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Debt Policy and Monetary Control in Britain

The increased interest in debt management problems and techniques that has been aroused by the United States Treasury's successful advance refunding operation in September makes timely a review of the similar problems in Britain. A major stimulus to the long-continuing discussion of these questions in that country has been the publication of the Report of the Committee on the Working of the Monetary System and of the evidence presented to the committee.[1] Publication of these documents greatly increased public knowledge of the structure and functioning of the British financial system and of the persistent funding problems faced by British financial policy. The evidence presented to the committee includes memoranda submitted by the Bank of England and the British Treasury, as well as oral testimony of numerous official witnesses, and is of particular value for the light that it sheds on debt management techniques and on the relation between debt management and monetary policy.

It was against the background of this evidence that the Radcliffe Committee expressed its view that in Britain "debt management has become the fundamental domestic task of the central bank", a position that reflects the close interweaving of debt policy and monetary policy that has developed in Britain's postwar economy. Since the war, the British economy has been under almost constant expansionary pressures— to repair war damage in the later forties, to rearm during the Korean conflict, and more recently to expand private consumption and investment. Year after year, the total of public and private capital outlays has threatened to outrun the economy's ability to generate savings. The task of the authorities in attempting to check the resulting inflationary pressures on the economy has been exceedingly complicated, partly because some credit demands have been more or less fixed under long-term government programs, but mainly because the public has had, in its large holdings of money and short-term government debt, a potentially inflationary means of financing private capital outlays.

In attempting to control this inflationary potential, the authorities have placed considerable reliance upon the sale of longer term government bonds to the public. According to British Treasury statements to the Radcliffe Committee, such "funding" sales, as they are called, are a multiple aid to monetary control: (1) They act to reduce the liquidity of the nonbank public. (2) They squeeze bank liquidity in two ways, (a) by the sale of bonds to the banks and (b) by the utilization of funds received from the sale of bonds to the nonbank public for the retirement of Treasury bills, which are counted in, and indeed form the largest share of, the banks' required holdings of liquid assets. (3) And, insofar as such funding sales are accompanied by rising interest rates, the incentive of bondholders to monetize outstanding debt is reduced by the capital losses that might be realized through sales.

MAGNITUDE OF THE DEBT MANAGEMENT PROBLEM

The British debt management problem has been formidable, involving the financing of the Treasury's very large budgetary and extrabudgetary requirements and the refinancing of maturing debt. While the Treasury's ordinary "above-the-line" budget has regularly shown a surplus, this surplus has normally been more (and sometimes considerably more) than offset by the "below-the-line" deficit, which reflects loans to the nationalized industries, local authorities, and colonial governments, and payments on account of war damage and for other capital purposes. The Treasury's financing requirements on budgetary account have at times been augmented by official gold and foreign exchange purchases in the market (of course, at other times, when sterling was under pressure, financing requirements have been reduced by the proceeds of official market sales of gold and foreign exchange). Finally, very substantial sums have been added to the Treasury's financing requirements by bond maturities that averaged over £300 million annually during the nine fiscal years through March 1960. All told, the financing requirements for such budgetary, extrabudgetary, and refunding operations averaged £525 million annually during those years, equivalent to more than half of the average annual amount of issues of capital floated in Britain on behalf of both official and private borrowers.

The British Treasury's financing requirements have been met from three sources: from increases in the government securities held by the Bank of England against its note issue, from nonmarket borrowing, and from market bor-

[1] The committee, which was appointed by the Chancellor of the Exchequer in May 1957 and was headed by Lord Radcliffe, is usually called the Radcliffe Committee. Both the report and the evidence were published by Her Majesty's Stationery Office, the report in August 1959 and the evidence in March 1960. The evidence is in four volumes, one comprising the minutes of oral evidence taken by the committee and three the principal memoranda submitted by official and other witnesses.

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rowing. As the note issue has increased—such increases averaged £94 million annually in the nine years ended March 1960—government securities holdings of the Issue Department of the Bank of England were correspondingly enlarged and the Treasury's requirements that had to be met by other means were thus reduced. The Treasury's requirements have also been partly met by sales directly to the public of nonmarketable Tax Reserve Certificates and small savings securities such as National Savings Certificates, Defense Bonds, and Premium Savings Bonds, as well as by the borrowing of deposits placed by the public in the Post Office Savings Bank and in the ordinary departments of trustee savings banks. Such nonmarket borrowing averaged £53 million annually in the nine years ended March 1960, becoming an important source for Treasury finance in the later part of the decade. For the most part, however, it has been through the sale of marketable government securities that the Treasury's requirements have had to be met, and it is with these issues that the rest of this article is concerned.

BILL FINANCE AND BANK LIQUIDITY

In stating to the Radcliffe Committee that "the refinancing of maturing debt and meeting the new requirements of the Exchequer and the nationalized industries . . . [have] been by far the most difficult and intractable of our domestic monetary problems", the Governor of the Bank of England highlighted the close link between debt management and monetary control in Britain. Institutionally, this link is reflected in the organization—not so much administratively as conceptually—of the Bank of England itself into an Issue Department, which operates in the government bond market and handles the debt management side of the bank's business, and a Banking Department, which operates in the money market and controls the cash base of the banking system.

The link is also reflected in the arrangements by which the Treasury, if it cannot cover its financing requirements in the bond market or in any other way, can always meet them by borrowing on Treasury bills in the London money market. Under arrangements that go back to the beginning of World War II, the twelve discount houses that are members of the London Discount Market Association submit bids that in total are always at least equal to the quantity of Treasury bills offered at the weekly tender. As a counterpart to this obligation to "cover the tender", the discount market is confident that the Banking Department of the Bank of England will so conduct its open market operations that the discount houses will normally be able to finance almost all of their portfolios with call loans, which bear an average rate of interest below the bill rate, which come largely from the clearing banks, and which (together with cash, Treasury bills, and commercial bills) qualify for inclusion in the banks' liquid reserves. In effect, the operations of the Banking Department will normally be such as to provide the additional cash reserves that the banking system needs in order to absorb the additional bills sold to it by the Treasury.

The connection between debt management and monetary control is thus direct and clear: to the extent that the Treasury cannot cover its requirements otherwise, they can always be met by the discount market, but only by increasing bank liquidity and thus facilitating credit expansion.

CONTINUOUS OFFICIAL BOND OPERATIONS

The avoidance of excessive reliance on bill finance and the maintenance of monetary control in Britain have been greatly facilitated by the highly developed techniques that the authorities employ in the government bond market. In effect, the authorities are continually scouring the market for any funds that the public is willing to lend, given the prevailing state of expectations and the level and structure of interest rates. The practice of making a formal offering of a bond issue to which the public is invited to subscribe in the course of a single day is still followed, but the authorities do not expect that anything like the whole amount offered will be subscribed by the public on that day. The amount not so subscribed is normally taken up by the Issue Department of the Bank of England, which sells the bonds to the market over the ensuing months. At the same time that the Issue Department is marketing its holdings of new bonds, it is buying up the next maturing issue, and sometimes others that are approaching maturity, in order to bring as much of each maturing issue as possible into official hands before the date of redemption. It is the net result of these market operations that is of particular importance. The goal of the authorities is of course to sell on balance an amount of bonds to the public that is sufficiently in excess of the amount maturing to cover the Treasury's market financing needs. When the goal is not achieved, the Treasury is forced to rely on increases in the bill issue.

The Issue Department's bond market functions are executed through a partner in a brokerage house that is a member of the London Stock Exchange and that also does business for private customers. This "government broker", on instructions from the Bank of England, begins the gradual buying-up of the next government bond maturity as much as a year ahead of the redemption date, offering

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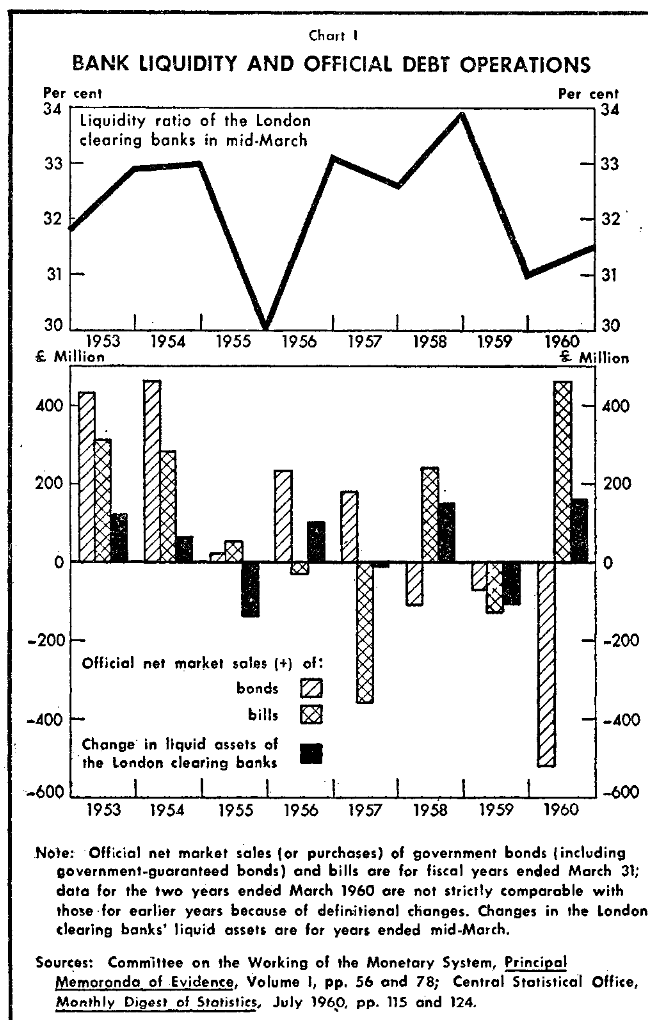

Note: Official net market sales (or purchases) of government bonds (including government-guaranteed bonds) and bills are for fiscal years ended March 31; data for the two years ended March 1960 are not strictly comparable with those for earlier years because of definitional changes. Changes in the London clearing banks' liquid assets are for years ended mid-March.

