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Bankers' Acceptances

The bankers' acceptance is a unique financial instrument. Used mainly to finance international trade, a prime bankers' acceptance is also a money market obligation of top quality and is regarded as an attractive investment by holders of short-term funds. Thus, the acceptance often becomes a device for channeling short-term funds other than commercial bank credit into the financing of commerce. For historical and other reasons, more fully discussed below, it has always been an important medium of investment for foreign funds. In recent years the bankers' acceptance has, to an increasing extent, become attractive to domestic investors.

While acceptance financing has been generally on the increase throughout the postwar period, the recent growth has been particularly rapid. The volume of acceptances outstanding nearly doubled during 1960, surpassing the previous peak reached in 1929, and has continued to expand in 1961. The pace of the recent advance warrants a review of the role currently played by bankers' acceptances and of the principal institutions participating in the acceptance market.

BANKERS' ACCEPTANCES AS A FINANCING DEVICE

A bankers' acceptance is a time draft or bill drawn on and accepted by a bank. Underlying the draft in most cases is a transaction which obligates a buyer of goods to make payment to the seller at some future date. Most frequently, the buyers and sellers are importers and exporters located in different countries. The "drawee" bank, in "accepting" the draft, undertakes the obligation of making the payment at the stated maturity. The credit risk of the transaction is thus shifted from the seller to the accepting bank, which has substituted its own credit standing for that of the buyer.

There are many ways in which acceptances may be originated, but the following is a typical illustration. Suppose that a firm in this country wishes to finance the import of goods from abroad. It would then arrange to have its local bank issue a commercial letter of credit in favor of the foreign exporter. The letter would normally empower the exporter to draw a time draft on the American bank. The obligation to make the actual payment for the goods to the exporter is thus transferred from the importer to his bank, with the importer of course becoming obligated to reimburse the bank.

The foreign exporter normally discounts this draft with his local bank, in order to realize the cash proceeds of the sale immediately. His bank then submits the draft and accompanying documents to the bank in the United States. At this point, the American bank "accepts" the bill, that is, it formally accepts the obligation to pay at maturity. The draft has become an acceptance.

The acceptance thus created is then ordinarily discounted for the foreign bank by the accepting bank. Thereafter, the accepting bank may retain the instrument in its own portfolio or, more commonly, resell it in the money market.

When the accepting bank is located in the United States, it normally incurs an obligation to make payment in dollars, and the resulting acceptance is known as a dollar acceptance. Of course, acceptances may be drawn on banks abroad and denominated in foreign currencies. In addition to dollar acceptances, however, only sterling acceptances exist in large volume and have an active market.

Although most outstanding dollar acceptances arise directly from international trade transactions, dollar acceptances also serve to finance domestic trade and, in addition, to make available dollar exchange for foreign banks.

INTERNATIONAL TRADE. Regulation C of the Board of Governors of the Federal Reserve System authorizes member banks to accept drafts that arise in the course of financing the following types of international transactions: (1) the import of goods, (2) the export of goods, (3) the shipment of goods between foreign countries, and (4) the storage of readily marketable staples in any foreign country. The maturity of member bank acceptances arising out of such transactions may not exceed six months.[1] These broad privileges were designed to en-

[1] A member bank may not extend acceptance credit of more than 10 per cent of its paid-up and unimpaired capital and surplus to any one borrower unless the bank is secured for that portion in excess of 10 per cent by documents or other security arising out of the transaction. In addition, the total amount of drafts accepted by a member bank may not amount to more than 50 per cent of its paid-up and unimpaired capital stock and surplus except with the special permission of the Board of Governors of the Federal Reserve System, which may allow a maximum of 100 per cent of capital stock and surplus; domestic acceptances, however, are limited to 50 per cent of capital and surplus in any event. There are no restrictions on the amount a member bank may invest in eligible acceptances of other banks.

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Dollar Acceptances Outstanding, Classified by Type of Transaction
In millions of dollars

Type of transaction	1929	1945	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	April 1961
International trade	1,348	128	364	412	389	471	556	562	738	966	866	915	1,596	1,893
Imports into the United States	383	103	245	235	232	274	285	252	261	278	254	357	403	397
Exports from the United States	524	18	87	133	125	154	182	210	329	456	349	309	669	863
Goods stored in or shipped between foreign countries	441	7	32	44	32	43	89	100	148	232	263	249	524	633
Domestic trade	308	26	28	55	64	75	300	63	227	296	244	162	308	268
Shipments	23	12	10	7	8	10	10	9	13	10	15	35	13	16
Storage	285	15	18	48	56	64	290	54	213	286	229	127	295	252
Dollar exchange	76	*	2	23	39	29	17	17	2	46	83	74	122	93
Total	1,732	154	394	490	492	574	873	642	967	1,307	1,194	1,151	2,027	2,254

Note: Data refer to end of period. Because of rounding, figures do not necessarily add to totals.
* Less than $500,000.

courage banks to participate in the financing of world trade, to add to the variety of money market obligations, and to enhance the role of the dollar as a key international currency.

Acceptances play a part in the financing of a wide variety of commodities entering into international trade. Among import items frequently involved are coffee, wool, rubber, cocoa, metals and ores, crude oil, jute, and automobiles. Export acceptances are used most often to finance transactions in cotton, automotive products, scrap metal, foodstuffs, chemicals, and iron and steel products. In connection with trade between foreign countries, acceptances drawn on banks in the United States have financed many transactions in foodstuffs, fuels, cotton, metals, automobiles, and other products.

The volume of dollar acceptances covering international trade transactions has grown fivefold since 1950 (see table). A number of favorable circumstances have been responsible for this rapid expansion. First, and most important, has been the sharp upsurge in the volume of international trade. A second factor has been the intensification of international trade competition in recent years, which has forced exporters to sell on more liberal terms and has encouraged greater use of time letters of credit, in contrast to the frequent reliance on sight drafts and on advance payment during the years immediately after World War II. Third, the proportion of United States exports financed commercially rather than through Government aid is now substantially higher than during the post-World War II reconstruction years. Fourth, the cost of acceptances relative to other instruments has recently favored resort to the acceptance market, and the banks, similarly, have more frequently found it to their advantage to accommodate customers through acceptance financing rather than the extension of direct loans. Finally, additional impetus to the use of acceptances was given by the return to convertibility of many of the world's leading currencies in 1958 which enabled a larger number of foreign banks to resort to acceptance financing in dollars.

As indicated in Chart I, the volume of dollar acceptance financing initiated by banks abroad (acting on behalf of business firms located in their respective countries) rose to an estimated $1,070 million by December 1960, up from an estimated $124 million in 1950, while the increase in dollar acceptances used by firms domiciled in the United States has been of smaller magnitude. A particularly large rise in acceptances has resulted from transactions with Japan, whose export-import trade with the United States has about doubled since 1955 and whose foreign trade with other countries has shown appreciable gains as well. In contrast, the volume of dollar acceptances used by Europeans has dropped since 1955, reflecting the more active utilization by many Europeans of other financing alternatives, including the Euro-dollar market.[2]

Yet, despite their recent growth, acceptances currently finance a smaller proportion of United States exports and imports than in the 1920's. In considerable measure this reflects the change in the nature of United States imports and exports. Since World War II, the share of finished manufactured products in United States imports and exports has been appreciably higher than in the 1920's. Many of these manufactured goods are produced by large concerns that have access to many alternative sources of funds, internal as well as external. Meanwhile, the share in United States foreign trade of raw materials, which are more likely to be handled by middlemen who tend to rely on acceptance financing, has declined.

[2] For a description of this market, see the November 1960 issue of the *Monthly Review*, p. 197.

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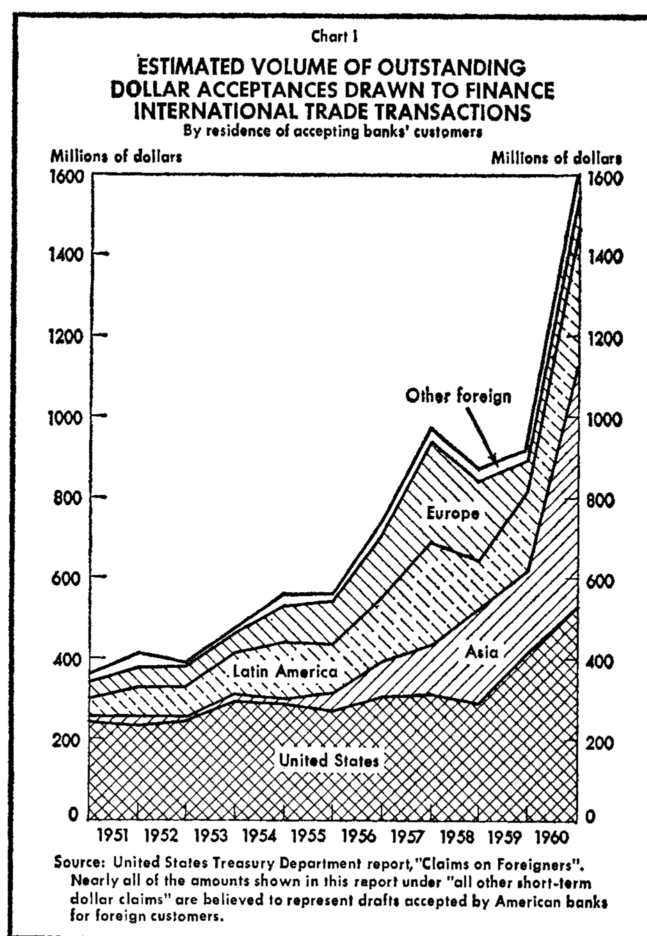

Source: United States Treasury Department report, "Claims on Foreigners". Nearly all of the amounts shown in this report under "all other short-term dollar claims" are believed to represent drafts accepted by American banks for foreign customers.

