FEDERAL RESERVE BANK OF NEW YORK

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The Business Situation

Recent business developments have been moderately encouraging. While the bottom of the recession may still not have been reached, there are now more signs that it may be near. Although optimistic in that sense, the signs cannot yet be taken as evidence that an early upturn is in prospect.

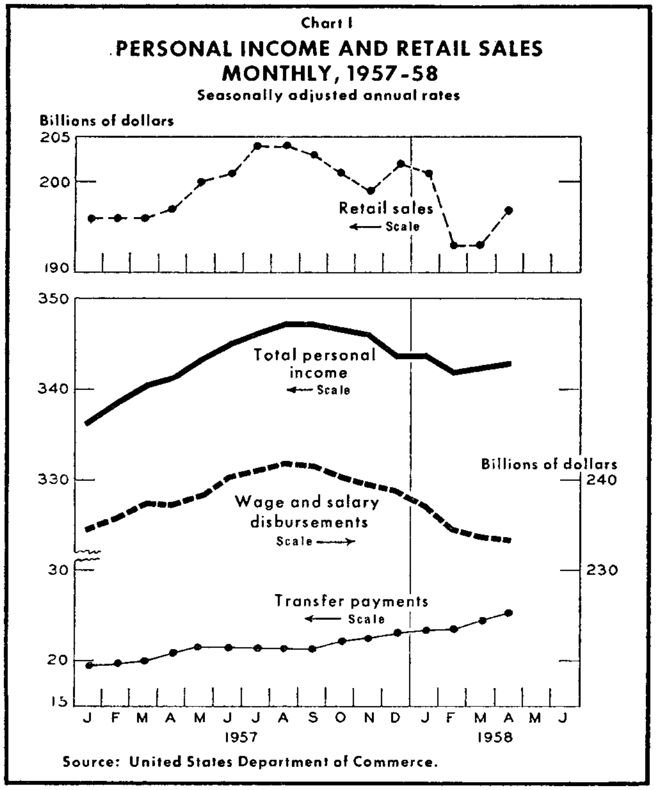
Steel and automobile production increased contra-seasonally in May, and the latest data on insured unemployment suggest that total unemployment, account being taken of seasonal influences, may not have increased further during that month. Some of the statistics now available for April also seem to foreshadow a relative improvement in the trend of production. Thus, the rate of military ordering during that month ran considerably above that recorded at the beginning of the year; the protracted decline in other new orders received by manufacturing firms appears to have slowed down markedly; total manufacturers' sales fell only slightly, in contrast to steep slides in each of the preceding five months; and housing starts showed a modest rise.

More significant perhaps than the month-to-month changes in individual series relating to production, orders, and employment are the signs that total consumer expenditures have been holding up well and that business confidence remains strong. Thus, retail sales rose in April, on a seasonally adjusted basis, and a continued favorable appraisal of the longer range outlook appears to be reflected in the recent behavior of the stock market and in a number of surveys of business sentiment. All in all, recent developments suggest that the rate of aggregate *final* demand for goods may now be holding relatively steady. If such demand holds up, then a rise in over-all output could result from a mere slowing-down in the rate of inventory liquidation. While the indications are that the inventory adjustment is not yet over, the reduction in inventories in the current quarter may well be proceeding at a slower pace than in the first quarter (when it amounted to $9 billion, on a seasonally adjusted annual basis) and may diminish further in coming months.

Total industrial production fell another two points in April, chiefly reflecting further cutbacks in the output of capital goods, automobiles, steel, coal, and iron ore. However, later weekly reports indicate that production in several important industries has stopped declining or has even increased since the end of April. Steel production, in particular, began to move upward after touching a low of 47.0 per cent of capacity in the week begun April 21, and during the first week in June scheduled production was estimated at 60.8 per cent of capacity. Higher demand from the construction industry and, to a lesser extent, from the farm equipment industry reportedly accounted for much of the rise. It is possible that, as in the last few years, hedging against another price increase at midyear also has been a factor in the upturn. Petroleum production appears to have stabilized at a level that has permitted heavy inventories to be reduced. Auto production actually increased somewhat in May but, according to industry reports, may be cut back sharply in the third quarter to less than half the year-earlier rate, mainly in order to reduce dealer inventories substantially before the end of the annual model change-over period, which is scheduled earlier this year than last. Finally, loadings of "miscellaneous and less-than-carload" freight—often a sensitive measure of total industrial activity—have been showing some improvement in recent weeks, although electric power output, another such measure, has not registered any net gain.

The indications of a leveling-off in the decline in manufacturing activity in recent weeks appear to be corroborated by weekly data on insured unemployment that have become available since the release of the last comprehensive statistics on employment and unemployment collected in mid-April. During the five weeks ended May 17, the unemployment insurance benefit rolls were reduced by some 344,000 persons, significantly more than the number of unemployed who have been dropped from the unemployment compensation rolls because they have exhausted their benefit rights. In general, it seems likely that total unemployment, after seasonal adjustment, was little changed in May, following the steep rise of the past several months. However, since more than 2 million graduates and students are expected to enter the labor force at the end of the school year, the actual number of unemployed in June might temporarily rise to more than 6 million persons, according to Labor Secretary Mitchell.

Despite the job losses and part-time employment brought on by the recession, retail sales have held up well. Final data indicate that total retail sales after seasonal adjustment showed no change between February and March (the preliminary figure had indicated a decline), and rose 2½ per cent in April (see Chart I). This would leave the dollar volume of March and April sales combined only about ½ per cent below the corresponding months a year ago. (Weekly data covering most of May

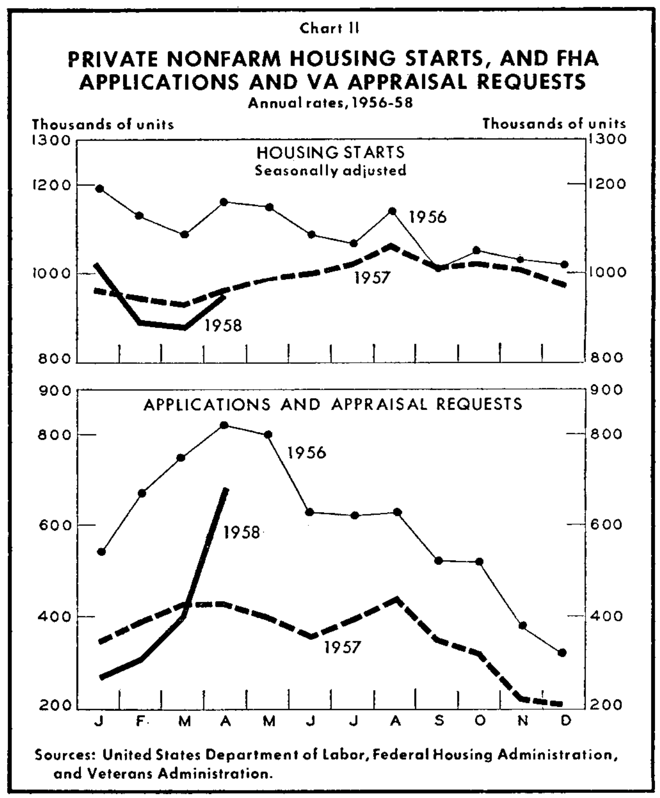


suggest that department store sales may have risen about seasonally in May, while auto sales apparently showed little change.)

One of the major factors underlying the strength of consumer spending has been the steadiness in personal income. In both March and April, personal income actually expanded slightly; these were the first increases recorded since last summer. Wages and salaries continued to decline, although less rapidly, but in both months the decline was more than offset by a $1 billion rise in the annual rate of government transfer payments,[1] mainly in social security benefits and unemployment compensation outlays, and by a further rise in farm income, which has been moving upward through the recession. In addition, consumers have benefited from increases in receipts not included in the current personal income total, such as private pension payments and supplementary unemployment benefits. (Employer contributions to pension and similar funds are included in personal income at the time they are paid in, rather than when these funds pay out benefits.) A substantial acceleration of Federal income tax refund payments in recent months has probably also played an important, though temporary, role in sustaining spending, even though such refunds are not included in personal income. From the beginning of March to mid-May refunds amounted to $3.3 billion, compared with $2.2 billion last year. By mid-May, however, the payment of refunds had largely been completed.

While the retail sales total has been well maintained, there have been significant changes in the pattern of consumer spending. During the present downturn consumers have shown, as in the preceding postwar recessions, that when confronted with a temporary reversal in the economic climate they seek mainly to maintain their accustomed purchases of foodstuffs and essential services, which account for about one half of total consumption expenditures. Indeed, the strength of total retail sales has to a considerable degree reflected the fact that the physical volume of food and services purchased has remained roughly constant despite continuing price increases. A further rise in food costs, which was again largely attributable to seasonal factors and temporary supply shortages, pushed the consumer price index up another 0.2 percentage points in April; service prices also continued to rise during the month, but prices of many durable and nondurable goods edged downward.

The rise in the cost of those purchases which consumers have attempted to maintain may well have been an ele-



[1] About one third of the April increase was due to a special dividend payment to World War I veterans holding United States Government life insurance.

ment in reducing their ability and willingness to purchase household goods and other durables. The lack of buoyancy in consumer demand for major durable goods seems largely attributable, however, to the general feeling of uncertainty and the apparently widely shared view that prices have risen too high. A survey of a group of consumers enjoying relatively high and steady incomes, analyzed by the National Bureau of Economic Research, revealed that in early April these consumers planned to spend 10-20 per cent less on durable goods in the six months from the date of the survey than they had planned last October, when a comparable survey was taken. While in the past this group's spending intentions have, according to the National Bureau, closely paralleled subsequent purchases of the general public, it must of course be emphasized that these plans cannot do more than reflect consumer attitudes at the time such a survey is taken and that they may be changed in response to the actual course of later events.