Sources: Committee on the Working of the Monetary System, Principal Memoranda of Evidence, Volume I, pp. 56 and 78; Central Statistical Office, Monthly Digest of Statistics, July 1960, pp. 115 and 124.

the going market price. It is also through the government broker that the Issue Department gradually sells recently issued bonds, of which the department seeks at all times to have a supply of at least one medium-term and one long-dated issue. These the broker sells at going market prices, which are in practice a little low relative to those of other government securities of comparable maturity. This process was described by the government broker to the Radcliffe Committee as follows:

> We only sell certain amounts of stock [i.e., bonds] at certain prices. The amounts of stock that we sell at each price depend very much on whether I think, having discussed it with the Chief Cashier [of the Bank of England], that we can raise the price quietly, and so encourage the market to go up, which is obviously our best chance of selling. At some stages we only sell quite a small amount of stock at each of a series of rising prices; for instance, when we come to the end of selling a particular stock. At the beginning we tend to sell more stock at a particular price.[2]

Closely related to these sales of longs and purchases of shorts are the bank's operations designed to maintain orderly conditions in the government bond market. For this purpose the Issue Department holds significant quantities of most government issues over the whole range of maturities. The bank is thus able to provide a market, or meet a demand, for a particular government bond and to iron out what the authorities may consider unreasonable fluctuations in prices. While the Issue Department may act to steady the market, however, or even to give the market a lead, the bank's stated policy in maintaining orderly conditions is to avoid resistance to definite market trends.

Exceptions to this general pattern of Issue Department operations have been notable if only because they have been rare. One occurred in November 1949 when, in order to deal with what was officially described as a "highly nervous condition" in the government bond market, the government broker, on instruction from the Governor of the Bank of England, let it be known that he stood ready to buy any government bonds without limit at the current market prices. Another exception occurred in February 1960 when the authorities were confronted with heavy commercial bank sales of government bonds to finance loan expansion. On the 24th of that month, the government broker, faced with bond offerings on an exceptionally large scale, modified his normal practice of smoothing the trend and reduced his buying prices on certain key short-term bonds by a full point. Holding that this action did not reflect "any sharp change in policy", the Chancellor of the Exchequer told Parliament that the government did not "believe that the market ought to be insulated by official action" from the effects of market pressures. It was true, he said, that when bonds were offered in exceptionally large quantities "the authorities very often ease the transition in prices by some support". In this particular instance, he said, the support was not withdrawn completely but was maintained at a somewhat lower price.[3]

[2] Committee on the Working of the Monetary System, *Minutes of Evidence,* question 11,930.

[3] *Parliamentary Debates* (Hansard), March 15, 1960, columns 1117-8.

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SOME PROBLEMS OF DEBT MANAGEMENT AND MONETARY CONTROL

While British debt management techniques have become highly developed, the British authorities—like their counterparts in the United States—have experienced a variety of debt management difficulties which have in turn complicated their monetary control problems. Sometimes these difficulties have arisen even though the Treasury's budgetary and extrabudgetary requirements have been covered by official net bond sales to the public, because the nonbank public and overseas investors have been reducing their large holdings of bills, which have shifted into the money market and increased bank liquidity (see data for year ended March 1956 in Chart I).

At other times difficulties have developed when official and private demands for investable funds have been outrunning the economy's voluntary savings, when the terms on which longer term government bonds were being offered have seemed relatively unattractive to the public, and when, as a result, the authorities have become increasingly dependent on the sale of short-term bonds or Treasury bills to finance the Treasury's requirements. Even when sales of such securities have been entirely outside the banking system, the change to short-term financing has involved a bunching of debt maturities in the near future and—what is essentially another aspect of the same problem—has given nonbank investors an option for cash in as little as three months. Additional problems have arisen when sales of short-term governments in the money market have been increased. Bank liquidity tends to rise not only when additional bills are acquired by the banking system but also when government securities of any maturity are acquired by the discount houses. Although even the shortest term bonds, when held by the banks themselves, are not eligible to be counted as part of the banks' minimum required liquid assets, an increase in the discount houses' holdings of bonds (or indeed any other securities) tends to ease bank liquidity because such holdings are largely financed by call loans from the clearing banks.

Some of these problems have been closely and unavoidably connected with British interest rate policy. This policy has been implemented through changes in the Bank of England's discount rate and through related open market operations, both of which typically have altered money market rates in steps and over extended periods. As money market rates have risen, bond prices have tended to drift gradually downward and funding has become difficult. It is true that the immediate effect of a rise in the discount rate was frequently an improved tone in the government bond market, as investors became more optimistic about the prospects for containing inflation. But often this effect and the associated increase in funding were only temporary. As optimism waned and the downward drift in bond prices continued, the authorities' self-imposed rule that they would not act directly to depress bond prices meant that funding tended to decline (see Chart II), and sometimes even became negative, during periods when inflationary pressures were increasing.

While the authorities' attitude toward longer term interest rates in periods when bond prices have been declining has been relatively passive, they have inevitably exerted a more positive influence when bond prices have been rising since it has been mainly during such periods that substantial bond sales to the public have been feasible. The degree to which such sales acted to retard upward movements in bond prices, however, has varied somewhat over the years. In certain periods of 1957 and 1958, for example, the authorities acted more deliberately than in

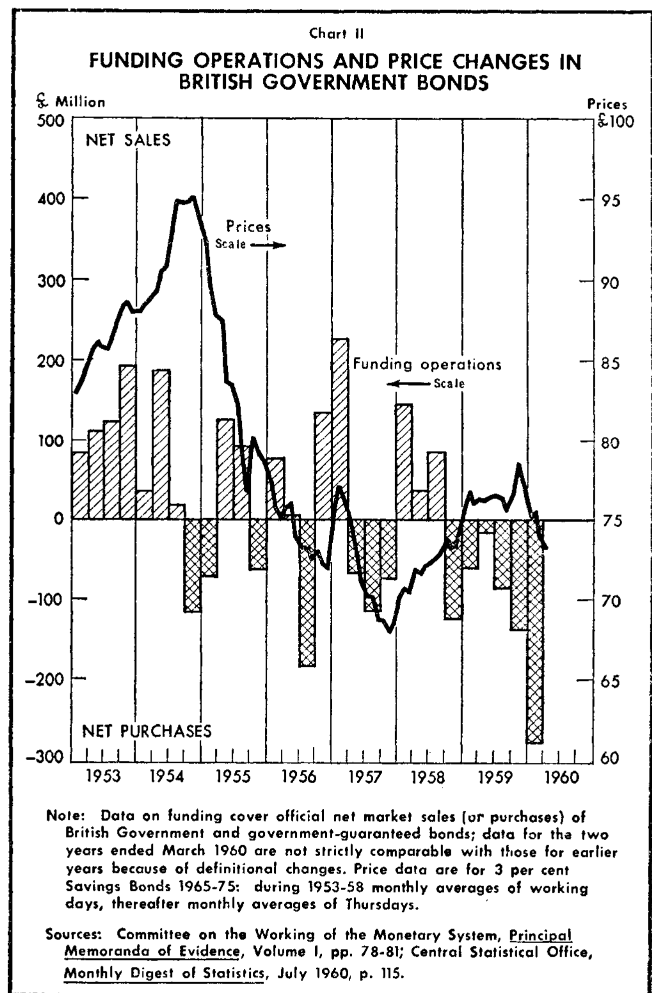

Chart II

FUNDING OPERATIONS AND PRICE CHANGES IN BRITISH GOVERNMENT BONDS

Note: Data on funding cover official net market sales (or purchases) of British Government and government-guaranteed bonds; data for the two years ended March 1960 are not strictly comparable with those for earlier years because of definitional changes. Price data are for 3 per cent Savings Bonds 1965-75: during 1953-58 monthly averages of working days, thereafter monthly averages of Thursdays.

Sources: Committee on the Working of the Monetary System, Principal Memoranda of Evidence, Volume I, pp. 78-81; Central Statistical Office, Monthly Digest of Statistics, July 1960, p. 115.

