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MONEY MARKET IN NOVEMBER

A downward adjustment in interest rates and a sharp spurt in securities prices highlighted market developments during November, while member bank reserve positions continued under moderate but somewhat reduced pressure. In the course of the month, this Bank and other Federal Reserve Banks lowered their discount rates by $\frac{1}{2}$ per cent to 3 per cent. Over the whole month, yields on the longest term Treasury issues declined almost 30 basis-points, and the longest outstanding three-month Treasury bills were trading at a discount of 3.14 per cent at the close of the month in contrast to a 3.60 per cent rate at the end of October.

Member bank reserve positions remained under moderate restraint during the first half of the month, but were subject to somewhat less pressure in the latter half as reserves were supplied through an expansion in float in the third week, and by Federal Reserve open market operations in the final week. As in October, bank loans did not show the expansion that is usual at this time of the year, and largely because of this, required reserves increased less than seasonally. Federal funds traded mainly at the $3\frac{1}{2}$ per cent ceiling rate in the first half of the month but were more readily available at this rate than in other recent periods. Over much of the second half of the month there were two distinct markets in Federal funds: in Federal Reserve Districts where the discount rate remained at $3\frac{1}{2}$ per cent, Federal funds also traded primarily at this rate, while in New York and some other centers the bulk of the trading was effected at 3 per cent.

Reductions of $\frac{1}{2}$ per cent in discount rates were announced late on Thursday, November 14, by the Federal Reserve Banks of New York, Richmond, Atlanta, and St. Louis, effective the following day. The eight other Federal Reserve Banks made similar announcements over the next fifteen days, with the lower rates taking effect as follows: Boston, November 19; Philadelphia, Kansas City, and Minneapolis, November 22; Cleveland, Chicago, and San Francisco, November 29; and Dallas, December 2. This was the first general reduction in discount rates since early in 1954, and it restored the 3 per cent rate

on member bank borrowing that had been in effect from August 1956 to August 1957. On November 18, shortly after the initial discount rate cuts, the Treasury announced the terms for 1.5 billion dollars of new money borrowing, and for the refunding of about 10 billion dollars in maturing certificates, all at lower rates than have been paid on recent comparable issues. As detailed below, the exchange and cash offerings were well received at these lower rates, with low "attrition" on the exchange and heavy oversubscription for the cash issues.

BANK RESERVE POSITIONS

Despite the sharp rise in securities prices and the easier market tone implied by reductions in short-term rates and by reserve statistics in the latter part of the month, member bank reserve positions were still under restraint in November. Pressure was less severe than in other recent months, however. With excess reserves averaging around 480 million dollars for the four-week period ended November 27, and member bank borrowing from the Reserve Banks at about 810 million, net borrowed reserves for the period averaged around 330 million. This was some 50 million less than in October and was the lowest average for any month since last March.

Member bank net borrowings were highest during the early part of the month when reserves were withdrawn through a combination of factors, including the usual reduction in float and a heavy outflow of currency partly associated with the Veterans Day holiday. These drains were offset through Federal Reserve acquisitions of Government securities including outright and repurchase transactions. Required reserves, meanwhile, had risen slightly

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in the first week of the month but then declined in the second week as member bank credit and deposits dipped.

In the statement week ended November 20, the rise in float of more than 400 million dollars (daily average) far overshadowed the reserve effects of other factors. While Federal Reserve holdings of Government securities dropped substantially and required reserves increased somewhat, average net borrowed reserves declined to 219 million dollars. Average net borrowings increased again during the final week of November, as pre-Christmas currency outflow began to gather momentum and float receded more swiftly than usual from its midmonth high. Net System purchases, as well as a dip in Treasury and other deposits with the Reserve Banks, supplied reserves but did not fully offset these drains. Over the entire four-week interval from October 30 through November 27, System holdings of Government securities increased by 342 million dollars, net, including 179 million on an outright basis and 163 million under repurchase agreements.

In the market for Federal funds, which banks use extensively to adjust their reserve positions and which therefore provides some indication of reserve pressures, restraint was still in evidence. Over the first half of the month, until the discount rate was lowered by this Bank and several other Reserve Banks, Federal funds traded almost steadily at the 3½ per cent "ceiling" rate. However, the supply of funds was relatively more ample at this rate than it has been for some time, and on November 13 the effective rate for the heaviest volume of trading dropped below 3½ per cent for the first time since early September. For

a number of days after November 15, there was a split market in Federal funds (similar to the situation last August) with funds traded at 3 per cent in New York but at 3½ per cent in a number of other important financial centers. By the end of the month, as additional Reserve Banks lowered their discount rates, Federal funds were trading at 3 per cent or occasionally slightly below this new "ceiling" rate.

GOVERNMENT SECURITIES MARKET

Prices of Treasury securities moved sharply higher during November, with much of the advance coming in the wake of the discount rate reduction. The price trend was vigorously upward in the early part of the month, too, however, as the market was affected by the less optimistic appraisals of business conditions in the fourth quarter of the year and evidence of a much smaller increase in business loans than in the previous two years. Persistent expectations of further steps to ease credit also reinforced the upward price movement.

Over the month as a whole, prices of notes and bonds maturing through 1962 increased from about ¾ point to nearly 3¼ points, with most of the gains clustered around 1 to 3 points. In the longer end of the market, price increases were mainly in the neighborhood of 4 or 5 points, but ranged to more than 6 points for some of the 2½'s of 1967-72. The recently issued 4's of 1969 and the 3¼'s of 1978-83, which are relatively close in maturity to the Treasury's latest long-term offering, showed net price increases over the month of about 3¾ points and 4¾ points, respectively.

As had been expected in the market, in view of the Federal Government's tight cash position, the Treasury's mid-November financing announcement included not only an exchange offering to holders of the 3½ per cent certificates that matured December 1, but also a cash offering for about 1.5 billion dollars. The announcement of the combined offering was made after the close of major financial markets on November 18, thus following by a few days the first announcements of discount rate reductions by several Federal Reserve Banks. In the refinancing, holders of nearly 10 billion dollars of maturing 3½ per cent certificates were permitted to take one-year 3¾ per cent certificates in exchange. Books were open for the exchange on November 21 and 22 and all but 141 million dollars of the maturing issue was turned in for the new certificates. The bulk of the maturing issue—around 8 billion out of 10 billion—was held by Federal Reserve System and United States Government accounts, and the estimated "attrition" rate on the remaining portion of roughly 2 billion was only about 7 per cent. In its most recent previous offering of one-year certificates the Treasury had set a 4 per cent coupon rate.

The lower interest rate structure was also evident in the terms set for the Treasury's cash offering, which included

Table I
Changes in Factors Tending to Increase or Decrease Member
Bank Reserves, November 1957
(In millions of dollars; (+) denotes increase,
(-) decrease in excess reserves)

Factor	Daily averages—week ended				Net changes
	Nov. 6	Nov. 13	Nov. 20	Nov. 27	
Operating transactions*					
Treasury operations*	+ 54	- 46	- 3	+ 43	+ 48
Federal Reserve float	- 103	+ 54	+ 433	- 221	+ 158
Currency in circulation	- 106	- 173	- 49	- 95	- 423
Gold and foreign account	- 13	+ 62	+ 49	+ 19	+ 108
Other deposits, etc.	- 61	- 95	+ 24	+ 116	- 16
Total	- 235	- 197	+ 444	- 137	- 125
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 77	+ 76	- 50	- 115	- 12
Held under repurchase agreements	+ 169	- 19	- 160	+ 145	+ 135
Loans, discounts, and advances:					
Member bank borrowings	+ 114	+ 86	- 156	+ 25	+ 69
Other	-	+ 1	- 2	-	- 1
Bankers' acceptances:					
Bought outright	+ 1	+ 1	-	+ 1	+ 3
Under repurchase agreements	-	-	-	+ 1	+ 1
Total	+ 361	+ 145	- 368	+ 57	+ 195
Total reserves	+ 126	- 52	+ 76	- 80	+ 70
Effect of change in required reserves†	- 47	+ 148	- 74	- 6	+ 21
Excess reserves†	+ 79	+ 96	+ 2	- 86	+ 91
Daily average level of member bank:					
Borrowings from Reserve Banks	817	903	747	772	810‡
Excess reserves†	430	526	528	432	482‡

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

* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for four weeks ended November 27.

about 500 million dollars of 3½ per cent seventeen-year bonds and about 1 billion dollars of five-year notes paying 3¾ per cent. Two months earlier the Treasury had offered 4 per cent on a five-year note that had the additional advantage of being redeemable after 2½ years at the holder's option, and 4 per cent on a twelve-year bond. Books were open for the new offerings on November 20, and both issues were heavily oversubscribed. For the bond, subscriptions of \$10,000 or less were allotted in full, while larger bids were filled to the extent of 26 per cent in the case of savings institutions, and 10 per cent for all others. Full allotments on the notes were given for subscriptions up to \$10,000, with a 25 per cent allotment on larger subscriptions for savings-type investors and 12 per cent to all others. Total awards on the two issues came to 1,792 million dollars, including the allotment of 100 million of each issue to Government investment accounts.

