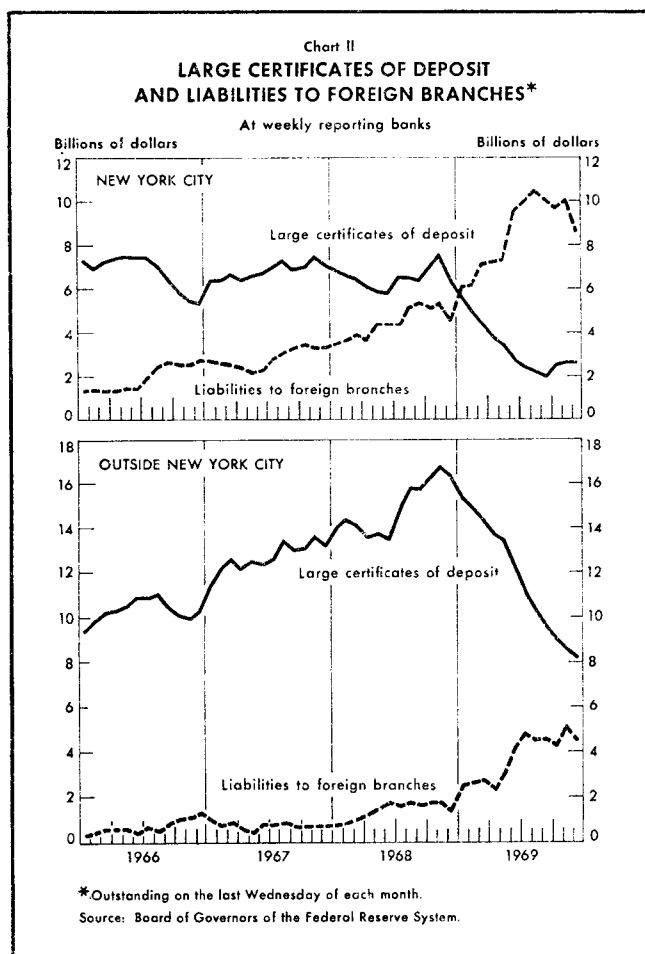
In a related action, the Board announced at the same

time its proposal to apply a 10 percent reserve requirement on funds obtained by member banks through the issuance of commercial paper or similar obligations by bank holding companies or affiliates. Banks have used the sale of commercial paper by their affiliates to obtain funds from a nondeposit source during a period of deposit contraction. The proceeds of these sales have been channeled back to banks primarily through the purchase of loans from the banks' portfolios by the affiliates. The Board's dual moves on the revision of interest rate ceilings and the proposal regarding funds obtained from the sale of commercial paper were undertaken within the framework of continued monetary restraint. The Board stated that the simultaneous measures were based on considerations which included a rebalancing of the Board's regulatory structure in the light of recently expanded authority in this field, a readjustment of the structure of maximum interest rates payable on commercial bank deposits to bring it more in line with yields on market securities, and a desire to encourage long-term savings in reinforcement of anti-inflationary measures.

The volume of bank-related commercial paper has grown substantially in recent months. Over the fourth quarter, such obligations increased by \$1.7 billion, bringing the total volume outstanding to \$4.2 billion at the year-end. The bulk of the fourth-quarter increase in commercial paper issued by bank affiliates occurred during the first month of the period, with somewhat smaller increases in November and December. The deceleration occurred subsequent to the announcement on October 29 by the Board that it was considering amending Regulation Q to include funds obtained from the sale of commercial paper by a bank's parent company or collateral affiliates, and that similar obligations by bank subsidiaries were already subject to Regulation Q ceilings and Regulation D reserve requirements. The application of this latter ruling was subsequently extended until February 26. The Board has since withheld action in applying interest rate ceilings to commercial paper issued by parent companies or affiliates, while it is considering amending its rules to apply reserve requirements to such obligations.

THRIFT INSTITUTIONS

Deposit growth at thrift institutions continued to be adversely affected during the quarter, as depositors were attracted by the increasingly higher yields available in alternative investments. Following the crediting of third-quarter interest payments, combined deposits at savings and loan associations and mutual savings banks experienced an actual contraction in October, the first monthly



decline in this aggregate on a seasonally adjusted basis since July 1966. Over the period as a whole, deposits at both institutions increased at a seasonally adjusted annual rate of just over 1 percent.

In order to mitigate somewhat the potential deposit losses facing savings and loan associations, particularly at the year-end when a heavy volume of savings certificates was scheduled to mature, the Federal Home Loan Bank Board on December 15 authorized the payment of up to 6 percent on "special housing certificates of deposit". The rate applied only to deposits of \$10,000 or more which existed as of December 15, 1969, and the new certificates were offered in maturities of from two to five years. An additional move to stem disintermediation was made by the Home Loan Bank Board at the time of the Federal Reserve Board's revision of interest ceilings under Regulation Q. The measure revised upward the maximum rate payable by savings and loan associations throughout the deposit-maturity structure. A similar measure was also carried out by the Federal Deposit Insurance Corporation with regard to mutual savings banks. (For details, see box on page 39.)

Although mortgage lending at thrift institutions slowed in the October-December period, the deceleration was not so severe as recent deposit experience would suggest. Mortgage holdings at savings and loan associations and mutual savings banks grew at a 4.3 percent seasonally adjusted annual rate in the fourth quarter, compared with 5.5 percent in the third. Even with this moderate slowing, it is of note that during 1969 mortgage lending was better maintained than in the 1966 period of monetary stringency. At that time, mortgage lending by mutual savings banks and savings and loan associations slowed to about 2 percent from the end of June to the end of October, when deposit growth was weakest. The major factor contributing to the improved condition in 1969 was an increase in borrowing by savings and loan associations from the Federal Home Loan Banks. In 1969, deposits at the savings and loan associations grew by approximately \$4.5 billion—not greatly above the \$3.6 billion increase in 1966; but during 1969 Federal Home Loan Bank advances to these associations of about \$4 billion almost matched the gain in deposits, whereas in 1966 advances rose by only about \$1 billion.

The Money and Bond Markets in January

Attention in the market for Government coupon issues was focused during much of the month on the Treasury's February refunding, for which terms were announced after the close of business on January 28. Prior to the announcement, there was considerable anticipatory selling by dealers of outstanding issues with maturities in the range expected to be offered in the February refunding. It was generally thought that the refunding would be a "rights" rather than a cash offering and that it would also include an advance refunding of the bonds due on March 15. Since only holders of maturing bonds would be eligible to buy the new issues in a rights refunding, there was increased demand for both the February and March maturities prior to the announcement. During the first half of the month there was an improved tone in the coupon market, reflecting the favorable performance in the corporate bond market and further indications of a slowdown in economic activity. Despite some deterioration later in the period, over the month as a whole price gains of from $\frac{3}{8}$ to $1\frac{3}{8}$ points occurred on most issues other than those under pressure from the awaited refunding.