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earlier periods to restrain rising tendencies in government bond prices. In this their aims were two. The first was to avoid the consequences of speculative excesses in the market. "In the absence of official action", the Governor of the Bank of England told the Radcliffe Committee, "gilt-edged prices would doubtless have risen more than they did" and speculative activity "would have accentuated the rise". When the "reckoning" came, he continued:

> We should then have had either to allow natural forces to reassert themselves, with a big setback in the market, or to prop the market up more or less where it had got to, which would have entailed financing Exchequer needs and debt maturities by increasing the floating debt. The first course would have meant another crisis in gilt-edged and fixed interest securities generally. . . . The second would have held it off for a time, but with a return of inflation fears it would have become inevitable in the end.[4]

The second and more positive objective was to prolong as far as possible the period during which the Issue Department could make substantial net bond sales in the market. Commenting on the bank's policy, the Governor told the committee that it was helpful for funding:

> to have a gilt-edged market which feels that, as regards reductions in Bank Rate in particular and interest rates in general, there may be more to come. Once the market feels that rates have touched bottom, this underlying reason for strength no longer exists, and more or less continuous "funding" becomes much more difficult. There is thus a tactical advantage, from this angle, in moderating the fall in yields.[5]

DEALING WITH DEBT MANAGEMENT PROBLEMS

The British authorities' debt management difficulties have prompted the government to adopt various special devices to limit the credit-expansion capacity that a rise in floating debt gives to the banking system. During the three years ended July 1958 the authorities placed considerable reliance on informal requests to the clearing banks to control their advances. But the authorities have found such requests to be unsatisfactory, partly because they tend to restrict competition among the banks and thus to have adverse long-term effects on the efficiency of banking services and also because, as the Bank of England noted in a memorandum to the Radcliffe Committee, the curbs on bank advances "tend to divert some business into institutions which may lie outside the existing machinery of control".

When the limitation on advances was withdrawn in the summer of 1958, new arrangements were announced under which the Bank of England could call for "special deposits" from the commercial banks. Through these special deposits, for which two calls were made in the spring and summer of 1960,[6] the authorities can in effect freeze liquid assets into the commercial banks, and thus prevent excessive liquidity from being used as a base for a secondary expansion of credit. However, the authorities hold that this device has certain limitations: (1) it can eliminate the primary expansion of credit that results from government borrowing from the banking system only if the banks are unwilling to switch from bonds into bills in order to meet their minimum liquidity requirements; (2) it arrogates to the authorities new power to determine the composition of the banks' assets and thus tends to shift to the government additional responsibility for their solvency; and (3) it operates through compulsion which tends to weaken the traditional informal and flexible cooperation between the banks and the authorities.

These problems, together with the recognition that both the requests and the special deposits deal only with symptoms, have led British observers to review alternative means by which to exert monetary policy in periods when the economy is approaching peak activity. The Radcliffe report emphasized the need, in such periods, to retard the expansion of cash and other liquid assets or even to reduce their outstanding volume, and suggested that this could be accomplished through appropriate changes in fiscal policy and also by so managing interest rates that the public would be induced to maintain or increase its holdings of longer term securities.

It was on the latter approach that the committee centered much of its investigation. Official witnesses were especially questioned on whether debt management difficulties in periods of bond market weakness could be avoided by sharply reducing government bond prices to a level that the market would consider a floor, from which bond prices would tend to rise and funding would be facilitated. To such a course, officials of both the Bank of England and the Treasury had strong objections. They granted that the government's anti-inflationary measures, including the successive increases in the Bank of England's discount rate, had played a significant role in the decline in bond values in the three years ended November 1957. Yet, in the authorities' view, the role of government policy was indirect; it was but one of a number of factors in the market and one that the market accepted.

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[4] Committee on the Working of the Monetary System, *Minutes of Evidence*, question 13,453.

[5] *Ibid.*

[6] For details see "International Developments", *Monthly Review*, May and September 1960, pp. 87 and 163.

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For the Issue Department itself to mark down sharply the prices of government bonds would, the authorities held, be wholly unacceptable to the market. It would be regarded, in the Radcliffe report's summary of the official argument, "as arbitrary juggling with the capital values of the Government's own creditors, and this would have seriously damaged 'Government credit', at the Government's expense in paying the service of the debt for many years ahead". Government bond jobbers, whose livelihood depends on making a small "turn" between buying and selling prices on a large volume of transactions, might be bankrupted by heavy capital losses on their inventory of securities. Institutional investors, such as insurance companies and pension funds, would suffer large capital losses, although these might be only on paper. Far from remedying the government's funding difficulties, a direct and sharp marking-down of government bond prices would, in the government's view, narrow and restrict the market for government securities. (Judging from the Chancellor's remarks referred to above, the February 1960 action of the bank in backing away from the market did not reflect a reversal of this view.) Finally, any damage to the government's credit that resulted from arbitrary juggling of bond prices would have repercussions on foreign confidence in sterling: "I need not remind you", the Governor of the Bank of England told the committee, "how closely the exchange markets and the gilt-edged market watch each other".

As it turned out, most of the official view was accepted in the Radcliffe report, the committee's only major qualification being that, if there were greater public understanding of the government's debt policy aims and debt management techniques, the authorities might thus gain market support for a more positive long-term interest rate policy.

Other British observers have emphasized the need not so much for better debt management techniques as for a reduction in the magnitude of the debt management problem through changes in fiscal policy. Some have suggested that the Treasury's cash deficit could be reduced by several hundred million pounds annually if the nationalized industries were required to meet the competition of the market—to meet their current outlays from current revenues and their capital outlays through bonds floated without government guarantee and without underwriting by the Issue Department. While this might very well entail a reduction in these industries' claims on the economy's real resources, it would change the government's over-all budgetary balance from deficit to surplus, which would in turn tend to strengthen government bond prices and thus facilitate debt management. Other observers have suggested that countercyclical fiscal instruments should be built into the budgetary mechanism—for example, through automatic increases in social security contribution rates in periods when the economy was expanding and through automatic decreases in such rates during recessions. The Treasury's budgetary position would thus be improved in just those periods when expansionary economic forces were tending to weaken the bond market, and vice versa.

CONCLUSION

The discussion of British debt management and monetary control problems that was initiated by the Radcliffe Committee is continuing among both government officials and the public at large. The vast mine of information in the Radcliffe report itself and in the evidence, much of it made public for the first time, is now being supplemented and in part kept up to date by new statistical series published by the authorities. This new information has swept away many public misconceptions about the manner in which British debt and monetary policies have operated, about the problems with which the authorities have been faced, and about the authorities' skill in handling them. What has been brought to light is a blend of government financial policies, adapted to British conditions, that has been unique, flexible, and effective. As this searching reappraisal is continued in the years ahead, and if—perhaps as one result of this continuing reappraisal—fiscal policy reduces the relative magnitude of the Treasury's financing problem, Britain's highly developed debt management techniques may have an increasingly favorable financial framework in which to operate.

Money Market in the Third Quarter

The Federal Reserve System took a series of actions during the third quarter to promote an easier credit environment: reserve requirements for central reserve city banks were reduced, the reserve eligibility of vault cash was increased, and discount rates were lowered by ½ per cent at all Reserve Banks. Commercial bank

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credit rose substantially, as banks acquired large amounts of securities and extended a heavy volume of loans around the September tax date. The sizable acquisition of short-term Government issues, along with an appreciable further reduction in bank borrowing from the Reserve Banks, resulted in a substantial improvement in bank liquidity positions. Despite the general easing in aggregate reserve positions, reserve pressures intermittently impinged on New York central reserve city banks, with consequent firmness in the money market except in mid-September.

With credit conditions easing, interest rates on intermediate- and long-term Government securities fell sharply during July and early August to the levels of late 1958, and over the rest of the quarter rose only slightly despite an unprecedented advance refunding of long-term Treasury bonds in September. Rates on corporate and State and local bonds declined gradually, paralleling rates on long-term Governments, and the volume of new issues exceeded flotations in the corresponding quarter of 1959. Short-term yields, having already dropped drastically earlier in the year, fluctuated moderately and showed little net change over the quarter. At the end of September, Treasury bill rates were about half as high as in early January.

BANK LOANS AND INVESTMENTS

Business demands for bank credit were relatively light during July and August but strengthened markedly in September. In July and August business loans (including loans to nonbank financial intermediaries) at all commercial banks declined by about $1 billion, as compared with smaller declines or sometimes quite sizable increases in other recent years. This weakness was in sharp contrast to the relatively strong expansion during the first six months—an expansion somewhat below the corresponding 1959 rate but more than twice the average of the past decade.

In contrast to the two preceding months, data covering the first three weeks of September for the weekly reporting banks show a marked resurgence of business demand for bank credit. Business loans rose by about $600 million over the three weeks, which compares with increases of $300-500 million in other recent years. Some loan categories that were particularly weak during July and August, such as metals and metal products, public utilities and transportation, and nonbank financial institutions, showed pronounced strength in September. In addition, weekly reporting banks apparently were called upon to provide a large volume of credit to business indirectly by extending credit to securities dealers who had previously been partly financed by nonfinancial businesses. Securities loans this year increased by $500 million over the three-week period as compared with declines or very small increases in previous years; about half of this gain occurred in the third week of September. Unlike business loans, securities loans at all commercial banks had increased appreciably in July and August, reportedly as a result of relatively heavy dealer inventories.