Along with other Government securities, rates on Treasury bills dropped sharply during November. In the first two regular bill auctions of the month the average issuing rates were 3.571 per cent and 3.473 per cent, which compared with about 3.62 per cent in the final two auctions of October. The declining rate trend sharply accelerated after the first announcement of Reserve Bank discount rate reductions, and the average issue rate in the November 18 auction dropped to 3.145 per cent. This decline of 33 basis-points was the more notable since the amount of bills auctioned was increased by 100 million from the preceding week to 1.8 billion dollars, conforming with the larger maturity of bills coming due. In the month's final bill auction, held on November 25, the average issue rate was nearly unchanged at 3.158 per cent. The drop in rates during the month was spread through the entire range of bill maturities. Yields on some of the bills maturing in December, which have been in short supply, dropped from around 3¼ per cent to 2½ per cent over the month. For the tax anticipation bill due next March and the special bill due next April, the rate declines during November amounted to 62 and 51 basis-points, respectively.

OTHER SECURITIES MARKETS

During the first half of November the markets for corporate and municipal bonds did not share the buoyancy exhibited by Government issues. The contrast with the behavior of Treasury securities was especially noticeable in the corporate market where new issues were given mixed receptions—some moving well but others lingering in the hands of underwriters. To some extent the absence of a greater price rise in the corporate area could be ascribed to the heavy volume of bonds that still remained in dealers' inventories following a 250 million dollar telephone utility flotation late in October. In the municipal bond area, new issues during the first half of November were reasonably well received but the market lacked real strength.

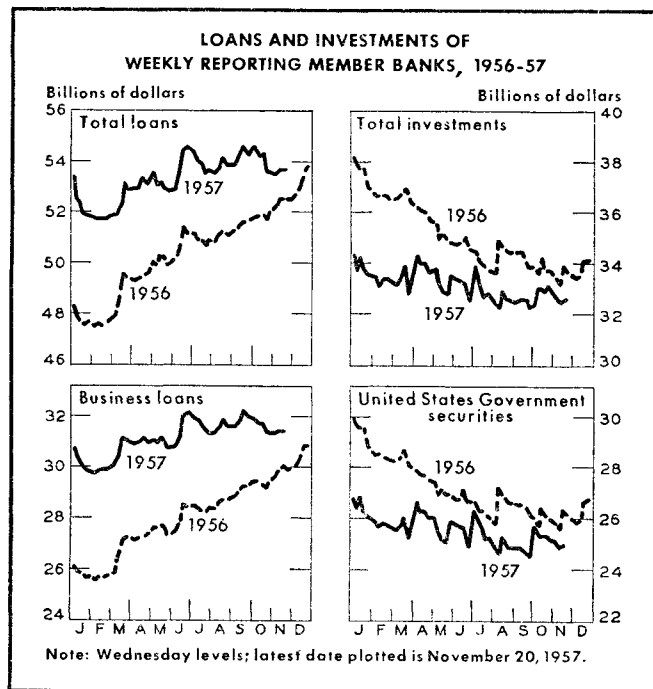
Table II
Changes in Principal Assets and Liabilities of the
Weekly Reporting Member Banks
(In millions of dollars)

Item	Statement week ended				Change from Dec. 26, 1956 to Nov. 20, 1957
	Oct. 30	Nov. 6	Nov. 13	Nov. 20	
<i>Assets</i>					
<i>Loans and Investments:</i>					
<i>Loans:</i>					
Commercial and industrial loans.....	- 59	- 3	+ 86	- 31	+ 505
Agricultural loans.....	+ 8	- 2	- 1	- 8	- 24
Securities loans.....	+ 48	- 92	+ 25	+ 150	- 585
Real estate loans.....	- 11	- 7	+ 25	+ 1	- 75
All other loans (largely consumer).....	+ 26	+ 26	+ 15	- 65	+ 320
Total loans adjusted*.....	+ 11	- 79	+ 149	+ 42	- 51
<i>Investments:</i>					
U. S. Government securities:					
Treasury bills.....	+ 28	- 145	- 128	+ 123	- 930
Other.....	- 107	- 87	- 46	+ 30	- 786
Total.....	- 79	- 232	- 174	+ 153	- 1,716
Other securities.....	+ 272	- 155	- 149	+ 34	+ 174
Total investments.....	+ 193	- 387	- 323	+ 187	- 1,542
Total loans and investments adjusted*.....	+ 204	- 466	- 174	+ 229	- 1,593
Loans to banks.....	+ 217	- 80	+ 322	- 527	- 185
Loans adjusted* and "other" securities.....	+ 285	- 234	-	+ 76	+ 123
<i>Liabilities</i>					
Demand deposits adjusted.....	+ 422	- 1,005	+ 225	+ 85	- 3,104
Time deposits except Government.....	+ 2	- 31	- 148	- 74	+ 1,635
U. S. Government deposits.....	+ 20	- 287	- 243	+ 749	- 480
Interbank demand deposits:					
Domestic.....	- 200	+ 619	+ 176	- 571	- 948
Foreign.....	- 11	- 15	- 33	- 27	- 48

* Exclusive of loans to banks and after deduction of valuation reserves; figures for the individual loan classifications are shown gross and may not, therefore, add to the totals shown.

After the midmonth adjustments in discount rates, the market atmosphere for corporates and municipals brightened—but again not so much as in the case of Treasury securities, as new offerings continued in heavy volume for this time of year. The slow-moving telephone bonds and other issues in underwriters' hands were now swiftly distributed, and many moved to premium quotations. Indicative of the rate adjustment, a sizable Aa-rated utility issue on November 20 was well received at a reoffering yield of 4.65 per cent, 25 basis-points below the yield on a similarly rated issue in late October. Among municipals, too, underwriters were able to reduce inventories substantially around midmonth, but interest charges on new offerings did not show any particularly sharp reduction. Thus a State issue on November 19 of 30 million dollars in Aa-rated thoroughfare bonds was awarded at almost the same net interest cost as a similar issue by the same State in October.

Rates on seasoned high-grade corporate issues, according to Moody's index, remained at or near 4.12 per cent from the end of October through mid-November, but by the end of the month the rate was down to 4.02 per cent. Top-grade municipal issues yielded 3.30 per cent in late October, and this rate had slipped to 3.28 per cent by mid-November and to 3.16 per cent near the end of the month. Public offerings of corporate bonds during the month totaled an estimated 445 million dollars, down from 535 million in the previous month but much greater than the low 130 million total for November 1956. Municipal flotations in the latest month totaled around 520



million dollars, which was also less than in October but again much greater than the 260 million total in November a year ago.

A number of shorter term interest rates were reduced during November, particularly in the second half of the month. Dealers in bankers' acceptances, finding a heavy demand for these instruments, reduced their rates for all maturities by $\frac{1}{8}$ per cent on November 6. There was a further reduction of $\frac{1}{4}$ per cent on November 15, immediately following the discount rate reductions by several Reserve Banks. Dealer rates on 90-day maturities were thus lowered to $3\frac{1}{2}$ - $3\frac{3}{8}$ per cent (bid and offered). During the next week, major dealers in open market commercial paper cut their rates twice, for a total reduction of $\frac{1}{4}$ per cent on all maturities, establishing a $3\frac{3}{8}$ per cent offered rate on prime four to six-month paper. Major finance companies placing paper directly with investors

also announced a reduction of $\frac{1}{4}$ per cent on all maturities of such paper; the rate on directly placed 30 to 89-day paper was thus lowered to $3\frac{1}{2}$ per cent.

MEMBER BANK CREDIT

Total loans and investments at weekly reporting banks decreased by 207 million dollars during the four weeks ended November 20, as a rise of 123 million in loans only partially offset the 330 million drop in investment holdings.

The moderate rise in loans was largely a reflection of the 131 million increase in securities loans during the four-week span, while business loans contracted slightly further. Business loans dipped in three of the four latest weeks, and while the net decline was only 10 million dollars for the period, there had been sizable increases in the comparable weeks of 1956 and other recent years. Thus, as shown in the chart, the outstanding volume of member bank business loans has shown smaller and smaller margins of increase over the year-earlier totals. Since the start of this year business loans at the reporting banks have increased by only about 500 million dollars, while in the same period last year the rise was 3.8 billion. The contrast is even sharper since midyear: a drop of about 750 million in 1957 as against a rise of nearly 1.6 billion in 1956. The slackened pace of business borrowing has been evident in various lines; industries that normally borrow heavily at this time of year (such as food, liquor, and tobacco firms and commodity dealers) have been borrowing less than usual. Sales finance companies and producers of metals and metal goods recently have been repaying loans, net, whereas a year ago they were borrowing.

The sizable drop in investment holdings during the recent four-week period stemmed chiefly from a reduction in reporting bank holdings of Treasury issues. Payment for the new Treasury securities was not made until November 29 in the case of the notes and until December 2 for the bonds, so that acquisitions of these issues do not appear in the accompanying table or chart.

INTERNATIONAL MONETARY DEVELOPMENTS

MONETARY TRENDS AND POLICIES

United Kingdom. Short-term interest rates declined somewhat in November. During the first half of the month, the average Treasury bill tender rate continued near the level reached immediately after the September increase in the discount rate, but it subsequently declined to 6.46 per cent on November 29. Prices of long-term government bonds, which in October had risen somewhat from the record lows reached in the preceding month, were steady; the yield of $2\frac{1}{2}$ per cent Consols was slightly higher at 5.46 per cent on November 29. The gilt-edged market has been relatively stable during the past two months despite indications of a substantial increase

in official net sales of government bonds; there has thus been some revival of demand for long-term government securities. This recent progress of the government's funding efforts, together with the earlier success in effecting substantial sales from official portfolios in April and May, has contributed importantly to monetary restraint by helping to keep bank liquidity below last year's levels; the increase in the tender bill issue that normally occurs during April-October was only 260 million pounds this year, compared with 390 million in April-October 1956. In November, however, the tender bill issue rose sharply.

