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The Business Situation

The strikes in the metal industries, which began in mid-July in steel and spread to copper and some other metals in August, introduced a number of crosscurrents into an otherwise strongly advancing economy. The most immediately apparent effects have been on employment in the strike-bound industries themselves and in closely allied mining and transportation activities. The impact of the shutdowns on metal-using industries, and on the economy as a whole, was still relatively minor at the end of August, although reports of actual and immediately prospective cutbacks were becoming more frequent.

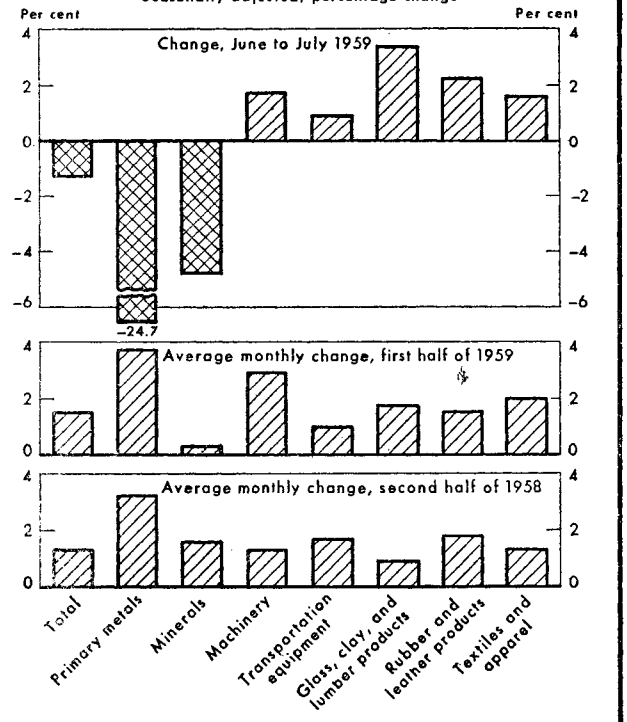
EFFECTS OF THE STRIKE

The fourteen-month climb in industrial output, which by June had pushed the Federal Reserve production index 23 per cent above the April 1958 cyclical low, was reversed in July as a result of the steel strike (see Chart I). For the month as a whole, the index declined about 1 per cent (seasonally adjusted), dipping from 155 to 153 per cent of the 1947-49 average. The principal factor was, of course, steel output, which in July was only one half of the previous month's level, bringing total output of metals down by one fourth. In August, steel output in the plants unaffected by the strike was about 12 per cent of the industry's capacity, while the strikes that began in August cut the output of copper by an estimated 75 per cent and also curtailed sharply the production of lead and zinc. Among activities that support the steelmaking process, the shutdown had already had an effect in July on coal and iron ore production. Coal output fell by 24 per cent, metal mining by about 30 per cent, and total minerals production by 5 per cent. Also reflecting the strike was a substantial decline in freight carloadings, which continued into August.

Chart I

INDUSTRIAL PRODUCTION AND SELECTED COMPONENTS

Seasonally adjusted, percentage change



Source: Board of Governors of the Federal Reserve System.

As a consequence of the steel strike, wage and salary payments, which had risen uninterruptedly from last October's seasonally adjusted annual rate of $242 billion to $262 billion in June, fell back by $500 million in July. This was almost entirely attributable to employment declines in the steel industry itself and in fields connected with the production and distribution of steel. At the end of July an estimated 500,000 persons were on strike in the steel industry, in iron mines, and on ore boats that ply the Great Lakes. Another 100,000 persons, it was estimated, had been laid off in other industries directly affected by the strike, including coal and railroads, and from construction projects in the steel industry. The strikes in the copper industry idled approximately 30,000 more persons during August.

THE ECONOMY AS A WHOLE

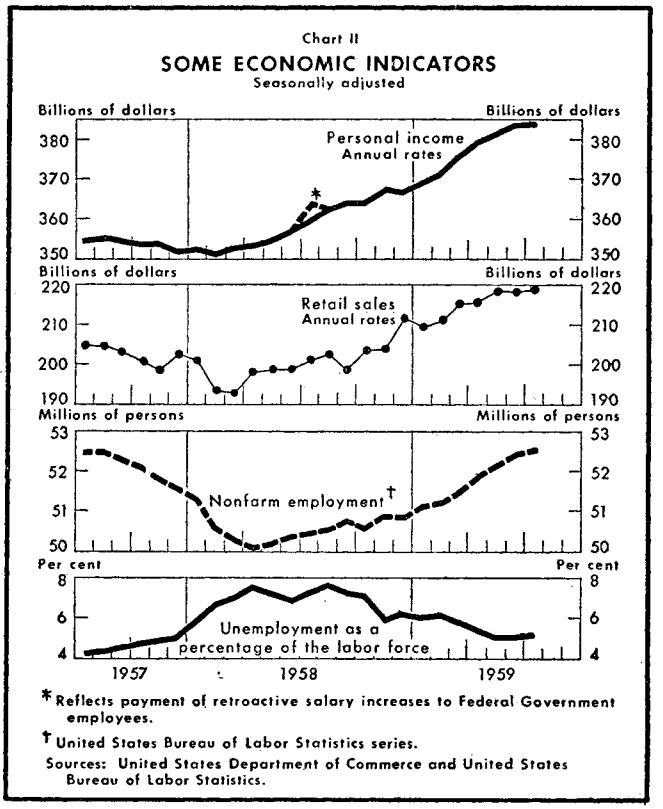
The latest figures available for the broader statistical series show that the economy was performing sufficiently well through July to be able largely to offset the impact of the strikes. Strength was particularly pronounced in durable manufacturing production, reflecting increases in fixed investment outlays by business and growing consumer demand. As can be seen in Chart I, machinery,

transportation equipment, and glass-clay-lumber products were three industrial groupings where further gains in July continued the strong increases registered during the past year. The widespread advances in durables output were supported by new orders, which, the latest statistics show, had turned up strongly in June, following a dip the previous month. Production of finished durable goods was hardly hampered by the steel strike, since most users reportedly had accumulated sufficient inventories to carry them into September or beyond. Output also advanced appreciably in July in a number of nondurable manufacturing lines—among them rubber and leather products and textiles and apparel.

. Personal income continued its forward movement in July (see Chart II), although the seasonally adjusted annual rate of increase of $300 million was the smallest for any month this year. The reduced payrolls in the steel, mining, and transportation industries were partially offset by increased wage and salary payments in other industries. And advances in proprietors' income and in interest and dividend receipts helped push total personal income beyond that of June. The latest employment figures show that the week the steel strike began, seasonally adjusted nonfarm employment (Bureau of Labor Statistics) had risen to an all-time high of 52.6 million persons. This was about 160,000 more than in June and a rise of 2.2 million from a year earlier. Total employment (Bureau of Census figures) had also reached a record high in mid-July of 67.6 million persons, or 2.4 million more than a year ago. However, the 250,000 rise from June was somewhat less than seasonal, partly because of bad weather that cut farm employment in the South, and unemployment as a percentage of the civilian labor force rose slightly (seasonally adjusted) to 5.1 per cent from 4.9 per cent a month earlier. Long-term unemployment (fifteen weeks or more) declined by mid-July to 820,000, less than half that a year earlier, although it was still 320,000 higher than in July 1957, at the height of the previous prosperity period.

Consumer spending also continued to show strength. Retail sales in July were at a record annual rate (seasonally adjusted) of $219 billion (see Chart II), up slightly from May and June. Department store sales in July were also at an all-time peak, rising 3.5 per cent above the June level; the latest figures suggest a further increase during the first half of August this year. Data for early August also indicate a rise in new car sales over the July level.

In contrast, outlays for new construction moved slightly downward in July and August on a seasonally adjusted basis, reaching a level 2 per cent below the April-May record but still 13 per cent ahead of a year previous.



The decline was almost wholly a result of a decrease in residential construction.

Prices, meanwhile, continued the general trends of the last few months. The consumer price index, which had been virtually stable between mid-1958 and March 1959, moved up in July for the fourth straight month, rising by $\frac{1}{10}$ of a point to 124.9 per cent of the 1947-49 average. The increase was due partly to a seasonal rise in food prices, but other broad groups of goods and services also showed increases. Outstanding among the latter were recreation, medical, and transportation costs (including used cars). Average wholesale prices, on the other hand, declined slightly in July for the third consecutive month, primarily as the result of a further decrease, of 1.6 per cent, in prices of farm products and of a smaller decrease in processed foods. Average wholesale prices of other goods rose slightly following a small decline in June, reaching again the record high of 128.4 first touched in May. The divergence in the trends for food prices at the wholesale and consumer price levels, which is not unusual over a short period, is probably attributable to differences in the relative importance of particular items in the two indexes and to the timing of the surveys.

Money Market in August

The money market remained tight throughout August, as member bank reserve positions continued under steady pressures. These pressures were particularly marked in the case of the New York City banks, which purchased large amounts of Federal funds and increased their borrowings from the Federal Reserve Bank. Average borrowings from the Federal Reserve by all banks rose further to $1.0 billion, the highest level since August 1957. The effective rate for Federal funds remained firmly at the 3½ per cent ceiling throughout most of the month, while dealer loan rates posted by the major New York City banks rose to 4¼ per cent from 3¾-4 per cent during the previous month. On September 1, the leading New York City banks announced an increase in their prime rate to 5 per cent from 4½ per cent, and certain other short-term market rates immediately moved upward.

