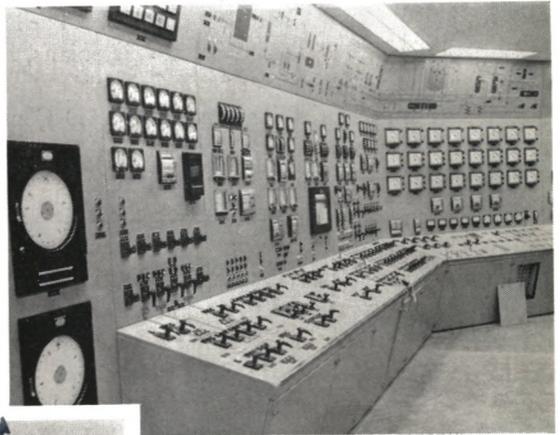


MONTHLY REVIEW



The Southeast's first atomic electric power plant, a joint project of four District power companies, was dedicated in October.

FIFTH DISTRICT

1962



At some moment possibly in late 1961 but probably in early 1962 the number of people living in the Fifth Federal Reserve District reached and passed the 17-million mark. At that point there were about 4.7 million North Carolinians and 4.1 million Virginians, accounting for more than half of the District total. The rest included 3.2 million Marylanders, 2.4 million South Carolinians, 1.7 million West Virginians, and 780,000 residents of the District of Columbia.

Population has been rising since the 1960 Census at a slightly slower pace in the District than in the nation as a whole. The increase during the past two years was 2.8% in the District compared with 3.6% nationally. A declining population in West Virginia was the main reason for the District's slower rate. In the other states the rise since 1960 has been 3.8% with increases in individual states ranging from 5.3% in Virginia to 2.2% in South Carolina.

During 1962 the District probably gained about 200,000 residents. The change was a result of natural increase and migration. Natural causes in 1962 tended to expand the population by about 250,000, a net result of some 400,000 births and 150,000 deaths. Thus, natural increase (estimated from the published record of vital statistics) exceeded the over-all increase (computed from official estimates of total population) by 50,000. This figure, therefore, should be the amount by which outmigration exceeded immigration during 1962. However, since the 50,000 figure is based on differences between estimates of much larger magnitude, it could easily be significantly wide of the mark, and as of now there is little additional evidence with which to compare it. Interpretations and projections of 1960 Census data suggest that some 300,000 persons now residing in District states probably moved to their present abodes "from other states" during 1962. But how many came from states outside the District would be little more than a guess at this point.

Although they are only approximations, these figures do indicate the size and mobility of Fifth District population during 1962. Now what were its economic characteristics?

LABOR FORCE The size of the civilian labor force in the Fifth District (excluding the District of Co-

lumbia which does not publish such data) ranged in 1962 from 5.7 million early in the year to 6.2 million at the seasonal peak in July. Variations from month to month, as with all unadjusted data, reflect the combined effects of growth, business cycles, seasonal forces, and erratic variations. Unemployment rates averaged about 5% and ranged from 6.5% in January to around 4% toward the end of the year. Unadjusted national rates were a little higher, beginning the year at 6.7%, dropping below 5.0% in the early fall, and rising again to 5.3% in November. The West Virginia unemployment rate began the year at 13.8% and dropped well below 10% toward the end. Elsewhere unemployment declined from early highs that ranged between 4.5% in Virginia and 6.8% in Maryland to lows of 2.6% and 4.4% in these same states. The Maryland labor market during 1962 remained pretty much in line with national conditions. In the District of Columbia, Virginia, and the Carolinas, however, employment opportunities were consistently more favorable. During 1962 an average of around 36% of all District residents were members of the labor force and 95% of these had jobs.

AGRICULTURE The experience of District farmers during 1962 was generally similar to that of 1961. Their gross incomes were slightly higher, but expenses were also up. Therefore, as the year drew toward a close net farm income seemed to be pointing directly toward 1961's \$1.1-billion level.

Flue-cured tobacco growers saw some significant changes during 1962. The year's crop was the largest since 1956 but drew complaints from some buyers, especially exporters, on the grounds that it failed to measure up to the usual standards of quality. The relatively large amounts placed under the Government's price support program and the generally lower level of prices tended to confirm the charges. Reasons were numerous and complex but two seemed particularly significant: first, use of a chemical (MH-30) which checks the growth of suckers and increases the yield but may adversely affect quality; second, the tendency of farmers to concentrate on a limited number of high-yielding varieties.

A monthly index of seasonally adjusted farm employment for 1961 and ten months of 1962 appears in

the left-hand chart at the bottom of the page. The declining trend has, of course, been in progress for many years. Some fairly sharp month-to-month fluctuations occurred in 1962 in contrast to the broader movements of 1961. In particular, farm jobs lacked seasonal strength in April, because cold, wet weather delayed ground preparation and planting in some localities, and again in July, because heavy rains greatly impeded spraying, cultivation, and other normal types of field work.

Farm employment ranged from little more than half a million at the seasonal low in January to 1.3 million in July. District farm workers in 1962 averaged between 15% and 16% of all employed persons, down from 17% a year earlier and 25% ten years ago. Nationally, less than 8% of all jobs were in agriculture, and 13% of the nation's farm employees worked in the Fifth District.

MINING District bituminous coal production, which accounted for 36% of the nation's total in 1962, is by far the most important type of mining in this five-state area. Bituminous coal demand, trending downward for a long time, showed some improvement in 1962 but still displayed no particular vigor. Responding to slightly stronger demand, coal mine operators again demonstrated their ability to dig more coal with fewer people.