The terms of the February refinancing were as follows: holders of some \$4.4 billion of 4 percent Treasury bonds maturing February 15 and almost \$2.3 billion of $2\frac{1}{2}$ percent bonds due on March 15 were offered three issues in exchange. These included an $8\frac{1}{4}$ percent 18-month note, an $8\frac{1}{8}$ percent $3\frac{1}{2}$ -year note, and an 8 percent 7-year note, all priced at par. The offering rates were the highest on comparable issues in more than a century, and initial market reaction was quite favorable. The public holds about \$5.6 billion of the maturing bonds, and about \$1.1 billion is held by Federal Reserve and Government accounts. Subscription books were open from February 2 through February 4.

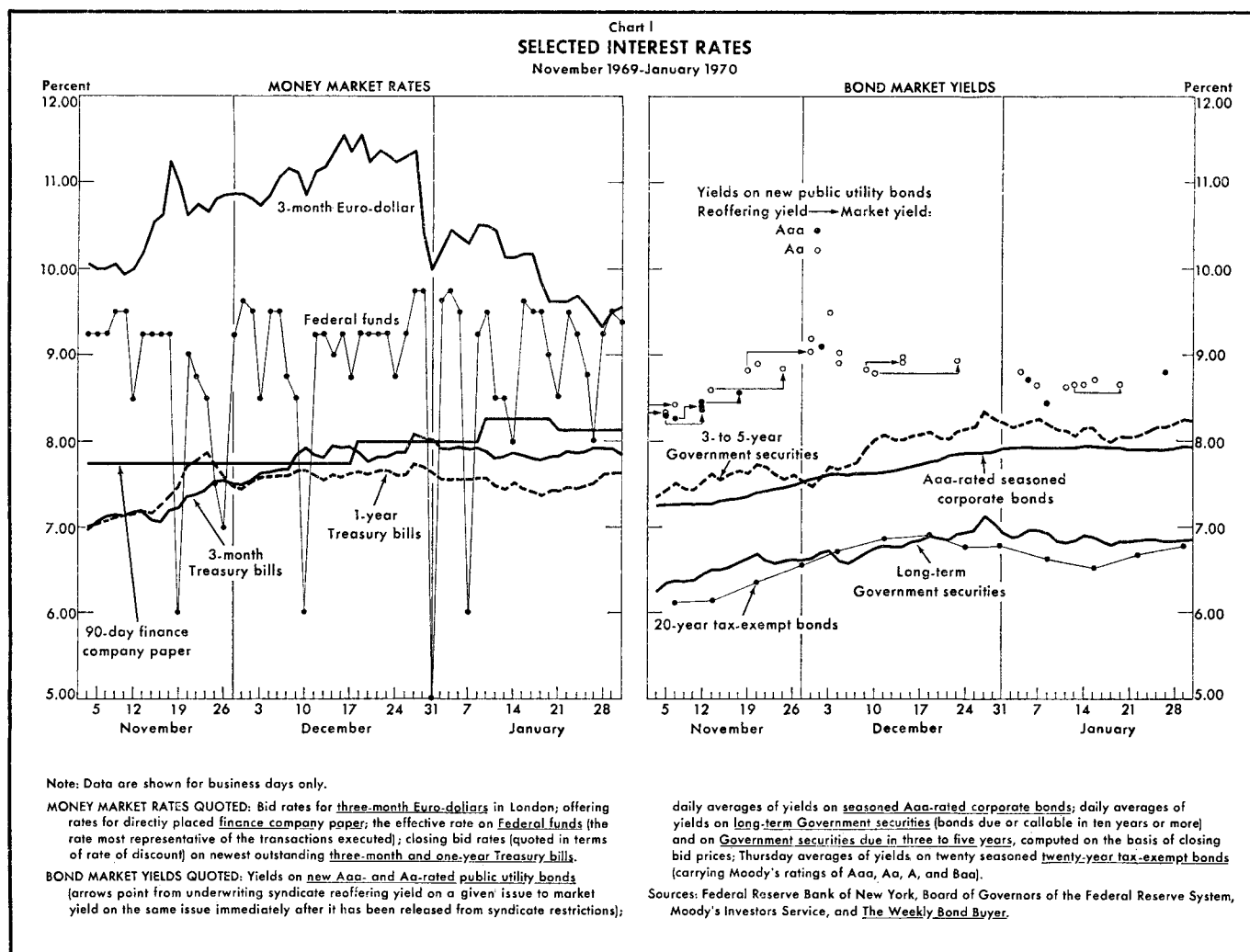
Rates on Treasury bills also declined in January, partly in response to considerable demand from individual investors. Noncompetitive tenders, which are usually utilized by small investors, accounted for more than one third of new bills awarded in the first three weekly auctions, well

above the proportion at the start of earlier years. Average issuing rates on new three- and six-month bills moved steadily lower during this period, as those with competitive tenders bid aggressively for the remaining supply. Subsequently, small investor interest declined somewhat, and rates backed up as high financing costs discouraged dealers from adding to their positions.

Renewed investor interest was also evident in the corporate and municipal bond markets early in the month, and rates on new offerings were generally several basis points lower than those on issues sold in mid-December, prior to the holiday lull. However, faced with heavy calendars of new issues and limited interest on the part of institutions, both markets encountered resistance as the month progressed, and toward the end of January both interest rates and the volume of unsold bonds began to move higher.

The average effective rate on Federal funds edged up to 9 percent in January, and offering rates on longer term directly placed commercial paper also moved higher. The rate on prime four- to six-month dealer-placed paper declined, however, by $\frac{1}{2}$ percentage point and the bid rate on ninety-day bankers' acceptances by $\frac{3}{8}$ percentage point. Both member bank excess reserves and borrowings at the Federal Reserve Banks also declined on average during the month.

Several changes were enacted or proposed by the authorities regulating depository institutions during the month. On January 20 the Board of Governors of the Federal Reserve System raised the ceilings on interest rates member banks may pay on time and savings deposits to $4\frac{1}{2}$ percent on passbook accounts and a maximum of $7\frac{1}{2}$ percent on large certificates of deposit with maturities of a year or more. At the same time the Board published for comment a proposal to impose a 10 percent reserve requirement on funds obtained by member banks through the issuance of commercial paper or similar obligations by bank affiliates, including a member bank's parent company—either a one-bank holding company or a company registered under the Bank Holding Company Act.



On the same day the Federal Deposit Insurance Corporation issued identical new interest ceilings for the commercial banks under its jurisdiction and comparable changes for the mutual savings banks which it supervises. There was no change in the 5 percent maximum which savings banks may pay on passbook accounts, but they may now pay $5\frac{1}{4}$ percent on ninety-day notice accounts and are permitted to offer certificate accounts at rates as high as $7\frac{1}{2}$ percent. The following day the Federal Home Loan Bank Board announced new ceilings for the savings and loan associations under its jurisdiction. The passbook rate was raised to 5 percent (most associations had been limited to $4\frac{3}{4}$ percent), and rates on certificates were raised to a maximum of $7\frac{1}{2}$ percent on those of \$100,000. (For further details, see the box on page 39.)