DOMESTIC TRADE. Despite their rapid growth during the last six months, acceptances drawn to finance domestic trade accounted for only $268 million, or 12 per cent of total acceptances, in April 1961. The great bulk of domestic acceptances has been drawn to finance the storage of staples—mainly cotton but also grain, rice, wool, tobacco, vegetable oils, peanuts, and sodium nitrate. The outstanding volume of acceptances of this type fluctuates sharply with the seasons; in the fall and winter months, when many staple products have been harvested and are brought to storage, acceptance volume typically rises, reaching a peak in December or early in the following year. However, the extent to which acceptance financing is employed in connection with domestic transactions also depends on the comparative cost, at these times, of acceptance financing and of direct borrowing from banks.

Several factors are responsible for the small role played by acceptances in domestic financing. Commercial banks in this country have developed numerous "tailor-made" lending techniques, many of which are more flexible than acceptance credits. Moreover, trade-credit practices in the United States have always militated against the growth of acceptances, since most domestic trade transactions involve open-account credit terms. In the United States, in contrast to many other countries, the use of drafts or bills with fixed due dates to settle trade transactions is confined to only a few industries.

The use of acceptance credits to finance domestic trade may also have been limited by Federal Reserve regulations. Regulation C of the Board of Governors of the Federal Reserve System states that a member bank may accept a draft for the purpose of financing a domestic shipment of merchandise only if "shipping documents conveying or securing title are attached or are in the physical possession of the accepting bank or its agent at the time of acceptance". Acceptances supported by the storage of goods in the United States (or in a foreign country) are limited by Regulation C to readily marketable staples; furthermore, at the time of acceptance these drafts must be secured "by a warehouse receipt or other such document conveying or securing title covering such readily marketable staples". Many domestic trade transactions do not fall within these bounds, some because it may not be practicable to transfer title at the time of shipment and some because the products involved do not qualify as readily marketable staples.

DOLLAR EXCHANGE ACCEPTANCES. Dollar exchange acceptances are bills or drafts, drawn by banks in foreign countries and accepted by banks in the United States, for the purpose of creating dollar exchange. Thus, dollar exchange bills do not arise from specific merchandise transactions. They are most frequently drawn by Latin American banks. Although the volume of dollar exchange acceptances has increased rapidly over the last few years, it represents only a relatively small proportion of total acceptances outstanding.

According to Regulation C of the Board of Governors, a member bank may not accept dollar exchange drafts or bills for any one foreign bank in excess of the amount which the foreign bank would expect to liquidate "through the proceeds of export documentary bills or from other sources reasonably available to such foreign bank or banker arising in the normal course of trade". The total amount of dollar exchange drafts that a member bank may accept is not to exceed 50 per cent of its capital and surplus, with the maximum for any one customer not to exceed 10 per cent (unless fully secured). The maximum maturity of these acceptances is limited by Regulation C to three months from date of acceptance.

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THE COST OF ACCEPTANCE FINANCING

The cost of acceptance financing consists of the commission charged by the accepting bank and the interest charge involved in the discounting of the underlying draft. In the illustration presented earlier, the importer pays his bank's commission charge, while the foreign exporter incurs an interest cost in discounting the draft with his bank. When the foreign bank in turn discounts the resulting acceptance with the American bank, it is in effect passing on to the American bank the interest payment that has been made by the exporter less compensation for its services.

For prime customers the minimum commission charge is generally a flat fee of 1½ per cent per annum, but higher rates are charged for others. In this connection, "prime" is defined more liberally than in the case of direct bank loans. Accepting banks generally charge lower commissions to foreign correspondent banks than to prime domestic customers, partly because banks are generally considered better risks than merchants and partly because of other benefits accruing to the accepting bank from relationships with these correspondents. The discount rate charged reflects the prevailing open market rate for acceptances, which is subject to a variety of influences described later in this article.

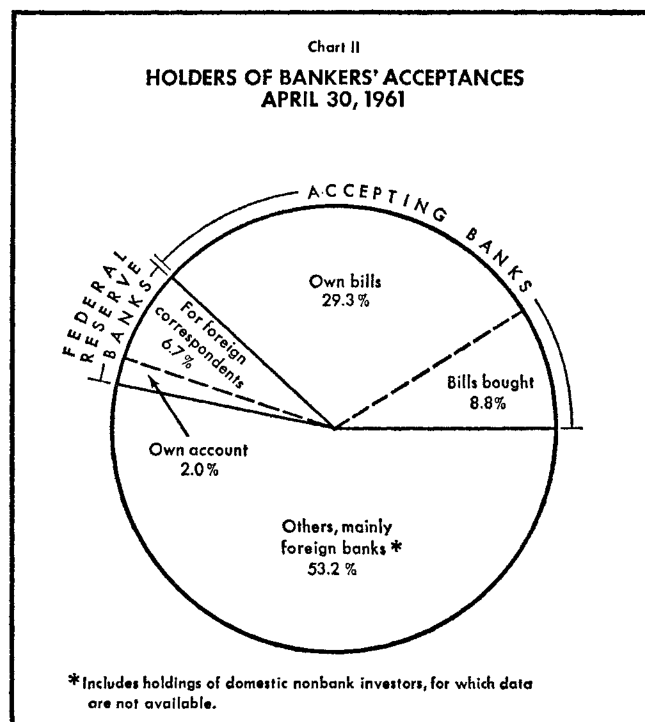
The cost of alternative financing opportunities, especially direct bank loans, is of course a major determinant in a borrower's decision to finance transactions through acceptance credits. The use of acceptances by United States residents has tended to grow more rapidly during periods in which financing differentials have favored acceptances, as from mid-1953 to the end of 1954 and during the early part of 1958. On some other occasions, when cost differentials have moved against acceptances, as happened in 1955 and in the latter part of 1958, the volume of acceptances has declined.

At all times, however, acceptance volume also reflects the liquidity of both the American and foreign banks. When American banks find their reserve positions under pressure, they frequently prefer to accommodate their customers through acceptance credits when feasible. This enables them to conserve their cash resources, since the acceptances that have been created are usually sold in the open market.

In recent years, moreover, foreign firms have become more aware of the savings sometimes obtainable in financing their international trade transactions through dollar acceptances. Financing costs in most foreign countries have been considerably higher than the cost of dollar acceptance credits, which reflects primarily the level of interest rates in the United States. For example, the large increase in dollar acceptances arranged through Japanese banks and United States agencies of Japanese banks in the last few years occurred during a period in which the cost of dollar acceptance credits was substantially below the cost of direct loans from Japanese banks. At various times, the relatively few borrowers abroad that have access to both American and British banks have found it less costly to finance their foreign trade transactions through dollar than through pound sterling acceptances. Financing costs favored dollar acceptances in 1960, and many firms apparently took advantage of the differential.[3]

Chart II

HOLDERS OF BANKERS' ACCEPTANCES APRIL 30, 1961



* Includes holdings of domestic nonbank investors, for which data are not available.

BANKERS' ACCEPTANCES: A MONEY MARKET INSTRUMENT

As a money market instrument, bankers' acceptances at present have a much narrower market than either Treasury bills or commercial paper. The bulk of outstanding acceptances has over the years been purchased by foreign central and commercial banks. As shown in Chart II, acceptances held by the Federal Reserve Banks for the account of foreign correspondents, together with acceptances owned by "other" holders (primarily financial

[3] For a discussion of the cost of dollar acceptances relative to pound sterling acceptances, see "Rebound in Use of Acceptances", *Monthly Business Review,* January 1961, Federal Reserve Bank of Cleveland.

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institutions abroad), accounted for 60 per cent of total outstanding acceptances on April 30, 1961. Banks in this country hold a smaller, but nevertheless sizable, proportion of total acceptances, which on April 30, 1961 amounted to 38 per cent. However, accepting banks normally sell a sizable portion of their holdings before maturity.

Investors abroad consider acceptances attractive assets for the placement of short-term funds. These investors have long recognized the highly safe and liquid aspects of bankers' acceptances. An added incentive has been the fact that the discount earned on bankers' acceptances held by nonresident aliens not engaged in trade or business in the United States or by nonresident foreign corporations has not been subjected to Federal income taxation.

