

FEDERAL RESERVE BANK OF NEW YORK



MONTHLY REVIEW

NOVEMBER 1958

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Volume 40

No. 11

The Business Situation

The business recovery is continuing, although the pace of the expansion seems to have diminished somewhat since midsummer. Industrial production increased in September for the fifth consecutive month, but the rise of one point in the Federal Reserve index was the smallest since the upturn began in May (see Chart I). Similarly, the rise in personal income in September was the smallest since April. And while employment increased further, the improvement continues to be slow; in five months of recovery between April and September, only about a quarter of the drop in nonfarm employment that occurred over the preceding nine or ten months was regained. In the meantime, the labor force continued to expand. On the other hand, most of the statistics for September and October would undoubtedly show more improvement if it were not for the drastic and prolonged shutdowns in the auto industry, first as a result of the model change-over and then because of labor disputes.

Historically, cyclical upswings have generally been rather rapid at first, and have then settled down to a more moderate pace within a matter of months. Thus, it probably was to be expected that the very rapid rate of growth in output and incomes achieved in late spring and early summer would not be maintained for long. Nevertheless, it is noteworthy that, even though personal income has been rising month after month, consumer demand for durable goods and other "postponable" items has not yet shown the resurgence which, it is generally agreed, would virtually assure—and indeed may be a prerequisite to—full and prompt recovery. In September the gradually rising trend of consumer spending was interrupted; retail sales showed an appreciable decline (after seasonal adjustment), with the setback centered chiefly in home furnishings, apparel, and automobiles. Total retail sales this September were 2 per cent lower than a year earlier; in contrast, both personal income and prices of consumer goods were nearly 2 per cent higher than in 1957. In October, moreover, department store sales, which had declined appreciably in September, showed little change.¹

The lack of buoyancy in final demand for durable goods (except for housing) is also reflected in the preliminary estimate of the nation's total output of goods and services (GNP) for the third quarter. The total GNP advanced

¹ Sales were considerably higher than in October 1957, but this reflects the fact that, partly due to the influenza epidemic, sales last October were the lowest for any month between late 1955 and the present (with the single exception of February 1958).

by \$11 billion to a seasonally adjusted annual rate of \$440 billion, one of the largest quarterly increases of the postwar period. But higher government expenditures (mainly on wages and salaries, rather than on goods) and a decline in the rate of inventory liquidation accounted for \$6 billion of the rise, while consumer outlays on non-durables and services rose by about \$3 billion, roughly in line with population growth and price changes. Outlays on durable goods, consumer as well as producer, did not change significantly from the recession lows.

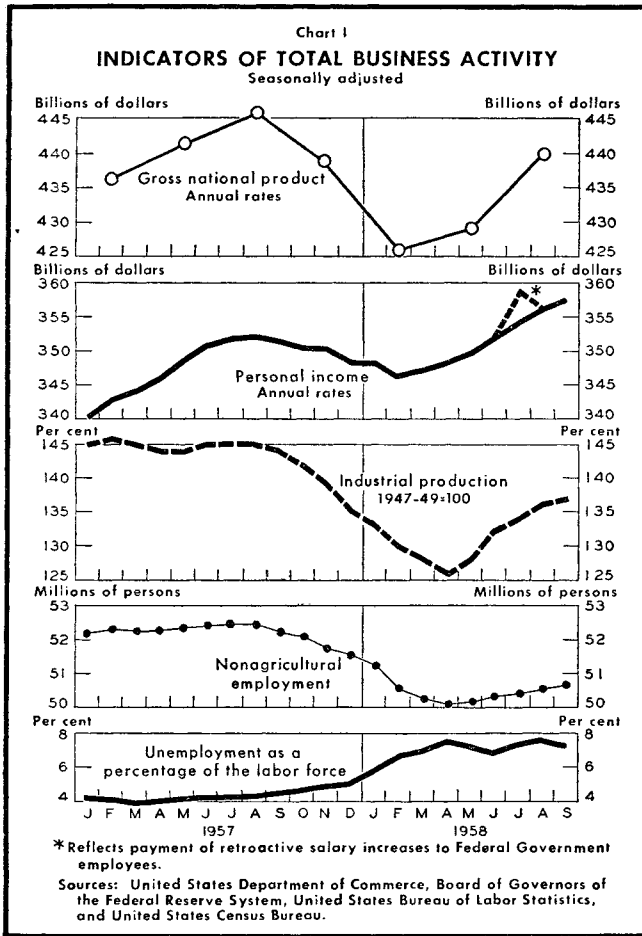
In considerable measure, the slackening of the business expansion results from the difficulties encountered by the auto industry in getting started on volume production of the 1959 models. The resumption of full-scale automobile production in November and the restocking of dealer showrooms with the new models should give a substantial boost to total output and sales.

In addition, some further advance in construction activity probably is foreshadowed by the sustained rise in private housing starts, which reached a three-year high at a seasonally adjusted annual rate of 1,220,000 in September, and the continuing record rate of contract awards for public construction. However, growing competition for funds appears to be resulting in some decline in the supply of funds available for Government-insured mortgages, and raises a question whether the current rate of housing starts can be maintained next year.

RECOVERY AND THE LEVEL OF EMPLOYMENT

The revival in employment thus far has been much slower than in the economic situation as a whole. As Chart II shows, the gains in employment since the over-all upturn in April have been smaller than the gains in output, not only in manufacturing, but also in virtually every industry connected with the production or distribution of goods. Over the period from April through September, total nonfarm employment (seasonally adjusted) increased by only 600,000 as contrasted with a 2½ million drop during the downswing; moreover, nearly 200,000 of this increase occurred in government rather than private employment.

Unemployment has, of course, declined appreciably in moving from its seasonal high in June, following the end of the school year, to its seasonal low in October after the resumption of classes. However, the seasonally adjusted rate of unemployment (the percentage of the labor force that is unemployed) has remained in the range of

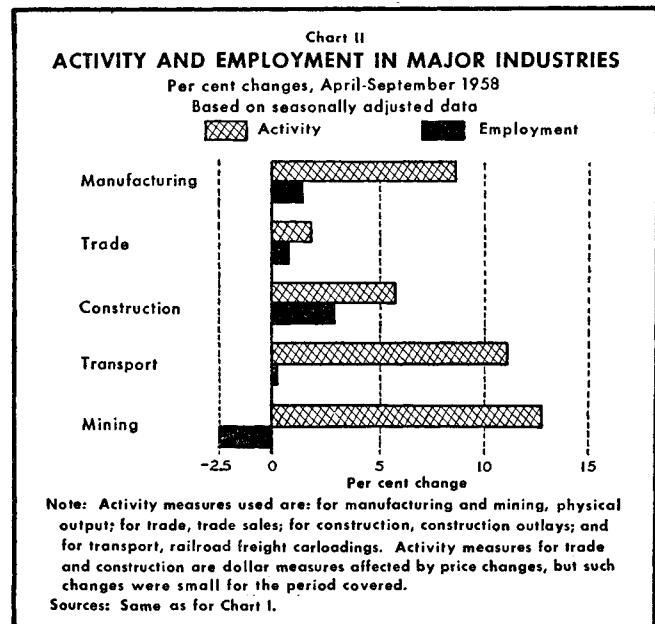


6.8 to 7.6 per cent since March; the figure for October was 7.1 per cent. (Alternative techniques of seasonal adjustment yield a somewhat more favorable picture.) Details of the October developments are not yet available. In September, however, for the first time since the recovery began, there had been a clearly more-than-seasonal reduction in the two categories of unemployment generally regarded as most burdensome: long-term unemployment—of half a year and longer—and unemployment among men twenty-five years of age and over, most of whom are heads of families.