BANK RESERVES AND THE MONEY MARKET

Money market conditions continued firm during January, with member banks bidding aggressively for Federal funds much of the time as seasonal churning produced uncertainties concerning reserve positions. Over the month as a whole the effective rate on Federal funds averaged 9 percent, slightly higher than the average in December. The effective rate declined at the close of each of the first three statement weeks in its usual pattern (see Chart I) but, in the first two, this was in part the result of unexpectedly large increases in float earlier in the week. Despite the general easing of the effective rate at the close of these periods, some trading did occur at rates as high as 11 percent late on the January 14 and January 21

settlement days when last minute buyers encountered a restricted supply. During the final statement week the effective rate moved progressively lower as reserves shifted toward the major money center banks. Accumulated reserves were absorbed by Wednesday, however, and the effective rate rose $1\frac{1}{4}$ percentage points on that day. The enlarged availability of reserves from operating factors led average borrowings at the discount window to decline to \$928 million in January (see Table I) from \$1,127 million in the preceding month. Since average excess reserves also declined by \$113 million, however, net borrowed reserves were reduced by only \$85 million, on average, to a level of \$767 million.

In a largely seasonal reversal of the December pattern, the forty-six money center banks decreased their average loans and investments by \$5.9 billion during January. However, the December rise and January fall apparently also reflected the shifts of loans between the banks and their holding companies and affiliates related to the establishing of a favorable tax position at the end of the year. Mainly as a result of the January decrease in loans and investments that offset sizable deposit outflows, the aver-

age basic reserve deficit of these banks declined by \$1.3 billion from the statement week ended on December 31 to that ended on January 28.

Over the first two statement weeks in January the average basic reserve deficit of the forty-six banks deepened by \$1.4 billion despite a \$3.3 billion contraction of loans and investments. The deterioration resulted primarily from a substantial net outflow of all types of deposits. In addition, the banks also reduced their Euro-dollar and other borrowing and had a large increase in required reserves based on their liabilities of two weeks earlier.

The trend was reversed during the last half of the month when the basic reserve position of the money center banks showed a marked improvement (see Chart II). The deficit at the eight New York City banks declined by \$1.6 billion and that at the thirty-eight other banks by \$1.2 billion (see Table II). Although deposits in private demand and time accounts continued to decline, there was a large rise in United States Government deposits during this period. Moreover, there was a reduction of some \$500 million in required reserves. A further \$2.7 billion runoff of loans and investments combined with these factors to produce most of the improvement over the final two weeks.

System open market operations absorbed \$2,025 million of reserves during January through outright sales, matched sale-purchase transactions, and maturities of repurchase agreements. Market operating factors provided reserves totaling \$2,432 million on a daily average basis largely through a decline in currency in circulation and an increase in the gold stock.

The money supply expanded at a seasonally adjusted annual rate of 9.0 percent in January, according to preliminary data. Over the three months ended in January the money supply grew at a 4.2 percent annual rate, compared with a 0.4 percent decline in the July-to-October period and a 2.5 percent rise for 1969 as a whole. Total member bank deposits subject to reserve requirements, adjusted to include Euro-dollar and other nondeposit liabilities, declined at a seasonally adjusted annual rate of 3.1 percent in January; the increase for the quarter ended in January was 3.4 percent, compared with a decline of 4.0 percent for the previous three months and essentially no change for the year 1969 as a whole.

THE GOVERNMENT SECURITIES MARKET

Most Treasury coupon issues registered price gains during January, with the exception of some intermediate maturities and a few bonds due after fifteen years. The price declines on intermediate issues largely reflected

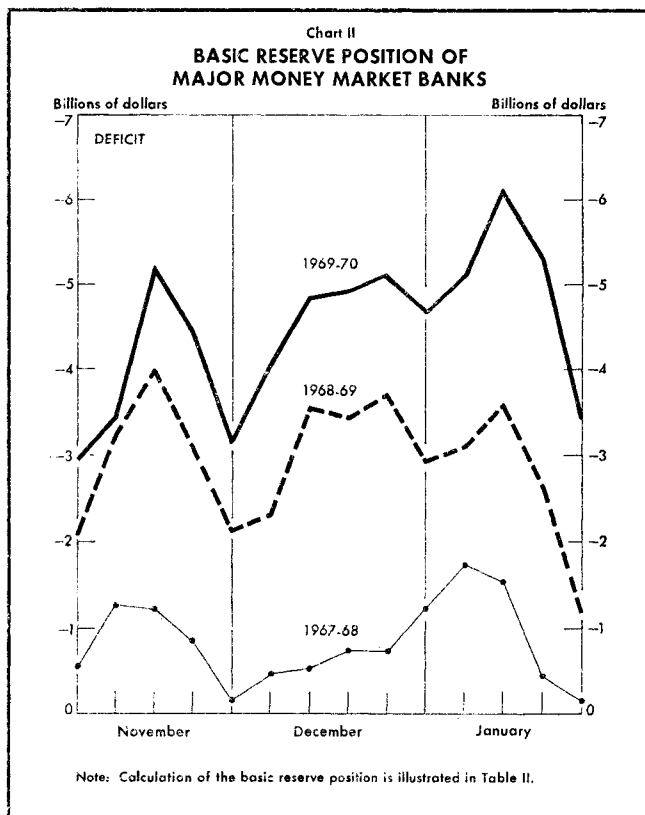


Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, JANUARY 1970

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

Factors	Changes in daily averages— week ended on				Net changes
	Jan. 7	Jan. 14	Jan. 21	Jan. 28	
"Market" factors					
Member bank required reserves	- 283	- 473	- 296	+ 614	- 238
Operating transactions (subtotal)	+ 197	+ 2,137	+ 438	- 340	+ 2,432
Federal Reserve float	- 289	+ 71	- 160	- 527	- 905
Treasury operations*	+ 145	+ 6	+ 161	- 88	+ 224
Gold and foreign account	- 44	+ 1,226	+ 20	+ 24	+ 1,226
Currency outside banks	+ 215	+ 1,011	+ 470	+ 303	+ 1,999
Other Federal Reserve accounts (net) ..	+ 170	- 178	- 53	- 52	- 113
Total "market" factors	- 86	+ 1,664	+ 142	+ 474	+ 2,194
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	- 171	- 1,055	- 61	- 738	- 2,025
Outright holdings:					
Government securities	- 174	- 688	- 57	- 738	- 1,652
Bankers' acceptances	+ 3	+ 2	- 4	-	+ 3
Repurchase agreements:					
Government securities	+ 30	- 296	-	-	- 266
Bankers' acceptances	- 4	- 35	-	-	- 39
Federal agency obligations	- 28	- 43	-	-	- 71
Member bank borrowings	- 350	+ 10	+ 102	+ 62	- 76
Other Federal Reserve assets†	+ 251	- 857	+ 13	+ 146	- 447
Total	- 170	- 1,902	+ 54	- 530	- 2,548
Excess reserves	- 256	- 238	+ 196	- 56	- 354

Member bank:	Daily average levels				
	Jan. 7	Jan. 14	Jan. 21	Jan. 28	
Total reserves, including vault cash	28,700	28,935	29,437	28,577	28,910‡
Required reserves	28,444	28,917	29,213	28,399	28,743‡
Excess reserves	256	18	214	158	162‡
Borrowings	854	864	968	1,028	928‡
Free, or net borrowed (-), reserves	- 598	- 846	- 752	- 870	- 767‡
Nonborrowed reserves	27,846	28,071	28,461	27,549	27,982‡
Net carry-over, excess or deficit (-)† ..	215	187	64	93	130‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels				
	Jan. 7	Jan. 14	Jan. 21	Jan. 28	
Less than one year	- 463	- 992	+ 456	- 587	- 1,586
More than one year	-	-	-	-	-
Total	- 463	- 992	+ 456	- 587	- 1,586

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Average for four weeks ended on January 28.