Canada. The recent downward trend of Canadian interest rates was accentuated last month as the average

Treasury bill tender rate fell sharply and bond yields continued the decline that had begun in October. The Treasury bill rate dropped about $\frac{1}{4}$ percentage point during the month, or more than in any single month since the war, and on November 28 stood at 3.58 per cent, compared with the August peak of 4.08. In the bond market, yields of long-term government bonds continued to move lower, while there was a repetition of the sharp October fall in interest rates on medium-term issues and an accelerated decline in yields in the short end of the market. The decline in market interest rates led the chartered banks to reduce their prime lending rate by $\frac{1}{4}$ per cent to $5\frac{1}{2}$, effective December 2. On November 25, the government announced that two new short-term bond issues, totaling 250 million and 400 million dollars, respectively, would be floated in December; the smaller issue, a $21\frac{1}{2}$ -month bond, will be priced to yield 3.81 per cent, as compared with 4.97 offered on an issue with the same maturity floated in mid-September. Further official recognition of the recent sharp decline in interest rates was the Industrial Development Bank's action in November in cutting its interest rate on new loans by $\frac{1}{2}$ per cent to 6 per cent; the president of the bank, who is the Governor of the Bank of Canada, stated that this action had been taken "in view of the substantial decline in yields on Canadian Government securities and other interest rates in Canada during the past three months".

Belgium. A number of changes in the Belgian monetary arrangements were announced by the Ministry of Finance after consultation with the national bank; the measures were stated to be aimed at countering the recent decline in bank deposits and at fostering the development of the Belgian money market over the longer run. The decline in deposits this year has been largely a result of the loss of foreign exchange, due to Belgium's growing import surplus and the attraction for Belgian capital of the higher interest rates prevailing elsewhere. One result of the fall in deposits has been that the commercial banks, which are required by law to maintain a reserve of short-term government paper in a fixed proportion to their deposits, have been redeeming Treasury certificates and thus contributing to the government's cash difficulties. The new measures will increase the banks' earnings on Treasury paper and thus enable them to offer depositors more attractive rates; actually, the banks' present holdings of Treasury paper will be exchanged for two new issues one of which will bear a higher yield than the current $1\frac{5}{16}$ per cent, and in the future the rate on the higher yielding issue is to be $\frac{3}{4}$ per cent less than the discount rate, but in any case not lower than 2 per cent. In addition, the Securities Stabilization Fund will henceforth be responsible for the redemption of all such Treasury paper whenever deposits decline, and this institution rather than the Treasury will issue additional paper, at rates equal to those on the higher yielding Treasury certificates, to meet increases in the banks' required reserves.

As a step toward the development of a wider and more active money market, it was announced that the Treasury, instead of issuing five, ten, and fifteen-day paper, as heretofore, will issue bills with maturities ranging from fifteen days to four months; at the same time, the maximum rate payable on these bills has been raised from $1\frac{5}{16}$ per cent to the equivalent of the discount rate at the time of issue. In addition, it is envisaged that the Treasury will offer on the money market longer term paper with maturities up to one year; and this paper, moreover, may be marketed by tender, as it was from 1937 to 1939.

EXCHANGE RATES

American-account sterling displayed a generally strong undertone during November, with the quotation rising to the highest level since May 1956. The announcements early in the month that Britain's gold and dollar reserves had increased in October by 243 million dollars and that the country had an October surplus of 24.5 million dollars in the European Payments Union were followed by good commercial demand for sterling in New York and offerings of dollars in London. With the support that these provided, the rate moved generally upward from $\$2.79\frac{5}{8}$ at the beginning of the month, reaching the high of $\$2.80\frac{13}{16}$ on November 26 when the covering of forward contracts falling due in November supplied further support. The rate at the month end was quoted at $\$2.80\frac{2}{32}$. In the forward market, the discounts on three and six months' sterling widened to $2\frac{17}{32}$ and $4\frac{9}{32}$ cents early in the month. As commercial interests became substantial buyers of forward sterling, the spreads narrowed, reaching $2\frac{1}{8}$ and $3\frac{3}{4}$ on November 8. Subsequently, the discounts tended to widen slightly, and, following the lowering of the New York Reserve Bank's discount rate, reached $2\frac{15}{32}$ and $4\frac{5}{32}$ on November 15. Thereafter, they moved rather erratically in a relatively small market, standing at $2\frac{1}{4}$ and $4\frac{1}{16}$ cents on November 29.

Good demand from the Continent raised the transferable-sterling quotation from $\$2.7810$ on November 1 to $\$2.7890$ on November 19. On the following day a somewhat easier undertone developed, with the quotation declining to $\$2.7875$. Later in the month, renewed Continental demand, including short covering, moved the rate to $\$2.7915$ on November 26. At the month end the quotation was $\$2.7865$. Securities sterling advanced 2 cents during the first week of November, with current investment demand and short covering playing a major role; the rate reached $\$2.77$ on November 7, the highest quotation since May 1956. The rise was then followed by a steady decline that carried the quotation to $\$2.72\frac{1}{2}$ on November 19. Subsequently, there was a slight recovery in a quiet market, resulting in a month-end quotation of $\$2.74\frac{1}{4}$.

The Canadian dollar rate firmed during the first week of November to $\$1.04\frac{17}{64}$, supported particularly by

offerings of United States dollars in the Canadian market. It then moved somewhat erratically lower, with occasional demand for Canadian dollars by grain interests and intermittent offerings of Canadian dollars from London in

evidence. By November 15 the rate had declined to \$1.03 $\frac{3}{8}$. It then fluctuated around \$1.04 in a relatively quiet market, but eased noticeably toward the month end and was quoted at \$1.03 $\frac{7}{8}$ on November 29.

THE NEW YORK FOREIGN EXCHANGE MARKET—II

An article in the November *Monthly Review* described the organization and functions of the New York foreign exchange market and the various instruments used in dealing in foreign exchange. The present article discusses exchange rates in the New York market and how they are determined, the techniques of exchange trading, and the relation of the Federal Reserve System to the exchange market.

EXCHANGE RATES IN THE NEW YORK MARKET

Exchange rates are prices, much like prices for commodities, except that in the exchange market the "commodities" traded are foreign currencies. For most currencies there is an officially declared parity, expressed in terms of gold or dollars, but underlying this par value is the whole complex of economic and other factors that make up each country's payments relationship with the rest of the world.

In addition to such basic economic factors as the relationship of incomes, prices, and interest rates in one country to those in other countries, seasonal factors may also affect exchange rates, causing a currency to appreciate during the peak of the export season and to depreciate during the slack months. Temporary factors, too—the outbreak of a strike affecting an important sector of a nation's economy, fears of domestic or international political instability, or a natural calamity, such as a drought or an unusually cold winter—may have their effect. Purely random factors, such as the accidental bunching of payments for imports, or even the timing of a single substantial payment, likewise may cause significant ripples in the day-to-day movement of rates.

Finally, exchange rates are shaped not only by actual developments of the types outlined above, but also by expectations of such developments in the future. At times, indeed, the most important factor determining the current rate of exchange between two currencies is the anticipation of what the rate will be at some later date.

To the foreign exchange trader in New York, as in other markets, all of these developments, and the cross-currents among them, are reflected in a constantly changing pattern of supply and demand for individual currencies and in parallel fluctuations in the rates of exchange. The extent to which a given offer of, or demand for, a currency will affect the exchange rate depends in part on the state of the market at any given time. In an active and confident market, the offer of a million pounds sterling may be absorbed with scarcely any effect on the exchange rate. In

a thin market, on the other hand, the offer of even a much smaller amount might cause an appreciable dip in the rate.

The effect on the exchange rate of sudden changes in supply and demand also depends to a considerable extent on the assessment by the exchange traders of the reasons for the change. Part of the job of each trader is to isolate, as far as possible, the motivation behind bids or offers of exchange, so that he may be able to anticipate future exchange rate movements. Whether or not he will mark up the exchange rate on receiving a bid depends in part on whether he believes this transaction is a "normal" one, or whether he feels it is the beginning of a new trend set off by some new development abroad. Because of the traders' efforts to "get behind" supply and demand, the market serves as a good barometer of international financial and economic developments. Indeed, it is not uncommon for some new development abroad to be reflected in the exchange market well before the news has become publicly known.

Limits to Exchange Rate Fluctuations

While exchange rates fluctuate in response to the changing patterns of supply and demand, they do not fluctuate without limitation. One set of limits is provided by the usual market law that at some point a commodity will become cheap enough to tap new sources of demand, or dear enough to attract new suppliers. These limits may vary from time to time, however, and if they were to be relied on exclusively there might be extremely wide swings in exchange rates that would prove disruptive to normal trade and financial patterns.

For most currencies the range of possible fluctuations in exchange rates is more directly limited by the buying and selling rates set by the foreign central bank or governmental exchange fund concerned with each of the other currencies. Forty-eight of the countries of the world have established par values for their currencies with the International Monetary Fund, and have agreed to maintain their exchange rates within 1 per cent either side of this par value.¹ The United Kingdom, for example, has established a par value of \$2.80 for the pound, and the Bank of England, on behalf of the Exchange Equalization Account, stands ready to buy all dollars offered to it at \$2.82 per pound, and to sell dollars (for approved transactions) at \$2.78 per pound. As a result, market transactions in

¹ In some countries, where multiple exchange practices exist, the official exchange rate applies to only a limited number of essential transactions, and there may be rates for other transactions that vary from parity by more than 1 per cent.

sterling and dollars in both London and New York take place within these limits. Some countries that have not established such par values—e.g., France, Italy, and Switzerland (which is not a member of the IMF)—likewise maintain their currencies within a fixed range of exchange rates with the dollar.