It is not unusual in the early stages of recovery for increases in employment and decreases in unemployment to be less pronounced than the expansion in general business activity. But the virtual stability of unemployment at close to the recession peak during recent months does not have much recent precedent. During the revivals of 1949 and 1954, unemployment was on the whole reduced sooner and more quickly than has been the case in 1958; and the current recovery in output has been perhaps even

faster than in these earlier upturns. Furthermore, the rate of unemployment reached in 1958 was higher than in the previous postwar recessions. In 1957-58, the rate rose from 3.9 per cent in March 1957 to 7.6 per cent in August 1958; in 1954, the maximum rate of unemployment was 6.1 per cent, and in 1949, 6.8 per cent (omitting October 1949, when the figure was boosted to 7.8 per cent by the effects of a coal strike). Unless the current slackening in the rate of business expansion is only temporary, therefore, the return to reasonably full employment may well take longer than in these earlier recoveries.

The lagging behavior of employment in the early stages of recovery results from two well-known factors: (1) the tendency on the part of firms, when increasing output, to return their existing work forces to a full workweek before hiring new employees, and (2) the tendency for output per manhour to increase sharply during cyclical upswings. Average weekly hours worked in manufacturing have lengthened by 1½ hours (or nearly 4 per cent) since April, and they have also increased in some other lines of work. Over the same period factory output has expanded by 9 per cent; thus, nearly half the growth in production has been accomplished through longer hours alone. Moreover, output per manhour has apparently also shown its characteristic upsurge for this stage of the business cycle. In fact, the increases in hours worked and in output per manhour appear to have been more pronounced than in the recovery years 1949-50 or 1954-55, thus explaining, at least in the statistical sense, the relatively slow im-



provement in the employment picture during the recent period.

The current rise in output per manhour, it will be recalled, follows a period of some two years in which the growth of productivity fell far short of the long-term average. To some extent, both the earlier lag and the recent increase may have reflected changing trends in the occupational composition of employment. In 1956, and to a somewhat smaller extent in 1957, there was a rapid expansion in "overhead" or "nonproduction" employment of all types—managerial, technical, and clerical (see Charts III and IV). These increases evidently in part reflected the rapid growth of research and development activities and in part were attributable to a relaxation in cost-consciousness resulting from the prosperous business situation. In manufacturing, for example—the only industry for which the data permit a direct comparison—total employment held more or less steady through 1956 and early 1957 even though the number of production workers was tending to decline. There is scattered evidence that similar developments were also occurring in other industries.

The recession resulted in some cutbacks in clerical and sales staffs, and also slowed down the expansion in managerial and professional jobs (the latter is more apparent in monthly and quarterly data than in the annual averages shown in Chart III). At the same time, the earlier increases in outlays on plant, equipment, and research probably were beginning to result in production economies. So long as production was still declining, the effects of the drop in "overhead" employment and of new production methods

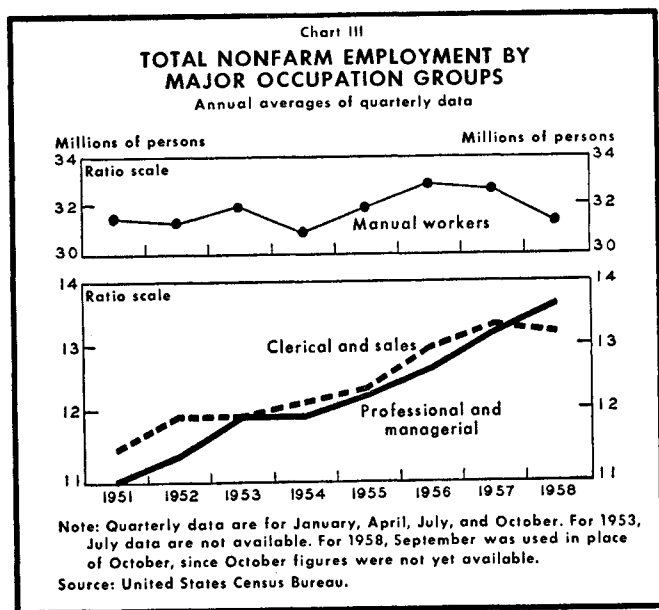
in speeding up productivity growth did not become evident, mainly because salaried staffs, unlike factory workers, were not being curtailed so sharply as production. Now that output is increasing, however, earlier economies and investments in modernization appear to be paying sizable dividends in terms of lower costs, and particularly lower labor costs.

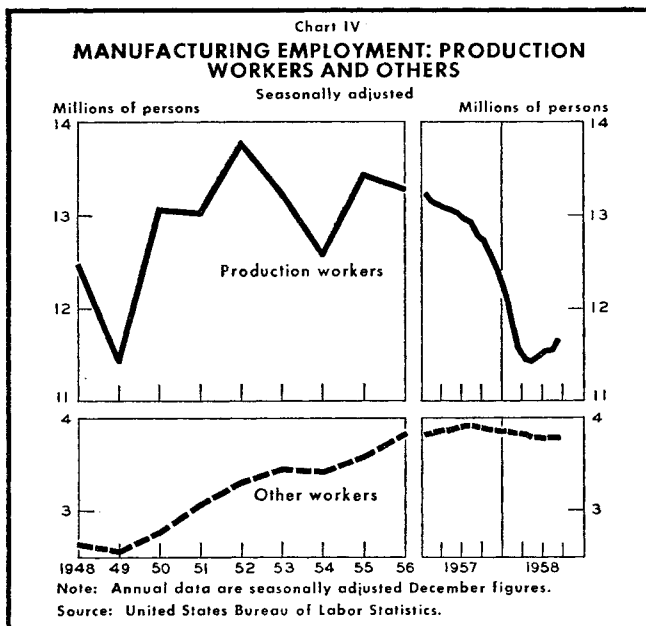
The shifts in the demand for various types of labor may pose some longer range problems in reducing unemployment to the levels prevailing before the recession. Since the war the demand for the relatively less skilled categories of factory workers has been growing only very slowly. For instance, when manufacturing output was at its all-time peak at the end of 1956 and in early 1957, production-worker employment was only 3 or 4 per cent larger than at the peak which preceded the recession of 1948-49, while output had increased by 41 per cent. Moreover, even though the recent leveling-off in the employment of clerical and sales workers has been largely attributable to the recession, it may also reflect to some extent longer range shifts in the direction of self-service, the use of business machines, and the like. While substantial increases in employment may be expected to accompany further recovery now that involuntary part-time employment has been considerably reduced, the experience of recent years suggests that more and more advanced training and skills on the part of the labor force may be required if the people looking for work are to find employment.

COSTS, PROFITS, AND PRICES

The other side of the coin to the rise in productivity in recent months is, of course, a sizable reduction in unit costs. In manufacturing as a whole, the direct wage costs of production workers per unit of output (excluding fringe benefits) were as low or lower during the third quarter than at any time since mid-1951, except for a one-year period from mid-1954 to mid-1955. Similar statistics for salary costs of manufacturing firms are not available. However, employment of nonproduction workers has been reduced since the recession began and has not increased since the start of the recovery, even though output has advanced sharply (see Chart IV). Thus, in recent months at least, there has very likely been some reduction in salary as well as wage costs per unit of output. In addition, prices of raw materials, though they have advanced recently, generally remain below year-ago levels, and prices for capital equipment have now been stable for nearly a year.

Corporate profits improved slightly in the second quarter over the poor first-quarter rate, even though total busi-





ness sales remained roughly unchanged. But in the third quarter, with sales rising and costs falling (on a seasonally adjusted basis), there was almost certainly a more substantial improvement. Significantly, third-quarter company reports show a fair sprinkling of "sales down, profits up" (from a year earlier), in contrast to the reverse situation that was so common in 1957. These reports provide further evidence that since last year many firms have been able to reduce costs substantially despite the continued rise in wage rates.

