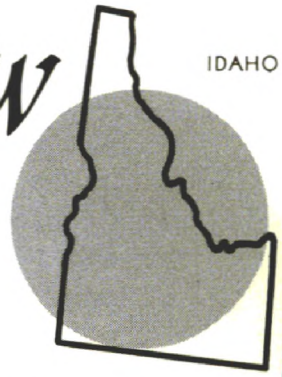
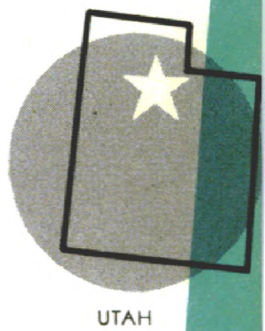
Monthly Review

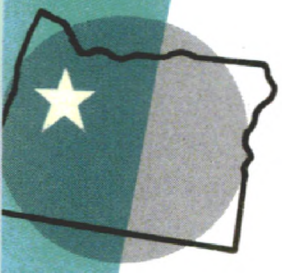


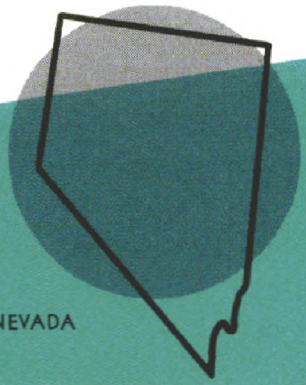
FEDERAL RESERVE BANK OF SAN FRANCISCO
TWELFTH FEDERAL RESERVE DISTRICT

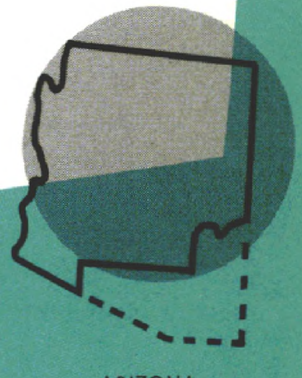
October 1961

In This Issue









Review of Business Conditions

BUSINESS activity continued to expand in both the nation and the Twelfth District during the latter part of the summer, but the rate of expansion was less than in earlier months. The nation's output of goods and services rose $10 billion to a seasonally adjusted annual rate of $526 billion in the third quarter, according to a preliminary estimate by the Department of Commerce. The increase from the second to third quarter was only two-thirds as large as the $15 billion gain from the first to second quarter, which was a record amount for the first quarter of any recovery in the postwar period. Personal income, at a seasonally adjusted annual rate of $419.3 billion in August, rose somewhat from July after subtraction of the special July payment of dividends to holders of World War II government life insurance.

Industrial production rose 1 index point to 113 percent of the 1957 average in August. While this is a continuation of the increase from the low point of 102 percent recorded last winter, it is the smallest month-to-month gain since March. Gains in the output of commercial and industrial equipment and machinery were responsible for the bulk of the increase, while consumer goods production held steady at the record levels of July. Manufacturers' new orders and sales rose in August above the July level, with most of the industry groups except automobiles contributing to the gain. Automobile sales fell in August in anticipation of the early model changes this year, but dealer inventories of new cars at the end of the month were well below those of August 1960. The auto model change-over, with its associated effects on steel and other materials output, also contributed to the lack of change in the industrial production index for September.

Employment in nonfarm business establishments in the nation rose somewhat in August, despite reductions at automobile plants associated with the model change-over period. Gains in the number at work were reported for metal and machinery industries and in retail trade establishments. Employment in financial business and state and local government rose to new highs. The seasonally adjusted rate of unemployment stayed at 6.9 percent in August, maintaining the level established last December, but preliminary mid-September data indicated a slight drop in the percentage unemployed.

The value of new construction activity totaled $57.8 billion in August at a seasonally adjusted annual rate. This was down somewhat from July figures, but preliminary data indicate some increase in September. Activity in August was about 2 percent above the average for the second quarter of this year and equaled the record high of mid-1959. Highway construction increased for the third consecutive month and residential building continued the rise which began in March. On the negative side, construction of military facilities declined somewhat, following a rise in July. Housing starts, as distinct from expenditures on new residential construction, declined in August and also fell below the number in the same month of 1960 for the first time in three months. The August declines occurred primarily in the Northeast and in the West, while housing starts rose in the Southern and North Central regions. Federal Housing Administration forecasts of total housing starts for 1961 have been revised downward somewhat to 1.3 million units but remain about 3 percent above last year's level.

Outlays of business firms for new plant and equipment are expected to rise in the last six months of this year above the low second-quarter levels. Department of Commerce estimates indicate that in the third quarter gains will be shown in outlays by primary iron and steel producers, in all categories of nondurable goods manufacture, nonrail transportation, public utilities, and a miscellaneous group. Capital spending by durable goods

manufacturers as a whole, however, are expected to show some decline from the second quarter. Since spending in the first half of the year was lower than had been anticpiated, the earlier estimate of $34.5 billion in total capital spending for the year as a whole has not been changed despite the increase mentioned above.

Retail sales as a whole rose 1 percent in August, and department store sales remained close to the high level reached in July. Retail sales of automobiles, however, fell in anticipation of the forthcoming 1962 models. Total consumer credit outstanding rose somewhat in August over July, after seasonal adjustment. Instalment loans for automobile purchases declined further in August, but all other consumer loan categories increased. Auto sales continued to lag badly in the first two-thirds of September, but sales picked up in the last third of the month and department store sales also improved.

The slack in over-all loan demand at commercial banks has been mainly offset by securities acquisitions. Total bank credit declined $300 million in August, after a substantial rise in July in response to that month's Treasury financing operations. Total loans remained unchanged, while the August decline in the United States Government security portfolios of banks was partly offset by an increase in their holdings of other securities. No change occurred in the seasonally adjusted money supply between the second half of July and the second half of August, but time deposits rose substantially in August as in previous months. Loans adjusted and investments increased nearly $3 billion at weekly reporting member banks during September. In late September banks bought large amounts of a new issue of tax anticipation bills, and some of the loan increase during the month was associated with Treasury financing operations. Preliminary estimates also indicate that the money supply rose significantly in the first half of September. Member bank reserve positions continued to be easy in August and September.

After the record pace of corporate offerings in the first half of this year, the capital markets have recently been dominated by Treasury financing operations. In the last half of September, the Treasury raised $2.5 billion in new funds through the sale of tax anticipation bills and completed an exchange of two wartime "tap" issues maturing in 1970 and 1971 for reopened 3½ percent bonds maturing in 1980, 1990, and 1998. Of the $7.6 billion of outstanding issues eligible for exchange, nearly one-half was converted into the longer term securities, with the amounts about equally divided among the three exchange issues. On September 28, the Treasury announced the sale on October 11 of an additional $2 billion of the outstanding 3¼ percent Treasury notes which mature May 15, 1963. As a final step in its autumn financing program, the Treasury will offer $2 billion of one-year Treasury bills to replace $1.5 billion of outstanding one-year bills which mature on October 16. Yields on medium and long-term Treasury bonds have been fairly stable in recent weeks, while Treasury bill yields have shown some downward trend, reflecting in part the continued ease in member bank reserve positions.

District employment situation improved in August

District nonfarm employment rose nearly one-half percent in August, compared with a one-tenth percent increase nationally.[1] Manufacturing employment was up 1.1 percent for the month, the largest gain in any industry category. Government and mining employment rose 0.5 percent, while trade and finance both gained 0.3 percent. Employment fell in the construction and service industries, both of which have been relatively weak throughout the entire recovery period. Within manu-

[1] All employment data are seasonally adjusted.

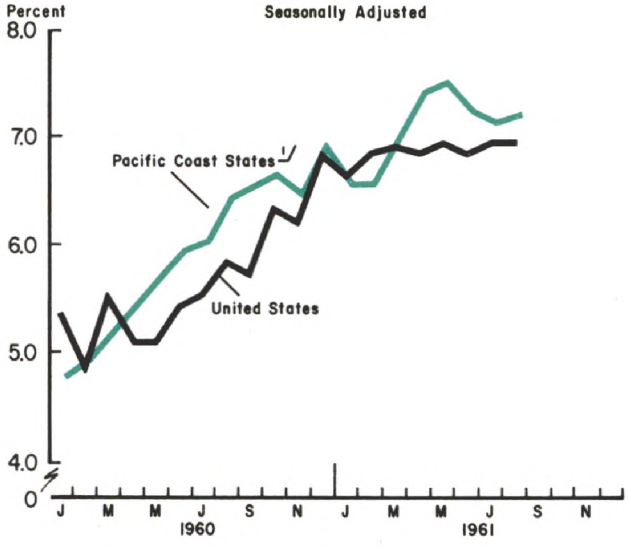
facturing, nondurables employment registered the sharpest advance, partly reflecting recovery from a nonseasonal decline the previous month in the typically erratic food and kindred products group. Fairly sharp gains occurred in transportation equipment and fabricated metals, while lumber and wood products and nonelectrical machinery were the only groups to record actual declines during the month.

Employment developments in the District in August measurably narrowed the gap between regional and national employment gains which has been a characteristic of the recent recovery. Since the turnaround in general business last February, nonfarm employment nationally has risen half again as fast as in the District. Although the regional lag is largely a reflection of slack in a few manufacturing industries, the District's construction, finance, and mining sectors have also fallen behind the national pace. In August, however, most nonfarm employment categories showed greater improvement in the District than in the nation as a whole.

In contrast, District unemployment—particularly in terms of the unemployment rate—showed no improvement. As of mid-August, unemployment in the three Pacific Coast states was up 12 percent from last February, compared with only a 0.3 percent increase nationally. From July to August, unemployment in the District rose nearly 3 percent, more than twice the relative gain in the nation as a whole. At mid-month, the unemployment rate remained slightly above the 7 percent level, compared with 6.9 percent nationally.

In August, the United States Bureau of Employment Security reclassified San Jose, California from an area of substantial unemployment to one of moderate unemployment (3.0 to 5.9 percent). The improvement resulted primarily from the usual seasonal expansion in food processing and an acceleration in durable goods manufacturing, particularly ordnance and electrical machinery. Of the fifteen major labor market areas in the District, 60 percent were still classified in August as having substantial unemployment (6.0 to 8.9 percent) compared with 57 percent for the nation. Seventeen smaller areas in the District were similarly classified; eight of these were also designated as "areas of substantial and persistent unemployment" and are eligible for assistance under the provisions of the Area Redevelopment Act recently enacted by Congress.

District rate of unemployment exceeds national rate



Note: Data represent unemployment as a percentage of the civilian labor force.
Source: United States Department of Labor and state departments of employment.

Construction contract awards rose in August

The dollar value of construction contracts awarded in the District during August amounted to $665 million. This was 7 percent above August 1960 compared with an 8 percent gain for the nation. Residential contracts rose 6 percent above August last year because of increased contracts for multi-family units. Contrary to the national pattern, nonresidential activity also increased in the District during August, rising 7 percent above the corresponding month of a year ago. Increased

contracts for industrial building contributed most of the gain. From January through August, the volume of this type of construction has been maintained at a relatively higher level in the District than in the nation. Heavy engineering activity rose 12 percent above August 1960, owing to some pickup in contracts for both public works and utilities construction.

Applications for FHA mortgage insurance on new housing in the District continued to increase in July. The total number received was almost one-third greater than in July 1960, raising the year-to-date total 12 percent above the corresponding 7-month period last year. Later data from several larger metropolitan areas suggest that the District will follow the national pattern of increase in FHA applications in August.

Larger discounts on FHA-insured mortgage have apparently been emerging in District residential mortgage markets. The latest survey by the Federal Housing Administration in its Western region, which includes Wyoming and Montana in addition to Twelfth District states, showed that secondary market prices on FHA-insured 5¼ percent new home mortgages on September 1 were slightly below the August level. Secondary market purchases in the District by the Federal National Mortgage Association picked up sharply in August, although the increase was somewhat less than that from July to August 1960.

Lumber orders failed to pick up in early September

New orders for Douglas fir, which had slipped perceptibly during the latter part of August, failed to pick up during the first half of September. As a result, fir production continued to remain above the level of new business. This is not uncommon at this season, but it is reported to have dimmed the industry's hopes for the remainder of the year. Fir inventories held steady during this period. Orders for western pine items also lagged through the first half of September and continued to run below pine output. Lumber prices continued to decline through the last half of August, but by no more than the usual seasonal amount. According to Crow's lumber price index, the average price fell by approximately $0.50 during the last two weeks of August, which was in line with recent experience. In early October, prices for both fir plywood (¼-inch sanded) and green fir lumber dropped significantly. The new $60 price for plywood equaled the post-World War II low reached early in 1961 and the $57 price for green fir random length two-by-fours was below the year-ago level. In both cases, the price reduction reflects the market effects of a volume of production which has been considerably in excess of demand in recent weeks.