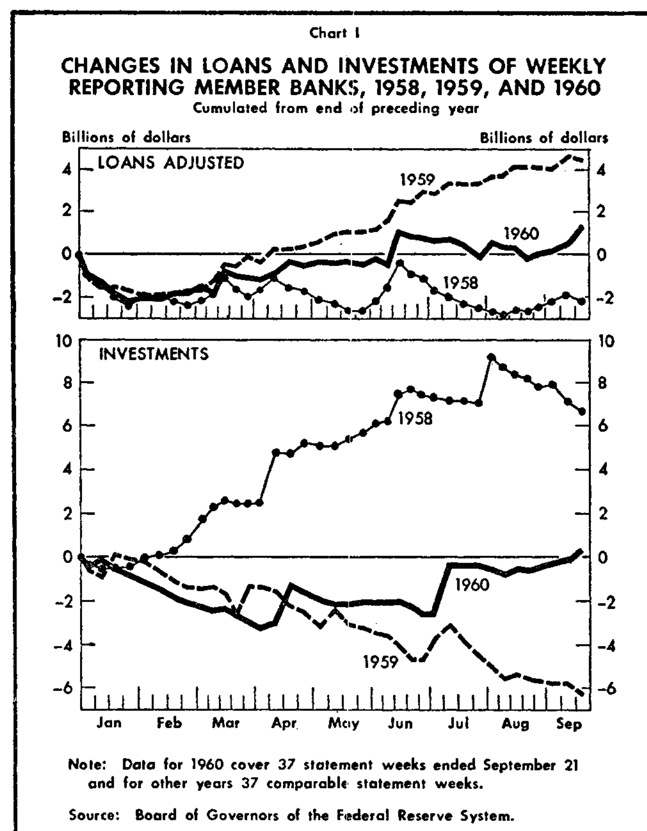
Other loan categories were relatively weak during the quarter. Consumer loans, which had contributed importantly to total loan demands during 1959 and earlier in 1960, lagged in July and August. Real estate loans continued to register relatively small gains.

Total loans adjusted of all commercial banks changed little during July and August, while in most recent years loan volume expanded moderately during this period except in the recession years 1954 and 1958 when declines of $1-2 billion were registered. However, following the pattern of business financing noted above, total loans picked up smartly in September, particularly in the third week covering the tax date. Chart I, which shows cumulative loan changes for the weekly reporting banks for the last three years, places this recent development in the perspective of the year's experience as a whole. During the first quarter of this year, loan behavior followed closely

Chart I

CHANGES IN LOANS AND INVESTMENTS OF WEEKLY REPORTING MEMBER BANKS, 1958, 1959, AND 1960

Cumulated from end of preceding year



Note: Data for 1960 cover 37 statement weeks ended September 21 and for other years 37 comparable statement weeks.

Source: Board of Governors of the Federal Reserve System.

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the pattern of 1959, a year of rapid loan expansion. During the second quarter, however, the loan expansion this year diverged perceptibly below that of 1959. Although the divergence in July and August was even more pronounced, in September it narrowed sharply.

Securities holdings of commercial banks rose substantially over the quarter with gains concentrated in July and in September. In July banks were permitted to make full payment for new tax anticipation bills by crediting Treasury Tax and Loan Accounts, and on balance over the month holdings rose by about $2.5 billion. Although the increase at the time of the financing was not much larger than during similar financings in 1958 and 1959, the heavy subsequent runoffs in those years did not occur this year and holdings remained almost constant through mid-September (see Chart I). In the first three weeks of September, holdings at weekly reporting member banks rose by another $600 million, in contrast to declines in comparable periods of other recent years. (Some part of this large increase in September may have been associated with securities liquidation by businesses raising funds to pay taxes.) Total commercial bank credit rose by $2.4 billion in the first two months of the quarter—the largest increase for this period since 1954—and apparently moved up still further in September.

The heavy securities acquisitions and the repayment of borrowings from Federal Reserve Banks permitted a further improvement in commercial bank liquidity positions during the third quarter. One liquidity measure—the ratio of selected short-term assets,[1] less borrowings, to total deposits less cash items and reserves—had risen to 15.2 per cent by mid-September for weekly reporting banks in New York City, compared with 12.2 per cent in June and a 1960 low of 10.4 per cent in March. For reporting banks outside New York City, the ratio at mid-September stood at 11.9 per cent, compared with 8.5 per cent in June and 8.9 per cent in March. Loan-deposit ratios, a somewhat cruder measure of bank liquidity (or rather, illiquidity), declined to 67.3 per cent in mid-September for New York City banks, compared with 68.6 per cent in June and a high of 69.8 per cent in March. For reporting banks outside New York, the ratio fell to 60.3 per cent in mid-September from a high of 61.2 per cent in June.

With liquidity positions somewhat improved and loan demands slackening, leading commercial banks in August announced a reduction in their prime lending rate to 4½ per cent. The rate had been unchanged at 5 per cent since the fall of 1959.

The appreciable increase in bank credit during July and August was accompanied by a modest ($0.6 billion) rise in the seasonally adjusted money supply (demand deposits adjusted plus currency outside banks). At the end of August the total adjusted money supply of $138.6 billion was $1.1 billion above the recent low point reached in May but still well below the peak of July 1959. Time deposits at commercial banks, on the other hand, have advanced sharply in recent months to successive new highs. The $1.5 billion increase in July and August compares with an average rise of less than $0.5 billion in the previous six years. At the end of August time deposits at all commercial banks were $3.4 billion (or 5.2 per cent) higher than a year earlier.

SYSTEM POLICY AND MEMBER BANK RESERVES

With inflationary forces quiescent, the Federal Reserve System moved on several fronts during the third quarter to provide an easier credit environment. Effective July 28, stock margin requirements were reduced from 90 per cent to 70 per cent. Member bank reserve requirements were liberalized by increasing the amount of vault cash allowable as reserves. For country banks, reserve eligibility was extended to that amount of cash in excess of 2½ per cent of net demand deposits and, for reserve city and central reserve city banks, to cash in excess of 1 per cent. (The ratios had previously been 4 per cent and 2 per cent, respectively.) This action, effective August 25 for country banks and September 1 for reserve city and central reserve city banks, increased the amount of vault cash allowable as reserves by about $500 million. The required reserve ratio on net demand deposits was reduced at central reserve city banks by ½ per cent to 17½ per cent effective September 1, releasing approximately $125 million of reserves. Discount rates, which had been cut in June from 4 per cent to 3½ per cent at all Reserve Banks, were reduced further to 3 per cent in August and early September.

Open market operations, along with the changes in reserve requirements and vault cash eligibility, provided member banks with more than enough reserves to offset substantial drains from operating factors. The principal drain arose from a gold outflow which aggregated $594 million during the thirteen-week period ended September 28. An increase in currency in circulation over the period absorbed $137 million of reserves, and this just about offset modest reserve gains from float and "other deposits, etc." Reserves on balance were also absorbed by a $219 million rise in required reserves. System purchases were concentrated in early July, particularly in

[1] Vault cash, balances with domestic banks, loans to banks, loans to brokers and dealers, and Treasury securities maturing within one year.

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Table I
Changes in Factors Tending to Increase or Decrease Member Bank Reserves, September 1960
In millions of dollars; (+) denotes increase, (−) decrease in excess reserves

Factor	Daily averages—week ended				Net changes
	Sept. 7	Sept. 14	Sept. 21	Sept. 28	
Operating transactions					
Treasury operations*	+ 9	+ 12	− 86	− 25	− 90
Federal Reserve float	+ 73	+ 203	+ 463	− 285	+ 454
Currency in circulation	− 194	− 117	+ 120	+ 167	− 24
Gold and foreign account	− 15	+ 5	− 167	− 73	− 250
Other deposits, etc.	− 25	+ 63	+ 45	+ 3	+ 86
Total	− 151	+ 165	+ 375	− 213	+ 176
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	− 42	− 116	− 29	− 39	− 226
Held under repurchase agreements	+ 38	− 19	− 79	+ 37	− 23
Loans, discounts, and advances:					
Member bank borrowings	− 12	+ 38	− 220	+ 146	− 48
Other	+ 1	+ 1	+ 5	+ 12	+ 19
Bankers' acceptances:					
Bought outright	+ 1	—	+ 1	—	+ 2
Under repurchase agreements	—	− 1	—	—	− 1
Total	− 14	− 96	− 322	+ 155	− 277
Member bank reserves					
With Federal Reserve Banks	− 165	+ 69	+ 53	− 58	− 101
Cash allowed as reserves†	+ 56	+ 154	—	+ 107	+ 317
Total reserves†	− 109	+ 223	+ 53	+ 49	+ 216
Effect of change in required reserves†	+ 128	− 62	− 359	+ 46	− 247
Excess reserves†	+ 19	+ 161	− 306	+ 95	− 31
Daily average level of member bank:					
Borrowings from Reserve Banks	261	299	79	225	216‡
Excess reserves†	658	819	513	608	650‡
Free reserves†	397	520	434	383	434‡

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 September 28, 1960.

the week including the Fourth of July, and in early August when reserve drains from operating factors were again sizable. Between the last week in June and the last week in September, System holdings of Government securities rose by $561 million. Free reserves of member banks increased from a daily average level of $41 million in June to $434 million in September, as member bank borrowings from the Reserve Banks fell by $209 million and excess reserves increased by $184 million.