During the recession, price reductions on industrial goods were relatively few, except for mostly unpublicized discounts from list prices. Now with demand increasing, fresh upward pressures on prices are, of course, to be expected. Discounts on industrial goods are reportedly becoming both smaller and less frequent, and here and there list prices are being raised—paradoxically, chiefly in the durable goods sector, where, in contrast to non-durables, most industries still have a long way to go before regaining previous peaks of output and sales. Foreign competition is a limiting factor in exceptional cases only. However, the gains in productivity and the continuation of vigorous competition resulting from ample capacity should, at the least, exert a restraining influence on prices. Beyond that, reduced costs may make feasible the lowering of prices in lines where some strong stimulus seems needed to get consumer buying off "dead center".

While there has been considerable discussion in recent months of the threat of inflation, most businessmen apparently do not anticipate a price rise of such magnitude as to

make it worthwhile to stock up ahead on inventories. Although inventory liquidation slowed to an annual rate of \$4 billion in the third quarter, from \$8 billion in the second and \$9.5 billion in the first, it was still about as rapid as at any other time in the postwar period. The hedge buying that flared briefly during the Middle East crisis subsided quickly. Indeed, there are reports that in some specialty lines, manufacturers and retailers have trimmed stocks to such an extent that there is some question as to their ability to fill Christmas demand. In some other retail lines, in which stores had been replenishing stocks that had been allowed to run down during the recession, the accumulation appears to have halted more recently as sales gains have remained relatively modest. There have been reports recently, however, of rebuilding of steel inventories among the steel industry's customers.

But even in the absence of inventory "speculation", the stimulus which economic activity has been receiving from the slowing-down in inventory liquidation seems likely to be maintained for at least some time. The principal boost to inventories is expected to be in the automotive sector, once full-scale production is resumed. Dealers' stocks of new cars declined considerably more than usual over the summer, and will probably increase correspondingly in November and December. Concurrently, the auto industry may enlarge its working stocks of parts and raw materials as production increases. According to reports in steel industry publications, the auto industry has not done much anticipatory buying in advance of the production pickup, and the available statistics are consistent with this view. In August, the latest month for which data are available, the seasonally adjusted book value of inventories held by the automotive industry was 23 per cent lower than last November, the first month of full-scale production of the 1958 models. In most other industries that had been reducing stocks rapidly earlier this year, monthly data now also show a slackening in liquidation. With production and sales generally rising, there seems to be no reason why liquidation should not continue to taper off.

CONCLUSION

The continued expansion in employment and incomes may provide the impetus to consumer demand which could once again speed up the rate of business recovery. The need for additional stimulus is becoming all the more apparent, since in the not-too-distant future many of the factors that have made possible the degree of recovery already achieved may have largely spent their force. Military orders have crested out, following their surge in the first half of the year; the loosening in the supply of mort-

gage funds which promoted the spurt in housing starts has given way to a slight tightening; and exhaustions of unemployment insurance rights are now sizable even in those States where the benefit periods have been temporarily extended as permitted by recent Federal legislation.

Money Market in October

The money market was moderately firm in October, as it had been in September, with a generally comfortable availability of reserves to support credit needs. Although free reserves in the banking system fluctuated rather widely from week to week, principally in reflection of changes in the level of float, the average level of free reserves for the month as a whole was approximately the same as that for September. The even character of the money market was accompanied by an improved atmosphere in the United States Government securities market, as the bearish sentiment that emerged in response to the Treasury's cash financing announcement in late September proved to have been overdone. Both new Treasury issues moved to good premiums above issue price and helped to strengthen the entire market. Day-to-day fluctuations in prices and market rates of interest were quite pronounced, particularly on short-term Government securities, but there was no evidence of a trend toward either higher or lower rate levels in these movements.

On October 23, the Reserve Banks of Philadelphia, Richmond, St. Louis, Minneapolis, and Dallas announced that they were raising their discount rates from 2 to 2½ per cent, effective on the following day. The move was explained as primarily a technical adjustment to bring discount rates into closer alignment with other short-term interest rates and had practically no effect on market rates. These Reserve Banks were joined at the 2½ per cent rate by the Reserve Banks of Atlanta on October 28, Cleveland on October 30, and Chicago on October 31. On October 15, the Board of Governors announced an increase from 70 per cent to 90 per cent in margin requirements for securities transactions, effective on the following day. The effective rate on Federal funds held at 2 per cent on almost every business day before the change in discount rates, after which, although there was occasional trading reported above 2 per cent, the effective rate declined to as low as ⅛ of 1 per cent.

MEMBER BANK RESERVE POSITIONS

Fluctuations in member bank free reserves during the five statement weeks ended in October were fairly wide,

Although the drop in business spending, the major factor in the recession, appears to have leveled off, it seems unlikely that private investment, whether in fixed capital or in inventories, could rise strongly or for very long unless supported by vigorous consumer demand.

but the \$133 million average for the month as a whole was little changed from the average for the four statement weeks ended in September. Excess reserves averaged \$559 million during October and member bank borrowing from the Federal Reserve Banks \$426 million, in both cases somewhat lower than during the preceding four weeks.

The various operating factors influencing member bank reserve positions fluctuated widely during the month, but the effects of these movements were in good part offset by System open market operations. Despite the fairly wide fluctuations in free reserves of all member banks taken together, the reserve positions of the reserve city and cen-

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

Factor	Daily averages—week ended					Net changes
	Oct. 1	Oct. 8	Oct. 15	Oct. 22	Oct. 29	
Operating transactions						
Treasury operations*	+ 55	+ 1	+ 64	- 70	- 47	+ 3
Federal Reserve float	- 299	+ 7	+ 11	+ 479	- 424	- 226
Currency in circulation	+ 70	- 137	- 146	+ 63	+ 136	- 14
Gold and foreign account	+ 18	- 74	- 94	- 21	+ 4	- 167
Other deposits, etc.	- 28	+ 48	- 71	+ 84	+ 48	+ 81
Total	- 186	- 153	- 238	+ 535	- 282	- 324
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 47	+ 203	+ 210	- 111	+ 58	+ 407
Held under repurchase agreements	-	-	+ 145	- 145	-	-
Loans, discounts, and advances:						
Member bank borrowings	- 33	+ 33	+ 39	- 104	+ 87	+ 22
Other	+ 1	-	-	-	+ 1	+ 2
Bankers' acceptances:						
Bought outright	-	+ 2	+ 1	+ 1	+ 1	+ 5
Under repurchase agreements	-	-	-	-	-	-
Total	+ 16	+ 237	+ 395	- 358	+ 145	+ 435
Total reserves	- 170	+ 84	+ 157	+ 177	- 137	+ 111
Effect of change in required reserves†	+ 46	+ 28	- 246	- 78	+ 94	- 156
Excess reserves‡	- 124	+ 112	- 89	+ 99	- 43	- 45
Daily average level of member bank:						
Borrowings from Reserve Banks	400	433	472	368	455	426‡
Excess reserves†	492	604	515	614	571	559‡

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

* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for five weeks ended October 29.

tral reserve city banks remained fairly steady.

During the first statement week ended in the month, reserves were drained from the banks by a sharp decline in float which more than offset small reserve gains from other operating factors. The principal factors absorbing reserves in the second and third weeks were an increase in currency in circulation, and gold and foreign-account transactions; reserves also were absorbed during this period by a sharp increase in required reserves, mainly reflecting payment for the Treasury's new special bills and notes on October 8 and October 10, respectively. In the final two statement weeks of October, unusually wide swings in float first caused a sharp bulge in reserves and then a net drain in the final week.