The Government securities market maintained a firm tone in the early part of the month in the wake of the recent highly successful Treasury refunding operation. Market optimism subsequently gave way, however, to a considerably more cautious attitude as statistical indicators underscored the brisk pace of business activity, and gave rise to expectations of a further strong economic expansion after settlement of the steel strike, with consequent upward pressures on interest rates. Moreover, commercial bank liquidation of securities apparently accelerated during the latter part of the month. Market yields on Government securities, which had declined steadily throughout all sectors since early July, increased sharply after mid-August, and in some cases closed the period at new postwar peaks. The yield increases were particularly marked in the short-term area, partly reflecting the additional supply of Treasury bills resulting from the Treasury's August cash financing.

MEMBER BANK RESERVES

Net borrowed reserves of all member banks, on a weekly average basis, remained within a $475-610 million range during the four statement weeks ended in August, averaging $532 million for the period as a whole, virtually unchanged from the $550 million (revised) average for the five statement weeks ended in July. Average excess reserves rose $66 million to $466 million, while average borrowings from the Federal Reserve Banks rose $50 million to $998 million.

On balance, regular market factors absorbed reserves during the month, as a decline in average required reserves was more than offset by a seasonal increase in currency in circulation and other factors. Float produced the largest week-to-week variations in reserve availability, withdrawing on average more than $200 million in the first statement week and then adding nearly $300 million in the third week. The sharp midmonth float expansion in the third week was partly offset, however, by an unexpectedly large increase in Treasury deposits at the Reserve Banks.

System securities operations during August were relatively moderate in scale and roughly offset the net reserve effect of other factors. Average System securities holdings rose by $114 million from the last week in July to the last week in August, as outright holdings of Treasury bills rose by $110 million and repurchase agreements by $4 million.

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, August 1959

(In millions of dollars; (+) denotes increase, (−) decrease in excess reserves)

Factor	Daily averages—week ended				Net changes
	Aug. 5	Aug. 12	Aug. 19	Aug. 26	
Operating transactions					
Treasury operations*	+ 50	+ 27	− 159	+ 77	− 5
Federal Reserve float	− 208	− 19	+ 294	− 115	− 48
Currency in circulation	− 35	− 146	+ 20	+ 100	− 61
Gold and foreign account	− 16	+ 13	− 17	− 2	− 22
Other deposits, etc.	− 29	− 40	− 49	− 20	− 138
Total	− 239	− 167	+ 92	+ 39	− 275
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 32	+ 157	− 72	− 7	+ 110
Held under repurchase agreements	+ 58	− 101	− 2	+ 49	+ 4
Loans, discounts, and advances:					
Member bank borrowings	+ 144	+ 39	− 128	− 5	+ 50
Other	—	—	—	+ 1	+ 1
Bankers' acceptances:					
Bought outright	− 2	− 1	− 2	− 1	− 6
Under repurchase agreements	—	—	—	—	—
Total	+ 233	+ 93	− 205	+ 38	+ 159
Total reserves	− 6	− 74	− 113	+ 77	− 116
Effect of change in required reserves†	+ 55	+ 181	+ 16	− 53	+ 199
Excess reserves†	+ 49	+ 107	− 97	+ 24	+ 83
Daily average level of member bank:					
Borrowings from Reserve Banks	1,034	1,073	945	940	998‡
Excess reserves†	428	535	438	462	466‡
Net borrowed reserves†	606	538	507	478	532‡

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 August 26, 1959.

GOVERNMENT SECURITIES MARKET

The Treasury announced on August 5 that it would raise $1.7 billion cash through the sale of an additional $1 billion of the tax anticipation bills maturing March 22, 1960 and through the addition of $700 million to the weekly issues of Treasury bills. The latter amount was subsequently reduced to $600 million. In an auction held on August 13, the tax anticipation bills were awarded at an average issuing rate of 3.719 per cent, compared with the 4.075 per cent rate established in the July 1 auction for the original $3 billion of that issue. The payment date was August 19, and commercial banks were permitted to pay in full through credits to Treasury Tax and Loan Accounts. In each of three consecutive weekly auctions beginning August 10, the Treasury offered $1.2 billion of 91-day Treasury bills, $200 million in excess of the amount maturing.

Although the size of the cash financing was somewhat larger than had generally been expected after the success of the earlier refunding operation, the announcement itself produced only limited initial reaction in the Treasury bill market. Nevertheless, the addition of $200 million 91-day bills introduced some caution in the regular weekly auctions and reinforced previous doubts regarding the existing level of short-term yields. (The 91-day bill rate, for example, had fallen in preceding weeks to about 3 per cent, a full ½ percentage point below the discount rate and more than 60 basis points lower than the yield on the six-month issue.) In reflection of a more cautious approach, the three-month bills were awarded at steadily increasing average issuing rates in the regular weekly auctions, reaching 3.889 per cent on August 31 compared with 3.047 per cent on July 27. The average issuing rate on the six-month bills declined in the first two auctions of August to 3.737 per cent and 3.690 per cent, respectively, from 3.860 per cent on July 27, but then rose successively to 3.782 per cent, 4.152 per cent, and 4.468 per cent in subsequent auctions. The spread between market bid rates on the issues nearest three months and six months to maturity narrowed from a recent peak of 81 basis points in late July to 30 basis points on August 20, but widened again to 55 basis points by the close of the month.

Led by the new 4¾ per cent note of 1964, prices of intermediate- and long-term Government securities advanced in the early part of the month, with the bid price on the 1964 issue reaching a peak of $101\frac{10}{32}$ by mid-month. Prices dropped sharply thereafter, however, as the market reappraised underlying economic developments and as commercial bank offerings increased under the impact of the continued pressure on reserve positions. Bid quotations on the 4¾ per cent note of 1964 declined by as much as $1\frac{10}{32}$ to par bid by the close of the period. Over the month the average yield on long-term Treasury bonds rose to 4.15 per cent from 4.10 per cent at the end of July.

OTHER SECURITIES MARKETS

The corporate and municipal bond markets maintained a steady tone through mid-August, with yields on seasoned issues tending to decline slightly. Subsequently, however, a note of hesitancy was injected into the markets by an increase in the calendar of new offerings and by the same influences that contributed to the weakening of the Government securities markets in the latter half of the month. In consequence, yields moved generally upward toward the end of the period and showed a moderate net rise over the month.

Corporate bond flotations totaled an estimated $410 million in August, representing a substantial increase over both the July total of $170 million and the August 1958 total of $205 million. The volume of municipal financing also increased, although less sharply, with new offerings totaling $455 million in August, compared with $370 million in July and $315 million in August 1958. Most of the month's corporate offerings were received without enthusiasm by the market. Toward the end of the period, the syndicates on three sizable offerings broke up without completing distribution. Also, in the last week of August, a $65 million Aa-rated bond issue, reoffered to yield 5 per cent, was accorded a poor reception by the market, although a $125 million issue of debentures, also reoffered to yield 5 per cent, was fairly well received. Municipal flotations during August were accorded widely varying receptions. Many of the month's smaller offerings performed poorly, but, in contrast, the largest offerings of the month—a $125 million State veteran bond issue and a $50 million issue of both term and serial bonds by a State highway authority—sold out rapidly.

Rates on several short-term debt instruments were raised during the month. Commercial paper dealers lifted their rates on August 18 and again on August 25 for a total increase of ¼ of a per cent, bringing the offering rate on prime four- to six-month commercial paper to 4⅛ per cent. On August 18 and 19 dealers in bankers' acceptances announced a ⅛ of a per cent increase, bringing the offered rate on 90-day unindorsed acceptances to 3⅝ per cent. The large finance companies announced on August 25 the lifting of the rates which they pay on their own paper placed directly with investors; effective August 26 the new rate on 30- to 89-day paper became 3⅞ per cent.

International Developments

BUSINESS TRENDS ABROAD

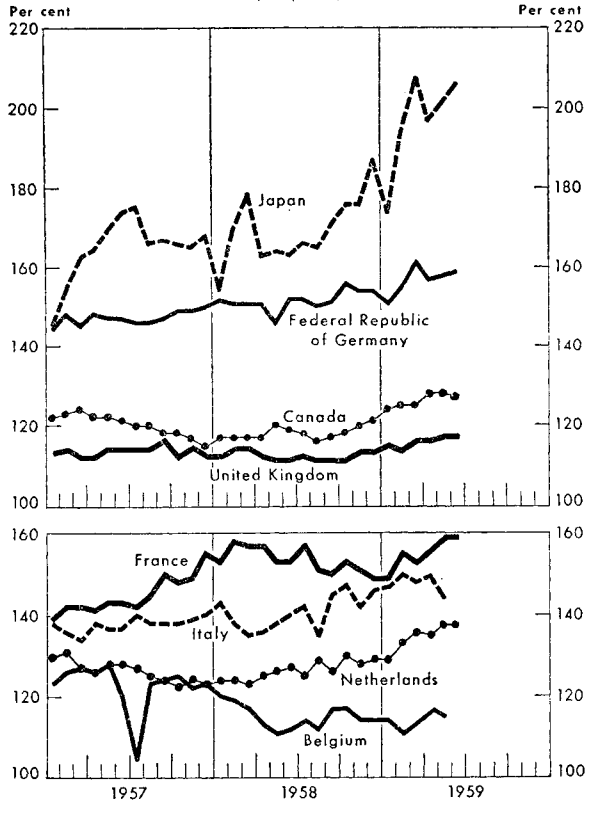
A brisk economic upswing is now under way in the major industrial countries abroad. This expansion has been gathering force since the start of the year and is pushing most business indicators beyond previous peaks. It follows a downturn in economic activity in these countries that had generally been briefer and milder than that experienced in the United States. The current upswing, unlike some in the past, is proceeding both with a high degree of price stability and against a background of ample and rising foreign exchange reserves.