Despite the easing in aggregate reserve positions, New York City and Chicago banks remained under moderate pressure during July and August and were net purchasers of Federal funds on most days. In September the position of the large Chicago banks eased and they were generally net sellers of Federal funds, but the New York City banks continued under reserve pressure. Prior to the reduction in the discount rate at this and three other Reserve Banks on August 12 from 3½ to 3 per cent, the Federal funds rate varied generally from 3½ to 3¼ per cent except around country bank settlement dates, when funds flowed into the financial centers. During the remainder of August and September, funds were traded for the most part at effective rates ranging between 2½ and 3 per cent.

LONG-TERM SECURITIES MARKETS

Flotations of new long-term securities were fairly heavy in the third quarter compared with the same quarter of 1959, following a relatively low volume of offerings in the first half of the year. The stepped-up pace of new financing was most evident in the markets for issues of corporations and of State and local governments. Considerable market interest, however, centered around Treasury financing operations. While these increased the outstanding supply of market instruments only modestly, they altered the maturity structure of the debt and introduced several innovations in public debt management.

Treasury debt operations in July were limited to the short-term sector, with a cash offering of $3.5 billion of tax anticipation bills maturing in March 1961 and a $1.5 billion issue of special one-year bills in partial replacement of the $2.0 billion maturing July 15. Commercial banks were permitted to subscribe to the TABs through Tax and Loan Accounts, but interest was strong in both issues.

In August, Treasury financing activity moved toward the longer end of the list and a new refunding technique was introduced. The maturing issues were $9.6 billion of Treasury notes and $797 million of FNMA notes. A part of this total ($1.5 billion) was redeemed for cash, and to replace the rest of it the Treasury offered two issues—about $7¾ billion of 11½-month certificates, and about $1 billion of 7-year and 9-month bonds. The innovation was that holders of the retiring issues would not have pre-emptive rights to the new offerings. These would, instead, be acquired only by cash subscriptions which were open to all investors and subject to allotment. Despite some uncertainty created by the new technique, the refinancing was generally considered successful. The new issues were heavily oversubscribed, and allotments, except for special classes of subscribers, were only 13 per cent of subscriptions for the certificates and 15 to 25 per cent for the bonds.

In another move toward increased flexibility of debt management, the Treasury on September 9 announced its long-expected plans to refund several years in advance of maturity some of the 2½ per cent bonds issued during World War II. The Treasury offered at par (a) 3½ per cent bonds of 1980 in exchange for 2½ per cent bonds of 1962-67, (b) an additional issue of 3½ per cent bonds of 1990 (originally issued in 1958) in exchange for 2½ per cent bonds of 1963-68, and (c) 3½ per cent bonds of 1998 in exchange for 2½ per cent bonds of June 1964-69 or 2½ per cent bonds of December 1964-69. The total

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outstanding amount of the 2½ per cent bonds eligible for exchange was $12.5 billion. Subscriptions to the 1980 bonds were not subject to limited allotment, but the award to the public of the two longest bonds (1990 and 1998) was to be held to a combined maximum of $4.5 billion. The subscription books were open from September 12 through September 20, and total subscriptions for the three new offerings came to $4.0 billion (including $3.4 billion from public holders and $0.6 billion from Government Investment Accounts). With this strong investor response, the operation was generally regarded as successful. As a result of the refunding, the average maturity of the marketable public debt increased from about fifty months to fifty-seven months, and this extension was achieved with a minimum of market disturbance.

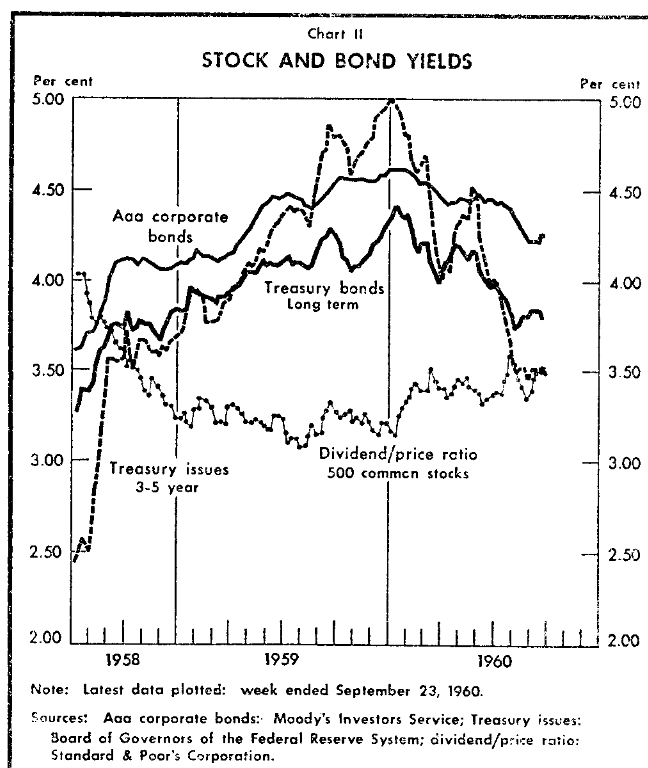
Corporate offerings of stocks and bonds for new capital climbed to an estimated $2.4 billion for the quarter. Although not high by historical standards, flotations in the third quarter were almost a fifth larger than in the corresponding period a year earlier, marking the first quarterly period in which flotations ran ahead of 1959. Part of this stronger showing lay in the heavy demands made on long-term capital markets by sales finance companies. These borrowers, apparently in a shift away from commercial bank financing, sold an estimated $450 million in public and private placements during the quarter, the largest volume of such offerings since the first three months of 1956. Other corporate borrowers, however, also increased the volume of new issues. The estimated total of about $2.0 billion offered by corporations other than sales finance companies was slightly under the second-quarter volume, but it was well above a year earlier, again the first quarter of this year to rise above the corresponding 1959 figure.

Flotations of tax-exempt issues showed much the same pattern. The volume, estimated at about $1.8 billion, declined seasonally from the second quarter, but it too was higher than a year earlier for the first time in 1960.

Despite relatively heavier offerings, average yields on tax-exempt and corporate bonds moved considerably lower before turning up early in September. At the end of the quarter, Moody's average yield on high-grade corporate bonds had climbed back to 4.27 per cent from a low point of 4.23 per cent (see Chart II). Similarly rated tax-exempts closed the period at an average yield of 3.18 per cent, 19 basis points above the low. In both cases, the closing average was well below the level at the end of the second quarter, and apparently reflected the generally easier availability of funds.

Rates on long-term Treasury issues also fell appreciably early in the quarter. However, they turned up more than a month earlier (in early August) than had yields on corporate and tax-exempt instruments. Dealer holdings of Government securities were reportedly slow to move during the early weeks of August, despite market expectations of easier credit conditions. There were also some additional uncertainties in connection with the Treasury financing operations in August and September. Investor demand for outstanding long-term Governments was relatively limited in September, and trading continued to be light. After the middle of the month, however, average yields moved down for a time, as the prices of most notes and bonds rose, including the new 3½ per cent bonds and the reopened 1990 bonds (which moved into line with the new issues). The 2½ per cent "tap" issues eligible for exchange ran about parallel with the new issues until after the books were closed and then receded slightly. Prices of notes and bonds subsequently edged lower, and by the end of September average yields had turned upward once more. At the close of the month, the average yields on three- to five-year notes and bonds were 7 basis points above the low points reached in August, but 47 basis points below their levels at the beginning of the quarter. For the longer maturities, yields were also on average 7 basis points above the August low, but were 15 basis points below the start of the quarter.

Chart II
STOCK AND BOND YIELDS



Note: Latest data plotted: week ended September 23, 1960.

Sources: Aaa corporate bonds: Moody's Investors Service; Treasury issues: Board of Governors of the Federal Reserve System; dividend/price ratio: Standard & Poor's Corporation.

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The yield advantage of high-grade bonds over common stocks, which had narrowed during the first half of 1960, diminished further during the third quarter. At the end of September, the yield on long-term Treasury bonds was 12 basis points higher than the average yield on 500 common stocks; this compares with a differential of 57 basis points at the end of June and 123 basis points at the end of December 1959 (see Chart II).

TREASURY BILLS AND OTHER SHORT-TERM INSTRUMENTS

Treasury bill rates fluctuated moderately during the third quarter, after declining sharply during the first six months of the year. The low levels to which short-term rates had fallen by the end of June resulted in part from the reduction in the Treasury's short-term debt during the first half of the year combined with a relatively large nonbank demand for short-term securities. Such demand, however, tapered off in the third quarter. After fluctuating moderately in July, bill yields dipped to a new low for the year in early August, but this was followed by a period of fairly sustained (although moderate) increase. At the end of the quarter, yields on three-month and six-month bills were almost unchanged from midyear, but were about 200 basis points below the end of 1959.