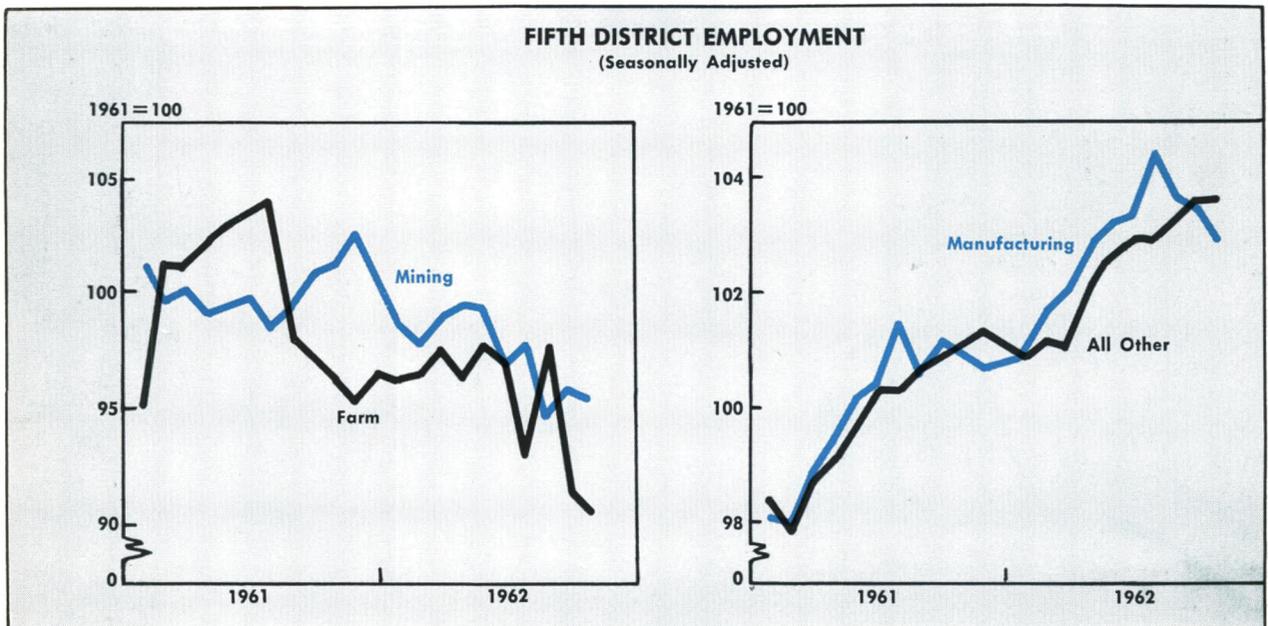
The left-hand chart below also shows the recent course of employment in mining, the District's second major area of diminishing job opportunities. Average employment at District mines declined from the preceding year in both 1961 and 1962. As the chart

shows, however, the downtrend continued at a faster pace again in 1962 after slowing considerably in the first half of 1961 and actually turning upward for a few months later the same year.

The record to date shows that all major users consumed more coal in 1962 than in the preceding year. Electric utilities, which account for nearly half of national consumption, continued to increase their use of coal as they have for many years, this time with a gain of about 7%. Despite something less than boom conditions in the steel mills, these big fuel consumers raised their purchases of coal nearly one-eighth in 1962. Other domestic users registered moderate increases. Canada reduced its imports from the United States slightly, but overseas customers led by Japan, Italy, and South America raised their aggregate imports about one-seventh.

Several 1962 developments stand out in the coal industry's efforts to compete more effectively with other fuels. Development and installation of cost-cutting equipment continued. Research into special uses for coal took a big step forward under both public and private auspices. Electric utilities made definite progress toward bypassing coal transport costs by the practice of generating electricity at the mine and transmitting it to distant customers over ultrahigh-voltage lines. But apparently the coal pipeline idea met sufficient opposition to shelve it indefinitely while coal-carrying railroads experiment with longer trains and faster handling.

NUCLEAR POWER DEDICATED Preparations for the commercial use of nuclear power in the Fifth District



reached final stages in 1962. Four District electric utilities, cooperating with the Atomic Energy Commission as Carolinas Virginia Nuclear Power Associates, dedicated the Southeast's first atomic electric power plant in October and began loading the reactor with uranium pellets in December. Four views of the plant showing water and steam ducts, controls, an external view, and the caps that cover the atomic fuel tubes appear on the cover. The \$45-million plant, located at Parr, South Carolina, is one of 24 being built by investor-owned electric utilities but is, nevertheless, of unique design. The plant will have a relatively small capacity but will provide the information and experience needed to build much larger plants in the future. At present about 85% of District power is steam generated compared with 80% for the nation as a whole. The rest is water power except for a fraction of 1% produced by internal combustion.

MANUFACTURING District manufacturing activity rose from the plateau condition of late 1961 to an all-time high in July 1962 and then declined gradually during the remainder of the year. Much of the weakening in the second half occurred in textiles and apparel. The success story of the year, on the other hand, was written by District furniture makers whose new designs gained widespread favor among furniture buyers in all parts of the nation. For other manufacturing industries, 1962 was a year of divergent developments but mostly at or near record levels of activity.