District steel production down; copper output up

Steel production in the Twelfth District for the month of August continued its decline from the high point in May, and weekly figures indicated a further decrease for September. However, a stronger demand from the construction industry resulted in the relighting of a furnace by a major producer in northern California, which was reflected in an increase in Western steel production during the week ended September 23.

Shipments and new orders of copper fabricators rebounded sharply in August from July, and industry officials expect September and October to show further increases. Refined copper production for August was at its highest level since May, while inventories increased for the first time this year in spite of a rise in shipments from July. Producers and custom smelters reported that the demand for copper eased somewhat in September, but the price of refined copper held steady at 31 cents per pound. However, settlement of labor disputes involving both domestic and foreign mine producers appear to

have contributed to the series of reductions in scrap copper prices in recent weeks.

Retail sales generally continue to lag

Sales of Group I retail stores[1] in the Twelfth District during July dropped 3 percent from June. However, for the second consecutive month they were above the year-ago level. The only types of stores which showed increases from June to July were eating and drinking establishments and gasoline service stations, reflecting vacation spending. Decreases from June levels were spread among all other types of retail establishments, although hard goods stores experienced sharper declines than did others.

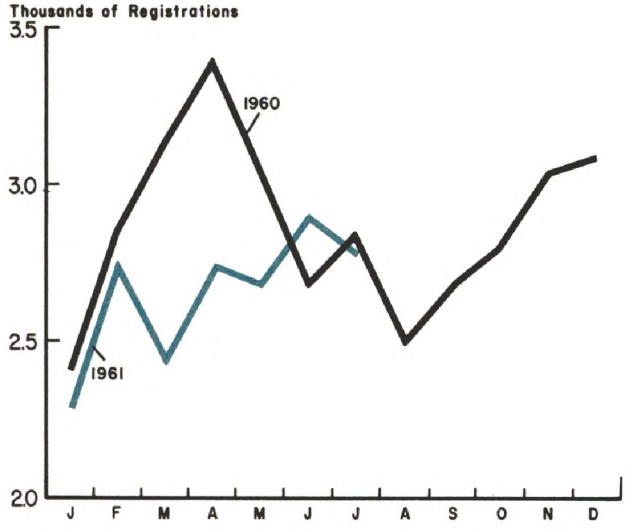
District department store sales declined 6 percent from July to August, after adjustment for seasonal factors. Preliminary figures taken from the weekly series indicate that September department store sales rose more than seasonally. For the 4 weeks ended September 23, department store sales were 7 percent above the year-ago level in the District compared with 2 percent nationally. Increased sales were fairly general throughout the District, although San Diego, Sacramento, Salt Lake City, and Spokane had considerably larger than average gains.

New passenger car registrations in the District during July were at the lowest monthly level since April, falling 8 percent below the June number and 2 percent below July 1960. California new car registrations in August were 14 percent below the July daily average. In the last two-thirds of August, they fell to the lowest daily average since the end of January of this year reflecting low inventories, and consequently a limited selection, as well as anticipation of the new models.

Farm receipts continue to strengthen

For the third consecutive month, receipts from marketings by District farmers in July

District new car registrations
less than last year



Note: Data represent daily average registrations for each month.
Source: R. L. Polk & Co.

were slightly higher than in comparable months of 1960. Nevertheless, receipts from farm sales during the first seven months of the year lagged behind the record-setting pace in 1960. Based on September 1 production estimates, crop output in the District is expected to be at least equal to that of 1960. Such a large supply of crops may raise District farm marketing receipts above the $5 billion level again this year.

Substantial annual increases in gross cash income are necessary to offset the effects of a steady rise in farmers' production expenses. Since 1954, the production expenditures of District farmers have risen on the average more than $100 million per year, with the bulk of the increase going to nonfarm recipients. Realized net income in 1960, despite the rise in costs, was about the same as in 1954. In the first seven months of 1961, cash receipts of District farmers totaled $50 million less than in comparable period last year. With a continued rise in production costs and lower cash income, farmers have had to borrow more heavily. In the first half of 1961, the extension of production credit loans to farmers by District member banks was $40

[1] Stores of firms operating 1-10 stores at the time of the 1958 Census of Business.

million larger than in the corresponding period of 1960. In addition, the dollar volume of loans made by Production Credit Associations also was greater.

District bank loans have risen from mid-year level

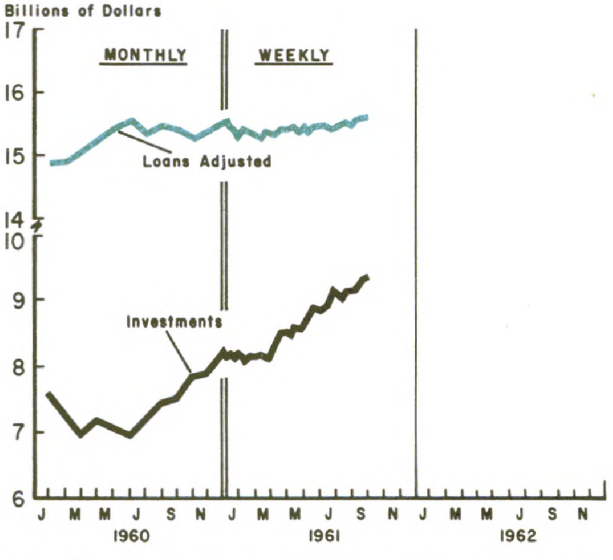
In the first two months of the third quarter member banks in the Twelfth District increased their loans and investments by $544 million, about $20 million less than the expansion in total bank credit in the corresponding period last year. The distribution of the increase between loans and investments, however, clearly indicates the difference in business conditions that prevailed in the two periods. This year, when business was expanding in July and August, more than one-third of the growth in bank credit was accounted for by loans, whereas in the depressed conditions of a year ago loans were responsible for only 2 percent of the increase. During July and August of this year, there was little variation between reserve city and country banks in the percentage increases in loans and investments. Member banks in Arizona, however, had small declines in both loans and investments during this period.

Data for weekly reporting member banks in the District indicate that loan volume continued to rise in the first three weeks in September. Except for loans to domestic commercial banks, the increase was general, with every loan category showing a gain. Borrowing to meet mid-September tax payments probably accounted for a major portion of the rise in business loans that occurred just prior to the middle of the month. Demands for funds by the food processing industry in connection with the canning season was also a supporting factor in the recent rise in business borrowing as was a modest increase in construction loans. The increase in loans to sales finance companies that occurred in the week ended September 20 is typical around corporate tax dates as firms holding sales finance company paper allow it to run off and finance companies turn to banks for temporary accommodation.

In the first three weeks of September, District weekly reporting banks increased their total holdings of United States Government securities as sales of Treasury bills were more than offset by gains in holdings of certificates of indebtedness, and of notes and bonds with maturities within less than one year. These banks also added substantial amounts to their other security holdings. The latter action probably reflects the banks' desire to obtain higher rates of return on their investments as a means of meeting generally rising costs, which have been accentuated by the increased costs resulting from daily computation of interest on time deposits.

That banks in the District had, on balance, excess reserves during the first three weeks of September was evidenced by the fact that they were unusually heavy net sellers of Federal Funds. For several days in the week ended September 13 net sales of Federal Funds by District banks were made in record amount, but the rates at which funds were sold averaged only ¼ to ½ percent below the discount

Volume of bank loans comparatively stable while investments rise



Note: Data are for Twelfth District weekly reporting member banks.

CHANGES IN SELECTED BALANCE SHEET ITEMS OF WEEKLY REPORTING MEMBER BANKS IN LEADING CITIES

(dollar amounts in millions)

	Twelfth District				United States			
	From Aug. 23, 1961 to Sept. 20, 1961		From Sept. 21, 1960 to Sept. 20, 1961		From Aug. 23, 1961 to Sept. 20, 1961		From Sept. 21, 1960 to Sept. 20, 1961	
	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
ASSETS:								
Total loans and investments	+379	+ 1.53	+1872	+ 8.02	+1602	+ 1.39	+7631	+ 6.96
Loans adjusted and investments[1]	+359	+ 1.46	+1876	+ 8.15	+1696	+ 1.48	+7779	+ 7.19
Loans adjusted[1]	+182	+ 1.18	+ 203	+ 1.31	+1321	+ 1.90	+ 976	+ 1.39
Commercial and industrial loans	+ 95	+ 1.79	+ 98	+ 1.84	— 372	— 1.18	— 644	— 2.03
Real estate loans	+ 22	+ 0.41	— 12	— 0.22	+ 88	+ 0.67	+ 249	+ 1.93
Agricultural loans	+ 11	+ 1.48	+ 62	+ 8.96	+ 29	+ 2.60	+ 78	+ 7.31
Loans for purchasing and carrying securities	— 22	—10.09	— 20	— 9.26	+ 481	+12.81	+ 557	+15.14
Loans to non-bank financial institutions	+ 37	+ 4.81	— 43	— 5.06	+ 252	+ 4.95	— 669	—11.13
Loans to domestic commercial banks	+ 20	+ 7.14	— 4	— 1.32	— 94	— 6.60	— 148	—10.01
Loans to foreign banks	+ 21	+11.54	+ 4	+ 2.01	+ 1	+ 0.18	— 141	—20.35
Other loans	+ 19	+ 0.60	+ 130	+ 4.27	+ 29	+ 0.18	+ 868	+ 5.64
U. S. Government securities	+ 63	+ 0.93	+1265	+22.64	— 141	— 0.42	+4824	+17.01
Other securities	+114	+ 5.01	+ 408	+20.57	+ 516	+ 4.61	+1979	+20.33
LIABILITIES:								
Demand deposits adjusted	+176	+ 1.54	+ 293	+ 2.59	+1286	+ 2.09	+1521	+ 2.49
Time deposits	+105	+ 0.81	+1662	+14.54	+ 389	+ 0.96	+6655	+19.43
Savings accounts	+ 64	+ 0.62	+ 954	+10.06	+ 148	+ 0.51	n.a.	n.a.

n.a. Not available.
[1] Exclusive of loans to domestic commercial banks and after deduction of valuation reserves; individual loan items are shown gross.
Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of San Francisco.

rate, indicating that District banks were in a considerably easier reserve position than banks in the rest of the nation. In the last part of the month, however, the reserve positions of District banks were less easy, and sales and purchases of Federal funds were more nearly in balance.

Borrowing costs on business loans decline

The quarterly interest rate survey conducted by the Federal Reserve Bank of San Francisco in September disclosed some decline from the second quarter in the rate of interest business firms paid for both short- and long-term funds borrowed from Twelfth District banks, but loans of more than one year in maturity accounted for almost all of the decrease. The unweighted average interest rate on short-term loans of one year and less made during the first half of September was 5.34 percent, a decrease of 2 basic points from the rate of 5.36 in June. This contrasts with the 8 basic point increase that occurred in the second quarter of 1961, but the average interest rate was still slightly above that prevailing in March. As in the second quarter, nearly one-third of the dollar amount of short-term loans was made at the prime rate of 4½ percent. The major change in the pattern of rates was a decline in the proportion of loans bearing rates over 6 percent. The average rate on business loans of over one year fell from 5.51 percent in June to 4.89 percent in September. This change in the normal interest relationship—lower interest rates on short-term than on long-term business borrowing—was accounted for by the large percentage of long-term loans made with 18 months' maturity at or near the prime rate.

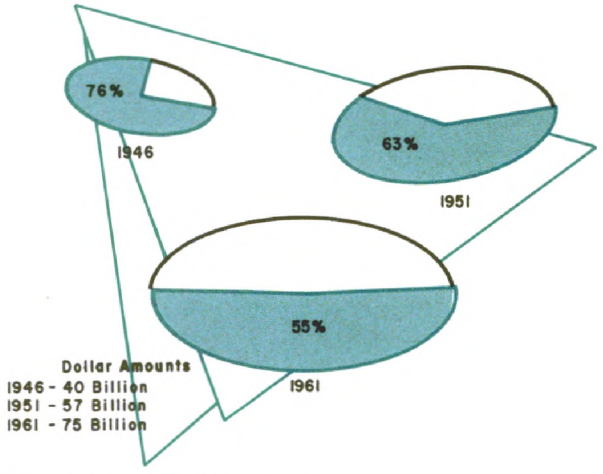
The Search for Certainty in An Uncertain World

Part III

THE PRESENT POSITION OF GOLD AND THE DOLLAR

As we have seen from the two preceding articles in this series,[1] gold evolved from a metal of primarily ornamental value into the predominant monetary standard of value and medium of exchange both for internal and external transactions and then, more recently, into its principal function today as part of the international payments system. Gold serves now more as a "cushion" or "buffer" against disturbances emanating from abroad although it still transmits international influences as it did under the old gold standard system. It is now only one of several components of the international payments mechanism. The United States dollar, the pound sterling, International Monetary Fund quotas and subsidiary payments arrangements such as the European Payments Union have supplemented gold in providing international liquidity. At the end of June 1961, gold accounted for approximately 55 percent of total official holdings of international reserves of monetary authorities and international institutions, compared with 63 percent in 1951 and 76 percent at the end of 1946. Thus gold has become a smaller part of international reserves in the postwar period.