Consumer spending for housefurnishings and related items may receive some lift from an upturn in residential building, an area where a number of hopeful signs have begun to appear. In past recessions, this strategic sector of the economy has played an important role in spurring business activity. This may be happening once again under the stimulus of easier credit conditions and the special measures recently taken to bolster Federally assisted home building. In April, housing starts increased to a seasonally adjusted annual rate of 950,000 units (see Chart II). Moreover, the April rise does not appear to have yet fully reflected the stimulus from the easing of the VA-FHA programs; requests for approvals under these programs rose sharply in March and April and in the latter month were at the highest rate since May 1956.

Money Market In May

Member bank reserve positions eased further in May. Movements of currency into circulation and additional purchases of gold by foreign central banks caused an almost continuous drain on reserve balances during the period, but these losses were offset by other factors, including principally an increase of $384 million in System holdings of Treasury securities between April 30 and May 28.

The tone of the money market reflected these System purchases and the resulting ample supply of reserves. Although the volume of free reserves in the banking system as a whole was little changed from April, there was a shift in the distribution toward the central reserve city banks. Treasury bill yields declined steadily, with the longest outstanding issue falling from about 1¼ per cent bid at the beginning of the month to 1 per cent at midmonth and to about ⅝ of 1 per cent by the close. The effective rate for Federal funds fluctuated between 1¼ per cent and ⅛ of 1 per cent, holding well below ½ of 1 per cent during most of the latter part of the month. Quotations on bankers' acceptances and commercial paper also moved lower. However, the capital markets were hesitant, and average yields on seasoned high-grade long-term corporate and municipal bonds and on longer Treasury issues either were fairly stable or rose slightly during May. New corporate and municipal offerings were accorded a mixed reception, in large part because of the continued large volume of new flotations during the month and uncertainties surrounding the terms of the Treasury's large borrowing operation scheduled to take place in June. The terms of the Treasury's offering were announced on May 29 and are outlined below in the discussion of the Government securities market.

On May 8 the Federal Reserve Bank of Dallas announced the reduction of its discount rate from 2¼ per cent to 1¾ per cent, effective on May 9. All twelve of the Reserve Banks are now at 1¾ per cent.

MEMBER BANK RESERVE POSITIONS

Average member bank free reserves rose slightly to $531 million during the four statement weeks ended May 28, thus reaching the highest level since late in 1954. The May level was about $40 million above the average for April and about $1 billion above the level of net borrowed reserves prevailing during August-September of last year. Excess reserves expanded from $623 million in April to $647 million in May, while member bank borrowing from the Reserve Banks declined slightly to an average of $116 million.

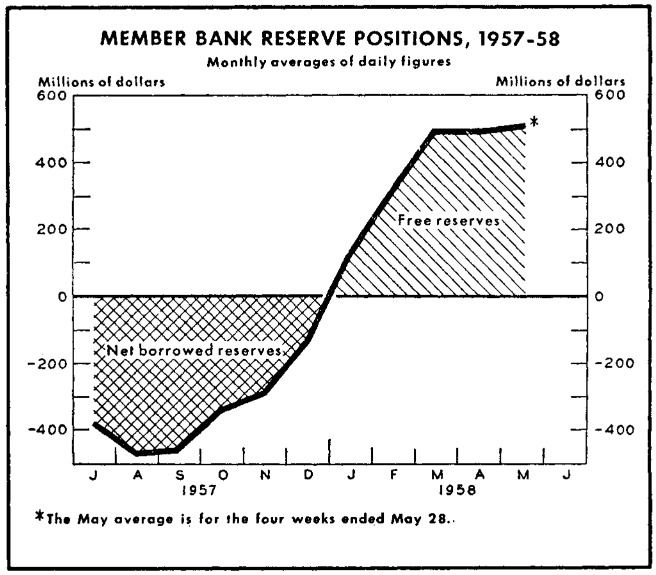
Purchases of gold by foreign central banks and related foreign account transactions resulted in reserve losses amounting to about $400 million over the four weeks. Since mid-February reserve drains attributable to gold and foreign account transactions have aggregated approximately $1.1 billion, reversing the gold flow into this country that had taken place throughout 1957. In addition, a large demand for currency absorbed almost $300 million of reserves during the month.

System open market operations served as the principal offset to the reserve losses during May, with total System holdings of Treasury bills rising by $384 million between April 30 and May 28. Outright purchases executed during the first half of the month increased holdings by $256 million between April 30 and May 14. The System Account was then increased by only $6 million in the following week, when a substantial rise in float augmented bank reserves. In the final statement week of the month, holdings rose by $122 million, thereby helping to offset reserve losses stemming from the end-of-the-month decline in float.

GOVERNMENT SECURITIES MARKET

Uncertainties surrounding both the business outlook and the terms of the Treasury's June refunding were major influences in the market for Treasury notes and bonds during most of May. About $9.5 billion of notes and bonds will mature in June, including $4.4 billion of 2⅞ per cent notes, $4.2 billion of 2⅜ per cent bonds, and $900 million of the partially tax-exempt 2¾ per cent bonds of 1958-63 which have been called for redemption on June 15. Outright trading dwindled, as investors assessed the probable terms of the Treasury's exchange offering and whether it would include a longer term issue.

After the close of the markets on May 29, the last trading day of the month, the Treasury announced that holders



of the maturing securities would be permitted to exchange into either 1¼ per cent certificates due on May 15, 1959 or 2⅝ per cent bonds to mature on February 15, 1965. The subscription books are to be open on June 4 through June 6. In addition, the Treasury offered for cash, at a price of 100½, $1 billion of 3¼ per cent bonds due on May 15, 1985; subscription books are open only on June 3, with payment equal to 20 per cent of the amount subscribed for required at that time, and delivery and final payment on June 18.

Prices of bonds and notes tended downward in the first part of the month, but then moved higher on balance over the rest of the period. For the month as a whole, issues maturing before 1972 generally gained from ⅛ to ½ of a point. Most longer bonds lost between $\frac{1}{16}$ and ¼ of a point, with the exception of the 3's of 1995 and the 3½'s of 1990, both of which gained about 1 point.

Treasury bill yields declined continuously during May as a sustained demand, from both banks and others, encountered only limited offerings. Government securities dealers satisfied a substantial part of the demand from their inventories, reducing their positions sharply as the month progressed. In the latter part of the month the apparent low level of dealer inventories contributed additional impetus to the drop in bill yields. The average issuing rate established in the weekly Treasury bill auction dropped from 1.367 per cent on April 28 to 1.187 per cent on May 5, to 1.112 per cent in the following week, and to 0.931 per cent on May 19. In the last auction of the month, held on May 26 for bills maturing on August 28, the average issuing rate declined to 0.635 per cent, the lowest average issuing rate established at a weekly

Table I
Changes in Factors Tending to Increase or Decrease Member Bank Reserves, May 1958
(In millions of dollars; (+) denotes increase, (−) decrease in excess reserves)

Factor	Daily averages—week ended				Net changes
	May 7	May 14	May 21	May 28	
Operating transactions					
Treasury operations*	+ 66	+ 62	+ 21	+ 33	+ 182
Federal Reserve float	+ 31	− 48	+ 234	− 214	+ 3
Currency in circulation	− 141	− 153	− 10	+ 9	− 295
Gold and foreign account	− 108	− 89	− 122	− 85	− 404
Other deposits, etc.	+ 13	+ 3	+ 8	+ 10	+ 34
Total	− 139	− 225	+ 130	− 246	− 480
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 187	+ 132	− 55	+ 177	+ 441
Held under repurchase agreements	− 14	—	—	—	− 14
Loans, discounts, and advances:					
Member bank borrowings	− 7	+ 5	− 19	+ 15	− 6
Other	—	—	—	—	—
Bankers' acceptances:					
Bought outright	—	+ 2	+ 1	+ 1	+ 4
Under repurchase agreements	—	—	—	—	—
Total	+ 166	+ 139	− 72	+ 192	+ 425
Total reserves	+ 27	− 86	+ 58	− 54	− 55
Effect of change in required reserves†	+ 3	+ 25	− 39	+ 27	+ 16
Excess reserves†	+ 30	− 61	+ 19	− 27	− 39
Daily average level of member bank:					
Borrowings from Reserve Banks	118	123	104	119	116‡
Excess reserves†	690	629	648	621	647‡

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 May 28.

auction since mid-1954. Thereafter, the dealers' bid rate for three-month bills pushed down to as low as 0.55 per cent, the lowest since 1947.

OTHER SECURITIES MARKETS

A heavy volume of new corporate and municipal bonds was again marketed during the month just past. New issues were accorded a mixed response as investors tended to be somewhat selective, particularly in view of the approaching Treasury refunding operation. An estimated total of $1.1 billion of new securities was publicly marketed during May, of which $775 million consisted of municipal bonds and $340 million of corporate bonds.

Early in the month a $30 million Aaa-rated utility issue was favorably received at a reoffering yield of 3.82 per cent. This compared with rates ranging from 3.65 per cent to 3.76 per cent on similarly rated corporate issues marketed during April. At about midmonth the underwriting syndicate was terminated for one of the large Aaa-rated utility issues marketed late in April, with a resulting rate adjustment to 3.83 per cent from the original reoffering yield of 3.76 per cent. Average market yields on seasoned long-term Aaa-rated corporate bonds, as measured by Moody's Investors Service, rose from 3.55 per cent to 3.57 per cent over the month.