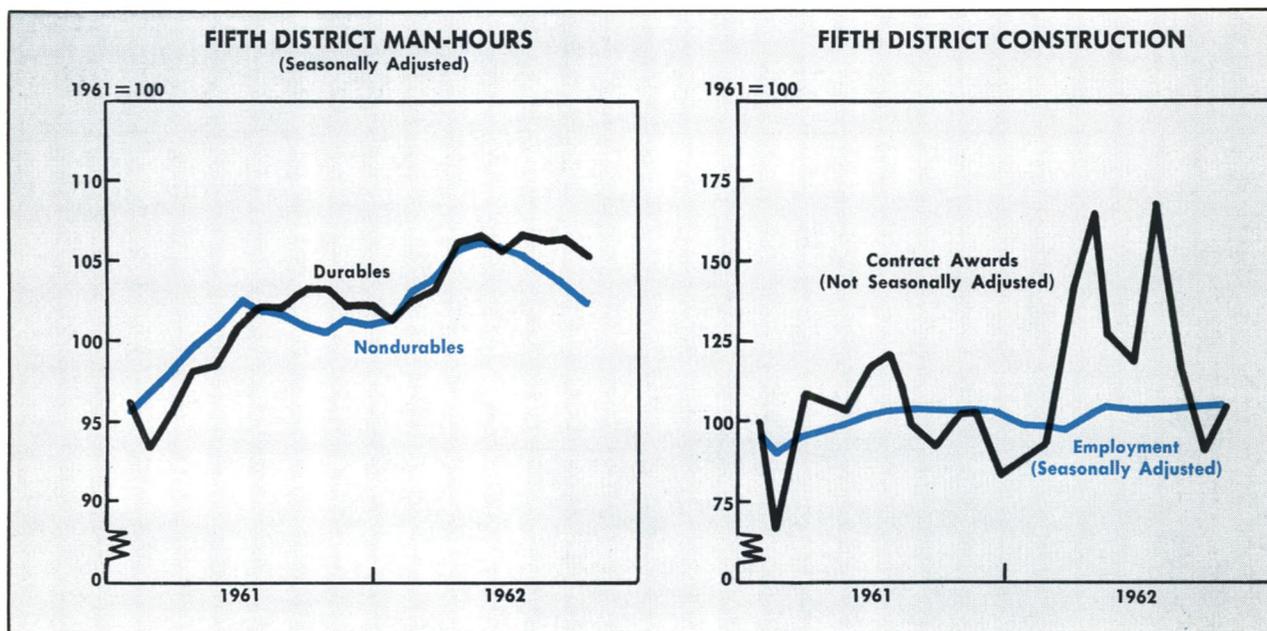
The right-hand chart on page 3 shows monthly

progress of factory employment in 1961 and 1962 relative to the 1961 average as 100. Factory jobs increased 3.5% between January and July 1962—from 0.9% to 4.4% above the 1961 average. At the July 1962 record high, 1,485,000 people were working in District factories. The declines that began in August reduced the magnitude of 1962's margin over 1961 to about 3%.

The graph of factory man-hours (below, left) gives these movements separately for durable and nondurable goods industries. Nondurable goods man-hours averaged 38 million per week during 1962, accounting for 64% of the District total. Durables contributed the remaining 36% with an average of 21 million man-hours weekly.

Durable and nondurable goods man-hours followed about the same upward path during the spring of 1962. In May the advance slackened. Both groups declined slightly in June, and nondurables continued downward. Durables, however, rallied again in July but began in August a slow, uneven decline that continued the rest of the year. August also saw the beginning of reductions in factory employment.

The June decrease in nondurables man-hours actually resulted from a combination of declines in food, tobacco, textile, and chemical industries. Whereas textile man-hours continued to decline, joined in July by apparel, most other nondurables industries strengthened and showed no further weakening until later in the fall when only food, paper, printing, and chemical industries continued to hold their own. Declines in textiles, apparel, and tobacco were sufficient to reduce total nondurables man-hours



some 4% during the second half of the year.

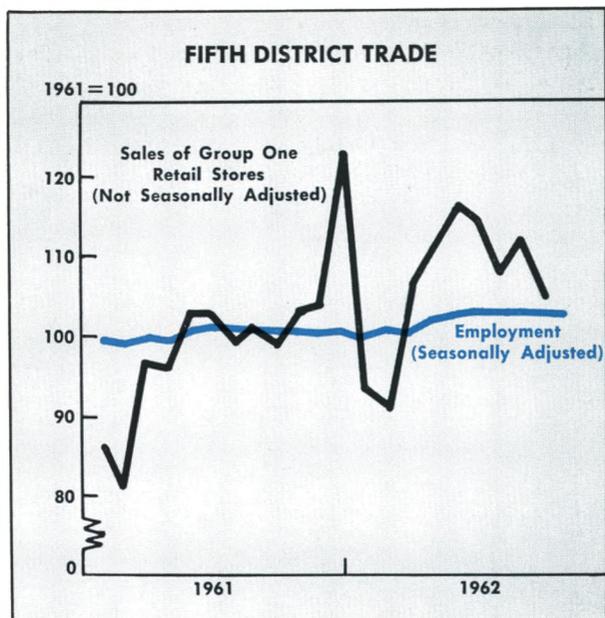
In durables the June man-hour decrease resulted from a sharp decline in primary metals industries and smaller reductions in the manufacture of lumber, stone, clay, and glass products, and furniture. The same industries with the exception of furniture accounted for the temporary comeback in July. Primary metals activity slowed again in August, but for the rest of the summer and early fall man-hour fluctuations in durables industries were small and scattered. Definite declines occurred again in October. Sharply curtailed activity in metal and machinery industries were partly offset by improvements in transportation equipment and lumber. The fast pace at District furniture factories remained unchanged.

