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Time and Savings Deposits at Member Banks

The substantial growth of time and savings deposits in the past fifteen years has drawn attention to the expanding role of these deposits in commercial banking. By the end of 1959 such deposits at all member banks had grown to $54 billion, almost 2½ times the volume of June 1945 (see Table I). Since demand deposits rose only 35 per cent over this period, the share of time and savings deposits in total deposits has climbed impressively—reaching 29 per cent of all deposits at the end of 1959, compared with only 18 per cent in 1945.

The growth of time deposits has been much faster, but also more irregular, than that of savings deposits. In June 1958, time deposits accounted for 24 per cent of total time and savings deposits as compared with only 7 per cent in June 1945; time deposits had increased eightfold, while savings deposits had doubled. Savings deposits, on the other hand, have shown a much steadier growth pattern than time deposits over the postwar years, especially in recent years when time deposits have fluctuated rather widely.

The rise in time and savings deposits reflects of course the usefulness of these deposit facilities to the holders of funds as well as the increase in the rates paid on them and the over-all growth of the economy. However, the steady rise in savings deposits, compared with the more irregular increases in time deposits, suggests that time depositors are motivated by different considerations in the allocation of funds than are savings depositors.

TIME AND SAVINGS DEPOSITS IN THE FINANCIAL PROCESS

Time and savings deposits at member banks are part of the broad spectrum of financial instruments, ranging from Treasury bills and commercial paper to long-term bonds, stocks, and even life insurance, in which funds that are not needed for current expenditures may be invested. Consequently, the growth and fluctuations of these deposits are determined by their attractiveness, in terms of interest yield and many other factors, compared with other investment outlets, and by the growth of savings and liquid assets generally.

In much of the writing on the subject, the term "time deposit" has been used to mean "time plus savings deposits". Time and savings deposits, however, are not ordinarily held for the same reason or by the same owners and, therefore, are subject to rather different competitive influences. Funds are placed in time deposits for a specified period of time (i.e., 30, 60, or 120 days or more); the deposit may be "firm" for an agreed duration, or the contract may provide for earlier withdrawals before the stipulated time at the cost of partial or total loss of interest. Savings deposits, on the other hand, do not have specific maturities, and are in practice withdrawable on demand. The holders of time deposits are primarily knowledgeable investors who are able to predict with some assurance the timing of their needs for cash. Savings de-

Table I

Time and Savings Deposits at All Member Banks

Selected call dates

Holder and/or type of deposit	June 30, 1945	June 6, 1957	June 23, 1958	Dec. 31, 1959	June 30, 1945	June 6, 1957	June 23, 1958	Dec. 31, 1959
	In millions of dollars				As a percentage of total time and savings deposits			
Time deposits, total	**1,618**	**8,946**	**12,575**	*	**7**	**20**	**24**	*
States and political subdivisions	392	2,128	3,296	2,383	2	5	6	4
Domestic banks	44	46	139	81	†	†	†	†
Foreign banks	16	1,323	2,127	1,257	†	3	4	2
United States Government and postal savings	102	302	259	259	†	1	1	1
Individuals, partnerships, and corporations	1,064	5,147	6,754	50,185	5	11	13	93
Savings deposits	**20,190**	**35,737**	**39,585**		**93**	**80**	**76**	
Total time and savings deposits	**21,809**	**44,682**	**52,160**	**54,165**	**100**	**100**	**100**	**100**

Note: Because of rounding, figures do not necessarily add to totals.
* Not available.
Less than ½ of 1 per cent.
Source: Board of Governors of the Federal Reserve System.

posits, in contrast, are held largely by individuals and, indeed, are by law restricted to individuals and nonprofit institutions.

Time deposits compete most directly with short-term market instruments, such as short-term United States Government obligations, commercial and finance company paper, and bankers' acceptances. Investment in these competing instruments, a transaction that is conducted in a comparatively impersonal manner, requires the buyer to maintain a somewhat greater familiarity with money market conditions than does investment in time deposits. Time deposits, on the other hand, are arranged through personal negotiations between the banker and the depositor, and the actual deposit contracts often take into consideration the many other aspects of the banker-depositor relationship. While time deposits at member banks have increased eightfold since World War II, the volume of short-term Government obligations held by the public has doubled, and somewhat smaller percentage gains occurred in the volume of other competing types of obligations.

With regard to savings deposits, on the other hand, member banks compete primarily with other savings media, ranging from savings deposits at mutual savings banks and accounts at savings and loan associations to United States Government bonds, life insurance, pension and investment trusts, and corporate stocks and bonds. Although savings deposits at member banks have doubled since 1945, their growth has nevertheless been slower than that of their closest competitors; deposits at mutual savings banks have risen by 128 per cent, while savings at savings and loan associations have grown sevenfold.

Time deposits are also more sensitive to interest rate differentials than savings deposits, since the holders of time deposits are more keenly aware of, and frequently have better access to, alternative investment opportunities. At the same time, rates on time deposits frequently have not adjusted immediately or fully to changes in market rates of interest. When market rates decline, time deposit rates may lag, thereby increasing the relative attractiveness of these deposits. Sizable changes in the other direction in the yield differentials between time deposits and other investments have also occurred quite frequently, partly because the maximum rates that member banks may pay on time or savings deposits are fixed by the Board of Governors of the Federal Reserve System under Regulation Q and by the Federal Deposit Insurance Corporation for insured nonmember commercial banks. In recent years these rates have not been so high as the peak levels reached by market rates on competitive instruments.

Table II

Maximum Interest Rates Payable on Time and Savings Deposits
Per cent per annum

Type of deposit	Nov. 1, 1933–Jan. 31, 1935	Feb. 1, 1935–Dec. 31, 1935	Jan. 1, 1936–Dec. 31, 1956	Effective Jan. 1, 1957
Savings deposits	3	2½	2½	3
Postal savings deposits	3	2½	2½	3
Other time deposits payable:				
In 6 months or more	3	2½	2½	3
In 90 days to 6 months	3	2½	2	2½
In less than 90 days	3	2½	1	1

Note: Maximum rates that may be paid by member banks as established by the Board of Governors under the provisions of Regulation Q. Under this regulation the rate payable by a member bank may not in any event exceed the maximum rate payable by State banks or trust companies on like deposits under the laws of the State in which the member bank is located. Since February 1, 1936, maximum rates that may be paid by insured nonmember commercial banks, as established by the Federal Deposit Insurance Corporation, have been the same as those in effect for member banks.

Source: Board of Governors of the Federal Reserve System.

The main purpose of the regulation of interest rates on member bank savings and time deposits is to prevent banks from reaching for deposits by offering interest rates that they could afford only if they invested the funds in high-yielding instruments which may involve excessive illiquidity and risk. In accordance with the authority granted to it under Regulation Q, the Board of Governors has made three changes in the maximum interest rates which member banks may pay on time and savings deposits (see Table II); the most recent amendment to Regulation Q, effective January 1, 1957, was the first in twenty years.

THE HOLDERS OF TIME AND SAVINGS DEPOSITS

The major holders of time and savings deposits in order of importance are: individuals; States and political subdivisions; foreign banks; and business firms. The behavior of each of these holders is influenced by somewhat different factors.

INDIVIDUALS. The deposits of individuals consist primarily of savings accounts, which are normally evidenced by a passbook. For these accounts, the banks may, but rarely do, require a thirty-day written notice of any intended withdrawal. Some savings-type deposits of individuals are also included in time deposits, which are evidenced either by certificates of deposit or by "time deposit-open accounts", established subject to a written agreement between the depositor and the bank. As of June 1958, savings deposits (including Christmas savings and savings accumulated for the payment of personal loans) and savings-type time deposits of individuals accounted for 78 and 4 per cent, respectively, of total time and savings deposits.[1]

In electing to place savings in a commercial bank savings account, many savers are motivated more by convenience and other nonfinancial factors than by the rates paid on savings deposits. In 1959, for example, despite yield advantages favoring alternative forms of savings, savings deposits at commercial banks continued to increase (although at a reduced rate), while time deposits declined as holders switched into other assets. These "uneconomical" actions are largely explained by certain characteristics of savings depositors. Some depositors utilize savings deposit facilities, not to accumulate a backlog of savings, but rather as a convenient way to build up funds for an anticipated future expenditure. To such individuals, yield considerations are secondary, since the period of deposit accumulation is likely to be short. Their selection of a savings institution is motivated more by its location and the types of services it offers than by rates paid. Many depositors prefer savings accounts to other investments because of the ease with which these accounts may be liquidated without risk of loss. A number of other investment alternatives involve the contractual commitment of funds for long periods of time as well as risks and benefits that do not attach to savings deposits. Still other savings depositors own small balances that are below the minima required for an investment in money or capital market instruments.

