Twenty-fifth Annual Report

Federal Reserve Bank of New York

For the Year Ended December 31, 1939

Second Federal Reserve District

CONTENTS

FEDERAL RESERVE BANK
OF NEW YORK

February 29, 1940.

To the Stockholders of the
Federal Reserve Bank of New York:

I am pleased to transmit herewith the twenty-fifth annual report of the Federal Reserve Bank of New York reviewing the year 1939.

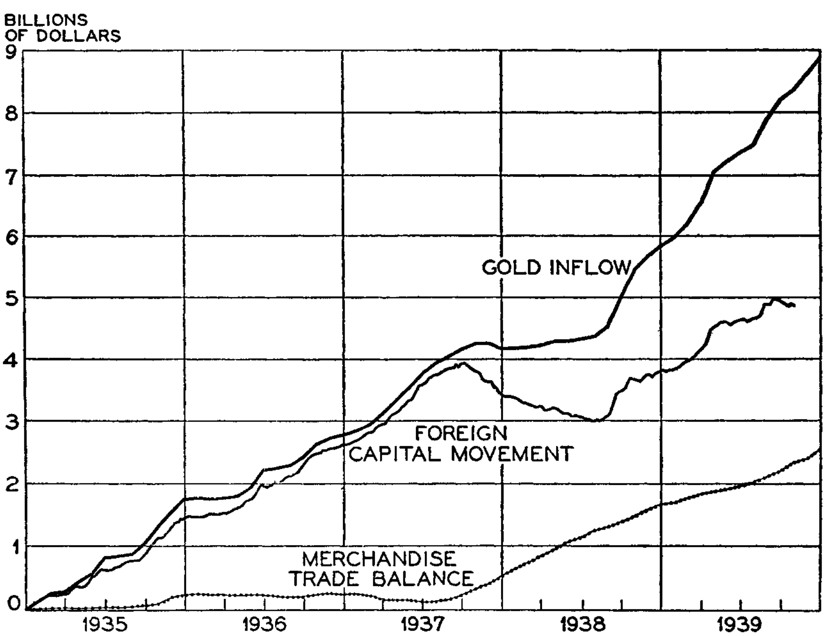
GEORGE L. HARRISON,
President.

Federal Reserve Bank of New York

Twenty-fifth Annual Report

Throughout the year 1939 developments in Europe exercised a dominant influence upon the New York money market and affected the course of American business. The ever present threat of war during the first eight months of the year and the actuality of war in the last four months of the year reacted upon a money market situation in which an already excessive supply of funds in the banks was finding little employment, and upon a business situation which, after a pause in the first months of the year, was resuming the recovery begun in the summer of 1938.

In the eight months preceding the outbreak of war, recurring crises in Europe induced a heavy flow of foreign funds to this country, primarily for safekeeping, as is evidenced by the fact that these funds largely took the form of idle balances in our banks. At the same time, a substantial excess of merchandise



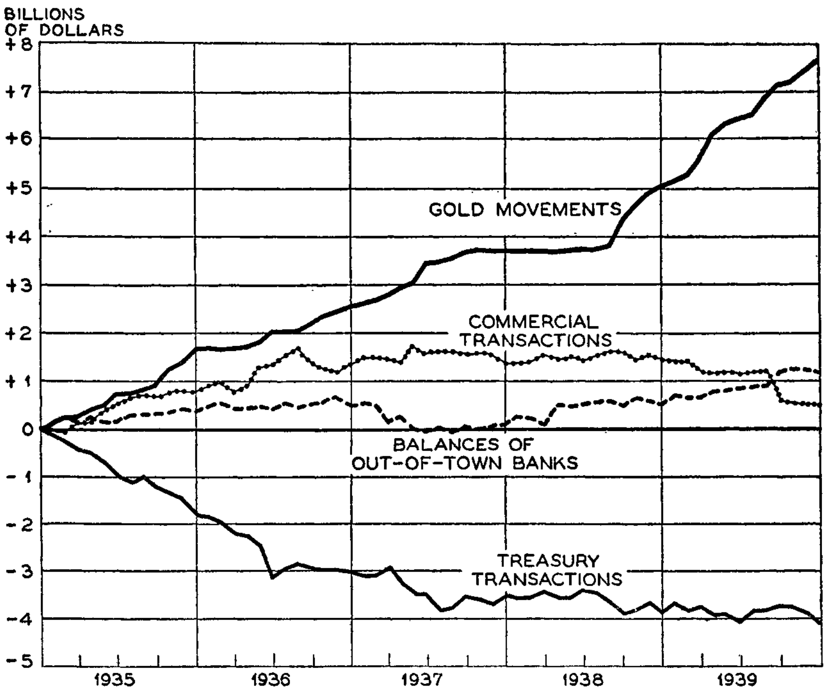
Principal Factors Causing Gold Flow into the United States
(Cumulative net imports of gold—less net change in earmarkings for foreign account—capital inflow, and excess of merchandise exports over imports, since January 1, 1935)

exports over imports contributed to the large balance of payments due the United States on international transactions. As a consequence, the flow of gold to the United States during this period was more rapid than in any corresponding period in previous years. Before the end of June the record gold inflow of close to 2 billion dollars in the full year 1938, was exceeded.

Upon the outbreak of the war at the beginning of September official restrictions in several countries curtailed the movement of foreign funds to this market. The balances due the United States on trade account tended to increase, however, as national defense efforts in Europe were further accelerated and some trade of neutral countries was diverted from the belligerent countries to the United States, even though exports of war materials to countries at war were prohibited by the Neutrality Act prior to its amendment in November and American shipping was subsequently prohibited from entering belligerent areas. Despite the restrictions on international capital movements, therefore, the gold flow to this country, after a temporary lull, again attained large volume in the closing months of 1939, and the total inflow for the year—$3,574,000,000—was more than 80 per cent greater than in 1938. Although some of the incoming gold was placed under earmark for foreign account at this bank, the increase in the gold stock of the United States during the year amounted to $3,132,000,000. This amount is larger than the total dollar value of the gold stock held by this country in any year prior to 1921.

This enormous movement of gold from abroad caused a further great expansion in the volume of reserves held by member banks, which reached successive, new high levels until the latter part of October. On October 25 the total volume of member bank reserves came within 50 million dollars of reaching the 12 billion dollar level. This was nearly double the amount of reserves which member banks were required to maintain against their deposits, notwithstanding the rapid increase in the amount of required reserves in recent years, due to a large increase in deposits and to the increased percentages of reserves which member banks have been required to maintain as a result of administrative action in the summer of 1936 and the spring of 1937. A temporary recession occurred between October 25 and December 13, owing to payments for new securities sold by a Government agency and by the Treasury and to seasonal currency withdrawals from the banks, but at the close of the year member bank excess reserves were again increasing rapidly.

The first and greatest effect of incoming foreign funds was felt by the New York City banks but, as in other recent years, part of the additional funds became widely distributed, through Government disbursements and, in 1939, through commercial transfers out of New York. Some of these funds were transferred back to New York and placed on deposit with the large New York City banks, so that banks in other localities not only had an increase in the amount of their reserves on deposit with their respective Federal Reserve Banks, but also held claims on a substantial part of the excess reserves of the New York City banks.



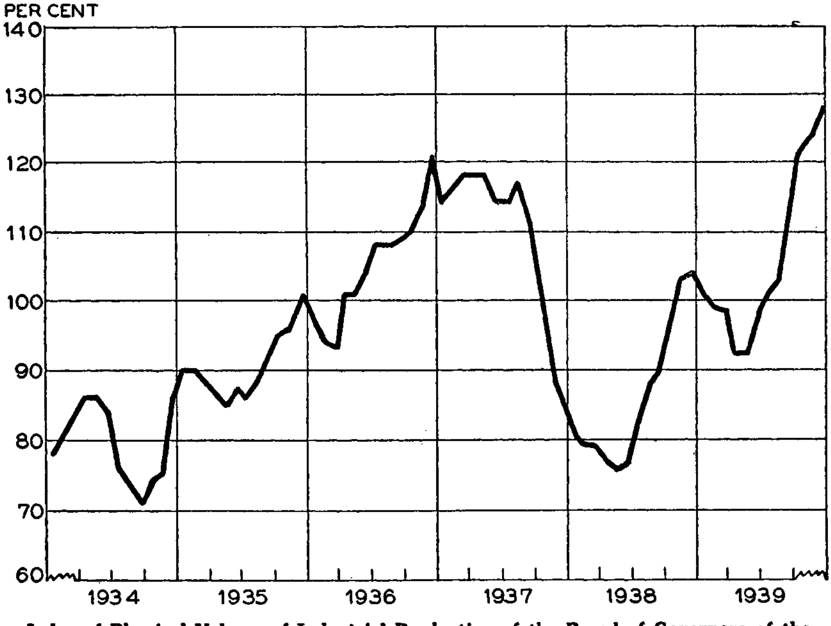
Principal Factors Accounting for Movements of Funds In and Out of the 2nd Federal Reserve District. (Cumulative since January 1, 1935)

One effect of the continued accumulation of surplus funds by banks in all parts of the country was a continued downward pressure on interest rates. Short term money rates, which already were extremely low, showed little change, but yields on medium and long term Government securities and on high grade corporate and municipal securities declined to new low levels in the summer of 1939. The developing crisis in German-Polish relations in August and the outbreak of war at the beginning of September reversed this trend, and led to a widespread feeling that the low point in interest rates had been reached, and that the long upward movement in prices of Government and other high grade securities was ended. This feeling was expressed in heavy sales of such securities, causing sharp declines in their prices and a corresponding rise in their yields. By the latter part of September, however, the influence of the domestic credit situation had reasserted itself and opinions concerning the effects of the war on business in this country had been partially revised. Investment buying of high grade bonds was resumed, and by the end of the year the general level of money rates had declined to the levels prevailing in the latter part of August, and was lower than at the end of 1938.

The heavy inflow of funds from abroad was also partly responsible for a rapid increase in bank deposits to new high levels during the year. Demand deposits in the weekly reporting member banks in New York City increased approximately $1,550,000,000 during 1939, and in 100 other principal cities throughout the country there was an increase of nearly $1,200,000,000. Approximately two-thirds of the increase at New York City appears to have represented an accumulation of idle foreign balances, which were of little immediate significance with respect to the financing of business in this country, although they may later be used to finance war and other expenditures of foreign nations. In so far as the New York City banks are concerned, this inflow of foreign deposits increased expenses without producing an offsetting increase in income, as the supply of short term loans and investments was far from sufficient even for the employment of funds previously held.