Gold has become a smaller part of international reserves



Source: International Monetary Fund.

THE CURRENT ROLE OF THE DOLLAR

Since the collapse of the gold standard in the 1930's and particularly after World War II, the United States dollar — and to a lesser extent the pound sterling — has constituted the largest source of additions to international liquid assets. Increases in the supply of gold from new production, dishoarding, and Russian gold sales combined have accounted for a smaller proportion of the increase in international reserves than dollars or sterling. At the end of 1960, United States liabilities to foreign official holders totaled almost $12 billion — or more than half of the foreign exchange reserves of foreign official institutions, pound sterling comprised about 35 percent, and liabilities of others such as the Bank for International Settlements and the European Payments Union accounted for the rest. The International Monetary Fund held about $11.7 billion in foreign exchange, more than half consisting of convertible currencies. The use of "key" currencies as international reserves and means of payment has permitted economization of gold and the relatively smooth expansion of world trade and production. Within the past ten years, foreign official dollar balances (excluding International Monetary Fund holdings of dollars) have risen by almost $8 billion while official gold

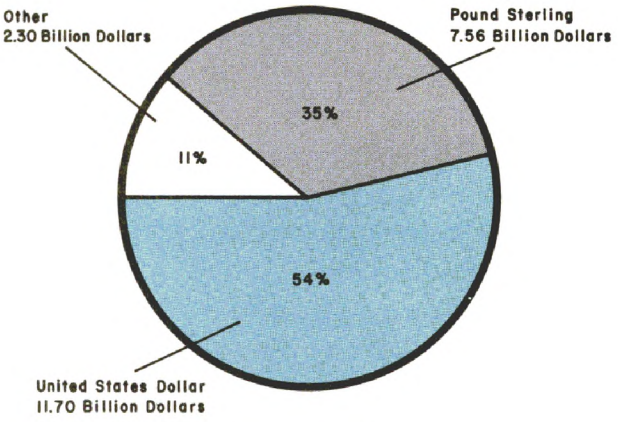
[1] *Monthly Review* of the Federal Reserve Bank of San Francisco, May and July 1961.

holdings increased by only $5 billion and sterling balances declined by $1 billion. At the present time, the United States dollar is more widely held as official reserves than the pound sterling.

The dollar is also used extensively in international trade and for settlement of other international payments. Since 1951, for example, private holders such as foreign commercial banks, businesses, and individuals have added about $3.5 billion to their short-term dollar balances in this country for a total of over $7 billion in short-term claims on United States banks at the end of 1960. During the same period United Kingdom liabilities to foreign nonofficial holders grew by almost $2 billion to $3.8 billion, but $1 billion of the increase occurred in 1960 alone because of the attractive yields obtainable in the United Kingdom on short-term money market assets such as Treasury bills.

The rise of the United States dollar to a position of pre-eminence as an international reserve currency in the postwar period was made possible by the fact that this country emerged from World War II economically and politically strong and physically unscathed. The United States is now the leading international banker, providing both long- and short-term finance to the rest of the world, and performing many of the essential functions that the position of banker to the world entails. There is an active foreign exchange market in New York where all the major currencies are bought and sold; bankers' acceptance financing has increased sharply; United States commercial banks have expanded their foreign and international operations; and the United States Treasury's policy of selling gold to foreign official institutions at $35 per fine ounce is the cornerstone of international currency stability. The United States has supplanted the United Kingdom as the principal supplier of capital to the world since the outflow from London was significantly reduced

U. S. dollar most widely held currency in official reserves



Source: International Monetary Fund.

by the loss of a large portion of the United Kingdom's overseas assets during World War II. This long-term capital has taken the form of Government grants and credits and private investments. The United States position is further emphasized by the role that this country occupies in the political arena through its assumption of world-wide military and political responsibilities.

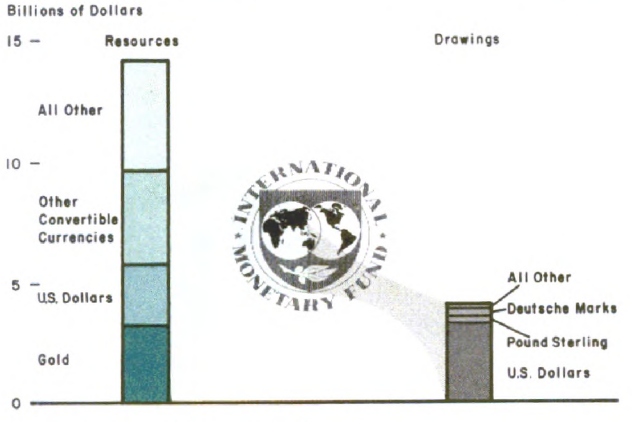
Postwar international institutions facilitate international payments mechanism

A number of international institutions were set up in the postwar period to assist in the adjustment process of the international payments mechanism, supplementing the functions of the United States dollar in evening out short-term disturbances and in providing longer term finance. The International Monetary Fund extends short-term financial help to countries in temporary balance of payments difficulties. Its resources consist of gold and currencies of the individual member countries paid in by each member as its subscription. Each country's quota is determined by its relative importance in international trade, population, and national income. One-fourth of each member's quota (or 10 percent of total gold and dollar reserves for members joining before 1948, whichever was smaller)

was paid into the Fund in the form of gold and the remainder in the member's currency (actually nonmarketable non-interest-bearing Government obligations). Drawings from the Fund (purchases of another currency from the Fund by deposits of the borrowing member's currency) are almost automatically approved for the first 25 percent of a country's quota (the so-called gold tranche), with subsequent drawings contingent upon presentation of evidence that the country concerned is taking the necessary steps to eliminate the payments imbalance. Repayment generally is in the form of "repurchase" of the country's own currency with gold and convertible currencies, in more or less the same proportion as the composition of the increase in the borrowing country's reserves. The obligation incurred by a drawing must be discharged within a period not exceeding 3 to 5 years.

Because of the postwar importance of the United States dollar in international payments, 90 percent of the gross drawings from the Fund from 1947 through 1959 — or $3.1 billion out of $3.4 billion — consisted of United States dollars. As other currencies have become convertible, however, less than 40 percent of the $780 million in drawings from January 1960 through July 1961 has been in United States dollars, 25 percent has been in deutsche marks, and 15 percent in pounds sterling. By providing such short-term financial assistance, the Fund has minimized the need for a country in balance of payments difficulties to impose trade and exchange restrictions or restrictive domestic measures to counter short-run balance of payments pressures and has thus contributed to the maintenance and expansion of multilateral trade.

Most of International Monetary Fund drawings have been in dollars



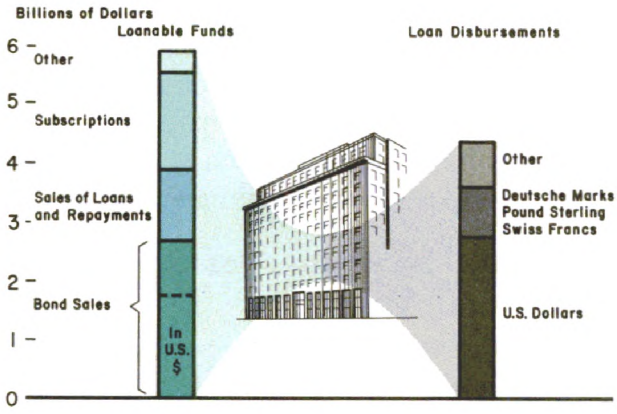
Note: Data as of June 30, 1961.
Source: International Monetary Fund.

The World Bank provides longer term finance

To meet the need for long-term developmental capital, the International Bank for Reconstruction and Development (also known as the World Bank) was established in 1946 at the same time as the International Monetary Fund. It was designed to promote economic development and stimulate the growth of productive capacity in member countries by providing a dependable source of investment capital. Credits are extended to member governments or to private borrowers who have obtained a government guarantee. If countries can rely on access to long-term funds from abroad when needed, especially underdeveloped countries with a relatively low level of savings and undeveloped capital markets, they can obtain additional resources currently to devote to economic growth and industrial development and at the same time maintain gold and foreign exchange reserves sufficient to meet temporary drains. One of the major problems of the interwar period was the unreliability of long-term capital exports from the United States and the United Kingdom, which impeded economic development, particularly for the primary-producing countries which are otherwise highly dependent upon sharply fluctuating receipts from exports for the foreign exchange to finance needed imports.

The World Bank utilizes funds derived from the paid-in portion of member countries' subscriptions and from the proceeds of

Large part of World Bank's loanable funds and disbursements in dollars



Note: Data as of June 30, 1961.
Source: International Bank for Reconstruction and Development.

its own bonds sold in the capital markets of member countries and Switzerland. Each member of the World Bank was required to pay in 2 percent of its quota in gold or United States dollars at the time it joined the organization and 18 percent in its own currency; the remaining 80 percent was subject to call only to meet obligations of the Bank if necessary. In 1959 the authorized capital of the Bank was increased from $10 billion to $21 billion. No part of the increase in each member's quota was paid in at the time, except for members whose subscriptions were more than doubled, although all of the increase is subject to call. By the end of 1960, more than 40 percent of the funds available for World Bank loans had been obtained from sales of Bank bonds, with another 23 percent from sale of Bank loans to private lenders and repayments on prior loans and 28 percent from subscriptions. More than three-fourths of the Bank's bonds have been denominated in United States dollars. The maximum lending authority of the Bank is 100 percent of unimpaired subscribed capital, reserves and surplus—or $21 billion. At the end of June 30, 1961 the World Bank had disbursed to member nations $4.3 billion of the $5.7 billion in authorized credits and received $850 million in repayments. Almost two-thirds of the Bank's disbursements have been in United States dollars, while 20 percent have consisted of pounds sterling, Swiss francs, and German marks.

Augmenting the long-term credit facilities of the World Bank are two affiliates: the International Finance Corporation, which came into operation in 1956, and the International Development Association, which was approved by the required number of member nations in 1960. The International Finance Corporation specializes in investing in private enterprises in developing member countries through long-term loans which carry additional rights to share in profits or growth of the enterprise and which do not require a government guarantee. Of the authorized capital of $100 million, $96.6 million has been subscribed and $42 million has been committed to various projects. The International Development Association provides capital for development projects from its $1 billion in authorized capital if financing is not available from private sources or the project is not eligible for a World Bank loan. The International Development Association's credits are extended on easier terms than those of the World Bank, with longer maturities, somewhat lower rates or even interest-free, and repayment in the currency borrowed. Regional organizations have also been established to provide investment capital to members, such as the European Investment Bank and the Overseas Development Fund for the European Common Market, the Central American Bank for Economic Integration for the Central American Common Market, and the Inter-American Development Bank.

The international payments system today is thus based on gold and the United States dollar, supplemented by the pound sterling and the International Monetary Fund which operated until recently largely in dollars. In contrast, the payments mechanism in the days

of the old gold standard revolved around gold and the pound sterling. The United States dollar became the dominant international currency only in the interwar period under the gold exchange standard without, however, the additional support now provided by international organizations.

An altered trading environment confronted the United States in 1958-60

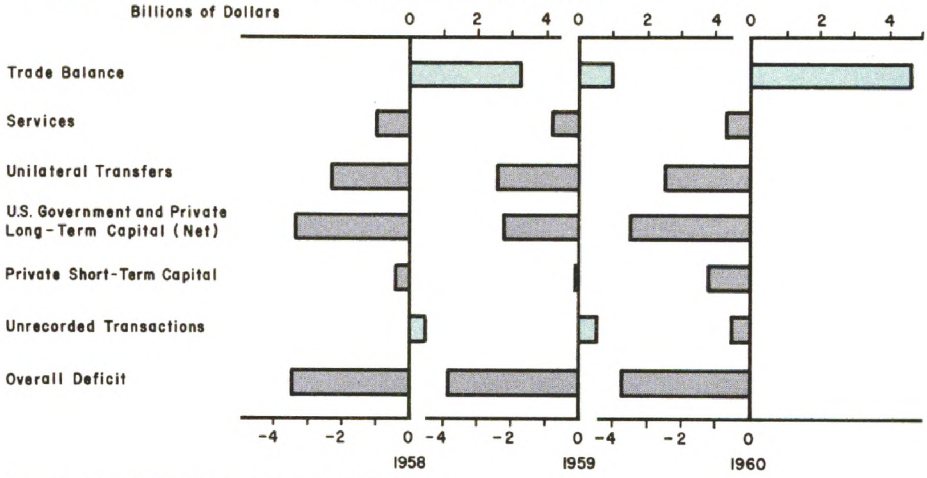
The experience of the United States with sizable balance of payments deficits in the three years 1958-60, sharply emphasized by the increase in the London gold price to $40 per ounce in October 1960 and speculative outflows of privately-held funds from the United States, and the recent problems encountered by the United Kingdom following the March 1961 revaluation of the German mark and the Netherlands guilder have stimulated discussion concerning the weaknesses and strengths of the current payments system. Initially, much of the discussion centered on the United States balance of payments position alone; but because short-term capital movements affected other countries such as the United Kingdom and Germany, as well, the discussion expanded into the more general topic of international liquidity. The problems arising out of the recent pressures on the United States dollar (and also the pound sterling) can be separated into three fairly distinct categories: (1) the restoration of balance between the external receipts and payments of a country in deficit, such as the United States or the United Kingdom, or of a country in surplus, such as Germany; (2) the ability to control or offset disruptive effects of sudden and large flows of "hot money" between countries, particularly from "key currency" countries; (3) the adequacy of international liquidity in the future.