There is some evidence that the savings deposits at commercial banks include a larger proportion of small accounts, whose holders have only limited alternative investment opportunities, than do savings accounts at other savings institutions. There was, for example, a marked difference in the response shown by the savings depositors of savings banks and of commercial banks to the 5 per cent Treasury notes issued in October 1959. Savings banks, which have higher average individual savings deposit balances (presumably indicating a higher proportion of more investment-conscious depositors) than commercial banks, experienced larger withdrawals during the first two weeks of October 1959 than did the commercial banks. However, the large withdrawals from both types of institutions did reveal that many savings depositors become keenly aware of investment alternatives as yield differentials widen significantly. Indeed, it is probably the higher interest rates offered by some savings banks and savings and loan associations that have attracted larger depositors to these institutions. Yet, the steady growth in savings accounts at member banks, even in those years when yields on alternative thrift media surpassed the maximum rates permitted on savings deposits, reflects the fact that savings deposits are less responsive to yield differentials than time deposits. To some extent, this growth may reflect the fact that in many communities commercial banks provide the sole local savings deposit facilities, except for postal savings.

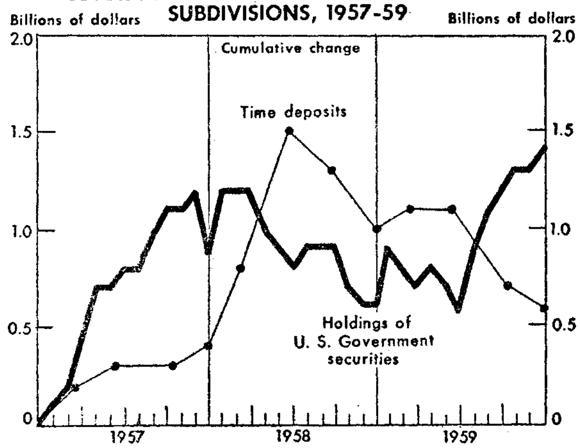
[1] Only occasionally, as in June 1957 and June 1958, have balances for savings deposits and savings-type time deposits of individuals been required separately on member bank call reports. Recently savings deposits have been shown separately in the data for the weekly reporting banks in the Atlanta, Boston, Dallas, Minneapolis, New York, Richmond, and San Francisco Reserve Districts.

STATES AND POLITICAL SUBDIVISIONS. The amount of liquid assets held by States and political subdivisions depends among other factors, on the size and time pattern of their tax receipts and operating expenditures, as well as on the pattern of their financing and construction programs. Construction expenditures in particular have been an important factor in the size of the liquid assets held by States and political subdivisions. These expenditures usually rise to a peak in the third quarter of the year and then fall to a low in the first quarter of the next year. Since tax receipts and new securities issues do not often follow the same seasonal pattern as construction outlays, State and local governments draw down liquid assets at times when these outlays are greatest and build them up at other times. Partly because of legal restrictions that in many areas require them to have all funds on hand before contracts are negotiated on construction programs, many States and political subdivisions raise funds in the capital markets in advance of contract payment dates. The idle funds are then temporarily held in cash or invested in time deposits or short-term marketable obligations, and they tend to be drawn down as construction programs are paid for.

Yield considerations are a strong influence on decisions as to whether the liquid funds of States and political subdivisions should be placed in time deposits or in Government securities. Thus, time deposits rose during the first half of 1957, a period in which the yield differential between time deposits and alternative investments was very small. As yield differentials widened in favor of other investments later in the year, however, time deposits tended to level off while holdings of United States Government securities continued to advance, though at a slower pace than earlier in the year (see Chart I). In contrast, States and political subdivisions added substantially to their holdings of time deposits in early 1958, when yield differentials favored time deposits, and simultaneously reduced their holdings of United States Government obligations. In the second half of 1958 their holdings of both time deposits and Government securities declined, but

Chart I

TIME DEPOSITS AND UNITED STATES GOVERNMENT SECURITIES HELD BY STATES AND POLITICAL SUBDIVISIONS, 1957-59



Sources: Time deposits: Board of Governors of the Federal Reserve System; holdings of United States Government securities: Treasury Bulletin.

since the yield differentials that had previously favored time deposits narrowed and finally disappeared, the larger part of the reduction fell on time deposits. Yield differentials then turned sharply against time deposits in 1959, and States and political subdivisions shifted funds out of time deposits and into United States Government obligations.

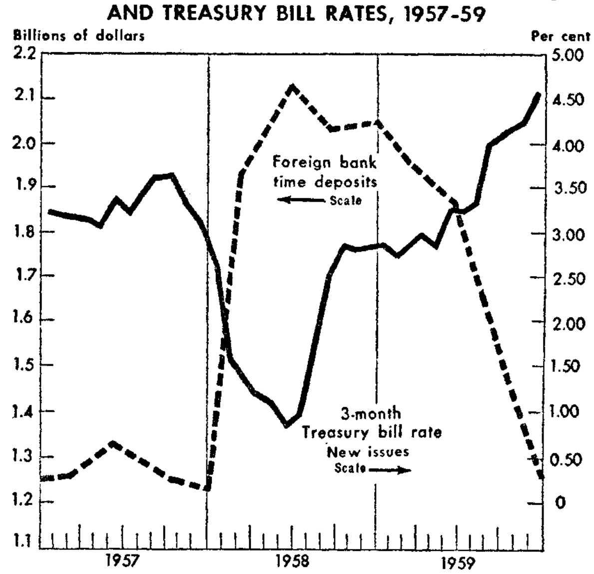
FOREIGN BANK TIME DEPOSITS. The potential availability of foreign bank time deposits has been significantly increased in recent years, as foreign banks have accumulated substantial dollar holdings above their day-to-day operating requirements. Because of liquidity needs, foreign banks have invested most of these funds in short-term dollar claims, primarily in time deposits, Treasury bills, and bankers' acceptances.

But the proportion invested in time deposits has fluctuated widely. When foreign banks weigh the acquisition of time deposits against other short-term dollar claims, they are mainly guided by yield considerations, as is demonstrated by the recent fluctuations in their holdings of time deposits.[2] In the first half of 1958, when the rates on Treasury bills fell very rapidly while the rates on time deposits tended to be more "sticky", a sizable yield premium resulted in favor of the latter. This induced foreign banks to add substantial sums to their time deposit accounts with member banks, principally with New York City banks (see Chart II). Short-term dollar claims invested in Treasury bills and certificates by foreign banks and official institutions declined by $1.1 billion during this period. However, as bill rates rose rapidly after June 1958 and eventually exceeded the maximum rates permitted on time deposits, time deposits of foreign banks declined precipitously. Newly available funds were placed in bills rather than time deposits, and time deposits were not renewed as they matured. In 1959, foreign banks and official institutions increased their total holdings of short-term United States Government obligations and reduced their holdings of time deposits, in each case by substantial amounts. Thus, in recent years time deposits of foreign banks have fluctuated more widely than time deposits of either States and political subdivisions or savings deposits of individuals, reflecting primarily the greater sensitivity of foreign banks to rate differentials between yields on time deposits and other short-term instruments.

BUSINESS AND OTHER TIME DEPOSITS. Business time deposits accounted for 4 per cent of total time and savings deposits in June 1958 and were mostly in member banks

Chart II

FOREIGN BANK TIME DEPOSITS AT MEMBER BANKS AND TREASURY BILL RATES, 1957-59



Source: Board of Governors of the Federal Reserve System.

[2] In this connection, it should be noted that the income earned from time deposits and from bankers' acceptances by all nonresident aliens and foreign corporations is exempt from Federal income tax. Some foreign central banks are exempt from tax on Treasury bills because of special rulings by the Treasury Department, and others have obtained exemption status through tax conventions. However, not all foreign banks enjoy such tax immunity on income from Treasury bills. As a result, some time deposits remain "protected" against competition from Treasury bills unless the differential widens sufficiently to wipe out the tax advantage.

outside New York City. These deposits are also quite volatile in response to changing rate incentives. Thus the $959 million or 92 per cent increase in these deposits between June 1957 and June 1958 may be attributed principally to the more attractive rates being paid on time deposits as compared with money market investments. Partial data suggests that these deposits have declined since mid-1958, as rates on money market instruments have risen. The decline in business time deposits, however, has apparently not been so sharp as in time deposits of States and political subdivisions or of foreign banks, partly because in recent years an increasing proportion of time deposits recorded for business firms seems to represent compensating balance arrangements required for loan accommodations. By placing his compensating balance in the form of a time deposit—usually noninterest-bearing in such cases—the borrower obtains a time certificate of deposit which he may sell at a discount for cash to an investor. He thus realizes that part of the loan proceeds that would have been tied up in compensating balances.

The remaining time deposits are held primarily by the banks' own or another bank's trust department. A relatively small amount is held by the United States Government and the Postal Savings System. These deposits are less sensitive to yield differentials than most other deposits.