The large volume of new municipal flotations induced some heaviness in that sector and several sizable new issues moved slowly. Moody's index of yields on outstanding Aaa-rated municipal issues advanced from 2.64 per cent to 2.71 per cent during the month, and dealers' advertised inventories rose sharply over much of the period, at one point approaching the recent high recorded in late February. However, the municipal market showed some tendency to improve toward the end of the month, partly because of a somewhat smaller supply of new offerings expected during June. Commercial banks were reported to be important buyers of tax-exempt securities, in some instances reaching out into 15 and 20-year maturities.

In view of the widening spread between Treasury bill yields and bankers' acceptance rates, and in an effort to encourage a greater supply of acceptances, dealers in bankers' acceptances lowered quotations by ¼ of 1 per cent across the board, effective on May 22. This brought the bid and asked rates on 90-day acceptances to 1¼-1⅛ per cent, 2⅞ percentage points below the 4⅛-4 per cent peak reached last August. On the same day, dealers in commercial paper followed suit with a ⅛ of 1 per cent cut to bring the offered rate on prime 4 to 6-month paper to 1⅝ per cent, 2½ percentage points below the 4⅛ per cent high reached last October.

MEMBER BANK CREDIT

Total loans and investments of the approximately 370 weekly reporting member banks decreased by $249 million over the four weeks ended May 21. Loans declined by $1 billion, as securities loans fell by $721 million and business loans by $337 million, but investment holdings expanded by $758 million.

The business loan decline included contractions of $109 million in loans to sales finance companies, $93 million in loans to food, liquor, and tobacco firms, $107 million in loans to petroleum, coal, and related products concerns, and $68 million in loans to metals and metal products firms. Commodity dealers increased their borrowings from the weekly reporting banks by $34 million. In the corresponding four-week interval last year, business loans had declined by $22 million as contractions in loans to sales finance companies, commodity dealers, and food, liquor, and tobacco firms more than offset a $119 million increase in bank borrowings by metals and metal products concerns.

Investments expanded by $758 million over the four weeks ended May 21, with holdings of Government securities accounting for practically all of the rise. Holdings of Treasury bills decreased by $31 million, and other Government securities increased by $780 million.

During the year thus far total loans and investments at the weekly reporting banks have risen by $2.8 billion,

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

Item	Statement week ended April 30	May 7	May 14	May 21	Change from Dec. 31, 1957 to May 21, 1958
Assets					
Loans and investments:					
Loans:					
Commercial and industrial loans	− 69	− 64	− 36	− 168	−2,346
Agricultural loans	+ 2	+ 8	—	+ 3	+ 37
Securities loans	− 26	− 379	− 130	− 186	+ 25
Real estate loans	+ 11	+ 11	+ 17	+ 26	+ 39
All other loans (largely consumer)	+ 46	− 39	+ 12	− 39	− 357
Total loans adjusted*	− 41	− 462	− 138	− 366	−2,629
Investments:					
U. S. Government securities:					
Treasury bills	+ 228	− 251	− 76	+ 68	− 1
Other	+ 213	+ 199	+ 91	+ 277	+4,434
Total	+ 441	− 52	+ 15	+ 345	+4,433
Other securities	+ 31	+ 4	− 65	+ 39	+1,012
Total investments	+ 472	− 48	− 50	+ 384	+5,445
Total loans and investments adjusted*	+ 431	− 510	− 188	+ 18	+2,816
Loans to banks	− 149	− 4	− 137	+ 201	+ 855
Loans adjusted* and "other" securities	− 10	− 458	− 203	− 327	−1,617
Liabilities					
Demand deposits adjusted	− 662	− 784	− 209	− 35	−2,216
Time deposits except Government	+ 118	+ 149	+ 75	+ 115	+3,292
U. S. Government deposits	+ 814	− 276	− 233	+ 486	+1,438
Interbank demand deposits:					
Domestic	+ 263	− 60	+ 530	− 709	−1,535
Foreign	+ 34	+ 4	+ 17	− 50	− 175

* 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.

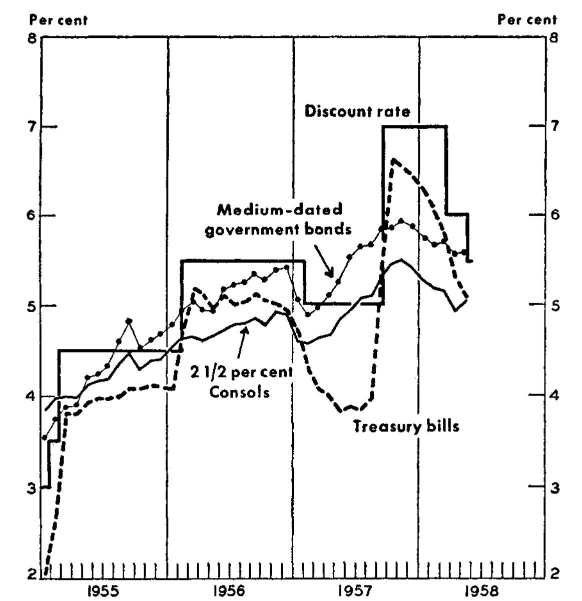
compared with a decline of $2.0 billion in the first twenty weeks of 1957. Loans have declined by $2.6 billion this year as compared with a drop of only $0.4 billion in the like period last year, but investment holdings have increased by $5.4 billion during 1958 whereas they fell by $1.6 billion in the first twenty weeks of last year.

International Monetary Developments

MONETARY TRENDS AND POLICIES

UNITED KINGDOM. The Bank of England reduced its discount rate to 5½ per cent, effective May 22, from the 6 per cent rate that had been in force since March 20, when the rate had been reduced from 7 per cent (see chart). Last month's move reportedly reflected the continuing improvement in the British gold and dollar position, which also had formed the basis for the reduction in March. The lowering of the rate does not imply, however, any reversal of the general direction of monetary policy. As the British Prime Minister stated on the day of the discount rate reduction, "the main object of the various steps the Government has taken has been . . . to provide a sound base for future expansion . . . Now that we are at last within sight of obtaining our goal, it would be disastrous to falter"; at the same time, he gave assurances that the government would not maintain its restraint measures any longer than was absolutely necessary.

BRITISH INTEREST RATES



Note: May 1958 data partially estimated. Treasury bills: weighted monthly averages of weekly allotment rates. Medium-dated bonds: 3 per cent Savings bonds, 1965-75, monthly averages. Consols: monthly averages.
Sources: Central Statistical Office, Monthly Digest of Statistics and International Monetary Fund, International Financial Statistics.

The improvement in Britain's external position is reflected most vividly in British gold and dollar reserves, which in April rose by $144 million and in May by $125 million, following an increase of $497 million in the first quarter; on May 30 reserves stood at $3,039 million, the highest level since September 1951. The discount rate reduction, however, must also be viewed against the background of current domestic conditions. The seasonally adjusted index of industrial production was virtually stable during the fourth quarter of 1957 and the first quarter of 1958; during the same period unemployment gradually increased, although in April it still amounted to only 2 per cent of the labor force. Although the retail price index rose slightly in April after having remained unchanged for five months, the Prime Minister indicated that the rise was only seasonal and that the "underlying trend of retail prices continues to show the improvement of recent months".

Following the discount rate reduction, the average Treasury bill tender rate, which stood at 5.20 per cent at the second and third May tenders, fell to 4.82 per cent, the lowest since mid-September. The yield on 2½ per cent Consols, which earlier in the month had been influenced by the general weakening of gilt-edged prices, fell from the month's high of 5.06 per cent on May 8 to 4.99 per cent on May 22 and to 4.98 per cent on May 30.

SWEDEN. The Riksbank lowered its discount rate to 4½ per cent from 5, effective May 3, thus becoming the seventh Western European central bank to reduce its rate since the beginning of 1958. The governor of the Riksbank indicated that the reduction of the rate was an adjustment to the changed economic climate both at home and abroad, particularly in view of the moderate rise in Swedish unemployment—at a time when a seasonal decline is normally experienced—and of the recession in the United States. The governor also stated that the large and growing over-all budget deficit, which primarily reflects substantial government investment and welfare expenditures, was not sufficient to counteract the contractive influences currently at work. He stressed, however, that the Riksbank intended to proceed cautiously and that no additional changes in credit policy were being considered. According to a statement by the Finance Minister, the discount rate reduction was "well-considered and appropriate in the present situation".

FINLAND. The Bank of Finland reduced as of May 1 the penalty rates it charges on rediscounting. Under the new regulations, no penalty rate, over and above the official discount rate,[1] will be imposed so long as a credit institution's total indebtedness to the Bank of Finland does not exceed 60 per cent of the institution's capital and reserves. If borrowing from the Bank of Finland exceeds this limit, the bank will charge a penalty rate ranging up to 2.1 per cent for borrowing equal to twice an institution's own resources. For borrowing in excess of this amount, an institution must make special arrangements with the Bank of Finland. The new schedule of rates replaces an earlier one, in effect since August 1, under which penalty rates ranging up to 5 per cent above the official discount rate had been applicable to *all* borrowing by the banking system. Last month's reduction in penalty rates, which aims at easing credit and stimulating economic activity, was accompanied by the granting of certain other rediscounting privileges to credit institutions. In addition, a reduction was announced in the special export levies that had been imposed to absorb part of the increases in exporters' incomes arising from last September's devaluation of the Finnish mark.