Foreign central banks and exchange authorities may intervene in the market for a variety of purposes even when the exchange rate is within the official limits. The most important reason for such intervention is to exert a steadying influence on the rate during periods of seasonal or other temporary pressures. Thus, central bank activity on one side or the other of the market is an important factor in the total supply and demand picture, and at times may be the determining factor in setting the market rate of exchange.

Special mention should be made of the Canadian dollar because of its importance in the New York market. Since 1950 it has been a “freely fluctuating” currency with no fixed limits. The Bank of Canada as agent for the Exchange Fund Account, nevertheless has been a factor in the market for this currency, acting primarily to prevent disorderly conditions from emerging while at the same time allowing basic market forces to exert their influence.

Exchange Rate Quotations in the New York Market

The New York banks do not charge a commission on their sales of foreign exchange (except on some small amounts), but operate on the basis of a small spread between their buying and selling rates. The banks thus make “double-barreled” rate quotations; the quotation for sterling on November 26, for example, was \$2.80 $\frac{3}{4}$ - $1\frac{3}{16}$, indicating that at that particular moment a bank would pay a customer \$2.80 $\frac{3}{4}$ for a pound or would sell to another customer at \$2.80 $1\frac{3}{16}$. On the same date the Canadian dollar was quoted at \$1.03 $4\frac{1}{4}$ - $4\frac{3}{16}$ and the Swiss franc at \$0.2333 $\frac{1}{2}$ -0.2334. The small spread between buying and selling rates—\$0.00 $\frac{1}{16}$ for the pound, \$0.00 $\frac{1}{32}$ for the Canadian dollar, and \$0.0000 $\frac{1}{2}$ for the Swiss franc—is an indication of the importance of very small fractions in day-to-day trading in the market and of the narrowness of the margin on which foreign exchange dealers operate.

The New York banks quote rates for both spot and forward foreign exchange. “Spot” exchange is exchange delivered immediately or within a few days. The spot rate for cable transfers is the basic rate in the market, and rates for other spot transactions—such as mail transfers and bills of exchange—are based on the cable transfer rate. Rates on these other transactions may vary from the cable transfer rate because of the length of time it may take before such market instruments are paid abroad. Since the purchaser makes dollar payment at the time the exchange instrument changes hands, he must be compensated for the tying-up of his funds, and this is done by adjusting the cable transfer rate accordingly.

A “forward” exchange transaction involves the purchase or sale of a foreign currency for delivery at a specified date in the future. The rate at which the transaction is to take place is fixed at the time of sale, but dollar payment is not made until the exchange is delivered by the seller. The main rates in the market are for one, three, and six months’ forward sterling, although there is also an active market in the forward Canadian dollar and at times in other currencies, such as the Swiss franc.

In transactions with their customers, banks quote forward rates for sterling and other currencies on an outright basis, i.e., for a straightforward purchase or sale of exchange for future delivery. In the interbank market, on the other hand, forward rates are usually quoted on the basis of a discount or premium (in cents per foreign currency unit) under or over the spot rate. The relationship between the spot and forward rates is too complex to be discussed here. However, it may be noted that, other things being equal, the forward rate of exchange between two currencies tends to vary inversely with relative interest rates (i.e., the currency of the country with the higher interest rate tends to be at a discount for forward transactions), but it is also especially susceptible to speculative supply and demand factors.

THE MECHANICS AND TECHNIQUES OF EXCHANGE TRADING

The day-to-day business of foreign exchange trading is a matter of perpetual fascination to the active participants in the exchange market, but to the outsider it is likely to appear clouded in an aura of mystery. It may be true, as is often said, that a foreign exchange trader is born and not made, but it is certain that long years of trading experience are required to turn out a really professional trader. It is, of course, impossible to cover in a short space all the complex details of foreign exchange trading, or to capture for the reader all the flavor of the market. Nevertheless, the broad outlines of the mechanics and techniques of exchange trading are not difficult to grasp, and a wider knowledge of them may contribute to a better understanding of some of the more complex problems of international finance.

The Trading Room

The trading room is the heart of a commercial bank’s foreign exchange activity. The number of foreign exchange traders at work in the trading room depends, of course, on the volume of the bank’s business. A bank with an active exchange turnover may have a half-dozen traders; the head trader—an officer of the bank—will ordinarily make the major decisions, with the more junior traders limited to relatively routine transactions. In addition to the traders, there are one or more “position men”, who keep a running record of the bank’s position in each of the currencies in which it deals, and one or more “contract men”, who carry out the clerical work involved in the mechanics of exchange trading.

The physical equipment required for foreign exchange operations is not elaborate, but is geared especially for speed of communication. Each trader has before him a "turret"—a box-like affair that links the trading room by direct wire to the foreign exchange brokers, the cable companies, and perhaps one or more of the bank's large correspondents outside New York City. The connections are so arranged that several traders can "listen in" on the same call. In addition, each trader has one or more regular telephones for customer contacts and for foreign calls, and most trading rooms have teletype facilities for direct communication with domestic and foreign correspondent banks.

At the outset of a day's activity the traders will have a sizable number of mail orders on hand for foreign exchange from customers or correspondent banks. Most are for small amounts, but they may include some sizable transactions. Some may be orders to buy or sell at "best", that is, at whatever the bank determines the going market buying or selling rate to be. Others may be "limit" orders, which can be carried out only if the bank is able to effect them at the rates specified by the customers.

While the overnight mail is being sorted, the senior trader gets a line on the tone of the market for the day ahead. Because of the difference in time, the London and Continental exchange markets have been operating for five hours or so before the New York banks open their doors. Developments in these markets will, therefore, have an important bearing on the opening exchange rates in the New York market, and the senior trader will probably have a series of cables from his correspondents abroad outlining exchange rate developments there. He may also discuss directly by phone the most recent developments with exchange traders in London or Zurich or other centers. He may also establish contact with one or more of the local brokers to determine if there has yet been any activity among the New York banks, and to get the brokers' appraisal of the probable rates at which exchange transactions will take place.

At the same time, the flow of telephone calls from potential buyers or sellers of exchange begins to come through, and simultaneously there is a steady flow of cables from foreign banks offering to buy or sell various foreign currencies. As the day progresses, the New York trader may be cabling bids and offers to banks abroad. In doing so, he must be continually alert to the possibilities of taking advantage of small divergences in exchange rates in different centers in order to engage in arbitrage transactions. Such transactions involve the purchase of a currency in one market for sale in another, and it is through them that exchange rates are kept uniform in the various markets. The opportunities for arbitrage for New York traders are mainly confined to transactions in sterling, the Canadian dollar, and the United States dollar in London, Montreal, Toronto, and New York, and to various operations in the Swiss exchange markets.

In addition to their actual trading activities, the traders must keep informed on exchange control developments in some sixty or more countries, so that they can correctly inform their customers as to which transactions are freely permitted and which are subject to license requirements. They must follow the pattern of present and anticipated exchange rate developments that may affect a customer's interest in order to protect him from losses on exchange transactions. And, in many instances, they perform an important function in bringing to the attention of their customers the possibilities of wider use of the exchange market in order to expand operations abroad.

Setting a Rate for a Customer

Competition is keen among the banks for the foreign exchange business of the firms and individuals engaged in trade and other operations abroad. Such competition, indeed, is ensured by the practices of most large business firms that buy or sell foreign exchange. While some firms buy and sell foreign exchange by mail or telegraphic communication with their banks, the bulk of the business is transacted by telephone. The rapid communication provided by the telephone affords them an opportunity to shop around among the banks for the best price before making an actual purchase or sale.

In general, customer rates are based on the market buying and selling rates quoted in the interbank market, where, as explained in the previous article, the foreign exchange brokers serve as middlemen in arranging transactions among the banks. For example, if a broker quotes sterling at $\$2.80\frac{3}{4}$ - $\$2.80\frac{1}{16}$, the bank's foreign exchange trader knows that, if he is selling sterling to a customer, he would probably be able to cover himself by buying sterling in the market at $\$2.80\frac{1}{16}$. Conversely, if he is buying sterling from the customer, he would probably be able to cover himself by selling sterling to another bank at $\$2.80\frac{3}{4}$.

However, the trader must go further. He must be able to sense the tone of the market, and answer the question: "Can I trade a little more favorably than the market quotation suggests, or will a sizable buying or selling order turn the market against me?" In addition, the trader must consider his bank's position in the currency being traded. A bank that has temporarily oversold a currency might be willing to offer a potential selling customer a slightly higher rate or, if it has overbought, might be willing to lower the rate a bit for a potential purchaser. In actually quoting his customer a rate, the trader irrevocably binds his bank to the transaction, no matter how much it may cost to straighten out its position. Quoting a rate is consequently a most important function, and in doing so the foreign exchange trader draws on his many years of experience, his knowledge of the current state of the market, his judgment as to its future course, and finally his trading instinct

—that imponderable but unmistakable attribute of the experienced foreign exchange dealer. It should not be imagined, however, that the process of giving a customer a rate is a lengthy one. For the experienced trader the calculation is nearly automatic, indeed almost instinctive, although behind it lies a careful assessment of the many factors described above.