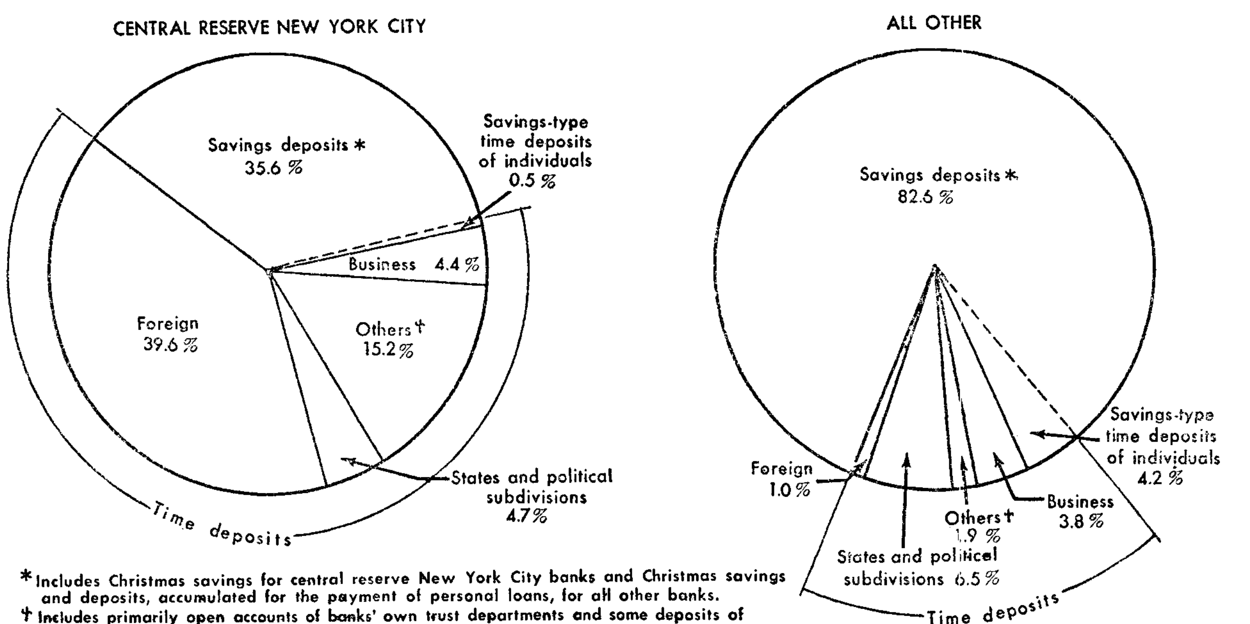
IMPACT OF TIME DEPOSIT FLUCTUATIONS

Over the postwar period, the share of total time deposits held by the more rate-conscious investors—foreign banks, States and political subdivisions, and business firms and individuals accumulating funds for investment purposes—has increased markedly relative to the less sensitive "savings" sector. Accompanying the growing importance of more rate-conscious depositors has been the appearance from time to time of advantages favoring investments other than time deposits. As a result of these developments, fluctuations in the total volume of time and savings deposits held at member banks have become wider.

The role of these rate-sensitive investors in time deposit fluctuations has been particularly pronounced for central reserve New York City banks. As Chart III shows, a relatively larger proportion of time and savings deposits at these banks is held in forms that are very sensitive to interest rate differentials. Thus, in June 1958 time deposits

Chart III

COMPARISON OF TIME AND SAVINGS DEPOSITS HELD AT CENTRAL RESERVE NEW YORK CITY MEMBER BANKS AND AT ALL OTHER MEMBER BANKS ON JUNE 23, 1958



* Includes Christmas savings for central reserve New York City banks and Christmas savings and deposits, accumulated for the payment of personal loans, for all other banks.

† Includes primarily open accounts of banks' own trust departments and some deposits of domestic banks, United States Government, and postal savings.

Source: Board of Governors of the Federal Reserve System.

at central reserve New York City banks accounted for 35 per cent of all time deposits at member banks, while savings and savings-type deposits at central reserve New York City banks amounted only to 4 per cent of the total savings deposits at all member banks. Between the June 1957 and June 1958 call report dates, an interval during which yield differentials on balance moved in favor of time deposits, time and savings deposits at the New York City banks rose by 40 per cent as compared with an increase of 15 per cent for all other member banks. But from June 1958 to December 1959, during which period yield differentials shifted in favor of other investments, the New York City banks lost 16 per cent of their time and savings deposits while banks outside New York City gained 6 per cent. During both periods, the swings in the volume of total time and savings deposits held by the New York City banks were mainly due to the substantial fluctuations in time deposits of foreign banks. To a lesser extent, they also reflected the shifts in time deposits of States and political subdivisions.

The structure of time and savings deposits at a commercial bank is, therefore, an important consideration in its lending and investing policies. Time deposits tend to be invested in shorter dated loans and securities than the funds derived from savings deposits. For example, the large volume of savings deposits in member banks outside the money centers has enabled these institutions to finance many real estate transactions.

It has been suggested that banks would be in a better position to prevent shifts in time and savings deposits if they were allowed to adjust rates, particularly on time deposits, beyond the present Regulation Q ceiling when they are losing these deposits. Greater rate flexibility would enable the banks to eliminate or reduce the rate differentials to which holders of time deposits are so extremely sensitive. Some member banks also are of the opinion that they could maintain their share of total savings deposits, which are less responsive to rate differentials than time deposits, if they were permitted to raise rates closer to those currently offered by other thrift outlets. On the other hand, it has been questioned whether, if Regulation Q were lifted, commercial bank competition on a rate basis with other financial institutions and instruments —and with each other—would remain within the bounds of prudent banking practices.

Difficult issues are raised in considering the extent to which commercial banks should be permitted to compete freely for time and savings deposits. Banks have come a long way from the traditional view of acting solely as lenders of working capital and depositaries for short-term balances. In addition to the customary seasonal loans, banks now provide a multitude of financing arrangements, including consumer loans, revolving credits, real estate financing, and term loans. Over the past decade, time and savings deposits have supplied a large part of the funds needed by individual banks in order to operate within this larger framework of commercial banking. Thus, the question of time deposit rate regulation is, in essence, really one aspect of the larger issues concerning the appropriate role of commercial banks in the financial process.

Money Market in the Second Quarter

The second quarter of 1960 witnessed a succession of divergent influences that brought frequent reversals in investor sentiment, resulting in irregular fluctuations in stock and bond prices and sharply lower rates on short-term market instruments. These influences, which were reflected in the varying receptions given to Treasury offerings during the quarter, included data bearing on the business outlook that were interpreted as pointing first in one direction and then in another. Uncertainties arose out of a sudden heightening of international tensions with the collapse of the Paris summit talks, but then dissipated almost as quickly as they arose. It became clearly evident that the Federal Reserve System was moving toward an easier credit policy, a movement that was "confirmed" by the discount rate reduction from 4 per cent to 3½ per cent at the Federal Reserve Banks of Philadelphia and San Francisco, effective June 3, which was followed soon thereafter by identical reductions at the other ten Reserve Banks. The reserve position of member banks eased considerably over the period, as net free reserves emerged in late May and persisted through June. The money market was correspondingly easier, and Federal funds frequently traded below the discount rate ceiling.

RECENT CREDIT DEVELOPMENTS

In the second quarter of 1960, as in the first quarter, the Treasury enjoyed a comfortable cash surplus that permitted the retirement of marketable debt and, consequently, the provision of funds to the capital markets. However, a smaller part of the surplus in the second quarter was used to retire debt, and a larger part was used to increase the Treasury's deposit balances at commercial banks. Retirement of marketable debt amounted to $1.6 billion in the second quarter, while deposit balances rose by $2.7 billion. In contrast, $2.9 billion of debt was retired during the first quarter, and Treasury deposits fell by $0.4 billion. The Treasury's repayment of debt during the second quarter came toward the end of the period, when $4.0 billion of June tax anticipation bills were redeemed. Early in April the Treasury borrowed $2.6 billion, including $370 million in 25-year bonds. About $600 million was paid out in attrition in the mid-May refunding, but about $300 million was subsequently raised by the Treasury through expanded offerings of 182-day bills.

A relatively moderate volume of securities offerings was placed on the market by Federal Government agencies, State and local authorities, and corporations during the second quarter. The amounts were larger than in the first quarter in each category, but except for agency offerings, where volume had been unusually low early in the year, the increases were of roughly seasonal proportions and probably did not alter appreciably the over-all demand-supply balance in the securities markets.

New capital issues of Federal Government agencies rose to about $550 million in the second quarter, roughly twice the first-quarter volume but well below the $640 million total registered during the second quarter of last year. Securities offerings for new capital by State and local authorities increased by about $0.3 billion to roughly $2.3 billion during the second quarter. This increase left the second-quarter volume somewhat short of last year's high $2.5 billion second-quarter total.