The effect of European developments upon our economy was evident, not only in increased bank reserves and bank deposits, and in changing interest rates and security prices, but also in the direct responses of the domestic business situation. Following a slight recession in business at the beginning of the year, concerns in a number of lines of business in this District reported an expansion in the volume of new orders received in February and early March, and there appeared to be prospect of an early resumption of the upward trend of industrial activity. The incipient revival of business activity was checked by the March crisis in Europe, which witnessed the German occupation of Czecho-Slovakia, and the break-up of that country under German domination into the Protectorate of Bohemia and Moravia and the Republic of Slovakia. Fears of an immediate European war had a disruptive influence on business in this country, causing a widespread suspension of future business commitments. Similar effects in the security markets tended to retard business financing of its capital needs, the demand for commercial loans remained inactive, and the volume of loans on securities declined.

Again, in the latter part of the summer, the development of the crisis in Europe over relations between Poland and Germany tended to have a restraining influence on domestic business which had resumed its upward trend in June. The outbreak of war at the beginning of September, however, brought with it an abrupt change in business sentiment. Whereas the recurring crises in Europe during the preceding year had regularly cast doubt on the business outlook, the beginning of actual warfare led, almost overnight, to a rather general conclusion that the war would have a stimulating effect on American business and inflationary effects upon commodity prices. Heavy buying, largely domestic in character, appeared in the markets for all



Index of Physical Volume of Industrial Production of the Board of Governors of the Federal Reserve System, Adjusted for Seasonal Variation (1923-25 average = 100 per cent)

sorts of merchandise. Commodity prices had a brief but substantial rise, and the demand for commercial and industrial loans increased. The market for high grade securities, however, was depressed by anticipations of a marked rise in prices, and of greatly increased business activity, and the flotation of new securities came almost to a standstill.

In the last quarter of the year, despite the failure of war orders or other new foreign business to materialize in the expected volume, industrial activity continued to expand at a rapid rate, partly on the basis of the large volume of domestic orders placed in September. Prices of stocks and commodities made no further gains, however, while prices of high grade bonds recovered all of the September declines, and the flotation of new securities was resumed on a gradually increasing scale.

Review of the Year

For a more detailed review of the developments of the past year it is convenient to divide the year into four periods, certain general characteristics of which were quite dissimilar: first, the period from January through April, in which the second Czecho-Slovakian crisis developed and came to a climax; second, the period of relative calm from the beginning of May to the latter part of July; third, the period from late July to the end of September, in which German-Polish relations reached a critical stage and the war in Europe began; and, finally, the last quarter of the year, in which the war continued, but on a basis which was quite different from earlier expectations and had less immediate effect upon this country than had been anticipated.

January to April

In the first few weeks of the year the inflow of capital from abroad, which had diminished considerably following the Munich Agreement in September, 1938, remained at a relatively low level. The inward movement increased in March, however, when a new crisis was precipitated by German demands on Czecho-Slovakia, and continued in heavy volume for several weeks after the occupation and dismemberment of that country by Germany. As a result of the increased transfers of capital to this country, together with payments due on the continued excess of merchandise exports over imports of the United States, heavy pressure was put upon European exchanges, especially sterling, and official supporting operations were required on a large scale. These supporting operations involved the shipment of gold to the United States in increasing amounts, and as a result the volume of bank reserves rose rapidly.

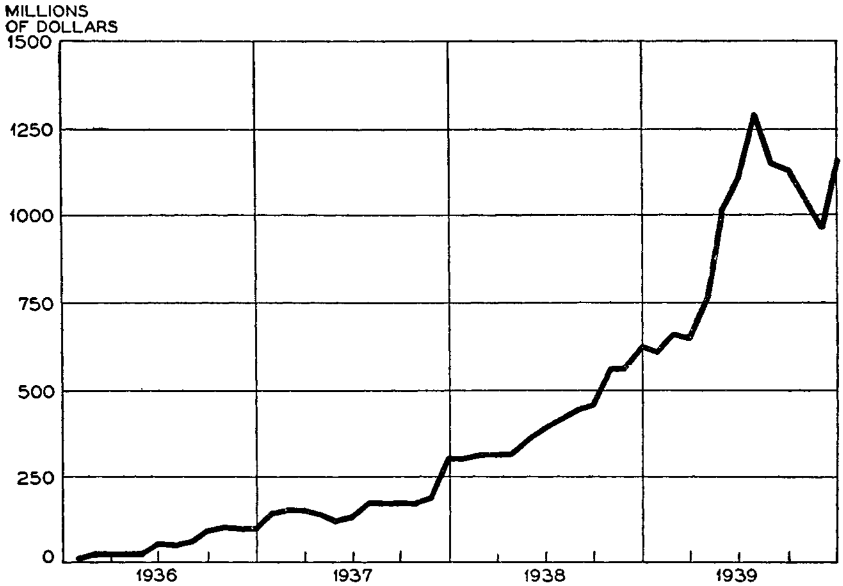
In addition to the large transfers of funds to this country there were unusual demands for United States paper currency for shipment to Europe, presumably for hoarding. In March and April shipments of our currency to Europe reached record figures. Reports received by this bank from principal commercial and private banking institutions in New York, which do not give a complete record, but presumably cover a large part of the shipments, showed total shipments of United States paper currency to Europe amounting to $73,000,000 in those two months.

The depressing influence of European developments on business in this country, previously referred to, tended to check the demand for bank credit by industrial and commercial concerns, and as the United States Treasury found it unnecessary to borrow on the usual Treasury financing date in March, there were few new outlets for the increasing volume of funds available to the money market. In the absence of other opportunities for the employment of funds, New York City banks added considerably to their holdings of outstanding Government bonds. Prices of high grade securities rose, and yields on such securities declined further. Despite the accentuation of easy money conditions, however, there was no evidence of a stimulating effect on business activity.

May to July

As the disquieting effects of the dismemberment of Czecho-Slovakia subsided, there was a temporary respite from disturbances in Europe. Movements of capital from Europe to this country practically ceased, and the foreign demand for United States currency subsided.

Nevertheless, gold imports continued in large volume during May, and were fairly sizable in amount during June and July. Only part of the gold, however, was sold here to obtain dollars with which to cover payments for this country's merchandise export balance and other transactions. The remainder was placed under earmark at this bank for foreign central banks, apparently reflecting a tendency for some European countries to transfer part of their gold reserves to the United States for safekeeping or to provide for possible future requirements for dollars. At the end of July the total amount of gold held under earmark for foreign accounts at this bank reached the unprecedented figure of approximately $1,300,000,000.



Gold Held Under Earmark for Foreign Accounts at Federal Reserve Banks

As only a part of the incoming gold was sold to the Treasury in these months, the rate of increase in the gold stock of the United States became much less rapid than in the preceding period, and the increase in excess reserves from this source was relatively small. Further additions to excess reserves, however, resulted from substantial disbursements from Treasury balances in the Reserve Banks to cover the excess of Government disbursements over current receipts.

The persistent accumulation of idle funds, even though it proceeded at a somewhat less rapid pace than in March and April, continued to have a stimulating effect on prices of high grade securities and a depressing influence on money rates. Prices of Government and other prime bonds reached new high levels, and bond yields correspondingly declined to new low levels. New security flotations increased considerably, but were mostly for refunding purposes, so that in general new securities provided only a limited outlet for the employment of the increased supply of funds.

Business activity remained at a relatively low level in May, and there was little demand for business loans or for loans to finance security trading. In June, however, there was an abrupt increase in business activity, possibly reflecting, in part, the temporary relief from disturbing developments in Europe, and the recovery continued at a moderate pace during the summer. This upturn in business was accompanied by a substantial recovery in prices of stocks and lower grade bonds, and, beginning in July, there was a moderate expansion in the demand for commercial and industrial loans. Bank investments, chiefly in Government direct and guaranteed obligations, also expanded fairly rapidly.

August and September

The lull between crises in Europe proved to be of short duration. An increasingly critical situation in the relations between Germany and Poland, near the end of July, led in August to the third major European crisis within a year, followed by the German invasion of Poland on September 1, and shortly thereafter by declaration of war against Germany by England and France.

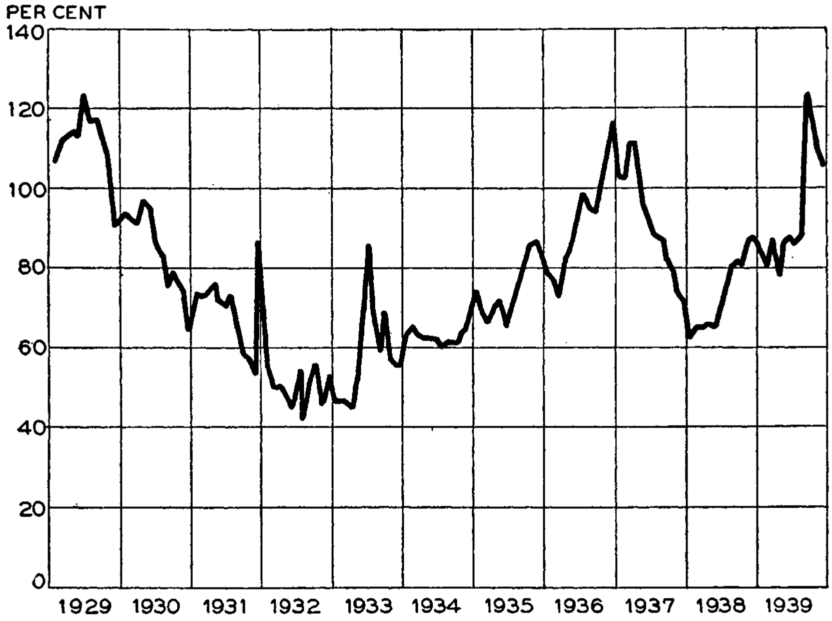
There was again an accelerated flow of capital from Europe to the United States, chiefly by way of London, which again caused heavy pressure against sterling exchange and required correspondingly heavy supporting operations by the British authorities to maintain the value of sterling against the dollar. The decision of the British authorities to suspend official support of sterling on August 25 led to a sharp drop in the pound from about $4.68 to $4.12. This action tended to check the flow of capital to the United States abruptly. After the outbreak of war, decrees were issued in the British and French Empires prohibiting further purchases of foreign assets by the residents of such countries, and placing sales of such assets under official controls, and the movement of private capital to this country diminished greatly. Nonresidents of those countries still had the option of transferring assets from those countries to the United States or elsewhere. In making such transfers, however, they could not in most cases acquire dollars at the official rates, but had to purchase dollars in the American market at the prevailing market rates. The losses involved in the transfer of assets under such conditions tended for a time to limit the movement of such funds to this country, even though the transfers were free from official prohibitions.