By mid-1959 industrial production had not only fully recouped previous losses but in all countries under review had attained levels above those recorded a year earlier (see Chart I). The rise in production over the year ended June 1959 ranged widely from 4 per cent in France to a high of 26 per cent in Japan. The timing of the revival also differed from country to country. In Japan and the Netherlands industrial production began to move upward as early as the second quarter of 1958, while in Canada, the United Kingdom, the Federal Republic of Germany, and Italy the rise got under way only during the second half of the year. In France and Belgium, however, the upturn in industrial output was delayed until the first quarter of 1959.

Chart I

INDUSTRIAL PRODUCTION IN SELECTED COUNTRIES

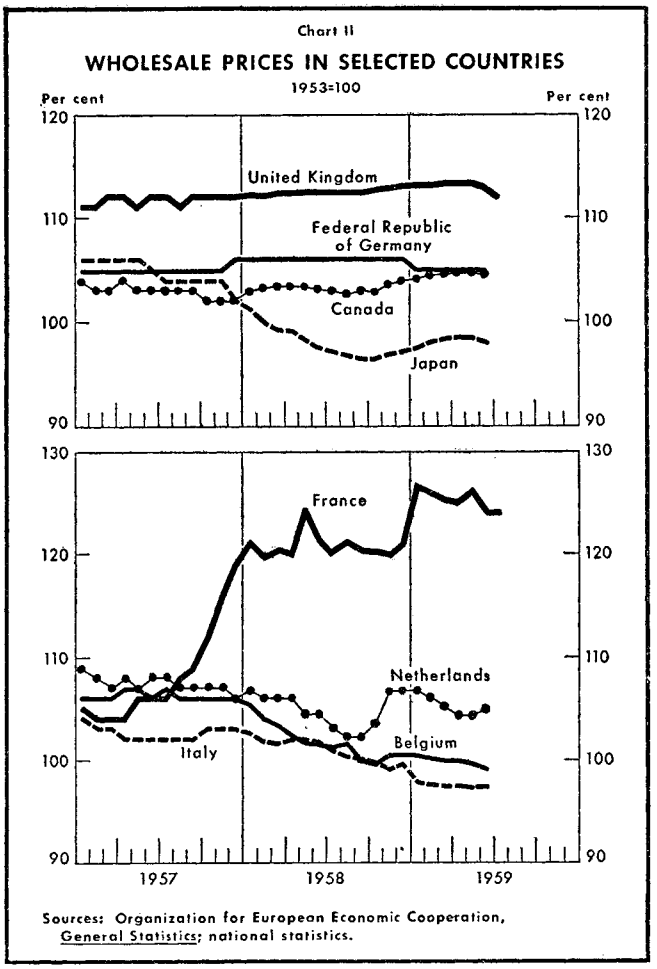
Seasonally adjusted, 1953=100



Sources: Organization for European Economic Cooperation, General Statistics; national statistics.

The upswing in industrial production has been paced by consumer durables and by the heavy industries, notably metals, machinery, and chemicals. Automobile output in the United Kingdom, for example, reached an all-time peak in May and in France in June of this year. By midyear steel production, too, was rapidly moving toward record levels in France and Germany; in the United Kingdom, steel output, after lagging in 1958, picked up strongly in the second quarter of 1959. The rise in the production of chemicals has been particularly rapid in Italy and France. Even the textile industry, which had been in the midst of deep-seated structural difficulties, has recently begun to show signs of strength, notably in Belgium and Italy. On the other hand, a revival in coal output has been checked by the existence of large excess stocks. Building activity has been vigorous in all countries, especially in Germany, where it has furnished a major stimulus to the current boom.

Employment, which had lagged in the early stages of the revival—partly because of productivity gains—is now also expanding rapidly in many industrial countries. Indeed, in Germany and the Netherlands labor shortages are already appearing in some industries. In the United Kingdom, unemployment declined further in June to a level slightly below a year earlier, although it remains somewhat above previous boom years. In Canada the number of jobless, while still rather sizable, in June was down 25 per cent from mid-1958. In Belgium, however, where the stagnation of the coal industry has been impeding the general pickup in business activity, employment has been rising only slowly and unemployment continues at relatively high levels.



The price stability achieved in the major industrial countries abroad in the recent past has been maintained to a remarkable degree this year (see Chart II). This stability reflects, besides lower raw material prices and the existence of some unused capacity, a general easing of wage demands. In part it is also attributable to monetary policies designed to promote expansion without sparking renewed inflation. Even in France, where the December devaluation of the franc had been expected to result in substantial price advances, wholesale prices rose only 2.8 per cent during the first half of this year.

The buoyancy of consumer demand, which had already helped to cushion the slackening of economic activity last year, continued this year to furnish a major stimulus to the expansion. Since the start of the year retail sales have been rising everywhere—but most markedly in Canada and Japan where they have been running 7 to 10 per cent above 1958. A notably large upsurge in retail sales has also occurred in the United Kingdom, reflecting partly the end last year of consumer credit controls and this year's tax relief measures.

Exports have provided the other principal impetus to the present economic upswing. French exports, in particular, climbed to an all-time peak during the first half of 1959, increasing 24 per cent over the first half of 1958. Exports also advanced markedly in the Netherlands, Italy, and Japan, while their rise was somewhat more subdued in the United Kingdom and Canada. Belgian exports, in contrast, have remained sluggish. The general export increase has covered the entire range of commodities, but has been especially pronounced in machinery, electrical equipment, and automobiles. In part, the increase has reflected the economic expansion in the United States and the heavier penetration of foreign products in the United States market.

The revival of consumer and export demand and the resultant recovery of manufacturers' orders during the first half of 1959 have already reversed last year's decline in inventories. With order books filling once again, stocks are being replenished at a rapid pace in many industrial countries abroad, especially in Canada and Germany. In view of the continued existence of unused capacity, however, no marked upsurge in fixed investment outlays has so far taken place. Nevertheless, as business prospects have turned increasingly auspicious, private capital spending plans have been revised upward. Even in France, where the outlook for private capital investment had been rather clouded earlier this year, an official survey now suggests that 1959 business investment will top last year's outlays by about 7 per cent. Belgium seems to be the one country among those reviewed where private investment activity continues to lag, but a government program just introduced is expected to promote capital expenditures and to hasten the modernization of the country's industries.

With investment outlays expected to reinforce expanding consumer and export demand, significant gains in the aggregate output of goods and services are generally anticipated in the major industrial countries abroad this year. For Western Europe as a whole, the United Nations Economic Commission for Europe had already earlier this year forecast an advance of more than 3 per cent, with increases substantially above this figure expected in several countries, notably Germany and the Netherlands. In Canada, where the business upswing has been especially strong, official Canadian estimates have placed the aggregate output of goods and services for this year at a level 7 per cent above that of 1958.

MONETARY TRENDS AND POLICIES

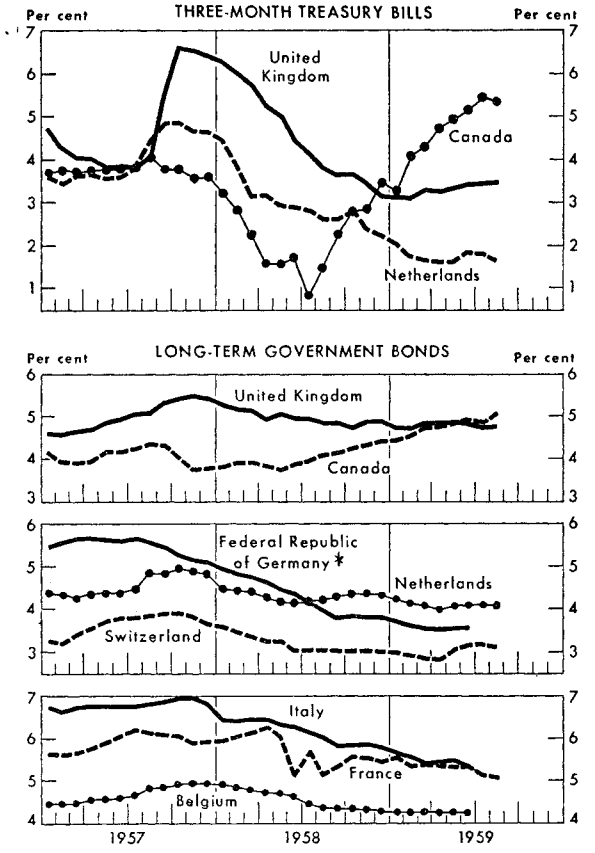
As economic expansion gathered momentum, most industrial countries abroad abandoned or modified the policies of monetary ease actively pursued during 1958 and early 1959. This is not to say that all these countries have again reverted to credit restraint, although concern over economic overexpansion has been voiced in several. Rather, in many foreign industrial countries the monetary authorities in recent months have simply ceased feeding the revival of economic activity. In general, interest rates have mirrored economic trends and the resulting changes in monetary policies. In Western Europe, the decline in rates that had characterized most of 1958 and early 1959 was halted or even reversed in recent months, while in Canada rates have risen steeply since the summer of 1958 (see Chart III).

