Beans and Bonds...OR

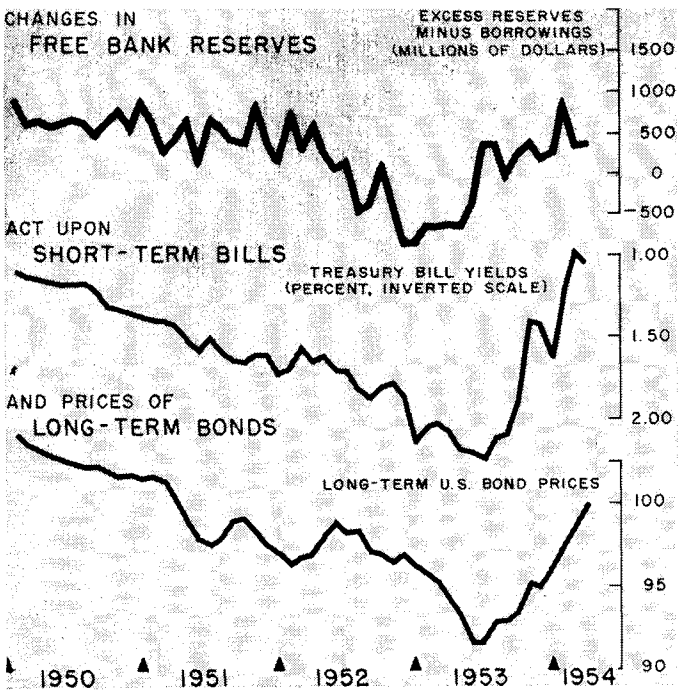
The PRICE *of* GOVERNMENT IOU's

Until recently, Government bond prices have been rising, in contrast to most commodity prices, which have jogged along or fallen slightly since the recession began. Despite the recent reversal in bond quotations, the price level of the IOU's of the Federal Government is substantially higher than it was a year ago.

The high price of Governments, of course, means lower cost of borrowing to the Treasury. In addition, it is indicative of eased credit conditions that mean lower cost and greater availability of credit to private borrowers. On the other hand, banks and other lenders obtaining most of their revenue from interest charges are hard pressed to maintain their 1953 earnings level.

Legumes and Liabilities

Although both lenders and borrowers are usually aware of the changes taking place in credit conditions and in the securities markets, less well understood is the background behind these changes. To facilitate such an understanding, it might be well to consider here a somewhat more familiar commodity—beans, for example. The price of beans, like the price of Governments, is determined by supply and demand conditions. Unlike the price of beans, which are perishable, however, today's price of Governments is affected by estimates of the future price—not only tomorrow's but a year from tomorrow's. For this reason the background of today's price has more than passing relevance in indicating the factors that are possibly important in determining tomorrow's and next year's price. In turn these background factors affecting Government prices are important in determining the future terms of private borrowing, so closely are the various markets for loanable funds tied together.



The supply of marketable Government securities has remained fairly constant since last fall at about 154.5 billion dollars, although a slight drop did occur in March when tax receipts were used to pay off some Federal obligations. More important than the constancy of the supply of Governments has been the changes in types of securities available to would-be purchasers. Just as there are many kinds of beans, there are numerous types of Governments, the various issues differing principally in the maturity or date of repayment. Since last summer there have been sharp changes in the amount of securities available in the various maturity ranges. Principal among these changes has been the sharp reduction in short-term securities—those maturing under one year.

Demand for Early Varieties Heavy

This reduction has been particularly important because of the large demand for these securities. Nonfinancial businesses investing funds being held for tax payments find them attractive, and some corporations have put funds obtained from reducing inventories into short-term securities. Finally, many state and local governments have put money raised for major construction projects into short-term Governments until they are ready to go ahead with the project. The heavy corporate and local government demand for short-terms beating upon the reduced supply of this particular variety of Government IOU's has helped to increase the price, making the return received a smaller proportion of the original cost. Short-term interest rates on Treasury bills, in other words, have fallen to a level lower than that at any time since 1947.

But what has this done to prices and interest rates on long-term Governments? To answer this question, let us return to our example of beans. When the price of pole beans gets too high, some people will shift to butter beans or snap beans. As a result, the price of butter beans or snap beans will start up too. The same thing happens in the case of Governments. When the prices are thought to be too high and the rates of return too low on short-term securities, some investors switch to long-term securities. Banks, for instance, have sold short-term Governments in order to invest in long-term Governments. Some investors even shift into different markets such as municipal securities or mortgages. The increased competition causes an increase in price and a decrease in interest earned on these types of debt obligations. Thus the high price of beans

even causes the price of black-eyed peas to rise—and that's another vegetable!