CONSTRUCTION District construction activity, an element of strength throughout the 1960 recession, has continued to demonstrate both strength and stability. This is apparent in the behavior of seasonally adjusted employment as revealed by the construction chart on page 4. The number of construction workers in 1962 averaged around 280,000, up 10,000 from previously typical levels that changed little from 1959 through 1961. As in other industries, worker productivity has continued to rise in the building business so that contractors' accomplishments can not be judged from changes in employment.

Increased productivity is apparent in the relationship of contract awards to employment. Awards rose 8% in 1960, remained unchanged in 1961, and rose 14% in 1962. Meanwhile employment fell 1% in 1960, remained unchanged in 1961, and rose somewhat less than 4% in 1962. These relationships, although partially obscured by the erratic behavior of contract awards, can be seen over the past two years in the data plotted on the construction chart. During these two years contract awards have clearly been moving up a steeper trend line than the employment figures.

Most of 1962's early strength in awards occurred in public works, utilities, and residential construction. Nonresidential awards when roughly compared with usual seasonal movements were a bit lower in the first half of 1962 than in the fall of the previous year. In April and July all categories of construction awards were fairly strong and contract values in these two months were among the highest of recent years. As the chart shows, awards dropped sharply in August and September and recovered only a small part of the loss in October, but employment continued to rise during the entire period.

TRADE District trade in 1962 surpassed all previous levels. The chart above clearly shows the



extent of 1962's margin over 1961 in terms of the seasonally volatile sales of "Group One" retail stores, a special compilation that includes all retail firms with from one to ten outlets. The sales figures charted for the months of 1962 were actually historical highs in every month. District department store sales were also at historical highs in 1962, averaging nearly 5% above 1961, the second highest year. Department store sales reached a new high in November then returned to seasonal strength in December—about on a par with the first nine months. Furniture store sales likewise hit record levels in 1962, 8% above previous highs reached in 1959 and 1961. Nationally, manufacturers' sales of lumber and furniture in the first ten months were 9% greater in 1962 than in 1961, and retail store sales of furniture and home furnishings were 7% greater. All evidence indicates that the rise in furniture sales at the manufacturing level was considerably greater than at retail. In fact many retail furniture dealers rated 1962 even with, or only a little better than, 1961. Evidently the portion of output handled through "contract sales" to large buyers (office buildings, hospitals, schools, hotels, motels, and restaurants) was larger than usual.

RECORD YEAR In the Fifth District, 1962 was a record year for business generally. Yet manpower and productive capacity in several lines were well below full employment. As most of the uptrends apparent in the first half lost much of their steam or actually turned down in the second half, the prevailing sentiment regarding 1963 weakened considerably but still remained optimistic.

CENTRAL BANKS

*This is the fifth in a series of articles on central banks
with special reference to the Federal Reserve System.*

Central banks generally set their policies primarily to influence the level of domestic economic activity. Domestic objectives, however, cannot always be pursued without regard to a country's economic relations with the rest of the world. The level of economic activity at home is closely interrelated with a country's exports and imports of goods, services, and capital. Moreover, these exports and imports, as registered in the balance of payments, play a crucial role in determining the strength of a country's currency in foreign markets. The latter consideration is of special significance to countries whose currencies function as "key currencies," that is, as substitutes for gold in the reserves of foreign central banks.

In the international payments system that has emerged since World War II, the major key currencies are the United States dollar and the United Kingdom's pound sterling. Accordingly, international considerations, while important for all central banks, are of special importance to the Federal Reserve System and to the Bank of England.

Policy Goals The ultimate goal of central bank policy in the international sphere is usually stated as the maintenance of international economic and financial equilibrium. The term "international equilibrium" denotes a condition in which there is no tendency for international economic and financial developments to disturb the smooth functioning of the domestic economy. In this perspective, the international functions of a central bank become a logical extension of domestic programs designed to maintain high and stable levels of employment, reasonable price stability, and a maximum sustainable rate of economic expansion.

The connection between international and domestic objectives of central bank policy is obvious when one considers the clear implications of export and import

trade for domestic levels of prices and employment and for the rate of expansion of the domestic economy. But this connection is a two-way avenue. Domestic developments themselves react strongly on the international economic situation. For example, changes in the domestic price level will almost certainly affect the volume of a country's exports and imports. Similarly, domestic interest rate movements influence the flow of capital between a country and the rest of the world. The effects of such price and interest rate movements on the international flow of goods, services, and capital in turn react on the domestic economy. Thus, the domestic and the international aspects of central bank policy objectives comprise a whole which cannot logically be separated.

Policy Conflicts Despite the obvious unity of international and domestic policy objectives, there may be a certain disharmony in actions directed at these objectives. For example, easy money and low interest rate policies encourage domestic business expansion and generally work to take up any existing slack in the rate of resources use at home. On the other hand, the same policies tend to make domestic commodity prices and investment yields less attractive relative to foreign markets. Thus, if a central bank is confronted simultaneously with a domestic business slowdown and a serious balance of payments deficit, it may be caught, so to speak, between the upper and the nether millstone. Easy money, low interest rate policies directed at promoting domestic recovery may also increase imports, reduce exports, and encourage some kinds of capital outflows, thus aggravating the balance of payments deficit and the international disequilibrium which it represents.

Since the advent of central banking institutions, attitudes respecting the relative importance of domestic and international objectives have undergone



a rather pronounced evolution. In the early years of central banking, and especially in the period of the "old gold standard" (roughly 1870-1914), international objectives appeared to take precedence. Then in the interwar period (1920-1940) domestic considerations predominated, with international objectives relegated to a subordinate position. Since World War II, and especially over the past few years, central banks have increasingly tended to give equal weight to the two sets of objectives and to seek an acceptable balance in the simultaneous promotion of domestic and international equilibrium.