In most industrial countries abroad, the current expansion in economic activity has been accompanied by a substantial increase in commercial bank lending. In Europe, much of this increase has reflected the growth of consumer instalment credit and the introduction of personal loan facilities by commercial banks. An especially large rise in commercial bank credit generally and in instalment credit has taken place in the United Kingdom. In the twelve months following the ending of the "credit squeeze" in July 1958, advances of the London clearing banks increased by over 30 per cent. During the same period, total instalment debt rose by over 50 per cent, with two thirds of this increase attributed to car financing.[1]

A sharp expansion of commercial bank credit has also occurred in Canada as economic recovery has accelerated. However, the rapid expansion of the money supply in 1958 and the recent vigor of the Canadian boom led the Bank of Canada to restrain any further growth of the money supply. With the central bank keeping a tight rein on reserves, the chartered banks were forced early this year to run down their liquid assets. By April their liquid-assets ratio had dropped to 15.6 per cent of deposits (the lowest level since the 15 per cent minimum came into effect in mid-1956) from 17.2 per cent in January. Moreover, during April the banks also began selling government bonds in order to meet their loan commitments. In mid-May, the banks agreed among themselves that, until the money supply was permitted to expand further, there should be no significant increase in the over-all loan total. While total loan expansion slackened briefly following this announcement, primarily because of a sharp cutback in loans to finance companies, general business loans nevertheless continued to rise at an undiminished rate during June and July, with the entire expansion having to be financed by sales of government securities; by the end of July, business loans had risen 22 per cent over the end of 1958. At the same time, money market rates advanced sharply, with the average tender rate on three months' Treasury bills rising from 5.01 per cent on July 2 to a record 6.16 per cent on August 13. At that point, the banks—whose maximum lending rate is legally set at 6 per cent—declared that this development had deprived them of the ability to grant new loans or permit increases in existing credit lines. The bill rate declined, however, to 6.04 per cent on August 20, as the Treasury accepted only $91.5 million of the regular $115 million of bids submitted on 91-day bills and $12 million of the $20 million submitted on 182-day bills. The rate dropped further to 5.33 per cent on August 27,

Chart III

INTEREST RATES IN SELECTED COUNTRIES



Note: August 1959 data partially estimated.

* Rates on mortgage bonds.

Sources: International Monetary Fund, International Financial Statistics; national statistics.

[1] It should be noted, however, that consumer instalment credit in the United Kingdom (as elsewhere in Western Europe) still is much less widespread than in the United States.

as the Treasury reduced its offering of 91-day bills to $95 million and offered no 182-day bills at all. A less-than-normal amount of both types of bills was also scheduled to be offered on September 3.

In order to moderate the current boom, the Swedish Riksbank on July 1 raised the commercial banks' required liquidity reserves (which are in the form of cash and government securities) to a 30-40 per cent range, depending on the size of the institution, from the previous 15-33 per cent range. The central bank pointed out, however, that this change would not force the banks to reduce the volume of loans outstanding at this time, but was intended, by adjusting reserve requirements to prevailing high liquidity conditions, to facilitate control of any future credit expansion.

In only two industrial countries—Belgium and France—did the authorities reduce the cost of credit further in attempts to encourage lagging private investment. The Belgian Treasury is providing grants to banks to enable them to reduce interest rates by as much as 2 per cent on loans to finance the establishment, extension, or modernization of industrial enterprises and to provide working capital. The Bank of France, continuing its policy of credit relaxation, on July 9 lowered its rate on advances against securities to 5½ per cent from 6 per cent, and also reduced the penalty rates applicable to borrowing in excess of an individual bank's discount ceiling. (The basic discount rate remained unchanged at the 4 per cent level set on April 23.) The reduced cost of central bank credit may not, however, become immediately effective, since the high liquidity of the banking system, reflecting recent foreign exchange gains, has made large-scale recourse to the central bank at penalty rates unnecessary in recent months. In July, also, the authorities lowered the commercial banks' minimum lending rate, as well as various commission charges, and raised from 500 million francs ($1.02 million) to 1 billion ($2.04 million) the ceiling on individual commercial bank credits that may be extended without prior Bank of France approval. In addition, controls over a wide range of consumer durable goods were relaxed by lowering the minimum downpayments and extending the maximum repayment periods.

The continuing re-examination by monetary authorities everywhere of existing monetary techniques and institutions, in an effort to improve their functioning, has resulted in a number of new developments in recent months. In the United Kingdom, the Committee on the Working of the Monetary System, appointed by the government in May 1957 and headed by Lord Radcliffe, published its report on August 19. In general, the report recommends the continuation of existing institutions and policies but suggests, among other things, that the authorities place increased reliance on changes in longer term interest rates as a means of achieving the government's debt-policy objectives and of thereby controlling the economy's liquidity. The report also recommends various steps to formalize the integration of monetary policy with the government's over-all economic policies, and the adoption of certain policy instruments designed to handle possible emergency situations.

The Belgian authorities in June enlarged both the resources and the scope of the Fonds des Rentes, a public institution established in 1945 to regulate government bond prices, in order to enable the Fonds to engage actively in open market operations—the central bank itself does not operate in the government securities market. In West Germany, the Central Bank Council revised the commercial banks' minimum reserve requirements, effective August 1, in order to reduce the requirements for small banks and thus make allowance for the fact that banks in towns without a branch of the central bank have to carry larger cash balances than those elsewhere. The change establishes four reserve classifications based on the size of total deposit liabilities, including savings deposits, in place of the previous six classifications that had been based on the size of deposits, excluding savings deposits. And in Japan, steps are being taken to facilitate the formal establishment of minimum reserve requirements for commercial banks, under legislation enacted in 1957 authorizing the central bank, with the consent of the finance minister, to impose such requirements up to 10 per cent of demand deposits.

EXCHANGE RATES

In the New York foreign exchange market spot sterling declined during August from $2.8121 to as low as $2.8052; on the other hand, three and six months' deliveries advanced to close the month at 12 and 16 points premium, the highest since January 1955. These movements primarily reflected switching from sterling to dollar securities in order to take advantage of higher interest rates in the New York market. At the month end the spot pound was quoted at $2.8054.

A sharp increase in Canadian bill rates, combined with short Canadian dollar positions, resulted in rising quotations for the Canadian dollar which reached 1.05\frac{7}{32}$ at midmonth, the highest since August 1957; at the month end the rate was 1.05\frac{1}{32}$. Quotations for Continental currencies, particularly the Netherlands guilder, tended to decline in terms of the dollar.

Borrowing from the Fed

The economic recovery and expansion of the past year has been accompanied by growing demands upon commercial banks for credit accommodation. The pressure of these demands, in turn, has caused an increasing number of banks to turn to the discount facilities at their Federal Reserve Banks. Most of these borrowings by member banks have been for short periods and have been in the nature of temporary assistance while the banks worked out orderly adjustments in their portfolios. As seasonal credit needs increase further during the latter half of 1959, it is possible, perhaps likely, that a growing number of member banks will consider turning to the "discount window" at the Reserve Banks to borrow the funds needed to cover temporary shortages in their reserves. This article examines the circumstances under which member banks might appropriately exercise their privilege to borrow from the Reserve Banks and also attempts to place the administration of the discount window in perspective against the monetary policy objectives pursued by the Federal Reserve System.

The circumstances that might lead a member bank to turn to the discount window for accommodation are varied, but the most important general type of circumstance is an unanticipated—or larger than anticipated—loss of reserves through the clearings process. As individuals, business concerns, and governments at various levels receive and make payments for the broad range of goods and services our economy produces, money is in constant motion from depositor to depositor, from bank to bank, and from region to region. It is to be expected that these flows will not be perfectly offsetting in any brief period of time as they affect any one bank, and it is to be expected, therefore, that individual banks will, from day to day or week to week, gain or lose reserves as they receive payments or make payments for the checks that pass through clearings.

Many of these gains or losses of reserves will be offsetting for a bank within a short period of time, perhaps within the weekly reserve computation period for reserve city and central reserve city banks, or within the semimonthly reserve averaging period of country banks. Some of the gains and losses, however, may not be offsetting for periods of weeks or even months, following a broad seasonal pattern that reflects the business or agricultural activities of the customers whom the bank services. Even in the case of these broad seasonal movements, the approximate size of the gain or loss is often predictable. The bank is accordingly able to make provision for such changes by accumulating highly liquid investments, such as Treasury bills, during the seasons when customer credit requirements are lowest.

The source of funds to which a member bank turns when it finds itself in need of reserves will depend upon the expected duration of the need for reserves, the availability of liquid short-term investment assets in portfolio, and the money management practices of the bank. Reserve shortages that are expected to be of some duration may be covered by liquidating Treasury bills or other secondary reserve assets, if these are available in sufficient amount in the bank's portfolio. Where the bank does not have an adequate supply of highly liquid money market securities in its secondary reserve, it may be necessary to sell longer term portfolio investments, perhaps at a considerable loss, or to retrench in lending activity in order to conserve reserves. Very brief reserve shortages, on the other hand, may be provided for by drawing down a correspondent balance, by buying Federal funds, or by temporarily borrowing funds through some other means. When the reserve need is expected to be of only a few days' or, at most, a very few weeks' duration, a member commercial bank may properly borrow from its Federal Reserve Bank.