UNION OF SOUTH AFRICA. The South African authorities on May 7 announced a series of measures designed to check the decline in the South African Reserve Bank's gold and foreign exchange losses, which during the first four months of this year had amounted to the equivalent of some \$62 million, or over 20 per cent. The commercial banks have been ordered to maintain as of June 30 supplementary cash reserves of 2 per cent against their deposit liabilities; this ratio, which is in addition to the existing statutory 10 per cent cash reserve requirement, is to be increased to 4 per cent one month later. The banks have also been requested to concentrate the reduction in lending implied by this move on loans that finance imports and to avoid as far as possible restricting credit for productive purposes. Furthermore, the government has offered higher interest rates on two conversion loans. Finally, the authorities have tightened their control over foreign exchange transactions between residents of South Africa and those of other sterling-area countries.

[1] This rate ranges from 6½ to 8 per cent, with the lower limit applicable to loans to private nonbank customers and the upper being the effective lending rate to the banking system.

EXCHANGE RATES

American account sterling, after displaying an easier undertone, firmed during the latter part of May. The threat of a strike by British rail workers early in the month occasioned some market apprehension over sterling and the rate declined to \$2.81 1/16, the lowest level since the beginning of the year. Shortly after midmonth, following the settlement of the rail wage dispute, the quotation recovered to \$2.81 27/32 with good commercial demand for sterling in evidence. The reduction in the British bank rate to 5½ per cent from 6 per cent, effective May 22, had no apparent influence on the spot sterling quotation, mainly because the market had been anticipating a change for several weeks. With the approach of the long Whitsuntide week end in England the rate moved to slightly lower levels. At the end of May, American-account sterling was quoted at \$2.81 9/16.

In the forward-sterling market, commercial activity was on a relatively small scale. The discounts on three and six months' sterling tended to narrow throughout the month; the British bank rate reduction caused only a slight further narrowing of the spread. At the month end three and six months' sterling were at discounts of 2 7/32 and 4 5/16 cents, respectively, equivalent to 3.160 per cent and 3.071 per cent per annum.

Transferable-sterling quotations, moving in sympathy with American-account sterling, declined to \$2.79 3/16 in the early part of May. Thereafter, on demand from the Continent the rate advanced to \$2.79 21/32 at midmonth, then turned somewhat lower and was quoted at \$2.79 11/32 at the month end. The quotation for securities sterling, after declining to \$2.79 earlier in the month, appreciated to \$2.79¾ at midmonth as investor interest developed in British Government bonds, oil stocks, and South African gold shares. Subsequently the rate moved down slightly.

The Canadian dollar quotations moved erratically between \$1.03 13/64 and \$1.03 49/64 during the month in a quiet market. After advancing at the beginning of May the quotation declined to the low on May 9. Subsequently the rate tended toward higher levels and was \$1.03¾ at the end of the month. New issues of Canadian securities in the New York market, although on a reduced scale, were a factor in the initial firmness of the rate, while demand for Canadian dollars from England and the Continent and offerings of United States dollars by Canadian commercial interests appeared to be the dominating influences in the subsequent movements of the quotations.

MONETARY POLICY IN A RECESSION

Remarks of Alfred Hayes, President, Federal Reserve Bank of New York before the Fifty-Fifth Annual Convention of the New Jersey Bankers Association Atlantic City, New Jersey, May 22, 1958

It is a real pleasure for us in the Federal Reserve Bank of New York, together with our good friends from the Philadelphia Bank, to have this opportunity to meet with the New Jersey Bankers Association. A year ago I had my first chance to get acquainted with you since joining the Federal Reserve System. Al Williams' presence and eloquence added much to that gathering and I am sure we all feel his absence this year. However, he has a worthy successor in Karl Bopp, who is well known to many of you, and with whom I count it a privilege to be associated in my Federal Reserve activities. I am grateful to you for this chance to say a few words to you about various matters on my mind which I hope may be of interest to bankers.

About seven months have passed since the Federal Reserve System, in recognition of a fundamental change in underlying business conditions, began to substitute a policy of credit ease for one of restraint. It would seem appropriate now to take stock briefly of what monetary policy has accomplished in this period—of what it is supposed to do to combat recession and promote recovery, and of what it cannot be expected to do. Parenthetically, I am not unaware of various comments to the effect that we did not turn soon enough—that we erred in holding on too long to a policy of restraint, fighting inflation when recession was already in evidence and constituted the greater danger. Whether the timing was exactly right I shall not try to argue, but I think the important thing is that the pattern of recession had already been set by imbalances which had grown up in the preceding two or three years—imbalances in costs, prices and incomes, in the expansion of capacity in relation to current demand, in our foreign trade, and perhaps in the debt structure—and which together made a period of adjustment inevitable.

Now, let us consider what monetary policy has done to cope with this state of affairs. As you know, our influence is exercised largely through affecting the availability and cost of credit through actions affecting the supply and cost of bank reserves. Oddly enough, for a number of weeks after our policy changed, it was the fashion to say "Yes, it is true that interest rates have dropped sharply because of expectations of future developments in business conditions and Reserve policy, but *really* the Federal has done very little". Actually, open market operations were then doing their job of easing the banks' reserve position by more than offsetting the seasonal strains of the year end, and by doing much less than in other years to offset the seasonal additions to reserves early in the new year. Subsequently, these operations have been powerfully supplemented by a series of reductions in required reserve ratios (which released nearly $1.5 billion of reserves) and by three further reductions in Reserve Bank discount rates.

Have we gone far enough to get the desirable degree of credit ease? Well, the member banks throughout the country, instead of having net borrowed reserves of about half a billion dollars, as they did during much of last year, have had free reserves of half a billion dollars or more in the last few months—a swing of about $1 billion in the figure which is perhaps most frequently used as a measure of pressure, or lack of it, in the banking system. As you all know, this statistical measure represents the difference between member bank borrowings and excess reserves. With excess reserves a relatively stable quantity, the swing has been due largely to a drop in borrowings at the "discount windows" of the Reserve Banks from around $1 billion to a little over $100 million.

Perhaps it would be well to note in passing that the total of member bank borrowings has responded as it should, in "classic" fashion, to the "Fed's" activities. At first glance it might be thought that, with four cuts in discount rates since November, we would expect to have stimulated greater, not less, use of the "discount window", but that is not the way discounting works. Banks borrow from us mainly to cover temporary deficiencies in their reserves, and their needs for borrowing are much less frequent when bank reserves generally are not under pressure. The discount rate reductions represented support and confirmation of the open market operations and the cuts in reserve requirements which have made reserves available and have made borrowing at the "Fed" virtually unnecessary.

The most significant indication of the effectiveness of the change in Federal Reserve policy is the fact that, over and above the tremendous swing from net borrowed to free reserves, member banks had enough additional reserves to be able to expand their earning assets and their deposit liabilities by several billion dollars. In this way the banks have used several hundred million dollars of the reserves released by the lowering of percentage reserve requirements. Thus the fact that member bank reserves are now lower than a year ago does not mean that there has been a corresponding contraction in the money supply.

On the contrary, the money supply in the form of demand deposits, seasonally adjusted, has been increasing at the rate of nearly $1 billion a month since January.

Statistics on changes in bank loans and investments since October also throw light on the profound alteration which has occurred in the banks' position. Total loans and investments have risen by $7 billion, as compared with less than $2½ billion in the corresponding period of 1956-57 and $1 billion in 1955-56. With demand for business loans shrinking, the greater part of the increase has been in investments, chiefly in United States Government securities, but with a substantial increase also in other securities and in loans to carry dealers' increased holdings of securities. Accordingly, we have witnessed a very considerable improvement in the liquidity of the banks, and along with it has come a gain in liquidity for others than banks as they have received cash directly or indirectly from the banks' security purchases. The loan-deposit ratios of banks, often looked upon as a rough measure of bank liquidity, have dropped since October from 66 per cent to 61 per cent in the case of the New York City banks, and from 55 per cent to 52 per cent in the case of banks outside New York. Granted that these loan-deposit ratios are still far above those of 1954, we have clearly made headway in restoring a good deal of the liquidity that was lost during the period of restraint—and I hope, and believe, that the banks are much better disposed now than six months ago to seek aggressively to meet all sound demands for credit.

Another major result of the change in Federal Reserve policy has been its effect on interest rates and the consequent stimulus to the capital markets. As is usual in any cyclical swing in rates, short-term rates have fallen much more sharply than long-term, although even in the latter the decline has been very substantial. Undoubtedly, an important factor preventing a steeper drop in long-term rates has been the very large volume of new corporate and municipal securities that have been brought out in response to the more favorable market conditions. Of course this has been a very healthy development which we have welcomed, as the corporate financing has helped to improve business liquidity and the municipal issues have contributed to the financing of expenditures which have provided a partial offset to recessionary tendencies. Long-term interest rates, having started down from a much higher level than was reached in 1953, are still considerably above the levels reached in 1954 in spite of the sizable drop since last autumn. The significance of any particular rate level is not always the same in all circumstances, however. The important consideration in present conditions is that money and capital should be readily available; that no sound economic project should be deferred or dropped because funds are not available on reasonable terms. The necessary condition is that rates be satisfactory to borrowers and, at the same time, acceptable to investors. It is that broader complex, and not just rates as such, which we try to keep in view in the development of credit policy.