System open market operations over the period were designed to offset a considerable part of the fluctuations in reserve positions caused by the above-mentioned factors. Over the first three statement weeks, average System outright holdings of Treasury securities increased by \$460 million, and holdings under repurchase agreements, which were extended only in the week ended October 15, showed a net increase of \$145 million in that week. In the following week, a reduction of \$111 million in outright holdings and the maturing of the repurchase agreements with Government securities dealers neutralized much of the large additions to reserves resulting from the midmonth bulge in float. In the final week, average holdings were increased by \$58 million to offset drains in member bank reserves. Over the period from September 24 to October 29, the net increase in System holdings of Treasury obligations was \$513 million.

GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds fluctuated over a fairly wide range in light trading during October. After a slight downward movement in the first few days of the month, which extended the decline that had begun in the last week of September, prices rallied strongly for about a week. They then eased gradually lower on balance over the remainder of the month. Average yields on long-term Treasury securities rose to a peak of 3.86 per cent on October 3, subsequently declined to as low as 3.68 per cent on October 9, and closed the month at 3.77 per cent.

The downward price adjustment in the opening days of the month was a continuation of the movement that had followed the announcement on September 25 of the terms of the Treasury's new cash offering. However, the two new issues, which had fallen to a slight discount in early "when-issued" trading which began on September 30, strengthened after the Treasury announcement on Octo-

ber 2 of a 44 per cent allotment on subscriptions for the \$2.5 billion of special 219-day Treasury bills and a 35 per cent allotment on subscriptions for the \$1 billion of 13-month 3½ per cent notes. Both issues traded at substantial premiums above issue price for the balance of the month.

The market began to recover on Friday, October 3, and moved ahead vigorously in the following week, apparently in response to market expectations that further moves in the direction of credit restraint were not in prospect. The rally, which was the sharpest and most prolonged since the June downturn in the Government securities market, lost its upward momentum on October 10.

Subsequently, most issues lost a large part of their gains, as the market began to consider the possible impact of the Treasury's new cash financing which was reported to be scheduled for November. There was no visible reaction on October 24 to the announcement the previous afternoon of the ½ per cent increase in the discount rates of five Reserve Banks, and prices closed the month on a slightly firmer note. Over the month, securities maturing before 1963 showed gains of up to 1½ of a point, while those in the 1963-72 range were mixed. Most longer term bonds were about 1 point higher, but the 3's of 1995 closed down 1 point over the month.

The rise in Treasury bill yields, which had been less pronounced in September than in August, came to an end in October despite the fact that each of the regular bill auctions during the month was increased by \$100 million to \$1.8 billion. Yields declined sharply early in the month as a result of strong demand, with longer bills falling to about 2½ per cent on October 3 from almost 3 per cent on September 30. Although yields rose somewhat in the week of October 6-10, the auction held on Friday, October 10 (because of the Columbus Day holiday observed in some parts of the country on the following Monday) attracted a record \$3.1 billion of subscriptions. During the following two weeks rates on longer bill issues fluctuated irregularly around 2¾ per cent, and in the final week fell to about 2½ per cent. The average issuing rate established in the auctions eased from 2.920 per cent on September 29 to 2.668 per cent on October 6, rose again in the auction on October 10 to 2.927 per cent, and then slipped downward to 2.804 per cent on October 20 and to 2.647 per cent on October 27.

OTHER SECURITIES MARKETS

The improved tone in the market for corporate and municipal bonds that was evident during the latter part

of September continued during October, reflecting both the lighter volume of new issues as compared with earlier months this year and the reduced level of dealer inventories. Yields on high-grade seasoned issues changed only slightly during the month: Moody's index of yields on long-term Aaa-rated corporate bonds stood at 4.12 per cent at the end of October, as against 4.13 per cent at the end of September, and the yield index for similarly rated municipals came to 3.21 per cent as against 3.24 per cent.

Investor response to the month's new offerings was mixed. Among the corporate issues that were distributed quickly was an \$11 million flotation of 30-year Aa-rated utility bonds reoffered at 4.57 per cent, and a \$20 million flotation of A-rated 20-year industrial debentures reoffered at 5.16 per cent, both of which were floated early in the month. The well-received municipal offerings included a \$24 million A-rated issue, made at a net interest cost of 3.80 per cent to the borrower; this compared with a net interest cost of 2.89 per cent on a flotation by the same borrower in May.

During the month, an estimated \$280 million of corporate bonds for new capital purposes and \$360 million of municipal bonds were publicly marketed. The October total of \$640 million was substantially below the \$1,420 million of September flotations and the \$1,140 million offered in October 1957.

In the market for private short-term debt instruments, four major finance companies announced a ¼ of 1 percentage point reduction in the rates they pay on directly placed paper of 30- to 89-day maturity. This rate cut, effective on October 24, brought the rate paid by all five major companies on 30- to 89-day finance paper to 2¼ per cent. Longer maturities remained unchanged. On October 28 commercial paper dealers lowered their rates by ⅛ of 1 percentage point, to bring the offering rate on prime 4- to 6-month paper to 3⅛ per cent.

MEMBER BANK CREDIT

Total loans and investments of the weekly reporting member banks declined by \$56 million during the five weeks ended October 22, with a small decline in both loans and investments. There was an increase in investments in the weeks of October 8 and October 15, when the banks took ownership of the still-unsold portions of their allotments of the special 219-day Treasury bills and the new 13-month notes. But the expansion in bank holdings of Government securities during these weeks was much smaller than their allotments of the new issues, thus indicating rapid redistribution to other investors, and during

each of the other three weeks holdings of these securities declined. Since the beginning of the year, bank Government securities portfolios have increased by \$5.4 billion, compared with a decline of \$1.5 billion during the same period last year, but all of this year's net increase occurred in the first half of the year.

Commercial and industrial loans were reduced by \$193 million over the five-week period, partly due to large repayments by sales finance companies. This compares with a reduction of \$800 million in business loans during the corresponding weeks of 1957 and a drop of \$9 million in the similar period in 1956. The total decline in business loans thus far this year amounts to \$2.1 billion, as against an increase of \$680 million during the same period of 1957 and \$3.1 billion the year before. Since midyear (July 2), business loans have fallen by \$139 million, as against a decline of \$514 million in the comparable period in 1957; during the corresponding weeks of 1956, on the other hand, business loans expanded by some \$800 million.

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. 31, 1957 to Oct. 22, 1958
	Sept. 24	Oct. 1	Oct. 8	Oct. 15	Oct. 22	
Assets						
Loans and investments:						
Loans:						
Commercial and industrial loans.....	- 227	+ 28	- 67	+ 215	- 142	- 2,079
Agricultural loans.....	+ 7	+ 12	+ 3	+ 8	+ 11	+ 157
Securities loans.....	- 18	+ 123	- 88	+ 17	- 98	- 468
Real estate loans.....	+ 3	+ 40	+ 38	+ 75	+ 26	+ 560
All other loans (largely consumer).....	- 74	+ 59	- 20	+ 53	- 16	- 89
Total loans adjusted*.....	- 309	+ 265	- 128	+ 367	- 218	- 1,962
Investments:						
U. S. Government securities:						
Treasury bills.....	- 283	+ 61	+ 629	- 27	- 100	- 22
Other.....	- 165	- 95	- 77	+ 167	- 169	+ 5,453
Total.....	- 448	- 34	+ 552	+ 140	- 269	+ 5,431
Other securities.....	+ 6	- 3	+ 61	- 3	- 35	+ 1,606
Total investments.....	- 442	- 37	+ 613	+ 137	- 304	+ 7,037
Total loans and investments adjusted*.....	- 751	+ 228	+ 485	+ 504	- 522	+ 5,075
Loans to banks.....	- 260	+ 314	- 376	+ 146	- 117	+ 767
Loans adjusted* and "other" securities.....	- 303	+ 262	- 67	+ 364	- 253	- 356
Liabilities						
Demand deposits adjusted.....	-1,269	+ 436	- 374	+ 543	+ 567	- 184
Time deposits except Government.....	- 68	- 37	- 27	+ 8	- 13	+ 3,888
U. S. Government deposits.....	+ 818	- 301	+ 583	- 64	- 757	- 209
Interbank demand deposits:						
Domestic.....	- 833	+ 506	- 59	+ 722	- 974	- 1,071
Foreign.....	- 64	- 12	+ 3	+ 17	+ 52	- 199

* 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.