Corporate issues for new capital, estimated at $2.4 billion, were about $0.3 billion higher than in the first quarter but somewhat below the volume of offerings in the second quarter of 1959 and substantially lower than the high of $3.1 billion raised in the same period of 1957. In fact, the volume of corporate securities offered during the quarter was the lowest for that period since 1955. New securities issues are, of course, only one of the channels through which corporations make their impact felt on the capital markets. Another important channel is their demand for bank loans, which has been moderately strong but far from buoyant. Business loans at commercial banks (which, of course, include loans to noncorporate as well as corporate borrowers) increased by $0.4 billion during April and May, which was about in line with the increase in previous years of business expansion with the exception of 1959, when an unusually large increase was registered. Thus, external financing needs by business—as reflected in new securities issues and the banks' business loans—appear moderate by past standards, although it is not yet clear to what extent businesses supplemented these sources of funds through liquidation of their Government securities holdings.

Total loans, adjusted, of all commercial banks increased by $2 billion during April and May, a larger increase for this two-month period than in any year of the last decade except 1959. The gain in business loans noted above was supplemented by a $0.7 billion rise in consumer loans, which matched last year's record expansion in this category, and by moderate increases in farm, securities, and "all other" loans. Real estate loans, however, continued to be weak relative to prior years. Data covering the weekly reporting banks through the first four statement weeks ended in June indicate a continuation of the pattern of moderately strong loan demands. However, the business loan category, which is frequently subject to erratic influences during short periods, registered smaller gains than in similar periods of recent years, as corporations apparently financed their tax payments to an increased extent through the runoff of liquid assets.

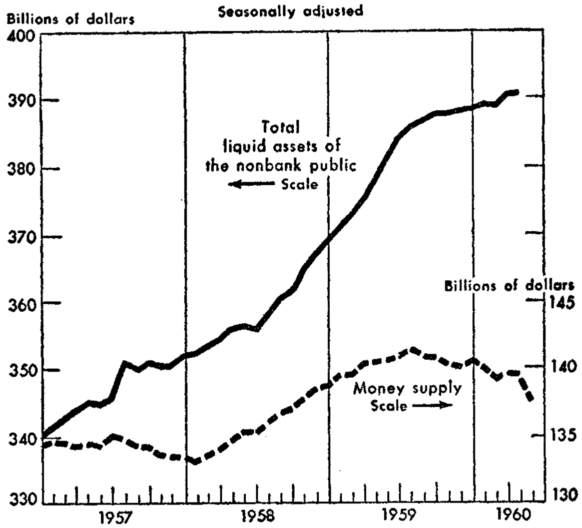
The liquidation of commercial bank securities holdings that had been under way since early 1959 was interrupted during April 1960, when the banks added $1.6 billion of Governments to their portfolios. This largely reflected acquisitions of the notes offered in the Treasury's April financing, for which banks were permitted to make 75 per cent of their payments with credits to Treasury Tax and Loan Accounts. Liquidation was resumed in May, however, with holdings falling by $0.7 billion in that month. Liquidation of other securities also continued during April and May. In June the rate of portfolio liquidation was apparently somewhat diminished.

Total loans, adjusted, and investments of commercial banks, which had declined by an unusually large $6 billion during the first quarter, were much stronger during the April-May period. The rise of $2.7 billion in total bank credit, although falling short of 1958's postwar record increase for this period, was about in line with 1957 and 1959 and well in excess of all prior years. The seasonally adjusted money supply (publicly held demand deposits plus currency outside banks), on the other hand, after holding steady in April, fell by $1.8 billion in May to $137.6 billion; this was $3.6 billion below the peak reached in July 1959 (see Chart I). The May money supply decline, however, largely reflected an unusual $2.4 billion increase in Government deposits. If Government deposits in that month had risen by an amount equal to

Chart I

LIQUID ASSETS HELD BY THE NONBANK PUBLIC

Seasonally adjusted



Note: Latest data plotted are as of end of April for total liquid assets, end of May for money supply.

Source: Board of Governors of the Federal Reserve System.

the average increase for May over the preceding five years ($0.7 billion), the seasonally adjusted money supply would have been about unchanged. The rate of use of the money supply, meanwhile, increased during April and May, as it has in nearly all months since its recession low in February 1958. The turnover of demand deposits in centers outside New York City and the other large financial centers rose by 7.8 per cent in the year ended May 1960.

The fairly steady rise in the turnover of demand deposits has been accompanied, as one would expect, by an increase in the ratio of gross national product to the money supply —i.e., income velocity. This ratio rose by 6.2 per cent between the first quarter of 1959 and 1960, resulting in large measure from a marked growth in public holdings of other liquid assets as supplements to or substitutes for demand deposits and currency. Thus, the nonbank public's holdings of short-term Government securities increased very rapidly during the first half of 1959 and somewhat less rapidly thereafter, while holdings of other liquid assets, such as time and savings deposits in commercial banks and in mutual savings banks and savings and loan shares, have been on a persistent uptrend. As a result, the total of public liquid asset holdings—including nonmoney liquid assets as well as the money supply—has continued to rise, reaching by the end of the first quarter of 1960 a level 4.0 per cent above a year earlier. The rise in GNP was more rapid, however, so that the ratio of GNP to total liquid assets has—like income velocity—tended to rise, showing a 1.7 per cent increase between the first quarter of 1959 and that of 1960. Information for April shows that total liquid assets continued to rise into the second quarter of 1960.

MEMBER BANK RESERVES

The reserve position of member banks, which had eased somewhat in the first three months of this year, became even more comfortable during the second quarter. Net borrowed reserves fell from an average of $219 million in March to $194 million in April, and to $33 million in May. In the final statement week of May, member banks had average free reserves for the first time since February 1959, and in June they enjoyed free reserves in every statement week, the average for the month amounting to $40 million. As usually is the case when reserve positions undergo a substantial shift, most of the change occurred in borrowings from the Reserve Banks, which declined

Table I

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, June 1960

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

Factor	Daily averages—week ended					Net changes
	June 1	June 8	June 15	June 22	June 29	
Operating transactions						
Treasury operations*	+ 78	+ 15	− 33	− 56	+ 53	+ 57
Federal Reserve float	− 168	+ 18	+ 18	+ 515	− 376	+ 7
Currency in circulation	− 127	− 106	− 59	+ 49	+ 60	− 183
Gold and foreign account	− 5	+ 7	− 8	− 24	− 45	− 75
Other deposits, etc.	− 99	+ 28	+ 29	− 41	+ 21	− 62
Total	− 319	− 39	− 54	+ 445	− 288	− 255
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 223	+ 177	+ 58	− 165	+ 118	+ 411
Held under repurchase agreements	—	− 11	− 16	—	—	− 27
Loans, discounts, and advances:						
Member bank borrowings	+ 34	− 36	− 26	+ 176	− 138	+ 10
Other	− 1	—	+ 1	− 1	—	− 1
Bankers' acceptances:						
Bought outright	—	—	− 1	—	+ 1	—
Under repurchase agreements	—	—	—	—	—	—
Total	+ 257	+ 130	+ 16	+ 11	− 20	+ 394
Member bank reserves						
With Federal Reserve Banks	− 62	+ 91	− 38	+ 456	− 308	+ 139
Cash allowed as reserves†	+ 15	− 59	+ 39	− 9	+ 29	+ 15
Total reserves†	− 47	+ 32	+ 1	+ 447	− 279	+ 154
Effect of change in required reserves†	+ 32	− 8	− 37	− 313	+ 189	− 137
Excess reserves†	− 15	+ 24	− 36	+ 134	− 90	+ 17
Daily average level of member bank:						
Borrowings from Reserve Banks	436	400	374	550	412	434‡
Excess reserves†	437	461	425	559	469	470‡
Free reserves†	1	61	51	9	57	36‡

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

* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for five weeks ended June 29, 1960.

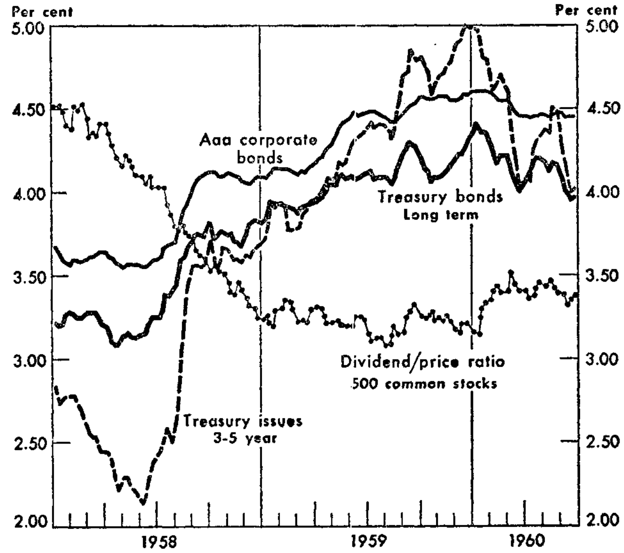
from $635 million in March to $424 million in June. Excess reserves increased only moderately from $416 million to $464 million. Over the quarter as a whole, the principal factor adding to member bank reserves was System open market operations. Between the last week of March and the last week of June, holdings of Government securities in the System Open Market Account rose by $890 million, more than offsetting reserve losses from an outflow of currency into circulation and other influences and allowing member banks to repay part of their borrowings at the Reserve Banks.