Domestic investors, other than commercial banks, have purchased only small amounts of acceptances over the years. Nonfinancial corporations frequently have found that they cannot obtain sufficient quantities of acceptances and that the available acceptances have maturities which do not meet their liquidity needs. To a large extent, this is due to the fact that bankers' acceptances reflect the amount and timing of the underlying trade transactions, and therefore are drawn in odd denominations (ranging from less than $1,000 to sometimes over $1 million) and carry maturities that are frequently not convenient to the investor. In contrast, Treasury bills and finance company paper are available in more suitable maturities and denominations.

However, at various times and most recently in 1960 and early 1961, domestic investors other than commercial banks have made more sizable purchases of acceptances. Their decision to purchase more acceptances probably reflected the relatively wide yield differential favoring acceptances as against Treasury bills. Moreover, because of the increase in the availability of acceptances as acceptance financing has grown, these investors have found it less difficult to obtain bills with suitable maturities and covering the desired amounts.

THE MARKET IN ACCEPTANCES

A dollar acceptance may pass through a number of money market institutions before it reaches the ultimate investor. The principal institutions involved in the marketing of acceptances are the accepting banks and the dealers. The Federal Reserve Bank of New York also participates to a considerable extent, as will be described later.

ACCEPTING BANKS. Most accepting banks sell a large percentage of their own acceptances prior to maturity. Some banks, indeed, do not retain any of their acceptances. The major accepting banks sell substantial amounts of acceptances to their customers, primarily foreign and domestic correspondent banks and corporations. Drafts not going into the banks' own portfolio, or held for sale to the banks' customers, are sold to dealers.

Accepting banks consider it the best practice to offer their customers acceptances with two bank names. They obtain such acceptances through swapping operations with dealers. The accepting bank sells its own acceptances to the dealer at his buying rate, say 2⅞ per cent, and buys back acceptances of other banks at the dealers' selling rate (2¾ per cent). When ultimately selling these acceptances to the final holder, the banks generally add to them their own endorsement, charging for this endorsement an additional ⅛ of 1 per cent commission. The yield earned by the ultimate purchaser is thus 2⅝ per cent.

Relatively few of the commercial banks in this country act as accepting banks. In December 1960, only about 100 banks accepted sizable amounts. The bulk of acceptances is generated by banks in New York City and, to a lesser extent, by banks in the San Francisco District. Banks in the New York District were responsible for 74 per cent of total acceptances outstanding on December 31, 1960, up from 67 per cent at the end of 1950. Banks in the San Francisco District accounted for 14 per cent, up from 11 per cent in 1950. The concentration of acceptance financing in large banks in these two districts reflects the importance of these banks in the financing of international trade.

DEALERS. There are only five dealers in bankers' acceptances, all of them located in New York City and all except one also actively engaged in dealing in other money market obligations. Although transactions are conducted by phone, dealers try to maintain and build up relationships with accepting banks and investors through periodic visits.

The dealer is primarily engaged in trading acceptances. His principal income is derived from quickly turning purchases into sales and not from speculation on changing yields or from interest income on acceptances held by him. The spread between dealers' buying and selling rates is ⅛ of 1 per cent. Swap transactions with banks, referred to above, represent a substantial part of total volume. Over the past ten years, most dealer purchases were made from accepting banks while generally over two thirds of dealer sales were to domestic banks. Since accepting banks pre-empt a large supply of acceptances for their own customers, the "free" supply of acceptances channeled through dealers' portfolios and

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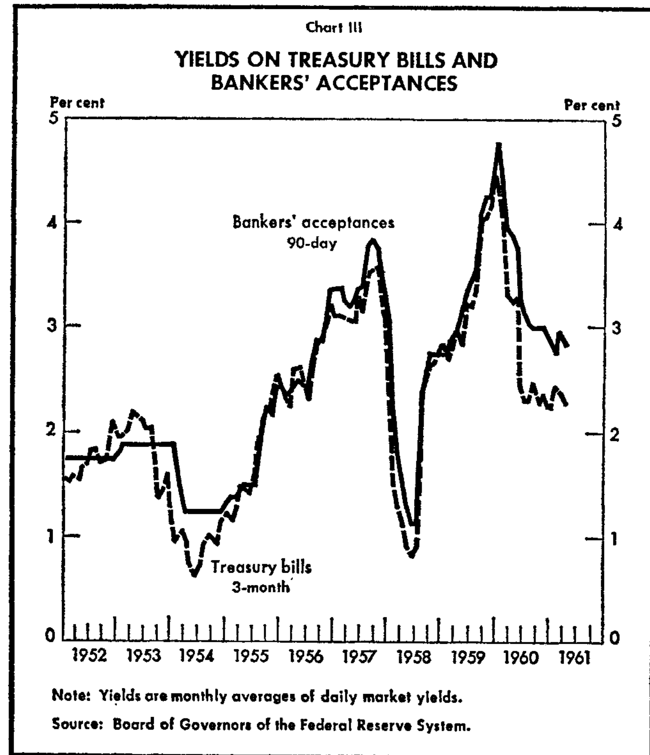
available for purchase by the public is relatively small in times of good demand.

On occasions, however, especially in the latter part of the year when the supply of acceptances usually rises, dealer portfolios expand. Dealers finance these positions primarily through call loans from commercial banks and agencies of foreign banks.[4] Occasionally dealers also obtain funds through repurchase agreements with nonfinancial corporations.

In determining buying rates for acceptances—which are widely publicized—dealers are influenced by a wide range of factors. The overriding consideration is generally the anticipated supply of and demand for acceptances, but the size of dealer portfolios and the cost of financing these positions are also important. On occasion, dealers may estimate that the increase in acceptances in hand may be too temporary to require a rate increase, as may be the case immediately before financial statement dates when banks and other investors in acceptances are anxious to bolster their cash reserves for "window-dressing" purposes. At other times dealers may change rates to keep them in line with competing short-term investments. Until recently, yields on acceptances have generally hovered at or not much above the Treasury bill rate (see Chart III). Since early 1960, however, acceptance yields have been about ½ per cent higher than Treasury bill yields.



There is very little secondary market activity in acceptances. However, some increase has occurred in recent years. Dealers have, on occasion, been called upon to repurchase acceptances, most frequently from nonfinancial institutions with an immediate need for cash. Dealers do not normally purchase acceptances that mature in twenty-one days or less.

THE FEDERAL RESERVE BANK OF NEW YORK. The Federal Reserve Bank of New York engages in a large volume of acceptance purchases for the account of its foreign correspondents. At times, it also purchases acceptances for its own account and finances acceptance dealers through repurchase agreements. The Reserve Banks may also discount eligible acceptances for member banks, but at this Bank, at least, none have been discounted for many years.

Acceptances purchased and held by the Federal Reserve Bank of New York for foreign correspondents amounted to $151 million as of April 1961, or nearly 7 per cent of total outstanding acceptances. Purchases, whether for the Bank's own account or for the account of foreign correspondents, have been confined to "endorsed" bills, i.e., acceptances bearing three names—those of the acceptor and the drawer and, in addition, the dealer or occasionally another bank. The yield on these bills is $\frac{1}{16}$ per cent lower than that for two-name paper ("unendorsed" bills). The Federal Reserve Banks guarantee acceptances purchased by the Federal Reserve Bank of New York for the account of foreign correspondents. The charge for this guarantee is ⅛ of 1 per cent.

Authority to purchase bankers' acceptances for their own account was given to the Reserve Banks by the Federal Open Market Committee in 1955. While such transactions are carried out as part of the System's open market operations, the mechanical aspects of processing and accounting were greatly simplified by the decision to handle the relatively small amounts involved through the balance sheet of the New York Reserve Bank alone. (By contrast, the contingent liability on acceptances purchased for foreign customers that arises from the guarantee added to such acceptances is "participated" among all twelve Reserve Banks according to a formula approved by the Board of Governors, and the proceeds of the guarantee fee are similarly participated.) One purpose of making the Federal Reserve an actual market partici-

[4] Dealers may also obtain funds from the Federal Reserve Bank of New York through repurchase agreements at times when the Reserve Bank is endeavoring to put reserves into the money market. The charge for this type of accommodation is ordinarily equal to the discount rate, although it may be set higher or lower at times.

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pant on its own account was to give additional recognition to acceptance financing, in the interest of expanding this method of financing international trade. At the latest seasonal peak in December 1960, holdings of acceptances by the Federal Reserve Bank of New York amounted to $74 million, or nearly 4 per cent of the total outstanding.

This Bank's role in the acceptance market, though small, has steadily increased in recent years. Measured in the widest terms—including the acceptances held for foreign correspondents and its own account and the financing of dealers—the total involvement of the Bank came to about $300 million in December 1960, compared with $60 million at the end of 1955.

CONCLUSION

The growth of bankers' acceptances in recent years has been a significant and welcome development. Acceptances have provided a means by which the commercial banks, especially in periods of monetary tightness, could continue to facilitate international trade, and by which investors seeking a safe and liquid outlet for funds have been enabled to play a valuable part in its financing. Dollar acceptances have proved to be especially attractive to foreign investors, thus helping to enhance the position of the dollar as a key currency and strengthening the position of New York as an international financial center.