Funding of Treasury debt earlier this year probably tended, at least in some degree, to slow the rate of decline in long-term rates and, with another large refunding in immediate prospect, the Treasury now faces the difficult problem of whether to include a long-term issue. The dilemma faced by the Treasury at times like this is how best to reconcile the need for improving the maturity structure of the debt with the desire to avoid serious interference with other desirable financing.

It seems to me that the developments of recent months refute pretty effectively the old allegation that monetary policy, effective though it may be in checking a boom, is helpless to combat recession. The fact is that the banks do largely use any reserves which are made available to them to make additional loans or investments, and in so doing contribute substantially to the supply of investable funds, with marked effect on the strength of the capital markets. Naturally I am not claiming that monetary policy alone can create eager borrowers nor that it can provide all the stimulus needed to pull the country out of a recession—but it can be of tremendous help and is, in fact, an indispensable element for resumption of economic growth.

I would like to emphasize that there is no electronic computer to tell us exactly how far we should go in this process of easing credit conditions. After all the obtainable statistics are accumulated and studied, it is still largely judgment which the central banker must use in deciding how far or fast to move. We must at all times be mindful of the "feel" of the money and capital markets, and the geographical distribution of reserves, so that there is not undue tightness in either the money centers or in other parts of the country. Incidentally, the action of the Board of Governors in reducing central reserve city bank reserve requirements more sharply than those of reserve city bank requirements, and the latter more sharply than country bank requirements, has not only helped to reduce an inequitably wide spread between requirements, but has also tended, along with other measures, to prevent the appearance of a degree of tightness in the larger cities which would have been inconsistent with our general policy of monetary ease.

As has often been said more eloquently than I can, monetary policy must always seek to tread a narrow and at times difficult path between the objective of steady economic growth and the objective of price stability. The replies a month or two ago by the Reserve Bank Presidents to the questionnaire sent to them by Senator Byrd set forth in considerable detail reasons why we believe that these two objectives are consistent in the long run. But we also recognized that there may arise substantial inconsistencies in the short run. We have been criticized for easing money too much by some observers who believe in fighting inflation at all costs, and we have been criticized for being tardy or niggardly by those who believe we should be more mindful of the growing supply of unused human and material resources in the country.

The first group have tended to point to the continuing increase in some price indices, notably in the consumer price index, as calling for continued restraint. Yet I am quite clear in my own mind that during recent months the immediate dangers of recession had come to outweigh very clearly the immediate dangers of inflation, and they still outweigh them. Granted that we may again be faced with a problem of fighting inflation after we emerge from the current recession, I think it would have been inexcusable to let this consideration prevent our doing all that we could reasonably do to combat the recession and to provide an atmosphere of money and credit ease conducive to recovery. Even though there are some signs that the bottom of the recession may be near, we cannot look with equanimity on current levels of unemployment or on the possibility of an increasing spread between actual output and the country's growing resources of labor and capital equipment. Naturally I hope and expect that we in the Federal Reserve System, and the country in general, will have the sense and courage to recognize the need for a change of monetary policy when it comes.

One serious problem is the adequacy of our statistical tools, on the basis of which important national policies must, to a considerable extent, be decided. An example is the consumer price index, which is one of the principal measures used in connection with our objective of attaining price stability. In spite of all the skill and care used in preparing this index, the question still remains whether it gives us an accurate reading as to the true cost of living for the average American family. Without attempting to go into all aspects of this subject, I might merely point out that, in the view of many economists, the index may not take sufficient account of improvements in quality; it represents a fixed "market basket" and cannot give recognition to the consumer's ability to make substitutions when certain prices rise; and it probably fails to give adequate weight to all the discounts or price reductions actually available at the retail level under present conditions. Similarly, many of our other statistical series are subject to substantial reservations.

Closely related to this matter of the adequacy of our statistical tools is another question which is often raised. Why cannot the monetary authorities forecast more effectively and anticipate needs for policy changes, instead of waiting until a business trend has become fairly obvious? The answer, I think, lies in the absence of conclusive statistical measurements even of present conditions, let alone of future conditions. Many of our statistical data tell us only what has happened some weeks previously, not what is happening now nor what will happen tomorrow. There are some so-called "lead" series which may give a clue to the future of other series, but I would stress that it is only a clue; that the statistical history of business cycles is full of false starts, both upward and downward. So there must always be an element of tentativeness in our approach. We can never go "all out" at the first suspicion of a trend, but must patiently watch and probe and reappraise, intensifying our efforts or pulling back as additional evidence becomes available.

Another problem has to do with the instruments of credit control at our disposal. By and large the Federal Reserve System has relied on very general credit controls —control of the total money supply and aggregate bank credit—with a minimum of interference with the market's allocation of credit and resources to the various segments of the economy. This is as it should be in an economy which relies for its motivation primarily on market forces and freedom of enterprise. In keeping with this philosophy, the System has applied restraint only when the aggregate of demand was tending to exceed available supply at stable prices, and when aggregate credit demands were running ahead of savings. Yet there have been occasions when imbalances have developed in particular sectors which may have contributed strongly to ultimate imbalance of the whole economy. Such specific imbalances might involve the proportion of output going into investment as against consumption, or the proportion going into some major industry or industries, under the stimulus of unusually rapid expansion of particular types of credit. Conceivably, monetary policy might have done better to supplement its general credit controls with some more selective controls, especially in the area of consumer credit, designed to check particular distortions before they had gone too far. As I recently wrote to Senator Byrd, there exists no bureaucratic urge in the Federal Reserve System to administer such controls—quite the contrary. But it is quite possible that the supplemental use of some selective controls (over and above margin requirement regulations, which constitute the only selective control currently exercised by the System) may prove useful at times in helping to achieve our goal of steady economic growth.

I hope I have made it clear that I believe there is a great deal which monetary policy can and should do to combat recession. But, while I think our record in the past few months in this regard is pretty creditable, I have some misgivings over the tendency of the nation to place too great a burden on monetary policy—to expect too much of it. There were times during the 1955-57 boom when fiscal policy could have contributed more strongly than it did to the checking of inflationary forces. More recently serious questions have been raised as to the extent to which fiscal policy might help in the efforts to combat recession and to promote recovery. Moreover, the actions of labor and management in the area of wages and prices can be at least as important to ultimate recovery as anything that may be done through monetary or fiscal policy.

So far I have spoken of our economic problems as if the United States were living in an isolated world of its own. We all know how far this is from reality and how important our relationships with the rest of the world are. As a matter of fact, the rest of the world is not hesitant to accuse us, from time to time, of giving too little thought to the international effects of our internal policies. Perhaps an extreme example of this is the advice we sometimes receive to let "a little inflation" occur in this country, so that foreign countries with somewhat shaky exchange rates and more sharply rising unit costs may escape a major exchange crisis. I can see no justification for such a plea. We in the Federal Reserve System are determined to do all we can to resist inflation, either slow or rapid, in this country. On the other hand, it is clear that we must do our best to avoid exporting recession to other countries. This is merely another way of saying, as has been said so often, that the most useful contribution we can make to world prosperity is to see to it that steady economic growth, with reasonable price stability, is achieved in our own country. I believe our responsibility in this regard is greater, perhaps, than it was in the last recession of 1953-54, for at that time Europe and other areas were surging ahead so strongly that a minor dip in our own activities was hardly felt. That momentum has recently diminished, in most foreign countries, so that they may be more sensitive than they have been in several years to economic tendencies in the United States. Fortunately there is ground for hope that we shall not let matters go so far in this country as to constitute a serious threat to the economies of our friends abroad.

It seems to me that all of us who are interested in the development of ever stronger economic ties between the major trading nations of the world can derive a good deal of satisfaction from events of the last few months. For one thing, sterling, which was subjected to such a powerful though misguided speculative attack last summer, has made a remarkable recovery, primarily because of the United Kingdom's demonstrated determination to take such internal measures as were called for to preserve its strength as a leading international currency. I am thinking also of the tendency in recent months for the total monetary reserves of foreign countries—gold and dollars—to increase again, after a pause in their growth during 1957. Although this pause in growth reflected in part the unusual demands for American products growing out of the Suez crisis and foreign crop difficulties, a large part was simply due to excessive internal demand in many foreign countries brought about by failure to check domestic inflation. The recent tendency for foreign monetary reserves to increase is attributable, at least partly, to a more effective control of inflation in a number of major foreign countries, which we may rightly applaud.

To some extent the growth of reserves abroad has taken the form of purchases of gold from the United States. These purchases have been quite heavy in the last few months, and the total so far this year has been of about the same order of magnitude as the sales of gold to the United States in all of 1957. Similar large gold movements have occurred from time to time since the war, and to me they are a decidedly healthy sign, showing that the international gold standard (a gold bullion standard, supplemented by a dollar exchange standard to the extent that dollars have been used as a reserve currency) is working as it should work. Gold and dollars are, and I am sure will continue to be, interchangeable at the present fixed price—subject only to minor handling charges in this country and the very limited swings in the London gold market. Even after the recent gold movement, the United States still holds almost $22 billion worth of gold, or 56 per cent of the free world's monetary gold stock. It would not be in the interest of world financial stability if this country were always to gain gold at the expense of the rest of the world. We make a crucial contribution toward the effective operation of the international financial and monetary system by standing ready to sell our gold at the same price at which we bought it, and by thus keeping stable the key relation between gold and the dollar.