During April and May, through the statement week of May 25, the aggregate market influences on member bank reserve positions were largely offsetting. Reserves provided during this period from System open market operations, amounting to about $500 million net, were well in excess of the amount absorbed by net changes in required reserves and by other factors.

During the last five statement weeks in the quarter, through June 29, member banks lost reserves through the usual market factors, but these changes in reserves were largely offset by System open market operations. From May 25 to June 29, System outright holdings of Government securities increased by $501 million, while holdings under repurchase agreements were about unchanged.

As the reserve position of member banks, measured by average free reserves, became increasingly easier during the second quarter, total reserves rose, showing a greater increase over the quarter than in any recent year. Other measures of bank liquidity during the quarter, however, showed divergent tendencies. The loan-deposit ratio for the New York City weekly reporting banks declined from the March high of 69.8 per cent to about 68.6 per cent in June. In contrast, the ratio for reporting banks outside New York increased from 60.5 per cent in March to about 61.1 per cent in June. The ratio of short-term liquid assets (including Treasury bills and certificates and loans to Government securities dealers) to deposits increased from 9.6 per cent in March to about 11.6 per cent in June for the New York City weekly reporting banks; over the same period the ratio for banks outside New York City rose from 7.0 per cent to about 7.3 per cent.

Chart II
STOCK AND BOND YIELDS



Note: Latest data plotted week ended June 24, 1960.
Sources: Aaa corporate bonds: Moody's Investors Service; Treasury issues: Board of Governors of the Federal Reserve System; dividend/price ratio: Standard and Poor's.

THE BOND AND STOCK MARKETS

The markets for interest-bearing securities went through several periods of rise and decline during the second quarter following the pronounced yield declines of the first quarter (see Chart II). Yield fluctuations on short-term instruments were unusually sharp, as transitory influences came to bear with the greatest severity on this sector. After a series of movements in opposite directions over the three-month period, yields on intermediate- and long-term securities were somewhat below levels prevailing at the end of March, while those on shorter maturities were down by about 50 to 80 basis points.

For Treasury notes and bonds, the first half of April saw a reversal of the upward price trend of the first quarter, as the feeling grew that the market's response to the slackened pace of economic expansion might have been overdone. Only moderate interest was shown in the Treasury's April cash offering of a 25-year bond callable after fifteen years and carrying an interest rate of 4¼ per cent, the maximum permitted for marketable Treasury bonds under existing legislation. Public subscriptions to the $1.5 billion bond offering aggregated only $370 million. By contrast, the $2.0 billion of a 4 per cent 25-month note also included in the financing attracted $6.7 billion in subscriptions; $2.2 billion of the note was allotted on a 30 per cent of subscription basis. Subsequently, prices of notes and bonds continued to drift downward in increasingly light trading.

Following the announcement on April 28 of the terms of the Treasury's refunding, the market atmosphere improved for a time. The operation was successfully completed on May 4 with all but $627 million of the $6.4

billion maturing securities exchanged into a 4⅜ per cent one-year certificate and a 4⅝ per cent five-year note, both issued at par. With the Treasury expected to be out of the market until July, prices of notes and bonds during early May recovered some of the losses sustained in April.

This firming in the market was short-lived, however, and market sentiment again shifted in response to a combination of factors. These included the uncertainties arising from international tensions over the summit talk failure and their possible implications for the domestic economy; newly released data suggesting a strengthening in general business; and an announcement by the Treasury that it would raise additional funds in the weekly bill auctions by expanding offerings of 182-day bills in order to reduce the need for borrowing in July. These factors dominated the market until the final week in May, when their force began to dissipate and a new set of influences and expectations emerged.

Toward late May it began to appear to many market observers that, contrary to expectations, recent international developments, and particularly the summit failure, were not to have any significant immediate repercussions on the domestic economy. With the economy still seeming to be moderately strong but without inflationary overtones, attention came to focus on Federal Reserve policy and on the degree to which it was being relaxed, particularly in late May, as the emergence of free reserves generated an easier tone in the money market. The moderate easing of credit restraint was then "confirmed" by reductions in the discount rate from 4 per cent to 3½ per cent at the Federal Reserve Banks of Philadelphia and San Francisco, effective on June 3. Eight other Reserve Banks, including the Federal Reserve Bank of New York, moved to the new discount rate on June 10, with the Atlanta and Boston Banks following suit effective June 13 and 14, respectively.

Against this background, and with bond prices rising sharply, the Treasury announced after the close of the market on June 6 an advance refunding, in line with authorizing legislation passed last September. Holders of the $11.2 billion outstanding of the 2½ per cent Treasury bonds of November 15, 1961 were given the option of exchanging them at face value for up to $3.5 billion of a 3¾ per cent Treasury note maturing on May 15, 1964 and up to $1.5 billion of a 3⅞ per cent Treasury bond maturing on May 15, 1968. Both new issues were to be dated June 23, 1960, with subscription books open June 8-13. Initially, the uncertainties and complexities attaching to a new type of financing operation led to a cautious appraisal of the refunding by investors and to a hesitation in the downward yield trend on notes and bonds. This setback proved temporary, however, and growing confidence in the persistence of an easier credit environment contributed to an increasingly more favorable appraisal of the refunding while the books were still open, and to a resumption of the general yield decline. After the close of the market on June 15, the Treasury announced that applications for the 3¾ per cent note aggregated $4.6 billion, or $1 billion more than the limit, and that subscriptions exceeding $25,000 would be subject to an 85 per cent allotment. Applications for the bond, however, amounted to only $321 million of the $1.5 billion offered.

In the final weeks of June, the market moved irregularly lower in light trading and then turned upward once more with press reports of the Treasury's favorable cash and debt position. After the close of business on June 30, the Treasury announced that it would auction, on July 6, $3.5 billion of a 252-day tax anticipation bill to be dated July 13 and to mature March 15-22, 1961. Commercial banks may make payments for the bill through credits to the Treasury's Tax and Loan Accounts. About $500 million of the funds raised, the Treasury said, would be used to retire part of the $2.0 billion of one-year bills maturing July 15, so that the volume of new one-year bills to be offered in the special quarterly auction on July 12 would be held to $1.5 billion.

Yield fluctuations on seasoned corporate and tax-exempt securities tended to move with those on United States Government securities during the quarter, but within a much narrower range. As measured by Moody's Investors Service, the average yield on Aaa corporate bonds at the end of June was just 1 basis point below the March 31 level of 4.45 per cent, while similarly rated tax-exempt securities were 2 basis points higher at 3.30 per cent. Offering yields on new corporate issues ranged somewhat more widely. The monthly average of 4.69 per cent for June was 3 basis points higher than in March.

Common stock prices also fluctuated within a fairly wide range during the second quarter, partly reflecting shifts in investor sentiment concerning the economic outlook. The modest rally begun toward the end of March was reversed in mid-April, principally by the disappointing first-quarter earnings reports. Prices, as measured by Standard and Poor's 500-stock index, reached a low for the quarter early in May. Subsequently, as business news grew more encouraging, prices began an irregular rise which picked up steam in early June following the reduction in the discount rate at two Federal Reserve Banks and optimistic reports from the steel and automobile industries. At the end of the quarter, Standard and

Poor's 500-stock index was 2.9 per cent above the end of March but still 5.7 per cent beneath the January 5 high for the year. The volume of trading increased somewhat during the period and, on May 18, 5.2 million shares were traded; this was the highest daily trading volume since October 17, 1958.

TREASURY BILLS AND OTHER SHORT-TERM INSTRUMENTS

The market for Treasury bills during the second quarter was subject to the same shifting winds of investor sentiment as the market for notes and bonds, but special factors in the short-term market led to much sharper yield changes. The first bill auction of the period, held on April 4, resulted in rates of 2.73 per cent and 2.93 per cent on 91-day and 182-day bills, respectively, the lowest auction rates of the year to that point. In the following week, however, yields increased by as much as 90 basis points. With the approach of the regular bill auction of April 11 and the April 12 auction of $2 billion of one-year bills to replace a like amount maturing April 15, nonbank demand had dried up. Contributing to this heavy market atmosphere was the fact that the payment date for regular bills—April 14—coincided with that for the issues involved in the Treasury's April cash financing, while that for the new one-year bills fell on Good Friday when many of the market's financing sources were closed.

The yield levels emerging from this unusual conjuncture of events were generally considered out of line by the market, and renewed nonbank buying interest brought a fairly persistent downward tendency in bill yields extending to early May. The improvement was abruptly terminated, however, by a general shift in market sentiment arising from the summit collapse, reports of better business, and the Treasury's plans to expand its weekly offerings of 182-day bills. By mid-May yields had risen to levels only slightly below their mid-April highs.