§ Not reflected in data above.

Table II
RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS
JANUARY 1970

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Average of four weeks ended on Jan. 28
	Jan. 7	Jan. 14	Jan. 21	Jan. 28	
Eight banks in New York City					
Reserve excess or deficiency (—)*	11	— 21	42	— 20	1
Less borrowings from Reserve Banks....	196	234	75	86	148
Less net interbank Federal funds purchases or sales (—)	1,215	1,407	1,248	— 3	966
Gross purchases	2,351	2,532	2,475	1,658	2,254
Gross sales	1,136	1,125	1,222	1,661	1,289
Equals net basic reserve surplus or deficit (—)	—1,400	—1,662	—1,276	— 112	—1,113
Net loans to Government securities dealers	980	811	568	486	711
Net carry-over, excess or deficit (—)†..	76	16	10	34	34

Thirty-eight banks outside New York City

Reserve excess or deficiency (-)*	198	- 74	34	74	53
Less borrowings from Reserve Banks ..	327	281	240	217	291
Less net interbank Federal funds purchases or sales (-)	3,576	4,061	3,755	3,152	3,644
Gross purchases	5,276	5,688	5,429	4,961	5,389
Gross sales	1,700	1,597	1,674	1,809	1,695
Equals net basic reserve surplus or deficit (-)	- 3,705	- 4,446	- 4,061	- 3,295	- 3,877
Net loans to Government securities dealers	207	231	189	101	207
Net carry-over, excess or deficit (-)† ..	33	58	- 30	8	17

Note: Because of rounding, figures do not necessarily add to totals.
reserves.

* Reserves held after all adjustments applicable to the reporting period less required

† Not reflected in data above.

Table III
AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—January 1970			
	Jan. 5	Jan. 12	Jan. 19	Jan. 26
Three-month	7.960	7.837	7.789	7.888
Six-month	7.991	7.784	7.603	7.776
	Monthly auction dates—November-January 1970			
	Nov. 25	Dec. 23	Jan. 27	
Nine-month	7.778	7.801	7.725	
One-year	7.592	7.561	7.533	

* 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.

the belief that the Treasury's February refunding would include issues in this maturity area. Some long-term bonds suffered from investor switching into higher yielding corporate securities.

Activity in the market for notes and bonds was generally light during the early part of the month and, after a brief carry-over from the year-end rally, prices moved lower in the wake of commercial bank selling of intermediate-term issues and restrained investor demand. Following the successful sale of a large corporate offering at a lower interest rate level, a firm tone developed toward the close of the week ended on January 9. In addition, there was a widespread hope at the time that the latest banking statistics indicated a slightly less restrictive monetary policy. The improved atmosphere continued after the weekend, but by midweek prices again turned downward in response to selling pressures from dealers adjusting their positions in preparation for the refunding and from investors moving out of Governments into corporate issues. Reports of a further decline in industrial production and no growth in real gross national product during the fourth quarter halted the downturn, however, and most issues due within six years posted gains for the week of January 16.

Prices drifted irregularly lower in quiet trading over the remainder of the period prior to the Treasury's announcement of its refunding terms on January 28. During this time, some \$1.8 billion of Federal agency issues were brought to market in addition to agency offerings totaling \$1.5 billion in the first half of the month, contributing to the cautious atmosphere preceding the Treasury's statement. Initial market reaction to the terms of the refunding was very good, and the "when-issued" notes quickly moved to premiums.

There was considerable small investor interest in the bill market during the first half of January, and record amounts of some \$1 billion of noncompetitive tenders were accepted in the first two weekly auctions. Average issuing rates on new three- and six-month bills moved progressively lower through the auction of January 19 (see Table III) and, despite a rise in the final week, were still 21 and 32 basis points, respectively, below their highs set on December 29. Rates on outstanding bills also turned down during January except for those in the shorter term area. Over the month as a whole, most bills with maturities of more than seven weeks registered declines of from 7 to 17 basis points.

Demand for Treasury bills was widespread at the start of the month, and sizable odd-lot buying emerged as a number of small investors withdrew funds from savings accounts following the interest-crediting period. Noncom-

petitive awards rose to a record one third of all new bills allotted in the auction of January 5, and on succeeding days substantial demand developed from those whose competitive tenders were rejected in the Monday auction. Some light but steady demand continued as the week drew to a close, and rates on most bills of three- to six-month maturities declined over the week. Prior to the next weekly auction, rates moved sharply lower in anticipation of aggressive bidding and another large volume of noncompetitive tenders. Small investors garnered almost two fifths of total awards, a new record, and once again strong market demand emerged from unsuccessful bidders following the auction. Interest in the bill market then began to wane until news of the latest economic statistics showing a further slowdown sparked a firmer tone.

Bidding in the auction of January 19 was relatively routine, and rates fluctuated narrowly over the remainder of that week in generally light activity. Pressure on rates resulted from some investor selling of short-term issues and the rise in interest ceilings on time deposits. However, selective demand for certain issues continued, and over the week changes in the bill market were mixed.

During the week ended on January 30, rates rose on bills of longer than three-month maturity in the wake of some foreign account and dealer selling and only light investment demand. Short-term bills showed some gains, however, in response to investor interest in this area. Bidding in the monthly auction on January 27 was fairly good, and the average issuing rates on the new nine- and twelve-month bills were set at 7.725 percent and 7.533 percent, respectively, down 8 and 3 basis points from the previous auction.

OTHER SECURITIES MARKETS

There was a considerable improvement in the corporate bond market during the first full week of trading in 1970 and, despite new issue yields that were several basis points lower than those offered prior to the December holiday lull, investor response was generally very good. A \$100 million issue of Bell System telephone bonds, for example, was priced to yield 8.70 percent, down 40 basis points from the record high for the Bell System set in December, and was oversubscribed almost immediately. Two other large issues of \$100 million and \$150 million with reduced yields were also sold quickly. To a large extent, however, these successful sales depended on funds from small investors, and the halt to the rally during the following week was attributable in part to the lack of significant institutional demand. Since the January calendar of new issues was unusually heavy, many institu-

tional investors were apparently marking time in order to see what future offerings would yield.