As some member banks have learned, however, access to the discount window is not an automatic right that goes with membership in the Federal Reserve System. The Board of Governors of the Federal Reserve System has established regulations, under authority of the Federal Reserve Act, which outline the general circumstances under which a member bank may properly borrow. Discount administration is intended to assist member banks temporarily in need of reserves, but to do so without impairing the ability of the Federal Reserve System to discharge its principal responsibility, the regulation of the supply of money and credit. The criteria for appropriate borrowing apply uniformly and objectively to all member banks; they do not attempt to make distinctions, for example, between the needs of very active banks in fast-growing communities and those of less active banks located in communities that are not growing so rapidly. Nor are the criteria changed from one month to the next

or over the various phases of the business cycle. It is important, therefore, that member banks understand the general circumstances under which they may appropriately turn to their Federal Reserve Bank for an advance when they have a temporary need for reserves.

THE OBJECTIVES OF FEDERAL RESERVE POLICY

In order to place the regulation of member bank borrowing in proper perspective, it would be helpful to review the broad objectives sought by the Federal Reserve System through its policies. The ultimate objective, of course, is to help to provide monetary and credit conditions conducive to sound, long-run growth in the economy, free of both inflation and deflation. In pursuit of this objective, the System exercises an influence upon the credit-granting capacity of the commercial banking system. Member banks are required to maintain certain minimum reserve balances on deposit with their Federal Reserve Banks. To the extent that an individual bank, or the banking system at large, holds larger reserves than are needed to cover requirements against deposits, it is in a position to grant new loans or to make new investments.

There are many factors which influence the reserves available to the banking system. For example, when the public requires a larger supply of currency, perhaps due to the shopping activity around the Christmas season, commercial banks draw down their reserve balances as they take currency out of the Reserve Banks to supply their depositors. Similarly, the return flow of currency after the seasonal need for the enlarged supply has passed enables banks to build up their reserves. As gold flows into or out of the United States in settlement of international balances, the settlements are reflected on the books of the Federal Reserve Banks with a resulting effect upon bank reserves. And there are many other influences upon total banking reserves.

The net effect of these influences may, in any particular time interval, either add to the supply of reserves in the banks or reduce reserves. Sometimes the net changes can be quite substantial. For example, the withdrawal of currency from the banks during the last few months of each year typically amounts to about a billion dollars, which is equivalent to about 4 or 5 per cent of the total supply of bank reserves. In order to hold to a minimum the disturbing impact that these sometimes random influences might otherwise have upon the ability of commercial banks to provide an orderly service to the community, the Federal Reserve System employs open market operations in Government securities to offset the greater part of their net effect upon bank reserves. That is to say, when the commercial banking system loses reserves each fall because of the seasonal increase in currency needs, the Federal Reserve System replaces these reserves by purchasing Government securities in the open market. There is, of course, no way to assure that the reserve funds which the System creates in buying Government securities will be distributed among the member banks in exact proportion to the reserve losses which they are intended to replace. The Federal Reserve System relies upon the free flow of funds through the money market's allocation process to distribute the reserves to the areas of greatest need.

Perhaps the most important influences upon bank reserve positions over the longer run are changes in commercial bank credit. These do not affect the total of reserves in the banking system but do change the total of reserves that banks are required to hold. When banks as a group make new loans or new investments, there is a roughly equivalent increase in deposits in the banking system, leading to larger required reserves. If the Federal Reserve System automatically supplied new reserves to replace those that have become tied up in required reserves as bank credit expands and deposits increase, there would be no limit upon the extent to which the banking system could grant new loans or make new investments. As the banks created new deposits in the process of lending and investing, an endless supply of reserves would be forthcoming to enable them to meet the higher reserve requirements. To avoid this inflationary outcome, the Federal Reserve System attempts to supply new reserves for the purpose of supporting new deposit growth only in amounts that are in pace with the money requirements of a soundly growing economy.

A consequence of this policy is that bankers feel that the supply of bank reserves is being limited—money is being made "tight"—during periods of accelerating business activity, when rising payrolls, inventory financing, and other uses for money cause the demand for bank loans to swell. At such periods, it is possible that the credit requirements of a bank's "good customers" might exceed the bank's ability to expand loans out of available resources, necessitating the sale of marketable securities. On the other hand, when business activity is not expanding, or is perhaps declining, loan requests ordinarily fall off and the banker finds that he has more funds than he needs to service his customers. Money is "easy". To the individual banker, it might well appear that the Federal Reserve System's policy with respect to growth in the money supply is perverse in its effects. It creates a situation where there is not enough money to service "good

loans", when such loans are in demand, and there is more than enough money to service all available loans when "good customers" are not interested in borrowing.

The Federal Reserve System attempts to regulate the money supply so as to achieve orderly monetary growth. Each new loan, with its simultaneous creation of a new deposit balance, represents an addition to the money that is available for spending on the goods and services the economy produces. However, the economy's physical capacity to expand the real quantity of its output in any one year is limited. If the money available for spending were allowed to increase at a faster rate than the economy's ability to increase real output, the net result would be not an increase in real product but only an increase in the prices paid for all goods and services. This is the classical situation of too many dollars chasing too few goods.

In other words, the Federal Reserve System cannot supply the commercial banks with all of the reserves they would need to service all of their loan requests when business is good without running the risk of inflationary money and credit growth. "Tight money" at periods when loan demands are piling up at a faster rate than reserves are available to service them, and the resulting need to refuse some loan demands, are the necessary conditions if inflation is to be resisted.

ADMINISTERING THE DISCOUNT WINDOW

Let us now return to the question of member bank borrowing from the Federal Reserve Banks. The preceding description of the manner in which the Federal Reserve System attempts to regulate banking reserves makes it clear that the System could not permit unrestricted access to the discount window by member banks. If it were to do so, it might defeat its own policy objectives in periods of rising business activity. It would be pointless to attempt to regulate the rate of growth in the money supply and in credit in use through open market operations if, simultaneously, the discipline thus being exerted upon the banking system were to be dissipated by a free flow of reserves through the discount window. Therefore, the Federal Reserve System must establish conditions for regulating member bank access to advances from the Reserve Banks. One method of influencing the amount of member bank borrowing is through changes in Federal Reserve discount rates; another is through discount administration at the Reserve Banks. This article discusses only the latter method and does not appraise the role of discount rates.

The Board of Governors of the Federal Reserve System has defined in its Regulation A the circumstances in which member banks may borrow. In the foreword to this Regulation, the general principles governing appropriate use of the discount window are presented, as follows:

> Federal Reserve credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources. Federal Reserve credit is also available for longer periods when necessary in order to assist member banks in meeting unusual situations, such as may result from national, regional, or local difficulties or from exceptional circumstances involving only particular member banks. Under ordinary conditions, the continuous use of Federal Reserve credit by a member bank over a considerable period of time is not regarded as appropriate.
>
> In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. It keeps informed of and takes into account the general character and amount of the loans and investments of the member bank. It considers whether the bank is borrowing principally for the purpose of obtaining a tax advantage or profiting from rate differentials and whether the bank is extending an undue amount of credit for the speculative carrying of or trading in securities, real estate, or commodities, or otherwise.

The wording in the preceding quotation is necessarily general, although it is sufficiently precise to afford a helpful guide to borrowers without attempting to establish a fine line between appropriate and inappropriate borrowings. Each borrowing request—and the circumstances that led to the request—differs in some respect from all other requests; and the circumstances surrounding each request must be appraised independently. At the same time, while each request is sufficiently different as to make precise definitions in a written regulation impossible, the types of circumstances that lead to borrowing usually fall under a few broad headings, and determination of the appropriateness of the request may be made fairly and objectively within the intent of Regulation A.

Perhaps the most common circumstance leading to member bank borrowing from its Federal Reserve Bank is miscalculation in estimating the flow of funds into a bank. As remarked earlier, customer deposits, and thus bank reserves, are constantly flowing through the clearings process, and it is completely understandable that a bank

may, from time to time, misjudge the amount of reserves that it will have at its disposal. Such borrowing would fall under the wording in Regulation A that provides for an adjustment made necessary ". . . because of developments such as a sudden withdrawal of deposits . . ." It should be added, however, that miscalculation of money flows is not an acceptable reason for frequent or prolonged borrowing. A bank that found it necessary to borrow from the Federal Reserve Bank during one or more reserve computation periods each month, at the points during the month when total reserve balances were lowest, would be relying upon the discount window to supply part of a predictable need for reserves. It is equally clear that, if a member bank requires access to the discount window for several consecutive weeks, the reserve shortage is more than temporary miscalculation and should be corrected through portfolio adjustments. In this context, it should be noted that continuous borrowing does not necessarily imply borrowing on each day.

Another relatively frequent occasion for borrowing is an unexpectedly large seasonal loss of reserves. Commercial banks in principally agricultural areas, resort areas, or regions in which a single type of industrial business predominates are likely to have fairly sizable gains or losses of reserves from one season to the next. As a general principle, it is anticipated that a bank will attempt to make preparations for seasonal reserve losses through its cash position or its short-term investment portfolio. But situations can and do arise when the seasonal reserve loss is greater than the bank could realistically have been expected to prepare for. In such circumstances, it is perfectly proper for the bank to turn to its Federal Reserve Bank for assistance until it has had an opportunity to make other adjustments. However, such a bank should not expect the Reserve Bank to continue to supply reserve balances through the discount window until the seasonal cycle has run its course and reserves again begin to flow in. Borrowing from the Reserve Bank in such circumstances is still a temporary expedient, to be used while the bank makes the necessary decisions as to the portfolio securities it will liquidate or the reduction in lending it will adopt in order to correct its basic reserve deficiency.