After the middle of May, the market reversed itself once again as apprehensions related to the international scene faded into the background and expectations of an easing in credit policy came to the fore. Between mid-May and mid-June, bill yields plummeted, as a moderate but steady nonbank demand was augmented intermittently by demands from banks investing reserve surpluses. The average issuing rates established in the weekly auctions declined in four consecutive auctions, reaching lows for the year on June 13. Rates on the 91- and 182-day bills established in that auction were 2.29 and 2.50 per cent, respectively, or 150 basis points below the highs reached in the auction of May 16. Rates turned upward by about 35 basis points the following week under pressure associated with the tax date but declined once more in the last auction of the quarter, on June 27, to 2.40 per cent on the 91-day bills and 2.81 per cent on the 182-day bills.

Rates on other short-term market instruments—bankers' acceptances, commercial paper, and sales finance company paper—generally moved in line with Treasury bills during the second quarter (see Table II). As usually is the case, however, rates on private short-term paper tended to lag behind changes in bill yields. Thus, following the rise in bill yields to their peak on April 11, commercial paper rates were raised by ⅛ per cent on April 12, and again on April 18. Similarly, bankers' acceptance rates, after being adjusted upward in line with bill yields early in April, were unchanged between April 12 and May 3, while bill yields were falling. Acceptance rates finally were reduced by ¼ per cent in two stages on May 4 and May 9, though by that time yields on Treasury bills were on the way up once again. However, the most pronounced downward movement in bill yields, extending from mid-May to mid-June, was accompanied by corresponding reductions on the other short-term instruments. During June, commercial paper rates were reduced by ⅝ per cent in three stages, bringing the offered rate on 4- to 6-month paper to 3⅝ per cent. Rates on bankers' acceptances declined by ⅝ per cent in four steps, bringing the bid rate on 90-day unendorsed acceptances to 3¼ per cent. And rates on sales finance company paper were reduced by 1 per cent, bringing the offered rate on 60- to 89-day paper to 2¾ per cent.

Table II

Short-Term Interest Rates

Date	Average issuing rate on new Treasury bills		Bankers' acceptances 90-day unendorsed bid rate	Commercial paper 4- to 6-month offered rate	Sales finance company paper 60- to 89-day offered rate
	3-month	6-month			
1960					
Mar. 28	2.792	3.187	3¾	4⅛	3⅜
April 4	2.731	2.927	3¾	4⅛	3⅜
April 11	3.622	3.854	3⅞	4	3⅜
April 18	3.306	3.705	4⅛	4¼	3¾
April 25	3.317	3.705	4⅛	4¼	3¾
May 2	3.003	3.349	4⅛	4¼	3¾
May 9	3.274	3.521	3⅞	4¼	3¾
May 16	3.793	4.000	3⅞	4¼	3¾
May 23	3.497	3.867	3⅞	4¼	3¾
May 27*	3.184	3.495	3⅞	4¼	3¾
June 6	2.716	2.871	3⅝	4⅛	3¼-3½
June 13	2.292	2.497	3½	4	2¾-3¼
June 20	2.613	2.877	3¼	3⅝	2¾
June 27	2.399	2.806	3¼	3⅝	2¾

*Because of the Memorial Day holiday on May 30, the Treasury bill auction was held on May 27.

The Business Situation

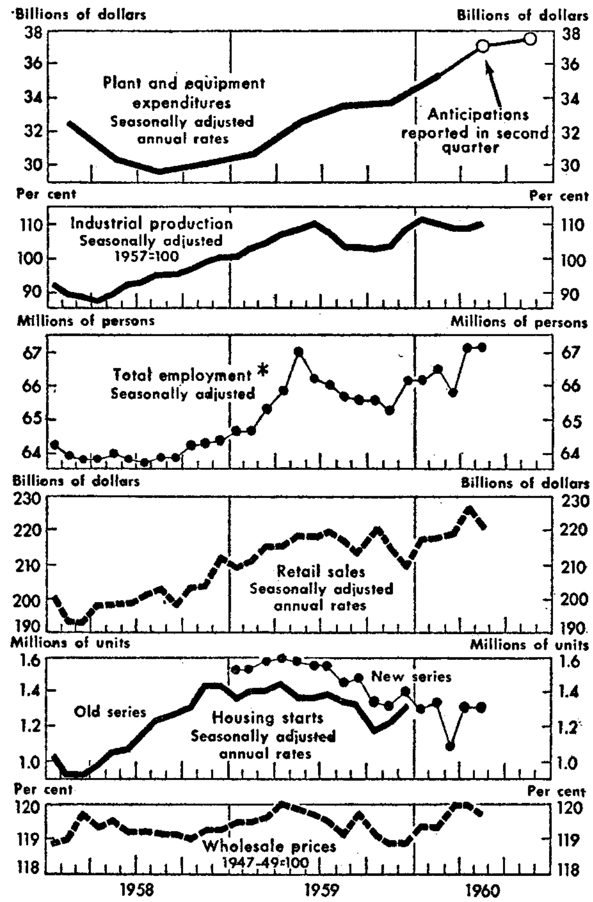
As the second quarter of 1960 ended, the economy appeared to be moving along a high plateau. While the current crop of indicators has yielded signs of both strength and weakness, the outlook remains favorable for some further expansion of economic activity. One of the most encouraging pieces of news on the immediate situation appears in the latest survey of plant and equipment expenditures. Business plans for expanded capital outlays were almost exactly realized in the first quarter of 1960, and plans for even higher outlays in the second quarter were unchanged from what business had expected three months earlier. Although consumer purchases in May were not fully sustained at the record April level, they nevertheless surpassed all other preceding months. It now seems likely that this sales rate was at least maintained in June. Thus two important components of final demand appear to be at near-record levels, and probably served to keep June employment at the May high. On the other hand, the absence of a strong expansionary thrust in any important sector of the economy has raised the question in many analysts' minds whether over-all production will expand sufficiently during the months ahead to cut down on the still large number of unemployed and, at the same time, to absorb the net additions to the labor force that are expected.

The increase in business spending for fixed capital so far this year has been substantial. The survey conducted by the United States Department of Commerce and the Securities and Exchange Commission during late April and May put actual outlays in the first three months of the year at a seasonally adjusted annual rate of $35.2 billion, $1.6 billion above the fourth quarter of 1959 (see chart). Plans for a further $1.8 billion rise to $37.0 billion in the second quarter, reported in the January-February survey, were found to be about unchanged in the recent sampling.

Plans for the rest of the year, however, point to a much slower rate of advance in plant and equipment outlays. The increase expected in the third quarter is considerably smaller than in the second, and the projected rate of spending for the entire year implies only a minor further increase in the fourth quarter. If this latest estimate of spending for the year as a whole ($36.9 billion) is realized, it will exceed 1959 expenditures by about 13 per cent, rather than the 14 per cent margin originally anticipated.

There are some other signs that capital outlays may lose momentum later in the year. Machinery orders have slipped to a somewhat lower level in recent months, after a rapid expansion during most of 1959 that foreshadowed the growth in actual spending during the first half of this year. Also, the recent study of capital appropriations in manufacturing industries—i.e., spending plans formally approved by business management for some time in the

BUSINESS INDICATORS



* Census Bureau Household Survey Series.

Sources: Board of Governors of the Federal Reserve System, United States Departments of Commerce and Labor, and Securities and Exchange Commission.

future—conducted by the National Industrial Conference Board, revealed a 5 per cent decline in new appropriations in the first quarter of the year, after seasonal adjustment. As appropriations usually precede actual outlays by six to twelve months, sustained strength in business sales could, of course, lead to an upward revision in these plans by the time actual spending gets under way.

Total business sales did rise in April by almost 2 per cent (seasonally adjusted), reversing the March decline and carrying the level to a new record. More than half of this increase resulted from the 3.5 per cent rise in retail sales, as consumers "caught up" after unusually bad weather had curtailed their purchases earlier in the year. The largest relative increases were in durable goods associated with home furnishing and repair—the sectors that had been the weakest earlier this year. In May total business sales receded slightly, as manufacturers' sales maintained the April rate but retail sales declined by 2.0 per cent. Retail sales, however, remained above the volume of either March or the previous peak in October 1959. A substantial part of the May decline was statistical, reflecting the absence of the usual upsurge in automobile sales. The daily average rate of car sales of 22,666 units (excluding the Memorial Day holiday) about equaled the April rate. A smaller volume of department store sales accounted for another large part of the decline. The late date of Easter, which is taken into account in adjusting sales for seasonal influences during the preceding but not subsequent weeks, may have accounted for some of the decrease. Preliminary indications suggest that the rate of consumer outlays may have been sustained at a high level in June. The daily average rate of automobile sales early in the month did not show quite so much strength as in May but was expected by industry spokesmen to show a spurt in the last ten days as sales contests closed (data are not yet available). Department store sales appear to have risen from the May rate after seasonal adjustment.