The $11 billion in United States balance of payments deficits in 1958-60 aroused doubts in some quarters about the strength of the dollar. Up until 1950 United States Government and private capital exports, and from 1950 onwards the over-all balance of payments deficits, contributed to the reconstruction and recovery of the war-torn countries overseas and to the better distribution of gold and foreign exchange reserves among the various trading nations. But from 1958 through 1960, United States deficits jumped sharply to $3.5 billion or more each year, a level that obviously could not be sustained for any extended period of time. European countries, which were the principal gainers, moreover, no longer needed financial assistance for reconstruction or the build-up in reserves. Foreign-owned short-term dollar balances in this country had risen to $15 billion by the end of 1957 and totaled more than $21 billion by the end of 1960. The United States gold stock fell to $17.8 billion by December 1960, causing some to question the adequacy of United States gold reserves in relation to short-term liabilities to foreigners and in view of the requirement that 25 percent of Federal Reserve Bank note and deposit liabilities had to be backed by gold.

The reasons behind the striking increase in the excess of United States payments to foreigners over receipts, which resulted in the accumulation of these large foreign-owned dollar balances, were partly structural in nature and partly due to temporary developments. The Suez crisis and its aftereffects in 1956-57, crop shortages in Europe, and large cotton shipments abroad boosted exports to unusually high levels in 1957, followed by a sharp decline in 1958 as these special circumstances ceased to affect our trade. In addition, the lag in United States conversion to jet aircraft production and the 1959 steel and copper strikes were in part responsible for keeping our exports down, while the strikes and sizable imports of foreign passenger cars in 1958-59 operated to swell imports

and reduce our surplus on merchandise trade. At the same time, the full impact of the recovery of Germany, Japan, and other industrial countries began to be felt in United States markets at home and abroad. These countries were now able to compete effectively with many United States products on the basis of price, style, quality, service, delivery time, and credit terms. The mobility of short-term funds, and their responsiveness to interest rate differentials or speculative prospects, was also enhanced by the adoption of nonresident currency convertibility by a number of leading countries at the end of 1958.[1]

U. S. payments deficits in 1958-60 due to both temporary and structural developments



Source: United States Department of Commerce.

In addition to the part played by the altered trading environment and the greater sensitivity of short-term funds in increasing the deficit in 1958-60, United States policies had not adjusted fully to the changed circumstances. The emphasis of United States Government long-term foreign aid programs had shifted largely from Western Europe to the countries of Asia, Africa, and the Near East. United States Government military expenditures abroad, on the other hand, still tended to be concentrated in countries with high and rising levels of gold and foreign exchange reserves; a large part of recent private direct investment has been in the industrial countries of Europe, encouraged partly by favorable tax treatment for earnings of foreign subsidiaries and partly by the establishment of the European Common Market; and foreign travel in the United States has not been actively promoted. Recently, the United States has stepped up its efforts to enlist the assistance of industrialized countries with improved reserve positions to help the United States achieve a better payments balance through continuing liberalization of international trade and capital movements, assumption of a large part of the burden of mutual defense, and increased aid to less developed areas of the world.

Large short-term capital outflow after mid-1960

From 1958 through mid-1960, the United States balance of payments deficit was caused primarily by weakness in the trade balance; the outflow of Government and private capital from the United States did not differ significantly from that of previous years. In the latter half of 1960, however, the widening of the deficit could be ascribed to sizable increases in the outward movement of both foreign and United States private short-term capital, which led to a gold outflow, rather than to the smallness of our merchandise trade surplus, which rose to an annual rate of $5 billion in the third quarter of the year and to $6 billion in the last quarter. Part of the short-term capital exports was due to divergent economic conditions in the United States and in Western Europe and Japan, which at-

[1] For a more detailed discussion of the whole postwar period, see "Our Balance of Payments in Perspective," *Monthly Review*, Federal Reserve Bank of San Francisco, August 1960.

tracted funds to those countries where yields were higher and encouraged foreign short-term borrowing in the United States, where interest costs were lower and credit more readily available. Funds also moved out of the United States into foreign stocks and bonds because the prospects of capital appreciation under boom conditions were bright. Part of the outflow, however, was attributable to distrust of the dollar created by the continuing balance of payments deficits, the conversions of dollars into gold, and fear of inflation in the United States. Speculation against the dollar was also evident in the sharp rise in the London gold price in the fall of 1960, the influx of funds into Switzerland and the Netherlands where interest rates were no higher than in the United States, and in the unaccustomed outflow of funds from the United States through lags in payment for goods and services and possibly temporary investment of corporate cash in foreign money markets instead of repatriation to the United States as investment income. Speculation in favor of an upward revaluation of the German mark because of Germany's persistent balance of payments surplus was also instrumental in the movement of private liquid capital abroad.

Doubts about the competitiveness of United States products in domestic and foreign markets, which had been suggested by the decline in our surplus on goods and services in 1958 and 1959, were to some extent dispelled by the improvement in the trade balance throughout 1960. Various price indexes for the United States and other industrial countries provided little support for the view that United States prices as a whole had risen faster than those of her competitors, although it is true that productivity increases have been somewhat greater abroad. Special short-run factors that held down American exports and swelled imports in 1958 and 1959, such as the demand for the smaller foreign passenger cars and delays in jet aircraft deliveries, had disappeared by 1960. The satisfactory showing of other United States exports also did not indicate that United States products were over-priced. But the situation of the past three years has underlined the importance of keeping United States goods and services competitive with those of other industrial nations.

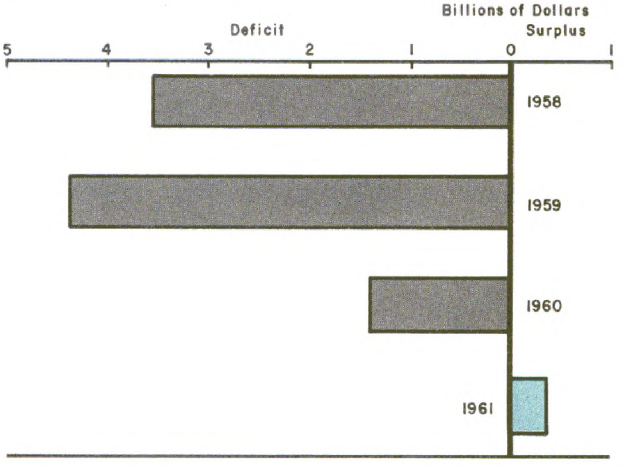
Some of the rise in the trade surplus in 1960, like that of short-term capital exports, was due to the strength of economic activity in Western Europe and Japan, which stimulated United States exports, and to the recession at home, which caused imports to drop off. Thus the conjuncture of a recession in the United States and boom conditions in Europe was responsible for both a larger trade surplus and the outward movement of short-term funds.

THE "BASIC" PAYMENTS DEFICIT

Measures to reduce or eliminate the "basic" balance of payments deficit[1] should include the proper monetary and fiscal policies that

[1]The "basic" balance of payments position refers to the balance between exports of goods and services and imports of goods and services (including military expenditures overseas) and net long-term capital movements (both Government and private).

"Basic" U. S. payments deficits sizable in 1958-60 but small surplus recorded in first half of 1961



Note: Data for 1961 are figures for the first half of the year on the basis of seasonally adjusted annual rates.
Source: United States Department of Commerce.

will help to control inflationary pressures and still contribute most effectively to domestic stability and economic growth. Not only is it important that the United States remain competitive in order to export, but a substantial surplus on goods and services is essential if the United States wishes to achieve certain vital economic and political objectives. Continuing deficits of the size recorded in 1958-60, even after excluding the extraordinary short-term capital flows, suggest, moreover, an imbalance in our "basic" payments position which cannot be ignored in the interests of general economic stability and international monetary stability. Our "basic" balance of payments position should therefore be kept under constant surveillance and not lost among other more immediate problems such as "hot money" flows or longer run problems concerning the adequacy of international reserves.

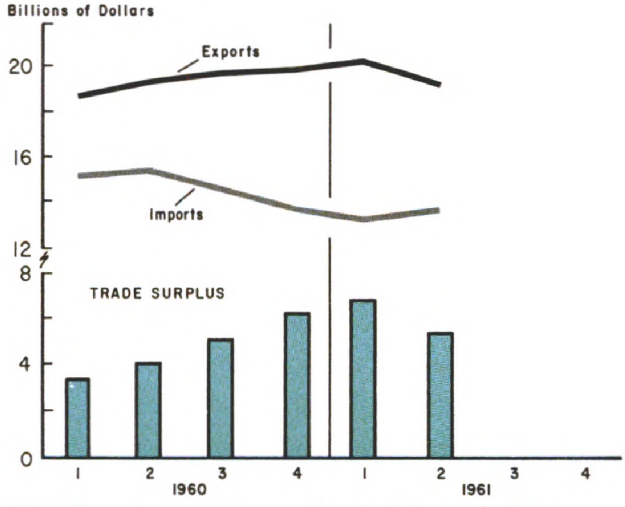
Various steps have been taken to reduce the basic United States deficit

Some steps have already been taken to increase our surplus on current transactions, such as export promotion programs, the required utilization of the proceeds of United States Government credits in this country, reductions in military expenditures overseas wherever possible, encouragement of foreign travel in this country, and the temporary lowering of the duty-free exemption for American tourists from $500 to $100. Foreign countries in turn have continued to remove quota restrictions on trade and have virtually eliminated discrimination against dollar goods. The member countries of the North Atlantic Treaty Organization have agreed to assume a larger share of the organization's expenses, while stepped-up programs of foreign aid announced by various countries should ease any additional financial load that the United States might assume in this direction. Advance repayments of postwar debt which have been made to the United States provide only temporary relief and do not reduce our "basic" deficit position.

Other measures, however, remain to be taken by both sides to restore a better international payments balance. When the boom in Europe tapers off and a vigorous recovery in the United States boosts imports, our surplus on goods and services will decline. From the first to the second quarter of 1961, the surplus had already fallen from $6.4 billion (at a seasonally adjusted annual rate) to $5.4 billion. Since every payments deficit is matched by a surplus elsewhere, action by the surplus countries to restore balance in their own international payments would ease the adjustment process for the deficit countries and minimize the need for deflationary measures by the latter countries. The continued accumulation of gold and foreign exchange reserves by the surplus country, moreover, constitutes consumption and investment foregone.

The actions taken so far to achieve a better balance in international payments have in general been those which have contributed to

U. S. trade surplus may be smaller as economic activity rises here and tapers off abroad



Note: Quarterly data at seasonally adjusted annual rates.
Source: United States Department of Commerce.

the further extension of multilateral trade, with its attendant benefits of optimum allocation of resources. The proposals that have been rejected, such as trade and exchange restrictions, deflation, and devaluation of the dollar, would, on the other hand, have been restrictive of trade and unsuited to the situation. A brief look at the discarded solutions, listing some of their claimed advantages and some of their pitfalls, might prove useful.

Trade and exchange restrictions, deflation, and devaluation are alternatives that have been rejected

Trade and exchange restrictions, such as higher tariffs, quotas, and exchange controls, would place artificial restraints on the movement of resources and capital between countries, thus preventing the best use of these factors by each country and curtailing the volume of trade. Trade and exchange controls may permit a country to pursue an independent domestic policy, provide a means of controlling the volume of foreign trade or the outflow of "hot money," and on occasion can be justified as a stopgap device where reserves are inadequate and short-term credits unavailable. On the other hand, such restrictions reflect the inability of a country to balance its accounts in a free market at existing exchange rates. Exchange controls in particular tend to be subject to abuse, to encourage bilateralism despite the fact that they may not be administered along bilateral lines, and to undermine confidence in a currency. A reserve center which imposes exchange controls is liable to find its position deteriorating sharply.