Continuous borrowing, which in effect means a member bank is using Reserve Bank credit to supplement its own capital resources, is inappropriate regardless of how meritorious the loans made by the member bank may be. For example, a situation which has occasionally led to inappropriate borrowing requests originates in the attempt of certain banks to provide financing for public projects, such as new schools, pending the sale of bond issues. This sort of loan demand can be foreseen long in advance, since public works rarely are entered into on the spur of the moment. There should be ample opportunity for the arrangement on a suitable basis of such financing as the school district or other public authority may require. Unfortunately, however, some banks have become involved in the financing of public works in amounts out of proportion to their resources and for periods of time which have become burdensome.

Situations do arise, however, particularly when capital markets are congested and interest rates are rising, when public bodies find they are unable to sell the bonds they have scheduled, at least at rates of interest they are willing to pay. The local bank in this case may suddenly find itself confronted with a request for a large construction loan that may run for a period of years, until the bonds finally are sold. What should the bank do? It does not have the immediate resources to make the loan but, if it refuses, the construction of a desperately needed school or other public facility may be delayed. The answer must be determined, even in this case, by the bank's own resources. In such a situation, the Federal Reserve Bank might extend temporary assistance while the bank arranged to liquidate other assets or to participate the loan. But it would be expected that such arrangements would be made promptly so that the Reserve Bank would not, in effect, become a participant in the loan. Similar circumstances frequently arise when a bank is approached by a public body to purchase tax anticipation notes.

Borrowing is also inappropriate in cases where a commercial bank, in responding to the loan demands arising in its community, extends new loans at a faster rate than it is able to provide for out of new deposits or liquidation of other assets. Sometimes the member bank, with some justification, feels that it has gotten into reserve difficulties because it has provided a superior service to its community. It may be hard for such a bank to understand that it should not have ready access to reserves "to make good loans to good customers". A moment's reflection will show why the Federal Reserve Bank cannot, in effect, become a partner with a bank so anxious to serve its community. Obviously, all banks consider the loans that they wish to make to be good loans or they would not wish to make them. If each Federal Reserve Bank in a sense "went into partnership" with each of its member banks that had good loan requests in excess of its ability to attract new deposit balances, by extending virtually unlimited Federal Reserve credit for an unlimited period, the entire structure of Federal Reserve efforts to impose necessary limitations upon money and credit might collapse.

In some cases, a bank that turns to the discount window for the first time in a rather long while may prove to have been borrowing funds steadily from other sources, either in the Federal funds market or through other types of loans. Such a bank, although it has not found it necessary to borrow consistently from the Reserve Bank, nonetheless has a basic reserve deficiency that it should adjust through its portfolio rather than rely upon the Federal Reserve Bank, even infrequently, to bail it out when it cannot find the funds elsewhere to maintain its overloaned or over-invested position.

In still other cases, a bank that has developed a reserve deficiency will not have made adequate provisions in its portfolio of short-term securities to take care of such a deficiency. The result might be that it would have to liquidate longer term securities — perhaps at discounts from book value that would substantially reduce bank earnings—to raise the necessary reserves. Realizing the member bank's reluctance to suffer such a loss, the Reserve Bank would nonetheless conclude in most cases that the member bank should liquidate securities in order that borrowing from the "Fed" might not become prolonged or continuous.

In reviewing requests for accommodation, the Federal Reserve Bank considers whether the need has, so to speak, been created artificially. For example, many member banks find participations in call loans, usually purchased through their correspondents, a profitable outlet for surplus funds. Such participations should not be retained except on a most transitory basis, if the bank is at the same time finding it necessary to have recourse to the discount window. Another example of such an artificial need is that of banks which take on mortgage commitments outside their normal business areas to increase their income. These should not be carried by recourse to the discount window.

IN CONCLUSION

This long list of "thou shalt nots" should not suggest that the privilege of member banks to borrow from their Reserve Bank is so limited as to be of little value. In the Second Federal Reserve District alone, nearly one half of all member banks borrowed at some time from the Reserve Bank during the first six months of 1959. The great value of the discount privilege is the assurance it extends to each member bank that reserve funds are always available to provide for the unexpected. Before the creation of the Federal Reserve System, individual commercial banks sometimes were the victims of national money crises that subjected them to massive withdrawals of money for which, individually, they were unable to compensate. The discount privilege assures the member bank that it may always borrow for brief periods while it makes other arrangements to offset the unexpected reserve loss that made the borrowing necessary. Also, there are circumstances in which a member bank may appropriately borrow for longer periods. For example, a bank located in a community that has been depressed for a long period might be subject to a steady loss of deposits and other adverse developments that would justify accommodation by the Reserve Bank as it worked out its problem.

The circumstances leading to a borrowing request and the relevant considerations surrounding that request are infinitely varied. But of utmost importance in the decision of the lending officer or discount committee at the Federal Reserve Bank is the intent of the borrower, as shown by his performance. So long as the member bank is making every reasonable effort to operate its business with its own resources, arrangements for temporary accommodation at the discount window can always be worked out. It is only when the borrowing bank relies upon the discount window of the Federal Reserve Bank as a continuing source of funds for its own operation that it is necessary for the Reserve Bank to discourage its use.

Finally, a common misconception with respect to the procedures followed by the Federal Reserve Banks in their lending operations should be corrected. The misconception is that lending standards become "tougher", that discount administration is tightened, when Federal Reserve policy becomes restrictive. It is easy to understand why this misconception has arisen in some quarters, since few banks find it necessary to borrow, and thus to encounter the limitations imposed by Regulation A, when money is easy. The fact is, however, that the standards applied to borrowing requests from the Federal Reserve Banks are consistent from year to year, when money is easy and when it is tight.

Reprints of the foregoing article on "Borrowing from the Fed" are available, and may be of particular interest to member banks and educational institutions. Requests should be directed to the Publications Division, Federal Reserve Bank of New York, New York 45, N. Y.

Treasury Debt Management

Management of the public debt has attracted increasing attention in recent years as Treasury efforts to refund outstanding debt and borrow new money, in the face of strong competing demands for funds at all maturities, have been a frequent source of heavy pressure upon the credit markets. Public debt management is a closely circumscribed area of public policy, for it must operate within the bounds of a Treasury surplus or deficit and must take into account general business and capital market conditions. Within these limits, however, debt management decisions are of considerable importance, since different approaches to managing the public debt can have widely differing effects upon the nation's economy. This is true principally because of the size of the debt—it accounts for about one third of total outstanding debt and is equivalent to about three fifths of gross national product—and because of its key role in the portfolios of so many private and institutional lenders.

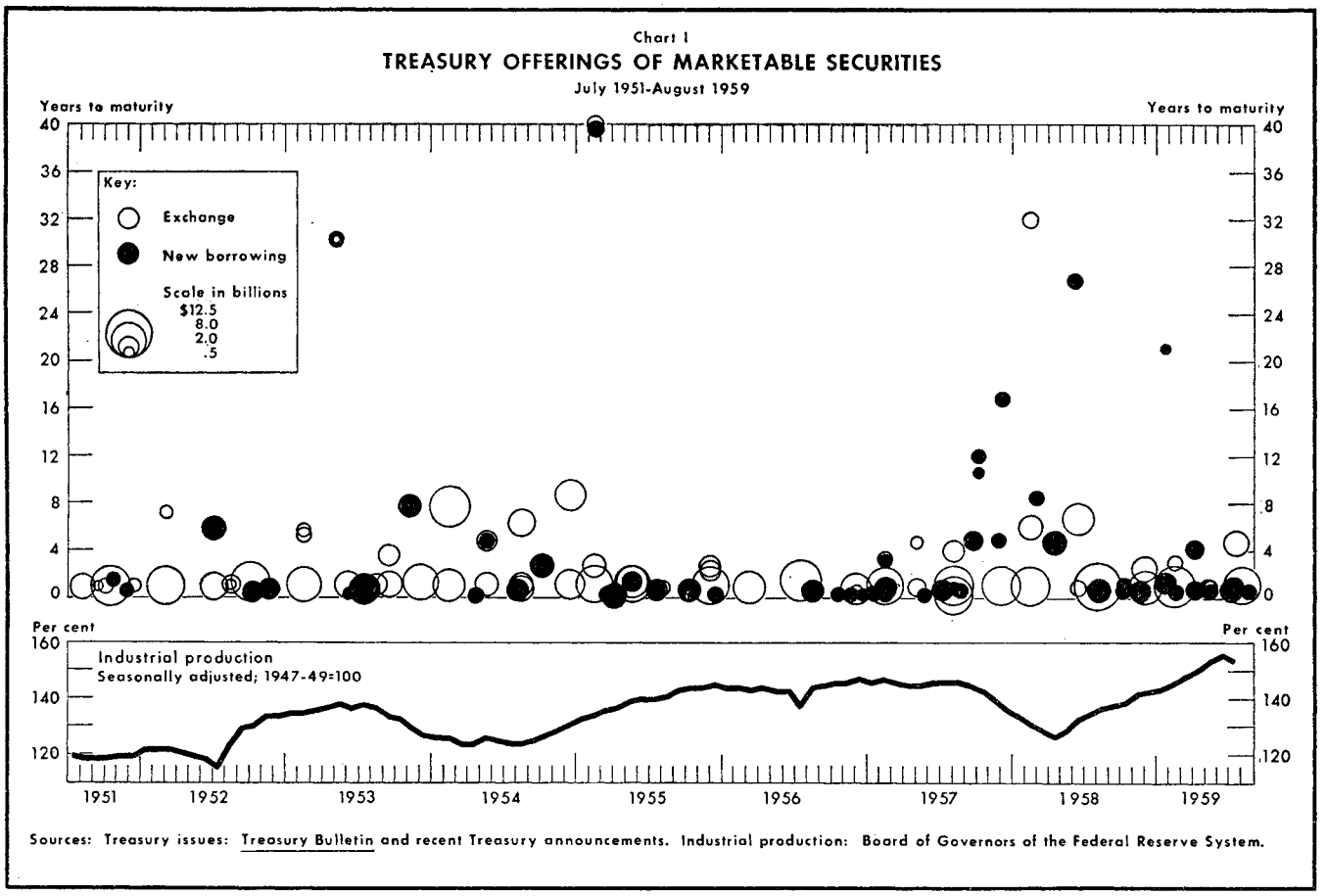
Not all parts of the debt pose equal problems to Treasury debt managers. Of the $285 billion in outstanding debt as of June 30, 1959, $55 billion was held in the United States Government trust accounts (such as the Old-Age and Survivors Insurance Fund) and $26 billion was owned by the Federal Reserve System. Still another $51 billion was in the form of Savings bonds. Administration of the Savings bond program, which is of considerable importance in itself, can have a major effect on the magnitude of other debt operations. The decisions involved are of a special nature, however, and this body of debt has been excluded from the discussion that follows. It is upon the remaining $153 billion of publicly held debt, of which all but $6 billion is in the form of marketable securities, that the most difficult problems of Treasury debt management center and through which the major effects of debt operations reach the economy.