International Economic and Financial Developments

The marked improvement in the United States balance of payments and reduced pressure on the United States dollar have been the outstanding developments in the international payments system during recent months. The United States trade surplus is running at a very high level. Moreover, the outflow of short-term capital has diminished under the influence of narrowing interest rate differentials with major foreign centers and renewed confidence in the dollar following unequivocal declarations that its value will be defended. Meanwhile, steps have been taken or are being considered, both in the United States and abroad, to improve the underlying international economic balance and to cushion the impact of such payments strains as have continued. A further reduction in West German interest rates helped bring about a closer international alignment of interest rates, and the Netherlands reopened its capital market to limited foreign issues. At the same time, the British Government is seeking authorization in its current budget for the use of more flexible fiscal instruments designed to avoid overburdening monetary policy. There was also an impressive display of central bank cooperation to cope with the heavy speculative short-term capital flows that followed the appreciations of the German and Dutch currencies in March and brought sterling under heavy pressure, despite an improved British trade position. To deal with such problems on a longer term basis, proposals have been made for broadening the scope of the International Monetary Fund's lending operations.

INTERNATIONAL PAYMENTS FLOWS AND RESERVE CHANGES

The measures already taken ought to become increasingly effective in discouraging disruptive short-term capital movements, which contributed significantly to the payments strains of last year and of early 1961. This year's pattern of short-term capital movements, however, has been very different from that of 1960. The earlier movements had been predominantly from the United States to Western Europe and particularly to Britain. These 1960 flows had offset the very large increases both in the United States merchandise trade surplus and in Britain's deficit on current and long-term capital account. In the early months of 1961, in contrast, a significant proportion of the private short-term capital that had flowed to Britain in 1960 seems to have been shifted to continental Western European countries. At the same time, the short-term capital outflow from the United States apparently declined and foreign investment in United States corporate securities increased. The improvement in the United States capital account stems in part from renewed confidence in the dollar following President Kennedy's categorical affirmation that the United States will not alter the dollar price for gold.

Confidence in the dollar was also increased by the further improvement in the United States trade account during the first quarter. Exports continued to grow, mainly in response to the sustained economic expansion in most

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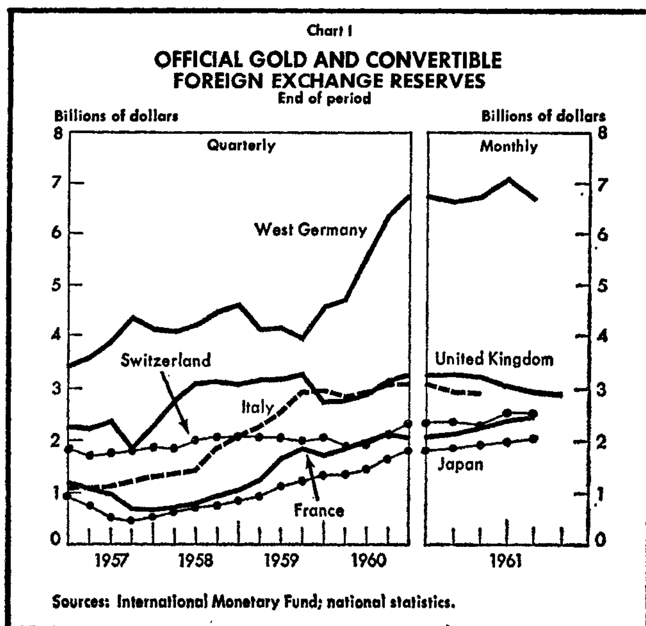
industrial countries abroad, while imports were lower due to the reduced level of economic activity in this country. Consequently, the trade surplus, seasonally adjusted, was the highest since the second quarter of 1957. (Preliminary figures for April indicate a slightly lower trade surplus.) The extent to which the recent large trade surpluses can be sustained in coming months will, of course, depend in part on the development of the business cycle, both here and abroad. The trade account improvement in January-March, together with the net improvement in recorded private capital flows and in unrecorded transactions, reduced the total balance-of-payments deficit (seasonally adjusted) in that quarter to the lowest level in more than three years.

The alteration of the international payments flows in recent months has been reflected in the pattern of reserve gains and losses of the major industrial countries. Whereas in the four months ended January 1961 the United States gold stock had dropped by $1.2 billion to $17.5 billion, in the next four months it remained essentially unchanged. On the other hand, Britain's gold and convertible-currency reserves, which had risen by $137 million in the four months ended January 1961 despite large debt repayments to the IMF and the United States, declined by $342 million in the four months ended in May (see Chart I). At the same time, other areas of the world continued to add significantly to their reserves. For example, during the four-month period ended in May, West Germany, France, Switzerland, and Japan together increased their official holdings of gold and convertible foreign exchange by an amount estimated to be nearly as large as the $807 million gain in the previous four months. The latest gains would have been even larger but for substantial German advance debt repayments at the end of April to Britain and the United States.



BUSINESS CONDITIONS ABROAD

The economic expansion in most of the major industrial countries abroad continued during the early months of 1961. In both Western Europe and Japan the long-sustained business expansion continued, although the mild recession in Canada persisted. In many countries, the major force underlying the expansion has been continued high investment activity, which has led to a boom in the capital goods and construction industries. The expansion has also been supported by a marked increase in consumer spending and a moderate improvement in export demand.

The continued growth of business activity abroad after the turn of the year was reflected in the rise of industrial production in a number of countries (see Chart II). In Japan, the trend of industrial production in January-March continued sharply upward, with all major economic sectors participating. Substantial advances in industrial production were reported during the early months of 1961 in several Western European countries, including Austria, the Netherlands, and Italy. In Germany, industrial output in January-March was no less than 4 per cent above the already high level of October-December 1960. However, industrial production in France expanded only slightly, while in the United Kingdom it remained virtually unchanged. In Canada, output continued to fluctuate 3 to 4 per cent below the all-time peak of January 1960.

The capital equipment boom, which acted as a significant expansionary force throughout 1960, showed no signs of slackening in early 1961. Moreover, in Japan and some Western European countries—Germany, Sweden, and the United Kingdom, for example—investment outlays in 1961 are expected to rise to substantially higher levels than in 1960. In Canada, on the other hand, a March survey indicated that 1961 capital expenditures by business may drop slightly below those of 1960.

In response to this investment boom, the most rapid advances in output continued to be registered in the capital goods industries. The investment surge has also stimulated a sharp increase in construction activity in such countries as Germany and the United Kingdom. In Sweden, where the building boom has been exerting considerable strain on supplies of labor and materials, the authorities

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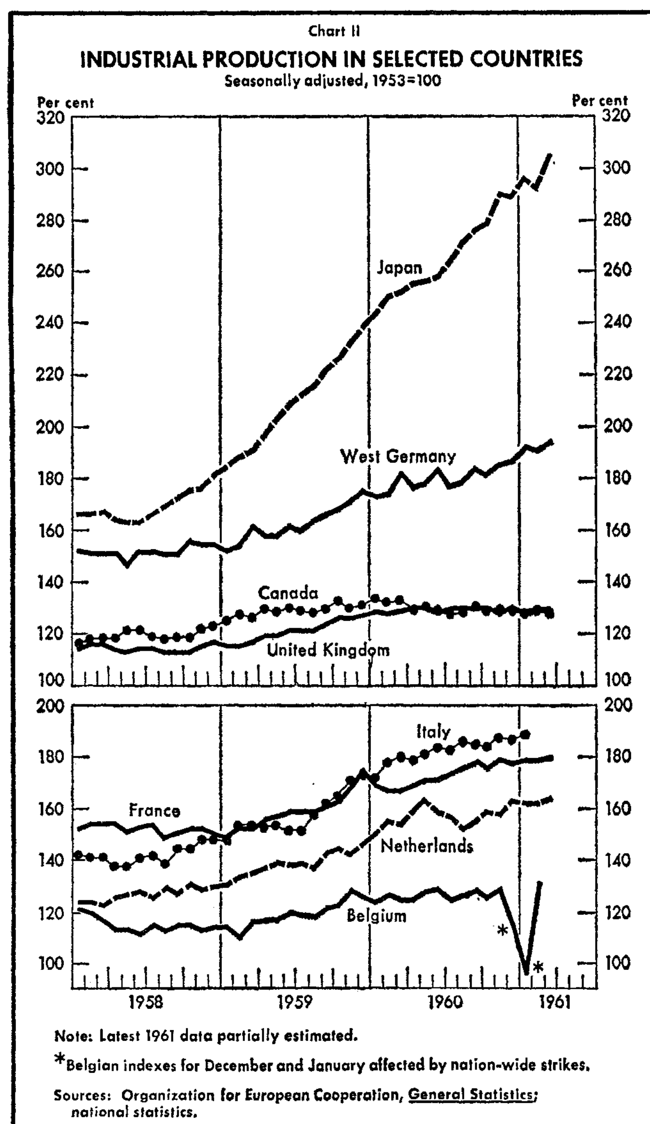

ordered a virtual stoppage of new small-scale construction projects until next autumn.