International Monetary Developments

MONETARY TRENDS AND POLICIES

UNITED KINGDOM. The British authorities lifted the remaining limitations on hire-purchase (instalment) buying on October 29 by abolishing the minimum downpayment and the maximum repayment period on hire-purchase sales of cars, radios, and television sets; a wide range of consumer durable goods as well as industrial and agricultural equipment had been freed from controls in September. These moves had been preceded by a substantial easing of credit restrictions and investment controls earlier this year.

Addressing the annual bankers' dinner at the Mansion House on October 16, the Chancellor of the Exchequer declared that the earlier measures, which had included four discount rate reductions and the removal of the ceiling on commercial bank lending, will contribute "to an orderly process of expansion with particular emphasis on investment in the private sector". He also stated that the government would be able to permit an increase in investment by the public sector during the 1959-60 fiscal year. The Chancellor expressed concern, however, over the British wage situation. He pointed out that during the past twelve months there had been an increase in wages that, although less than in the preceding year, exceeded on the average the increases in both productivity and the cost of living. He warned that a similar increase in the year ahead would handicap the competitive position of British industry in world markets.

The Governor of the Bank of England on the same occasion stated that there had been no violent upsurge in bank lending following the easing of credit, but that results so far showed "a significant increase for general business purposes". He declared that, in the event of renewed inflationary pressures, "it would not be desirable to have recourse again . . . to the system of requests to the banks to limit advances". The Governor commented that the special-deposits scheme, proposed as an alternative (see the August 1958 issue of this *Review*), appeared to be "the most flexible, the most obviously monetary in form, and the least open to possible abuse as a method of inflationary borrowing by government from the banking system". Turning to Britain's over-all economic situation, he pointed to "something of a dilemma between short-term and longer-term aims. In the short term we must try to prevent the economy, only recently recovering from long

years of overstrain, from running down fast or far: but in meeting this threat we must not build in new hostages to inflation in later years."

FRANCE. The Bank of France, effective October 16, reduced its discount rate to 4½ per cent from the 5 per cent rate in force since August 12, 1957. At the same time, the bank lowered to 7 per cent from 8 the penalty rate applicable to borrowing between 100 and 110 per cent of the ceiling set for each commercial bank. The penalty rate for borrowing in excess of 110 per cent of a bank's ceiling remained unchanged at 10 per cent; it had already been lowered from 12 per cent at the end of July. The latest reductions came against the background of some slackening in the rate of growth of economic activity and a moderate improvement in France's balance-of-payments position. These moves, together with the lowering in August of the required downpayments on instalment purchases of a wide range of household goods, indicate a readiness by the authorities to move cautiously toward relaxing the monetary restraint policy introduced in the spring of 1957. However, the easing of this policy is far from general at this time since the commercial banks' discount ceilings are being retained, and the banks, moreover, remain limited in the amount of short- and medium-term credit they may extend to the private sector.

EXCHANGE RATES

American-account sterling moved between \$2.80⁹/₁₆ and \$2.80¹⁵/₁₆ during October. There was good underlying commercial demand for sterling (in part by oil companies) during most of the month, and the demand for dollars in London appears to have been less than in September. The announcements during the month that Britain had had a sizable surplus of exports over imports in the year ended June 1958 and that its gold and dollar reserves had reached the highest level in seven years were important factors sustaining the strength of sterling. As the month ended, sterling was quoted at \$2.80²¹/₃₂ in a quiet and steady market.

Forward-sterling discounts fluctuated narrowly during the first half of October with the spreads for three and six months' deliveries narrowest at about ¹¹/₃₂ cent and ³/₄ cent, respectively, at the beginning of October and again at midmonth. In the latter half of the month the spreads tended to widen somewhat in a relatively small market, and on October 31 three and six months' forward sterling

were at discounts of $2\frac{1}{32}$ and $1\frac{1}{8}$ cents.

Transferable sterling advanced to $\$2.79\frac{7}{16}$ by October 6 on Continental demand, but then quickly eased to $\$2.78\frac{15}{16}$ as such demand subsided. Subsequently, the quotation recovered to about the $\$2.79\frac{1}{4}$ level where it was generally maintained in a quiet market. Securities sterling, quoted at $\$2.77\frac{7}{8}$ on October 1, moved up markedly to $\$2.79\frac{1}{8}$ on the following day under strong bidding on behalf of European interests. A subsequent reaction dropped the quotation to $\$2.77\frac{7}{8}$ by October 10, from which it recovered to $\$2.78\frac{3}{8}$ as investor interest developed toward midmonth. Thereafter, securities sterling moved between $\$2.78$ and $\$2.78\frac{3}{4}$ in a featureless market and was quoted at $\$2.78\frac{1}{2}$ at the month end.

The Canadian dollar quotation moved rather erratically during October, ranging between $\$1.02\frac{31}{64}$ and $\$1.03\frac{23}{64}$. From time to time there was good demand on commercial account from both London and the United States. Also, there was some activity on the part of Canadian paper companies whose offerings of United States dollars added to the demand for Canadian funds. The auction of Canadian oil leases and the announcement of a pending new issue of a Canadian municipal security also brought temporary improvements in the Canadian dollar rate, although investment activity generally was on a reduced scale during October. Near the end of the month the Canadian dollar dipped below $\$1.03$ but by the month end had improved to close at $\$1.03\frac{1}{4}$.

The Significance and Limitations of Free Reserves

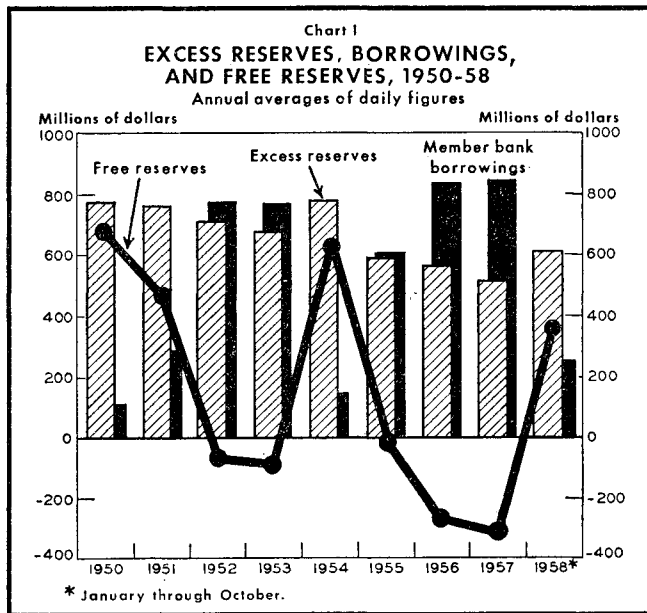
Each Friday morning, in the financial pages of major newspapers, there appears an item on member bank reserve positions. And, more often than not, the emphasis in these stories falls heaviest on the recent change in "free reserves"—or, as it is termed when negative, "net borrowed reserves". The prominence given this measure of reserve availability reflects in part the desire to find a single measure for interpreting Federal Reserve policy actions that are necessarily complex. While changes in the availability of bank reserves, and the resulting pressures exerted upon the liquidity of banks and their capacity to expand credit, lie at the heart of monetary and credit control, there is an understandably human tendency at times to oversimplify. It is therefore important that the meaning of the free reserves concept be thoroughly understood, and its limitations always kept in mind. Especially is it important to realize that a specific level of free reserves (negative or positive) may be associated with one degree of credit restraint or ease at one time, and with significantly different credit conditions in other periods.