The Bank's Foreign Exchange Position

In his dealings, the bank's foreign exchange trader must, of course, keep a close watch on his "position" in each of the currencies in which he deals. The over-all position in a currency is nothing more than the net balance of the bank's purchases and sales. On the whole, the New York banks try to keep as even a balance between purchases and sales as possible, although there may be some minor differences in practice among them, partly indeed because of differences in temperament among the traders. This does not mean that the traders invariably undo in the market each and every transaction that they carry out with customers. Ordinarily they will tend to let an unbalanced position ride for a time in the hope that it may be ironed out by a compensating transaction with another customer or by a later market transaction at a more favorable exchange rate. At times, too, a bank trader may be a bit bullish or bearish, and consequently be willing to go "long" or "short" of a currency for brief periods. The New York banks, however, are not exchange speculators, and ordinarily pass on to the market any basic supply or demand trend arising from the action of their customers.

A bank's foreign exchange position is not quite the simple matter that it might appear at first glance, because of the fact that foreign exchange—as explained in the previous article—is not a homogeneous commodity. Depending on the particular form of foreign exchange instrument that the bank has bought or sold, its account abroad may be affected almost immediately or only after a varying time lag. The following simplified version of a bank's over-all sterling exchange position will illustrate this.

Sterling Position of "X" Bank

Balance with correspondents		£200,000
Purchases not yet credited to account:		
Cable transfers	£350,000	
Sight drafts	25,000	
Time drafts	40,000	
Forward contracts	100,000	515,000
Total purchases		£715,000
Sales not yet charged to account:		
Cable transfers	400,000	
Sight drafts	40,000	
Forward contracts	350,000	
Total sales		£790,000
Over-all position		- £ 75,000

In the example, the bank's over-all sterling position is £75,000 short. Despite this, it has £200,000 in its London accounts, and these balances, together with the

cable transfers it has purchased, will be enough to cover its sales of cable transfers, with £150,000 to spare. As far as the spot end of the position is concerned, the bank is long in sterling, and it is not until the forward contracts start falling due that the bank will have to be actively concerned with covering its over-all short position.

Whether or not the trader decides to cover immediately will depend in large part on his assessment of the future movement of the exchange rate. The advantage of an over-all balance in the foreign exchange position is, of course, that the bank is then protected against any major change in the exchange rate, although it may still have to worry about changes in the relationship of the spot to the forward rate if the distribution of its purchases and sales over time is not even. Should the trader decide to cover, he may be forced to do so by purchasing additional spot exchange in the interbank market, thereby still further enlarging the bank's long position in spot. Once spot has been acquired, however, he can most likely arrange to "swap" it against forward sterling and thereby even out the long-spot and short-forward positions.

In other cases, a bank may have an over-all long position in a currency, and yet be short of that exchange for, say, the next few days. In still other cases, the over-all position may be balanced, yet on some days the bank may be short and on others long. Consequently, the continuing maintenance of an accurate position sheet, detailing the bank's future daily position for as many as three months, is a vital task. It is also a highly tedious and frustrating one, since every purchase and sale affects the bank's position on each succeeding day. The position consequently is in a constant state of flux, and great adeptness is required to keep the inflow and outflow of exchange through the bank's accounts abroad running smoothly.

Arranging a Trade Through a Broker

The services performed by a broker in matching up buyers and sellers in the market have already been referred to. Since this matching is the broker's primary function in the market it may prove of interest to follow through the details of such a transaction. To return to the illustration, let us suppose that the bank trader has decided to cover his over-all short position by buying £75,000 spot in the market, rather than postpone action in the hope of either picking up the required amount from another customer or buying in the market at a more favorable rate later on. His first step is to pick up a phone and flash one of the brokers on his switchboard. The following conversation might ensue:

Trader X: What's sterling?
 Broker: $3\frac{3}{4} - 1\frac{3}{16}$.
 Trader X: Is that real?
 Broker: Yes.
 Trader X: I'll take 75,000 at the middle.
 Broker: Call you back.

The shorthand and jargon of the foreign exchange profession used in market transactions often conveys little to the layman. In the imaginary conversation reproduced above, sterling was quoted only as the terminal fraction, \$2.80 being understood. The trader at this point, however, knows that he can sell sterling at $\$2.80\frac{3}{4}$ or buy at $\$2.80\frac{1}{16}$, i.e., that the rates quoted by the broker are "real". If the broker did not have actual bids and offers from other banks, his quotation for sterling would represent his judgment as to what the market might be, and he would have answered the question, "Is that real?" in the negative. He would then contact other banks, endeavor to get real bids and offers, and relay these back to the trader making inquiry. His task would, of course, be simplified if the trader indicated whether he wanted to buy or sell and quoted a rate at which he was willing to do business. A trader might often, however, prefer to hide his hand and let someone else make a bid or offer.

In this case, the broker did have both a prospective buyer and prospective seller. The trader was willing to buy £75,000 at the middle rate quoted by the broker, i.e., at $\$2.80\frac{2}{32}$, or $\frac{1}{32}$ below the rate at which the broker was offering to sell for another bank.

The broker would immediately contact his prospective seller, say Bank Y, on his direct wire and the following attenuated conversation might ensue:

Broker: $\frac{3}{4}$ bid for £75,000.
 Trader Y: Done. Who receives?
 Broker: Bank X.

Although the broker has a bid of $\$2.80\frac{2}{32}$ from Bank X, he shows this to the prospective seller, Bank Y, as $\$2.80\frac{3}{4}$ in order to allow for his commission of $\$0.00\frac{1}{32}$ per pound. The contract between the two banks will be made at $\$2.80\frac{2}{32}$, however, and Bank Y will settle with the broker for his commission at the regular monthly settlement date.

The broker now immediately calls back Trader X and informs him: "You bought 75,000 from Bank Y at $\$2.80\frac{2}{32}$ ". The market transaction has been completed entirely by telephone. Later on, the two banks will exchange information as to which bank in London will receive the pounds and which bank will pay them out. Bank Y cables instructions to its London correspondent to pay £75,000 to the account of Bank X in London on the following day and at that time receives the corresponding dollar payment from Bank X. Similarly, Bank X instructs its correspondent to receive £75,000 from Bank Y's London correspondent.

The brokers also perform a very useful function in arranging "swaps" between banks that are ironing out their foreign exchange positions for different dates. In the illustration, the trader in Bank X ironed out his over-all short position in sterling by buying £75,000 spot, but in order to even out his long-spot and his short-forward position he will have to sell spot sterling and buy forward.

Since it would be only rarely that two banks would have exactly offsetting positions that could be swapped out, some banks have to be satisfied with swaps that only approximate their needs. It is often possible, however, for a broker to arrange more satisfactory swaps if a third, fourth, or even fifth or more banks can be worked in. Some swaps, consequently, become extremely complicated and call for much hard work on the part of the brokers.

The cost of the swap to the bank depends on the relation between the spot and forward exchange rates. If forward exchange is at a discount, the seller of spot against forward (or near-forward against long-forward) would receive the difference between the two rates. If the forwards, on the other hand, are at a premium, the seller of spot against forward would have to pay the premium.

THE FEDERAL RESERVE SYSTEM AND THE MARKET

As we have seen, most foreign central banks play an active role in exchange markets. In the United States, on the other hand, neither the Federal Reserve System nor the Treasury currently intervenes in the exchange market to shape exchange rates.

The difference stems basically from the function of the dollar as an international reserve currency and its use, along with gold, as a benchmark for establishing the relationships among other currencies throughout the world. It also reflects the manner in which the United States and foreign countries, respectively, meet the obligation that they assumed as members of the IMF to maintain the international value of their currencies. Foreign countries do this through operations in foreign exchange markets. The United States, on the other hand, does this by maintaining the interconvertibility of the dollar and gold, for the legitimate monetary purposes of foreign monetary authorities, at a fixed price of \$35.00 per troy ounce of fine gold, plus or minus $\frac{1}{4}$ of 1 per cent for buying or selling. As a result, there is no need to "support" the dollar in the exchange market. The Federal Reserve Bank of New York, acting for the System as a whole, holds only the token amount of \$12,000 in foreign currencies, compared with foreign official short-term dollar holdings of 7.6 billion at the end of September 1957.

The fact that monetary authorities in the United States do not interfere with the establishment of the rate at which dollars exchange for foreign currencies does not mean that the Federal Reserve System stands aloof from the foreign exchange market. The Federal Reserve Bank of New York, as fiscal agent of the United States, buys and sells foreign exchange for the United States Treasury and other Government agencies that use foreign exchange in their operations. In connection with the operation of foreign central bank accounts, in which all the Federal Reserve Banks participate, it also executes exchange orders at the request of its correspondents. Moreover, the foreign exchange market provides an excellent listening post for the many developments that affect the relationships of the

United States with individual countries throughout the world. The Federal Reserve Bank of New York, through its Foreign Department, therefore maintains the closest possible contact with the market, and serves as a source of exchange rate and other information for the System and the United States Government as well as for its own foreign correspondents. Direct wires connect the foreign exchange trading room of the Federal Reserve Bank with the trading rooms of a number of the largest New York foreign exchange trading banks.

In its day-to-day operations, however, the New York foreign exchange market remains a free market, servicing the needs of both Americans and foreigners who are en-

gaged in international trade and finance. Its future growth, and the diversity of its operations, depend not only on the level of United States trade and payments with foreign countries, but also on the further relaxation of exchange controls abroad, and on the progress toward convertibility for the leading currencies of the world. This in turn depends on economic stability both abroad and at home and on the continuing efforts by all countries to promote the free movement of goods and capital throughout the world. The foreign exchange market is especially designed to facilitate the latter, and such is the flexibility of its organization and the efficiency of its operations that it appears likely to be equal to whatever task the future may set for it.