During the first part of July, market yields on three-month and six-month bills rose under the impact of heavy offerings by banks and dealers. This rise was interrupted by aggressive bidding in the July 12 auction of $1.5 billion of one-year bills to replace the $2.0 billion maturing July 15. From mid-July to early August bill yields declined, and on August 1 the average issuing rates on both three-month and six-month bills reached their lowest points since 1958 at 2.131 per cent and 2.409 per cent, respectively.

Subsequently until mid-September, bill yields rose fairly steadily, despite the easing in reserve availability over this period. The reinvestment demand expected from the net Treasury debt redemption of $0.5 billion in the July 15 financing and $1.5 billion in the August 15 refinancing, which had stimulated buying in the latter part of July, failed to materialize to any appreciable extent. The auction rates on both three-month and six-month bills reached their high points for the month in the September 12 auction when the liquidity pressures created by the approach of the tax-payment date in conjunction with the factors noted above brought average rates about 50 basis points above the early August levels, to 2.654 per cent and 2.916 per cent, respectively.

After the mid-September tax date, rates declined somewhat as demand from bank and nonbank investors expanded moderately. In the auctions of September 19 and September 26 special interest was shown in the three-month issues, since they bore maturity dates just after the December 15 tax date (for which there is no outstanding tax anticipation obligation) and just before the year end. Demands for the six-month bills were somewhat restrained, however, by the expectation that the Treasury in October might offer a tax anticipation bill to mature in June. In the final auctions on September 26 the average issuing rates were 2.286 per cent and 2.729 per cent, 11 and 8 basis points respectively below those at the end of June.

Other major short-term money rates moved within a range of ½ per cent or less during the quarter, with rate adjustments relatively infrequent and, as usually is the case, lagging behind adjustments in Treasury bill yields. Rates on 60- to 89-day paper directly placed by sales finance companies were reduced from 2¾ per cent to 2½ per cent on July 20, but the 2¾ per cent rate was restored on August 31, and on September 15 the rate was raised further to 3 per cent where it remained through the balance of the period. The firmness of this rate may have resulted from the relatively heavy volume of short-term paper placed by sales finance companies during the quarter. At the end of August, the outstanding volume of paper with original maturity of 270 days or less was a record $3.5 billion, about $200 million higher than in June and $0.7 billion higher than in August 1959.

Rates on bankers' acceptances were unchanged from midyear until August 12, when they were reduced by ¼ per cent following the reduction in bill yields to the lowest point of the year. A week later acceptance rates were restored to their previous level, where they remained until

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					
June 27	2.399	2.806	3¼	3⅝	2¾
July 1*	2.307	2.805	3¼	3½	2¾
July 11	2.567	3.175	3¼	3⅜	2¾
July 18	2.307	2.625	3¼	3⅜	2¾
July 25	2.404	2.701	3¼	3⅜	2½
Aug. 1	2.131	2.409	3¼	3⅜	2½
Aug. 8	2.215	2.458	3¼	3⅜	2½
Aug. 15	2.278	2.621	3	3⅜	2½
Aug. 22	2.518	2.806	3¼	3⅜	2½
Aug. 29	2.550	2.826	3⅛	3¼	2½
Sept. 2*	2.520	2.802	3⅛	3¼	2¾
Sept. 12	2.654	2.916	3⅛	3⅜	2¾
Sept. 19	2.434	2.743	3⅛	3½	3
Sept. 26	2.286	2.729	3⅛	3½	3

*Because of holidays on July 4 and September 5, the Treasury bill auctions were held on July 1 and September 2.

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August 24 at which time they were reduced by ⅛ per cent. This brought the bid rate on 90-day unendorsed acceptances to 3⅛ per cent where it remained through the close of the period. Commercial paper dealer rates were adjusted more frequently, within a ½ per cent range. The offered rates on prime 4- to 6-month paper closed the period at 3⅜ per cent, slightly lower than at the beginning of the quarter.

International Developments

NEW CENTRAL BANKS

During the past three years, central banks have been established in seven newly independent countries: Ghana, Guinea, Malaya, Morocco, Nigeria, the Sudan, and Tunisia. All these new central banks are located in economically underdeveloped countries and operate in financial settings that are still in an early stage of evolution. In most of these countries, the use of money is largely confined to urban centers while subsistence farming and barter predominate in the rural regions. Moreover, low levels of income and savings and the limited size of internal markets inhibit the use of banking facilities and money market instruments. Such funds as are available for lending and investment are generally channeled into real estate or short-term ventures promising quick returns.

As a result, a prime task of central banking in these new nations is the broadening of the financial structure as a prerequisite for sustained economic development. This requires the adaptation of the tools of monetary management to particular local conditions, and the use of these tools in a manner that will not only encourage steady economic expansion and price stability, but also promote the growth of sound and diversified financial institutions and foster confidence in, and habitual use of, money and banks. In all these countries, the strengthening of the financial structure and the effective exercise of central bank influence on the economy are closely intertwined.

The statutes establishing new central banks appear to have abandoned the practice of "legislating" monetary policy, as had been done in many earlier statutes creating central banks in other underdeveloped countries after World War II. Instead, the new statutes are relatively brief and flexible, and grant broad powers in the field of discount policy, commercial bank reserve requirements, and open market operations. Major reliance is thus placed upon central banking procedures as developed in older countries, rather than upon the granting of special powers or new and complex credit-control devices. Broadly speaking, the central banks of Ghana, Malaya, Nigeria, and the Sudan are in the tradition of the Bank of England, while those of Guinea, Morocco, and Tunisia are more closely patterned after the Bank of France. Certain features of the Sudanese statute also show the influence of the United States Federal Reserve Act.

All the new statutes define the principal purposes of the central bank in terms of the note-issuing, fiscal-agency, and exchange-management functions. Most of the statutes make specific reference to the objectives of promoting monetary stability and economic development. All but one of the central banks are charged with the task of safeguarding the external value of the currency, and all but the central banks of Tunisia and Guinea are specifically required to maintain a monetary reserve of gold or foreign exchange.

Each of the new central banks is government owned. The banks that incline toward the Bank of England tradition are run by seven-man boards of directors, which include the governor and deputy governor. These directors are appointed by the government, and are selected to represent the views and interests of the major sectors of the economy. The banks patterned after the French system do not have boards of directors as such, but place major administrative and policy-making responsibilities on the government-appointed president and general manager. Provision is made, however, for the appointment of an unspecified number of counsellors to assist the banks' chief administrative officers in the formulation of policy.

The provisions regarding discount policy are indicative of the differences between the broad flexible provisions of the newer laws and the detailed provisions of central bank statutes enacted earlier in other underdeveloped countries. The only specific references in the new laws to the rates that may be charged on discounts and advances are the provisions in the statutes of Ghana, Malaya, and Nigeria that advances against collateral other than Treasury bills shall be at least 1 per cent above the minimum rediscount rate. The Sudan law permits the central bank to establish

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differential rates for various classes and maturities of discounts and advances. Earlier laws, on the other hand, frequently specified an elaborate structure of rates, and contained rules as to when rates and the volume of central bank lending should be changed.

The range of paper eligible for central bank credit is generally quite wide, and special consideration is given to paper arising from the financing of agricultural and industrial production. While commercial paper must mature within three months to be eligible, agricultural paper may have a maturity of nine months under most of the statutes. In Morocco and Tunisia the central bank may discount paper with a maturity of up to five years if drawn for the financing of industrial plant and equipment, exports, residential construction, or in Morocco transportation facilities. This extension of medium-term credit is in keeping with French practice, as is the power of the Moroccan and Tunisian banks to give a written commitment to rediscount specific medium-term loans in the future. All but one of the new banks are empowered to grant advances against warehouse receipts or other evidence of title to goods; securities of business enterprises are eligible collateral in Morocco and Tunisia; and several of the banks are permitted to make advances against any collateral that is acceptable to them. The broad powers of the new central banks to monetize a great variety of financial assets serve to strengthen the liquidity of the commercial banks and to give the central bank considerable flexibility in influencing both the volume and the destination of credit.

The credit-control burden in four of these countries is placed on reserve-requirements policy—generally considered among the most useful instruments in countries with underdeveloped financial systems. The Sudan law places primary reliance on cash-reserve requirements while the Ghanaian, Malayan, and Nigerian statutes call for a reserve against demand and time liabilities consisting of cash and other liquid assets; the Ghanaian and Malayan statutes also permit the establishment of cash-reserve requirements. Although the central bank laws of Guinea, Morocco, and Tunisia, following the French pattern, do not explicitly mention reserve requirements as such, the statutes of these banks appear to be sufficiently flexible to permit their establishment. No limits are placed on the levels of reserve requirements except in the Sudan legislation, where there is a 20 per cent ceiling. The Ghanaian statute explicitly provides that the liquidity reserve may consist of any or all of the various categories of liquid assets, thus making this a potential instrument for influencing the flow of credit into particular channels. Whether the other statutes will be interpreted so as to permit this selectivity among categories of liquid assets is not clear. Under the Malayan statute, however, the liquidity reserves may be limited solely to domestic assets, thus creating a powerful instrument for restricting the amount of short-term assets held abroad by banks.