During the period of the heavy inflow of foreign funds to this country before the war started, gold shipments to the United States were greatly accelerated, and gold continued to arrive in this country in large volume for a few weeks after the capital flow had diminished. By the end of August the increase in the gold stock of this country since the beginning of the year amounted to $2,130,000,000, and was greater than in any preceding calendar year except 1934. In that year approximately two-thirds of the increase—$2,800,000,000—was due to the upward revaluation in the gold stock. The gold stock of this country continued to rise rapidly in September, reflecting purchases by the Treasury of gold shipments for private accounts that had been arranged before the outbreak of war, together with some further substantial shipments for official accounts.

The prewar effects of this third European crisis on business and on the markets for commodities and the more speculative securities in this country appear to have been rather less than in the preceding crises of March, 1939, and September, 1938. This was due, possibly, to a gradual weakening of the expectation that in the event of a war there would be a repetition of the effects on American business and markets that were observed in 1914. In the earlier crises it was apparent that there was a rather general expectation that another European war would have a retarding effect on American business, at least in its early stages, and would also have a seriously depressing effect on the security markets and, in some instances, on commodity markets as well.

With the actual outbreak of war on September 1 there was prompt and clear evidence of this change in expectations. Commodity and stock prices rose sharply, and many lines of industry experienced a great expansion in the volume of new orders received. Available data indicate that the total volume of orders booked by American business enterprises in September, 1939, reached about the highest level in recent years. On the basis of these orders industrial activity was expanded with unusual rapidity, and the expansion continued during most of the remainder of the year.

The sudden change in business and speculative psychology apparently was based upon the expectation that the war would lead to a great expansion of American export business, partly as a result of war orders from the belligerents, and partly as a result of a diversion of the import trade of neutral countries



Index of New Orders Booked by Massachusetts Manufacturers, Adjusted for Seasonal Variation (Associated Industries of Massachusetts data; 1926 average = 100 per cent)

to the United States. The huge volume of orders received in September, however, proved to have been very largely from domestic sources, reflecting forward buying in anticipation of advancing prices, and possible delays in obtaining deliveries if war orders should attain large volume.

The outbreak of war did, however, have the expected effect of causing heavy pressure on the market for high grade securities. Fears were expressed that because of the war there would be an upward trend in money rates for an indefinite period, and that prices of high grade securities would decline accordingly. These fears apparently were based largely upon the expectation that there would be a substantial expansion of bank loans which would absorb idle funds and lessen the dependence of banks upon security investments for income, that expanding business would cause a diversion of investment interest from high grade bonds to more speculative securities, and that the war might lead to inflationary tendencies which would call for restraints on credit expansion.

In April, 1939, the President of this bank attended conferences held at the Treasury in Washington, D. C., for the purpose of discussing various steps that might be taken in preparation for meeting the possible shock to the financial markets of the country of the outbreak of a European war. At that time he suggested that it would be advisable to form a general committee representative of the different interests in the New York money market which would be available in the event of war, or at other times, to serve as a convenient channel through which this bank, either in its own behalf or in behalf of the interested departments of the Government, might obtain information or through which it might transmit information or suggestions to the financial community. Such a committee, he suggested, would also form a convenient means through which prompt and orderly action in the money market might be sought whenever desirable.

Near the end of August, when the European situation became more and more threatening, steps were taken by this bank to put this suggestion into effect. Different groups representing the various interests in the market were called together to discuss the formation of such a general committee, and they having unanimously approved the suggestion, were requested to select their own representatives who would be available to serve on such a committee. The formation of a foreign exchange committee was also effected in a similar way and with a similar purpose, namely, to function with respect to operations in and questions concerning the foreign exchange market.

The general committee which was formed at that time consists of five representatives of the commercial banks and one representative each of the investment banking firms, the savings banks, the insurance companies, and the New York Stock Exchange.(1) The foreign exchange committee consists of five representatives of the commercial banks, two representatives of the private banks and investment houses doing a foreign exchange business, and one representative each of the foreign banks operating in this market, and the Stock Exchange firms doing a foreign exchange business.(2)

During the course of the meetings attending the formation of the general committee, which were held at the Federal Reserve Bank of New York, representatives of the larger New York City member banks expressed the view that in the event of the outbreak of a European war or the development of other conditions abroad resulting in marked pressure on the Government bond market, their respective banks would not endeavor to liquidate their Government security holdings. Furthermore, each of the New York City banks represented at the meetings indicated that it would, on inquiry from its various correspondent banks in other parts of the country, inform them of its own purpose not to try to sell its Government security holdings in such circumstances. All of these steps proved of assistance in preserving some degree of order in the Government security market when war finally broke out.

Nevertheless while most of the large banks in New York City and in other principal cities held their security portfolios practically intact, recognizing the impossibility of selling their large holdings without disorganization of the market under the conditions then existing, many of the smaller banks and other holders of Government securities throughout the country undertook to dispose of part of their investments. The consequent heavy selling in the market for Government bonds and other high grade securities, accompanied by a virtual absence of ordinary buying orders in the market, led to a rapid decline in prices of such securities during the first half of September,

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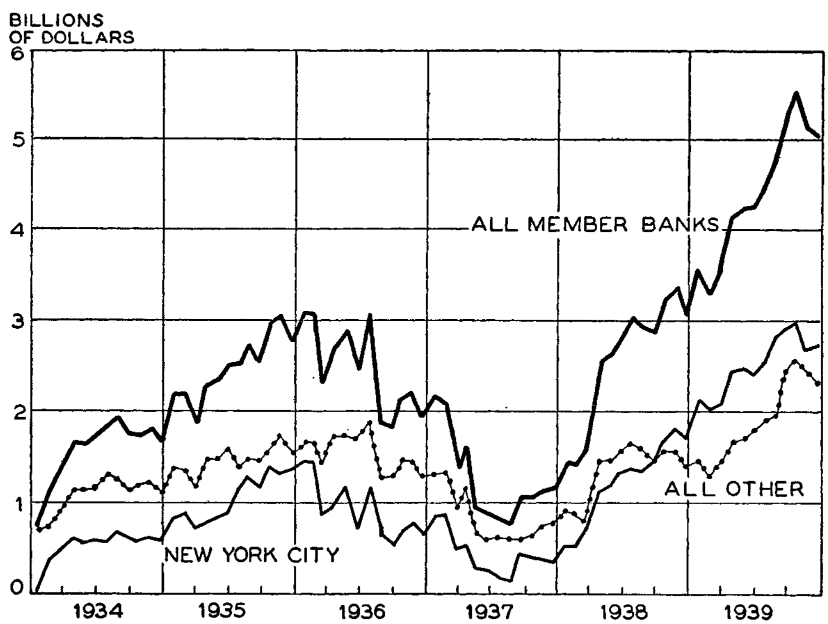
(1) The committee includes the following representatives of the commercial banks: Mr. William C. Potter, Guaranty Trust Company, (Chairman), Mr. Leon Fraser, First National Bank, (Vice Chairman), Mr. Winthrop W. Aldrich, Chase National Bank, Mr. James H. Perkins, National City Bank, and Mr. J. C. Traphagen, Bank of New York and Trust Company; also Mr. Henry S. Morgan, Morgan, Stanley and Company, Inc., representing investment banking firms; Mr. Charles A. Miller, Savings Banks Trust Company, representing savings banks; Mr. Frederick H. Ecker, Metropolitan Life Insurance Company, representing insurance companies; and Mr. William McC. Martin, Jr., New York Stock Exchange, representing members of the Stock Exchange.

(2) This committee includes the following representatives of the commercial banks: Mr. R. F. Loree, Guaranty Trust Company, (Chairman), Mr. J. C. Rovensky, Chase National Bank, (Vice Chairman), Mr. C. E. C. Freyvogel, Bankers Trust Company, Mr. B. Hwoschinsky, Central Hanover Bank and Trust Company, and Mr. L. N. Shaw, National City Bank; also Mr. I. C. R. Atkin, J. P. Morgan and Company, and Mr. Knight Woolley, Brown Brothers Harriman & Co., representing private banks and investment houses; Mr. C. J. Stephenson, Canadian Bank of Commerce, representing foreign banks; and Mr. S. J. Weinberg, Goldman, Sachs and Company, representing Stock Exchange firms.

which continued, but at a diminishing rate, through the third week of the month. Rather than run the risk to the whole banking system, and to the capital market, of such selling feeding on itself, the Federal Reserve System, under the direction of the Federal Open Market Committee, and acting through this bank, placed bids in the market for Government direct and guaranteed securities. In the five weeks ended September 27, the Federal Reserve Banks bought, at declining prices, a total of $474,000,000 of United States bonds and notes, including Government guaranteed securities. These purchases were made, not in an attempt to fix or peg the prices of Government securities, but rather for the purpose of facilitating an orderly readjustment of the market to levels at which buying orders from other sources would come into the market in sufficient volume to maintain the conditions of orderly trading. By the last week of September this objective had been achieved.

Reflecting the combined effects of the large purchases of incoming gold, and the Reserve Bank purchases of Government securities, the volume of excess reserves held by member banks rose very rapidly, during September, despite some increase in



Excess Reserves of New York City (Central Reserve) Member Banks, Other Member Banks, and All Member Banks (Last Wednesday in each month)

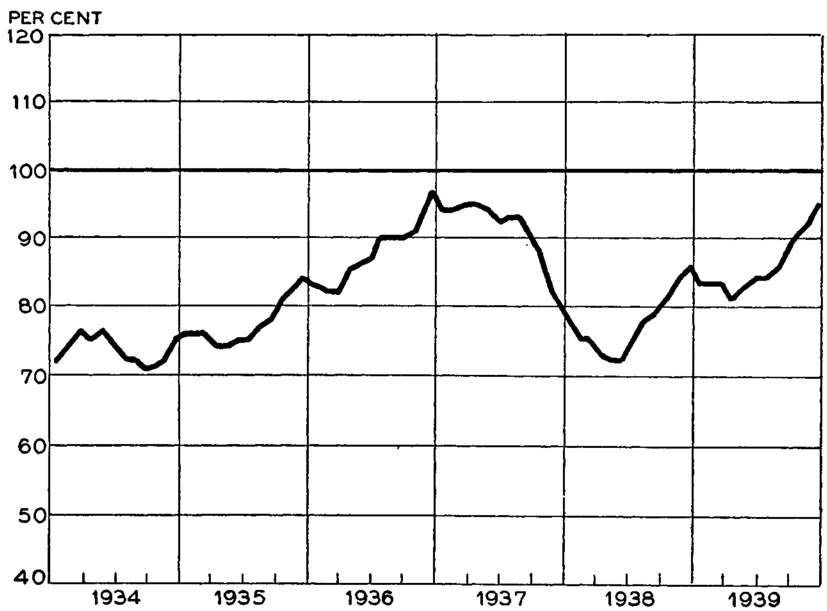
the demand for bank credit and a further rise in deposits to new high levels, which brought about a proportionate increase in member bank reserve requirements. Near the end of September, all member banks had about $5,350,000,000 of excess reserves, an increase of approximately 2 billion dollars since the end of 1938, and New York City banks had nearly $3,000,000,000 of excess reserves, or over 1 billion dollars more than at the end of 1938.