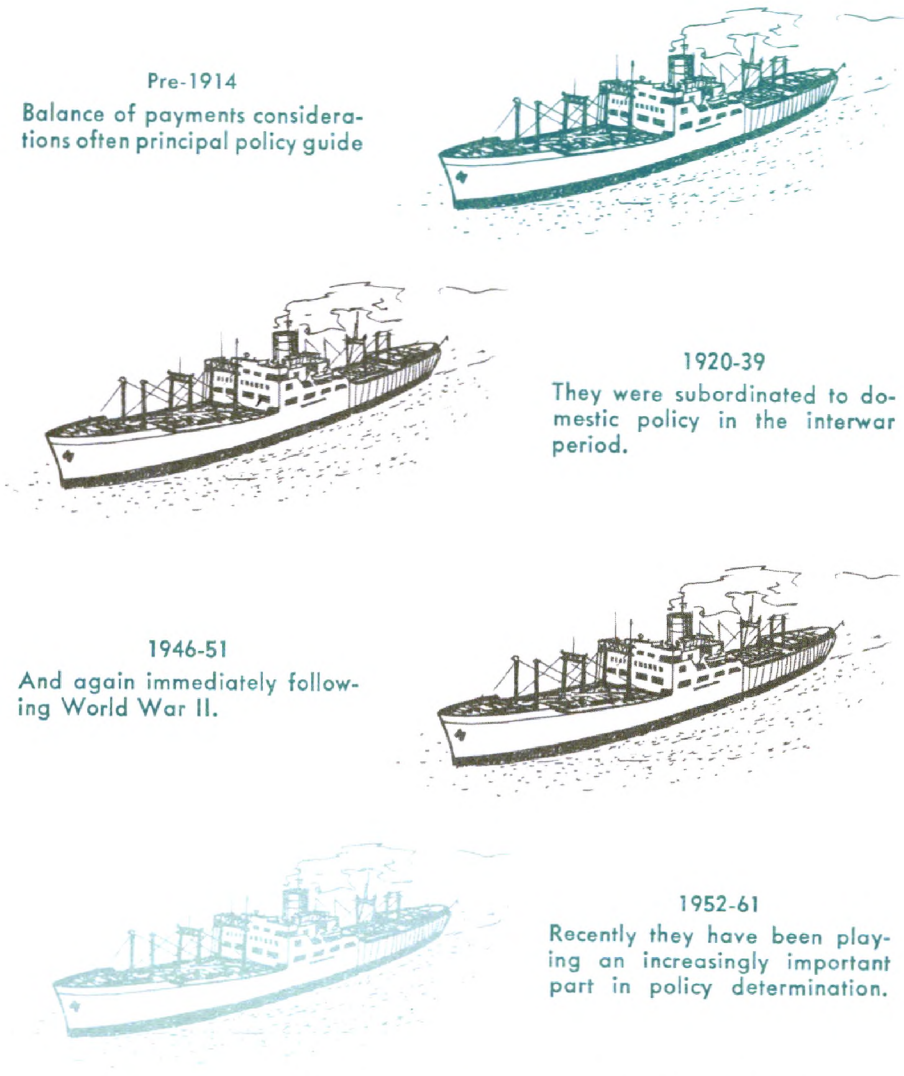
Deflation as a means of correcting a payments imbalance might be appropriate if the import surplus was caused by the existence of inflationary pressures which encouraged imports and discouraged exports. Restrictive monetary and fiscal policies would reduce prices, making exports cheaper and imports dearer and thus increasing the merchandise trade surplus. Credit restraint would help to check the outflow of short-term capital — in the absence of speculation. Deflation, however, could increase unemployment and depress production and income so that the external balance attained at a lower level might not be a true equilibrium position. Strong social resistance would also probably be encountered. For an economy in recession, deflationary action would be even more inappropriate.

Devaluation, or an increase in the price of gold in terms of dollars, was also proposed as a solution to the United States payments imbalance. Aside from any contribution to longer run international liquidity that such a move might make (which will be discussed later), larger gold reserves in terms of dollars might give the United States more time in which to restore over-all balance. But the proposal has serious disadvantages. Devaluation of the dollar would tend to undermine confidence in the international payments system centered on the dollar and could aggravate the difficulties of the situation by increasing the outflow of gold from this country if it were felt that the dollar was no longer a strong reserve currency. It would reduce international liquidity by weakening the dollar, and it would possibly stimulate hoarding. The structure of United States costs and prices in relation to her major trading partners, moreover, does not indicate the need for any fundamental realignment of currencies. Any advantage for merchandise exports that the United States might reap from devaluation would also be quickly erased if other countries followed suit, as would probably be the case. In addition, the principal beneficiaries would be Soviet Russia and South Africa. But the most telling argument against an increase in the price of gold as a means of correcting the payments imbalance is the fact that a change in the gold price would not attack the

basic causes of maladjustment. Deficits would recur once the additional reserves were exhausted because the symptom rather than the cause of the imbalance was treated.

Balance of payments discipline reappears in many countries

The situation in 1960 and 1961, when the United States and Western Europe found themselves in different phases of the business cycle, was not the first of its kind in the postwar period but was the first in which there was relative freedom of movement for short-term funds. As a consequence, differential interest rates affected capital flows and thus the domestic economies of the respective countries. Internal domestic policy in these countries and elsewhere has thus been compelled to take balance of payments considerations into account to a greater extent than ever before in the post-World War II period. Because the United States is a key currency country, moreover, policies conducive to stability on both the domestic and international fronts are essential to a smooth functioning of the international payments system.



"Balance of payments discipline" therefore has re-emerged as a more conscious part of national economic policy in many countries.[1] Over the years, the relative weight of internal and external considerations in the formulation of economic policy has varied. Before 1914, under the gold standard, no sharp distinction was drawn between internal and external requirements, although the state of the nation's balance of payments was often the principal policy guide. In the interwar period, adherence to the "rules of the gold standard" resulted in unfavorable repercussions on income, employment, and production. Consequently, internal considerations assumed top priority in the 1930's, and international currency policy was made to conform to domestic policy rather than the

[1] "Balance of payments discipline" can be defined as "a set of constraints imposed on the internal and external policies" of a country "by the need to maintain long-run equilibrium in its external balance of payments, under a system of international trade that is largely unrestricted except by internationally-agreed tariffs." Ralph C. Wood, "The Discipline of the Balance of Payments—Postwar Experience in Europe," *The Journal of Finance*, May 1961.

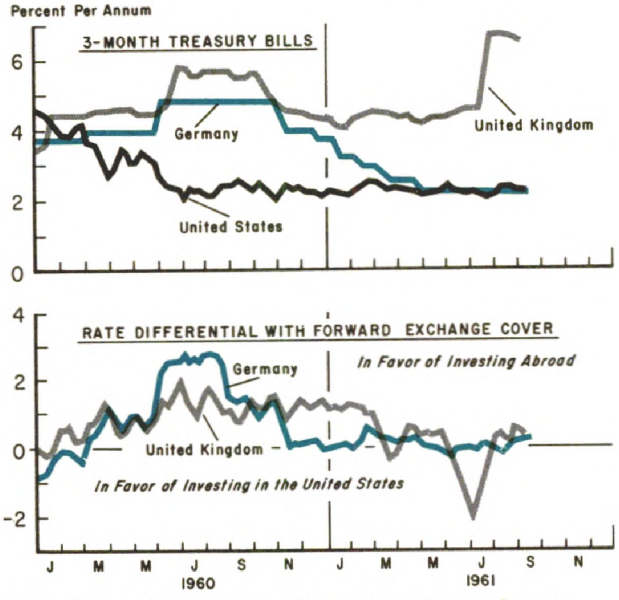
other way around. During much of the period immediately following World War II, the insulation of domestic from foreign developments was generally the rule, since many countries were either unable or reluctant to expose their economies to external influences. Recently, however, balance of payments considerations have been playing an increasingly important part in policy determination in a number of countries. History has shown that internal and external stability cannot be easily separated, especially where there is relative freedom of movement of goods and capital between countries.

SHORT-RUN LIQUIDITY

The discipline exercised by the balance of payments can be illustrated by the recent experience of the United States in dealing with short-term capital flows. These shifts of short-term funds were due both to interest incentives and to speculative forces and have been popularly called "hot money." Technically, "hot money" refers to movements of funds that are not justified by economic considerations, such as higher yields, and that tend to intensify an existing imbalance in a country's international payments; political disturbances and speculation are two of the principal causes of "hot money" flows. But since it is often difficult to distinguish between the two types until some time after their occurrence —if at all—the problem of coping with the movement of both kinds of liquid funds will be considered at the same time. It might be noted, however, that measures that may prove effective in checking or reversing one type of short-term capital movement may be totally ineffective against the other.

Because of the leveling off in economic activity in the United States and the downturn which began in May 1960, a policy of greater monetary ease was adopted. Federal Reserve Bank discount rates and member bank reserve requirements were reduced in several stages, and their influence combined with open market operations permitted member bank free reserves to increase from an average of $424 million in net *borrowed* reserves at the end of December 1959 to $682 million in net *free* reserves by December 1960. In the first eight months of 1961, free reserves averaged almost $550 million. From the end of 1959 short-term interest rates fell, with the market yield on United States three-month Treasury bills declining from an average of 4.49 percent per annum in December 1959 to 2.46 percent in June 1960 and to 2.30 percent in the following two months. On the other hand, the pressure of rising economic activity and high levels of employment abroad, especially in the United Kingdom and Germany, led to the adoption of restrictive monetary policies in those countries. The United Kingdom increased its Bank Rate from 4 to 5 percent in January 1960 and to 6 percent in June, while Germany raised the Bundesbank's discount rate from 4 to 5 percent in the latter month. Germany also increased reserve requirements several times and reduced rediscount quotas. The divergent movement of short-term interest rates in the United States and in the major industrial countries thus presented something of a dilemma to the United States. The decline in output and the increase in unemployment in this country called for the easing of credit and lower interest rates, but the substantial outflow of short-term funds made it desirable that short-term rates not contribute further to such an outflow. At the end of May 1960, for example, three-month Treasury bills of the United Kingdom yielded 0.79 percent per annum more than a comparable United States Treasury bill after covering for foreign exchange risk. The incentive in favor of United Kingdom Treasury bills rose as high as 1.95 percent on a covered basis on July 1 and remained above 1 percent for most of the remainder of 1960.

Divergent interest rates encouraged private short-term capital exports



Source: Board of Governors of the Federal Reserve System.

United States policies adapted to meet short-term capital outflows and recession

Some modification of economic policy was clearly called for under the circumstances — both here and abroad. In the United States, the Federal Reserve System began purchases in late October and in November 1960 of short-term United States Government securities other than Treasury bills in accordance with an amendment of the directive to the Federal Open Market Committee to conduct open market operations not only with due regard to "fostering sustainable growth in economic activity and employment" but also "taking into consideration current international developments."[1] Under the terms of legislation enacted in 1959 permitting banks to count all of their vault cash as reserves by 1962 at the latest, the System completed the process in the late summer and fall of 1960 partly in order to supply the seasonal need for reserves, rather than purchase Treasury bills, which would have further depressed short-term rates. In February 1961, the System announced a further broadening of its open market operations to include longer term securities, some of which would exceed five years. In this way it was hoped that short-term rates would not be further depressed as reserves could also be supplied to the market by System purchases of longer term securities. Furthermore, by operating in longer term securities, longer term rates might be lower than otherwise would have been the case and would thus tend to encourage expansion. From the time the policy was inaugurated in February through the end of August, the net change in System holdings of securities maturing in over a year amounted to about $2 billion, after adjustment for changes in the maturity distribution of the System's portfolio arising from the exchange of issues in Treasury refundings and the shift of securities into the short-term category as they approached maturity.

Debt management policy was also formulated with regard to balance of payments considerations. The Government cash budget pumped funds into the economy, partly because of recession-depressed receipts, partly because of some unanticipated increases in spending on special programs, and because of some deliberate acceleration of Government disbursements, such as the advance release of funds for highway construction. But refunding of maturing Government security issues and new cash offerings were largely concentrated in the short end of the market, which had the effect of increasing short-term interest rates. The adaptation of both monetary and debt management policy to the problem posed by the recession and the balance of payments points up the importance of using an appropriate "mix" of policies; either one could not have been expected to carry the burden alone.

The United States Government, in addition, carried out other policies designed to ease further the balance of payments problem created by the short-term capital out-

[1] *Forty-Seventh Annual Report* of the Board of Governors of the Federal Reserve System.

flows. Tax exemption was extended to the interest income of all foreign official holdings of United States Government securities to reduce the incentive to official holders to shift into higher earning assets abroad. Private ownership of gold abroad by United States citizens was prohibited, a step that should remove a reported source of pressure on London gold prices in the fall of 1960. The Federal Reserve Bank of New York also began operations in the foreign exchange markets for the account of the Treasury, a modification of previous policy under which the Treasury supported the dollar only by its willingness to buy and sell gold to foreign official institutions at $35 per ounce. The Treasury, through arrangements with Germany, sold forward marks for the purpose of lowering the premium on the forward mark and thereby narrowing the spread between the spot and forward dollar-mark rate. The smaller spread between the spot and forward exchange rates reduced the incentive to move funds abroad on a covered basis. Subsequently, the New York Federal Reserve Bank, again acting as agent for the Treasury, undertook operations in spot marks. In addition, part of the postwar German debt was repaid to the United States in March in marks in order to permit the United States to participate more actively in the exchange markets in the future, while certain other convertible currencies have been acquired in "relatively small amounts."[1] At the end of July 1961, the international reserves of the United States included $105 million in convertible foreign currencies.