Consumer demand abroad, supported by the 1960 rise in earnings and employment, continued to increase substantially in the first quarter of 1961. Consumption of nondurable goods, in particular, showed a steady upward trend. In the United Kingdom and Germany, retail sales increased sharply in March, while French department store sales continued well above a year earlier. Sales of consumer durable goods also showed some improvement in Western Europe toward the end of the quarter. Mirroring this rise in demand, automobile production in both the United Kingdom and France picked up sharply in March, following a marked drop in the last quarter of 1960 and in early 1961.

Extremely tight labor market conditions continued to act as a significant check to the expansion in business activity in Western Europe, and to account for a pronounced increase in wage rates in many countries. In the United Kingdom, weekly wage rates in March were up 4 per cent over a year earlier, while in Germany, standard hourly wages in the first quarter were as much as 8 per cent higher than in the first quarter of 1960. Significant wage increases have also been granted in France, Scandinavia, and Japan. New demands for higher wages and shorter hours have become more intense in several countries, and have led to an increasing number of strikes. Against this background, prices in several of the major foreign industrial countries moved up slowly but steadily.

ECONOMIC POLICIES ABROAD

The wage-price pressures have been partly caused by, but have also added to, the substantial demand on real resources that the high level of exports in several continental European countries has imposed on their economies. To restrain these pressures, several countries have therefore reduced the incentives for their producers to export, and have made their markets more freely accessible to imports. The 5 per cent appreciations of the West German and Dutch currencies, announced early in March and discussed in the April issue of this *Review,* already seem to have had a moderating influence on the upward price pressure in these countries. In France, the government likewise has acted to curb such upward pressure by facilitating imports. In April, it removed most remaining quantitative controls over industrial imports from Canada, the United States, and OEEC countries, and announced that by the year end all these imports (except state-traded ones) would be free from such restrictions. France also unilaterally reduced its duties on imports from its Common Market partners—by 10 per cent in the case of textiles, chemicals, machinery, and cars and by 5 per cent on other nonagricultural products—and extended these cuts to other countries on condition that the resulting tariffs not be lower than those set under the Common Market treaty.

Continental European countries have also taken steps to expand their foreign grants and loans. In April, the Dutch Government relaxed the ban imposed in 1955 on new foreign bond issues in the Netherlands. However, access to the market remains subject to the approval of the central bank, and has been restricted for the time being to government flotations not exceeding $14 million equivalent. Early in May, the German Government offi-

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cially presented to Parliament its program for making available during 1961 and 1962 the equivalent of $1¼ billion for development aid. By way of comparison, a net total of $415 million equivalent was made available through official channels during 1959.

While several continental European countries adopted measures that are expected to reduce their payments surpluses, Britain took steps to insure that there would be no repetition this year of what Chancellor of the Exchequer Lloyd referred to as Britain's "very unsatisfactory" balance-of-payments performance in 1960.[1] Holding that the key to the reduction in Britain's deficit on current and long-term capital account lay in an expansion of exports, the government has acted to facilitate the granting of export credits. The Bank of England early in February introduced special discount arrangements to help commercial banks provide finance for exports; and in early April, the government's Export Credit Guarantee Department announced reductions in the charges on virtually the whole range of its services, a special new provision for guaranteeing loans to overseas borrowers to finance the export of major capital goods, and special assistance to small exporters. These measures were followed by the presentation of the British Government's budget for the 1961-62 fiscal year that began April 1. The budget proposals are designed to prevent rising personal incomes from drawing goods into domestic consumption that might otherwise be sold abroad. In his budget speech, the Chancellor announced increases in various excise taxes, and estimated that revenues would increase considerably more than the prospective rise in government outlays. The over-all budget deficit would consequently be reduced from £394 million in the year ended March 1961 to only £69 million, the smallest in seven years. In addition, the government is to broaden its policy of increasing incentives for individual effort by reducing taxes on upper middle personal income. Most of the prospective revenue loss from this reduction is to be made up by an increase in the tax on corporate profits, but the effects on revenue of these offsetting tax changes are expected to become significant only during the 1962-63 fiscal year.

While the authorities abroad, as in the United States, have been concerned with the elimination of basic international payments imbalances, they have at the same time acted to reduce disruptive short-term capital flows between international financial centers. In Britain, to which a large volume of short-term capital had been attracted during the summer and autumn of 1960 by the relatively high interest rates that then prevailed in London, significant proposals were made in the new budget for the introduction of two new flexible fiscal instruments that would ease the load on monetary policy. Under these proposals the government would be authorized, for a limited period, to increase or reduce by up to 10 per cent almost all of the existing excise taxes and to impose on employers a weekly payroll tax of up to 4 shillings (56 cents) per employee. Official estimates indicate that these new taxes would enable the authorities to reduce purchasing power by roughly £400 million annually, an amount equal to 2 per cent of Britain's gross national product. The authority to "act by quick and flexible fiscal measures", said the Chancellor in his budget address, would "greatly improve the government's ability to regulate the economy".

In Germany, where the continued inflow of short-term funds has been a chronic concern of the authorities, several new steps have been taken to reduce interest rates. The central bank discount rate, which had already been lowered in two steps from 5 per cent last November to 3½ in January, was cut to 3 per cent on May 4. Shortly before the latest move, President Blessing of the central bank stated that such an additional lowering of interest rates was warranted because monetary restraint measures had lost their effectiveness as a result of the heavy foreign exchange influx. The German central bank also lowered further the rates at which it is prepared to sell Treasury bills and short-term bonds; and, in an effort to reduce the dependence of German banks upon external funds, the authorities reduced the banks' reserve requirements and restored, as of March 1, the previous cuts in the banks' rediscount quotas. Also, reserve requirements against all foreign-owned sight, time, and savings deposits were raised to their legal maxima, but in computing their reserve requirements the banks may deduct their foreign short-term assets from their deposit liabilities to foreigners.

In addition to promoting a better alignment of interest rates between various financial centers, the authorities abroad have acted to cushion the impact of disruptive short-term capital flows. Action to this end, in the form of cooperation among major central banks, was taken following the appreciation of the German and Dutch currencies. These currency changes had set off heavy speculative movements of funds across national frontiers in anticipation of possible additional exchange rate adjustments. On March 12, however, the European central bank governors issued a joint statement following their regular monthly meeting in Basle, Switzerland, indicating that rumors regarding possible further exchange rate changes had "no foundation" and that the various central banks

[1] Denmark and New Zealand also acted to thwart balance-of-payments pressures by increasing their discount rate (to 6½ and 7 per cent from 5½ and 6 per cent, respectively).

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were "cooperating closely in the exchange markets". Commenting on this cooperation at the end of April, the president of the German central bank, which has been a major participant in these cooperative arrangements, affirmed that "speculation could not succeed against closely cooperating central banks".

In addition, the Netherlands recently made prepayments of $40 million on its postwar debt to the United States, and Germany (as previously noted) has made substantial advance repayment of obligations falling due in future years. At the end of April, some $189 million equivalent was repaid to Britain out of sterling balances of the German central bank and, on April 28, $587 million was transferred to the United States. Part of the latter payment was in Deutsche marks, thereby providing the United States authorities with resources with which to counter any possible future speculation.

Such cooperative measures to help strengthen individual countries' reserves can of course be buttressed by the machinery of international financial cooperation already existing in the IMF. As the currencies of continental Western Europe have increased in strength, the need for making these currencies available to help assure a smoothly operating international payments system has risen correspondingly. The IMF has therefore been exploring the possibility of using its authority under Article VII of its charter to increase its resources by borrowing. In particular, the IMF, according to its managing director, Per Jacobsson, is considering the advisability of establishing:

> a network of stand-by arrangements with the main industrial countries, under which the Fund will be able to use increased amounts of their currencies whenever the need for such use would arise as part of a Fund operation. Our aim is to look beyond immediate needs and to seek to equip the Fund to be able to handle flexibly the many and varied situations that may arise under a system of freely convertible currencies.[2]

[2] From Mr. Jacobsson's report to the thirty-first session of the Economic and Social Council of the United Nations, April 20, 1961.

THE CHALLENGE OF GOLD AND THE DOLLAR

This Bank has recently published an illustrated booklet — intended for the interested layman — entitled *The Challenge of Gold and the Dollar*. Written by Paul Meek, Manager of the Public Information Department, the booklet presents the basic features of the present international financial position of the United States and discusses the factors behind the large United States balance-of-payments deficits in 1958-60. Copies are available in limited quantities, without charge, from the Publications Section, Federal Reserve Bank of New York, New York 45, N. Y.

The Business Situation

Signs that the economy is now moving upward continue to multiply, while at the same time the over-all price stability of recent months has continued. Substantial gains have been recorded by many important business indicators, including industrial production, residential construction outlays, sales by manufacturers, and new orders received by them (see Chart I). Personal income has also risen, as has nonfarm employment. Retail sales, on the other hand, have been somewhat disappointing, and neither the Federal Reserve Board's April survey of consumer buying intentions nor the National Industrial Conference Board's March-April survey gives any particular indication of a strong surge in consumer demand. Government spending has continued upward, however, and, in line with the President's proposals in his special message to Congress, may soon be stepped up even more than previously expected. Business spending on plant and equipment is also scheduled to rise, with prospects for higher levels of Government spending apparently an important factor in business expectations. These developments in the Government and business sectors should lead to more substantial gains in personal income than have occurred until now, and thus help to stimulate consumer buying.