THE GOLD STANDARD ERA

Under the old gold standard, central banks were concerned more with international than with domestic developments. A primary objective was to maintain public confidence in convertibility, that is, in the general exchangeability of currency into gold on demand. This was of prime importance in that period, since a crisis in confidence could be expected to lead to wholesale redemptions of bank notes for gold specie, with corresponding reductions in the money supply, bank credit, and domestic and foreign commerce. Frequently, threats to convertibility were initiated by external drains of gold which resulted from balance of payments deficits. Such drains diminished the banking system's reserves and, if prolonged, damaged public confidence in the ability of banks to continue redeeming their notes. Because of this, central banks generally tried to halt adverse gold flows with reasonable speed.

Gold Standard Features The gold standard embodies certain features which automatically make for stability in certain important aspects of international economic relationships. When most countries were on a gold standard, the important currencies of the

world were defined in terms of gold, and the various monetary authorities stood ready at all times to buy and sell gold at prices corresponding to the gold content of their respective currencies.

These conditions resulted in relatively fixed exchange rates, or value relationships between currencies. Exchange rates could vary only within narrow limits set by the cost of shipping gold.

Automatic Equilibrium The relative fixity of exchange rates under the gold standard worked to maintain international equilibrium of a sort, but tended to generate episodic disturbances domestically. A balance of payments deficit for a given country increased the supply of that country's currency held by foreigners and diminished the foreign currency holdings of the deficit country's residents. This tended to drive up the exchange rates on foreign currencies. If the deficit persisted, the cost of foreign currencies would rise to a point at which payments abroad could be made cheaper by buying and shipping gold. Under such circumstances the deficit country would experience gold losses. This tightened money and credit conditions, tending to depress domestic prices and incomes and to push up interest rates. At the same time, the foreign countries receiving the gold experienced monetary expansion, which exerted upward pressure on prices and incomes and downward pressure on interest yields.

As a result of these developments, capital was attracted to the deficit country to take advantage of the higher yields. Moreover, the price and income changes tended to increase the deficit country's exports and to reduce its imports. In this fashion, the forces automatically set in motion under the international gold standard tended to eliminate deficits and to restore international equilibrium.

But it should be noted that this automatic equi-

brating process was not without hazard, especially to the deficit country. Reduced prices and incomes there could well be accompanied by business failures and unemployment. Moreover, the gold losses could touch off serious banking disturbances that might lead to temporary business paralysis. In the countries receiving the gold, inflation became a danger. These possibilities made balance of payments developments a matter of prime concern to central banks.

The Rules of the Game In the gold standard period, the general prescription for dealing with international disequilibrium called for central bank action to support the forces automatically set in motion by the gold movements. In a deficit country, the central bank was supposed to reinforce the deflationary effects of its gold losses by raising the discount rate or selling securities in the open market. Opposite action was called for by the central bank of a country experiencing gold and capital inflows. This prescription, which really amounted to helping nature take its course, came to be known as following "the rules of the game."

It is sometimes assumed that the period of the gold standard was an idyllic age in which central banks faithfully supplemented the automatic equilibrating forces inherent in the monetary system. In practice, however, central banks often hesitated to deflate further the domestic economy when a balance of payments deficit coincided with a domestic recession. Conversely, they were often reluctant to inflate the domestic economy deliberately in opposite circumstances. In such situations, therefore, central banks sometimes did nothing or even adopted policies which offset the effects of market developments. It must be said, however, that convertibility and international equilibrium were regarded as the principal goals during the gold standard period. Consequently, central banks rarely, if ever, took action to offset completely the effects of international gold movements.

Abandonment of the Gold Standard The gold standard era came to an end with the outbreak of World War I when one country after another resorted to inconvertible paper standards. Most nations regarded the suspension as temporary, but in the economic confusion that followed the end of hostilities, restoration of the gold standard in its prewar form proved impossible. Only the United States, among the major nations, was able to return promptly to prewar arrangements. England, long the world's financial center, was not able to reinstate gold until 1925, and then in a form somewhat different from its prewar system.

Most other nations, eager to maintain some connection with the gold standard despite their meager gold holdings, adopted the gold exchange standard. Under this system a country's central bank held part of its reserves in currencies which were convertible into gold at fixed prices. These convertible currencies became "key currencies" in the sense that they supported the monetary and credit systems of other nations. Therefore, the gold stock of the gold-rich countries performed double duty, supporting the domestic currencies and also providing a base on which a huge inverted pyramid of international liquidity rested.

Gold Exchange Features Under the gold exchange standard, relatively large claims on key currency countries are held abroad. When a key currency country experiences a balance of payments deficit, these foreign claims grow. As foreign central banks accumulate the key currency beyond their reserve needs they are likely to convert it into gold and the key currency country experiences gold losses. Continued gold losses may eventually impair confidence in the key currency to the point that foreigners begin wholesale conversions into gold. Indeed, such conversions might be touched off, independently of a balance of payments deficit, by any of a variety of developments, economic or political, which might affect world confidence in the currency.