At the start of the week ended on January 16, new issues continued to be aggressively priced at yields below the preceding week. The bonds moved slowly, however, and subsequent new offerings were sold at increasingly higher yields but without much success until the final day of the week, when this market also responded favorably to reports of additional signs of an economic slowdown. On the following Tuesday the Ford Motor Company conducted its first public borrowing in the United States through the issuance of \$125 million four-year notes and \$75 million twenty-year debentures. This offering received considerable presale interest because of its size and Aaa rating, and the four-year notes were successfully marketed at a yield of 8.20 percent. The debentures, however, were priced more aggressively than had been anticipated and met with investor resistance. Wednesday, January 21, brought an announcement by American Telephone and Telegraph Company of plans to offer shareholders \$1.57 billion of thirty-year debentures plus stock-purchase warrants, reportedly the largest single financing ever undertaken by a private corporation. Although this will probably not occur before April, the combination of the AT&T announcement, a sizable buildup in unsold bonds, and a continuing heavy calendar of new issues resulted in a market slide during the remainder of the month.

The municipal bond market also registered price gains as the new year began but later experienced difficulties, particularly in the longer term maturities where investor interest waned as the month progressed. On January 6, an issue of A-rated highway revenue bonds provided yields about 10 basis points below those of similar securities marketed in mid-December, and a week later the first sizable Aaa-rated tax-exempt bonds were scaled to yield some 50 basis points less than similarly rated bonds at the mid-December peak.

The reception to new issues was generally enthusiastic during the first week and a half, but investors became increasingly selective after that time. As a result, underwriters found it necessary to cut offering prices in an attempt to improve sales. Nevertheless, inventories of unsold bonds mounted, and the Blue List of advertised dealer stocks rose from \$249 million on January 12 to \$448 million at the close of the month. Reflecting the reversal in the tax-exempt market, *The Weekly Bond Buyer's* index of yields on twenty municipal bonds dropped from 6.79 percent on December 30 to 6.53 percent on January 15 and then turned up, climbing to 6.78 percent on January 29.

NEW INTEREST CEILINGS ON TIME AND SAVINGS DEPOSITS In percent		
Institution and Instrument	New maximum	Previous maximum
Federal Reserve and Federal Deposit Insurance Corporation ceilings for commercial banks		
Passbook savings	4.50	4.00
Deposits of less than \$100,000:		
30- to 89-day multiple maturity*	4.50	4.00
90-day and over multiple maturity*	5.00	5.00
30-day to 1-year single maturity	5.00	5.00
1-year single maturity	5.50	5.00
2-year single maturity	5.75	5.00
Deposits of \$100,000 or more, with single maturities of:		
30 to 59 days	6.25	5.50
60 to 89 days	6.50	5.75
90 to 179 days	6.75	6.00
180 days to 1 year	7.00	6.25
1 year or more	7.50	6.25
Federal Home Loan Bank Board ceilings for savings and loan associations		
Passbook savings	5.00	4.75 or 5.00†
90-day notice passbook accounts	5.25	5.00
Certificates of less than \$100,000, with maturities of:		
3 to 6 months	5.25	—
6 months to 1 year	5.25	5.25
1 year but under 2 years	5.75	5.25
2 years or more	6.00	6.00
Certificates of \$100,000 or more, with maturities of:		
60 to 89 days	6.50	—
90 to 179 days	6.75	—
180 days to 1 year	7.00	—
1 year or more	7.50	—
Federal Deposit Insurance Corporation ceilings for insured mutual savings banks		
Passbook savings	5.00	5.00
Deposits of less than \$100,000:		
90-day multiple maturity*	5.25	5.00
Single maturity of:		
90 days to 1 year	5.25	5.00
1 year to 2 years	5.75	5.00
2 years or more	6.00	5.00
Deposits of \$100,000 or more, with single maturities of:		
30 to 59 days	6.25	—
60 to 89 days	6.50	—
90 to 179 days	6.75	—
180 days to 1 year	7.00	—
1 year or more	7.50	—
* Multiple maturity time deposits include deposits that are automatically renewable at maturity without action by the depositor and deposits that are payable after written notice of withdrawal.		
† The higher ceiling previously applied without qualification to associations located in Alaska, California, Hawaii, and Nevada. The ceiling in other areas varied, depending in part on rates paid by mutual savings banks.		

Activation of the Special Drawing Rights Facility in the IMF

By MARTIN BARRETT*

The issuance and regulation of national currencies is one of a few truly sovereign functions, one which had never had its counterpart in the deliberate multilateral control of international money. For the most part, the supply of international reserve assets of the kinds that existed before this year—the stock of gold, reserve currencies, and reserve positions in the International Monetary Fund (IMF)—has been governed primarily either by the vagaries of gold production and its flow into or out of monetary use or by such fortuitous factors as the deficits of reserve currency countries and the readiness or reluctance of monetary authorities to hold reserve currencies, principally the United States dollar and the pound sterling. For this reason alone, the first allocation of special drawing rights (SDR's), on January 1, 1970, is an event of great importance. The mechanism for the creation and use of SDR's, as it has been elaborated in an amendment to the Articles of Agreement of the IMF, is luxuriant in its detail. Stripped of its complexities, the mechanism provides a means by which existing international reserve assets may be supplemented periodically, through a process of international decision, at rates reasonably related to the world's need for reserves.

Although the first issue of SDR's represents, in a sense, an abrupt break with the past, the mechanism itself has been drafted as an evolutionary development in the international monetary system, and has emerged only after years of exhaustive study and determined negotiation. The potential need for some supplement to international reserves had long been recognized. However, in the search for a solution to the problem of a potential reserve short-

age, there was a clear divergence of views on such questions as to how reserve needs should be measured, what form additional liquidity should take, and how it should be distributed initially and used in the settlement of international payments imbalances. Thus, there was a clear division of opinion as to whether any reserve supplement should take the form of increased credit facilities or should consist of an expansion of "owned" reserve assets.¹ As the discussions moved ahead, the conviction grew that it would be necessary to invent a new reserve asset, rather than provide additional liquidity by an expansion of Fund quotas or through other credit facilities. Yet, there remained for a time a difference of opinion as to whether the new reserve asset—usually designated a reserve unit—should be created by the IMF and distributed to all Fund members or should be issued through a new institutional setup more restricted in membership than the Fund and distributed only to a limited group of countries.

These were not the only clashes of doctrine or opinion that developed over the years. During 1966, however, as inquiry gave way to negotiation, the principles and many of the characteristics of a possible agreement began to emerge, and by August 1967 the Group of Ten countries had hammered out a brief outline which set forth in broad terms many of the essential features of the SDR facility. The outline was unanimously approved by the Board of Governors of the Fund at its annual meeting at Rio de Janeiro in September 1967, and over the next six months or so the outline was transformed into a legal instrument in the form of a proposed amendment to the Articles of Agreement. The amendment, in turn, was approved by the

* Chief of the Balance of Payments Division, Federal Reserve Bank of New York.