Despite encouraging developments in several areas, it is still too early to tell whether the expansion will prove more vigorous than that following the 1957-58 recession. The importance of this question is obvious, particularly in view of the fact that the unemployment rate has not declined even though employment has expanded.

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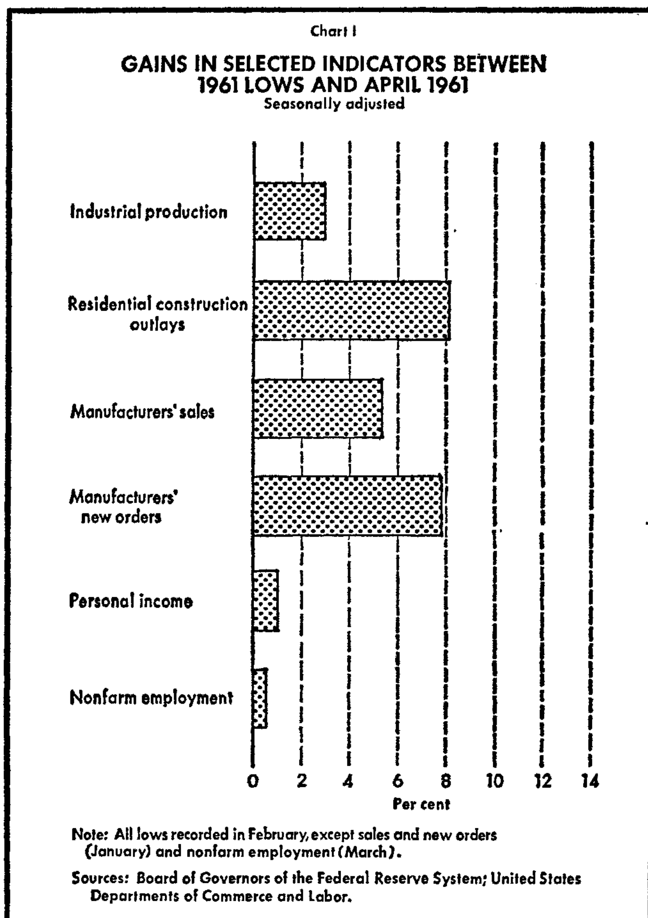

OUTPUT, ORDERS, AND INVENTORIES

One of the most important indications of improvement in business conditions in April was the seasonally adjusted rise of three points in the industrial production index. This brought the index to 105 per cent of the 1957 average, the highest level since last October, and erased approximately one third of the recession decline. While April increases in production were quite general, the largest rise was in the durables sector, with particularly large advances being posted by the steel and auto industries. In May, steel production continued to rise more than seasonally and output was higher than at any time since May 1960. An easing in steel operations is usually expected during the summer months, but some industry spokesmen believe the decline this year may prove smaller than usual. Auto production in May also showed greater-than-seasonal strength. In view of the gains in autos and steel, it appears likely that the production index as a whole moved up again in May.

The April increase in the production index was paralleled by a gain of 3 per cent (seasonally adjusted) in new orders received by manufacturers and brought a slight increase in manufacturers' inventories. Orders, which began to rise in February, have now reached their highest level since December 1959. The April advance was centered in durables, particularly in the auto and steel industries (with orders in the auto industry actually representing deliveries made to dealers in that month). Increases in defense orders for durables were also substantial. Machine tool orders, on the other hand, fell sharply in April, but the significance of this decline is hard to assess because of the erratic nature of this series. While manufacturers' inventories fell again in the durables sector, the decline was small, and in the nondurables sector inventories were accumulated at a somewhat faster pace than in preceding months. Total business inventories, including trade as well as manufacturing stocks, rose slightly in April after nine months of declines.

TRENDS IN FINAL DEMAND

In contrast to the marked improvement at the manufacturing level, consumer outlays in April showed moderate weakness. Retail sales of both durable and nondurable goods (seasonally adjusted) declined, wiping out two thirds of the total March increase. In May, auto sales appear to have shown a significant gain over April, but department stores sold less in May than in the preceding month, even after allowing for seasonal influences.

Personal income, which is one of the major determinants of consumer spending, rose again in April. The increase was larger than the March gain, if allowance is made for the concentration of payments in March of veterans' 1961 insurance dividends, and was mainly in wages and salaries. If the current upward movement in personal income continues, it is sooner or later bound to result in higher retail sales. But a really strong increase in consumer demand must await a rise in the share of their income that people are willing to spend; this share has been relatively low since the middle of last year.

Prospects for the capital goods sector continue to be favorable. As reported last month, the McGraw-Hill April survey of businessmen's spending intentions indicated planned outlays for 1961 at only 1 per cent below 1960 outlays. This suggests a higher level of outlays during the second half of 1961 than in the first half. Additional support for the view that a turnabout in plant and equipment outlays is in the making has come from an April McGraw-Hill survey of machinery manufacturers, which indicated that the respondents were anticipating a steady increase

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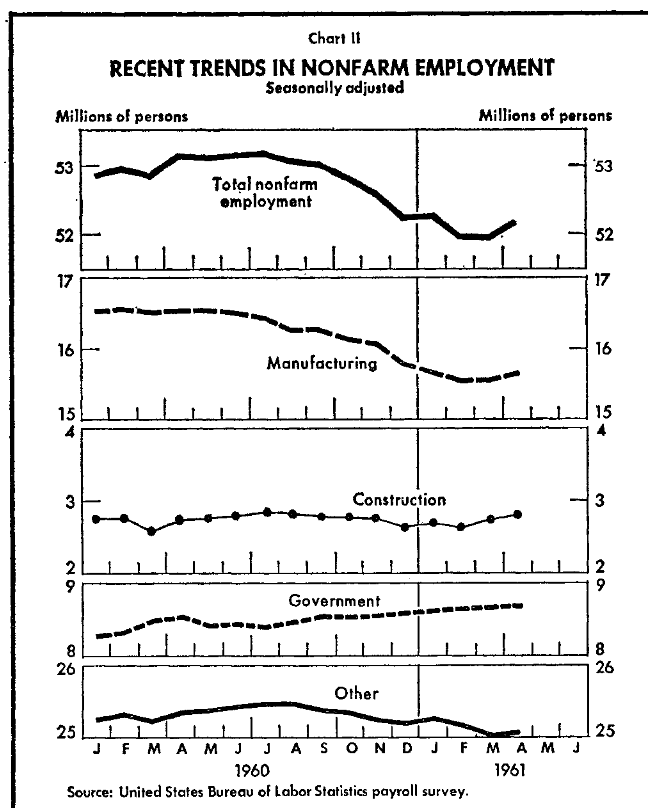
in new orders (seasonally adjusted) during the last three quarters of 1961, with fourth-quarter orders running 9 per cent above orders in the first quarter.

While recent reports on business plans point to a prospective expansion in fixed capital spending, current outlays still tend to reflect plans made several months earlier —a fact that may explain the continued decline in May (2 per cent, seasonally adjusted) of outlays on commercial and industrial construction. This reduction was nearly offset, however, by increases in other types of private nonresidential construction, so that total private nonresidential outlays declined only very slightly. Government construction outlays rose in May after a rather sharp contraction in April, owing primarily to a rebound in highway construction. In mid-May the Federal Government released $818 million of highway funds originally scheduled for allocation to the States during the summer, and this may lead to further expansion in highway outlays.

Residential construction outlays (seasonally adjusted) were up in May for the third straight month. While the total rise since the low in February has amounted to over 10 per cent, the industry is still depressed relative to 1959 and 1960. Residential contract awards and private nonfarm housing starts, which tend to lead fluctuations in outlays, were both weak in April. The small rise in contract awards for that month appears to have been below seasonal expectations, and housing starts declined moderately after seasonal adjustment, following three successive rises. At least some part of the March-to-April decline in starts, however, was attributable to the smaller number of working days in the latter month.



EMPLOYMENT AND PRICES

In April, the payroll survey of nonfarm employment showed its first significant gain, seasonally adjusted, in a year (see Chart II). Most of the advance represented nearly equal increments to manufacturing and construction payrolls. The addition of 81,000 workers to manufacturing payrolls in April was especially encouraging, since the manufacturing sector has been the most important source of weakness in over-all employment during the recession. The government sector is the only major area of nonfarm employment that has shown steady increases in the past six months. All of this gain has been in the State and local field. According to Census Bureau data, nonfarm employment advanced further in May. On the other hand, the improved pace of business activity has as yet had little effect on unemployment. The seasonally adjusted level of unemployment in May, even though slightly below the March high, actually showed a small rise over the April total, and the May unemployment rate of 6.9 per cent was equal to the highest levels reached in the 1960-61 recession. The unemployment rate has been fluctuating within a narrow range, just under the 7 per cent mark, for the past six months.