RECENT BUSINESS TRENDS

Business activity has not registered its customary fall expansion this year, and employment and incomes, seasonally adjusted, have declined somewhat from the levels achieved in July and August. At the same time, the upward tendencies in the price level have slackened appreciably, partly as a result of the moderate decline in economic activity, but also because of the substantial additions to productive capacity recently completed or shortly in prospect in many industries. In recognition of the less-than-seasonal increase in production and sales and the lessened inflationary strains on the nation's economic resources, this Bank and the Federal Reserve Banks of Atlanta, Richmond, and St. Louis in mid-November reduced their discount rates from 3½ to 3 per cent (as noted in the article on money market developments), and the other Reserve Banks later followed suit.

As the weakening of inflationary tendencies has become more evident, the buoyancy that had characterized business sentiment earlier this year has given way to more sober appraisals of the outlook. Many industries now appear to expect a modest further decline in economic activity, and this shift in expectations has been reflected in the drop in stock prices and in the appearance of more cautious purchasing and investment policies. With capacity now ample to meet current demand for most important industrial products, numerous business firms have curtailed their orders for additional capital equipment, resulting in declines in order backlogs and output for the nation's capital goods industries and, in turn, among their suppliers. In many of the same industries, moreover, the reduction in new business has been accentuated by a sharp drop in defense orders as well as by some decline in demand from abroad.

Meanwhile, however, activity in many other sectors of the economy has remained stable and in some cases advanced. While the gains registered in the spring and summer have not been extended, output and sales of consumer goods and services have been more or less maintained at close-to-record rates. Construction activity has increased,

as home building has recovered somewhat following two years of decline and public construction has been stepped up to an even more rapid pace. State and local government employment continues to expand. The decline in Federal military purchases, moreover, may have largely run its course and seems likely to give way to some increase as decisions to accelerate military research and the production of missiles and other weapons are implemented.

The crosscurrents in the present economic situation are reflected in the strikingly divergent trends in the price structure. Sensitive commodity prices, chiefly of scrap and some other industrial materials that respond quickly to changes in demand, have been declining more or less steadily since late 1956 and are now at the lowest levels in several years. On the other hand, the "round" of increases during the summer in such basic costs as wage rates, freight rates, and steel and aluminum prices has been reflected in further price increases for many finished manufactured goods, the demand for which has remained sturdy enough to permit these higher costs to be passed on at least in part to the ultimate users. On balance, industrial wholesale prices have declined a little from their summer peak, but the higher cost of manufactured goods and the continued advance in charges for services and shelter have exerted further pressure on the cost of living. Nevertheless, the consumer price index leveled off in September and October, largely because of a seasonal decline in food prices. While a renewed increase in consumer prices is believed to have occurred in November, Government officials are reported to be expecting a leveling off in subsequent months.

CHANGING PATTERNS OF PRODUCTION AND EMPLOYMENT

The impact of the reduced demand for military and industrial equipment has, of course, been most severe in the metal and metal fabricating industries. Largely reflecting the output declines in this sector, total industrial production (as measured by the seasonally adjusted Federal Reserve index) fell by about 2 per cent over the September-

October period, and in October was below the level of the same month in both 1955 and 1956. To some extent, however, the recent decline in industrial production has also been attributable to a more-than-seasonal but temporary dip in automobile assemblies during the model change-over period. In November, auto assemblies increased substantially.

The decline in the output of capital goods and military equipment seems to have had its beginnings in the spring but until recently has been relatively mild. Thus far, the fall from the peak has amounted to about 8 per cent, with the sharpest drops being recorded in such lines as industrial machinery, machine tools, and aircraft. Reflecting reduced output as well as expanded capacity, production in durable goods manufacturing has been averaging only about 80 per cent of capacity, according to a recent survey by the McGraw-Hill Publishing Company; moreover, shipments in many industries apparently are still running well in excess of new orders.

The reduction in capital goods output has further aggravated the prolonged decline in the demand for steel, which recently seems to have become more pronounced. Principally, however, the lag in steel orders appears to be related to a marked shift in inventory trends. Steel users are believed to have been adding to their stocks during the first half of the year, to some extent in anticipation of the July 1 price increase, but since then have apparently switched to outright liquidation. During the summer, the steel companies reportedly sustained output by building up inventories themselves, in anticipation of a later increase in demand. So far, however, the expected increase has not materialized, and as a result, output has had to be curtailed appreciably—at a time of year when a substantial increase is usually the rule. In terms of actual tonnages produced, steel output has declined in recent weeks to the lowest levels (except for strike periods) since late 1954.

Paralleling the decline in the output of capital goods, business construction has receded from the peak reached in the spring. Factory and store building, in particular, have fallen off by about 10 per cent and 4 per cent, respectively. However, owing to the continued rise in construction outlays by public utilities (now running some 17 per cent higher than a year ago), and to modest increases in office and warehouse construction, the decline in business construction has been much less pronounced than that in capital goods manufacturing.

In contrast to the decline in steel and capital equipment production, consumer goods output this fall has apparently held at a relatively steady rate (apart from the swings in auto production resulting from model changeovers). Production of consumer goods had shown a fairly broad rise during the June-August period, sufficient in magnitude to offset the decline in capital goods and to

bring about a modest increase in the aggregate production index. The improvement in consumer goods output apparently reflected primarily the completion of widespread programs to reduce inventories at both the manufacturing and retail levels, rather than any important increase in the physical volume of retail sales.

In construction, as in manufacturing, production for the consumer market—that is, home building—has shown the greatest relative strength. The two-year decline in housing starts apparently reached bottom in February and March, when the (seasonally adjusted) annual rate of new private starts fell to about 935,000 dwelling units. The rate then recovered during April and May—chiefly reflecting a spurt in the construction of apartment houses—and since then has been hovering about the 1 million mark. Recently, moreover, public construction activity, and particularly highway construction, also has shown a renewed rise, following several months of approximate stability. As a result of the increases in residential and public construction, over-all construction activity, which had been contracting earlier in the year, has once more begun to show significant gains (in seasonally adjusted terms).

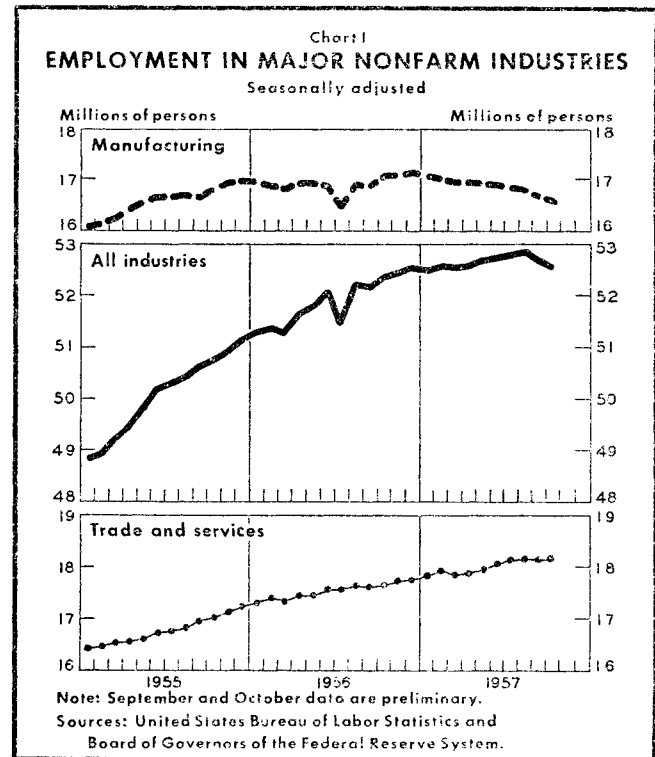
In both manufacturing and construction, however, employment and hours of work have been falling for several months (on a seasonally adjusted basis), even though during much of this period physical output has been stable or increasing. By October, when manufacturing production was only about one per cent below its level this spring, and construction activity had actually increased by about 3 per cent in real terms, employment in manufacturing had declined by about 350,000 persons, or over 2 per cent, and in construction by about 100,000 persons, or 3 per cent (all figures seasonally adjusted). Conceivably, this apparent divergence between output and labor utilization may merely reflect some deficiency in the statistics, or a shift in the composition of output in favor of lines which require relatively less labor. On the other hand, the introduction of more efficient methods and equipment, in the course of the huge business expansion and modernization programs now being completed, may finally be speeding up the growth of productivity—which in 1956 apparently had lagged sharply behind its postwar trend.

While employment in manufacturing and construction has been falling, several other major sectors of the economy have continued to expand their work forces, and the total number of nonfarm wage and salary earners actually increased for six consecutive months from March through August (see Chart I). Although employment has contracted subsequently, reflecting a more rapid decline in manufacturing and some shrinkage in Federal payrolls, the aggregate reduction has been relatively moderate and the total number of jobholders has remained ahead of year-earlier levels.

The largest gains in employment during recent months have been registered in the trade and service industries, and for State and local governments, chiefly reflecting an increase in the number of teachers and other school employees. Taken together, the number of jobholders in these fields—trade, services, and State and local governments—expanded by about 300,000 persons during the seven months ended in October, and by about 700,000 over the last twelve months.