The magnitude of these problems, and the frequency with which they arise, may be gauged from Chart I, which shows the amount and maturity of each Treasury security offering (exclusive of the regular bills rolled over in the weekly bill auctions) since July 1, 1951, not long after the Treasury-Federal Reserve accord. Treasury flotation of marketable securities has averaged $52.0 billion a year during this period—$13.5 billion a year in new cash borrowing and $38.5 billion a year in refundings. While some new money borrowing is required nearly every year to cover seasonal needs, the total of new borrowing has varied from year to year with the size of the Treasury's cash deficit or surplus, with the attrition on refundings, and with other debt operations. In fiscal 1959, for example, when the budget deficit was $12.5 billion, new money borrowing totaled $26.1 billion, almost twice as much as the average for the period since 1951 and about three times the $8.8 billion total of fiscal 1956. The volume of Treasury exchange offerings has also varied considerably from year to year, depending primarily upon the schedule of maturing obligations. Thus, while the volume of marketable securities issued in exchange for maturing issues was $39.4 billion in fiscal 1959, it was as high as $57.3 billion in fiscal 1958 and as low as $29.0 billion in fiscal 1956.

In order to avoid adding further to the short-term debt, and thus to the refunding problem, the Treasury has sought opportunities to sell debt of intermediate and longer maturity. The sale of securities of longer term, whenever economic and market conditions warrant such action, is also necessary to avoid the inflationary potential inherent in a steadily shortening maturity structure. However, the Treasury has not found it possible to float many large issues of longer maturity in the period since 1951 (see Chart I). With the passage of time moving the entire body of the outstanding debt closer to maturity, therefore, the maturity structure of the debt has shortened. The portion of marketable debt maturing within five years rose from 42.7 per cent in mid-1946 to 63.6 per cent in mid-1951 and to 72.9 per cent on June 30, 1959, despite efforts to avoid this debt shortening (see Chart II).

A related Treasury objective has been to minimize any inflationary potential that might possibly arise from the acquisition of its securities by certain classes of investors, particularly commercial banks. In these efforts to influence the ownership of the debt, some degree of success has been achieved. As shown in Chart III, Government securities in the hands of commercial banks increased from $58 billion on June 30, 1951 to $61 billion on June 30, 1959, but as a proportion of total publicly held Treasury debt the amount held by commercial banks was about 30 per cent at both the beginning and end of this interval.

Numerous elements affect the Treasury's efforts to control the inflationary (or expansive) effects on economic activity of its debt operations and to achieve an appropriate maturity structure. The following sections develop



briefly the significance of these two broad objectives of public economic policy and discuss the role of competitive interest rates in achieving these objectives.

TREASURY FINANCING AND ECONOMIC ACTIVITY

Because different methods of Treasury borrowing—and repayment—can differ widely in their economic effects, Treasury debt management may within limits either supplement or offset the economic effects of Government fiscal policy. Thus, the expansive effects of a Government deficit, or the constrictive effects of a Government surplus, may—with a given Federal Reserve monetary policy—have either much or little influence on economic activity, depending upon the methods of debt management employed. Since expansive effects may be desirable in certain circumstances but inappropriate and inflationary in others, the implications of various financing methods are of considerable importance in debt management deliberations.

Basically, Treasury borrowing is expansive or inflationary if the money borrowed to finance Treasury spending is drawn from funds which otherwise would not be used—that is, if either the money supply or the velocity of money is increased so that some other demand upon the resources of the economy is not reduced and, as a result, the total demand for goods and services is expanded. By the same token, the policies followed in refunding existing Treasury debt may have a net expansive or inflationary effect, even during periods of balanced budgets or slight surpluses. This will occur, for example, if the net effect of these refunding policies is to shorten the maturity structure. As the debt shortens, ownership tends to shift from "savings-type" investors to investors who hold Governments as a "money substitute". Thus the Treasury, in effect, borrows funds that would otherwise be idle and releases longer term funds that flow into active use.[1]

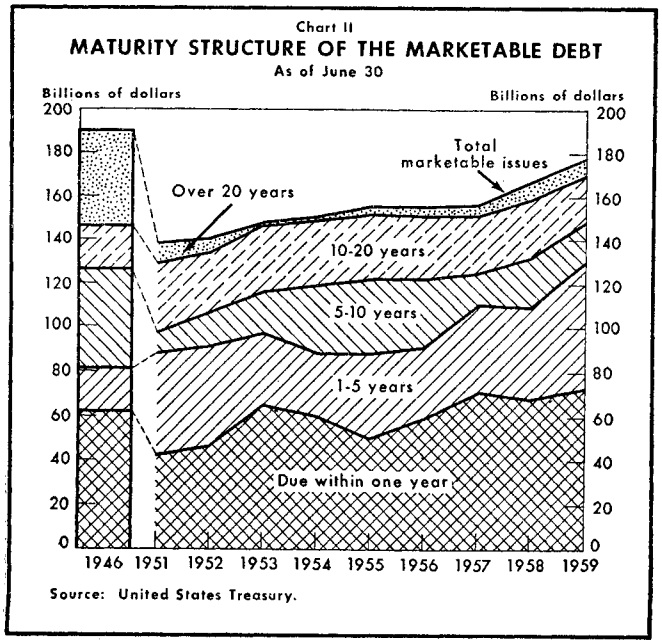
In practice, therefore, Treasury financing may increase or decrease the total demands upon the real resources of the economy. Treasury borrowing may add to such demands, and at times to inflationary pressures, by relying upon the creation of new bank credit, which would increase the supply of money. Alternatively, such an effect

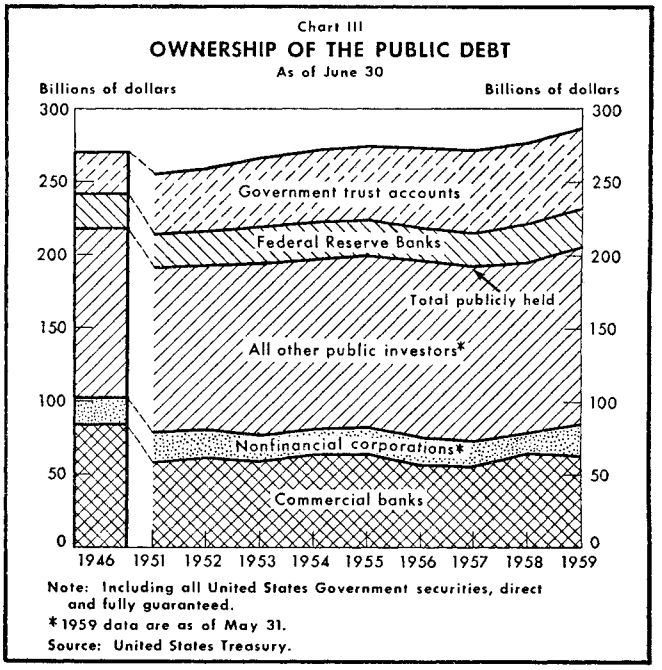
[1] The reverse of these conditions would, similarly, be deflationary.

might be achieved through the activation of otherwise idle cash balances, which would increase the velocity of money. In immediate impact, increases in either the velocity or supply of money tend to have expansive effects. Since, however, an increase in velocity necessarily involves a decline in liquidity, it is likely that debt management policies which result in an increase in velocity are less expansive or inflationary than those which add to the money supply. The likelihood of net expansive or inflationary pressures from debt management operations is great when a sizable deficit is to be financed and reliance is placed principally upon funds borrowed from banks or raised by the issue of short-term instruments which serve to activate what would otherwise have been idle balances.