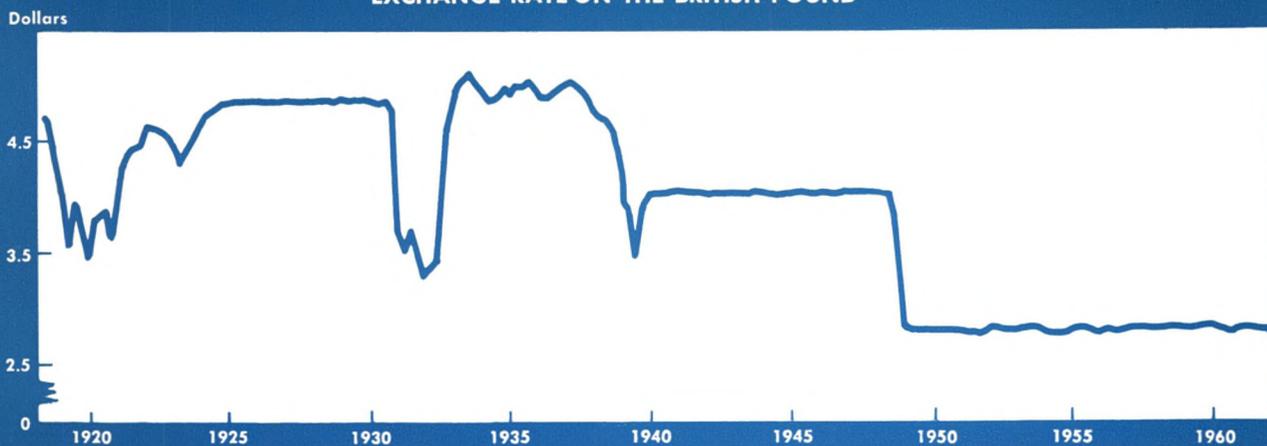
The collapse of a key currency is likely to be accompanied by serious worldwide dislocations. The monetary systems of numerous countries would be affected and the value relationship among the world's currencies, that is, the exchange rate structure, would be seriously disturbed. Inevitably, sharp curtailments in the volume of international trade and investment would follow.

THE INTERWAR PERIOD

The rules of the game apply in general in the gold exchange as well as in the old gold standard. But under the gold exchange standard of the interwar period the major countries of the world were little disposed to follow those rules. Nor were they prepared to engage in the kind of cooperation that is necessary for the continued success of a gold exchange system. Rather, each country was preoccupied with domestic problems of unemployment and with the thorny reparations issue, both a legacy of World War I. International equilibrium in this period was sacrificed to these preoccupations.

The gold exchange system of this period collapsed in 1931 with a run on the British pound, the principal key currency of that time. In that year, Brit-

EXCHANGE RATE ON THE BRITISH POUND



ain was forced off the gold standard, with disastrous effects upon the monetary systems of most other countries. The ensuing curtailment of international trade and investment was a major factor in the severity and persistence of the Great Depression.

Exchange Stabilization Funds Other countries soon followed Britain in abandoning gold. As a result, rates were torn loose from their gold moorings and began to fluctuate widely. Moreover, the world tended to divide itself into currency blocs—the sterling area, the exchange control group, and the “gold bloc.” In that environment, central banks acquired additional functions and revised their views of their immediate policy responsibilities.

Widely fluctuating exchange rates introduced added risks and complications in making international payments and discouraged world trade and investment. Accordingly, one of the first problems confronting the monetary authorities of the various countries was that of restoring some order in the exchange rate structure. To this end some countries set up exchange stabilization funds to buy and sell foreign currencies with a view to limiting exchange rate fluctuations. For the most part those exchange stabilization funds were managed by central banks. Thus central banks were called on to perform a function which was discharged automatically under the old gold standard.

A New Orientation From 1931 to the outbreak of World War II central banks, following the lead of their governments, concerned themselves primarily with promoting recovery from the Great Depression. International economic relationships were evaluated primarily from the standpoint of their immediate impact on domestic employment. Most countries introduced close controls over international trade in order to insulate the domestic economy from adverse employment effects arising out of foreign trade. Gone were the days when central banks permitted

balance of payments deficits to exert deflationary pressures on domestic business. Rather, the general practice was to pursue policies of active ease at home and to cushion the balance of payments effects of these policies through a comprehensive set of restrictions on foreign intercourse. Indeed, whenever it was possible to employ these restrictions to help domestic employment, even at the expense of another country, this practice was commonly followed.

Exchange Controls Among the various restrictions employed in this period were protective tariffs, import quotas, and exchange controls. The latter were perhaps the most important. Central banks played an important role in administering these because their effective employment required the cooperation of the commercial banking system.

In essence, exchange controls involved the mobilization of the foreign exchange earned by residents and the allocation of this exchange among importers and others wishing to make payments abroad. The execution of exchange control policy was by no means simple. The exchange control authority had to decide such things as how much to allocate for specific imports and for other purposes, what countries to favor, what domestic industries to encourage, and so forth. These decisions affected not only the external relations of the country but also the structure and performance of the domestic economy. Hence, exchange controls involved much more than mere financial manipulation.

Exchange controls, exchange rate manipulation, and the various other restrictions adopted in the period proved an effective set of tools in subordinating international economic relations to the requirements of domestic programs to restore full employment. The extremes to which they were carried in the 1930's lead many economic historians to characterize this period as one of monetary nationalism. While the restrictions may have made short-run contribu-

tions to the solution of unemployment problems, they suffered from one serious shortcoming. All countries could employ them, in beggar-thy-neighbor fashion, to help themselves at the expense of other countries. In practice they degenerated into vicious instruments of foreign policy and became an important factor contributing to the embittered international relations that preceded World War II. Their net economic effect was to reduce the volume of foreign trade and investment and to divert the resources of the world to less efficient uses.