October to December

In the last quarter of the year it became apparent that the immediate effects of the war on business and financial conditions in the United States had been overestimated. The character of the war was less violent than had been expected and involved less destruction of war materials; there were indications that, with the exception of a few urgent needs, such as aircraft, the allied countries either had accumulated their initial requirements for war materials and food, or, together with their colonies and dominions, were prepared to produce sufficient supplies, so as to be able to avoid large purchases (and large expenditures of foreign exchange reserves) in this country. There was also evidence that purchases, which might otherwise have been made in this country, were being diverted, when possible, to other countries as part of the political and economic strategy of the war. Even after the revision of our neutrality legislation no very large volume of war orders, except for aircraft, was reported.

The volume of new orders received by business enterprises from all sources subsided gradually from the unusually high levels of September, but industrial activity continued to expand until November and in some cases into December, and showed less than the usual seasonal decline in the closing weeks of the year. A large part of the expansion in industrial activity during the last four months of the year reflected business spending on plant, equipment, and inventories. Machinery orders were reported to have risen to unusually high levels, commercial and industrial construction contracts increased moderately, railroad orders for rolling stock and track supplies were the largest since 1937, public utility construction programs were expanded, and forward buying of supplies was more prevalent than at any previous time in more than two years.

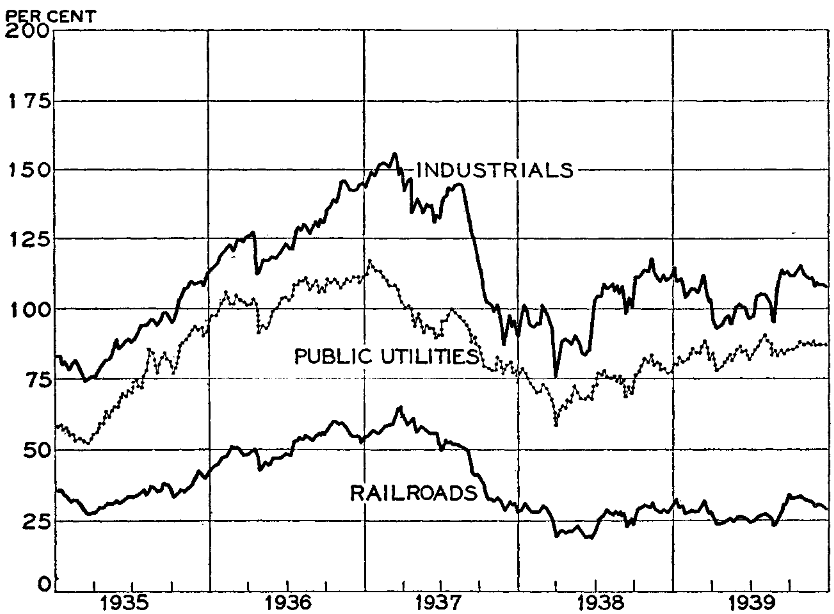
While the largest gains in the latter part of 1939 were in the production of iron and steel and other durable goods, which were especially affected by the sharp increase in the rate of business spending, there were substantial increases in production of consumers' goods as well, although output in one of the important industries in the latter category, the automobile industry, was restricted by a strike in the plants of one of the major producers during most of October and November. Wholesale trade also expanded, railroad freight movements increased substantially, electric power production showed considerably more than the usual seasonal increase, and retail trade, reflecting increases in payroll disbursements and in other elements in the National income, rose moderately. The only major exception to the general tendency toward expansion of business activity was in the construction industry, which, except for the moderate increase in industrial construction, previously mentioned, remained at approximately the same level in the second half of the year as in the first half. A comprehensive business index, such as this bank's Index of Production and Trade, in which all of these various lines of business activity are represented, rose considerably less than industrial production in-



Index of Production and Trade in the United States (Federal Reserve Bank of New York index, expressed as a percentage of the estimated long term trend, and adjusted for seasonal variations)

dexes, but nevertheless extended substantially the recovery which began in 1938.

In contrast with the rising level of business activity and the consequent expectation of a substantial increase in business profits, stock prices declined during the last quarter of the year and, at the close of the year, were slightly lower than at the end of 1938. Lower grade bonds showed comparatively little net gain for the year. Various explanations were offered for what was interpreted to be a lagging tendency in such securities. Among these were the depressing influence, in a thin market, of foreign selling (especially from British holders), which proceeded at a moderate rate, but rather persistently, after the early part of September, disappointment over the failure of foreign buying of war materials and other products to develop on a larger scale; doubts as to the maintenance of business activity, in the early months of 1940, at the relatively high levels attained during the fourth quarter of 1939; uncertainties as to the effects on business of political developments during an election year; and an over-all feeling that, perhaps, stock values must now be appraised more conservatively than in the recent past, because of possible changes in the distribution of the profits of business.



Movement of Stock Prices (Standard Statistics Company weekly indexes; 1926 = 100 per cent)

Commodity prices, after the first sharp rise in September, fluctuated irregularly, and in general showed no material change during the last quarter of the year, the movements in individual commodities reflecting actual or prospective changes in the relationship between supply and demand in each case.

Commercial and industrial loans at reporting member banks continued to expand moderately until the closing weeks of the year, but it was apparent that the volume of available funds remained far in excess of any probable demands within the near future, despite a temporary reduction in excess reserves during November and early December. As already mentioned, gold continued to come to this country in substantial volume during the last quarter of the year, and, although some of it was placed under earmark for foreign accounts at this bank, the United States gold stock showed a further increase of $712,000,000. The effect of payments for incoming gold on member bank reserves was more than offset for a few weeks by sales of new securities by the Reconstruction Finance Corporation and the Treasury, by reductions in Reserve Bank security holdings, and by seasonal currency demands. In the last two weeks of December, however, excess reserves of member banks turned upward again, and further substantial increases were in prospect at the year end, owing to the usual seasonal retirement of currency from circulation in January, Treasury disbursements, and further gold inflow.

Money rates declined again, during the last quarter and, at the end of the year, were back to the low levels prevailing in August, before the outbreak of war. The revival of demand for high grade securities, which had begun to appear in the market for the shorter maturities before the end of September, spread gradually to the longest maturities. At the end of the year yields on long term Treasury bonds, while still slightly above the lowest points reached during the summer, were lower than at any time prior to March, 1939; yields on the highest grade corporation bonds were close to July lows; and yields on high grade municipals were down to new low levels.

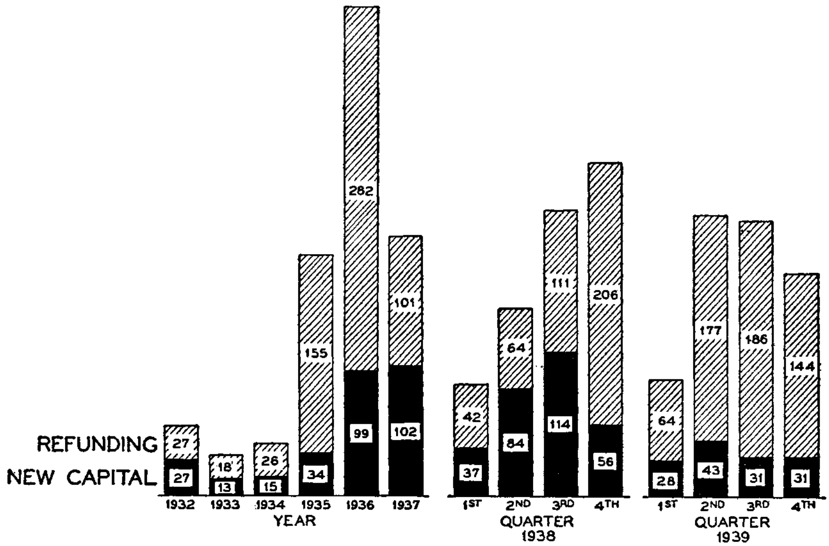
The year closed with an appearance of stability in the financial markets. Although business activity was at a relatively high level, there was little evidence of a war boom or the beginnings of a war-time inflation; bank credit had expanded only moderately, the volume of idle funds seeking employment remained extremely large, and money rates were close to the lowest levels ever reached. Nevertheless, the situation at the end of 1939 left unanswered a number of important questions, such as the ultimate effects of the war on international trade and capital movements, on industrial activity in this country, on commodity prices, on security prices, and on interest rates; and such as the ability of this country to take effective action to solve the monetary problem arising out of the existing volume of excess reserves and the continuing heavy flow of gold to the United States.

New Security Issues

Another question of major importance, as yet unanswered, is how best to bring the savings of the country into productive use through investment. It is generally recognized that changes in the volume of investment in expansions and improvements of the productive and distributive facilities of the country are an important element in the fluctuations of industrial activity and employment, and that a substantial part of such investment ordinarily is financed through the flotation of new securities. The Annual Report of this bank for 1938 directed attention to the fact that the amount of new capital going into private enterprise in recent years has been small, and that, consequently, an important stimulus to business recovery from this source has been lacking. This situation continued to prevail in 1939.

The rising trend of new corporate security financing during 1938 was checked in January, 1939, apparently because of increasing apprehension over the European situation and because of a moderate downturn in business activity. Some revival occurred in February, only to be halted again by the Czecho-Slovakian crisis of March. There was an increase in offerings during the second quarter of the year, and the volume of new securities brought out during July and August was at a fairly high level, accompanying a strong market for high grade bonds. Activity was checked again toward the end of August and in September by the prospect and the outbreak of war. In the final quarter of the year rising prices of high grade bonds and increasing business activity again promoted a moderate revival of the new issue market, but the total volume of new securities sold did not reach the levels of the two preceding quarters.

For the year as a whole, the total volume of new domestic corporate securities sold was approximately $2,100,000,000, including not only securities offered for public subscription, but also securities placed privately either with insurance companies and other investing institutions or with the security holders of the issuing companies. While the total volume was approximately the same as in 1938, a larger proportion in 1939 represented refunding operations. The low money rates that prevailed during the year facilitated the refunding of outstanding securities with new securities involving less interest cost to the borrowers. This is a process which has been going on, in volume, since 1935 and some of the earlier refundings have been refunded again. The total volume of refunding operations during 1939 was larger than in 1937 or 1938, but remained well below that of the peak year, 1936.