Treasury borrowing from these purchasers or in these maturity ranges need not necessarily be expansive in character. It would not be so, for example, if short-term securities were purchased with bank reserves or deposits that would otherwise be lent or expended for other active uses. Similarly, sales of long-term securities by the Treasury might have an expansive or inflationary effect if they were purchased, on balance, by banks employing reserves supplied for the purpose by the Federal Reserve System or with excess reserves or deposit balances that would otherwise be idle. Any resulting increase in the money supply or velocity, of course, may or may not be consistent with the objectives of monetary policy at any particular time, depending essentially on whether the chief current problem is inflation or deflation.

In general, however, it may be assumed that reliance upon new bank credit to absorb Treasury securities is the most expansive (and potentially inflationary) method of finance, and that reliance upon short-term issues, even though they are purchased by nonbanks, is only marginally less so in its effect upon the economy. Short-term securities carry an inflationary potential even after their sale. Unlike longer issues they can soon be turned in to the Treasury for cash and thus provide a natural money substitute for investors wishing to keep, in a near-cash form, reserves or surplus funds that are not immediately needed. To most investors in short-term Government securities, these investments are considered virtually the equivalent of cash, and the decision to purchase them does not take the place of decisions to spend the money in other directions. The purchase of longer term obligations, on the other hand, usually represents a decision that these funds will not be scheduled for other expenditure for an indefinite period ahead. Long-term securities may be "locked in" the portfolios of their holders by any subsequent rise in market interest rates because of the large capital losses which their sale might entail. Shorter issues, because of their early maturity, do not fluctuate so widely as longs in capital value, and hence may generally be sold with relatively little capital loss if holders should require cash prior to redemption.





MATURITY

Expansive or inflationary effects on total demands for goods and services offer one guide line for the choice of

an appropriate maturity structure for the public debt, but there are other important elements which must be taken into account. One of these is the Treasury's capacity to repay and retire debt at maturity. If fiscal policy since World War II had provided for gradual repayment of the public debt out of an excess of current revenues, as it did after previous wars, the most efficient policy would have been to space out the maturity of the Treasury's obligations to fit its repayment capabilities. But recent Federal budgets, at least since 1949, have not provided for regular debt repayment, and the defense burden imposed by the cold war probably will continue to make it difficult to achieve a budgetary surplus.[2]

What then are the considerations—other than inflationary or expansive effects—which may guide the choice of a maturity structure for Treasury issues? There are several.

(1) Some Treasury borrowing is carried out to meet strictly seasonal needs. These characteristically arise in those months—usually during the first half of each fiscal year—when the uneven flow of Treasury receipts cannot cover the far more regular requirements of expenditures. Since such borrowing—which has averaged about $6 billion in recent years—can be repaid out of an excess of Treasury receipts over current expenditures later in the fiscal year, its maturity dates can be chosen to fit the pattern of expected Treasury revenues.

(2) Because maturing Treasury issues other than those covering seasonal needs will most likely not be repaid out of current revenues, the Treasury must borrow new funds from the market to replace the old issues when they come due. The availability of intermediate and longer term funds in the market at any one time is generally limited, however, and too frequent maturities may mean, in effect, that the Treasury has no alternative but to offer short-term securities. This can best be avoided by an unbunched, even spacing of maturities which takes into account the market's capacity to accumulate longer term funds.

(3) Frequent Treasury borrowing operations are also undesirable for other reasons. For the credit and capital markets, because the Treasury is such an important borrower, each Treasury financing operation occasions a period of flux, uncertainty, and "churning", as lenders await first the terms of the new offering and then the results of its reception. For the Federal Reserve System, which gives recognition to Treasury financing problems, frequent Treasury trips to market may mean some limitation upon independent policy decisions, and consequently upon the effectiveness of monetary policy. For the Treasury itself, frequent operations may mean that the market is kept off-balance and the difficulty of designing offerings that will be well received is increased. For all of these reasons, it is desirable to issue some part of the Treasury's borrowing in the form of intermediate and longer term securities, which give rise to less rapid turnover of the debt and fewer Treasury trips to the market. To the extent that a substantial short-term debt is necessary to meet the liquidity needs of the economy and must be refunded frequently, interference with the market and with both the Treasury and Federal Reserve System may be held to a minimum through a program for regularizing offerings of short-term issues, thus reducing the market effects of uncertainty as to what the Treasury will offer in exchange. The Treasury has moved in this direction during the past year with the institution of cycles of six-month and one-year issues, in addition to the cycle of regular three-month Treasury bills.

(4) Treasury borrowing (or repayment) of funds in each maturity range may be expected to have a significant impact upon the availability and cost of funds to other, competing borrowers—such as mortgage borrowers, State and local governments, and corporate borrowers in the longer maturities, for example. While the supply of loanable funds is not fully compartmentalized as to maturity, and borrowers may also vary the maturity area in which they borrow, the magnitudes of Treasury financings are typically so large as to affect materially the supply of funds of that maturity available to other borrowers. The Government may wish, of course, for reasons of social or economic policy, to encourage or discourage expanded investment spending by such other borrowers.

It has been a shifting combination of all these elements —as an examination of the magnitude, maturity, and timing of each Treasury offering over the business cycle, shown in Chart I, may indicate—that has determined Treasury action over the past few years.

INTEREST RATES

The most important, most obvious, and most often misunderstood fact of debt management is that, if the Treasury is to sell its securities in a market characterized by the free decisions of lenders and borrowers, it must be prepared to pay a competitive interest rate.

To be sure, it is theoretically within the Government's power to abridge the freedom of lenders' and borrowers' choice in order to sell its securities at less-than-competitive interest costs. The Government, for example, might re-

[2] Of course, to the extent that the Treasury enjoys a cash surplus—even though it does not have a budget surplus—the net shift of debt ownership from the public to the Treasury's trust accounts does represent a form of debt "retirement".

quire that specified institutions—such as banks or pension funds—hold additional prescribed reserves in the form of Government securities. With this legislated addition to the demand for its securities, it would appear that the Treasury should be able to sell its obligations at lower interest rates. Also, since this method would represent a forced diversion of funds from other uses to the Treasury, and would not require expansion of total credit, it would seem that these lower rates could be achieved without inflationary consequences. The immediately apparent difficulty with this scheme for reducing the Government's interest cost is that, unless the requirement tended to freeze in all, or much the largest part of the publicly held marketable debt, it would be largely ineffective. Prices are set at the margin, and so long as there was a marginal amount of Government debt that had to compete with other demands for funds, the Government's interest rate would have to be competitive. The effective placement of Government securities at artificially low interest rates through administrative force would involve greater and more extensive regimentation of the market than has been seriously contemplated or, perhaps, than has been appreciated by those who propound such schemes.

Alternatively, the Government might attempt to lower its interest costs through efforts to create a greater demand for its securities by adding to the existing supply of money. To channel funds into the purchase of new Treasury issues, the Government might authorize or require the purchase of its securities with funds previously immobilized, such as the required reserves of banks. Or, lower Treasury interest costs might be achieved by setting for the Federal Reserve System the task of purchasing Government securities at fixed or variable support prices. For such support to be effective, control over the money supply, and any attempt to check inflation, would have to be sacrificed. In effect, Treasury borrowing costs would have been reduced by turning Treasury securities into interest-bearing money. An expectation of continuing inflation would soon be engendered, and other borrowers—e.g., individuals, corporations, and municipalities—would have to pay skyrocketing interest rates to compensate investors for the anticipated deterioration in the real value of their investment.

If the total supply of money is not to be expanded in an inflationary manner, or if the freedom of lenders' choice is not to be abridged by appropriating to the Treasury a larger share of loanable funds through administrative force, there is no alternative but for the Treasury to sell its securities by competing with other borrowers through competitive interest rates. It may be possible for such rates to be disguised, as through the offering of lower interest rate payments that are either partially or wholly exempted from Federal income taxation, as was indeed the case with Treasury securities before 1941. Such an arrangement, of course, leaves part of the Government's actual interest payments to be paid by the Treasury in sacrificed tax revenues.

Even without tax exemption or similar devices, the Treasury can usually sell its securities in a free market at costs that are somewhat lower than those which must be paid by other borrowers. The qualities of credit risklessness and a broad secondary market that attach to Treasury securities generally make them salable at interest rates somewhat below those on competing issues of other high-grade borrowers.

This differential has diminished considerably, however, since World War II, perhaps chiefly as a result of actions by the Government itself. Growing confidence in the Government's assumption of responsibility for high levels of employment has, in the eyes of many investors, taken much of the risk out of top-grade corporate obligations. At the same time, various Government programs for the insurance or guarantee of mortgages and other types of debt instruments have brought these instruments to almost the same level of safety, in investors' eyes, as direct Treasury obligations. Long-term Government securities have consequently come to enjoy a far smaller interest rate differential relative to other high-grade securities. It should also be noted that the rate of interest the Treasury must pay and its relationship to other interest rates reflect closely the demand and supply in the capital market, in which both current and expected Government borrowing needs play a very significant part. Thus, the large supply of Government securities resulting from the war and the frequent and large Treasury financing operations in recent years have, themselves, tended to reduce the competitive rate advantage of Government obligations.

In short, the Treasury has no realistic alternative but to pay competitive market rates of interest in financing the public debt. Efforts to avoid paying market rates must involve inflation of the money supply or interference with the freedom of investors' decisions. And such devices as tax exemption, in addition to having a perhaps unintended income redistribution effect, do little but conceal the rate of interest actually paid by the Treasury. Moreover, if the Treasury is to prevent its management of the debt from having inflationary consequences, it must resist the movement of the debt toward a shorter maturity structure by regularly selling—at competitive rates of interest—intermediate and longer term obligations. These are the hard facts of Treasury debt management.