Although the scope for open market operations in countries with rudimentary money and capital markets is necessarily limited, all the new banks are authorized to conduct such operations. Here, too, they are given wide powers, and may buy and sell most of the assets that they may discount or accept as collateral. All these central banks, however, are barred from trading in titles to commodities, and all except one are subject to limitations on the amount of government securities that they can acquire. None of the new laws has any specific provision concerning the stabilization of the government bond market, although several provide that the central banks may take up new government issues for subsequent distribution to the public. Like some of the central banks established in earlier postwar years, the Guinean bank has the power to issue its own obligations with government guarantee, thus protecting it against the possibility of having no conveniently salable assets at a time when credit restraint may be needed.

Direct controls over the cost and availability of credit are authorized in only three of the seven statutes. In Guinea and Malaya the central banks may fix commercial bank interest rates. The Sudan bank may set ceilings both upon the aggregate amount of any or all types of credit extended by individual banks and upon the size of individual loans that can be granted without central bank approval. All the new banks will be in a position to exercise "moral suasion", but only the Malayan statute contains an express provision empowering the central bank to "recommend" credit policy to the banking community.

In order to strengthen the national financial structure, most of the new banks are instructed to establish branches and to maintain clearing houses in cooperation with commercial banks where needed, so as to facilitate the flow of funds within the country and provide deposit facilities for government agencies and nonbank financial institutions. The central banks of Malaya, Nigeria, and the Sudan are specifically authorized to invest in the shares of any domestic corporation established by, or with the approval of, the government for the purpose of developing a money market or securities market, or for financing economic development. The powers of the central banks in Guinea, Morocco, and Tunisia also appear to be sufficiently broad to enable them to make such investments. In the area of bank supervision, all the new central banks are given the power to require commercial banks to sub-

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mit financial statements and provide information necessary to ensure that bank laws and regulations are complied with. The Malayan central bank is also empowered to direct the policies, and if necessary take over the operation, of banks threatened with insolvency, thus increasing the safety of depositors' funds and encouraging the holding and use of bank deposits.

In brief, it appears that all the new central banks are generally equipped to facilitate the financial and economic development of their countries. Experience in developed as well as in other underdeveloped countries suggests, however, that the effectiveness of credit controls depends, in large part, on how judiciously and flexibly the available instruments are used and to what extent fiscal policy coincides with central bank objectives.

EXCHANGE RATES

In the New York foreign exchange market, the quotation for spot sterling was subject to substantial movement during September. Good commercial demand during the first half of the month enabled dealers to reduce their balances of sterling to minimum levels in the face of an anticipated reduction in the British bank rate. This resulted in day-to-day shortages and gradually advanced the rate to $2.8167 by midmonth, the highest since May 1959. Thereafter, a further strengthening of market expectations of a cut in the bank rate prompted substantial offerings of sterling, primarily from Continental sources, which weakened the rate to $2.8077 on September 27. At the month end, however, with the bank rate remaining unchanged and the announcement of a British Treasury bond issue, on attractive terms for nonresident investors, the rate climbed to $2.8117.

In the forward market the discounts on three and six months' sterling generally widened during most of the month, reaching 168 and 240 points, respectively, on September 20. A subsequent narrowing brought the spreads to 137 and 209 points at the month end.

The Canadian dollar quotation fluctuated erratically within a range of about one cent on a relatively small volume and registered a net decline for the month to close at $\$1.02^{23}/_{64}$.

The Business Situation

The over-all level of economic activity remained generally unchanged between July and August, and so far there are no indications that the results for September will show any significant shift in the business situation. Many of the seasonal forces that ordinarily contribute to a strengthening of activity as the autumn begins were again evident, but not in sufficient strength to offset the dampening influence of other adjustments that have been under way in the economy for several months. The automobile industry, which has been widely viewed as a possible bellwether of the direction and momentum of economic change in the current period, clearly reflected the mixture of offsetting influences now at work in many sectors of the economy. Attempting to reduce stocks of existing models, dealers made generous price concessions, and, as the public responded to these price inducements, auto sales actually rose in August in seasonally adjusted terms. Retail sales of other goods apparently fell slightly behind seasonal expectations in August and September, but questions were being asked as to whether the current declines in dollar sales might not reflect only the initial impact of price reductions that had not yet been followed by larger physical volume. Capital expenditures continued upward, though apparently not so strongly as originally anticipated, and surveys of future plans suggested that such expenditures might level or edge downward. At the same time, there were some signs of a moderate edging upward of residential construction, and spending by all levels of government has also continued expanding slowly.

OUTPUT AND EMPLOYMENT

The Federal Reserve's industrial production index reached a seasonally adjusted peak of 111 in January (1957=100), and has since been fluctuating from 109 to 110. In August, the index dipped again to the lower figure (see Chart I).

Output did begin to pick up in mining and in nondurable manufacturing, but, since the August seasonal pattern calls for considerably larger increases, the adjusted figures actually showed a decline in nondurables. Most increases in durable goods manufacturing were so small that the customary statistical adjustment for the expected seasonal rise converted them into declines also. The one area of definite advance on a seasonally adjusted basis was motor vehicles, where there occurred a 3 per cent increase after allowing for the decline that usually results in August from time lost during model change-overs. The better-than-usual performance reflected efforts of manufac-

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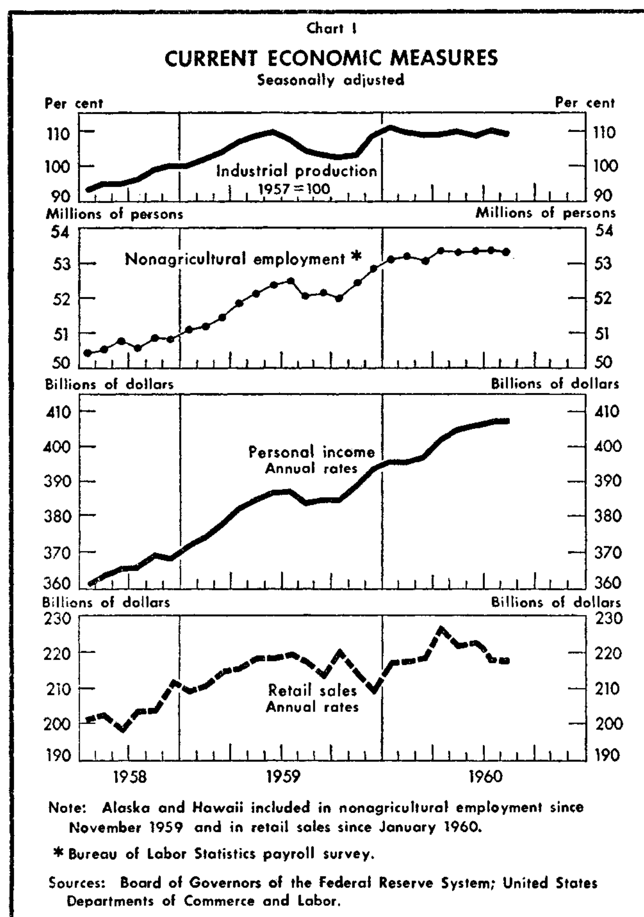
turers to get large stocks of 1961 cars into dealers' hands before the cars were officially introduced to the public. On the other hand, the seasonal push fell short of the customary intensity in the iron and steel industry, with the result that adjusted iron and steel output declined by about 1 per cent in August. While auto production for September pointed to another better-than-seasonal advance, September steel production, which usually rises, was about the same as in August.

Nonfarm employment (as measured by the Bureau of Labor Statistics payroll survey) rose in August, on an unadjusted basis, to a record 53.4 million persons, mostly because of a strong seasonal increase in the canning industry. The seasonally adjusted figure was 53.3 million, down about 100,000 from July (see Chart I). This decline is overstated, however, since it reflects to a large extent the temporary curtailment of activity in the auto industry for model change-overs; no allowance is ever made in the employment statistics for model change-over idleness, which this year was heavily concentrated in August rather than being spread over two or three months. There were,



in addition, substantial cutbacks, on a seasonally adjusted basis, in the metal and metal products industries, in the apparel field, and in service industries. Less-than-seasonal reductions in government and retail trade employment established the principal offsets to these declines. Total employment (as measured by the Census Bureau's household survey) slipped about ½ of 1 per cent, seasonally adjusted, although agricultural employment declined less than seasonally. With this over-all contraction in the number of jobholders, the unemployment rate rose to 5.9 per cent from 5.4 per cent in July. Without the temporary idleness resulting from automobile model change-overs, the increase in the unemployment rate would have been smaller.