Even earlier this year, when total employment was increasing, the number of unemployed had been tending to edge higher (on a seasonally adjusted basis). This fall, however, unemployment has increased more rapidly. In October, the number of unemployed was about 400,000 above the year-earlier level, and for the first time since 1954, the number of unemployed adult men has recently been increasing significantly. Furthermore, the expansion in the labor force this year has been considerably slower than in 1955 and 1956, when the number of teenagers, women, and older people in the labor force increased by a total of over 2 million, as attractive job opportunities delayed retirements from the labor market and induced persons who had not previously been looking for work to take jobs. In 1957, by contrast, the comparable increase may be less than half a million, partly because the liberalization of social security benefits for farmers and older women has fostered earlier retirement, but probably also in important measure because the demand for marginal labor has declined as the growth in business activity has tapered off.

Despite the less taut labor market, wage rates in most industries have continued to push upward, although less rapidly than last year. Much of the rise has been associated with deferred wage increases and cost-of-living adjustments provided for in existing contracts and with the pressure such increases have exerted on other industries to bring their wage scales into conformity. Until as recently as August, the increases in incomes resulting from rising wage rates and from higher employment outside manufacturing outweighed the declines stemming from reduced hours and employment in manufacturing; the annual rate of total personal income expanded by 5 billion dollars in the second quarter and 4 billion in the third—as rapid an advance as had been recorded since early 1956. In September and October, however, manufacturing payrolls contracted more rapidly, reflecting sharper declines in both employment and hours; the latter fell in October to an average of 39.5 hours, the lowest for any month since mid-1954. A part of the recent declines in manufacturing payrolls, however, probably resulted from the widespread incidence of influenza and other respiratory ailments, which at one time or another in October, according to estimates by the United States Public Health Service, confined to bed approximately 45 million persons. As a

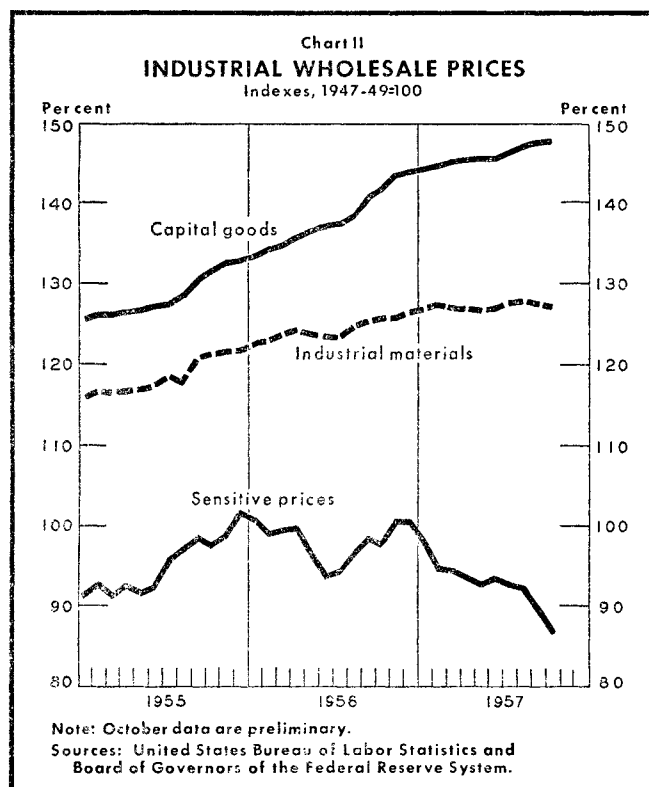


result of the lower payrolls, total personal income declined during both September and October.

A LEVELING-OFF IN DEMAND

The boom in business capital investment, which was the driving force in the expansion of economic activity during 1956 and early 1957, appears to have passed its peak. In dollar terms, capital outlays were still rising slowly during the first half of the year, and businessmen reported in August that they expected to increase outlays slightly further in the third quarter and to maintain the higher rate for the remainder of the year. The increase in capital outlays, however, has been slower than the continued rise in the prices of capital equipment, and the physical volume of additions to plant and equipment may actually have been on the decline since the spring. On the basis of the recent survey by McGraw-Hill, moreover, business firms plan to reduce their capital expenditures in 1958 by roughly 7 per cent from the rate apparently prevailing currently.

With a few important exceptions—notably the public utilities and possibly also the petroleum and chemical industries—the leveling-off in capital outlays over the year has extended to most major industries. In 1958, moreover, scarcely any industries expect to step up spending appreciably, while many anticipate sharp declines. Planned reductions in metal, machinery, and transport equipment manufacturing—probably the sector in which the largest additions to capacity have recently been made—average about 25 per cent, and smaller, but significant cuts are



expected in most other manufacturing lines as well. Mining and railroad companies reportedly also anticipate appreciable reductions in investment. In other industries, however, the outlook seems more favorable. In particular, the public utilities, airlines, and petroleum, communications, and shipping industries, which together account for approximately 40 per cent of all (nonfarm) business outlays on new plant and equipment, reported that they expect to maintain such spending at about the prevailing record rate.

Many of the industries affected by actual and prospective declines in business purchases of capital goods have suffered further setbacks as a result of developments affecting the defense program. According to statements by Government officials, military ordering in the current fiscal year has until recently been curtailed substantially below the rate required to support even the reduced level of outlays for military goods planned prior to the Russian satellite launchings. The drop in military orders, moreover, has further tended to curtail capital equipment purchases by the industries affected by the cutbacks. On the other hand, the Government has recently announced accelerations in several important defense programs, but it may take some time before this decision can be translated into significant increases in new contracts and actual production.

According to the most recent official statements, the Defense Department expects its military outlays for the fiscal year to come to over 38½ billion dollars (more than half a billion dollars above the original target) and the

budget proposals for the fiscal year beginning next July are expected to allow for a further moderate increase. In the July-October period, the first third of the fiscal year, the outlay pace slowed to an annual rate of about 39 billion from the peak rate of 40.2 billion reached in the April-June quarter. Other outlays closely related to the defense program also declined by about 1 billion dollars (at annual rates). Thus, much of the planned reduction in the rate of military expenditures appears to have been already accomplished.

The reductions in employment and working hours resulting from the declines in business investment and in military demand have been reflected in a leveling-off in consumer spending this fall, following a rapid rise in the spring and summer. For the third quarter as a whole, the seasonally adjusted annual rate of these outlays was estimated to have increased by some 4¾ billion from the second quarter, and was 5½ per cent over a year earlier. For October, however, preliminary data for retail sales (which recently have been subject to fairly sizable revisions) indicate a substantial decline, probably attributable partly to the marked increase in influenza cases. It is possible that such factors as the increase in unemployment, the decline in overtime, and the fall in stock prices, are currently tending to make consumers, like businessmen, more cautious in their spending, but as yet there is no firm evidence that this has actually occurred.

In real terms consumer spending has shown little increase for the last year. The third-quarter advance in consumer outlays largely reflected the fact that rising prices compelled consumers to spend more merely to maintain their standard of living. There was also, however, a small increase of consumer expenditures in real terms, with the increase apparently financed by a decline in saving. In both money and real terms, most of the gain in consumer buying occurred in the food, apparel, and some other soft-goods lines, while sales of autos and household durables remained relatively stable (in seasonally adjusted terms).

Since Labor Day, sales of new cars have been running well ahead of the model "clean-up" period last year, when dealers reportedly lost sales because stocks of 1956 models were exhausted before the 1957's became available in quantity. Although dealers entered the change-over season with record stocks for this time of year, they apparently have been fairly successful in disposing of the 1957 models, reportedly helped by unusually liberal factory allowances. On the other hand, the public's initial response to some of the new 1958 models has apparently been relatively disappointing. Total sales of cars this year (including foreign cars) will probably show little change from the 1956 level of close to 6 million. Measured in dollar volume, however, a substantial increase may be recorded for 1957, chiefly reflecting the higher prices of the 1957 models and increased purchases of optional equipment;

for the January-October period, sales receipts of automotive retailers bettered the year-earlier months by 8 per cent.

The volume of consumer spending has been supported by a continued expansion in consumer credit, but the rate of growth of such credit has not increased. In fact, the volume of instalment credit has been expanding more or less steadily at a (seasonally adjusted) rate of about 200 million dollars a month for the past year—somewhat faster than in the second and third quarters of 1956 but much more slowly than in 1955. During the latter part of this year and through 1958, the record number of families that bought autos on credit during 1955 will be completing their monthly payments and releasing the significant parts of their incomes which have been earmarked for obligatory payments. It remains to be seen whether these funds will be used as the basis for new credit purchases (including home buying under the recently lowered Federal Housing Administration downpayments), or will be devoted instead to cash purchases—or, indeed, to building up savings accounts.

