FEDERAL RESERVE BANK OF NEW YORK

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The Business Situation

Economic activity rose at a somewhat more rapid pace in March, partly as a result of inventory rebuilding. Steel output advanced sharply, setting a new monthly record, while automobile production benefited from the end in February of an important suppliers' strike. Construction activity remained on the record high plateau of recent months, and an advance in business capital outlays was indicated by the latest Commerce-Securities and Exchange Commission survey of capital spending intentions. According to press reports of preliminary estimates by Government statisticians, based on incomplete data, gross national product rose in the first quarter by about $11 billion to the vicinity of $464 billion. Unemployment remained high in February, but weekly data on unemployment insurance claims suggest some improvement may have occurred in March. Consumer prices have remained steady, but sensitive industrial raw material prices rose in March.

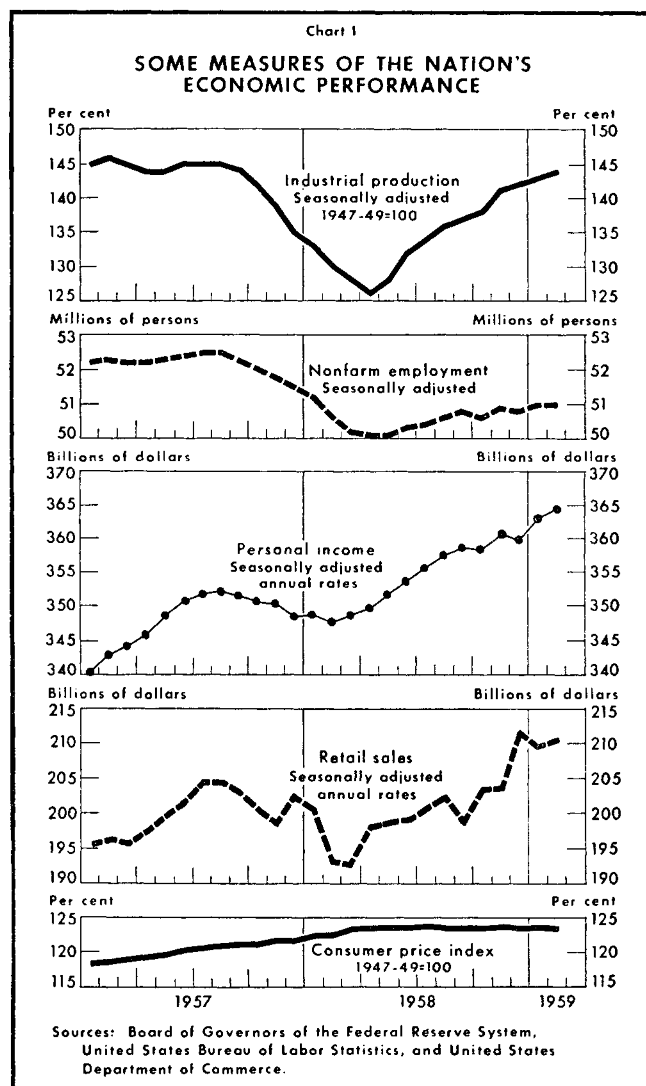
Industrial production advanced by one point in February for the third successive month. This brought the Federal Reserve Board's seasonally adjusted index back to 144, just one point short of the pre-recession levels of the summer of 1957 (see Chart I). Output apparently advanced further in March. Steel production, spurred by inventory buying, was at 92.9 per cent of capacity in the week ended March 29, compared with the 88.5 per cent achieved in the last week of February, and a similarly high level of operations is generally expected for the second quarter. The output of passenger cars bounced back in March as a major producer resumed full production after settlement of a labor dispute in the glass industry. There were, however, some cutbacks by other auto producers, as stocks in dealers' hands climbed to over 800,000 units. Other signs of rising industrial output in March were the weekly advances in freight carloadings and electric power production.

Business inventories have been expanding. In January manufacturers' stocks rose significantly for the first time since August 1957, after shrinking by $5 billion in the intervening months. Presumably most of this build-up was in steel, for which new orders rose sharply in January. Inventories also rose at the retail level, reflecting the further increase in dealers' stocks of new cars; elsewhere in retail trade, however, and also in wholesale trade, inventories declined.

Consumers apparently entered 1959 feeling significantly better about their own prospects than in early 1958, according to the Federal Reserve Board's annual survey of consumer finances. Spending plans of the households taking part in this survey were moderately above the previous year, and particularly strong in the case of houses and home improvements. In fact, actual housing starts in January and February were at a seasonally adjusted annual rate of over 1.3 million which, although about 100,000 below the November-December rate, was 38 per cent higher than in January-February 1958. Retail sales in February apparently were again maintained close to December's peak rate. Sales of cars have continued to run well ahead of last year's depressed levels but through mid-

Chart I

SOME MEASURES OF THE NATION'S ECONOMIC PERFORMANCE



Sources: Board of Governors of the Federal Reserve System, United States Bureau of Labor Statistics, and United States Department of Commerce.

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March were considerably below the 1956-57 pace. Support for retail buying continued to come from both increased consumer borrowing and rising consumer incomes. During January and February, consumer credit expanded at a rate approximately matching the record 1955 pace while personal income advanced to successive new peaks.

Employment, however, showed no significant improvement in February. In the five months since September, nonfarm employment (Bureau of Labor Statistics payroll data seasonally adjusted) has risen only 256,000, compared with an advance of 726,000 in the previous five months. The total number of jobless workers rose slightly in February to 6.1 per cent (seasonally adjusted) of the labor force. However, unemployment insurance claims appear to have declined more than seasonally in March.

FURTHER RISE SEEN FOR CAPITAL OUTLAYS

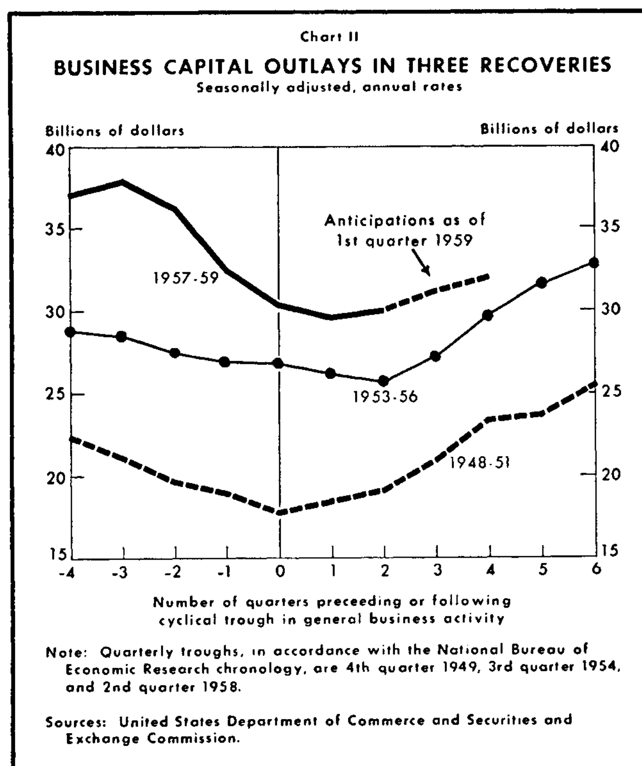
Business spending on plant and equipment rose slightly in the fourth quarter of last year after having fallen $8 billion (seasonally adjusted) from the peak annual rate achieved in the third quarter of 1957. More importantly, according to the latest Commerce-SEC survey of capital-spending intentions taken in February, businessmen were planning to increase their spending by $1.2 billion to a seasonally adjusted annual rate of $31.2 billion in the first quarter, and further to $32.0 billion in the second. The survey also showed sentiment to be more expansive than prevailed three months ago when expectations of first-quarter outlays were lower in nearly all lines of business. More than three fourths of the anticipated fourth- to second-quarter increase is expected to reflect higher investment by manufacturers, with durable and nondurables contributing about equally to the rise. Higher outlays are also foreseen by both rail and other transportation firms with a sharp pickup in rail outlays from a very low level. Expenditures by public utilities and by commercial and other concerns, which were relatively stable in 1958, are expected to show little change, and in mining no pickup is envisioned from near-trough levels.