The strengthening of this international gold standard must always be of tremendous interest to the Federal Reserve Bank of New York, acting as we do as the principal arm of the System in holding dollar deposits, investments and gold for the central banks and international financial institutions of the world. But I believe it is of virtually equal interest to the entire System and indeed to the entire country; for there is no escaping the fact that internal stability and external stability are inextricably intertwined in every country of the free world, including the United States. I trust that we in this country will always have in mind the need for keeping our own house in order, and for pursuing policies with respect to foreign trade and investment, as well as with respect to money and credit, which will contribute to the healthy and growing world economy we all seek.

May I thank you again for this opportunity to address you.

The Capital Markets Since October

The relaxation of credit restraint last fall had a sharp and immediate effect on the capital markets. The backlog of newly issued securities was quickly distributed, and by the end of December long-term interest rates on outstanding issues had declined by almost as much as during the 1953-54 business recession. In the face of growing demands for long-term funds—demands that were augmented by Federal Government borrowing at long term—market yields rose in February and March. Subsequently, however, yields again moved downward, partly under the influence of additional measures of credit ease, but still remain appreciably above the 1954 lows.

In the perspective of the full period from October through May, the progressive relaxation of credit restraint has stimulated the flow of long-term funds while lowering the costs of borrowing and inducing an expanded demand for such funds. Total corporate and municipal bond offerings, in fact, reached a record volume during the first quarter of 1958 and continued at an exceptionally high rate in April and May. The recurrent tendency since January for long-term rates to firm and even rise suggests, however, that even in a period of credit ease a heavy volume of prospective flotations, especially when reinforced by market uncertainties, can at times make investors hesitant to commit long-term funds at the prevailing rates. Such hesitancy, as well as the easing of money market conditions, has been a factor in the widening of the spread between short and long-term rates.

VOLUME OF NEW CAPITAL ISSUES

From the end of October 1957 through May 1958 the volume of corporate and municipal bond offerings (excluding refundings) totaled an estimated $10.6 billion, an increase of $1.5 billion over the comparable 1956-57 period. In addition, the Federal Government sold for cash $7 billion of intermediate and long-term securities, as the Treasury attempted to lengthen the maturity structure of the public debt; a year earlier, in a period of monetary restraint and rising interest rates, the Treasury had sold for cash less than $1 billion of such securities, centering its borrowing in the short-term market. A substantial portion of the Treasury's offerings was apparently acquired, directly or indirectly, by commercial banks and other institutional investors who wished to replenish their Government securities portfolios.

Municipal offerings of approximately $5.1 billion in the latest seven months compare with $3.9 billion sold in the November-May period of 1956-57. As described below, this substantial growth includes some issues previously postponed because of high interest rates during the tight money period, but it also reflects new offerings planned in response to the decline in borrowing costs as well as the persistence of the basically strong demand for funds by State and local governments evident for the last four or five years.

As interest rates fell below the statutory limitations in effect in many State and local jurisdictions, increasing amounts of previously postponed issues were sold. According to the Investment Bankers' Association, the backlog of bond issues postponed by States and municipalities—defined to include only issues actually offered for sale but not sold—reached a peak in June 1957, when the cumulative total since mid-1956 was $352 million; the total remained close to this level until October 1957. But, during the next seven months a total of $341 million of previously postponed issues was distributed, while only $147 million of new securities offerings was postponed. More than half of these new postponements occurred during February and March 1958 when some congestion developed in the market.

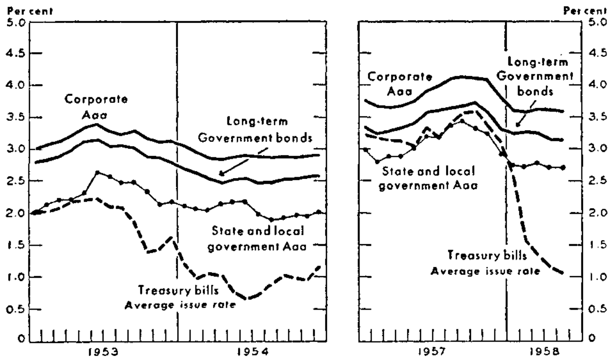
Corporations raised an estimated $5.5 billion of new capital through bond sales between October 1957 and May 1958, as against $5.2 billion in the same period a year earlier. Included in the total is a mammoth public utility offering of $718 million of convertible debentures sold in March, which raised total corporate bond sales in the first quarter of 1958 to a level slightly above that in the exceptionally high opening quarter of 1957. The continued high rate of investment in plant and equipment by public utilities—the only major industrial sector anticipating a rise in capital outlays from 1957 to 1958—was an important factor underlying the heavy corporate demand for funds; some corporations used part of the proceeds of bond issues to repay bank loans.

INTEREST RATES IN THE BUSINESS RECESSION

As indicated above, the downward adjustment of long-term interest rates since last October is similar in magnitude to that which occurred during the 1953-54 period of credit ease, although the recent level of these rates still is appreciably higher than at the bottom of the earlier

Chart I

SELECTED INTEREST RATES, 1953-54 AND 1957-58



Note: Yields are monthly averages of daily or weekly figures. May 1958 figures are estimated.
Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, and Moody's Investors Service.

decline. As shown in Chart I, between October 1957 and May of this year, average yields on outstanding high-grade corporate bonds fell from 4.10 per cent to 3.57 per cent—a decline of 53 basis points and almost equal to the total decrease during the 1953-54 recession. On newly issued corporate bonds converted to a Aaa basis, the drop of about 1 percentage point in average rates (from 4.71 per cent in October to 3.66 per cent in May) was about twice as large as on comparable outstanding bonds (see Chart II). Although the decline in new issues rates since last October was slightly less than the maximum reduction in 1953-54, it considerably exceeded that registered in the comparable seven months of the earlier recession.

In the municipal market, yields on seasoned Aaa securities fell by more than 60 basis points (from 3.31 per cent in October to 2.70 per cent in May)—a decrease that was considerably larger than that which took place during the first seven months of the 1953-54 recession. Since October 1957 new issues rates on long-term Aaa municipals have declined less than those on outstanding obligations, as the longer maturities among the new offerings occasionally encountered investor resistance.

Virtually all of the 1957-58 decrease in long-term rates occurred before the end of January, however. As already indicated, the trend was reversed during February and March, under the impact of the heavy volume of new flotations. This temporary reversal was especially evident in the new issues market where the increases far outstripped the advance in yields on seasoned issues. Long-term bond yields declined again in April—although less rapidly than in the November-January months—and moved irregularly during May.

The differential effects of market forces on various maturity sectors of the capital markets are well illustrated by the behavior of reoffering yields on municipal bonds since the beginning of the year. New Aaa municipal bonds maturing in less than five years declined steadily from 2.00 per cent in January to 1.68 per cent in April;[1] those of intermediate maturities (up to ten years) rose slightly from 2.15 per cent in January to 2.25 per cent in March but subsequently receded to 2.23 per cent in April. On the other hand, Aaa bonds with a life of twenty years rose from 2.45 per cent in January to 2.70 per cent in March and April, with most of the gain occurring in February when the average yield on new issues was 2.63 per cent. These differences in behavior reflect both the concentration of issues in the long end of the municipal market and aggressive buying by commercial banks in the short-term area. After short-term rates declined, banks apparently used their increased reserves to reach out into the intermediate range.

MARKET FORCES

In the few weeks preceding the reduction of the discount rate in mid-November 1957, different sectors of the securities markets showed divergent trends. Prices of Treasury bonds rose as much as 2½ points in the first half of the month—when evidence was accumulating that the expansive forces in the economy had eased—but prices of outstanding municipal and corporate securities held virtually stable, reflecting the heavy volume of new flotations and the growing backlog of unsold issues. This market congestion was immediately relieved after November 14, when the Federal Reserve discount rates were reduced from 3½ to 3 per cent, thus precipitating a sharp fall in market interest rates. After a few days, however, the advance in bond prices was temporarily halted, partly as the result of the Treasury's announcement that its forthcoming financing would include—contrary to market expectations—a cash offering of 3⅞ per cent seventeen-year bonds. Investors' demand soon revived, in the expectation of a continued easing of credit conditions, and bond yields resumed a decline that extended through most of January.

By the middle of January, the capital market had to contend with a rising inventory of unsold municipal bonds and a heavy schedule of proposed flotations, both of which served to dampen investor enthusiasm. In addition, the uncertainties in the business outlook were counteracted somewhat by expectations that the business recession might be short-lived and by increased concern over the possibility that inflationary pressures might reappear later in the year. The Treasury's request to raise the debt ceiling, along with press reports that it was planning to

[1] The Investment Bankers' Association's series on new issues yields by maturity and rating classifications start in January 1958, and April figures are the latest available.

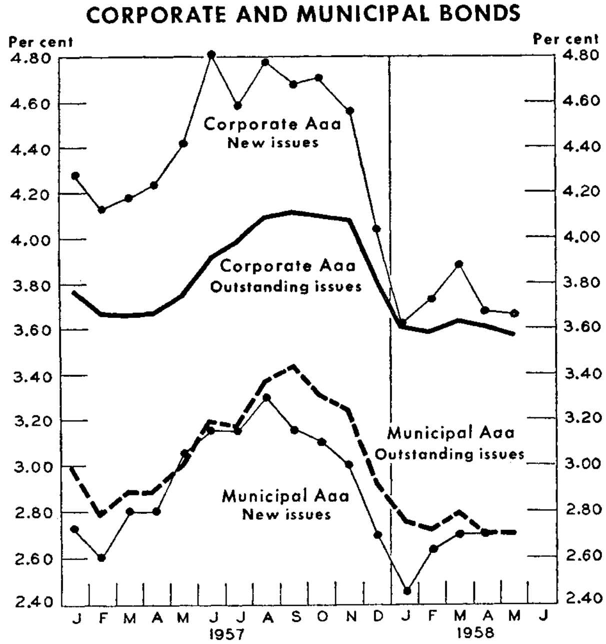
include a long-term bond in the February refunding, induced some investors to defer new commitments. Another reduction in the discount rate announced on January 21 and the almost simultaneous reduction in the prime rate at large commercial banks from 4 per cent to 3½ per cent stimulated only a small expansion in demand because the market had generally anticipated such moves.