Spending for residential construction, seasonally adjusted, edged up very slightly in June after a four-month decline, and recent movements in the number of starts of private nonfarm dwelling units also offer the prospect of a leveling-out in this sector. As measured in a revised series, housing starts advanced from a low level of 1.1 million units (seasonally adjusted annual rate) in March to 1.3 million units in April, and maintained the same rate in May. (These statistics have recently been revised on the basis of a more inclusive definition—which now covers vacation houses and other "low cost" units—and more information from current surveys; as a consequence, the new series shows a higher level of starts than did the old series—about 11 per cent higher for the year 1959; month-to-month fluctuations may also be larger since current information on the actual start of construction is used instead of estimates based on a fixed lag between the issuance of housing permits and start of construction.) Spending on private nonresidential and public construction is estimated to have declined slightly in June.

Foreign spending for United States goods has been an element of strength in the domestic business picture. In May, merchandise exports declined from an unusually high April level but remained above the earlier months of this year. The trade surplus, which had increased quite sharply in April, also edged down in May but appears to have remained about equal to the first-quarter average after seasonal adjustment.

The recent higher levels of domestic and foreign sales and the firm demand in the investment sector were undoubtedly factors in the small but widespread gains in industrial production in May. The total production index (seasonally adjusted) rose by one point to 110 per cent of the 1957 base, just one point short of the all-time record set in January. The largest increase was in the business equipment component which rose two points to 105 per cent, matching the January peak. Production of consumer goods, which moved up for the second month, also returned to its January peak as the output of consumer durables recovered markedly. The automobile industry contributed substantially to this expansion, with the number of units produced rising almost 5 per cent from April to May in contrast to the usual seasonal decline. A further step-up was scheduled in June, before producers begin the expected sharp summer cutback in order to reduce inventories of 1960 models. The June expansion in auto output, if realized, should have done much to offset the decline that apparently occurred in the appliance industry.

Output of materials, however, moved down again in May for the fourth successive month, reaching a level 2.7 per cent below January. A major influence in this component was, of course, the continued decline in steel production which dropped by one third from 93.1 per cent of rated capacity at the beginning of March to 60.6 per cent at the end of May. Subsequently the operating rate leveled off in the low 60's for three weeks before falling to about 55 per cent at the end of June. Some increase is generally expected later in the summer, for it now appears that users' inventories of steel are being depleted at a rate that cannot continue for long without stocks reaching inconveniently low levels. In this industry, as elsewhere in manufacturing, however, any major future expansion of output will depend heavily on growth in the sales of finished goods, since order backlogs have declined steadily throughout the year and businessmen apparently continue to aim at minimum efficient levels of inventories.

The increase in production and the renewed strength in some components of construction resulted in a slight rise in employment in May, despite layoffs in some manufacturing industries and the termination of temporary government jobs for census takers. Total employment, according to the household survey of employment conducted by the Census Bureau, rose to the record level of 67.1 million persons (seasonally adjusted). While this was a gain of less than $\frac{1}{10}$ of 1 per cent, nonagricultural employment rose by a full percentage point. The payroll survey conducted by the Bureau of Labor Statistics (which does not include self-employed persons and domestics) showed a very slight decline in nonagricultural employment, partly due to small losses in manufacturing but primarily attributable to reductions in government employment. Unemployment (seasonally adjusted) fell by 2 per cent in May to 3.5 million, and the seasonally adjusted unemployment rate fell to 4.9 per cent of the civilian labor force, only $\frac{1}{10}$ of a point above the 2½-year low reached in February.

Personal income, reflecting the small gains in employment, edged up $\frac{4}{10}$ of 1 per cent in May to a seasonally adjusted annual rate of $399.4 billion. Slightly more than one third of the $1.6 billion increase was in labor income. Construction payrolls continued to rise sharply from the unusually depressed levels of late winter, and average hours worked rose. Farm income rose for the second month, after having declined sharply from December through March, and small increases also occurred in the other major components of income, with the exception of rental income which was steady and of transfer payments which declined slightly.

Consumers supplemented the high level of income in April with large additions to consumer credit to finance their record purchases. Total consumer credit outstanding rose to $52.2 billion in April, carrying the ratio of credit to annual personal income slightly above 13 per cent for the first time since January. On a seasonally adjusted basis, the increase of $692 million in credit outstanding was not only the largest this year but was surpassed in only one month last year. In May, although the ratio of credit to personal income rose somewhat further, the addition to credit outstanding was relatively small on a seasonally adjusted basis.

The rise in economic activity in recent months has been coupled with relatively stable prices. Although wholesale prices in general rose about $\frac{8}{10}$ of 1 per cent from December through April, the index of all commodities other than farm products and foods rose less than $\frac{1}{10}$ of 1 per cent. In May the total index declined by $\frac{3}{10}$ of a point to 119.7 per cent of the 1947-49 base—$\frac{2}{10}$ of a point below a year ago—as prices of farm products edged down and the index of industrial prices dropped by ½ of a point, the largest month-to-month decline in over five years. Some further decline seems to have occurred in June.

The total consumer price index continued to creep upward in May despite a decline in the index for all commodities other than foods. The rise of $\frac{1}{10}$ of a point, the fourth consecutive month-to-month increase, resulted from increases in the prices of foods, which appear to be largely seasonal, and of services, which have risen steadily since October 1958. At 126.3 per cent of the 1947-49 base, the total index in May was $\frac{8}{10}$ of 1 per cent above the level at the end of 1959 and almost 2 per cent above a year ago. Average prices of goods other than foods, however, have declined $\frac{9}{10}$ of 1 per cent during the current year and were less than 1 per cent above a year ago.

International Developments

THE LONDON GOLD MARKET

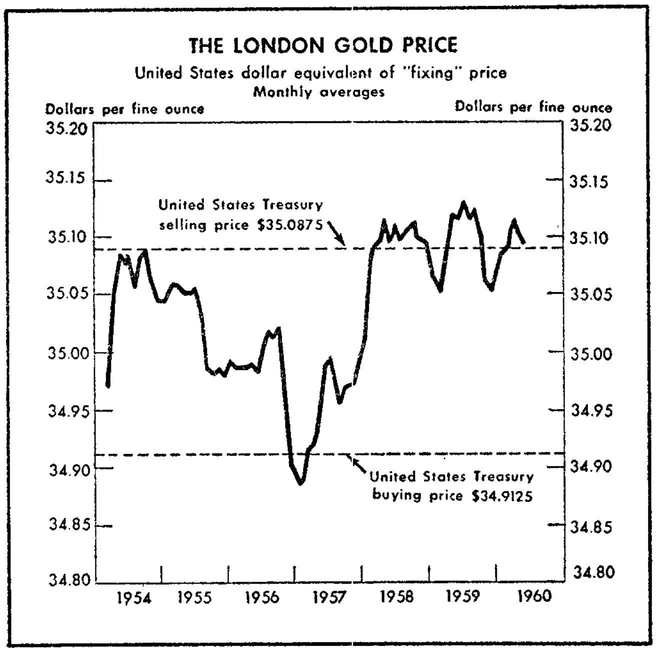
The closing of the London gold market in 1939 deprived the international economy for fifteen years of one of its major institutions. Since the market's reopening on March 22, 1954, however, it has been gradually resuming its prewar functions, and now is again providing a center through which the bulk of the non-Communist world's gold output is flowing.

The first steps toward reopening the market were taken by the British authorities in 1952. In that year specified London firms were given permission to act as agents for the sale against United States dollars of newly mined British Commonwealth gold to buyers outside the sterling area. These firms were thereby enabled to maintain contact with the world's free gold markets, but they were still barred from transacting business as principals in these markets. It was only after sterling had recovered from its early postwar difficulties and gold prices in free markets abroad had declined from the levels reached during the Korean war that the British Government considered it feasible to authorize the formal reopening of the market.

Since its reopening in 1954 the market has operated in very much the same manner as it did before 1939. The prewar custom of "fixing" the London gold price daily was immediately resumed. Participating in the "fixing" are the representatives of the five member firms of the London bullion market who meet every working day at 10:30 a.m. in the offices of N. M. Rothschild & Sons in St. Swithins Lane. Earlier in the day, each of the firms has matched as many as possible of the buying and selling orders received from its clients. Then at the meeting the firms "fix" a price for gold in terms of shillings and pence at which their net offerings or demands can best be brought together. However, a great deal of business is usually done outside the fixing at prices that may differ somewhat from the fixing price.