The turnaround in capital spending has come a little earlier this time than in the recovery of 1954-55 but later than in 1949-50, when capital spending and general business activity began to move up simultaneously (Chart II). The outlook of businessmen in the recent expenditures survey is for a somewhat less vigorous rebound in capital outlays than took place in the earlier postwar recoveries. In fact, total spending in 1959 is expected to be only 4 per cent above 1958. In real terms this would mean only a small advance over 1958 when the physical volume of purchases of producers' durable equipment, the main component of capital outlays, was at the lowest level since 1946. The 1959 total also implies that second-quarter spending rates will be continued for the last half. However, in 1955 the annual survey also projected only a continuation of the second-quarter spending rate during the latter part of the year, but actual outlays rose sharply—even after lagging behind expectations in the second quarter. Business sales expectations are quite restrained, according to the Commerce-SEC survey; full-year sales are expected to be only 1 to 1½ per cent above the current annual rate of manufacturers' and retail sales (seasonally adjusted).

Chart II

BUSINESS CAPITAL OUTLAYS IN THREE RECOVERIES

Seasonally adjusted, annual rates



Note: Quarterly troughs, in accordance with the National Bureau of Economic Research chronology, are 4th quarter 1949, 3rd quarter 1954, and 2nd quarter 1958.

Sources: United States Department of Commerce and Securities and Exchange Commission.

A further moderate upturn in manufacturing investment is also indicated by the National Industrial Conference Board survey for *Newsweek* of the capital appropriations of large manufacturing firms. Such appropriations rose in the last three months of 1958 for the second quarter in succession, although total new appropriations remained below year-previous levels.

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The Money Market in March

The money market retained a generally firm tone through most of March, with occasional slight tendencies toward ease. During the first ten days of March the relatively liquid status of corporations was reflected in a steady volume of nonbank investment in short-term Treasury issues; at the same time, a shift of corporate funds in preparation for tax and dividend settlements brought a sizable flow of funds into the central money market. Moderate pressures developed around the quarterly tax date but these pressures, which were less than in some previous years, were readily accommodated, in part through System open market transactions to supply reserves. Thereafter, the market remained generally tight through the month end.

The money and capital markets adjusted smoothly to the discount rate increases in the first half of the month. On March 5 the Federal Reserve Banks of New York, Chicago, Philadelphia, and Dallas announced advances in discount rates of ½ per cent, effective the next day. The other eight Reserve Banks made similar announcements during the ensuing ten days, with the new 3 per cent rate taking effect on March 10 for Boston, March 12 for San Francisco, March 13 for Cleveland, Richmond, St. Louis, and Kansas City, and March 16 for Atlanta and Minneapolis. This marked the first revision in the discount rate of the Federal Reserve Bank of New York since the rate was raised from 2 per cent to 2½ per cent on November 7, 1958. The effective rate for Federal funds was at or close to the 2½ per cent discount rate ceiling through March 5, and then moved to a range between 2½ and 3 per cent. Market rates on Treasury bills rose immediately following the announcement of discount rate action, but they subsequently moved back down and were, at the end of March, at about the same level as before the increase in discount rates. Yields on Treasury notes and bonds followed a similar pattern during the first half of the month. The announcement by the Treasury on March 19 of a $4 billion cash financing involving three different offerings was received without serious disturbance to the market, but at the month end yields on outstanding issues were at levels above those at the beginning of the month.

MEMBER BANK RESERVE POSITIONS

In the first two statement weeks of March member banks lost reserves, mainly as a result of a decline in float and an increase in currency in circulation; these drains were only partly offset by a decline in required reserves and by other market factors (see Table I). Over this period, System securities transactions absorbed a small amount of reserve funds. Later in the month, during the two statement weeks ended March 25, when the rise in required reserves absorbed more funds than were supplied by regular market factors, System operations provided some relief through a combination of direct market purchases and extension of repurchase agreements to dealers. As a result of increases in outright holdings of $114 million and outstanding repurchase agreements of $18 million, total System holdings of Government securities rose $132 million between February 25 and March 25. Between those dates net borrowed reserves averaged $175 million—compared with $41 million for the four statement weeks of February—and exhibited only small week-to-week variations.

Money market banks in New York City experienced an easing of reserve positions early in the month, as corporations moved funds into City banks to prepare for mid-month disbursements. Reserve pressures were concentrated on banks outside New York both during this period

Table I
Changes in Factors Tending to Increase or Decrease Member Bank Reserves, March 1959
(In millions of dollars; (+) denotes increase, (−) decrease in excess reserves)

Factor	Daily averages—week ended				Net changes
	Mar. 4	Mar. 11	Mar. 18	Mar. 25	
Operating transactions					
Treasury operations*	− 90	+ 90	+ 8	− 4	+ 4
Federal Reserve float	− 99	− 102	+ 151	− 39	− 89
Currency in circulation	− 15	− 89	− 72	+ 56	− 120
Gold and foreign account	+ 15	− 44	+ 15	− 5	− 19
Other deposits, etc.	+ 150	+ 5	− 6	− 3	+ 146
Total	− 40	− 140	+ 97	+ 5	− 78
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	− 100	+ 37	+ 88	+ 42	+ 67
Held under repurchase agreements	+ 56	− 26	+ 17	− 3	+ 44
Loans, discounts, and advances:					
Member bank borrowings	+ 73	+ 174	− 178	+ 75	+ 144
Other	—	+ 1	− 1	—	—
Bankers' acceptances:					
Bought outright	− 1	− 1	− 1	− 1	− 4
Under repurchase agreements	− 4	+ 1	− 2	—	− 5
Total	+ 26	+ 186	− 79	+ 114	+ 247
Total reserves	− 14	+ 46	+ 18	+ 119	+ 169
Effect of change in required reserves†	− 8	+ 112	− 164	− 52	− 112
Excess reserves†	− 22	+ 158	− 146	+ 67	+ 57
Daily average level of member bank:					
Borrowings from Reserve Banks	529	703	525	600	589‡
Excess reserves†	352	510	364	431	414‡

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 March 25, 1959.

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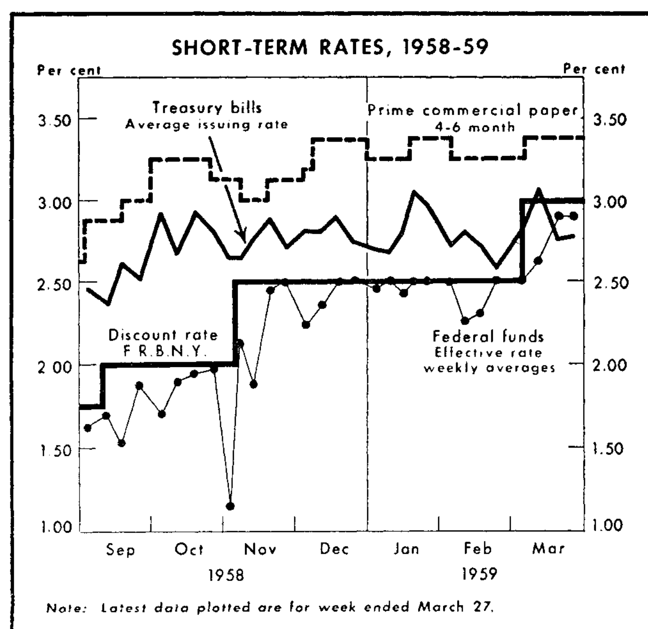
and again at the end of the month. The Chicago banks were under substantial pressure throughout the month, in good part due to their activity in stockpiling Treasury bills in order to meet the special demand for short-term securities associated with the April 1 tax assessment on bank deposits in Cook County.