On the day following the Treasury's announcement on January 29 that its February exchange offering would consist of two bonds, of six years' and thirty-two years' maturity, and a certificate of indebtedness, prices of long-term Treasury bonds dropped ½ to 1⅜ points. Gradually rising yields spread to other sectors of the capital market, although the immediate effect in these sectors was a further build-up in dealer inventories; bond dealers, their shelves heavy with undistributed bonds acquired at relatively high prices, were not ready to offer the price concessions required to move their holdings into investors' hands.

While underwriters bid aggressively for the large volume of new corporate and municipal issues that came to the market in February, reoffering yields had to be set at levels sufficiently above the rate of return on the new

Chart II

YIELDS ON NEWLY ISSUED AND OUTSTANDING CORPORATE AND MUNICIPAL BONDS



Note: May 1958 figures are estimated.

Sources: Yields on outstanding bonds are from Moody's Investors Service. Yields on newly issued municipal bonds are from the Investment Bankers' Association, and those on newly issued corporate bonds are from The First National City Bank of New York.

Treasury 3½ per cent bond of 1990 to attract buying orders. At this time investor interest seemed to focus primarily on the build-up of the calendar of new corporate and municipal financing.

Late in February, when the Treasury made public its decision to sell for cash an 8½-year 3 per cent bond on February 28, prices of new corporate and municipal obligations were again reduced in an attempt to keep them competitive in yield with Treasury bonds. On the whole, yields in the new issues market—and particularly in the long end of the market—bore the brunt of the intense competition for funds in this period. Market conditions improved somewhat in response to the lowering of the discount rate on March 6 and the March 18 announcement of another reduction in reserve requirements, and the firmer tone was also aided by an appreciable slackening in the pace of new flotations. Some underwriters, spurred by expectations of a considerable increase in buying orders, bid vigorously for new issues, but they were forced to price the bonds rather closely when reoffered. As the month progressed, the large backlog of unsold bonds, the continuing heavy schedule of projected flotations (especially of municipals), and the uncertainties surrounding the Treasury financing expected in early April contributed to a further weakening of bond prices, so that long-term interest rates were again rising at the end of the month. Also in March, for the first time since the shift to credit ease, a sizable volume of corporate flotations was postponed.

Following the Treasury's announcement on April 2 that its next cash financing would be confined to a 2⅝ per cent note due in 1963, prices of Treasury issues began to rise. In the corporate and municipal sectors, however, buyers remained hesitant. Shortly after midmonth the market received a stronger stimulant by another round of reductions in the Federal Reserve discount rate and in member bank reserve requirements. The spurt in demand was rather brief, however, and the decrease in the prime rate by commercial banks was virtually unnoticed in the capital market. By the close of April, market yields on outstanding municipal and corporate bonds had generally returned to the low levels that had been reached in January, but new issues rates were still slightly above the January levels.

No clear patterns emerged in the capital market during May. The mixed reception accorded new issues not only reflected the relatively large volume of current and scheduled offerings but also uncertainties about the inclusion of a long-term bond in the Treasury financing due in June. Nevertheless, municipal dealers succeeded in reducing their near-record inventories after midmonth, when the pace of new flotations slackened. Corporate bond yields of the highest and lowest grades tended to diverge in May, with yields on outstanding Aaa issues gaining a few basis points while those on Baa issues declined. Yields on new corporate obligations remained fairly stable in May.

CONCLUSIONS

The extent to which corporate and municipal borrowers have entered the capital market to take advantage of the lower cost and greater availability of funds has been the outstanding feature of the markets since mid-November, especially in the context of declining business activity. The main influence on the capital markets, of course, has been the easing of Federal Reserve policy, as evidenced by lower discount rates, higher levels of free reserves, and successive reductions in required reserve ratios. Ease has tended to permeate the capital markets, although not to the same extent as the money market. The capital markets did in fact weaken somewhat in February and March, when heavy flotations led to a temporary rise in yields and some congestion in the distribution of new flotations, but this situation has largely disappeared in the last two months. Most important, the huge volume of issues successfully floated has tended to ease the financing problems of State and local governments and to improve the liquidity positions of corporations, thus helping to build the foundation needed for a renewed upswing in general economic activity.

The Financing of Small Business: Survey of Second District Commercial Banks, Part II

This is the second of three articles analyzing the findings, as they pertain to the Second District, of the special survey of financing facilities available to small business, which was undertaken by the Federal Reserve System in the fall of 1957. As explained in the May issue of this *Review,* both a statistical survey and a broad interview program were employed in an attempt to evaluate the performance of these facilities during a period of monetary restraint. The present article analyzes the results of the statistical survey of Second District member banks with respect to interest rates, regardless of borrower size, and in addition considers in greater detail than in the previous article some of the findings concerning loans to small business.

INTEREST RATES ON BANK LOANS

As would be expected in a period in which heavy demands for funds pressed hard against a limited supply, the entire structure of interest rates moved upward between 1955 and 1957. Thus, the average rate of interest on all commercial loans at Second District member banks rose from 3.8 per cent in 1955 to 4.5 per cent in 1957.[1] In the earlier year 60 per cent of the dollar value of all commercial loans had borne an interest rate of under 4 per cent, while two years later this percentage had declined to 15 per cent; by number of loans, the shift toward higher interest rates was less marked, but the number bearing rates of less than 5 per cent fell from about 25 per cent of the total in 1955 to about 10 per cent.

The increase in rates tended to be larger for large borrowers, defined in terms of given dollar asset size, than for small borrowers. Thus the biggest borrowers, those with assets of $100 million or more, paid 1.1 percentage points more on the average for bank loans in 1957 than in 1955, while borrowers with assets of no more than $50,000 experienced a rise in interest costs of only 0.6 percentage point.

The cost of short-term loans tended to rise more sharply than the cost of intermediate or long-term loans. Table I indicates that for all borrowers, rates on short-term loans rose by 1.0 percentage point, on intermediate loans by 0.8 percentage point, and on loans maturing in over five years by only 0.4 percentage point. Nonetheless, this relation varied sharply with the asset size of the borrower. The very smallest firms, for example, experienced increases in rates on short and intermediate-term loans of only about ½ of 1 percentage point, while the rates paid on their long-term borrowing were up a full percentage point. In contrast, the largest borrowers paid rates on short and intermediate-term loans that were each up by more than 1 percentage point, but on long-term loans the rise was only 0.1 percentage point. For firms of intermediate size the pattern was mixed.

For each size category of borrowers, average rates were higher in 1957 on intermediate-term loans than on either short or long-term loans. (In 1955 longer loan rates had in some cases exceeded those on intermediate loans.) The higher rates in the intermediate area reflect the fact that a large proportion are in the form of instalment loans

[1] The average interest rates quoted in this section for both 1955 and 1957 refer to the rates on loans made in the period from July 1 to the October survey date and still outstanding on the survey date.

Table I
Average Interest Rates on Commercial Loans Made by Second District Member Banks, 1955 and 1957*
(In per cent)

Asset size of borrower (in thousands of dollars)	Banks with total deposits of (in millions of dollars)									
	Under 10		10-100		100–1,000		1,000 and over		All banks	
	1955	1957	1955	1957	1955	1957	1955	1957	1955	1957
	Loans maturing in one year or less									
Under 50	5.8	6.0	5.5	5.9	5.4	5.8	5.0	5.7	5.4	5.8
50–250	5.5	5.8	5.0	5.6	5.0	5.6	4.7	5.5	4.9	5.6
250–1,000	5.4	5.6	4.8	5.4	4.6	5.3	4.3	5.2	4.5	5.3
1,000–5,000	4.0	4.7	4.4	5.2	4.2	5.1	3.8	4.9	3.9	5.0
5,000–25,000	3.5	4.6	3.9	4.8	3.7	4.8	3.5	4.6	3.5	4.7
25,000–100,000	3.1	4.5	3.5	4.5	3.3	4.6	3.4	4.6	3.4	4.6
100,000 and over	†	4.0	3.3	4.6	3.2	4.5	3.2	4.4	3.2	4.4
Total—all borrowers‡	5.5	5.7	4.8	5.4	4.1	4.9	3.6	4.7	3.8	4.8
	Loans maturing in one to five years									
Under 50	7.7	8.3	7.3	8.7	9.6	9.5	6.2	7.5	7.7	8.2
50–250	5.6	6.5	5.6	7.5	6.0	8.7	5.5	7.1	5.7	7.7
250–1,000	6.6	6.1	5.1	6.3	5.9	7.4	5.1	5.7	5.3	6.7
1,000–5,000	6.7	†	4.8	6.1	4.4	5.7	4.3	5.1	4.4	5.4
5,000–25,000	—	—	3.5	5.3	4.0	5.5	3.8	5.2	3.8	5.3
25,000–100,000	—	—	—	—	3.5	4.6	3.9	4.5	3.9	4.5
100,000 and over	—	—	4.5	—	3.6	4.3	3.3	4.4	3.3	4.4
Total—all borrowers‡	6.4	7.0	5.7	7.0	5.0	5.8	4.0	4.8	4.3	5.1
	Loans maturing in over five years									
Under 50	5.4	5.7	5.0	6.6	4.9	5.6	—	—	5.1	6.1
50–250	5.2	5.8	4.9	5.7	4.6	5.4	—	—	4.9	5.6
250–1,000	—	5.8	4.8	5.1	4.5	5.7	4.5	5.0	4.6	5.2
1,000–5,000	—	—	4.7	5.5	4.5	5.2	4.5	—	4.5	5.2
5,000–25,000	—	—	—	5.0	3.6	4.5	4.2	4.7	4.1	4.7
25,000–100,000	—	—	4.5	—	3.4	5.0	3.6	4.3	3.6	4.3
100,000 and over	—	—	—	—	3.3	4.0	3.5	3.6	3.5	3.6
Total—all borrowers‡	5.2	5.8	4.9	5.7	3.9	5.1	3.7	4.0	3.8	4.2

* Rates shown are averages for loans made from July 1 to the October survey date and still outstanding on that date.
† Too few loans reported to yield a representative interest rate for the category.
‡ Includes borrowers whose asset size is unknown.

on which the effective rate is usually relatively high. The longer loans are frequently secured by real estate, thus requiring a relatively low risk premium.