Average Monthly Volume of Domestic Corporate Security Issues for New Capital and for Refunding (Commercial and Financial Chronicle data; in millions of dollars)

What is more important, the amount of new capital obtained by business through security sales, during 1939, at no time reached any considerable volume, and for the year as a whole was the smallest since 1934. Even the strong rise in business activity during the last four months of the year failed to stimulate the flotation of new capital issues appreciably.

There was evidence, however, of a substantial increase in business expenditures for new equipment, plant extensions, and inventory expansion during the latter part of the year, notwithstanding the small amount of new capital obtained through the security markets. An alternative form of business financing, which was of some importance during the past year, was term loan financing through the banks for periods ranging from 1 to 10 years, usually with serial maturities. Such financing apparently continued in considerable volume throughout the year except for a short period following the beginning of the war in Europe. No data are available to show the amount of working capital obtained in this way; in some cases it was reported that the proceeds of term loans were to be used for the retirement of outstanding securities, so that the loans represented, in part, refunding operations.

There was no evidence, however, of unusual activity in this form of business financing during the latter part of the year, when business was most active, and it would appear that the increased business spending in that period was financed to a considerable extent through the investment of cash already at the disposal of business enterprises. Many corporations and firms apparently had accumulated considerable amounts of idle cash in preceding periods of less active business, and a considerable expansion of their operations could take place without the necessity of their raising large amounts of new funds through the sale of securities. This is not an avenue of financing open to new businesses, of course, and the demand for term loans at banks, together with some railroad borrowing from the Reconstruction Finance Corporation to finance purchases of new equipment during the autumn, and the moderate expansion of new security financing whenever market conditions were favorable, indicated that there are businesses both old and new, which are not now in a position to finance expansion or improvement of their productive facilities without borrowing. Consequently, it would appear probable that for a broad and sustained rise in business activity to the levels required for real prosperity, a considerable enlargement of the flow of new capital into business organizations, through the investment securities market or other channels, would be necessary.

Federal Reserve Policy

There was no change in the general credit policy of this bank during 1939. The only change in the discount rates of the bank was a reduction from 3½ per cent to 1 per cent in the rate charged on advances to nonmember banks against Government securities. This change, which became effective on August 25, was made as a precautionary measure in view of the critical situation in Europe, so that in the event that war should occur and should have a seriously disturbing effect on the Government security market, nonmember banks could have access to credit extensions by this bank against Government security collateral on the same terms as member banks, and thus could readily obtain any funds they might need without having to liquidate their holdings of Government securities under adverse market conditions.

The open market operations in which this bank participated during the past year were not undertaken primarily with a view to affecting the reserve position of member banks, but rather with a view to exercising an influence toward the maintenance of orderly conditions in the market for Government securities.

In accordance with the statement issued by the Federal Open Market Committee on December 30, 1938, (quoted on page 26 of the Annual Report of this bank for 1938) the Federal Reserve System began, near the end of June, 1939, to permit Treasury bills in the System Open Market Account to mature without replacing them through purchases of other Treasury bills in the market. On June 29, when the first reduction in Treasury bill holdings was shown by the weekly Federal Reserve Bank statement, the following announcement was issued by the Federal Open Market Committee:

> As a result of a reduction in holdings of Treasury bills, this week's statement of condition of Federal Reserve banks shows a decline of $13,378,000 in the System Open Market Account. This is in accordance with action taken by the Federal Open Market Committee on June 21, 1939. For some time past, Treasury bills have been purchased for the System's account at or near a no-yield basis and the account at times has had difficulty in replacing its maturing bills. It was decided that it would serve no useful purpose to continue full replacement of maturing bills, the supply of which is not always equal to the market demand. This action is in response to technical conditions in the bill market and does not represent a change in general credit policy.

Between June 21 and December 6, all of the $477,000,000 of such bills which were held on the earlier date were allowed to "run off". The demand for high grade securities of short maturity continued far in excess of the supply throughout the year, and the increase in the supply of Treasury bills available in the market, which resulted from the elimination of such bills from Reserve Bank portfolios, had little effect on the yield of such securities.

Of much greater importance as an aid to the maintenance of orderly conditions in the Government security market were the heavy purchases of Government direct and guaranteed bonds and notes in the latter part of August and in September. During the five weeks ended September 27, this bank, acting under the authority and direction of the Federal Open Market Committee, bought a total of $474,000,000 of such securities for the System Open Market Account. Circumstances leading to these large purchases have been reviewed in a preceding section of this report. During the latter part of the year $72,000,000 of Government bonds and notes, including guaranteed as well as direct obligations of the Government, were sold on occasions when an excess of bids over offerings in the market was tending to cause unusually rapid advances in prices. The effect of these purchases and sales was to facilitate orderly readjustments of the market to conditions arising out of the war in Europe.

The net effect of the elimination of Treasury bills from the open market account and of the net purchases of notes and bonds was to reduce total Government security holdings of the Reserve Banks by $80,000,000 during 1939, and to lengthen the average maturity of the securities held. In earlier years it had been the practice of the Reserve Banks to keep a substantial part of their portfolios in the form of securities maturing within a year or two, so that, if it became desirable as a matter of general credit policy, to reduce the volume of member bank reserves, that objective could be attained in large part by permitting securities held by the Reserve Banks to mature without replacement. Because of the great expansion in member bank reserves in the past few years, however, excess reserves of the banks are now more than twice as large as the total holdings of Government securities of the Reserve Banks; it is quite unlikely that the reserve position of member banks could be brought under control merely by permitting short dated securities in the System Open Market Account to mature without replacement. A policy which contemplates a portfolio of diversified maturities, rather than a portfolio of preponderantly short term securities, enables the System more effectively to exercise an influence toward orderly conditions in the Government security market. It enables the System to buy, without restriction as to maturity, whatever securities are in oversupply in the market in circumstances such as existed in September, 1939, and to offer in the market securities of maturities that are in special and unsatisfied demand, as it did in November and December, 1939.

The Foreign Exchanges and Capital and Gold Movements

The year 1939 witnessed an intense demand for dollar exchange. This arose primarily from a continued heavy flight of capital to the United States, as political and military developments abroad, culminating in the outbreak of war, led many holders of funds abroad to seek a safer haven for their capital. Of almost equal importance, however, was the demand for dollars to pay for this country's continued large export balance in merchandise trade, which amounted to $859,000,000 for the year as a whole. As a result, most foreign exchange units, especially the pound sterling, were under considerable pressure during the greater part of the year and in many markets extensive supporting operations by foreign monetary authorities were required to maintain some degree of stability in rates.

For the purpose of reviewing the foreign exchange market, the past year may conveniently be divided into two periods—the eight months prior to the start of the war, and the subsequent months in which the currencies of the belligerents were subject to rigid control.

At the turn of the year 1939, the decline in the pound-dollar rate, which had been in progress during the second half of 1938, was halted by a series of steps taken by the British authorities, presumably designed to bolster the forces defending the pound. These steps included the transfer on January 6 of £200,000,000 in gold, valued at the statutory rate (£350,000,000 at current prices), from the Bank of England to the Exchange Equalization Account; also requests that the British banks refrain from transactions in forward gold and from facilitating advances against gold, and that they scrutinize exchange operations with a view to eliminating undesirable transactions. The effect of these measures was to bring about a rally in sterling, which carried the quotations at New York from $4.62½ on January 3 to $4.68 1/16 on January 7. British exchange continued to improve until mid-March, when tension abroad was heightened by the German occupation of Czecho-Slovakia and later of Memel, by Italian agitation for territorial concessions from France, and by the Italian occupation of Albania in early April. The ensuing flight of capital from London exerted considerable pressure against the pound, although, presumably through official support abroad, the rate held at about $4.68. Some support during this period was also rendered by heavy gold shipments from London to New York for private account, such gold being supplied in part by private hoarders, who feared that in the event of war shipments to this country would become difficult. The demand for dollars continued through August, varying in degree according to the alternating periods of intensification and relaxation of tension abroad. As Europe approached the actual outbreak of war the strain became intense, and on August 25 the British authorities were reported to have withdrawn from both the exchange and bullion markets. On that day the sterling rate broke sharply, depreciating from the previous level of about $4.68 to a low of $4.12 during the following days.

In contrast to the pound sterling, the French franc was in some demand during most of the first eight months of the year, accompanying a continuation of the return of capital to France which began toward the end of 1938. It has been officially estimated that about 26 billion francs of gold were repatriated in the ten months preceding the war. The franc was maintained around 177 to the pound during these months, or well within the maximum level of 179 promised when the franc was devalued by decree in May, 1938. In terms of the dollar, French exchange firmed, along with sterling, from about $0.0262 at the beginning of the year to $0.0265 at the end of February, and remained at or near this higher level until the pound depreciated in August.

The major neutral European currencies—the guilder, belga, and Swiss franc—showed rather wide and erratic fluctuations in the months leading up to the war, as the presence in these countries, especially in Holland, of a large volume of nervous refugee funds rendered rates particularly susceptible to both external and internal political disturbances. The guilder declined from $0.5441 to $0.5308½ during January and February and, although there were intermittent periods of strength, the rate remained below $0.5400 at all times between the end of February and the end of August. The belga was under pressure from mid-February to the end of April, when some recovery occurred after the Cabinet obtained special decree powers in financial matters, but specifically disavowed any intention to devalue the belga. By the first week in May quotations had improved to $0.1702¾, or about 22 points above the April low and the highest level since February, 1938. Swiss francs moved from a high of $0.2275¼ in February to a low of $0.2240 in early April, as refugee money fled in fear of possible military movements against Switzerland.

Trading in the non-European exchanges during the first eight months of the year was featured by sharp declines in rates for the Shanghai dollar, the Mexican peso, and the Cuban peso. The war situation in the Far East, in the case of the Chinese currency and, in general, internal conditions, including capital flights and projected monetary legislation, apparently were largely responsible for these developments, rather than the state of world markets. The rate for the Brazilian milreis turned downward, following the restoration of a "free market" on April 10, primarily as a result of a large commercial demand for foreign exchange, and by the end of August the "free" milreis was quoted at $0.0506.

Immediately at the outbreak of war, gold and exchange restrictions were imposed in the United Kingdom and this was soon followed by similar action in other parts of the British Empire and in France. Soon after the establishment of exchange control, virtually all (£280,000,000 at the official price) of the Bank of England's remaining gold holdings were transferred to the Exchange Equalization Account. On September 5 the Bank of England established official selling and buying rates for the dollar of $4.02 and $4.06. (Rates were also established for a number of other monetary units.) The buying rate was lowered to $4.04 on September 14 and this rate, together with the selling rate of $4.02, remained unchanged during the remainder of the year. A free market rate, however, soon developed in neutral countries for transactions by nonresidents of the British Empire, not subject to the British exchange control. In the ensuing months this rate pursued a course which diverged markedly, at times, from the rates in the official market. The New York rate for British exchange depreciated to a low of $3.75 on September 18 and to $3.77 in mid-November, but with these exceptions the pound fluctuated between about $3.80 and $4.05½ during the last four months of the year. At the close of 1939 the rate was $3.95¾, or 6¼ cents below the official London selling rate for dollars.