GOVERNMENT SECURITIES MARKET

After the close of the market on March 19 the Treasury announced a $4 billion cash financing, consisting of three issues. It offered at par an additional $500 million of a 10½-year 4 per cent bond initially issued in October 1957 and maturing October 1, 1969, and drawing interest from April 1, 1959. In addition, $1.5 billion of 4-year 4 per cent notes was offered at par, to be dated April 1 and to mature May 15, 1963. Finally, it was announced that $2.0 billion of 289-day bills, to be dated April 1 and to mature January 15, 1960, would be auctioned on Thursday, March 26. Payment was allowed on all issues by credit to Treasury Tax and Loan Accounts. The books were open for the notes and bonds for one day, Monday, March 23, and the issues were oversubscribed. The new bills were awarded at an average issuing rate of 3.386 per cent, following aggressive bidding by the banks, and traded around 3.50 per cent in the secondary market. On March 26 the Treasury announced allotments of the bond issue at 65 per cent for savings-type investors, 35 per cent for commercial banks for their own account, and 20 per cent for all other subscribers, with subscriptions for $25,000 or less from savings-type investors and commercial banks,



Note: Latest data plotted are for week ended March 27.

and $10,000 or less from others, allotted in full. Allotments of the note issue were 50 per cent on subscriptions in excess of $100,000 (but with minimum allotments of $100,000 on all subscriptions in excess of that amount) and in full for smaller subscriptions.

The Treasury stated that the 289-day bill was the first step in a plan aimed eventually at getting a substantial proportion of the one-year debt on an auction basis. The goal is a new cycle, to be instituted as market conditions permit, in which a sizable amount of one-year obligations will mature every January 15, April 15, July 15, and October 15. Under this plan the "rolling over" of a significant part of the one-year debt is expected to become routine, although the bulk of such debt will continue to be in certificates maturing on February 15, May 15, August 15, and November 15.

Rates on Treasury bills were generally steady prior to the increase of the discount rate on March 6, but moved up sharply following the discount rate announcement. The higher levels were not maintained, however, as sustained demand from nonbank investors, in combination with the higher rates on bills, encouraged aggressive dealer bidding in the Treasury bill auction of March 9. Consequently, bill rates quickly moved down to a range near where they had been before the discount rates were changed. Pressures around the tax date proved to be relatively modest, and light corporate selling was absorbed with little or no impact on bill rates. This favorable performance, together with the reappearance of investor demand and the reception of the Treasury's cash financing program, lent strength to the market toward the end of March, as did reinvestment demand by holders of certificates maturing on March 24 who did not use those obligations for payment of taxes. Rates on outstanding bills at the end of March were at about the level of the beginning of the month.

In the weekly auctions for 91-day bills, average issuing rates rose from 2.589 per cent for the bills dated February 26, to 2.816 per cent for March 5, and to 3.062 per cent for March 12, then fell to 2.763 per cent for March 19, thereafter moving to 2.766 per cent for March 26, and 2.841 per cent for bills dated April 2. In the auctions for 182-day bills, the respective rates, compared with 2.978 per cent for bills dated February 26, were 3.111 per cent, 3.375 per cent, 3.058 per cent, 3.093 per cent, and 3.236 per cent.

The market for certificates, notes, and bonds was moderately active during March. Prices were generally rising at the beginning of the month but declined by as much as 1¼ points on the two trading days following the initial rise in discount rates. Thereafter, the market exhibited an undertone of firmness which continued over the tax and

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dividend date. Prices in the intermediate range were generally unchanged immediately after the Treasury's announcement of its offerings, and longer term bonds declined only slightly. The reopened bond issue of October 1969 fell immediately from 101⅜ to 100¼ after the announcement, and subsequently traded slightly below par through the end of the month. Other Treasury bonds and notes declined fractionally in the last ten days of March and closed the month lower by as much as a point and a quarter, while certificates were near the prices prevailing at the start of the month.

OTHER SECURITIES MARKETS

Yields on seasoned corporate and municipal bonds were moving downward as the month opened, but this movement was reversed following the discount rate advance. In the second half of March, rates on outstanding municipals were steady while those on corporate issues tended to rise slightly. The average yield on Moody's seasoned Aaa corporate bonds rose by 2 basis points to 4.15 per cent, while similarly rated municipals were on balance unchanged over the month at 3.06 per cent.

Despite the relatively small volume of corporate bond flotations, some resistance to close pricing by underwriters affected reception of several issues at the end of the month. Corporate issues for new capital purposes were again light in March, totaling an estimated $195 million, compared with $185 million in February and $435 million in March 1958, excluding a $718 million American Telephone and Telegraph Company convertible debenture issue in the latter period. By contrast, the large volume of new municipal flotations met mixed investor response, although the reception of some larger issues was excellent. Municipal bond issues marketed during the month totaled an estimated $535 million, against $790 million in February and $450 million in March 1958. The volume of prospective new issues of municipal bonds remains heavy.

On Wednesday, March 4, before the discount rate advances, one finance company announced increases in its offering rates on the longer maturities of its paper, effective the next day, and on March 10 all major finance companies posted new rates. The new schedule lifted rates to a range of 2¾ per cent to 3½ per cent, depending on maturity of the paper. On Friday, March 6, increases of ¼ and ⅛ per cent, respectively, became effective on bankers' acceptances and on commercial paper. Bid and offered rates on unendorsed 90-day bankers' acceptances were set at 3⅛ and 3 per cent, while the dealer offering rate on prime four- to six-month commercial paper was increased to 3⅜ per cent. Acceptance dealers, however, reduced their rates on all maturities by ⅛ per cent on March 13.

MEMBER BANK CREDIT

Total loans and investments of the weekly reporting member banks expanded by $667 million over the four weeks ended March 18, with loans rising $1,272 million while investments declined $605 million (see Table II). The advance in business loans of $961 million was almost entirely concentrated in the two "tax-period" weeks ended March 18. All other categories of loans also rose modestly in the four-week period.

The runoff of Government securities by the weekly reporting banks which commenced last August continued in March, but at a more moderate rate than in February. Holdings of Government securities in the four weeks ended March 18 were reduced by $887 million, while they fell $1,107 million in the preceding four statement weeks. At the same time, other investments were expanded $282 million by these banks in the most recent four-week period.