THE MEANING OF FREE RESERVES

The concept itself is, of course, an outgrowth of the legal requirement that member banks hold reserves equal to a specified percentage of their deposits. Member bank reserve balances in excess of these required reserves are known as "excess reserves", and as such they are an indicator of surplus primary liquidity in the banking system. However, when member banks are obtaining a relatively large proportion of their reserves by borrowing from the Federal Reserve to meet temporary reserve needs, a given volume of excess reserves does not have the same

significance, in terms of reserve availability and credit expansion potential, as when the banks have little need for recourse to borrowing. This stems from the fact that member bank borrowing from the Reserve Banks, although it is a source of reserves and therefore potential backing for bank deposits, may be undertaken only temporarily by any single bank. For the individual bank it is a stopgap. Rather than resort too frequently or on too large a scale to the "discount window", a member bank must take other steps to maintain or restore its reserve position—perhaps through liquidating investments or restricting loan volume. Thus a bank in debt to the Federal Reserve is always under pressure, because it is necessarily in search of funds in order to repay.

In the early years of the Federal Reserve System, the volume of member bank borrowings was widely used as an index of money market pressures, particularly after the mid-twenties, as the realization grew that changes in this volume moved in close tandem with interest rate changes. During most of the 1930's, however, member banks held large amounts of excess reserves, and did little or no borrowing at the Reserve Banks after the "bank holiday" in 1933. Attention thus shifted to excess reserves as a measure of reserve availability and potential credit expansion. In more recent years, many member banks have again found it necessary to borrow frequently, even while excess reserves existed elsewhere in the banking system. Indeed, near the close of a reserve-accounting period, the same member bank might simultaneously be holding excess reserves and borrowing additional reserves from the central bank in order to meet a reserve deficit accumulated earlier in the period. Thus, taken alone, neither excess



reserves nor borrowings can provide an adequate continuing measure of credit availability.

To meet the need for such a measure, the concept of "free reserves"—defined as excess reserves less member bank borrowings from the Reserve Banks—was developed. By the same token, "net borrowed reserves", or "negative free reserves", exist when total member bank borrowings from the Federal Reserve Banks are larger than excess reserves.

The fluctuations in free (or net borrowed) reserves, excess reserves, and borrowings from the Reserve Banks are shown in Chart I for the period since 1949. It may be noted that, while excess reserves have been fairly stable, free reserves have moved over a wide range, marking out the major swings between monetary ease and restraint. Because excess reserves tend to vary to a relatively small extent, it is sometimes satisfactory to use member bank borrowings alone, rather than free reserves, as a measure of greater or less credit restraint. At times, however, there will be sizable movements (or small, but still significant, movements) in excess reserves that are automatically picked up by the free reserves-net borrowed reserves concept, but that might be lost from sight if borrowings were the sole criterion.

The volume of free reserves in the banking system is affected by a number of influences. First, there are what may be grouped together as technical market or operating factors, which affect mainly the reserve base, and include among others the volume of Federal Reserve float, the amount of currency in circulation, and various inter-

national transactions.¹ Secondly, there is the amount of required reserves, as determined by the volume of bank deposits (which in turn reflect primarily the amount of bank credit outstanding). Finally, there are Federal Reserve operations, either in the form of open market operations or in the form of changes in reserve requirement percentages. The latter are usually made only at infrequent intervals to effect massive changes in reserve availability. Open market operations are conducted flexibly from day to day and often are directed only at offsetting the effects of other influences on the reserve base, but they are also used to bring about major shifts in the availability of reserves and hence in credit conditions.

Obviously, such major policy shifts are reflected, at different times and under different conditions, in different levels of free reserves. When free reserves are both positive and relatively high, member banks would usually find themselves actively seeking to acquire earning assets, and hence increasing the money supply. But the level of free reserves at which such results may be expected is not fixed and immobile. The figure would have to be higher, for example, when the national total of free reserves included a heavy concentration in those member banks that habitually maintain substantial excess reserves (usually "country" banks). Money market banks are generally more aggressive in seeking outlets for excess funds than are country banks, so that the significance of any national total of free reserves, or of net borrowed reserves, must depend in part upon the distribution of the total. The significance of any level of free reserves is clearly also influenced by such other factors as the existing state of bank liquidity and the strength of current demand for loans, both nation-wide and among classes of banks. At times when banks have, for example, higher ratios of loans to deposits, or of long-term loans to short-term loans, they may be less responsive to higher levels of free reserves. Should the demand for bank credit be unusually strong, somewhat lower levels of free reserves might well produce a suitable influence upon credit availability, and an appropriate rate of growth in the money supply.

When free reserves are held for some time at a relatively high level, member banks will not only continue to make loans available to their customers—and probably more readily available than at lower levels of free reserves—but they are also likely to seek out new investment

¹ These are described in *Bank Reserves, Some Major Factors Affecting Them*, Federal Reserve Bank of New York, 1953; and in *Federal Reserve Operations in the Money and Government Securities Markets*, by Robert V. Roosa, Federal Reserve Bank of New York, 1956 (pp. 66-76). Both publications are available on request from the Publications Division of this Bank.

opportunities aggressively, acquiring Treasury securities and other debt instruments as a means of putting these additional funds to work. But a time of credit ease and large free reserves is also a time of slackened business activity, so that the demand for loans that banks are willing to make may be weak. For this reason, banks will tend to increase their holdings of securities relative to loan assets. Thus a period of substantial free reserves is likely to be a time when banks are enhancing their secondary liquidity. In the course of this process, securities prices will be bid up, and the entire structure of money market interest rates will move lower—from yields on Treasury bills to rates on business loans. At the same time, as the banks acquire investments, and deposits increase correspondingly, the money supply expands, the liquidity of the nonbank public is increased, and interest rates on bonds and mortgages tend to decline. It is in this way, through the pressure of an enlarged supply of bank funds seeking investment against a reduced demand for bank credit, that there is a tendency for a high level of free reserves to be associated with falling interest rates, increased liquidity in the banking system, expansion of credit, and growth in the money supply.

In a similar way, the maintenance of free reserves at relatively low levels (and especially levels going well down into the negative range) sets in motion an opposite set of reactions. To avoid becoming too deeply or too steadily indebted to the Reserve Banks, member banks tend to finance the expansion of their loans by liquidating secondary reserve assets. Under this continued selling pressure, securities prices generally fall and interest rates rise. Or in some cases, as securities prices fall, banks may become increasingly unwilling to take the capital losses entailed in selling their investments and may turn instead to limiting the extension of loans. In any event, the result of sustained net borrowed reserves is restraint on bank credit, a lessened expansion (or possibly a moderate contraction) of the money supply, and a curbing of liquidity both within and outside the banking system.