Foreign countries have cooperated in dealing with short-term capital flows

When short-term funds began to move in unprecedented volume from this country in the latter half of 1960, principally to the United Kingdom, Germany, and Switzerland, these countries took steps to curb the inflow. In Germany, credit restrictions were relaxed by lowering reserve requirements against domestic deposits and reducing the discount rate and other official interest rates, primarily for balance of payments reasons. The restrictive credit policy that had formerly been in effect encouraged the large influx of both German and foreign money, which nullified the attempt to impose restraints on the expanding economy. In addition, efforts were directed toward reducing the payments surplus by encouraging the export of both long- and short-term funds and by the upward revaluation of the deutsche mark in March, which would tend to stimulate imports and discourage exports. The revaluation was also designed to end speculation about appreciation of the mark, which had been responsible for a large part of the funds moving into Germany.

Much of the short-term funds moving into Switzerland, on the other hand, were seeking safety because of unfavorable economic and political conditions abroad. Nevertheless, Switzerland took measures to discourage the influx of foreign capital by prohibiting payment of interest on new deposits, by increasing the notification time required for withdrawal of deposits, and by authorizing additional foreign stock and bond flotations on the Swiss market.

During the same period, the United Kingdom was experiencing a substantial inflow of funds attracted by the high interest rates which were a part of the Government's program to keep expansionary forces under control. The inflow of short-term funds masked the weakness in Britain's balance of payments on current transactions and increased her international reserves. But the monetary authorities greeted the influx with mixed feelings because they feared possible disruptive effects on Britain's payments position when the

[1] Testimony of Secretary of the Treasury Dillon and Mr. Charles Coombs of the Federal Reserve Bank of New York before the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Congress of the United States, May 16, June 19-21, 1961.

funds were repatriated. Consequently, the Bank of England reduced its Bank Rate twice —in October and December — since "continuing large movements of money to London were not in the interests either of this country or of the United States . . . . but also because by the end of 1960 there were signs of some easing in the pressures of home demand."[1] The Bank of England also intervened in the London gold market in late October 1960 to check the rise in the gold price, which was weakening confidence in the United States dollar.

Insofar as these liquid funds were impelled by interest incentives, the measures taken by various foreign countries probably helped to stem the outflow from the United States. Variation of interest rates to effect international economic adjustment, however, had repercussions on the use of interest rate changes to affect domestic economic activity. Where speculation rather than interest arbitrage is the principal reason for capital movements, such measures may prove only partially effective unless the underlying economic situation is sound.

The United States situation was repeated on a somewhat larger scale — and within a shorter span of time — by the United Kingdom in March 1961 when the German mark and Dutch guilder were revalued upward by 5 percent. The heavy movement of private short-term funds from the United Kingdom to Germany and other continental European countries reached sizable proportions in the weeks immediately following the revaluation, despite declarations by the German authorities that additional appreciation was not in prospect. In order to minimize the repercussions of these flows on the United Kingdom's reserve position, the central banks of Europe meeting at Basle, Switzerland agreed to hold sterling balances for a certain period instead of converting them into gold. In effect, the sterling balances relinquished by private holders were shifted into official holdings. This action was accompanied by a joint announcement by the Governors of the central banks that they were satisfied "that the rumours which circulated last week in the markets about possible further currency adjustments have no foundation and they wish it to be known that the Central Banks concerned are cooperating closely in the exchange markets."[1]

Within the past year, therefore, international cooperation and coordination of policies have developed out of the payments problems of various countries. Domestic economic policies have been modified to accommodate other countries and relieve balance of payments pressures, and inter-central bank agreement to minimize the unfavorable impact of large, volatile movements of short-term privately held funds has proved successful.

The main problem involved in the movement of private short-term funds from country to country is whether means are available to any country or group of countries to counteract or minimize the impact of such flows in the short run. It is a problem that may be of increasing concern as other money and capital markets are freed. In other words, should a country's international liquidity position be adequate to cope with this type of payments problem? Or, should there be other arrangements in existence to handle these sudden movements of liquid capital? Adequacy of international reserves has been the subject of much heated debate in recent months, with equally vehement voices claiming on the one hand that international liquidity is "adequate" and, on the other, that it is "inadequate."

[1] *Annual Report* of the Bank of England for the year ended February 28, 1961.

[1] Communique issued by the Bank for International Settlements on March 12, 1961, Bank for International Settlements *Press Review*, March 13, 1961.

International liquidity cannot be measured in quantifiable terms

In the short run, adequate liquidity implies the availability of, or access to, the means to cushion temporary and possibly rather large fluctuations in the balance of payments due to imbalances of a seasonal or cyclical nature. United States gold holdings are patently adequate at the present time to meet any temporary drains from transactions in goods and services. However, reserves do not permit a country to perpetuate a so-called fundamental imbalance in its payments structure, such as a chronic discrepancy between domestic and foreign costs and prices; no amount of reserves is adequate for such a task.

International reserves of a country are generally defined to include gold, United States dollars, pound sterling, and other convertible currencies held by foreign central banks and other official institutions. Other assets can serve as secondary reserves, such as credits under regional payments arrangements, International Monetary Fund quotas, swing margins under bilateral payments agreements, other private and official short-term credits, and longer term capital channeled through the World Bank and similar institutions. Recourse to the "second line of defense," however, is not always feasible or easy. The availability of drawing rights on the International Monetary Fund, for example, becomes more limited as its facilities are more extensively utilized.

The amount of reserves necessary depends on the types of drains to which the country may be exposed and on the relative importance of the country in the international payments system. In general, international reserves do not have to increase at the same rate as the volume of trade, although the same relative magnitude of fluctuations with a larger volume of transactions may result in larger absolute swings each way. Although the value of imports of any trading nation might be considered, moreover, to indicate roughly the maximum potential reserve drain from current account transactions, the bulk of international payments is actually cleared in the foreign exchange markets and only the remaining balance has to be settled by changes in reserve holdings. For a country acting as international banker, however, short-term liabilities and capital movements must also be considered. The short-term liabilities of key currency countries constitute the reserves of other countries and are subject to greater variation unrelated to the reserve country's own payments. Reserve currencies, moreover, are more subject to speculative pressures. A high level of confidence in the over-all economic and political stability of a "key currency" country diminishes a reserve center's need for reserves. As in the case of a commercial bank, depositors' confidence in the soundness of the bank reduces the chances of a "run on the bank" and therefore its need for vault cash and other liquid assets. On the other hand, instability of a reserve country may increase the difficulties of obtaining short-term assistance, much in the same way that bank lending officers are sometimes alleged to be willing to extend credit most readily to borrowers who are not really in need of funds!

Certain types of reserves may be more efficient than others in enhancing the ability of a country to weather particular types of reserve drains. International Monetary Fund quotas, for example, might be more easily adapted to the problems of individual countries. The same volume of reserves could go further if fluctuations in international payments could be reduced or minimized through synchronization of domestic policies in regard to income, employment, and prices; through achievement of greater internal stability in each country; or through diversification of the economies of primary-produc-

ing countries. International liquidity can thus be improved by reducing the need for reserves as well as by increasing the supply.

The international liquidity position of a country might be compared with that of a business corporation. A corporation keeps on hand cash and various liquid assets with which to meet certain definite commitments in the near future or unforeseen contingencies. If the drain on cash holdings is large and holdings of liquid assets insufficient, the company can seek short-term bank credit or other short-term financing. Once the emergency situation has passed, the loan can be repaid and cash balances rebuilt. But if cash on hand, liquid assets, and other short-term credits are too small, the company may be forced to restrict operations or sell investments at a loss in order to meet the drain. The corporate cash position would be considered adequate if short-run needs for liquidity did not necessitate the curtailment of operations. International reserves similarly should be large enough to permit absorption of fluctuations in the payments balance without disturbance to either the country's economy or the economies of other countries.

Short-run liquidity can be increased by increasing the supply

International liquidity can be increased in the short run by increasing the supply of eligible liquid assets available to meet drains from current transactions or from short-term capital flows. One method would be to increase the total dollar value of gold held as international reserves. An increase in the price of gold (or devaluation of the dollar), subsidies for gold producers, and an embargo on gold exports from the United States have all been proposed as means of improving the liquidity position of the United States. Aside from the general observation that all these proposals might lessen confidence in the dollar, they may be open to other objections. As mentioned earlier, an increase in the price of gold would increase United States reserves in terms of dollars and provide a larger buffer stock but would not help to remove the causes of the basic payments imbalance or check the short-term capital outflow. This criticism also holds true for gold subsidies, which would also be vulnerable to the criticisms directed against subsidies in general and doubts about the efficacy of subsidies in adding significantly to supplies of gold. An embargo on exports of gold or on sales by the Treasury would of course have an extremely harmful effect on foreign and domestic confidence in the dollar, similar to the refusal of a commercial bank to allow withdrawal of deposits.

Elimination of the gold certificate requirement of 25 percent against Federal Reserve Bank note and deposit liabilities has also been suggested as a means of augmenting our international reserves. The abolition of the gold certificate cover requirement would release all of our gold to serve as international means of payment, a logical move since gold no longer circulates domestically and gold exports and imports do not necessarily affect the monetary system. The United States, incidentally, is one of the few major countries in the world maintaining statutory gold requirements in its domestic monetary system. On the other hand, the gold certificate requirement may act as a desirable disciplinary instrument against inflationary tendencies in the economy. If the ratio of gold certificates to note and deposit liabilities is well above the minimum, however, as has been the case for many years, the requirement exerts little or no restraining influence and therefore is of little practical effect. The timing of any such action could also be important; repeal during periods when confidence in the dollar is weak might stimulate instead of dampen speculative pressures.

It has been suggested that the United States draw on the Fund

It has been suggested that the United States —and any other countries that might be subject to "hot money" flows — draw on the International Monetary Fund. But Article VI of the Fund's Articles of Agreement states that the Fund's resources should not be used by any member "to meet a large or sustained outflow of capital." Article VII (the so-called scarce currency provision which permits the Fund to borrow additional supplies of scarce currencies) could possibly be invoked to offset the flight of capital from one country to another. But use of this Article would allow members to discriminate against the "scarce currency" country and be detrimental to international trade and payments.

Standby credits are another alternative that could be adopted to deal with short-term capital flows, arranged under the sponsorship of the Fund or other international organizations. Under such an arrangement, countries running a payments surplus would lend their currencies to countries experiencing a substantial loss of short-term funds, thus minimizing the disturbing effects of these movements. Mr. Per Jacobsson, Managing Director of the International Monetary Fund, has advanced a proposal of this type,[1] while Mr. Edward Bernstein, formerly on the staff of the Fund, and Governor Xenophon Zolotas of the Bank of Greece have presented suggestions for "rescue operations" somewhat along the same lines.[2] These proposals would have the advantage of providing a relatively uncomplicated means of handling short-term capital flows within the framework of present international financial arrangements.

[1]For further discussion, see page 217.

[2]Edward M. Bernstein, "International Effects of U.S. Economic Policy," Study Paper No. 16, Joint Economic Committee Print, United States Congress, January 25, 1960; Xenophon Zolotas, *Towards a Reinforced Gold Exchange Standard*, Bank of Greece Paper and Economic Lectures, 1961.

Short-run liquidity can also be increased by reducing the need

In addition to supplementing the present sources of liquidity, short-run liquidity could in effect be increased by reducing the need for liquidity, such as the further refinement of some of the methods that have been tried out in the past. Guarantees of the gold value of existing reserves held in key currencies have been suggested, similar to those incorporated in the European Monetary Agreement that went into effect in 1958, in the Tripartite Agreement of 1936, and in the Basle Agreement of 1961.[1] If a gold value guarantee provision were in effect, dollar balances might be preferred because they would be an earning asset. As dollar balances pile up beyond current needs for payment and liquidity, however, the exchange rate for dollars would weaken, although with a guarantee foreign countries might be more willing to accumulate dollars. An exchange guarantee might be likened to a "beware of the dog" sign in the absence of a dog, however; effective if untested and ineffective if tested! If used, it would impose a cost on the guaranteeing country in terms of additional real resources and would tend to weaken the position of the reserve currency as a means of international payment. If speculative pressures were strong, moreover, the exchange rate guarantees would probably be ineffective. Under certain limited circumstances, exchange guarantees might be an addition to the arsenal of weapons available to the authorities of a country.