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, 1958 to Mar. 18, 1959
	Feb. 25	Mar. 4	Mar. 11	Mar. 18	
Assets					
Loans and investments:					
Loans:					
Commercial and industrial loans	+ 7	+ 46	+ 373	+ 535	− 165
Agricultural loans	− 1	− 3	− 3	+ 9	− 38
Securities loans	+ 60	− 12	− 58	+ 135	− 462
Real estate loans	+ 19	− 14	+ 23	+ 22	+ 187
All other loans (largely consumer)	+ 12	+ 54	+ 2	+ 74	+ 114
Total loans adjusted*	+ 94	+ 69	+ 336	+ 773	− 375
Investments:					
U. S. Government securities:					
Treasury bills	− 95	+ 6	+ 98	− 121	− 68
Other	− 263	− 204	− 117	− 191	− 1,530
Total	− 358	− 198	− 19	− 312	− 1,598
Other securities	+ 60	+ 62	+ 141	+ 19	+ 127
Total investments	− 298	− 136	+ 122	− 293	− 1,471
Total loans and investments adjusted*	− 204	− 67	+ 458	+ 480	− 1,846
Loans to banks	+ 315	− 214	+ 6	− 242	+ 669
Loans adjusted* and "other" securities	+ 154	+ 131	+ 477	+ 792	− 248
Liabilities					
Demand deposits adjusted	+ 399	− 864	+1,459	− 646	− 2,026
Time deposits except Government	+ 16	+ 80	+ 52	+ 2	− 25
U. S. Government deposits	− 301	− 539	− 830	+1,573	+ 82
Interbank demand deposits:					
Domestic	− 433	+ 620	− 26	+ 64	− 1,770
Foreign	− 29	+ 131	+ 40	+ 59	+ 66

* 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.

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International Monetary Developments

MONETARY TRENDS AND POLICIES

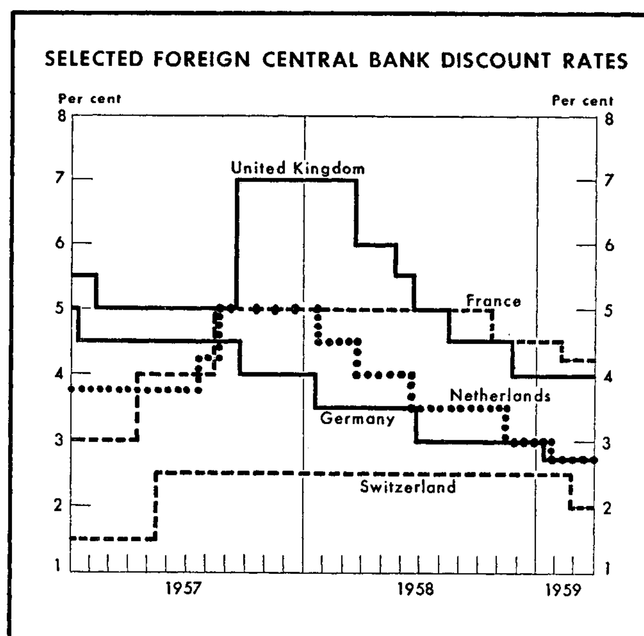
In line with the trend evident since early 1958, the industrial and financially developed countries abroad have generally continued to pursue a policy of monetary ease. In a number of these countries, additional measures of credit relaxation were adopted during the past two months.[1] In February, the central banks of Finland, France, Japan, and Switzerland reduced their discount rates. At the same time, the Bank of Finland also lowered the rates it charges private nonbank customers, and the French National Credit Council removed the year-old ceilings on outstanding commercial bank credit; in March, moreover, the Bank of France reduced the penalty rates applicable to all commercial bank borrowing in excess of an individual institution's discount ceiling. In the United Kingdom, the Treasury removed most of the remaining controls on capital issues; in the Union of South Africa, the central bank announced a further reduction in the commercial banks' supplementary cash-reserve requirements; and in the Netherlands, the maximum repayment period for instalment credits was abolished.

On the other hand, in the primary-producing countries, where inflationary pressures generally persist, the tendency to maintain or strengthen credit restrictions continued. In particular, the Central Bank of the Philippines in February raised both its discount rate and the commercial bank reserve requirements, and in March the Reserve Bank of India called on the commercial banks to exercise restraint on the further expansion of credit.

That some of the industrial countries have moved far in the direction of monetary ease and, in fact, have emerged from the previous phase of inflation and tight money is indicated by the relatively low levels to which discount rates have been carried by the February decreases. Thus, the reductions in the Swiss rate to 2 per cent from 2½ and in the French rate to 4¼ per cent from 4½ have made these rates the lowest since early or mid-1957 (see chart). The decrease of the Bank of Japan's basic discount rate to 6.935 per cent from 7.3—the third reduction since last June—has brought that rate even below the level prevailing prior to the introduction of a tight money policy in the spring of 1957. The current Finnish discount rate of 6¾ per cent is the lowest since April 1956.

[1] For developments in January, see "International Monetary Developments", *Monthly Review,* February 1959.

As in January, the current moves to ease credit reflected certain common factors. These moves came, in each country, against the background of a continuing increase in gold and foreign exchange reserves and an accompanying rise in market liquidity. In addition, in several countries, concern over domestic economic conditions appears to have played a definite role in the authorities' decisions. In France, industrial production (seasonally adjusted) had declined in November and December, largely in response to a decrease in consumer demand, and remained unchanged in January. Prospects for increased demand in the consumer sector in 1959 are not particularly encouraging since, under the government's new stabilization program, income taxes have been raised and subsidies have been removed on many items. In Finland, where unemployment currently is substantial, the central bank indicated that its discount rate reduction was intended to lead to an over-all lowering of interest rates, and requested the banks to reduce their lending charges correspondingly as of April 1. The British Treasury, for its part, lifted in February the remaining controls on new capital issues by private domestic borrowers, in the wake of a substantial easing of credit restrictions and investment controls since last July. However, foreign borrowers still must seek permission to raise more than £50,000 in any



twelve-month period, and new issues by local authorities likewise remain subject to control. In the meantime British economic activity and employment have picked up again; at the same time, short-term interest rates have shown a tendency to rise.

The Swiss National Bank, on the other hand, stated that the reduction of its discount rate was exclusively a technical adjustment and was not to be interpreted as an anticyclical measure; the bank, in fact, warned against any excessive increase in commercial bank lending. In Japan, the economic situation is improving and industrial output has been rising. Both the Swiss National Bank and the Bank of Japan may well have lowered their rates at this time in order to gain sufficient room for maneuver and to be in a better position to raise these rates should the need for credit restraint recur.

The measures adopted in India and the Philippines in recent months represent efforts to deal with the severe economic stress that these countries have been suffering for the past few years. In India, the government appears determined to push ahead with its economic development program and introduced another deficit budget for the fiscal year that began April 1. The central bank, in directing the credit institutions to show restraint in their lending, pointed out that commercial bank credit had recently been expanding faster than in the corresponding periods of the past three years; moreover, there was evidence that such credit had been utilized for commodity speculation. The Central Bank of the Philippines, besides increasing the discount rate on all but two categories of paper to 6½ per cent from 4½, prohibited commercial bank loans against real estate or for construction purposes. At the same time, reserve requirements were raised to 19 per cent from 18, with an additional increase to 20 per cent in March and a further 1 per cent hike scheduled for April.

EXCHANGE RATES

During March, the New York foreign exchange market continued quite active, with sterling and the Canadian dollar generally appreciating. The Swiss franc, however, declined to its lowest quotation in recent years, although it recovered slightly toward the month end.

Spot sterling was generally maintained at about $2.8115 during the first half of March. In the latter part of March the quotation gradually appreciated and reached $2.8163 on March 31, the highest since June 1958. This rise resulted for the most part from increased commercial demand in New York, from Canadian demand, and from the over-all strength of sterling as indicated in part by the narrowing of the British trade gap in February.

In the forward market, the discounts on sterling narrowed somewhat in the early part of the month under some commercial demand and in anticipation of a cut in the British bank rate, with the spreads moving to 20 and 38 points for three and six months' deliveries, respectively. Subsequently, as the bank rate remained unchanged and yields on United States Treasury bills declined, the discounts generally widened to 40 and 70 points on March 31.