There was intermittent selling of foreign owned sterling from September on, and these offerings, although reportedly fairly well absorbed by American importers of merchandise and others owing sterling debts, seem to have been largely responsible for keeping the pound-dollar rate in the so-called free markets below the official quotations. Toward the end of the year a British order-in-council was promulgated, to become effective on January 8, 1940, which provided for more strict control over all transfers of sterling balances and sterling securities from resident to nonresident accounts, thereby reducing the amount of sterling available for sale in the outside markets.

One of the immediate consequences of the sharp depreciation in sterling at the end of August, and the imposition of exchange restrictions, was the withdrawal of a number of countries from the sterling bloc. Most of the Scandinavian countries severed their ties to the pound in September; toward the end of that month the Argentine peso was revalued in terms of the dollar and the pound; in October the Japanese yen was pegged to the dollar at about 23½ cents; and Portugal tied its currency to the dollar in the following month.

The New York rate for French exchange moved with that of sterling, after the imposition of exchange restrictions in both the United Kingdom and France, and on December 12 it was announced that the British and French Governments had agreed to link the two currencies at the rate of 176½ francs to the pound until six months after the signing of a peace treaty. The franc declined in this market to a low of $0.0213 in mid-September and again in early November to $0.0212¾, in sympathy with the weakness in the pound, but subsequently improved to end the year at $0.0224⅜. Although it was not reflected in the exchange rate for the franc because of the peg to sterling, there was reported to have been a substantial repatriation of French funds during the latter part of the year.

The neutral European currencies continued under some pressure during the last four months of the year, although, except for the belga, rates for these exchanges held relatively steady in terms of the dollar, owing no doubt to foreign official supporting operations. The belga declined from a high level of $0.1720 at the beginning of September to $0.1608 in November, but later recovered to close the year at $0.1678. The Swiss franc was maintained around $0.2243 from the middle of October, while the Dutch guilder did not decline below $0.5308. In terms of sterling, these currencies appreciated nearly 15 per cent between August 24 (prior to sterling's depreciation) and the end of the year. The rate for the Italian lira, which continued subject to official restrictions during the year, held at \$0.0526¼ through the end of August. In the following month, however, Italian exchange was lowered to \$0.0505, a rate which continued during the remainder of the year.

Among the non-European exchanges, the Canadian dollar, which in July reached parity with the United States dollar for the first time since March, 1938, declined substantially in terms of the United States dollar in the early weeks of the war and its discount in this market was about 11¼ per cent at the end of December. Some recovery occurred in the Mexican peso during September, but toward the end of the year a deterioration of the Mexican export trade as a consequence of the war led to a renewed depreciation to about the low level reached at the end of June.

Closing Cable Rates at New York

Exchange on	January 3	December 30
Belgium	\$ .1687	\$ .1678
Denmark	.2065	.1933
England *	4.6250	3.9575
France	.0262	.0224
Germany	.4011	.4020
Italy	.0526	.0505
Netherlands	.5438	.5328
Norway	.2324	.2273
Sweden	.2382	.2383
Switzerland	.2260	.2243
Canada	.9916	.8869
Argentina, Official †	.3078	.2978
Brazil, Official ‡	.0588	.0606
Brazil, Free ‡	—	.0513
Uruguay, Controlled §	.6087	.6583
Japan	.2698	.2345
India	.3458	.3015
Shanghai	.1650	.0763
Hong Kong	.2892	.2469

* Official rates established on September 5. At the end of December official buying rate for dollars was \$4.04; official selling rate, \$4.02.

† Official buying rate for dollars.

‡ Only one rate (official) prior to April 10, 1939. Subsequently only 30 per cent of exchange to be delivered at official buying rate (16½ milreis to the dollar) and remainder sold in free market.

§ Peso unpegged from pound sterling on September 2, 1939 and pegged to the dollar on September 19, 1939.

Capital Movements

Published data on capital movements between this country and foreign countries indicate that the influx was almost continuous and in unusually large amount through September, totaling $1,179,000,000. This movement, however, was abruptly reversed after the third quarter of the year, as controls over foreign exchange transactions and capital movements by the belligerents tended to eliminate all international capital transactions except those of the authorities and such private operations as had official approval. As a result, the net inflow for the ten months ended in October, the last month for which published data are available, was reduced to $1,083,000,000, which, however, was still nearly three times the net inward transfer for the full year 1938 and $281,000,000 more than in 1937.

Movement of Capital between the United States and Foreign Countries

December 29, 1938 to November 1, 1939 (a)

(In millions of dollars; capital inflow + or outflow —)

By Source	Short term banking funds	Security transactions (b)	Total
England	+ 199	—108	+ 91
France	+ 71	+ 19	+ 90
Germany	+ 21	— 2	+ 19
Italy	+ 10	+ 5	+ 15
Netherlands	+ 106	+ 18	+ 124
Switzerland	+ 88	+ 42	+ 130
Other Europe	+ 220	+ 24	+ 244
Total Europe	+ 715	— 2	+ 713
Canada	+ 103	— 6	+ 97
Latin America	+ 104	+ 21	+ 125
Far East	+ 92	+ 5	+ 97
All Other	+ 45	+ 6	+ 51
Grand Total	+1,059	+ 24	+1,083
By Periods			
Dec. 29, 1938 to Mar. 1, 1939	+ 183	+ 24	+ 207
Mar. 2, 1939 to June 28, 1939	+ 564	+ 45	+ 609
June 29, 1939 to Sept. 27, 1939	+ 376	— 13	+ 363
Sept. 28, 1939 to Nov. 1, 1939	— 64	— 32	— 96
Total	+1,059	+ 24	+1,083

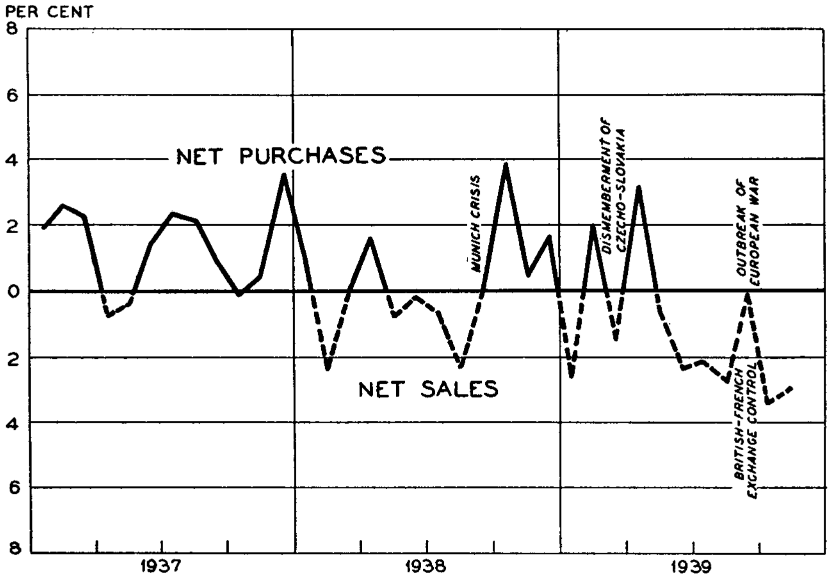
(a) Source: United States Treasury Department. (b) Including the movement in brokerage balances.

This flight of capital, which was most pronounced in March and April and again in August, was almost entirely in the form of short term banking funds. This was in sharp contrast to the movement of previous years, particularly 1935, 1936, and 1937, when foreign buying of American securities, together with the repatriation of foreign securities held in the United States, played an important part in the flow of capital to the United States. Of the $1,179,000,000 influx of capital during the first three quarters of the past year, $1,123,000,000 was in short term funds, which originated in all parts of the world. The heaviest movements, however, were from the United Kingdom, from neutral European countries which in the past had been havens for refugee funds, and from other European countries not listed separately in the table below, including the Scandinavian countries.

With respect to international security transactions, foreigners repatriated a net amount of $79,000,000 of their own securities through the end of October, and an additional capital inflow of $32,000,000 was reflected in changes in brokerage balances. These items, however, were largely offset by the net sales by foreigners of American securities amounting to $87,000,000, British and Canadian holders being the chief sellers.

Of the $96,000,000 net reduction in the amount of foreign funds in this country reported during October, nearly one half resulted from a reduction in foreign central bank funds held in New York. The remainder was accounted for primarily by the continued liquidation of British-owned American securities, which was accelerated immediately after the outbreak of war. This selling continued, though at a less rapid rate, during the remainder of the year. The reduction in the amount of foreign funds in this country, despite further large gold shipments to the United States, would appear to indicate that large amounts of foreign funds were disbursed here during the latter months of the year to cover commitments made before the outbreak of the war and to pay for the continued large excess of merchandise exports from the United States over imports.

In order to give some measurement of the relative importance of foreign participation in our security markets in recent years, the accompanying diagram has been prepared to show foreign net purchases or sales of domestic securities in each month since the beginning of 1937, expressed as a percentage of the value of the total turnover of stocks on the New York Stock Exchange. It should be noted that in this diagram foreign security transactions, including both stocks and bonds, are compared with Stock Exchange sales of stocks only. While this may overstate somewhat the importance of foreign security operations in this country, it is assumed that the bulk of foreign transactions in American securities during the past few years have been in stocks.



Net Purchases or Net Sales of American Securities by Foreigners, Expressed as a Percentage of Total Stock Transactions on the New York Stock Exchange in Each Month

The most striking fact shown by the diagram is the relatively small percentage of foreign operations to total operations during the last three years, although in thin markets or in particular stocks, concentrated buying or selling might, of course, be an important influence. At no time did the monthly volume of net foreign purchases or sales amount to as much as 4 per cent of the total volume. During the period of heavy foreign buying in the first quarter of 1937, net purchases never accounted for more than 2½ per cent of the total stock turnover on the New York Stock Exchange. Accompanying a sharp decline in stock prices from March, 1937 to April, 1938, foreign participation in our security markets remained limited, although in most months purchases were somewhat in excess of sales. During the year leading up to the war, political considerations appear to have been the motivating force in the investment policy of foreigners. Immediately after the "Munich crisis" in September, 1938, there was a heavy wave of foreign buying and net purchases in the following month amounted to $65,000,000. This volume of net purchases, however, amounted to less than 4 per cent of total stock transactions on the Stock Exchange.