¹ For a survey of the various schemes that were considered in the early exploratory studies, see Group of Ten, *Report of the Study Group on the Creation of Reserve Assets*, May 1965.

Board of Governors of the Fund in May 1968, and then submitted to member governments for ratification. The amendment entered into force on July 28, 1969, following its acceptance by three fifths of the Fund's members representing four fifths of the total voting power. By August 6, 1969 the required majority of Fund members had become participants in the SDR system, so that it became legally possible for the group of participating members to decide to activate machinery by allocating SDR's to all participants.

ACTIVATION AND ALLOCATION

The amount of SDR's allocated at any time is intended to meet a long-term global need for liquidity, and not the requirements of one or more individual participants for additional reserves to enable them to avoid measures that may be needed to correct payments deficits. Accordingly, the amendment provides that decisions to allocate SDR's will be made for "basic periods"—normally five years in duration—and that any allocation of SDR's will be distributed at a uniform rate, on the basis of IMF quotas, to all members of the Fund participating in the SDR system. However, since there is no generally accepted mechanical test by which to gauge additional liquidity needs, the amendment makes no attempt to fix an elaborate or detailed list of criteria for decisions on the amount of SDR's to be allocated. Instead, the formulation in the amendment clearly recognizes that judgments must be made whether there is too much, enough, or too little liquidity in the international monetary system. More importantly, the amendment is designed to ensure that there is broad support among both surplus and deficit countries for any proposal to create SDR's.

In the process of reaching a decision on the timing and creation of SDR's, the Managing Director of the Fund plays a central role. Any decision to create and allocate SDR's must be made on the basis of a formal proposal by the Managing Director. Before he can make a proposal, he must conduct consultations among participating members to ensure that there is, in fact, widespread support for the proposal. To become effective the proposal must be concurred in by the Executive Directors of the Fund and must then be approved by a majority of the participating countries with 85 percent of the weighted voting power of the Fund.

The 85 percent requirement ensures that the need for SDR's, in the amounts proposed, is generally recognized. Clearly, the workability of the mechanism itself would be impaired if a proposal to create SDR's resulted in dissension, or led to a collision of interests, between participants

in balance-of-payments surplus and those in deficit. Of course, the very process of consultation, both within and outside the Fund, tends to reduce the importance of the voting procedure by which a proposal is formally approved. As early as July 1969—even before the amendment actually entered into force—the Group of Ten countries had agreed to support a decision to allocate \$9.5 billion in SDR's over a period of three years. Involved and comprehensive consultations in the Fund toward the same end were proceeding during the summer as well. In September the Managing Director, with the concurrence of the Fund's Executive Directors, made a proposal to begin allocations on January 1, 1970 with the creation of \$3.5 billion for the first year and \$3 billion at the beginning of each of the two following years. On October 4 the Governors of the Fund members that had become participants in the SDR mechanism adopted this proposal by a vote far in excess of the required 85 percent of weighted votes.²

With the establishment and activation of the new facility, the Fund now conducts its operations through two separate accounts. All the traditional operations and transactions of the Fund, including drawings and repurchases by members, are carried on through what is now known as the "general account". Transactions and operations involving SDR's are conducted primarily through the "special drawing account". The clear distinction between the two accounts does not mean that they are rigidly separated. In fact, the Fund itself may accept and use SDR's in connection with certain transactions conducted through the general account. Nevertheless, the two accounts are fundamentally different. In the general account, the Fund holds large resources of gold and currencies, which have been derived primarily from the subscriptions of members to their quotas. Insofar as a member's subscription consists of gold, it involves of course a corresponding loss of reserves to the member, but at the same time the member acquires rights to draw on the resources of the Fund in amounts which, though subject to conditions, are potentially much larger than its gold subscription. In contrast, when a participating member receives an allocation of SDR's, it is not required to deposit an equivalent amount

² Although every participating country has a right to receive SDR's in the initial allocation, no country is obligated to do so. If the Governor of a Fund member has not voted in favor of a proposal to create SDR's, but the proposal has been approved nonetheless by an 85 percent vote, that country may refuse to receive its allocation of SDR's or "opt out" of the decision. The amount of SDR's created in the initial allocation, \$3,414 million, was slightly less than the amount proposed, because one country opted out.

of gold or currency for the purpose of any subsequent transactions involving SDR's. Thus the effect of any allocation of SDR's is to increase the international reserves of each recipient without reducing the reserves of any country.

Although SDR's are issued by the Fund, they do not constitute a claim on the Fund to provide currency. If a participant wishes to use its SDR's to obtain foreign currency, it obtains the currency directly or indirectly from another participant and not from any pool of resources contributed to, or deposited in, the Fund. The fact that the Fund is able to issue SDR's without the use of resources as "backing" is one of the most fundamental differences between the two accounts. This does not deprive SDR's of their usability as an asset, however, since any participant, whenever designated by the Fund, is obligated to accept SDR's and provide convertible currencies to other participating members. Indeed, the right to obtain convertible currency in exchange for SDR's and the corresponding obligation of members receiving SDR's to deliver convertible currency on demand is the fundamental proposition on which the entire facility rests.

While no country is obligated by the provisions of the amendment to treat SDR's as reserve assets for all purposes, the overwhelming majority of participants have chosen to include SDR's in their international monetary reserves.⁸ The reasons are not hard to find. SDR's are endowed with a variety of characteristics that enable monetary authorities to regard them as assets with complete confidence. First, SDR's are expressed in terms of a fixed amount of gold, equivalent to the gold content of the United States dollar. Thus, countries that receive SDR's, whether by allocation or as a result of subsequent transfers, can be certain that there will not be a reduction in the gold value of their rights and, therefore, that they can accept SDR's in transfers without fear of loss. Second, each participant receives interest on its holdings of SDR's in excess of the amount of SDR's received in allocation. Interest is paid in effect by other participants whose hold-

ings are less than the amount of SDR's allocated to them.⁴ Despite these provisions, no country would accept SDR's when in balance-of-payments surplus, unless it enjoyed absolute assurance that it could transfer SDR's to other countries when in deficit. Fundamentally, SDR's derive their essential character as a reserve asset from the fact that they can be used, with complete confidence, for the settlement of payments deficits.

THE FACILITY AND ITS USES

Once held by monetary authorities, SDR's can be transferred by participating countries whenever they have a balance-of-payments or reserve need to do so. SDR's cannot be used to intervene in the foreign exchange markets, but can be used only to acquire currencies convertible in fact, and these currencies can then be employed, alone or in combination with other reserve assets, for the settlement of payments deficits. When a transfer of SDR's takes place, the use by a participant results in a debit to its holdings as recorded in the special drawing account and in an equivalent credit in favor of one or more other countries to which SDR's are transferred. The movement of SDR's from the user to the recipient is accompanied by a counterflow of currency from the one to the other. For the United States, an increase in holdings of SDR's acquired in transfers from other countries may be matched by an increase in dollar liabilities to foreign official institutions. For most other countries, any increase in holdings of SDR's derived from transfers (rather than from allocations) will involve the substitution of one kind of international reserve asset for another. SDR's may flow back and forth, but unlike foreign exchange assets that are created as a by-product of credit operations and extinguished with the repayment of the credit, SDR's represent a permanent addition to the stock of international liquidity.