Securities-sterling quotations, reflecting persistent demand from investors in British securities, advanced from $2.80¼ at the beginning of March to $2.81⅜ on March 27, a new record for this quotation.

The Canadian dollar, quoted at $\$1.02\frac{23}{32}$ on March 2, advanced appreciably thereafter under good commercial demand and reached $\$1.03\frac{3}{16}$ on March 5. On that date, however, following announcement of the rise in the discount rates of some of the Federal Reserve Banks, the quotation declined abruptly. Subsequently, it rose to $\$1.03\frac{29}{64}$ on March 25, under general commercial demand and bidding for Canadian oil leases. There also was some investment demand from Continental sources and the United States. In connection with the latter, tenders for Canadian Treasury bills were accepted at an average of 4.30 per cent per annum on March 25, a new high yield for those bills. On March 31 the Canadian dollar was quoted at $\$1.03\frac{11}{32}$.

The Swiss franc was under some pressure during the first half of March, the quotation declining to as low as $0.2311½ on March 11. Thereafter, the rate tended to firm slightly, and at the month end was quoted at $0.2316½.

THE NEW YORK FOREIGN EXCHANGE MARKET

A new 56-page booklet, *The New York Foreign Exchange Market,* written by Alan R. Holmes, has been published by this Bank. This booklet is primarily concerned with a description of the New York foreign exchange market as it exists and operates today. Parts of the booklet which appeared earlier in this Bank's *Monthly Review* in a slightly different form have been brought up to date, and new material on forward exchange and interest arbitrage has been added. Copies are available from the Publications Division, Federal Reserve Bank of New York, New York 45, N. Y., at 50 cents a copy and at a special rate of 25 cents a copy to educational institutions on quantity orders (plus New York City sales tax, where applicable).

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The Common Market and European Economic Integration

The European Common Market, merging the economies of Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands, is one of the most far-reaching economic undertakings of all time. These six countries have a total population almost as large as that of the United States, are already highly developed, and abound in skilled labor and in economic resources generally. By 1973 at the latest, according to the member countries' agreement, their economies are to be combined into a single economic unit. Meanwhile, the way in which the Common Market evolves during this transition period will do much more than shape the destinies of the six participating countries. Action here will help determine the political and economic structure of the whole of Western Europe as well as the economic health of the entire Free World.

The signing and ratification of the Common Market treaty in 1957 was a milestone on the postwar road toward the economic integration of Western Europe. But much of the way ahead remains uncharted. In particular, the closer association of the economies of other Western European countries with those of the six Common Market countries is still under discussion. Western Europe has traveled far since the war toward the unification of its national economies, and toward freer, multilateral, and nondiscriminatory trade—two major goals of United States postwar economic policy. To continue this advance is a great challenge that faces the Common Market members and the other Western European countries.

THE EUROPEAN COMMON MARKET

The core of the Common Market is a customs union—the removal of all tariffs and quota restrictions on mutual trade and the establishment of a common external tariff against the rest of the world. The duties of this tariff are in principle to be set at the unweighted arithmetic average of the original duties of the member countries. This customs union the participating countries have pledged themselves to accomplish, according to a precise timetable, over a period of at least twelve and at most fifteen years. But the Common Market they envisage is much more than a customs union. They have also committed themselves to eliminate restrictions on the movement of capital and labor within the integrated area and to coordinate their national fiscal, monetary, and economic policies. In addition, they have established special financial institutions to help channel funds to strengthen their combined economies, and they have closely associated their overseas territories with the Common Market. Finally, in line with the political conception of their endeavor, they have formed a complex institutional framework which, some hope, has the seeds of supranational political authority.

The Common Market countries expect that the creation of a unified market will speed the growth of living standards by leading to a more efficient use of resources. Through a better division of labor they hope to reap the benefits of specialization, standardization, large-scale production, and the resulting expansion of trade. However, a limited regional free-trade agreement, unlike global free trade, does not necessarily bring about world-wide benefits. For example, if a customs union only diverts trade from lower cost outside industries to higher cost inside industries, a less efficient rather than a more efficient use of resources will result. On balance, the structures of the six Common Market economies appear to be such that the economic benefits of trade expansion should be large enough to offset any unfavorable effects of trade diversion. Such a result seems probable, because these economies are now very competitive but potentially very complementary; that is, while at present they produce many of the same products, an elimination of trade barriers should result in each country's concentrating more on supplying to the others the products in which it is more efficient. A substantial expansion of their mutual trade should thus come about.

Nevertheless, it may well be that some of the more ardent claims on behalf of the Common Market have been somewhat exaggerated. This is particularly likely as regards the alleged great scope for economies of large-scale production. It seems probable that, for most industries, the domestic markets of most of the participating countries are already large enough to reap the benefits of mass production techniques. On the other hand, the increase in competition that should follow the enlargement of markets freely accessible to member country industries should clearly be of considerable benefit by leading to a more efficient industrial structure. For example, such increased competition should help to end the domination, in some industries, of relatively small domestic markets by a few large firms that have little incentive to cut costs and prices.

But the extent to which the advantages of a more efficient use of resources will materialize will obviously de-

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pend on the degree to which marginal high-cost producers and even entire national industries will adjust to freer trade. The benefits of economic unification can be reaped only if individual enterprises adapt their production and price policies to the new competition of the Common Market and, where necessary, even release resources that can be used more efficiently in other directions. The way in which the new competitive forces will actually work out will hinge importantly on the extent to which the Common Market countries prevent—in line with the provisions of their treaty—mergers and concentrations of enterprises that would tend to reduce competition.

THE COMMON MARKET AND OTHER WESTERN EUROPEAN COUNTRIES

On balance it appears that the economic advantages the Common Market countries can be expected to reap are great, even though the results cannot be predicted with certainty. Why then, an outsider may ask, have the other Western European countries not become associated with it? After all, these countries have all worked closely together in other postwar ventures in the economic field, such as the Organization for European Economic Cooperation (OEEC), the European Payments Union, and more recently the establishment of nonresident convertibility.

No simple answer is possible. The other OEEC countries apparently found it difficult to accept the political implications of the Common Market as to national sovereignty. Some of them (Austria, Sweden, Switzerland), in particular, appear to have felt that these implications would not be easily reconcilable with the political neutrality they traditionally follow. The United Kingdom, for its part, apparently was not prepared to abandon its close economic ties with the Commonwealth, as exemplified by the Commonwealth preference system and the sterling-area arrangements. Finally, some of the Scandinavian countries appear to have placed great emphasis on their close economic relations with the United Kingdom, despite their important trading links with the Six. In addition, their attitude may well have been reinforced by their feeling that, because they have traditionally maintained very low tariffs, the raising of their tariffs to the level of the future external tariff of the Common Market would be too high a price to pay.

Thus, instead of joining the Common Market, the other Western European countries, at the initiative of the United Kingdom, proposed the formation of a Free Trade Area that would include the Common Market. In this area, each member would be obligated to eliminate trade restrictions against the others, but—in contrast to the Common Market—would set its own tariffs on imports from outside countries. Negotiations to establish such an area were difficult and protracted, and although at times they seemed to show encouraging progress they were often marked by controversy and friction. After eighteen months a deadlock developed, and toward the end of 1958 negotiations were broken off.