POSTWAR DEVELOPMENTS

World War II further disrupted the pattern of world trade and investment, and restrictive practices were much tighter at the end than at the beginning. Monetary authorities the world over, however, felt keenly the need for a revitalized system of international payments under which multilateral trade could flourish.

The International Monetary Fund The establishment of the International Monetary Fund (IMF) in 1944 was a first step in the creation of a new and more wholesome environment of international economic relations. This institution aimed at abolition of exchange controls, restoration of exchange rate stability, and the institution of a system of international payments under which national governments could pursue full employment objectives while at the same time enjoying all the advantages of relatively free international trade and investment.

Basically, the IMF agreement envisaged a world payments system which had the advantages of the gold standard without its more significant disadvantages. By requiring all member nations to establish fixed, or par, values for their currencies in terms of either gold or United States dollars and to limit exchange rate fluctuations within 1% of the par value, the IMF set up an exchange rate structure similar to that under the gold standard. In the chaotic economic conditions following World War II, it was recognized that the aims of the new organization could not be achieved at short range. Therefore, special provisions were made to allow countries to move gradually over to the new system without prejudice to their programs for promoting reconstruction and recovery from the dislocations of the war. For example, member countries were allowed to maintain exchange controls and other restrictions, but with the understanding that these would be abolished as soon as recovery allowed.

Very relevant for monetary policy was the creation of a currency pool on which members could draw

in the event of temporary deficits. This pool, managed by the Fund, made available a supply of supplemental reserves which can be drawn upon in time of need. These reserves allow member countries to weather temporary deficits without deflating their domestic economies or devaluing their currencies.

In addition, member nations were allowed to change the par value of their currencies by 10% on their own authority or by any amount with the approval of the Fund if they could show this was necessary to correct a basic disequilibrium. The latter arrangement provided a means for correcting balance of payments deficits without domestic deflation, for lower exchange rates encouraged a country's exports and discouraged its imports.

As the Fund has developed, it has also become an important forum through which the world's major central banks work to coordinate their activities to maintain international equilibrium as well as domestic full employment. Other agencies which supplement this function include the Bank for International Settlements and the recently established Organization for Economic Cooperation and Development.

The New Gold Exchange Standard The painstaking efforts of international organizations like the IMF and the cooperation of the countries of the Free World led to the emergence by the late 1950's of a distinctly new international payments system. In form, the new system is a gold exchange standard, bearing a close resemblance to that of the 1925-31 period. In several important respects, however, the present system differs from its earlier counterpart. First, the major countries of the world regard it as a permanent, workable system, not as a temporary expedient. Also currencies may be defined in terms of either gold or the United States dollar. Thus, the United States dollar, rather than the British pound, has become the prime key currency, although the pound is the second major such currency.

In the present system, pyramiding on the world's gold base has been carried somewhat further than in the 1920's. In other words, a larger proportion of the world's international reserves is in the form of foreign exchange holdings, which means that the gold stock available to the Free World has to support a relatively larger volume of outstanding claims against it.

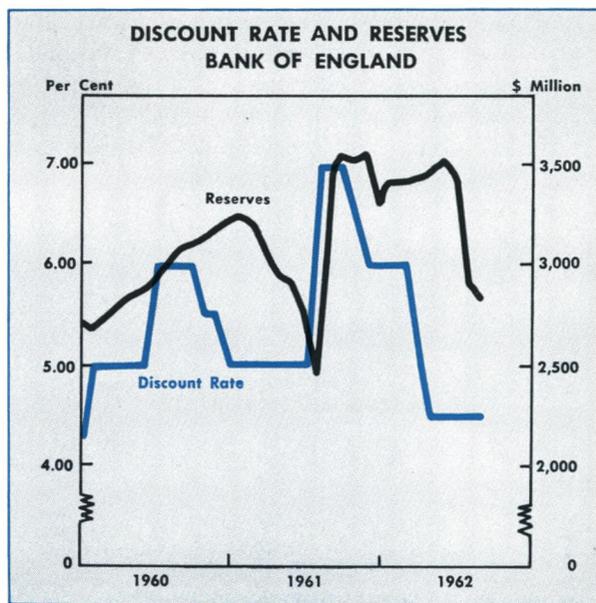
The greater degree of pyramiding, however, by no means implies greater instability. While pyramiding involves problems, it also serves a very useful purpose in economizing gold and making possible a sizable increase in international liquidity to accommodate the expanding volume of international transac-

tions. Fundamentally, the stability of the system rests on continued cooperation among the world's several monetary authorities, and this appears to be forthcoming today to a much greater extent than in the 1920's. More specifically, the system's workability depends on continuing confidence of the rest of the world in the key currencies, and this places great responsibility on the key currency country to manage its external affairs, as well as its internal finances, with prudence. The situation is analogous to that of the banker, whose deposit liabilities are far in excess of his reserves. So long as his customers' confidence is maintained, he can continue to provide his community with a satisfactory payments system. But public confidence rests ultimately on demonstrated prudence in the management of his affairs.

Balance of payments developments become of acute significance to the central bank of a key currency country. A balance of payments surplus, for example, will deprive other countries of their reserves and generate problems for them. On the other hand, persistent deficits, by placing increasing amounts of the key currency in the hands of foreign central banks, create the danger of large-scale conversions into gold. Disequilibrating balance of payments developments may be associated with international trade in goods and services or with international capital movements. The latter, especially those of a speculative nature, can be particularly hazardous. For that reason, the central bank of a key currency country must pay close attention to a variety of factors bearing on foreign trade and foreign capital movements. In particular it must be acutely alive to exchange rate movements, in both spot and forward markets, to international price differentials, and especially to international interest rate differentials and other factors that affect capital flows.