It is important to realize, in addition, that the easing or restraining effects are related primarily to the level of free reserves that is being maintained and are not dependent upon continuing further changes in that level. To be sure, as noted above, a given magnitude of free reserves may induce different degrees of ease at different times, depending on a variety of influences. But, in maintaining whatever degree of ease or restraint has been achieved under the conditions prevailing at any particular time, it is not necessary for free reserves or net borrowed reserves to rise continuously to higher and higher levels, as has

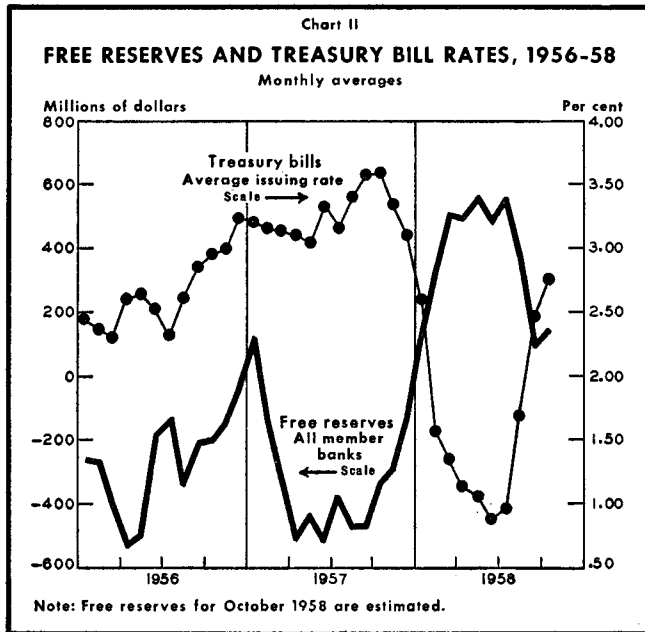
sometimes been supposed. For example, when a level has been found at which banks genuinely "feel easy", they will continue adding securities to their portfolios, thus increasing their own secondary liquidity and the money supply, as long as their reserve balances continue (in the aggregate and on average) to increase sufficiently to cover the growth in their required reserves. This process does not necessarily require any further increase in the average volume of free reserves.

LIMITATIONS OF THE CONCEPT

It is the loose fit of any specific level of free reserves to any degree of credit ease or restraint that creates the basic limitation of the concept as a precise indicator of actual credit conditions. For this reason, along with other more technical considerations, it is a mistake to assume a rigorous correspondence between, on the one hand, any given level of free reserves and, on the other hand, the availability of reserves to banks or the availability of bank credit to the nonbank public.

LIMITED MEASURE OF RESERVE AVAILABILITY. Suppose, for example, that the Federal Reserve authorities were to try to rely on this measure alone, and elected to maintain a constant level of free reserves, well above any levels previously attained, as a sure sign of genuine ease. As banks make use of existing free reserves to enlarge their investment or loan portfolios, deposits and thus required reserves will rise, thereby reducing the level of free reserves. So long as the monetary authorities wish to maintain the target level for free reserves, they must continue to create new reserves (probably through open market purchases) to match the increase in required reserves. And each new injection of reserves may simply disappear into required reserves as the banks lend or invest even more. There thus may be a continuing increase in total reserves, the money supply, and the liquidity of the economy, without any appreciable rise in the averages of free reserves. Relatively constant free reserves at this "disappearance" level would not imply a constant level of reserve availability (or of bank credit).

This description applies equally well, it may be noted, to periods of Treasury financing. During such periods, the central bank usually attempts to maintain an "even keel", so far as its own operations are concerned. With the provision of reserves sufficient to enable the banks to fulfill their underwriting function, and initially carry the bulk of the securities by means of temporary credit creation, the end result, so far as free reserves are concerned, may be little or no change. Moreover, once the distribution phase begins, reserves may be reabsorbed



in whole or in part by the central bank, while the bank-held securities are dispersed into the hands of ultimate investors. Thus, it is quite possible that a well-integrated program of central bank aid to the market and the Treasury, during the technical phase of subscription and initial redistribution, may result in substantial changes up and down in total reserves, without any appreciable change in the averages of free reserves from week to week.

An illustration of this general limitation of the concept may be found in the experience of the first half of 1958 (see Chart II). Following a steep rise in late 1957 and early 1958, as credit policy shifted from restraint to ease, aggregate free reserves remained around \$500 million from March through July 1958. Yet Treasury bill yields and other short-term interest rates continued to head lower for several months after the plateau in free reserves was reached, as did loan-deposit ratios for weekly reporting banks. The nation's money supply also expanded considerably further after the first quarter of the year. Thus, a process which resulted in a relatively steady (though indeed high) level of free reserves meant the continuous supplying of reserve balances, and fostered greater and greater liquidity and an expansion of the money supply.

LIMITED MEASURE OF BANK CREDIT AVAILABILITY. However, the mere existence of additional reserve balances will not by itself insure that member banks will be willing to extend additional credit to the nonbank public. Judging the availability of bank credit merely on the basis of the free reserve level might be compared to weighing

the liquidity of a corporation simply on the basis of its current cash balance and some particular segment of its current short-term debt. Obviously, a variety of other assets and liabilities, as well as records of past performance, must also be taken into account. Thus, in judging the availability of credit from the banking system, consideration must be given to such factors as the distribution of bank assets among loans and investments of varying degrees of liquidity, the size and composition of bank liabilities, and the level and structure of interest rates. In addition, explicit consideration must be given to the manner in which the banking system has responded to past patterns of free reserves.

In the latter part of 1956, for example, credit availability was generally under pressure even though net borrowed reserves declined markedly (that is, free reserves rose). The maintenance of restraint in this case was partly a result of the usual seasonal build-up of demand for bank credit. However, it was also an outgrowth of the increasing pressures that had been brought to bear on the banking system through 1955 and 1956, as the Federal Reserve System sought to limit the rapid expansion of credit. In particular, bank liquidity had been steadily diminishing. Moreover, new uncertainties were injected into the money and capital markets by the Suez crisis and the approach of a national election.

Accordingly, it was considered desirable, in order to avoid unduly heightening the degree of restraint, to ease up somewhat on the level of free reserves. Thus, as indicated in Chart II, free reserves rose (or, more accurately, net borrowed reserves declined) substantially in the last several months of 1956 while, nonetheless, Treasury bill rates and other money market yields moved considerably higher.

VOLATILITY. At a more technical level, the usefulness of free reserves-net borrowed reserves as an indicator of credit conditions is limited by its tendency to fluctuate sharply in short periods. To some extent, these swings occur because the factors that affect reserves cannot always be fully foreseen and offset by Federal Reserve open market operations. For example, the pre-Christmas outflow of currency into circulation might proceed more rapidly than usual, causing an unexpected tightening of reserve positions. Usually, if the unforeseen easing or tightening lasts for only a very short time (say for a few days), the effects on credit conditions will be quite small, perhaps extending only to the market for Federal funds² and the shortest

² In this market, deposits with the Federal Reserve Banks are transferred among member banks, flowing from banks with temporarily redundant reserves to banks with current reserve deficiencies, and the rates charged and paid fluctuate below (and up to) the discount rate.

dated Treasury bills. But if the "aberration" lasts for a longer time, or if market psychology at the time is for some reason particularly sensitive to hints of possible changes in credit conditions, the reaction may be considerably greater.

Not all of the fluctuation in free reserves is a result of such unexpected developments; at times, relatively large short-term movements are foreseen but not offset. For the most part, as noted above, very short-run changes in the statistics have little material effect on the credit climate; indeed, the attempt to smooth out each wiggle in the statistics might have much more disturbing market repercussions than the fluctuation in free reserves itself. For example, there is typically a rise in free reserves (or decline in net borrowed reserves) at about the third week of each month, coinciding with the regular monthly rise in float and return flow of currency. To offset fully the reserve bulge caused in this way would require a rapid succession of reversals in the direction of Federal Reserve open market operations, which would tend to upset and confuse the money market. To a considerable extent, the more alert participants in the market have become accustomed to an increase of free reserves in the third week of the month; since the condition is recognized as being only temporary, it does not produce the credit-easing effects sometimes associated with higher free reserves. Offsetting action often is taken but never mechanically, and only rarely would the fluctuation be fully counteracted.