As a result, the scheduled first steps toward the formation of the Common Market's customs union took place on January 1, 1959 without parallel action toward the establishment of a wider Free Trade Area. Nevertheless, the Six agreed to extend the 10 per cent tariff cuts, made on their mutual trade, to all members of the General Agreement on Tariffs and Trade (GATT), although only so far as this would not bring any tariff below the level of their eventual common tariff. At the same time, the Common Market countries extended to all OEEC members, on a provisional and reciprocal basis, their 20 per cent increase in import quotas. However, the parallel step of enlarging import quotas to at least 3 per cent of the domestic production of each product was restricted to the Common Market countries. For many products this was a much more important measure, since many of the quotas had been very small.

The reasons for the breakdown of the Free Trade Area negotiations are complex and many. Some of the difficulties centered around the establishment of a common external tariff under the Common Market at the same time that such a common tariff would not have existed under the proposed Free Trade Area. While there was agreement that the absence of a common external tariff under the Free Trade Area might give rise to some problems, considerable disagreement developed over the question whether or not these could be solved. Some Common Market advocates expressed the fear that it would be impossible to prevent countries with a low external tariff from re-exporting to member countries with high tariffs their imports from outside countries. At the same time it was argued that the low-tariff countries' industries that use outside materials would gain a cost advantage in competing with the other countries of such a Free Trade Area. Arguments such as these seem greatly to have strengthened the hand of those within the Common Market area who were already fearful of increased competition arising from the removal of trade restrictions. On the other hand, serious difficulties also arose because the Free Trade Area proponents apparently were not ready to accept some of the political emphasis that is so important to the Common Market countries. These countries, as the first general report of the Common Market's Commission (the community's top administrative body) put it, seek to create

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for themselves "a powerful economic fabric which could subsequently be filled in on the political plane". This desire undoubtedly led the Common Market members to emphasize the importance—not only in their own grouping but also in a wider one—of harmonizing and coordinating domestic economic and social policies as well as of developing an institutional framework.

Despite these and other difficulties, most Western European countries—Common Market members and nonmembers alike—are currently giving fresh thought to ways of creating a Western European grouping beyond the confines of the Common Market. Thus, in mid-March the Common Market countries set in motion new machinery to clarify their own views on such a grouping. At the same time the other OEEC countries continued their consultations, exploring the situation that resulted from the breakdown of the Free Trade Area negotiations.

IMPLICATIONS FOR THE UNITED STATES

The United States is of course vitally interested in the outcome of all these discussions. In many respects, the economic implications for this country of the Common Market and of a wider grouping are very similar. What the over-all impact on United States exports might be is by no means clear. On the one hand, the United States—like other outside countries—may initially be unfavorably affected both by the Common Market and by a wider freeing of intra-European trade, since such arrangements automatically confer a competitive advantage on the products of member countries as against those of nonmembers. Such a change in the competitive situation, of course, is not brought about by the imposition of new barriers. Rather, it results from the removal of restrictions on the trade among participants at the same time that restrictions against outside countries are being left essentially unchanged. Moreover, to the extent that such arrangements succeed in increasing productivity, the competitive position of United States exports in third markets may also become more difficult. On the other hand, insofar as the hopes of stimulating Europe's economic growth are realized, widened markets should lead to opportunities for United States exports that should more than offset any adverse short-run effects.

The implications of the Common Market can be spelled out in greater detail not only because it has already been set in motion but also because it contains a number of features, besides the removal of internal barriers, that are of importance for outside countries. United States exports to the Common Market countries are currently running at more than $3 billion a year, or about 15 per cent of total United States exports. Since both the present tariffs of the six member countries and the future common external tariff on many raw materials and semimanufactured products are relatively low, the short-run effects of the proposed customs union on United States industry will mainly concern United States exports of cars, chemicals, and other manufactured products, which make up about a third of our exports to the area. In order to avoid these difficulties, many American manufacturers are already increasing their investments in the Common Market countries by establishing or enlarging local branches or subsidiaries or by arranging licensing and royalty agreements with local firms. However, the uncertainty as to whether or not a wider European market going beyond the Six will materialize, and the resulting doubts as to the best location for an expansion of European operations, have reportedly led to the postponement of investment decisions by some American firms.

The extent to which United States exports may be affected by the Common Market likewise remains unclear. Many items of the planned common external tariff are still to be set by negotiations, even though in principle—as already noted—this tariff is to be fixed at the arithmetic average of the tariffs of the members. The decision that is reached on these individual tariffs, which involve many important raw materials and semimanufactures, not only may show the direction—protectionist or free trade—the Common Market may be taking, but may also have vital dollars-and-cents implications for many American producers. At the same time, the fate of United States agricultural exports to the Common Market may hinge importantly on how the six countries finally decide to regulate their production and trade in agricultural commodities under the provisions of the Common Market treaty.

The position of United States exports may also be affected by the manner in which the Common Market countries conduct their external commercial policy in general. With the advent of nonresident convertibility, the balance-of-payments basis for discriminatory restrictions against dollar goods has been wiped out. The emphasis that the leaders of the Common Market have repeatedly given to the importance of fostering still greater freedom of trade within the entire free world is clearly encouraging. Nevertheless, it has already been pointed out that the logic of the Common Market might justify discriminatory quota restrictions—and not merely tariffs—against United States and other outside goods. This issue may become important only in the event that the Common Market countries experience future balance-of-payments difficulties. Since trade restrictions on their mutual trade are in principle ruled out and since they also have committed themselves to a common external policy,

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the imposition of discriminatory restrictions against third countries might seem to some an easy way out of balance-of-payments difficulties. While such problems may never arise, it is important to stress even now that such measures would hardly be consistent with progress by the free world toward a freer, multilateral, and nondiscriminatory trade system to which all countries belonging to GATT subscribe.

Mortgage Financing in the Postwar Period

The nation's stock of housing has been increased by about one third in the thirteen years since the end of World War II. During the course of this expansion, the volume of residential construction and the amount of mortgage financing have reached unprecedented heights. This tremendous growth has come in strong bursts rather than in a smooth, steady advance. But, in striking contrast to most other industries, the surges in residential construction have usually begun during periods of economic recession, and then have moved sideways or declined once the rest of the economy reached levels of high prosperity. Probably the major factor in this countercyclical pattern has been the changing availability of mortgage credit, as competing demands for long-term funds tended to rise and fall with the cyclical swings of the economy. In terms of economic activity as a whole, the behavior of mortgage credit and residential construction would thus appear to have exerted a stabilizing influence. On the other hand, the construction industry has been subject to fluctuations, and potential homeowners, at times, have had to delay home buying, with consequent hardships to those concerned.

The foundation for the postwar housing boom was, to be sure, provided by a strong basic demand for homes. This was in part a legacy from the depression and war years, when construction failed to keep up with demand, and a reflection of the high rate of household formation in the early postwar years. Beyond this, the high rate of population growth and increasing real income per family unit combined to provide a strong sustaining influence. Moreover, the fact that demand for housing held up well in periods of recession indicates that the confidence of home buyers, and of lenders, was not impaired in such periods. Residential construction has turned out to be, in large measure, insensitive to short-run changes in current national income, but quite sensitive to changes in the availability of credit to finance housing.