While the 1954 reopening widened the scope for gold dealings in London, the market has from the beginning been subject to a number of restrictions. Gold transactions are under the general supervision of the Bank of England, and transactions are conducted only by the bank itself and by authorized dealers. The latter include not only the five members of the London bullion market but also all banks that are authorized to deal in foreign exchange. Residents of the sterling area have only limited access to the market. They may sell gold freely, but their purchases are restricted to the limited amounts authorized for approved industrial and export purposes. This is in sharp contrast to prewar arrangements, when sterling-area residents had free access to the market.

Since the reopening, nonresidents of the sterling area have had complete freedom to buy or to sell gold on the London market, provided payment is made in dollars or convertible sterling. Since the British exchange controls at the time of the reopening permitted such sterling to be held only by dollar-area residents, the British authorities acted at that time to facilitate operations in gold by nondollar-area residents by introducing a new type of sterling account called a "registered account", which could be held by *any* nonresident of the sterling area and could be opened or replenished by the sale of dollars or gold. However, when Britain, along with other Western European countries, moved to nonresident convertibility in December 1958, the need for registered sterling ceased.



Accordingly, such sterling was merged with other types of sterling into a single external-account sterling that is freely convertible into dollars and other currencies. Nonresident convertibility has increased the attractiveness of the London gold market, and has apparently brought about the transfer of a substantial volume of transactions from Continental markets; this was reportedly a major factor behind the sharp increase in turnover on the London market last year.

From the date of the reopening, gold could be traded in London in both coin and bullion form. Gold purchased by nonresidents could be either exported to destinations outside the sterling area or set aside in special accounts established in London by authorized dealers. During the first five years of operations the dealers were granted general authority to conduct only spot transactions, i.e., with delivery and payment within two working days; overbought or oversold positions in gold could be carried only within limits specifically authorized by the Bank of England. This restriction on forward dealing was removed in March 1959.

While the London gold price reflects market forces, including the operations of the Bank of England, the United States Treasury's buying and selling prices of $34.9125 and $35.0875,[1] respectively, tend to keep the London gold price within a relatively narrow range. As a matter of fact, the London gold price has remained within the range of the Treasury's buying and selling rates during most of

[1] $35 per ounce minus or plus ¼ per cent handling charge.

the period since the market's reopening, as the chart indicates. However, for substantial periods during 1958 and 1959 the price was above the Treasury's \$35.0875 selling price. This was possible partly because private foreign demand for gold is not met by the Treasury which (apart from supplying domestic artistic and industrial needs) sells only to foreign governments and monetary authorities for legitimate monetary purposes. In addition, foreign central banks may buy gold in London—despite the fact that the price exceeds the Treasury's selling price—because they sometimes prefer for reasons of convenience or economy to hold gold in London rather than New York.

Dealings on the London gold market have been advantageous to both buyers and sellers because of the narrow spread (usually one cent per ounce or less) between the buying and selling prices. For this reason and because of the facilities it affords, the London market has won the bulk of the world's gold business. Since the reopening, virtually all of South Africa's gold production—almost three fifths of the Free World's total—has been handled by the Bank of England acting as agent for the South African Reserve Bank. In this capacity, and as an operator on its own account, the Bank of England has normally been by far the largest single factor in the market. In addition, the London market receives supplies from other sterling-area producers, and much of the not inconsiderable amount of gold sold by the Soviet Union in Western Europe has been marketed in London. Foreign central banks and the Bank for International Settlements operate both as buyers and sellers in the London market, accounting during some years for between one third and one half of the total turnover. Finally, private individuals and nonofficial institutions have normally weighed heavily on the buying side of the market, the flow of gold on this account to Continental Western Europe and the Middle and Far East being particularly significant.

The fact that buyers and sellers of gold could generally obtain better prices in London than in New York contributed, along with an improvement in the United States balance of payments, to the decline in the Treasury's purchases and sales of gold during 1954-57. Net United States gold sales to foreign countries, which had totaled \$1,164 million in 1953, fell to \$327 million and \$69 million in 1954 and 1955, respectively, and were followed by relatively small purchases in the next two years. In 1958 and 1959, however, the demand for gold by foreign monetary authorities increased to a level that exceeded by wide margins the supplies available both from new production and from sales out of the existing holdings of countries other than the United States. This change in the market situation largely stemmed from the substantial strengthening in the balance of payments of the United Kingdom and other European countries that traditionally hold the bulk of their reserves in gold. Whereas in earlier years the Bank of England sold gold to acquire United States dollars, in 1958 and 1959 it became a net buyer of gold in substantial amounts. This, combined with demand from other sources, helped to keep the dollar equivalent of the London gold price above the United States Treasury's selling price during most of 1958 and 1959. Under these circumstances, a large part of the world's official demand for gold was, until the latter part of 1959, satisfied by the United States. Even at this time, however, central banks bought gold in London from time to time, especially when the London price was equal to or under the United States price.

In reopening and supervising the London gold market, the British Government has remained conscious of its position as a member of the International Monetary Fund. From the earliest postwar years the Fund has urged members to "take effective action to prevent external transactions in gold at premium prices" and to support policies that, to the maximum extent practicable, would bring gold into official reserves rather than let it disappear into private hoards. However, the Fund has realized that, in view of the widely varying conditions among countries, it would be "impracticable to expect all members to take uniform measures in order to achieve the objectives" of this policy, and the Fund has accordingly left to its members the "practical operating decisions" involved in its implementation.[2] In this spirit the British Government stated in March 1954 that the reopening of the London gold market was not to be taken as implying that the government questioned the "wisdom of the principle that gold should, as far as possible, be canalized into monetary reserves where it would readily serve payments purposes". However, the statement went on to affirm the government's belief that "the continued closure of the London market would serve no useful purpose internationally and would be damaging to the interests of the United Kingdom and the sterling area".

The extent to which member countries—including especially Britain, because of the overriding importance of the London gold market—have implemented the Fund's gold policies has been kept under review by the Fund. In its 1958 *Annual Report,* the Fund indicated that the general easing of restrictions on gold transactions in recent years had not led to any substantial increase in private hoarding. On the contrary, the incentives to hoard have been weak-

[2] "Statement on Premium Gold Transactions", September 28, 1951, published by the International Monetary Fund in the *Annual Report* of the Executive Directors for the fiscal year ended April 30, 1952, p. 95.

ened by the progress made toward currency convertibility and toward the control of inflation. Indeed, the "disappearance" of Free World gold production into the arts and industry and into private hoarding has generally been lower since 1954 than in earlier years.

Despite the decline in private hoarding, it continues to be a problem, albeit one to which the solution has long been known. A brief summary of the means for dealing with the problem of private gold hoarding was given in the Fund's 1952 *Annual Report*, which observed that, insofar as such hoarding reflected lack of confidence in the value of a currency, the best way to reduce "disappearance" was "to adopt budget and credit policies that will restore or maintain this confidence". The Fund recognized that, where hoarding was a matter of social tradition rather than a safeguard against the risks of currency instability, the hoarding habit could not be changed quickly, but might be gradually weakened by "the spread of banking and the growth of financial institutions which may lead to a wider preference for bank deposits, securities or investments in productive enterprises".

EXCHANGE RATES

In the New York foreign exchange market, spot sterling generally appreciated during most of June, in part reflecting technical adjustments to money rate changes. Good commercial demand in New York and demand from the Continent tended to maintain a firm undertone in the rate throughout the month. The more substantial upward movements in the quotation, however, followed the ½ per cent reduction to 3½ per cent in the discount rate of two Federal Reserve Banks announced on June 2 and the 1 per cent rise to 6 per cent in the British bank rate on June 23. The more advantageous short-term interest yields in London attracted funds from the Continent and in the latter half of June also from New York. By June 24 the quotation advanced to $2.8067 from the month's low of $2.7988 on June 2, and on June 30 was $2.8066.

In the forward market the discounts on three and six months' sterling generally widened, but not sufficiently to prevent the yield incentive for moving funds to London on a covered basis from rising further. At the month end three and six months' sterling were at discounts of 121 and 186 points, respectively, compared with 42 and 80 points on June 1.

The Canadian dollar fluctuated rather erratically during the month, although the trend was upward. Early in June substantial demand for the Canadian dollar from Continental sources firmed the rate from $\$1.01\frac{19}{64}$ to $\$1.01\frac{63}{64}$ by June 3. After a slight easing, the quotation rose irregularly to $\$1.02\frac{19}{64}$ near the month end, primarily under the influence of the placement in the New York market of a Canadian Provincial bond issue and the offering in Canada of two Canadian utility bond issues attractive to foreign interests. The quotation closed at $\$1.02\frac{1}{32}$ for the month.

Widespread rumors of an upward revaluation of the German currency led to increased demand for the mark during the middle of June. At the midmonth, when the German banks were closed for a four-day holiday week end, sales of Deutsche marks in fact were effected above the official upper support limit of 4.17 to the dollar (1 Deutsche mark = $0.239808). Following the categorical denial by the German Government and the central bank of any intention to revalue, however, the quotation reverted to approximately the upper limit. At the same time, the premium on forward marks narrowed after having risen sharply earlier in the month.