INCOME AND SALES

Personal income rose to a new high in August, although the increase was less than $\frac{1}{10}$ of 1 per cent, seasonally adjusted. Income derived from the private sector of the economy actually declined. Wage and salary income in the manufacturing industries fell almost 1½ per cent, reflecting the decrease in automobile and other manufacturing employment as well as a shorter workweek (seasonally adjusted) and a slight drop in hourly earnings. (The latter was attributable to reduced overtime and to some shift in employment from high- to low-paying industries.) An expansion of wages and salaries in the service and distributive industries, and increases in dividends and personal interest income almost offset the decline in manufacturing wages and salaries. Concomitantly, farm income again moved lower. An increase in government wages and salaries, resulting partly from a Federal Government wage rise that became effective during July, and an increase in transfer payments, mostly through a rise in unemployment insurance benefits, accounted for a sum considerably larger than the size of the total August gain in personal income.

Retail sales in August, according to the advance report, were practically unchanged from July (see Chart I). The apparent stability in retail sales resulted primarily from increased sales of automobiles above the low July figure, stimulated by sizable price reductions made by dealers in order to cut their large stocks of 1960 models. Dealers were assisted in this effort by automobile manufacturers, who in August began to grant special, large premiums and bonuses. Consumer purchases other than automobiles were lower than in July. During the early weeks of September, the number of automobiles sold fell below August levels, but this may have been no more than the usual seasonal drop. Department store data suggest, however,

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that purchases of other types of consumer goods declined again in September.

CONSTRUCTION AND CAPITAL EXPENDITURES

On the other hand, spending may be picking up in another important sector, residential construction. Interest in the building of new homes, which had appeared particularly weak in July, seemed to strengthen somewhat in August. Housing starts rose, following sharp declines in June and July. In addition, applications for FHA-insured mortgages and requests for VA appraisals increased. This could presage a long-awaited upturn in housing outlays, although the FHA and VA series are so erratic that it is hazardous to draw conclusions on the basis of changes over one month. Housing outlays, which include expenditures on additions and repairs as well as on new buildings, continued downward meanwhile, slipping in August and slightly further in September.

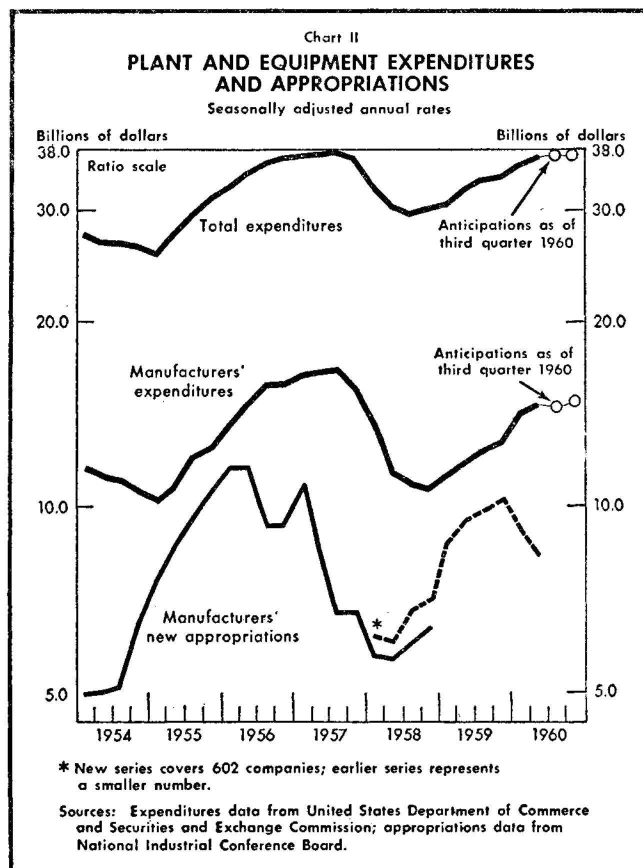
Business spending on plant and equipment has been leveling off, presumably as a result of reduced profit margins, idle capacity, and uncertainty about future demand. The latest joint survey by the Department of Commerce and the Securities and Exchange Commission, taken in late July and August, indicated that businesses planned to invest in fixed capital 2 per cent more (seasonally adjusted) in the third quarter than they actually spent in the second quarter. And they expected to hold spending in the fourth quarter to the third-quarter level (see Chart II). In the manufacturing sector alone, plans were for a slight decrease in the third quarter, followed by an increase of somewhat larger magnitude in the last quarter.

These projections fall short of earlier plans, just as the actual expenditures in the second quarter were somewhat below previously stated intentions. In the past history of the survey, when plans have been revised downward, actual expenditures have usually fallen even lower. This may happen again. Such an eventuality is also suggested by the National Industrial Conference Board's recent survey of plant and equipment appropriations, which usually precede expenditures by some months. Appropriations by the companies covered in the survey reached a peak in the fourth quarter of 1959 (see Chart II) and then fell rather sharply in the first two quarters of 1960.

Chart II

PLANT AND EQUIPMENT EXPENDITURES AND APPROPRIATIONS

Seasonally adjusted annual rates



* New series covers 602 companies; earlier series represents a smaller number.

Sources: Expenditures data from United States Department of Commerce and Securities and Exchange Commission; appropriations data from National Industrial Conference Board.

On the whole, however, August and September have continued to demonstrate the influence of mixed forces, providing no firm basis for expectations of a major move, either upward or downward, in the immediate future.

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Federal Reserve Bank of St. Louis

Federal Reserve Publications

The following Federal Reserve System publications are available from the Publications Section of the Federal Reserve Bank of New York, New York 45, N. Y. Where a charge is indicated, remittance should include New York City sales tax, if applicable.

The Federal Reserve System, Purposes and Functions. A 208-page booklet, explaining the structure, objectives, and methods of operation of the Federal Reserve System.

Money: Master or Servant? A 48-page booklet explaining in nontechnical language the role of money and banking in our economy.

Federal Reserve Operations in the Money and Government Securities Markets. A 105-page booklet discussing the manner in which operations are conducted through the Federal Reserve Bank of New York's Trading Desk in carrying out the directions of the Federal Open Market Committee.

The Money Side of "The Street". A 103-page account of the workings of the New York money market, including a discussion of the functions and usefulness of the short-term wholesale money market and of its role in the operations of the Federal Reserve. 70 cents per copy; 35 cents a copy on orders from educational institutions.

The Quest for Stability. A 54-page booklet of five essays describing efforts to achieve an efficient monetary system in the United States.

Forty-five Years of the Federal Reserve Act. An 18-page booklet describing in layman's language the history of the Federal Reserve Act from 1913 to 1958.

Readings on Money. A 47-page booklet, discussing the nature of money and the processes of its creation and circulation. Articles include the rising money supply, currency and coin, kinds of currency and coin, demand deposits, bank reserves, and money lenders.

Deposit Velocity and Its Significance. An 88-page booklet on the behavior of deposit velocity, over the business cycle and over long periods. 60 cents per copy; 30 cents per copy on orders from educational institutions.

Weekly Financial Barometers. A 37-page booklet telling how to interpret the weekly reports of member banks and the Federal Reserve Banks. Among the subjects treated are the loans and investments of weekly reporting member banks in leading cities and the sources and uses of bank reserve funds. A glossary of terms used in the weekly Reserve Bank statement is included.

Exercises in the Debits and Credits of Bank Reserves. A 16-page booklet of exercises, in simple "T account" form, indicating the essential nature of transactions affecting bank reserves. Explanations include the effect on reserves of changes in Federal Reserve credit, gold and currency flows, and Treasury transactions.

The New York Foreign Exchange Market. A 56-page booklet describing the New York foreign exchange market as it exists today. 50 cents per copy; 25 cents a copy on orders from educational institutions.

Foreign Central Banking: The Instruments of Monetary Policy. A 116-page booklet describing the development of central banking techniques abroad during the postwar period.

Monetary Policy Under the International Gold Standard, 1880-1914. A 62-page analysis of the performance and policies of central banks under the pre-1914 gold standard, in the light of current monetary and banking theory. 50 cents per copy; 25 cents per copy on orders from educational institutions.

Each of the Reserve Banks publishes a monthly review of credit and business developments available upon request from the following addresses. The Board of Governors of the Federal Reserve System (Washington 25, D. C.) publishes the *Federal Reserve Bulletin* monthly; an annual subscription in the United States costs $6.00.

Federal Reserve Bank of Atlanta
Atlanta 3, Georgia

Federal Reserve Bank of Boston
Boston 6, Massachusetts

Federal Reserve Bank of Chicago
Chicago 90, Illinois

Federal Reserve Bank of Cleveland
Cleveland 1, Ohio

Federal Reserve Bank of Dallas
Dallas 13, Texas

Federal Reserve Bank of Kansas City
Kansas City 6, Missouri

Federal Reserve Bank of Minneapolis
Minneapolis 2, Minnesota

Federal Reserve Bank of New York
New York 45, New York

Federal Reserve Bank of Philadelphia
Philadelphia 1, Pennsylvania

Federal Reserve Bank of Richmond
Richmond 13, Virginia

Federal Reserve Bank of St. Louis
St. Louis 2, Missouri

Federal Reserve Bank of San Francisco
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