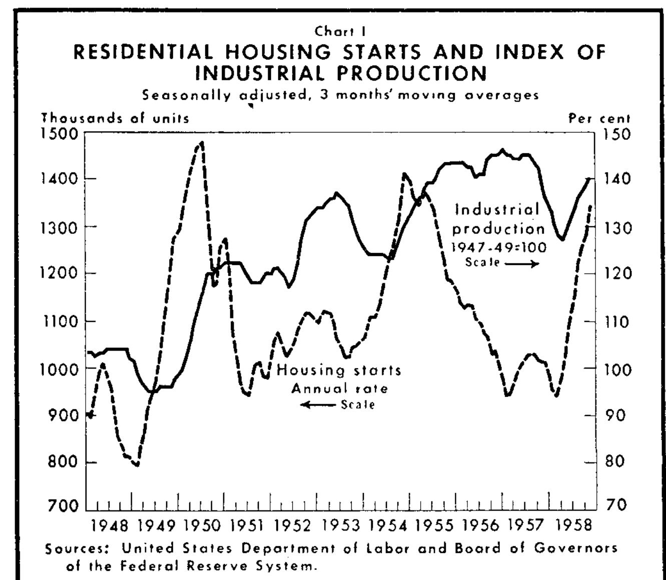
The greater sensitivity of residential construction to the availability of credit probably rests on the fact that, with rare exceptions, a family's purchase of a house represents its biggest single investment outlay. Almost invariably, such a purchase requires credit, since few buyers can meet the entire cost of a house out of their own resources. As a result, roughly $3 out of $4 spent on new construction has been raised by mortgage borrowing in the postwar period, and the outstanding home mortgage debt of consumers has come to be more than twice as large as the total of other consumer debt.

The countercyclical swings in mortgage financing and in residential construction activity may be seen by comparing the Federal Reserve index of industrial production with the data for housing starts, which measure the number of dwelling units on which work has just begun and for which financing has presumably already been arranged. Starting with the boom year of 1948 (see Chart I), housing starts moved to a peak, then dropped off as the industrial production index remained high. In the boom periods of 1951-53 and 1955-57, housing starts again fell to levels that were relatively low. Conversely, in the recession years of 1949, 1953, and 1958, housing starts began sharp uptrends that tended to peak out, following the first two recessions at least, well ahead of the peak points of general business

Chart I

RESIDENTIAL HOUSING STARTS AND INDEX OF INDUSTRIAL PRODUCTION

Seasonally adjusted, 3 months' moving averages



Sources: United States Department of Labor and Board of Governors of the Federal Reserve System.

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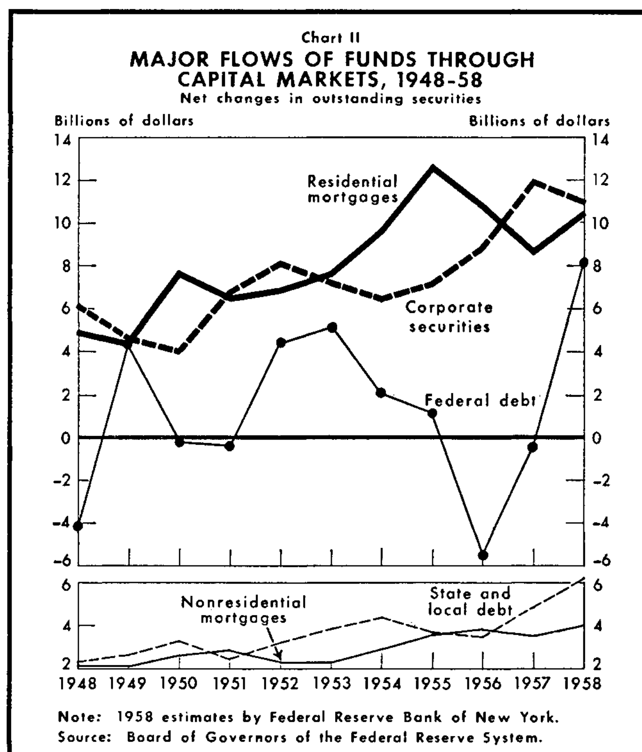
activity. In the current business upswing, after a sharp rise, housing starts are showing signs of leveling off.

The countercyclical pattern of residential mortgage financing is based mainly on swings in Federally underwritten mortgages since conventionally financed construction has followed a relatively stable growth trend in the postwar period. The sharp fluctuations in Federally underwritten mortgages are related to their interest rate ceilings. Although these ceilings have been moved up a number of times, they have tended to place such mortgages at a competitive disadvantage with other borrowers in those periods when accelerating business activity has been associated with strong demand for funds in the capital market and rising interest rates. On the other hand, the stability of conventionally financed construction can be attributed in large part to the freely varying interest rates on conventional mortgages.



SUPPLY OF MORTGAGE FUNDS IN RECESSION AND EXPANSION

The financing of mortgages takes place in that broad and vaguely defined area known as the capital market, where many different kinds of demands for funds come together. Consequently, a full-scale analysis of the influences which affect the flow of funds into mortgages would involve nothing less than a survey of all flows of funds in the entire economy. Thus, the total flow of funds into all capital market instruments is influenced by current savings flowing either directly from individuals or indirectly through savings institutions as well as by changes in bank credit as influenced by monetary policy. Moreover, a part of this flow of savings and credit will be absorbed in short-term investments, with the amount depending on the volume of short-term offerings and the demand for such offerings, both of which will be affected by the structure of yields, expectations as to the future course of yields, and liquidity needs. Finally, even among long-term investments, residential mortgages face competition from an array of other capital market instruments, including corporate securities, the debt issues of the Federal Government and of State and local governments, and nonresidential mortgages.

But even without such a full-scale analysis, an examination of the competition for funds among capital market instruments, supplemented where necessary by a consideration of variations in the total flow of savings and credit, reveals some of the influences affecting the flow of funds into mortgages.

The two panels of Chart II show the annual net changes in the outstanding volume of the principal capital market instruments, regardless of maturity, since 1948.[1] Two striking relationships are evident. First, an upsurge in residential mortgage financing in the postwar period has almost invariably accompanied a downturn in corporate flotations, while downturns in mortgages have tended to be associated with increases in corporate financing. Secondly, net increases and decreases in mortgages were at times also associated with opposite movements in total Federal debt outstanding—although over the period as a whole some major groups of institutional investors have let their holdings of Government securities decline while their mortgage portfolios increased. Fluctuations in other forms of borrowing have been comparatively small, with State and local flotations moving in a generally upward trend and nonresidential mortgages fluctuating within a relatively narrow range.

The offsetting fluctuations in mortgages, on the one hand, and corporate financing and Treasury borrowing, on

[1] Net changes in capital market instruments shown in Chart II reflect net increases or decreases in the volume of these instruments outstanding as estimated in the flow-of-funds accounts of the Board of Governors of the Federal Reserve System. "Residential mortgages" refers to changes in mortgages on one- to four-family properties; "corporate securities" includes the net changes in the volume of stock and bond issues but excludes other types of borrowing, such as bank loans; "Federal debt" includes the change in both short-term and long-term debt, as does State and local debt; "nonresidential mortgages" includes changes mainly in industrial and commercial mortgages.

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the other, reflect a number of factors associated with the business cycle. These interrelations may be seen through an examination of, first, periods of recession and recovery and, second, periods of boom when demands for productive resources in most sectors of the economy were pressing against available supplies.

In the recession year of 1949, corporate financing needs were reduced but the Treasury was forced to borrow rather heavily. In the face of this competition for funds, net additions to the volume of mortgages declined. During the recovery year of 1950, the Treasury's accounts moved into balance, and it redeemed a small amount of debt. The net new volume of corporate issues remained modest, because corporations were able to finance the revival of plant and equipment spending and inventory accumulation by drawing down available liquid assets. With this modest volume of corporate flotations and some debt redemption by the Treasury, it was possible for the flow of funds into mortgages to increase substantially over the previous year.