Just as the actions of the largest buyer or potential buyer can affect the bean market, so Federal Reserve policy is indirectly important in the securities market. During the last part of 1952 and early 1953 the Reserve System supplied bank reserves only niggardly, causing banks to restrict their lending and investing activity. This was done, of course, to head off the apparent inflationary bubble at that time and it resulted in falling Government bond prices. As the economy began to turn around, however, Reserve Bank policy also turned around in order to discourage deflationary developments. This action shortly manifested itself in sharply rising prices of Government bonds.

Neither Too Fast Nor Too Slow

The shift in Federal Reserve policy last year is perhaps best illustrated by changes in wording of the directives of the Federal Open Market Committee, a record of which is published as a part of the annual report of the Board of Governors. In early March the committee was directing that the open market account continue to be operated "with a view to exercising restraint upon inflationary developments." At the June meeting the directive was changed to "avoiding deflationary tendencies without encouraging a renewal of inflationary developments." In September the directive was again changed to prescribe operations "avoiding deflationary tendencies." Finally, at the December meeting the Committee prescribed that operations be carried on with the view "to promoting growth and stability in the economy by actively maintaining a condition of ease in the money market."

Here the official record ends, yet the reduction in the rate at which Reserve Banks lend to their member banks to 1¾ percent in January and another reduction at some Reserve Banks in April to 1½ percent seem to indicate that the policy of "active ease" has not been changed. So far, however, the Reserve Banks have not flooded member banks with reserves but instead have released reserves in some weeks and sopped them up in other weeks as the private credit needs of the economy required. Free reserves—that is, excess reserves minus borrowings—have been maintained in this manner at an average level of about 500 million dollars during most of 1954, as is shown by the weekly Federal Reserve statements. Present monetary policy, therefore, although directed toward freer credit conditions as is consistent with a period of declining business conditions, can hardly be characterized as a "crash" program designed to stimulate the economy at all costs.

The fact that large pools of excess reserves do not exist at present is evidence that monetary policy has been effective in stimulating banks to expand loans and investments at rates of return attractive both to themselves and to their borrowers. The high price of Governments, particularly short-term Governments, is therefore only partially the result of deliberate Federal Reserve policy.

The "Natural" Price

The record of policy actions taken by the Federal Open Market Committee in 1953, contained in the Annual Report of the Board of Governors, indicates that during most of last year open market purchases and sales were conducted only in short-term Government securities and were "entered into solely for the purpose of providing or absorbing reserves." In the discussion of this policy it was made clear that this course was adopted because it was felt the monetary authority should not attempt to determine "what the market should be" and that direct purchases and sales in the short-term sector would affect least the dollar price of securities. Thus, "the market would still reflect natural forces of supply and demand and thus furnish a signal of the effectiveness of credit policy aimed primarily at the volume and availability of bank reserves." The price of butter beans was not being determined directly by the biggest potential buyer, for he was buying only pole beans. Butter bean prices still reflected the "natural" forces of the market as well as the manner in which the demand for them "spilled over" from high-priced pole beans.

Although long-term operations are not precluded in the event of disorderly market conditions or when otherwise required, the weekly statements of Reserve Bank holdings of the various classes of securities show no operations in the long-term sector this year.

As long as monetary policy continues to be a foremost weapon in fighting cyclical swings in economic activity and as long as changes occur in both the supply and type of Government debt instruments, some changes in the price of Governments may well be expected. Because changes in the price of Governments are both a reflection of general credit conditions and an important causal factor in determining movements in the cost and availability of private credit, alert investors and businessmen who make use of credit as well as lenders who supply credit, might well say with Thoreau "I was determined to know beans."

THOMAS R. ATKINSON

Bank Announcements

On May 20, the Jackson-Hinds Bank, Jackson, Mississippi, a nonmember bank, located in territory served by the New Orleans Branch, together with its branches in Leavell Woods and Terry, Mississippi, began to remit at par for checks drawn on it when received from the Federal Reserve Bank. Officers of this bank include Marvin Collum, President; Max T. Allen, Jr., Vice President and Cashier; George A. Morgan and George W. Morgan, Vice Presidents; and Chester Thornton and Mrs. Clyda Harper, Assistant Cashiers. Its capital amounts to $400,000 and surplus and undivided profits to $114,377.

The Bank of Dickson, Dickson, Tennessee, did not open April 1 as was announced in the April issue of this Review. The exact opening date was May 28. A nonmember state bank, it will remit at par. Officers are Hugh Wynns, President; Wayne Sensing, Executive Vice President; and Glenn Hamilton, Cashier. It has a capital of $100,000 and surplus of $100,000.