Agreement among central banks to hold each other's currencies when liquid funds are moving between countries in large volume and not to convert them into gold, as under the Basle Agreement of March 1961, indicates a line of action that might be useful again in the future, especially if the movement

[1]Guarantee of the gold value of the dollar, for example, is generally taken to mean that in event of devaluation the United States guarantees foreign official holders of dollars that their dollar holdings will be written up in value by the amount of the devaluation.

is expected to reverse itself shortly. Such agreements could be concluded for relatively short periods of time, with the International Monetary Fund or other agency taking over if the outflow is protracted. Operation in the foreign exchange markets could also be employed to reduce the incentives to move funds from center to center, although operations might be ineffective against strong speculative anticipations. Consultation among central banks and coordination of credit policies may also be a fruitful avenue of approach.

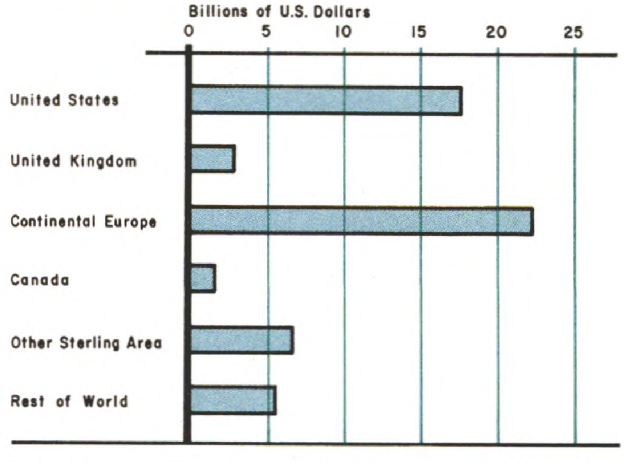
LONGER TERM LIQUIDITY

United States payments deficit brings longer term liquidity requirements into question

Not only did the United States balance of payments deficit pose problems concerning a "basic" imbalance in our payments situation and substantial shifts of private short-term money, but it brought to the fore the role of the United States dollar in supplying the longer term liquidity requirements of the international payments system. If the United States deficit were reduced, where would the rest of the world obtain liquid assets to add to their international reserves, outside of gold, without depriving some other country? At the present time, there is no over-all shortage of international liquidity despite the fact that a number of the underdeveloped countries have extremely small reserves. If these countries had larger reserves, they might be able to maintain imports at desired levels without trade and exchange restrictions. Some of the less developed countries, however, have made the deliberate choice to forego the "luxury" of larger "nonproductive" reserves in favor of what they feel is a more rapid rate of economic growth and development. The low level of their reserves reflects in usual cases, moreover, a lack of balance in their economy so that any volume of reserves would soon be exhausted. Other countries, on the other hand, continue to accumulate reserves in possible excess of needs. But this is essentially a problem either of maldistribution of external reserves among countries or the failure to reconcile the requirements of internal and external stability rather than a shortage of liquidity.

Freely fluctuating exchange rates or a widening of the margins for exchange rate movements have been frequently advanced as a means of reducing or even eliminating the need for reserves by placing the burden of adjustment to the balance of payments on exchange rates. Under a regime of freely fluctuating exchange rates, rates are theoretically left free to find their "equilibrium" level through the interplay of natural market forces of supply and demand. The advantages claimed for such a system are greater maneuverability for the monetary authorities in market operations, more realistic rates, and an effective and economical means of resisting and smoothing out temporary fluctuations in the balance of payments and combating the explosive effects of speculative capital movements. On the other hand, freely fluctuating exchange rates, with their element of risk,

Overall international liquidity adequate at present although sharp variations exist in the positions of individual countries.



Note: Figures refer to June 30, 1961 except for "other sterling area" and "rest of world," which refer to March 31, 1961.
Source: International Monetary Fund.

would tend to discourage international trade by increasing uncertainty and would impede adjustment to changes in the trade balance. The fluctuations might also tend to be cumulative and self-aggravating. When exchange rates are flexible and psychological factors dominate or when the underlying economic situation is suspect, disequilibrating rather than balancing capital movements may occur, as in the case of France in 1924-25 and 1937 and the United States in 1933. A system of fluctuating exchange rates works best when there is internal financial stability and external balance, in which case there is little need for flexibility and thus little difference from a fixed exchange rate policy.

Better balance and international cooperation can increase liquidity

Over the longer run, a significant body of opinion has held that a larger supply of reserves will be necessary to take care of the anticipated expansion in world trade and production. But there is no fixed relation between the volume of transactions financed between countries and the volume of payments media. It is possible to reduce the need for reserves —and much can still be accomplished in this direction—as well as increase the supply to meet future needs. By working toward a better balance in international payments, for example, the demand for international liquidity can be reduced. If deficits and surpluses are minimized, the amount of reserves required by each country would be correspondingly smaller.

The continuation of international cooperation and consultation also can contribute to a reduction in the demand for reserves, both for the short run and the long run. Cooperation among central banks and governments can facilitate the achievement of better balance between internal and external stability and help to distribute more evenly the burden of adjustment between deficit and surplus countries and between countries experiencing inflationary and deflationary pressures. The closer coordination of monetary and fiscal policies, demonstrated by the actions of governments in dealing with the outflow of short-term funds from the United States and the United Kingdom in the latter part of 1960 and early in 1961, can thus be a useful addition to each country's range of economic policy instruments. The extension of International Monetary Fund consultations to countries that have adhered to Article VIII (the so-called "convertible" countries), in addition to the regular annual discussions with Article XIV members (those that still maintain restrictions on trade and payments for balance of payments reasons), is another constructive step by which the Fund can keep itself informed of developments in various countries and the policies being followed. The initiation of intergovernmental talks under the auspices of the Organization for European Economic Cooperation (OEEC) and its Economic Planning Committee during the period of "hot money" movements furnished an appropriate forum for discussions on mutual problems and possible solutions. The association of the United States and Canada as full members in the Organization for Economic Cooperation and Development, successor to the OEEC, should keep open this channel of communication between the leading industrial countries of the world. Inter-central bank cooperation under the aegis of the Bank for International Settlements has also proved workable, as illustrated by the Basle Agreement of March 1961. An observer from the United States has been attending meetings of the Bank for International Settlements, providing another point of contact between countries. The continued interchange of views through these various organizations should prove helpful in the formulation of future international economic policy and in efforts to improve international liquidity.

International cooperation and consultation between governments can be facilitated through the OECD

The members of the OECD are:

Austria	Germany	Luxembourg	Sweden
Belgium	Greece	Netherlands	Switzerland
Canada	Iceland	Norway	Turkey
Denmark	Ireland	Portugal	United Kingdom
France	Italy	Spain	United States

Source: Organization for Economic Cooperation and Development.

Closer cooperation among countries in coordinating monetary and fiscal policies and regular consultation can assist nations to guard against the emergence of sharp divergencies in national policies which might exert strong pressures against particular countries or areas.

The supply or availability of international reserves could be increased

A number of suggestions have been put forward to enhance longer run international liquidity either by increasing the availability of present reserve holdings or by increasing the supply. At one end of the spectrum is the proposal for an increase in the price of gold, which has been advanced as a solution to all the problems arising from the balance of payments. The advocates of a rise in the world price of gold as a means of providing for additional liquidity in the long run base their support on the following points: (1) that the present international payments imbalance is due primarily to a shortage of gold, thus encouraging bilateralism and discrimination in trading arrangements; (2) that world trade has expanded much faster than the means of payment and that the gap will widen in the future; (3) that world gold production has lagged because of low gold prices; (4) that an increase in the price of gold is the necessary first step prior to the restoration of the gold standard system, which would eliminate most of the current payments problems. If the price of gold were doubled, for example, official gold reserves as of March 1961 would rise in value to $81.3 billion.

Objections, however, have been voiced to the view that a higher gold price is the best way to bolster international liquidity over the longer run. All the "profits" of the gold revaluation would theoretically be available to support higher levels of trade and economic activity. But such a step would tend to diminish confidence in the pound sterling and the dollar as international currencies if it were felt that greater liquidity could be met simply by periodic increases in the gold price. Countries might therefore reduce their foreign exchange reserves and hold more gold so that the increased liquidity arising from a higher gold price would be partly offset by the decline in their holdings of the two key currencies. A standard of value, such as gold and the dollar, the value of which was altered as commodity prices or the volume of transactions rose, would be a contradiction in terms. Moreover, a higher gold price would leave fundamentally unchanged the present distribution of gold reserves among foreign countries. Countries with large gold reserves—or with most of their international reserves in the form of gold—and gold-producing countries would benefit most, while those with small gold reserves or a high proportion of

their reserves in foreign exchange would find that their relative position had deteriorated. In addition, countries with currently inadequate reserves would be liable to spend any increment to their holdings.

An increase in the gold price has also been opposed on other grounds. By expanding the monetary reserve base or through the income effects of larger domestic gold production or gold imports, a rise in the gold price would tend to be inflationary unless the monetary authorities neutralized its impact. From a political standpoint, a higher gold price would boost the value of both the current output and stock of gold in Russia and other Iron Curtain countries. As stated earlier, an increase in the price of gold would not affect the basic causes of imbalance and might only postpone needed corrective measures. There is also no consensus at the present time that present payments arrangements will be unable to supply the demand for increased liquidity in the future.

International liquidity could be augmented by expanding the functions of existing institutions or utilizing existing facilities more extensively. Fuller utilization of International Monetary Fund quotas, enlargement of the number of convertible currencies held by the Fund through adherence to Article VIII, or increase of Fund quotas would increase international liquidity without necessarily adding to the reserves of countries now holding adequate reserves. Greater use could also be made of Fund facilities in the ordinary course of meeting temporary balance of payments deficits, as has been proposed, instead of limiting their use to emergency situations, and drawings on the Fund could also be made more automatic and not contingent upon a particular course of action approved by the Fund.[1] Two rather similar proposals to meet prospective increases in the need for reserves have been advanced, both of which can also be used to deal with the problems caused by the erratic movement of short-term funds. One of these proposals, outlined in principle by the Managing Director of the International Monetary Fund, Mr. Per Jacobsson, and presented to Fund members at their annual meeting in Vienna in September 1961, would set up a network of standby arrangements with the main industrial countries, under which the Fund would be able to borrow their currencies whenever the need for them arose in excess of current Fund holdings.[1] The other proposal made by Mr. Edward M. Bernstein would establish a Reserve Settlement Account as a subsidiary institution to the Fund which would specialize in transactions connected with capital movements and conversion of reserve currencies. Fund members would purchase, up to stated amounts, interest-bearing notes of the Reserve Settlement Account, which could be used by the deficit countries in the exchange market or to meet conversions out of its currency. At the Fund meeting, the Jacobsson plan was accepted in principle, with the details to be worked out by the permanent directors representing the Fund membership.

New international institutions have been suggested to meet long-term liquidity needs

Some informed observers of the present scene feel, however, that existing institutions are not equipped to cope with the anticipated expansion in the demand for international liquidity and that new institutions must be formed. One of the more widely discussed proposals has been Professor Robert Triffin's proposal for a supranational institution in which gold and foreign exchange reserves would be concentrated.[2] Under this proposal, the United States dollar and the pound ster-

[1] Edward M. Bernstein, "The Reserve Centres and the International Monetary Fund," *The Irish Banking Review*, June 1961.

[1] The Subcommittee on International Exchange and Payments of the Joint Economic Committee of Congress has also recommended a plan of this type.

[2] Robert Triffin, *Gold and the Dollar Crisis*, 1960.

ling would eventually lose their status as reserve currencies. Triffin's plan resembles in some respects Lord Keynes' proposal for an International Clearing Union, which was submitted by the British during World War II in the course of discussions concerning the postwar international financial structure. This "international central bank" would be endowed with the authority to extend credits on a discretionary basis to members, and balances with the bank would be freely usable in settlement of all international transactions. Creation of liquid assets by the new institution would provide for the growing requirements of international trade, production and payments. International liquidity would be increased as needed, according to some predetermined formula. Under this plan, pressures on the dollar and sterling would supposedly be eliminated, and the flow of international capital facilitated.

Another blueprint for a new international financial institution has been drawn up by Mr. Maxwell Stamp of the United Kingdom.[1] Briefly, the proposal calls for the issuance of gold certificates by the International Monetary Fund — or its successor — to countries in exchange for their own currency. These certificates would be given to an international economic development agency which would allocate these certificates to the less developed countries for import of capital equipment from the industrialized nations. The certificates could also be used to finance deficits and therefore would end up with the countries in over-all surplus in their balance of payments. Thus arrangements would be set up to link the surpluses of countries in a favorable payments position with aid to underdeveloped areas.