At the onset of the second postwar recession, the net flow of mortgage credit again rose sharply while Treasury borrowing and corporate flotations declined. When economic activity revived in 1955, corporations once again began to finance their renewed investment needs out of greatly expanded internal sources, but raised the volume of issues by only a small amount. Sharing in the recovery, the Treasury's budget moved close to a balance in 1955 so that its borrowing again dropped. The reduced competition of these other borrowers was associated with a sizable rise in the flow of funds into mortgages.

During the recent recession and the subsequent recovery in 1958, roughly offsetting shifts in mortgage and corporate financing occurred. Federal borrowing, on the other hand, rose by about $8 billion as the result of a recession-induced deficit. Moreover, the rise in Treasury borrowing was superimposed upon a $3 billion growth in the aggregate of the other capital market instruments. The total 1958 increase in capital market instruments constituted a postwar record, reflecting that year's upsurge in the over-all supply of savings and credit.

Once a boom is well under way and liquidity positions are squeezed, the capital market pattern tends to be reversed. Prior to 1951-52, corporations had apparently about used up the available margin of liquid assets to finance new investment outlays. Their drafts on the capital market nearly doubled between 1950 and 1951 and rose further in 1952. Although the Treasury did not need to borrow in 1951, Korean war costs mounted rapidly in 1952, with the result that Treasury demands on the capital market rose sharply. Thus, although the total flow of savings and credit into the five capital market instruments rose in 1951 and very sharply in 1952, mortgage borrowing was lower in each year.

Similarly, the boom in plant and equipment spending in the period 1956-57 brought a record flow of corporate issues into the market, which displaced a sizable volume of mortgage borrowing. The flow of funds into non-Treasury issues in 1956 might have been raised substantially through net debt redemption by the Federal Government, but in fact the total flow of savings and credit into all capital instruments declined sharply. Indeed, the volume of new financing through non-Treasury issues was the same in 1956 as it had been in 1955.

Although mortgage borrowing underwent sizable fluctuations year after year, such borrowing was nonetheless quite large for the period 1948-58. Out of the aggregate supply of funds moving into the five competitive capital market instruments, residential mortgages absorbed the largest single share. The flow of funds into such mortgages was 10 per cent greater than that into corporate securities, and absorbed about one third of the total flow of funds into the capital market.

FEDERALLY UNDERWRITTEN MORTGAGES AND COMPETITIVE INVESTMENTS

Throughout the postwar years, and whatever the stage of the cycle, the major share of financing has been done through conventional mortgages. But mortgages insured by the Federal Housing Administration (FHA), or guaranteed by the Veterans Administration (VA), have also been important and have accounted for about 40 per cent of all mortgages issued in the period 1948-58. The role played by each of these three kinds of mortgages may be seen in Chart III, which indicates that FHA and VA mortgages have clearly been the most volatile segment of the total. Indeed, the sizable countercyclical fluctuations in flows of funds into mortgages and in total housing starts are attributable almost wholly to variations in borrowings through FHA and VA mortgages.

Two of the downward movements in Federally underwritten mortgages have taken place directly following Federal policy measures designed to cut back the volume of mortgage credit. After the outbreak of hostilities in Korea when the economy was already nearing full stretch, downpayment requirements were raised and maximum maturities were shortened on FHA and VA mortgages, and also on conventional mortgages, through selective credit control under Regulation X. Shorter maturities tend to check borrowing by increasing monthly payments on a mortgage of a given size, thus raising the income requirements of home buyers. Similarly, in 1955, after the

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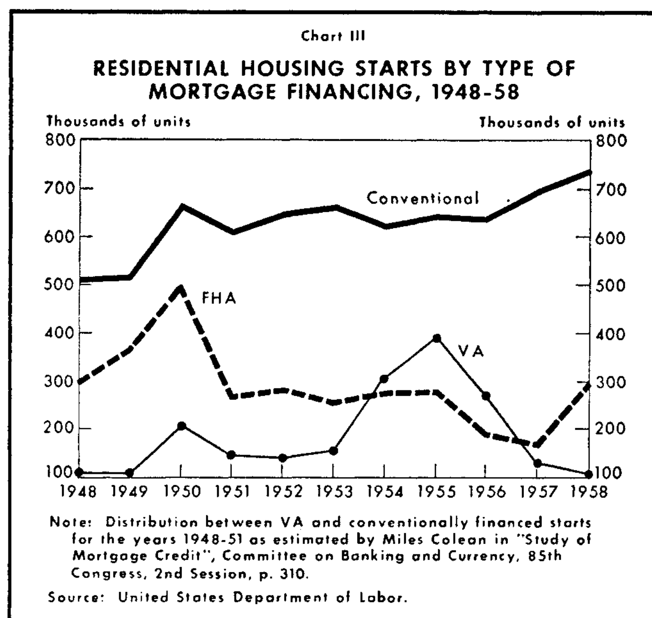

Note: Distribution between VA and conventionally financed starts for the years 1948-51 as estimated by Miles Colean in "Study of Mortgage Credit", Committee on Banking and Currency, 85th Congress, 2nd Session, p. 310.

Source: United States Department of Labor.

volume of construction had accelerated rapidly along with the broad upsurge throughout the economy, a number of measures were instituted to restrain housing credit. These included a reimposition of VA downpayment requirements and a shortening of permissible maturities on both FHA and VA mortgages. Some restraint was also placed on conventional mortgages by limiting the credit available to savings and loan associations from Federal Home Loan Banks. By and large, these changes in mortgage terms appear to have contributed to the countercyclical behavior of mortgage credit.

Measures designed to increase the flow of funds into FHA and VA mortgages met with their greatest success at times when competing demands were light. For example, in 1958 when credit had become easier, the support provided FHA mortgages in the secondary market by a large increase in purchase commitments of Federal National Mortgage Association (FNMA), and the increased attractiveness resulting from a rise in interest rate ceilings to 5¼ per cent on FHA mortgages, were accompanied by a strong rebound in FHA starts.

At other times, strong competitive demands in the capital market held down the flow of funds into FHA and VA mortgages even though measures were taken to encourage such a flow. Thus, the interest ceiling on FHA mortgages was raised from 4.5 per cent to 5 per cent in the fall of 1956. Further, the support provided FHA and VA mortgages by FNMA in the secondary market in 1956 was about double that of 1955. Meanwhile, in order to provide further assistance to potential home buyers, thirty-year maturities were restored in late 1955 and early 1956 on Federally underwritten mortgages and downpayments were reduced on FHA loans. Despite all these measures, the volume of funds moving into Federal mortgages in 1956 declined sharply. Indeed, further easing of downpayments, and increases in FNMA purchases in 1957 failed to stem an additional decline in the volume of FHA- and VA-financed starts.

By contrast, the relatively stable growth during the postwar years in conventionally financed housing starts is striking. Indeed, changes in the volume of such starts have been relatively slight in periods of easy credit, while there have been no pronounced reductions in years of relatively tight credit.

The reluctance of lenders to acquire FHA and VA mortgages in periods of high economic activity has generally involved a switch to competing investments. Because there are interest rate ceilings on VA and FHA mortgages (and even though these ceilings have been adjusted upward on several occasions since 1953), the rates for these mortgages have tended to lag behind other interest rates in boom periods as the competition for funds became more intense. Indeed, the higher competitive rates became, the less attractive these mortgages became relative to other securities, and the greater the tendency to divert credit to other uses. This tendency was only partly offset by the practice of "discounting" FHA and VA mortgages. During periods of business contraction the reverse process occurred. As the general demand for funds fell and was accompanied by declines in interest rates, the fixed rates on these mortgages became more attractive to lenders and they became more willing to make mortgage loans. On the other hand, a comparatively stable flow of funds went into conventional mortgages, whose interest rates are free to move in response to changes in competing rates.

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