Rates generally rose more at large banks than at small banks. The largest borrowers, those with assets of $100 million or more, appeared to be able to obtain funds at fairly uniform rates regardless of bank size. The smallest borrowers, on the other hand, obtained term credits at the smallest banks (those with deposits of less than $10 million) at a lower rate than at medium-sized banks, possibly because the smallest banks did not make extensive use of instalment lending techniques.

The rise in interest rates between 1955 and 1957 was not accompanied by an increase in the proportion of the loans secured by some form of collateral. In both years 70 per cent of the number and 41 per cent of the dollar amount of loans were so secured. This stability, however, apparently reflected two roughly offsetting developments. On the one hand, within each borrower size class there was an increase in the proportion of the total amount of loans outstanding that was secured. But on the other hand, the largest increase in the amount of loans outstanding was to borrowers in the upper size classes, a relatively small proportion of whose loans are secured.

BANK LOAN RATES AND OPEN MARKET RATES

With few exceptions, the increases that occurred in bank lending rates during the 1955-57 period were smaller than those which occurred over the same period in open market rates. While the average rate on bank business loans in this District moved up 0.7 of a percentage point (1 point for loans under a year and 0.4 for loans with maturities of more than five years), commercial paper rates and rates on Government obligations maturing in less than a year increased by 1.5 to 1.8 percentage points, and intermediate-term government and corporate obligations moved up at least a percentage point.

Several factors are of importance in explaining why bank rates generally rise less rapidly than open market rates. First, many banks never charge more than 6 per cent on business loans either because of usury laws or tradition,[2] and at the time of the 1955 survey, many borrowers—particularly the smaller ones—were already at this "ceiling". Second, many bank loans are made under commitments set up a number of months or even years before the credit is actually extended; the rate for the entire amount of the credit extension is sometimes determined at the time the original commitment is made. Third, problems of administering loans to a large number of borrowers, many with special requirements, often preclude a rate schedule as flexible as that of the open market. However, there are some changes in the total cost of a bank loan which the stated interest rate does not indicate, since banks frequently require borrowers to maintain compensating balances. The extent to which the banks police these requirements, as well as the size and industry classification of the borrowers subject to such requirements, varies over the credit cycle.

Rates on short-term bank loans to large borrowers show a somewhat closer relationship to the Federal Reserve Banks' discount rates and open market rates than do rates on short-term bank loans to small borrowers. This partly reflects the fact that large borrowers have more ready access to other sources of credit, through the capital and commercial paper markets in which rates tend to be related to the discount rate. Competition is therefore a factor tending to keep bank loan rates to large borrowers on shorter credits somewhat more sensitive to open market rates. The flexibility of bank rates to small borrowers, on the other hand, is limited by the relatively high administrative costs of putting such loans on a bank's books.

SMALL BUSINESS LOANS

As was pointed out in the first article of this series, a business with $5 million of assets would be considered "small" in some industries, "large" in others. For analytical purposes, it may be useful, therefore, to examine some of the results which arise when "small", "medium", and "large" are defined by using different asset-size breaks for different industries.[3] When tabulated by these relative size classifications, the survey data indicate that Second District member banks had 139,000 loans to small business on their books in October 1957, accounting for 59 per cent of the total number of their loans, compared with 56 per cent in 1955. In the aggregate these loans totaled $1,374 million or just under 10 per cent of all their business loans, compared with 13 per cent in the previous survey.

The data on loans by industry classifications (shown in Table II) indicate that, with few exceptions, the *dollar* amount of loans to small business increased less (or decreased more) than the amount extended to medium and large firms in the same fields. In some industry classifications, however, the *number* of loans to small businesses rose more rapidly than the number to medium and large businesses. Although the number of small businesses receiving bank credit increased somewhat, the average amount loaned to each borrower apparently declined.

In terms of dollar volume, the largest amount of loans to small business outstanding in October 1957 was to firms in the metals and metal products industries (where "small" was defined as under $5 million). These totaled $321 million, or 23 per cent of the aggregate amount of loans to small business outstanding. Loans to this industry group increased more in dollar terms ($63 million) than those in any other industry group and by the second largest amount (25 per cent) in relative terms. The next most important small borrower group was the textile, apparel, and leather manufacturing category ("small", under $1 million), which had $274 million of loans outstanding last October. However, loans to this group of companies showed the largest decline—$43 million—of any industry group. Loans to small retail, public utility (including transportation), and miscellaneous nonfinancial business firms ("small", under $50,000) showed net increases in the amount outstanding.

In terms of the number of loans outstanding, small trade and service (under $50,000) firms led the field, accounting for 34 and 17 per cent, respectively, of the 139,000 loans outstanding to small business. But the number of these loans outstanding showed almost no increase between the two surveys. On the other hand, there were increases of more than 50 per cent in the number of loans to small firms in the public utility, real estate, and miscellaneous categories, substantially larger increases than those that occurred in the number of medium or large borrowers in these fields. There were also increases of approximately 30 per cent in the number of loans to small firms in the sales finance category and the petroleum, coal, chemical, and rubber category.

Average interest rates on loans to small businesses in all industries increased between 1955 and 1957, although in almost all cases by less than those for loans to medium and large businesses. In no case, however, was the differential

[2] In the three States, all or part of which are included in the Second District, the maximum legal charge on loans to noncorporate borrowers, other than on instalment loans which are extended under special small loan laws, is 6 per cent.

[3] A complete description of the industry asset-size breaks used to determine "small", "medium", and "large" business may be found on p. 409 of the April 1958 *Federal Reserve Bulletin.*

Table II
Percentage Changes in the Dollar Amount and Number of Loans to Small, Medium, and Large Businesses Made by Second District Member Banks, 1955-57*

Business of borrower	Amount of loans			Number of loans		
	Small	Medium	Large	Small	Medium	Large
Manufacturing and mining:						
Food, liquor, and tobacco	− 2	− 11	+ 86	+ 19	+ 14	+ 17
Textiles, apparel, and leather	− 14	− 7	+ 15	− 17	− 6	+ 14
Metals and metal products	+ 25	+ 99	+154	+ 14	+ 37	+112
Petroleum, coal, chemicals, and rubber	− 10	+ 23	+153	+ 28	+ 38	+ 18
All other manufacturing and mining	− 5	+ 34	+ 73	+ 2	+ 13	+ 65
Trade:						
Wholesale trade	− 3	− 9	+102	†	+ 8	+152
Retail trade	+ 6	+ 27	+ 17	+ 1	+ 21	+ 40
Other:						
Commodity dealers	− 87	− 80	+ 5	− 32	+ 66	+121
Sales finance companies	†	+ 55	+ 18	+ 30	+ 49	− 14
Transportation, communications, and other public utilities	+ 54	+ 62	+ 43	+ 56	+ 32	+ 16
Construction	− 12	− 1	+ 40	+ 6	+ 23	+ 13
Real estate	+ 2	− 13	+ 22	+ 56	+ 45	+ 24
Service firms	+ 4	+ 33	+ 43	+ 2	+ 22	+ 32
All other borrowers	+ 24	+ 13	− 5	+ 64	+ 10	+ 9
Total—all borrowers	†	+ 28	+ 56	+ 9	+ 21	+ 34

Note: This table excludes data on changes in loans to borrowers whose asset size is unknown.
* For definition of relative size classes of borrowers, see the April 1958 *Federal Reserve Bulletin*, p. 409. Loans outstanding on October 5, 1955 and October 16, 1957.
† Less than 0.5 per cent.

between the rates on loans to small and larger businesses eliminated. The highest average rates paid by small borrowers were found in the construction, public utility and transportation, service, and "all other" industry categories. The average rate on secured loans to small construction businesses outstanding on October 16, 1957 was 7.6 per cent and on those to the small public utility and transportation group, 7.2 per cent. The higher rates in these two areas reflect both the higher degree of risk involved in financing these firms and the limited-purpose type of collateral generally offered by firms in these fields. The lowest average rates on secured loans were found, as they are for the larger borrowers, in the petroleum, coal, chemical, and rubber category (4.9 per cent in 1957). The other manufacturing and mining industries, trade, sales finance companies, and real estate companies had average rates between 5 and 6 per cent. Service and the "all other" group averaged over 6 per cent.