Critics discount some of the advantages claimed for the proposed credit-creating institutions and question whether they would be better able to withstand acute balance of payments pressures and general economic disturbances than the present mechanism.[1] Some feel that confidence would be weakened and that the present discipline exercised by gold movements might be lost. Other criticisms are directed against the possibly illiquid nature of the new institution's proposed investments and other technical details of organization and operation. The price to the key currency countries under the Triffin plan has also been held to be excessive, entailing among other things intervention in their money markets through transfer of ownership of dollar and sterling balances to the international central bank.

SUMMARY AND CONCLUSIONS

By tracing the role of gold through the ages, we can see how it rose to a position of prominence in domestic monetary affairs, as Britain became the dominant political and economic power, and in international trade through its use as the preferred medium of settlement by the principal trading nations in turn: Greece, the Roman Empire, the Byzantine Empire, the Moslem Empire, the Italian city-states, and Great Britain. Gold, however, was not the primary domestic medium of payment and standard of value until relatively recently—in the late 19th century when most of the major countries followed Britain's example and went on the gold standard. From that time onward, however, the position of gold declined, both internationally and domestically. Internally, the development of paper money and the banking system and various credit instruments soon outstripped gold, while certain "key" currencies supplemented gold in international settlements: first the pound sterling and later the United States dollar. Even before the demise of the gold standard, gold

[1] A. M. Stamp, "Sterling and International Liquidity Arrangements," in *International Payments Imbalances and Need for Strengthening International Financial Arrangements*, Hearings before the Subcommittee on International Exchange and Payments, United States Congress, May and June 1961.

[1] See, for example, Oscar L. Altman, "Professor Triffin on International Liquidity and the Role of the Fund," International Monetary Fund *Staff Papers*, May 1961.

had become less important in domestic economic policy as fractional reserve systems were introduced and gold flows were neutralized, as in the 1920's. Thus, although gold remains a part of our monetary economy, it is no longer an overriding element in the formulation of our domestic economic policies, and it has become relatively less important in the international financial mechanism.

As gold declined in importance—with the eventual collapse of the gold standard in the 1930's, monetary management rose in importance. By the 1930's, monetary management encompassed international economic relations as well, and external developments were insulated from the domestic economy by the deliberate actions of national authorities. The balance of payments discipline that had been exercised under the "rules of the gold standard" was replaced by the twin objectives of high levels of employment and price stability. In the postwar period, on the other hand, balance of payments discipline has reappeared as a factor in national economic policy, but it is discipline of a different kind. Automaticity, such as that under the gold standard when gold flows affected interest rates, credit, and the money supply, is no longer desired because of its possible perverse effects and its unpredictability. The discretion of monetary and fiscal authorities and their management decisions permit the use of more adaptable methods of dealing with the multiplicity of problems that arise in the domestic and international economy.

The United States dollar in particular has come to dominate much of the international monetary scene, augmented by the pound sterling and the facilities of international institutions. Within the past several years and particularly in the past year, international cooperation and consultation has emerged as a potentially useful weapon of international economic policy. Closer international cooperation and coordination of national economic policies has helped to reduce the United States' basic balance of payments deficit, check short-term capital flows (due both to interest rate differentials and to speculation), and also to increase international liquidity for the longer run by reducing the need for liquidity. Earlier experience with various forms of international cooperation—some of them unsuccessful—provided the groundwork on which present methods have been built and improved.

International financial cooperation was first tried on a large scale immediately following World War I when the United States supplied long-term development capital to other countries. But the outflow was unfortunately erratic. Under the gold exchange standard, in addition, reserves were often supplied through short-term lending, with the result that reserves were extinguished as soon as the credits were withdrawn, thereby producing an undependable credit foundation. International financial assistance was also extended during the 1931 banking panic, first from England and France to Germany and Austria and then, as the disturbances spread, from the United States and France to England. These efforts were unsuccessful, however, because they were undertaken in a world based on a highly unstable and weak underlying credit structure and inappropriate domestic economic policies. The Tripartite Agreement, concluded in 1936 after the "gold bloc" countries left gold, proved somewhat more successful and helped to maintain exchange stability until the outbreak of World War II.

Since World War II, the various international institutions, such as the International Monetary Fund and the World Bank, have gradually expanded their operations and adapted their policies to meet challenges as they appear. Their flexibility in dealing with various situations promises well for the future. At the same time, regional and international cooperation, such as through the European

Payments Union, the General Agreement on Tariffs and Trade (which promotes the reduction of tariffs and trade barriers around the world), the Organization for European Economic Cooperation (and its successor, the Organization for Economic Cooperation and Development), and arrangements similar to the Basle Agreement, furnishes another likely approach for dealing with international economic problems.

The present international payments system, revolving around the United States dollar and to a decreasing extent gold, thus has worked fairly well in the past year or so in handling problems created by short-term flows and "basic" imbalances. The arrangements concluded to deal with "hot money" movements, the steps taken by the United States and other countries to reduce "basic" payments imbalances, and the possibility of *reducing the need* for liquidity before increasing the supply seem to provide a varied enough assortment of alternatives to cope with payments problems in the near future. As in the case of most "man-made" institutional arrangements, gradual progress and evolution may oftentimes be the "better part of valor."

It might be noted in conclusion that the problems encountered by the United States dollar in the past few years have involved to a significant extent a decline in the liquidity position of the United States,[1] but this weakening does not imply a deterioration in the wealth of the United States. International assets of the United States (including gold) of $89.2 billion at the end of 1960 exceeded foreign investments in the United States by almost $45 billion. Although our international assets rose by approximately the same amount as foreign assets and investments in the United States in the three years 1958-60, our net foreign position improved by more than $7 billion in the preceding five years.

In addition, the large movements of short-term capital that were detrimental to our payments position in 1960 need not always be adverse. Short-term capital flows can greatly facilitate the smooth functioning of international trade and the investment process, despite the fact that greater freedom of movement of short-term funds has introduced additional complications. The benefits of closer international consultation and cooperation among various countries in weathering the immediate impact of short-term capital movements and other payments problems has also been demonstrated within the past year. But the degree of success achieved should not obscure the fact that the principal burden of correction for payments imbalances and for the establishment of lasting internal and external stability still lies in improving general economic efficiency.

[1] As measured by the ratio of our gold holdings plus other short-term claims against foreign countries and drawing rights on the International Monetary Fund to foreign liquid claims on the United States.

BANKING AND CREDIT STATISTICS AND BUSINESS INDEXES—TWELFTH DISTRICT[1]

(Indexes: 1947-1949=100. Dollar amounts in millions of dollars)

Year and Month	Condition items of all member banks[2, 7]				Bank debits index 31 cities[4, 5]	Bank rates on short-term business loans[6, 7]	Total nonagricultural employment	Total mf'g employment	Carloadings (number)[5]	Dep't store sales (value)[5]	Retail food prices[7, 8]
	Loans and discounts	U.S. Gov't securities	Demand deposits adjusted[3]	Total time deposits							
1929	2,239	495	1,234	1,790	42	....	...	...	102	30	64
1933	1,486	720	951	1,609	18	....	...	...	52	18	42
1939	1,967	1,450	1,983	2,267	30	....	60	57	77	31	47
1951	7,866	6,463	9,937	6,777	132	3.66	112	121	101	112	113
1952	8,839	6,619	10,520	7,502	140	3.95	118	130	100	120	115
1953	9,220	6,639	10,515	7,997	150	4.14	121	137	100	122	113
1954	9,418	7,942	11,196	8,699	153	4.09	120	134	96	122	113
1955	11,124	7,239	11,864	9,120	173	4.10	127	143	104	132	112
1956	12,613	6,452	12,169	9,424	190	4.50	134	154	104	141	114
1957	13,178	6,619	11,870	10,679	204	4.97	139	160	96	140	118
1958	13,812	8,003	12,729	12,077	209	4.88	138	155	89	143	123
1959	16,537	6,673	13,375	12,452	237	5.36	146	166	94	157	123
1960	17,139	6,964	13,060	13,034	253	5.62	150	166	88	156	125
1960											
September	16,923	6,339	12,575	12,547	253	5.53	150	164	86	156*r*	126
October	16,958	6,626	12,848	12,628	263	....	150	164	85	161*r*	126
November	16,898	6,697	12,907	12,616	248	....	150	163	85	153*r*	126
December	17,139	6,964	13,060	13,034	258	5.50	150	163	87	159	127
1961											
January	16,751	6,984	13,010	13,121	254*r*	....	151	162	84	154	127
February	17,525	6,991	12,750	13,639	273*r*	....	151	162	83	164	127
March	17,517	6,916	12,860	13,754	273*r*	5 48	151	162*r*	83	160	127
April	17,637	7,436	13,222	13,999	266*r*	....	151	162	88	164	127
May	17,632	7,393	12,865	14,289	265*r*	....	151	163	81	153	127
June	17,578	7,571	12,935	14,371	268*r*	5.50	152	164	85	162	126
July	17,504	7,935	13,206	14,492	267*r*	....	152	164	86	167	126
August	17,779*r*	7,863*r*	13,212	14,656	262*r*	....	153	165	84	157	125
September	18,039*p*	7,954*p*	13,222*p*	14,781*p*	277	....	...	...	...	...	...

Year and month	Industrial production (physical volume)[5]							Waterborne Foreign Trade Index[7, 9, 10]					
		Petroleum[7]						Exports			Imports		
	Lumber	Crude	Refined	Cement	Steel[7]	Copper[7]	Electric power	Total	Dry Cargo	Tanker	Total	Dry Cargo	Tanker
1929	95	87	78	55	...	103	29	190	150	247	124	128	7
1933	40	52	50	27	...	17	26	110	...	...	72	...	...
1939	71	67	63	56	24	80	40	163	107	243	95	97	57
1950	114	98	103	112	125	115	120	92	80	108	144	145	103
1951	113	106	112	128	146	116	136	186	194	175	162	140	733
1952	115	107	116	124	139	115	145	171	201	130	204	141	1,836
1953	116	109	122	131	158	113	162	141	138	145	314	163	4,239
1954	115	106	119	133	128	103	172	133	141	123	268	166	2,912
1955	122	106	124	145	154	120	192	166	178	149	314	187	3,614
1956	120	105	129	156	163	131	209	201	261	117	459	201	7,180
1957	106	101	132	149	172	130	224	231	308	123	582	216	10,109
1958	107	94	124	158	142	116	229	176	212	123	564	221	9,504
1959	116	92	130	174	138	99	252	188	223	138	686	263	11,699
1960	110	91	134	161	154	129	271	241	305	149	808	269	14,209
1960													
August	109	90	138	164	125	121	275	227	280	153	1,025	261	20,948
September	106	90	136	143	131	141	279	250	347	113	885	284	16,550
October	103	91	131	159	127	144	275	244	347	97	779	238	9,240
November	100	91	135	155	129	141	276	220	306	97	826	254	15,744
December	99	91	137	151	133	137	274	271	338	175	1,046	245	21,919
1961													
January	101	91	134	159	111	139	277	235	318	118	779	218	15,394
February	101	91	134	176	152	134	276	248	362	95	666	233	11,985
March	103	92	131	178	162	137	285	264	363	124	952	252	19,268
April	114*r*	92	135	168	172	133	283	261	331	163	759	286	13,139
May	111*r*	92	143	169	191	143	...	265	331	171	865	292	15,856
June	111*r*	91	142	188	187	143*r*	...	...	...	...	...	...	...
July	110	...	...	157	183	129*p*	...	...	...	...	...	...	...
August	...	...	...	160	180	...	...	...	...	...	...	...	...

[1] Adjusted for seasonal variation, except where indicated. Except for banking and credit and department store statistics, all indexes are based upon data from outside sources, as follows: lumber, National Lumber Manufacturers' Association, West Coast Lumberman's Association, and Western Pine Association; petroleum, cement, and copper, U.S. Bureau of Mines; steel, U.S. Department of Commerce and American Iron and Steel Institute; electric power, Federal Power Commission; nonagricultural and manufacturing employment, U.S. Bureau of Labor Statistics and cooperating state agencies; retail food prices, U.S. Bureau of Labor Statistics; carloadings, various railroads and railroad associations; and foreign trade, U.S. Department of Commerce. [2] Annual figures are as of end of year, monthly figures as of last Wednesday in month. [3] Demand deposits, excluding interbank and U.S. Government deposits, less cash items in process of collection. Monthly data partly estimated. [4] Debits to total deposits except interbank prior to 1942. Debits to demand deposits except U.S. Government and interbank deposits from 1942. [5] Daily average. [6] Average rates on loans made in five major cities, weighted by loan size category. [7] Not adjusted for seasonal variation. [8] Los Angeles, San Francisco, and Seattle indexes combined. [9] Commercial cargo only, in physical volume, for the Pacific Coast customs districts plus Alaska and Hawaii; starting with July 1950, "special category" exports are excluded because of security reasons. [10] Alaska and Hawaii are included in indexes beginning in 1950. *p*—Preliminary. *r*—Revised.