With the exception of February and April, foreign sales of our securities exceeded purchases in all months of the year 1939. It can be seen, however, that this liquidation did not represent an important part of all stock business done on the New York Stock Exchange. Even during October and November, when the net British liquidation averaged nearly $8,000,000 a week, foreign net selling remained under 4 per cent of the total stock turnover, and in December the volume of foreign selling is reported to have diminished considerably.

Gold Movements

The reported gain of gold from abroad, resulting from imports less exports, and changes in gold held under earmark for foreign account amounted to $3,039,500,000 during 1939. Of this amount, $721,300,000 came in during the first quarter, $804,400,000 in the second quarter, $855,600,000 in the third quarter, and $658,200,000 in the fourth quarter. Total net imports during the year aggregated $3,573,900,000, but of this amount $534,400,000 net was placed under earmark at this bank for foreign account. Imports from England alone reached a total of $1,826,500,000 during the past year, and substantial amounts were also received from Canada, the Netherlands, Japan, Belgium, and Switzerland. Gold movements during 1939, by countries of origin or destination, are summarized in the accompanying table. Some of the gold receipts shown in the table were placed under earmark for foreign account upon arrival, but such transactions are not reported by countries.

Gold Movements by Countries
(In thousands of dollars)

Country	Exports to	Imports from	Net
Australia	....	74,249	74,249
Belgium	....	165,122	165,122
Canada	167	613,116	612,949
China and Hong Kong	....	26,185	26,185
Colombia	....	23,239	23,239
England	60	1,826,463	1,826,403
India	....	52,868	52,868
Italy	....	15,719	15,719
Japan	....	165,605	165,605
Mexico	206	33,815	33,609
Netherlands	....	341,373	341,373
Norway	....	10,953	10,953
Philippines	2	35,637	35,635
South Africa	....	22,862	22,862
Sweden	....	28,716	28,716
Switzerland	68	87,054	86,986
All Other	5	51,438	51,433
Total	508	3,574,414	3,573,906

Foreign Relations

During 1939 this bank with the approval of the Board of Governors of the Federal Reserve System, opened two additional accounts for foreign central banks. A new account was opened in the name of the Central Bank of the Republic of Turkey, and the account maintained by the Bank of Java from 1919 until 1935 was reopened in December, 1939. The number of foreign central banks (including the Bank for International Settlements) which have accounts on the books of this bank, was thereby increased to forty-two. Balances maintained by foreign correspondents with the Reserve Banks totaled $397,380,000 at the end of 1939, as compared with $199,211,000 at the end of 1938, and $171,750,000 at the close of 1937. On September 19, 1939, such balances reached a record high level of $498,839,000. A record high level was also reached in earmarked gold on August 1, 1939, when the total stood at $1,303,300,000. Total gold earmarked for foreign accounts on December 31, 1939 was $1,163,004,000, as compared with $628,587,000 a year previous.

With the approval of the Board of Governors of the Federal Reserve System, and on behalf of this and other Federal Reserve Banks, four short term loans secured by gold earmarked at this bank (one of which was renewed at maturity), were extended to a foreign central bank during 1939 for a total amount of $8,329,000, of which $5,020,000 remained outstanding at the end of the year.

The participation of the Federal Reserve Banks in the credit originally extended in 1931 jointly by a group of central banks and the Bank for International Settlements to the National Bank of Hungary was reduced during the year, through partial repayments of principal, from $2,055,000 at the end of 1938 to $1,830,000 at the end of 1939.

Balances held abroad by this bank in its own behalf and in behalf of the other Federal Reserve Banks were reduced during 1939 from an aggregate amount equivalent to $172,000 to the equivalent of $47,700; of the latter amount $25,800 is repayable in United States dollars and the remainder in foreign currencies. Holdings of commercial bills denominated in foreign currencies which at the beginning of 1939 amounted to the equivalent of $549,200 (exclusive of the Hungarian credit referred to above), were entirely liquidated by October, 1939.

Operations of the Bank During 1939

The volume of transactions in the operating departments of the bank, where the work can be measured readily by counting the number of transactions, is shown in the following table. The principal increases in activity were in the money, collection, and fiscal agency operations of the bank. There were sizable increases in the number and dollar amounts of currency and coin received and counted (also in currency payments), in the number and amount of checks handled, and in the number of items handled in connection with the fiscal agency operations

	1939	1938
Number of Pieces Handled		
Bills discounted:		
Applications	773	1,912
Notes discounted	933	2,174
Industrial advances:		
Notes discounted	76	125
Commitments to make industrial advances	5	14
Bills purchased in open market †	119	158
Currency received and counted	657,400,000	645,229,000
Coin received and counted	931,986,000	880,939,000
Checks handled	208,359,000	199,324,000
Collection items handled:		
United States Government coupons paid *	5,018,000	4,971,000
All other	1,970,000	2,026,000
Issues, redemptions, and exchanges by fiscal agency department:		
United States Government direct obligations	1,281,000	1,080,000
All other	427,000	360,000
Wire transfers of funds	194,000	209,000
Amounts Handled		
Bills discounted	$38,853,000	$87,161,000
Industrial advances:		
Notes discounted	275,000	973,000
Commitments to make industrial advances	231,000	1,789,000
Bills purchased in open market for own account	828,000	1,091,000
Currency received and counted	3,296,368,000	2,971,426,000
Coin received and counted	94,785,000	89,189,000
Checks handled	76,502,457,000	70,471,328,000
Collection items handled:		
United States Government coupons paid *	545,532,000	496,769,000
All other	1,783,187,000	1,725,713,000
Issues, redemptions, and exchanges by fiscal agency department:		
United States Government direct obligations	16,845,724,000	17,958,369,000
All other	3,255,959,000	1,995,611,000
Wire transfers of funds	29,077,778,000	27,498,995,000

† Includes number purchased by this bank for System account.

* Includes coupons from obligations guaranteed by the United States.

for the Government in the issue, redemption, and exchange of direct obligations of the Government. The increase in number of direct Government obligations issued reflected chiefly the larger number of United States savings bonds sold in 1939 than in 1938. Operations for Government agencies also showed a considerable increase both in number and amount.

Lending operations of the bank declined considerably, partly because of a further reduction in the number of member bank applications for rediscounts and advances, and partly because of a greatly reduced number of inquiries for loans of working capital (under Section 13b of the Federal Reserve Act) from business organizations that were unable to obtain funds from other sources. During 1939 only 109 inquiries for such loans were received, compared with 693 in 1938, and the number of formal applications received was only 24 in 1939, as compared with 131 in 1938. Of the 24 applications received during the past year, 16 were from previous borrowers, leaving only 8 new applicants. Total loans of $193,500 to 11 applicants were approved, while 13 applications for a total amount of $502,000 were declined. The number and amount of industrial notes discounted, as shown in the accompanying table, include several notes of different maturities discounted for the same borrowers.

Financial Statement

The earning assets of this bank, shown in the accompanying comparative statement of condition as "Total bills and securities," decreased approximately $45,000,000 in 1939. The decline was almost entirely in Government security holdings, reflecting in part a net reduction in the amount of securities in the System Open Market Account, due to the transactions discussed on earlier pages of this report, and in part to the relinquishment by the New York Reserve Bank in favor of other Reserve Banks of some securities, through the periodic reallocations of the System Account portfolio. Discounts for member banks remained at a very low level, the amount of industrial advances outstanding was reduced, and there was a decline in commitments to make this type of loan. The increase in "Other bills discounted" reflected loans on gold, referred to in Foreign Relations section of this report.

The continued influx of gold into the United States is reflected in the rise in the reserves of this bank, and also in the reserve accounts of member banks. Federal Reserve notes of this bank outstanding continued to increase in 1939, partly because of the foreign demands for United States currency, previously discussed, and partly as a result of a further increase in domestic circulation.

The "float" at this bank, consisting of the excess of "Uncollected items" over "Deferred availability items," was increased appreciably because of a revision in the time schedule, effective September 1, 1939, which now provides for credit by the Reserve Bank on out-of-town checks presented for collection by member banks in three days at the most, even though the time required for the actual collection of the checks may be as long as seven days.

(In thousands of dollars)

Assets	Dec. 31, 1939	Dec. 31, 1938
Gold certificates on hand and due from U. S. Treasury	$7,225,434	$5,115,945
Redemption Fund—Federal Reserve notes	1,619	1,226
Other cash	71,716	103,924
Total reserves	$7,298,769	$5,221,095
Bills discounted:		
Secured by U. S. Government obligations, direct and guaranteed	$ 90	$ 804
Other bills discounted	2,258	241
Total bills discounted	$ 2,348	$ 1,045
Bills bought in open market	$	$ 215
Industrial advances	2,035	3,879
U.S. Government securities, direct and guaranteed:		
Bonds	$ 419,593	$ 267,426
Notes	351,944	367,938
Bills		180,058
Total U. S. Government securities, direct and guaranteed	$ 771,537	$ 815,422
Total bills and securities	$ 775,920	$ 820,561
Due from foreign banks	$ 18	$ 65
Federal Reserve notes of other banks	4,336	5,337
Uncollected items	245,508	207,064
Bank premises	9,895	9,038
Other assets	17,226	13,388
Total assets	$8,351,672	$6,276,548

(In thousands of dollars)

Liabilities	Dec. 31, 1939	Dec. 31, 1938
Federal Reserve notes in actual circulation	$1,269,922	$1,029,296
Deposits:		
Member bank—reserve account	$6,319,837	$4,460,340
U. S. Treasurer—General Account	139,593	212,295
Foreign bank	136,108	71,368
Other deposits	165,323	188,480
Total deposits	$6,760,861	$4,932,483
Deferred availability items	$ 199,137	$ 194,382
Other liabilities	873	1,214
Total liabilities	$8,230,793	$6,157,375
Capital accounts:		
Capital paid in	$ 50,972	$ 51,043
Surplus (Section 7)	53,326	52,463
Surplus (Section 13b)	7,109	7,457
Other capital accounts	9,472	8,210
Total capital accounts	$ 120,879	$ 119,173
Total liabilities and capital accounts	$8,351,672	$6,276,548
Ratio of total reserves to deposit and Federal Reserve note liabilities combined	90.9%	87.6%
Contingent liability on bills purchased for foreign correspondents	$	$ 27
Commitments to make industrial advances	1,803	2,677

Income and Disbursements

Earnings of this bank increased moderately in 1939 because of larger holdings of United States Government bonds, which produced considerably higher interest yields than the Treasury bills which were eliminated from Reserve Bank holdings during the year. Net expenses were practically the same as in the previous year. As a consequence, current net earnings were $3,899,000 for 1939, compared with $3,370,000 in 1938. Profits on sales of United States Government securities, amounting to $1,262,000, were only about one-half as large as in 1938, but, on the other hand, deductions from current net earnings were much smaller in 1939.