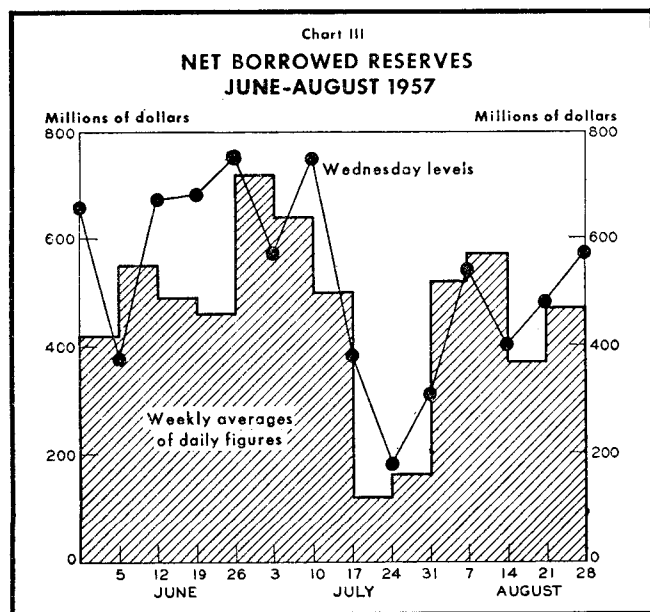
Some of these instances of volatility are illustrated in Chart III, which shows weekly average net borrowed

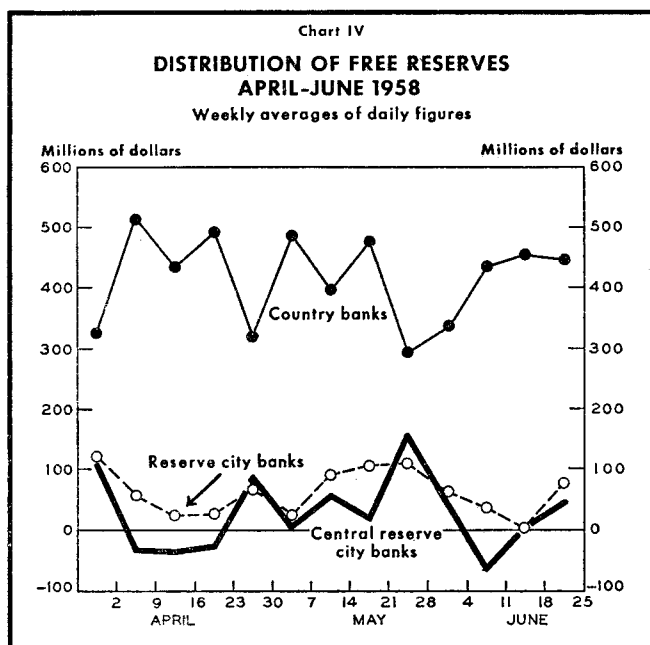
reserves and Wednesday levels of net borrowed reserves over the three-month interval June through August 1957. This was a period of sustained monetary restraint; Federal funds were in continuous demand and average issuing rates in the weekly Treasury bill auctions ranged from about 3 to 3½ per cent—not a particularly wide range of movement for a three-month period. Yet weekly average net borrowed reserves fluctuated between \$117 million and \$723 million.

The short-run volatility of net borrowed reserves is strikingly illustrated by the sharp dip in late July 1957. At this point, increases in float and a return flow in currency combined forces to ease reserve positions by considerably more than had been anticipated. A complicating factor at the time was a huge Treasury refunding operation, which produced a great deal of "churning" in the money market as investors moved into or out of "rights" to the exchange. This tended to create a much greater degree of firmness in the money market than would be suggested by the low level of net borrowed reserves at the time. In early August, with the Treasury financing operation out of the way, there was a swift return to the previous range of net borrowed reserves—again without the sharp tightening of credit conditions that might have been expected merely on the basis of the reserve statistics.

Chart III also points up the fact that even a period so short as a week may contain fluctuations of an appreciable magnitude. While daily figures are not published, the statistics for each Wednesday (the closing day of the statement week) are made available and, as may be seen from the chart, these Wednesday levels often diverge widely from the average for the full seven days of the period, thus indicating significant volatility within the week.

GEOGRAPHIC DISTRIBUTION. Probably the most frequent cause of week-to-week variability in the condition of the money market is not the aggregate volume of free reserves but rather changes in the geographical distribution of these reserves. For example, a dealer in Government securities, located in the central money market, might see from the weekly figures published on Friday morning that total member bank free reserves averaged \$500 million in the statement week ended the previous Wednesday, and then wonder why he had experienced any difficulty in arranging bank loans to finance his firm's securities holdings. More often than not, the answer will be that free reserves were concentrated in country banks or possibly in some of the reserve city banks as well, while the larger banks in other centers and the New York money market banks had little or none to spare.





In Chart IV, the geographic pattern of reserve distribution is shown for the second quarter of 1958. Over this interval, weekly average free reserves for all member banks taken together moved between \$400 million and \$600 million—a relatively narrow range. In early April, however, there was a sizable movement of reserves from banks in financial centers toward country banks, producing some firmness in the money market despite the ample volume of aggregate free reserves across the country. At the end of April the money market became very easy, with the Federal funds rate moving in a range well below the discount rate (then $1\frac{3}{4}$ per cent) and dropping occasionally to as low as $\frac{1}{8}$ of 1 per cent, owing chiefly to the more comfortable reserve position of the money market banks. Toward the middle of June, free reserves again became concentrated at country banks and some firmness returned to the money market even though nation-wide free reserve figures remained high. The moderate pressures on money market banks at this time stemmed in large part from seasonal tax borrowing and the financing needs of Government securities dealers and others which were unusually heavy because of Treasury debt operations.

Fluctuations in the geographic pattern of reserve distribution are, in a fundamental sense, usually much greater than is indicated in Chart IV. For example, when New York and Chicago banks show net borrowed reserves, it is typically a sign that they are also heavy buyers of Federal funds. Such purchases tend, of course, to make the net borrowed reserves of these banks lower than they would otherwise be. In large measure, it is these heavy demands for Federal funds, as well as reserve adjustments through such means as liquidating Treasury bills or reducing the volume of dealer loans, that gives the money market a tight atmosphere.

CONCLUSION

For all its limitations, the free reserves concept remains a useful guide to the interpretation of credit policy. It cannot stand alone, as a single, all-purpose indicator of liquidity or credit availability, but for that matter neither can any other measure. Even changes in the discount rate, although often taken by the general public as a signal of central bank intentions, may signify nothing more than a technical adjustment to prevailing market rates of interest. However, viewed together with other factors, such as the banking system's ratio of loans to deposits, the size and turnover rate of the money supply, the volume and growth of bank credit, and trends in various market interest rates, and with due regard for regional differences around the country, the amount of free or net borrowed reserves can give a useful lead in the interpretation of changing credit conditions. Clearly, it is more meaningful than either excess reserves, or total borrowings, taken alone, and represents another in the continually unfolding series of aids that can be used in analyzing current monetary developments and Federal Reserve policy.

Additional copies of the foregoing article on "The Significance and Limitations of Free Reserves" are available to educational institutions. Requests should be directed to the Publications Division, Federal Reserve Bank of New York, New York 45, N. Y.