All participating countries are able to use SDR's unconditionally, but are expected to do this only to meet balance-

⁸ In the United States, SDR's are held along with certain other reserve assets by the exchange stabilization fund of the Treasury. Against these SDR's, the stabilization fund may issue special drawing rights certificates to the Federal Reserve System. On the Federal Reserve's balance sheet, these certificates are recorded as an asset and the offsetting liability is a deposit credit in the stabilization fund's account maintained with the Federal Reserve Bank of New York. This process is virtually the same as the monetization of gold through the issue of gold certificates to the Federal Reserve. In January 1970 the stabilization fund monetized \$200 million of the \$867 million of SDR's distributed to the United States in the first annual allocation.

⁴ In addition to the interest on its holdings, each participant pays a charge on the amount of SDR's allocated to it. Under the provisions of the amendment, the rate of interest and the rate of charges must be the same. This rate has been set initially at 1½ percent per annum, although the Fund at its discretion may vary this rate within a range of 1 to 2 percent. As a matter of accounting practice, the amount of interest to be paid to a participant and the amount of charges paid by that participant are offset, and only the balance is paid or collected. The net effect of these provisions is that any participant holding more SDR's than its allocation will receive a net payment, and one holding less than its allocation will make a net payment. Both charges and interest are payable in SDR's.

of-payments needs or in the light of developments in their aggregate reserves. In broad terms, this means that SDR's can be used to forestall or reduce a drop in other components of reserves, resulting either from a balance-of-payments deficit or from a desire on the part of other countries to convert balances of the using country's currency into gold, but SDR's cannot properly be used for the sole purpose of changing the composition of the using country's reserves. In either case, a country's use of SDR's cannot be questioned on the grounds that it has failed to pursue appropriate corrective policies, nor can their use be challenged on the grounds that the country has not satisfied the "requirement of need". If a country has failed to observe this requirement and uses SDR's simply to alter the composition of its reserve assets, that abuse can shortly be reversed by the Fund, simply by directing subsequent transfers of SDR's to the offending country.

Among the major issues that developed in the negotiation of the agreement was whether a participant should be able to choose the country to which it transferred drawing rights, or whether participants should be able to agree freely on transfers between them, or whether transfers should be subject to criteria applied by the Fund. Unilateral choice by a participant might have resulted in a forced acceptance of drawing rights by other countries. This difficulty can be avoided through bilaterally negotiated transfers, but a system of transfers solely by agreement might have resulted in a haphazard distribution of drawing rights that would leave no margin for acceptance by transferees at a time when countries needed to use SDR's. In order to avoid this result, the amendments provided for a system of guided transfers by the Fund as well as for transfers by agreement.

The provisions for transfers by agreement give a participant the right to use SDR's to purchase balances of its own currency from the monetary authority of another participant, even if the latter has not been designated by the Fund as a transferee. However, a country can exercise this right only if the receiving country agrees to the transfer and if the currency provided is the currency of the transferor. If both parties agree to the transaction, the guidance of the Fund is not needed. Although any country may exercise the right to transfer SDR's by agreement, this option has special significance for the United States. It is through transactions of this kind that the United States might to some extent direct its use of SDR's to those countries having dollar balances that might otherwise be converted into gold. Of course, the necessity for agreement means that other countries may refuse a transaction of this kind.

Under the system of guidance, a country may be desig-

nated to provide currency for SDR's if it has a sufficiently strong balance-of-payments and reserve position. Among those countries designated by the Fund, SDR's are expected to be allocated in order to produce insofar as possible equality in the ratios of their holdings of SDR's in excess of net cumulative allocations to their gross holdings of gold and foreign exchange. In short, the general principles for guidance are intended to promote a balanced and equitable distribution of drawing rights among those countries designated by the Fund.⁵ Despite the importance of these provisions, the Fund may designate a country to receive SDR's to ensure certain specific operational objectives of the facility. Thus, if a country used its SDR's simply to get rid of them and to obtain reserve assets that it preferred, that country may be designated by the Fund as a transferee, even though the country does not satisfy the general criteria for designation. This abuse of the facility, if it happens at all, may not occur with frequency. Indeed, the fact that the Fund has the authority to designate participants to accept SDR's as well as other sanctions should by itself obviate the need to exercise that authority.

SAFEGUARDS AND LIMITATIONS

In the negotiations that preceded the establishment of the SDR facility, it was agreed that the new reserve supplement should be endowed with certain characteristics which would enable monetary authorities to accept it as an asset with complete confidence. Because SDR's are a new feature of the international monetary system, a number of safeguards and limitations have been incorporated into the amendment in order to increase confidence in them. Perhaps the most fundamental of these safeguards is provided by the basic "rule of need" itself, which protects participating countries from the risk that a country might use SDR's simply to get rid of them. If a country violates this rule, the Fund may direct subsequent trans-

⁵ This system of guidance builds on the experience and practice of the Fund in the selection of currencies for regular transactions through the general account. Among the countries whose currencies are usable for drawings, preference is ordinarily given to those enjoying payments surpluses, those with large reserves, and those where the Fund's holdings of their currencies are not unduly high in relation to quota. In the selection of currencies to be used in meeting repurchase commitments, preference is given to countries with high Fund positions relative to quota and to countries in payments deficit. The net effect of these policies has been that the gold tranche positions of those countries whose currencies are used for drawings and repurchases have, on the whole, moved in the same direction as their reserves and have tended to move toward a uniform ratio to reserves.

fers to that country, and if that practice fails to ensure compliance, the Fund may suspend the participant's right to use SDR's altogether. Even when SDR's are used for appropriate purposes, excessive use is restrained by the "reconstitution requirement", and still another safeguard is provided by the "acceptance limits".

RECONSTITUTION. Perhaps the most controversial of all questions connected with the facility was whether a participant using the facility should be obligated to restore its holdings of the asset and, if so, to what extent. Some feared that, without an obligation of this kind, the asset could be used to finance unduly protracted or permanent balance-of-payments deficits and thereby impose a continuous strain on the real resources of surplus countries. Accordingly, it was argued that SDR's should be regarded as a credit and, when used, should be subject to repayment just as purchases of foreign currencies in drawings from the Fund through the general account must be reversed within three to five years from the date of purchase. It was generally conceded that international monetary reserves by their very nature can be used only to meet temporary balance-of-payments deficits and, in practice, a country's reserve holdings are usually restored following a correction of the difficulty in which they are employed. However, the transformation of a practice of restoration into a repayment obligation was resisted by many countries as inconsistent with the essential character of a reserve asset.