Prices at both retail and wholesale levels have shown considerable stability in recent months. The consumer price index in April was unchanged from its December level of 127.5 per cent of the 1947-49 average. This reflected offsetting movements in the prices of services, which continued to creep upward, and in the prices of goods, which moved slightly downward. While a decline in food prices appears to have been largely seasonal, declines in other nondurable goods and in durable goods indicate softness in demand for some products. As for wholesale prices, the index of all commodities actually fell a little over the December-April period, owing primarily to decreases in the farm and processed foods components. Prices of producers' and consumers' finished industrial goods, however, also showed declines, and the only substantial increase for any major component of the wholesale price index was registered by the industrial raw materials group, a cyclically sensitive component.

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The Money Market in May

After a brief period of exceptional ease early in the month—attributable principally to a concentration of reserves at New York City banks—the money market turned less easy over most of May. Heavy flows of funds associated with the May 15 payment for the Treasury's refinancing operation contributed to a shift of reserves tending to stiffen money market interest rates. Beyond this, the Treasury raised approximately $500 million of new cash in the May refinancing. Over the month as a whole, the effective rate on Federal funds rose from a ¼ to 1 per cent range during the first week to hold generally within a 2 to 3 per cent range thereafter. Similarly, rates posted by the major New York City banks on new and renewal call loans to Government securities dealers varied from 1 to 3¼ per cent through the period, but held at the lower end of the range through May 8.

The release of data revealing an impressive rise in industrial production along with other signs of economic recovery sparked a reversal of investor expectations as to the future course of interest rates. During the early part of the month, investors anticipated a continuation of recent declines in yields and an extended period of monetary ease and, in consequence, bond prices were bid up in most markets. Toward midmonth, however, sentiment began to change, and this was reflected in occasional sharp price declines in the second half of the period.

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, May 1961

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

Factor	Daily averages—week ended					Net changes
	May 3	May 10	May 17	May 24	May 31	
Operating transactions						
Treasury operations*	− 190	+ 167	− 156	+ 73	+ 113	+ 7
Federal Reserve float	− 213	− 63	+ 234	+ 71	− 343	− 314
Currency in circulation	− 36	− 125	− 113	+ 80	− 54	− 248
Gold and foreign account	− 27	+ 17	+ 3	+ 13	− 11	− 5
Other deposits, etc.	+ 1	− 5	− 23	− 67	+ 7	− 87
Total	− 464	− 8	− 55	+ 170	− 288	− 645
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 303	+ 100	− 109	− 85	+ 201	+ 410
Held under repurchase agreements	—	+ 9	+ 33	+ 13	− 52	+ 3
Loans, discounts, and advances:						
Member bank borrowings	+ 24	+ 3	+ 109	− 107	+ 26	+ 55
Other	—	+ 1	—	− 1	—	—
Bankers' acceptances:						
Bought outright	—	− 3	− 1	− 2	+ 2	− 4
Under repurchase agreements	—	—	—	—	—	—
Total	+ 326	+ 109	+ 32	− 181	+ 177	+ 463
Member bank reserves						
With Federal Reserve Banks	− 138	+ 101	− 23	− 11	− 111	− 182
Cash allowed as reserves†	− 72	− 162	+ 189	+ 16	+ 18	− 11
Total reserves†	− 210	− 61	+ 166	+ 5	− 93	− 193
Effect of change in required reserves†	− 54	+ 69	− 40	− 39	+ 100	+ 36
Excess reserves†	− 264	+ 8	+ 126	− 34	+ 7	− 157
Daily average level of member bank:						
Borrowings from Reserve Banks	61	64	173	66	92	91‡
Excess reserves†	467	475	601	567	574	537‡
Free reserves†	406	411	428	501	482	446‡

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 May 31.

BANK RESERVES

Operating factors absorbed reserves, on balance, during the five weeks ended May 31, as float declined and currency in circulation expanded. A substantial volume of reserves was provided through System open market operations, however, as outright holdings increased by $410 million and holdings under repurchase agreements rose by $3 million.

Over the five weeks as a whole, free reserves averaged $446 million, compared with $572 million in the four statement weeks ended April 26. Average excess reserves declined to $537 million during May from $632 million in the April period, while average borrowings at $91 million were about $31 million higher than in April.

GOVERNMENT SECURITIES MARKET

The strength which characterized the entire range of Treasury obligations in the early part of May subsequently gave way to caution, in line with improved business expectations. In the second half of the month, prices in the intermediate and long area of the market declined as much as 2 points.

The month opened with market interest focused upon the Treasury's $7¾ billion refinancing operation in which $5¼ billion of 3 per cent one-year certificates and $2½ billion of 3¼ per cent two-year notes were offered for cash on May 1. Both issues were heavily oversubscribed, and allotments of 27 per cent of certificates and 12 per cent of notes were made to nonpreferred

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subscribers. The new certificates and notes moved immediately to premiums of 100⁹⁄₆₄ and 100⁹⁄₃₂, respectively, in "when-issued" trading, and the enthusiasm generated by their performance spread quickly to outstanding issues. The entire market was strengthened further by press reports suggesting that the monetary authorities might take action which would result in lower long- and short-term interest rates. Under the additional influence of the reduction, on May 4, of the West German central bank's discount rate from 3½ per cent to 3 per cent, prices of Treasury notes and bonds continued their upward movement, as many issues went to the highest levels recorded since 1958. After a temporary price reaction caused in part by moderate professional profit-taking on May 8 and 9, prices of longer term issues resumed their upward surge, engendered in some degree by discussion of the Administration's long-term interest rate objectives and public awareness of the magnitude of System Account operations.

From the middle of the month, prices of notes and bonds began a fairly persistent downward drift which continued almost without interruption to the close of the period. Along with the sharp rise in stock prices, other factors exerted an influence on the market. In the face of offers of long-term securities against little demand, dealers apparently preferred to lighten their positions. Toward the end of the month the decline in prices gained momentum on rumors of the likelihood of a new advance refunding by the Treasury, the release of reports pointing to an accelerated pace of economic recovery, the expectation of a rise in Government spending, and a growing calendar of corporate and municipal offerings. There was, moreover, increasing newspaper discussion as to the nature and extent of System Account operations, both current and prospective. In this context, a heavy atmosphere pervaded the market for Treasury securities, and price declines in the latter half of the month more than canceled the early gains, so that over the month as a whole prices of Treasury notes and bonds generally receded from ³⁄₃₂ to ¾ of a point.

Developments in the market for Treasury bills were in consonance with those in the longer term maturity areas and the money market. Rates of discount on 91-day bills moved lower in the first half of the month in an easy money market where a broad demand from bank and nonbank sources favored the shortest maturities. As an additional $100 million of new money was raised in each of the first two weekly bill auctions through increases in allotments of six-month bills, declines in longer bill rates were comparatively slight. Subsequently, Treasury bill rates rose generally, as supply was augmented by selling offers from commercial banks and other institutions in a firmer money market. By the end of the month, rates on the latest 91- and 182-day bills had risen to 2.34 and 2.57 per cent, respectively, 7 and 19 basis points above the end of April.

OTHER SECURITIES MARKETS

Movements in yields on corporate and tax-exempt bonds primarily reflected the same factors which influenced Government securities as well as the expected growth in the calendar of new offerings. Over the first two thirds of the month, markets for seasoned corporate and tax-exempt bonds strengthened, and large fractional gains were common in both categories. Toward the close of the month, however, prices weakened somewhat, as investors became more hesitant on reports of increasingly sanguine appraisals of the business outlook and a rising volume of planned new securities issues.

The volume of new publicly offered corporate bonds declined slightly to $615 million in May from the heavy volume of $630 million in April; this compares with corporate financing of $182 million in May 1960. The largest new corporate issue of the month was a $100 million (Aa-rated) oil company offering of 4½ per cent debentures due 1991 and reoffered at 99¼ to yield 4.55 per cent. Late in the month, however, some new issues met resistance and, following dissolution of a number of investment syndicates, yields rose by as much as 15 basis points. Nevertheless, the month-end average yield on Moody's Aaa-rated seasoned corporate bonds was 4.28 per cent, unchanged from the end-of-April level.

The volume of new tax-exempt flotations declined to about $550 million in May, considerably below the April level of $660 million but substantially above the $494 million in May 1960. Toward the end of the month, new tax-exempt issues met mixed receptions and there was some evidence of increases in dealer inventories. Yields on seasoned Aaa-rated tax-exempt bonds, as measured by Moody's, rose to 3.28 per cent over the month, 4 basis points above the level prevailing at the end of April.

Rates on money market instruments were shaded early in the month in line with the easier money market. On May 8, dealers in bankers' acceptances reduced their rates on all maturities by ⅛ per cent, bringing the new rate on 90-day unendorsed acceptances to 2¾ per cent (bid). From May 11 through May 16 the major finance companies announced a ⅛ per cent rate reduction on 60- to 89-day paper, making the new rate 2¼ per cent (offered). However, following the rise in yields on Treasury bills toward the end of the month, short-term money rates

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adjusted upward. On May 25, dealers in bankers' acceptances raised their rates in all maturity categories by ⅛ of a percentage point, canceling the earlier reduction. Effective May 29, commercial paper dealers also raised their rates by ⅛ of a percentage point. And, on May 31, the major finance companies announced increases from ⅛ to ½ of a percentage point on various maturities of commercial paper they sell directly to investors.