Net earnings amounted to $4,831,000, of which $3,055,000 was paid out as dividends to member banks, and, after transferring $349,000 from special surplus (Section 13b) against the losses and reserves for losses on industrial advances deducted from current net earnings, $2,125,000 was transferred to ordinary surplus (Section 7). Ordinary surplus then was reduced by the amount of the profits on sales of United States Government securities mentioned above, which was added to reserves for contingencies in "Other capital accounts."

Profit and Loss Account
For the calendar years 1939 and 1938
(In thousands of dollars)

	1939	1938
Earnings	$ 11,211	$ 10,706
Net expenses	7,312	7,336
Current net earnings	$ 3,899	$ 3,370
Additions to current net earnings:		
Profits on sales of U. S. Government securities	$ 1,262	$ 2,316
All other	94	83
Total additions	$ 1,356	$ 2,399
Deductions from current net earnings:		
Losses and reserves for losses on industrial advances	$ 405	$ 448
Special reserves on bank premises		737
Prior service contributions to retirement system		1,282
All other	19	11
Total deductions	$ 424	$ 2,478
Net earnings	$ 4,831	$ 3,291
Dividends paid	$ 3,055	$ 3,057
Transferred to surplus (Section 7)	2,125	520
Transferred from surplus (Section 13b)	—349	—286
Surplus (Section 7) beginning of year	$ 52,463	$ 51,943
Addition as above	2,125	520
	$ 54,588	$ 52,463
Transferred to other capital accounts	1,262	
Surplus (Section 7) end of year	$ 53,326	$ 52,463

Membership Changes in 1939

At the end of 1939 member banks represented 76 per cent of the total number of commercial banks domiciled in the Second Federal Reserve District. This is a slightly larger percentage than at the end of 1938, owing to a drop of thirteen in the number of nonmembers (four were absorbed by member banks and two became new Federal Reserve members). There was a net decrease of four in the number of member banks; three were consolidated with other member banks, two became insolvent, and one went into voluntary liquidation, while two trust companies were admitted to membership. One bank gave up a National charter in favor of a State charter, but retained its membership in the Federal Reserve System.

The tables below show the classification of banks in this District according to their charters, and the record of changes in membership during 1939.

Number of Member and Nonmember Banks in Second Federal Reserve District at End of Year
(Exclusive of Mutual Savings Banks and Industrial Banks)

Type of Bank	December 31, 1939			December 31, 1938		
	Members	Non-members	Per cent Members	Members	Non-members	Per cent Members
National banks	596	0	100	599	0	100
State banks	43	107	29	44	111	29
Trust companies	129	138	48	129	147	47
Total	768	245	76	772	258	75

Changes in Federal Reserve Membership in Second District During 1939

Total membership beginning of year	772
Increases:	
Admission of Trust companies	2
Newly chartered member State bank organized to succeed a National bank	1
Total increases	3
Decreases:	
Member banks combined with other members	3
National bank succeeded by newly chartered member State bank	1
Insolvencies	2
Voluntary liquidation	1
Total decreases	7
Net decrease	4
Total membership end of year	768

Changes in Directors and Officers

In December, 1939, the Board of Governors of the Federal Reserve System redesignated Owen D. Young, Honorary Chairman of the Board, General Electric Company, New York, N. Y., as Chairman and Federal Reserve Agent of this bank for the year 1940, and redesignated Beardsley Ruml, Treasurer, R. H. Macy & Co., Inc., New York, N. Y., as Deputy Chairman for the year 1940.

At a regular election in the autumn of 1939, Neil H. Dorrance, President, The First National Bank and Trust Company of Camden, Camden, N. Y., was elected by member banks in Group 3 as a Class A director for a term of three years beginning January 1, 1940, to succeed William F. Ploch of Long Beach, N. Y., whose term expired December 31, 1939; Robert T. Stevens, President, J. P. Stevens & Co., Inc., New York, N. Y., was reelected by member banks in Group 3 as Class B director for a term of three years beginning January 1, 1940.

In December, 1939, the Board of Governors of the Federal Reserve System reappointed Edmund E. Day, President, Cornell University, Ithaca, N. Y., a Class C director of this bank for a term of three years beginning January 1, 1940. At the same time the Board of Governors reappointed Gilbert A. Prole, Genesee Farm Supply Company, Batavia, N. Y., a director of the Buffalo Branch for a term of three years beginning January 1, 1940.

In November, 1939, the Board of Directors of this bank appointed George F. Rand, President, The Marine Trust Company of Buffalo, Buffalo, N. Y., a director of the Buffalo Branch for a term of three years beginning January 1, 1940, to succeed Fred J. Coe, Niagara Falls, N. Y.

The directors of this bank reappointed Robert M. O'Hara, Managing Director of the Buffalo Branch for the year 1940.

Member of Federal Advisory Council

In January, 1940, the Board of Directors of this bank reappointed Leon Fraser, President, The First National Bank of the City of New York, New York, N. Y., a member of the Federal Advisory Council for the Second District, to serve during the year 1940.

Changes in Officers

On April 7, 1939, the directors of this bank appointed Frederick Stocker, formerly Chief, Cash Custody Division, Cash Custody Department, Manager, Cash Custody Department; on April 15, 1939, Felix T. Davis, formerly Assistant Counsel, was appointed Manager, Check Department.

Effective July 1, 1939, the Board of Directors of this bank appointed Robert G. Rouse, formerly a Second Vice President of the Guaranty Trust Company, an Assistant Vice President of this bank, assigned to open market operations and Treasury issues. On November 16, 1939, Mr. Rouse was appointed a Vice President, and on December 13, his selection by this bank as Manager of the System Open Market Account, succeeding Allan Sproul, First Vice President, was approved by the Federal Open Market Committee.

On November 16, 1939, Silas A. Miller, Manager, Securities Department, was appointed an Assistant Vice President of the bank by the Board of Directors; on the same date, Marcus A. Harris, formerly Supervisor, Purchase and Sale Section, Securities Department, was appointed Manager, Securities Department.

Walter B. Matteson, Assistant Vice President, a member of the staff since the bank opened in 1914, having reached the retirement age under the Retirement System of the Federal Reserve Banks, retired July 31, 1939.

Directors and Officers

DIRECTORS

Class	Group		Term Expires Dec. 31
A	1	WILLIAM C. POTTER, Old Westbury, N. Y. Chairman, Board of Directors, Guaranty Trust Company of New York, New York, N. Y.	1940
A	2	OTIS A. THOMPSON, Norwich, N. Y. President, The National Bank and Trust Company of Norwich.	1941
A	3	NEIL H. DORRANCE, Camden, N. Y. President, The First National Bank and Trust Company of Camden.	1942
B	1	THOMAS J. WATSON, New Canaan, Conn. President, International Business Machines Corporation, New York, N. Y.	1940
B	2	WALTER C. TEAGLE, East Portchester, Conn. Chairman, Board of Directors, Standard Oil Company (New Jersey), New York, N. Y.	1941
B	3	ROBERT T. STEVENS, Plainfield, N. J. President, J. P. Stevens & Co., Inc., New York, N. Y.	1942
C		OWEN D. YOUNG, Van Hornesville, N. Y., *Chairman* Honorary Chairman of the Board, General Electric Company, New York, N. Y.	1940
C		BEARDSLEY RUML, New York, N. Y., *Deputy Chairman* Treasurer, R. H. Macy & Co., Inc., New York, N. Y.	1941
C		EDMUND E. DAY, Ithaca, N. Y. President, Cornell University.	1942

DIRECTORS—BUFFALO BRANCH

	Term Expires Dec. 31
HOWARD KELLOGG, Buffalo, N. Y. President, Spencer Kellogg and Sons, Inc.	1940
MARION B. FOLSOM, Rochester, N. Y. Treasurer, Eastman Kodak Company.	1941
GILBERT A. PROLE, Batavia, N. Y. Genesee Farm Supply Company.	1942
WILLIAM A. DUSENBURY, Olean, N. Y. President, The First National Bank of Olean.	1940
FRANK F. HENRY, Buffalo, N. Y. Director, General Mills, Inc.	1941
GEORGE F. RAND, Buffalo, N. Y. President, The Marine Trust Company of Buffalo.	1942
ROBERT M. O'HARA, *Managing Director*	1940

MEMBER OF FEDERAL ADVISORY COUNCIL

LEON FRASER

President, The First National Bank of the City of New York, New York, N. Y.

OFFICERS

George L. Harrison, *President*

Allan Sproul, *First Vice President*

Ray M. Gidney, *Vice President*

L. Werner Knoke, *Vice President*

Walter S. Logan, *Vice President and General Counsel*

Leslie R. Rounds, *Vice President*

Robert G. Rouse, *Vice President*

John H. Williams, *Vice President*

William H. Dillistin, *Assistant Vice President*

J. Wilson Jones, *Assistant Vice President*

Herbert H. Kimball, *Assistant Vice President and Secretary*

John W. McKeon, *Assistant Vice President*

Silas A. Miller, *Assistant Vice President*

Arthur Phelan, *Assistant Vice President*

James M. Rice, *Assistant Vice President*

Harold V. Roelse, *Assistant Vice President*

Valentine Willis, *Assistant Vice President*

Dudley H. Barrows, *Manager, Personnel Department*

Wesley W. Burt, *Manager, Accounting Department*

Donald J. Cameron, *Manager, Foreign Department*

Felix T. Davis, *Manager, Check Department*

Norman P. Davis, *Manager, Security Loans Department*

Edward O. Douglas, *Manager, Collection Department*

Edwin C. French, *Manager, Cash Department*

Marcus A. Harris, *Manager, Securities Department*

Myles C. McCahill, *Manager, Service Department*

Robert F. McMurray, *Manager, Safekeeping Department*

Horace L. Sanford, *Manager, Research Department, and Assistant Secretary*

William A. Scott, *Manager, Government Bond Department*

William F. Sheehan, *Manager, Bank Examinations Department, and Chief Examiner*

Insley B. Smith, *Manager, Bank Relations Department*

Frederick Stocker, *Manager, Cash Custody Department*

Todd G. Tiebout, *Assistant Counsel*

William F. Treiber, *Assistant Counsel*

Rufus J. Trimble, *Assistant Counsel*

Charles N. Van Houten, Jr., *Manager, Security Custody Department*

George W. Ferguson, *General Auditor*
Harold A. Bilby, *Assistant General Auditor*

OFFICERS—BUFFALO BRANCH

Robert M. O'Hara, *Managing Director*

Reginald B. Wiltse, *Assistant Manager*

Halsey W. Snow, *Cashier*