The Federal Reserve and the New System The key position of the United States in the present world payments system represents a new role for this country. Traditionally, economic activity in this country has had a predominantly domestic orientation, and foreign trade and investment have been of less relative importance than in the major trading countries of Europe and Asia. Moreover, the United States in the first half of the twentieth century had no experience with serious disequilibrium in its balance of payments. Consequently, interest in balance of payments developments has not been as great in this country as elsewhere.

After 1950, however, balance of payments deficits began to develop. The deficits between 1950 and 1958 were persistent but relatively small, in a mag-



nitude of about \$1 billion per year. In these years foreign private interests were quite willing to hold dollars, and foreign central banks were willing to hold most of the dollars presented to them in exchange for local currencies. Since 1958 the deficits have been much larger, averaging \$3.4 billion per year. These deficits have added some \$15 billion to the dollar holdings of foreigners, a large part of which has accrued to foreign central banks. Increasingly, these foreign central banks have shown a tendency to convert their additional dollar holdings to gold, and about \$7 billion has been so converted over the past five years. The threat to the dollar's world position which has been posed by these gold losses was dramatized in the fall of 1960 by the sharp rise in the price of gold on the London gold market and by the shifting of short-term funds to Europe.

These short-term capital movements involved large-scale conversions of dollars into local currencies by foreigners and placed large amounts of additional dollar balances in the hands of foreign central banks, many of which already held more dollars than they customarily held for their reserve needs. Such movements, if continued over any extended period, could result in foreign demands on the United States gold stock of dangerously large proportions.

In these circumstances, the Treasury's Exchange Stabilization Fund began more vigorous operations in the foreign exchange market in order to absorb excess dollars in foreign markets through purchases of dollars with foreign currencies and thus to reduce the purchase of gold by foreign central banks. In addition, it aimed to influence both spot and forward

prices of dollars in terms of foreign currencies in order to reduce the underlying incentive for speculative movements of capital out of this country.

To help the Treasury achieve its goal, which was also vital to the System, the Federal Reserve System began foreign exchange operations early in 1962. Operations for both the Treasury and the Federal Reserve are conducted by the Federal Reserve Bank of New York, and frequent telephone conversations between the Treasury, System, and New York Bank insure coordination in the use of both funds.

The Treasury and Federal Reserve have also cooperated to maintain short-term interest rates competitive with those abroad. To help keep short rates up, the Treasury has added significantly to the supply of short-term debt outstanding. For its part, the Federal Reserve now conducts its open market operations throughout the list of Treasury issues with a view to minimizing downward pressure on short-term yields. When, for example, the Federal Reserve needs to supply reserves to the commercial banking system, it can do so with a minimum of downward pressure on short rates by purchasing intermediate- or long-term securities.

Through interest rate policy and foreign exchange operations, the Treasury and Federal Reserve System have thus far been able to moderate foreign pressure on the dollar and the United States gold stock.

Inter-Central Bank Cooperation In its new operations in the arena of international finance, the Federal Reserve has received the wholehearted cooperation of foreign central banks and monetary authorities. This cooperation has been forthcoming in large measure from a realization that self-interest requires it. The important trading countries have a vital stake in the new gold exchange system and can ill-afford to risk its destruction. But cooperation is not a one-way street. The U. S. Treasury and the System have acted on a number of occasions to ease the problems of other countries.

Cooperation has manifested itself in a number of ways. In the first place, the foreign currency resources required for the Federal Reserve's new operations have been acquired as a result of "swap" arrangements with foreign monetary authorities. These involve granting dollar credits to these authorities in exchange for foreign currency credits, under agreements that the dollars thus acquired will not be converted into gold but rather retired by the Federal Reserve with foreign currencies purchased when the markets are more favorable. Most of these "swap" agreements have been on a stand-by basis to be implemented in time of need.

A notable example of cooperation occurred in the last half of 1960 when several of the European countries most directly involved took appropriate action to prevent flights of short-term capital from the United States and to restore confidence in the dollar. Monetary authorities of Germany and England adopted policies of greater credit ease, and the Bank of Switzerland sought to discourage the inflow of foreign capital by changing the regulations governing time deposits and the flotation of bond and stock issues on the Swiss market.

Another example occurred in March of 1961 when the pound sterling came under pressure as a result of large-scale short-term capital flights to Germany and the Netherlands touched off by revaluations of the currencies of those two continental countries. To protect English reserves, the central banks of Europe agreed to hold sterling balances instead of converting them into gold. They also issued a joint announcement to the effect that the central banks were cooperating closely against speculative capital movements. The most recent and perhaps most dramatic evidence of international cooperation occurred in June 1962, when the International Monetary Fund, the Export-Import Bank, the Federal Reserve System, and the Bank of England extended to Canada over \$1 billion in short-term credits.

Conclusion In recent years the international payments mechanism has been the subject of much controversy. Some argue that the existing system is obsolete and should be replaced by an international central bank which would perform for the entire world a function similar to that performed by a central bank for an individual country. On the other extreme, some advocate returning to the gold coin standard of pre-World War I days.

The countries of the Free World have rejected these extremes. All nations feel keenly the need of a satisfactory system of international payments, but they are also interested in preserving existing institutions. Consequently, their monetary authorities are cooperating to meet problems as they occur. They appear determined to make the gold exchange standard a workable, efficient system of international payments.

PHOTO CREDITS

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