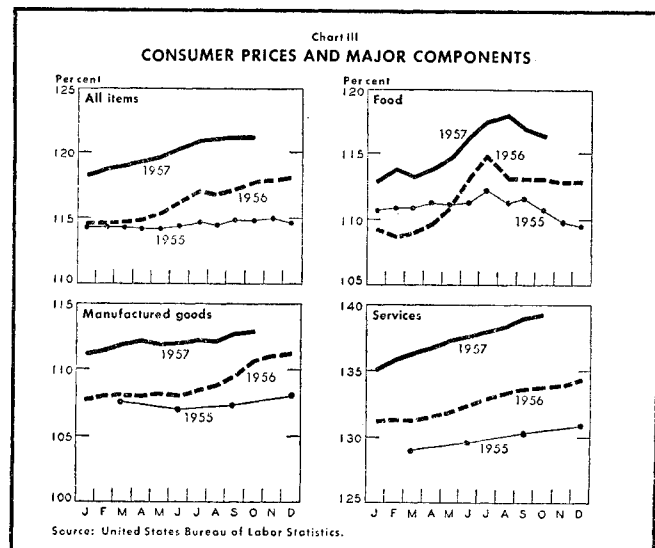
CROSSCURRENTS IN PRICES

The expansion of manufacturing capacity has been accompanied by a distinct lessening of the upward pressure on commodity prices, and by actual price declines for some important commodities. Competition among suppliers has intensified, while buyers have cut down their purchases, partly as a result of the decline in industrial production, but perhaps primarily because they no longer feel the need to maintain stocks as a precaution against shortages or sharp price rises. With current purchasing in many instances being curtailed below actual consumption, just as producers are completing sizable additions to capacity, there has been a tendency in a few industries for stocks to pile up from time to time at the manufacturing level—most recently, in the primary metals industries. So far, however, such “involuntary” accumulation has been modest, as the affected industries have generally been quick to adjust output to conform to current orders and sales. While total nonfarm business inventories continued to expand in the third quarter at about the same moderate rate as in the preceding three months, most of the increase occurred in retail automotive stocks; net accumulation at the manufacturer's level slowed appreciably and, measured in real terms, appeared to be very small.

The drop in purchasing for inventory—on the part of both domestic and foreign buyers—has chiefly affected the markets for basic industrial materials, and it is in these markets that most of the recent price declines have occurred. Declines have been particularly widespread among commodities traded internationally and subject to significant competition from imports (including among others copper, lead, zinc, and petroleum) and for steel scrap and

some other waste materials. Although the over-all level of industrial materials prices is somewhat higher now than in the spring, mainly because of the increased price of steel, materials prices have been declining slowly since mid-September (see Chart II). Other costs, such as wage rates and transport charges, also advanced further in the summer, so that the over-all level of production costs apparently moved up yet another notch. Producers of finished goods have been able to pass on these cost increases at least in part, and prices of such items—and particularly of capital goods—have pushed still higher. Nevertheless, the aggregate index of industrial wholesale prices actually receded slightly in September and October, as the decline in materials prices outweighed the further rise in prices of finished goods. Moreover, the number of important industrial price increases on the horizon seems smaller now than in any recent period.

In contrast to the leveling-off in wholesale prices, consumer prices have held at peak levels through a period in which some seasonal declines might normally be expected. Nevertheless, the virtual stability of the consumer price index during the September-October period stands in marked contrast to the appreciable rise recorded in these months a year ago. One major factor in the continued rise in the cost of living this year (see Chart III) has been the marked advance in food, and especially meat prices. After declining for some four years, retail food prices turned upward in mid-1956, and are currently some 3 per cent higher than a year ago. In the meantime, the seemingly inexorable rise in the cost of services and shelter has accelerated, partly reflecting increases in controlled rents, utility rates, transport fares, and other service charges subject to official regulation. Finally, as consumer demand has remained high, merchants have been able to pass on some of the earlier increases at wholesale, so that retail prices of manufactured goods have also been creeping higher. However, competition has intensified in retail trade as in other sectors of the economy, and in some in-



stances retailers have had to absorb increases in their costs at the expense of profit margins.

CONCLUSION

Inflationary pressures have abated recently, as additions to capacity have caught up with, or have temporarily overtaken, the growth in demand. The resultant shift from sellers' to buyers' markets, in turn, has reduced incentives to undertake further additions to capital equipment and is apparently prompting some firms to attempt to reduce their inventory positions. The drop in military ordering and expenditures, as well as a marked decline in exports, have added to the downward pressures on economic activity, and contributed to the emergence of a downward tilt in aggregate output, employment and incomes during the past three months.

At the same time, however, consumer spending has been relatively well maintained, home building has strengthened, and State and local government demand seems likely to show some further increase. In some of the sectors where demand has experienced downward adjustments, moreover, the period of most severe decline may have been passed. Thus, the Government is already planning increases in some military programs, while in the foreign trade sector, exports have declined to the levels which prevailed before the spurt attributable to the Suez crisis and the rapid expansion of agricultural surplus sales. While it is essential during any economic downturn to be on guard against a possible cumulation of the downward pressures, the adjustments that may be involved before the advance in economic activity can be resumed seem at present to be relatively mild.

SELECTED ECONOMIC INDICATORS United States and Second Federal Reserve District

Item	Unit	1957			1956	Percentage change	
		October	September	August	October	Latest month from previous month	Latest month from year earlier
UNITED STATES							
<i>Production and trade</i>							
Industrial production*	1947-49 = 100	142 _p	144	145	146	- 1	- 3
Electric power output*	1947-49 = 100	—	230	231	218	#	+ 5
Ton-miles of railway freight*	1947-49 = 100	—	100	104	106	- 4	- 9
Manufacturers' sales*	billions of \$	—	28.2 _p	28.6	28.7	- 1	+ 4
Manufacturers' inventories*	billions of \$	—	54.1 _p	54.2	51.8	#	+ 6
Manufacturers' new orders, total*	billions of \$	—	26.7 _p	27.3	28.8	- 2	#
Manufacturers' new orders, durable goods*	billions of \$	—	12.6 _p	13.2	14.3	- 5	- 3
Retail sales*	billions of \$	16.6 _p	16.9 _p	17.0	15.9	- 2	+ 4
Residential construction contracts*	1947-49 = 100	—	n.a.	n.a.	230	n.a.	n.a.
Nonresidential construction contracts*	1947-49 = 100	—	n.a.	246	260	- 2	- 4
<i>Prices, wages, and employment</i>							
Basic commodity prices†	1947-49 = 100	84.8	87.3	89.3	90.7	- 3	- 7
Wholesale prices†	1947-49 = 100	117.7 _p	118.0	118.4	115.6	#	+ 2
Consumer prices†	1947-49 = 100	121.1	121.1	121.0	117.7	#	+ 3
Personal income (annual rate)*	billions of \$	345.6 _p	346.6	346.8	334.1	#	+ 3
Composite index of wages and salaries*	1947-49 = 100	—	159 _p	158	152 _r	+ 1	+ 5
Nonagricultural employment*	thousands	52,507 _p	52,644 _p	52,844	52,367	#	#
Manufacturing employment*	thousands	16,590 _p	16,663 _p	16,836	17,045	#	- 3
Average hours worked per week, manufacturing†	hours	39.5 _p	40.0	40.0	40.7	- 1	- 3
Unemployment	thousands	2,277	2,317	2,380	1,909	- 2	+ 19
Unemployment†	thousands	2,508	2,552	2,609	n.a.	- 2	n.a.
<i>Banking and finance</i>							
Total investments of all commercial banks	millions of \$	74,900 _p	72,960 _p	73,060 _p	73,760	+ 3	+ 2
Total loans of all commercial banks	millions of \$	93,000 _p	93,400 _p	92,840 _p	88,780	#	+ 5
Total demand deposits adjusted	millions of \$	107,160 _p	105,500 _p	105,100 _p	107,400	+ 2	#
Currency outside the Treasury and Federal Reserve Banks*	millions of \$	31,016 _p	31,112	31,128	30,772	#	+ 1
Bank debits (337 centers)*	millions of \$	81,708	81,281	83,608	79,037	+ 1	+ 3
Velocity of demand deposits (337 centers)*	1947-49 = 100	142.5 _p	148.1	146.3	138.1	- 4	+ 3
Consumer instalment credit outstanding†	millions of \$	33,244	33,159	33,045	30,811	#	+ 8
<i>United States Government finance (other than borrowing)</i>							
Cash income	millions of \$	3,410	8,115	7,104	3,434	-58	- 1
Cash outgo	millions of \$	6,930	6,647	7,404	6,409	+ 4	+ 8
National defense expenditures	millions of \$	3,806	3,223	4,402	3,892	+18	- 2
SECOND FEDERAL RESERVE DISTRICT							
Electric power output (New York and New Jersey)*	1947-49 = 100	—	168	163	153	+ 3	+11
Residential construction contracts*	1947-49 = 100	n.a.	n.a.	n.a.	160	n.a.	n.a.
Nonresidential construction contracts*	1947-49 = 100	n.a.	n.a.	n.a.	268	n.a.	n.a.
Consumer prices (New York City)†	1947-49 = 100	118.4	118.3	118.7	115.7	#	+ 2
Nonagricultural employment*	thousands	—	7,781.4 _p	7,810.8	7,849.6	#	- 1
Manufacturing employment*	thousands	—	2,613.6 _p	2,630.9	2,685.8	- 1	- 2
Bank debits (New York City)*	millions of \$	76,664	73,909	75,175	70,093	+ 4	+ 9
Bank debits (Second District excluding New York City)*	millions of \$	5,388	5,274	5,272	5,179	+ 2	+ 4
Velocity of demand deposits (New York City)*	1947-49 = 100	196.2	194.3	197.3	177.9	+ 1	+10
Department store sales*	1947-49 = 100	110	115	126	112	- 4	- 2
Department store stocks*	1947-49 = 100	133	133	134	130 _r	#	+ 2

Note: Latest data available as of noon, December 2, 1957.

p Preliminary.

r Revised.

n.a. Not available.

* Adjusted for seasonal variation.

† Seasonal variations believed to be minor; no adjustment made.

‡ New basis. Under a new Census Bureau definition, persons laid off temporarily and those waiting to begin new jobs within thirty days are classified as unemployed; formerly these persons were considered as employed. Both series will be published during 1957.

Change of less than 0.5 per cent.

Source: A description of these series and their sources is available from the Domestic Research Division, Federal Reserve Bank of New York, on request.