These conflicting views gradually converged on a solution that necessarily involved a compromise. Under the amendment, a participant is entitled to use all of its SDR's, but the average of its daily holdings over any five-year period must be no less than 30 percent of its average daily net cumulative allocations over the same period. Stated in another way, this provision means that a participant can use its drawing rights up to the hilt, but must reconstitute its holdings from time to time, so that its average daily use of SDR's over a five-year period is no more than 70 percent of its cumulative allocation. For example, if a participant used no more than 70 percent of its average cumulative allocation, it would automatically comply with the reconstitution requirement. However, if it should use more than that amount for some part of the five-year period, it would be required to increase its holdings above 30 percent for a period long enough to bring its average use to no more than 70 percent for the entire five-year period. This requirement, which is designed to promote a degree of circumspection in reducing holdings too far, has been described as analogous to a compensating balance requirement or to a repayment provision.

Neither analogy is strictly correct, since a participant is not required to retain a permanent minimum balance of the drawing rights allocated to it, nor is it obligated to recapture SDR's, after having used them, in accordance with a strict repayment schedule.

The amendment provides detailed arrangements by which participants are to reconstitute their holdings of SDR's to satisfy the minimum holding requirement. Indeed, the amendments contain not one, but two, sets of reconstitution arrangements. Under certain circumstances, a country with deficient holdings of SDR's may transfer its foreign exchange holdings to another country in exchange for SDR's, if the latter country agrees to the transfer and if the currency provided is that of the transferor. However, as already noted, a system of transfers by agreement might result in a maldistribution of SDR's which would leave no margin for acceptance by transferees at a time when some participants were in difficulties and needed to use their SDR's. Thus, the main mechanism for promoting the performance of reconstitution obligations will be the designation of participants to accept transfers of SDR's from other countries. If for any reason the designation procedure fails to ensure reconstitution, then the participant must obtain the necessary SDR's from the general account of the Fund, by selling at its option gold or convertible currency acceptable to the Fund. If the Fund does not hold enough SDR's, then the participant is obliged to obtain them from other countries specified by the Fund. In any event, countries are expected to maintain a balanced relationship between their holdings of SDR's, on the one hand, and their total holdings of gold, foreign exchange, and reserve positions in the Fund, on the other. If they fail to do so, the process of reconstitution will ordinarily result in the use of gold or other reserve assets which have not already been used in financing payments deficits.

ACCEPTANCE LIMITS. As already noted, countries are able to use SDR's whenever they have a balance-of-payments or reserve need to do so. On the other side of the transaction, countries are obligated, whenever designated by the Fund, to accept SDR's in exchange for convertible currency. Normally, a country will be designated for this purpose only when its balance-of-payments or reserve position warrants designation. Once designated, however, a country must accept drawing rights up to three times its cumulative allocation; that is to say, a participant's obligation to accept drawing rights ceases at the point at which its holdings in excess of its net cumulative allocation reach twice the amount of its allocation.

The acceptance limits are designed to protect partici-

pants from too onerous an obligation to provide convertible currencies. At the same time, however, the limits appear to be large enough to ensure that, if any participant finds it necessary to use its SDR's, there will always be other countries in a position to accept them without transcending their obligatory acceptance limits. As already noted, the United States has received about \$867 million in SDR's in the initial allocation, and the European Economic Community (EEC) countries taken as a group have received approximately \$634 million. The potential acceptance commitments resulting from these allocations would be twice these amounts, assuming that the United States and the EEC countries hold and retain all their initial allocations. Thus, the United States could be required to provide about \$1.7 billion equivalent in convertible currency to other participants—an amount large enough to accommodate easily a transfer of all EEC holdings. Similarly, the Common Market countries' acceptance undertakings are large enough to absorb a transfer of all United States holdings. Although the system is not expected to work in such a way that these extremes would be reached, the margin between the amounts created and the acceptance commitments should prove ample enough to ensure full coverage for any likely transfers of SDR's.

CONCLUDING OBSERVATIONS

The Fund's policies and practices with respect to regular drawings and repurchases have changed considerably since the Bretton Woods Agreement was negotiated more than twenty-five years ago. And the new facility will undoubtedly become more flexible over time as familiarity with, and confidence in, the new asset grows. Indeed, some of the possibilities for greater flexibility in the operation of the system are already built into the facility. The amendment provides, for example, that the Fund must review the rules for reconstitution at the end of the first and each of the subsequent basic periods. On any one of these occasions the Fund may modify existing rules, or go so far as to abrogate the reconstitution requirement altogether. If the latter action were taken, there would be no obligation to restore holdings of SDR's, even to the limited average level required for the first basic period. And, of course, it would be possible to reduce the holding requirement if it were not eliminated completely. However, in view of the importance attached to the reconstitution provisions, any modification will require a majority of 85 percent of the total voting power. Similarly, the acceptance obligations may be raised from time to time. Even if they are not raised, the acceptance limits should not impair the effective

operation of the facility. Indeed, the term "acceptance limit" is somewhat of a misnomer. The limit is simply a country's maximum legal obligation to accept SDR's, but any participant is free to hold SDR's in amounts beyond the obligatory limit, if it chooses to do so.

Even in its present form, the facility clearly constitutes a useful mechanism for supplementing existing reserve assets through a process of deliberate international control. It is equally clear, however, that the control applies only to SDR's and not to other components of international liquidity, except indirectly, in the sense that changes in the amount of other reserve assets may affect subsequent decisions to increase allocations of SDR's. Moreover, the control exercised through the allocations or recall of SDR's is intended only to meet long-run needs. The facility does not allow for short-term, much less day-to-day, management of liquidity, nor does it provide for specific injections of liquidity where it may be most needed at a particular time. For these needs, countries will continue to rely—perhaps to a greater extent than before—on their regular drawing rights in the Fund and on central bank credit facilities.

The first issue of SDR's, however important or historically significant, does not obviate the need for a more balanced pattern of international payments—especially between the United States and Europe—and the activation of the facility comes at a time when there is still little agreement on how the burdens of balance-of-payments adjustment should be distributed between surplus and deficit countries. However, the SDR mechanism does provide an environment in which measures to reduce payments deficits may become more effective. In recent years it has become increasingly evident that few countries are prepared to see their national reserves decline by significant amounts, and most countries wish to raise their level of reserves by amounts which, in the aggregate, are substantial and exceed the assets available under the present system of reserve formation. Consequently, fears of a decline in national reserves have induced surplus countries to follow policies which have tended to frustrate the attempts of other countries to reduce or eliminate their payments deficits. In short, the allocation of SDR's provides a means to reconcile the reserve needs and objectives of both surplus and deficit countries. More importantly, the accrual of reserves through the acquisition of SDR's may reduce efforts to add to reserves through surpluses on account of other balance-of-payments transactions. It is through these alterations of incentives that the allocation of SDR's may exert a beneficial influence on the adjustment process.

The negotiation, ratification, and activation of the SDR

facility is a major achievement in the history of international financial cooperation. That the agreement was reached in spite of divergent national interests indicates that national interests can be and have been submerged in the joint interest that monetary authorities in all countries share in the effective performance of the international economy and in the further growth of trade and payments. Indeed, the relative ease with which the amendment was approved by national legislatures suggests that this joint interest is generally recognized in a wider circle as well.

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