The Role of Savings Bonds in Government Finance

The twentieth anniversary of the current Savings bond program, observed this year, honors a program unique in American public finance. Originally initiated as a World War II financing technique, it was continued, expanded, and revised during peacetime and represents the first large-scale and sustained effort to lodge a sizable portion of the national debt in the hands of small savers. For the small saver, the Savings bond has been a comparatively high-yielding but riskless investment outlet. For the Treasury, the Savings bond program was a major source of funds during World War II, contributing $44 billion or about one fifth of total funds borrowed to finance the war. Even though the program's size has been somewhat reduced in recent years, Savings bonds remain the second largest bloc of publicly held Federal debt and are continuing to make a major contribution toward easing the problems of Federal debt management.

CHARACTERISTICS OF SAVINGS BONDS

Savings bonds are nonmarketable Government securities redeemable at the option of the holder. Some are "discount" or "appreciation" bonds on which interest accrues according to a fixed schedule but is paid only upon redemption; Series E bonds, the longest lived and most popular Savings bonds, are of this type. Others, like the Series G, H, and K, pay interest semiannually. Only two issues are now sold: Series E bonds, on which interest accrues at 3.75 per cent if held to maturity (seven years, nine months) and which are sold in denominations of as little as $25 at 75 per cent of their maturity value; and Series H bonds, which are sold at 100 per cent of maturity value, in denominations starting at $500, pay interest semiannually and mature in ten years. Series E bonds also have an extension privilege and interest continues to accrue after maturity; those bought between 1941 and 1949 will pay 3.75 per cent in the second extension period, while those bought between 1949 and 1957 yield somewhat lower rates. These rates reflect several upward adjustments after 1952 that were designed to bring the Savings bond program abreast of current market conditions.

In recent years, it has been estimated that 40 million persons own Savings bonds. Among the factors responsible for their widespread appeal are ease of redemption, an attractive interest rate, absence of market risk, and replacement of the security in case of loss, theft, or destruction. Perhaps the most outstanding feature, however, is convenience of purchase, particularly through the provision available in many companies for automatic payroll deductions—these now cover about 8 million payroll savers. A recent addition to this phase of the program has been the selection of Savings bonds as the form of savings in many company savings plans where employees and employers make joint contributions. Many holders of the Series E bonds have also incorporated them into their retirement income programs and hold them long past their original maturity. Indeed, $18 billion, or about 40 per cent of all Savings bonds outstanding on December 31, 1960, were more than ten years old.

EARLY EXPERIENCE

Savings bonds were first sold in 1935 in order to encourage thrift and "democratize public finance". The current program, however, was born in May 1941 with the introduction of "Defense Savings bonds" of Series E, F, and G. At that time, the Savings bond program was part of a broader program designed to minimize the inflationary effects of war finance by helping to absorb consumer purchasing power and by placing as large a part of the public debt as possible outside the banking system (commercial banks were prohibited from buying Savings bonds). In line with these objectives, Series E bonds offered the highest rate available on any Government security at that time and sales were aggressively promoted. Win-the-war drives, the availability of small denomination bonds and stamps, and the institution of automatic payroll deductions were specifically devised to encourage investment in these

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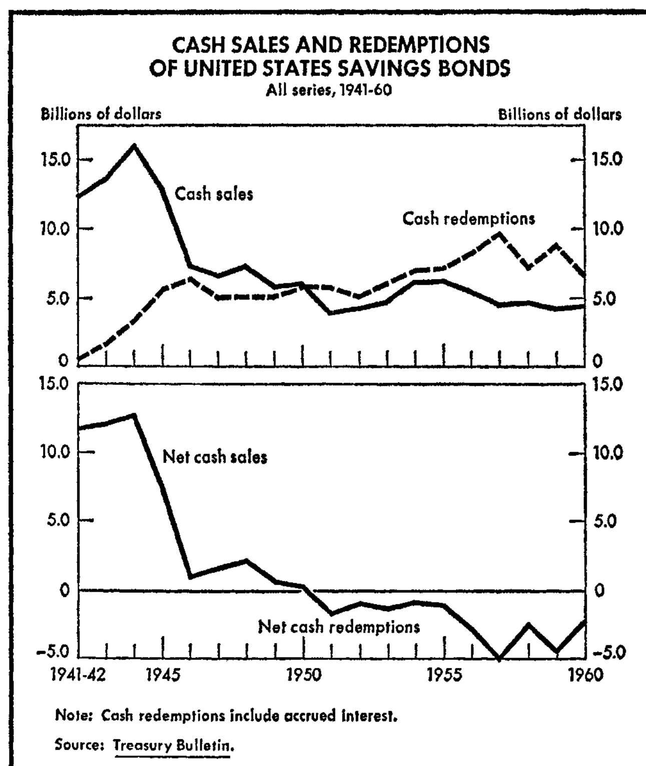
securities by small savers. Under the impetus of bond drives appealing to patriotism, sales of Savings bonds during the war years topped $10 billion in almost every year.

After the war, sales of new bonds tapered off while bonds accumulated during the war were redeemed in increasing amounts by holders eager to acquire the houses, automobiles, and other consumer goods that had previously been in short supply. At the same time, rising interest rates on alternative forms of investment reduced the relative attractiveness of Savings bonds, particularly to larger investors. As a result, the growth of the program slackened after 1945, and by 1951 more funds were paid out on redemptions than were received from new sales. The total volume of Savings bonds outstanding did not begin to decline until 1955, however, when the excess of redemptions over sales grew large enough to offset the continued growth of accrued interest.

Although the Treasury's net requirements for additional funds were far smaller during the 1950's than during World War II, the continuing high level of Government outlays did not permit any substantial reduction in outstanding indebtedness. The goal of the Savings bond program thus became one of "holding the line" by adapting the program to changing economic conditions.



ADJUSTMENT TO CHANGING CONDITIONS

Beginning in 1951, the Treasury took a succession of measures to hold down the size of the drains upon its cash arising from redemptions in excess of sales. In that year, the first ten-year extension privilege on Series E bonds was announced, i.e., interest on these bonds would continue to accrue for another ten years after maturity. In 1952, sales of Series F and G bonds—which had never been so popular as Series E bonds—were discontinued and Series J and K were introduced as replacements, bearing a higher rate of interest over the full maturity and in the intermediate years. The interest rate on Series E bonds also was raised, and the maturity was slightly shortened. In addition, these bonds henceforth could be redeemed with interest after six months (rather than twelve months) and the redemption values in the earlier years were improved. Another innovation was the introduction of Series H bonds; these were current interest bonds designed as a companion to the revised Series E bonds.

While these changes increased total sales of Savings bonds, they failed to reduce the high rate of redemptions. Indeed, redemptions rose steadily each year, reaching $8.3 billion in 1956. This increase was concentrated in redemptions of Series F, G, J, and K bonds; holders of these bonds, which included nonbank financial institutions as well as individuals, were more sensitive to interest rates on marketable securities than were the individual holders of Series E bonds. Redemptions of these four series thus rose from $1.1 billion in 1951, representing about 19 per cent of all redemptions, to $3.4 billion, or more than 40 per cent of total redemptions in 1956. Rising market interest rates also depressed sales of these bonds, and by 1956 the Treasury's net cash drain from these four series had climbed to almost $3 billion.

In February 1957 the Treasury again overhauled the Savings bond program, in recognition of the interest-sensitivity of the larger investors in Savings bonds. Sales of Series J and K bonds were discontinued, rates on Series E and H were raised to 3.25 per cent, if held to maturity, and the maximum permissible amount of annual purchases by any one individual, which had been raised in 1952, was now reduced. Nevertheless, in 1957 total redemptions reached a postwar peak of $9.6 billion and the net cash drain increased to a record $5 billion. Underlying this deterioration was the sharp advance in market interest rates which brought yields on long-term Government marketable securities considerably above the rate paid on Series E bonds.

Still further steps were taken in the three following

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years to plug the cash drain. In 1958, the Treasury liberalized restrictions on groups eligible to purchase Series E and H bonds so that only commercial banks remained ineligible. In the following year, the rate on these bonds again was raised, bringing it to the current level of 3.75 per cent, while the maturity on Series E bonds was cut to seven years, nine months. In addition, several exchange offerings were made, including a continuing offer beginning in January 1960 to holders of Series E, F, and J bonds to convert to Series H. Further exchanges involved the offer of marketable securities for Series F and G bonds, thereby increasing redemptions by the amounts exchanged. In 1959, $746 million of these bonds was exchanged for 4¾ per cent marketable notes of 1964, while in the following year another $148 million was exchanged for 4 per cent marketable bonds of 1969.

Redemptions have remained generally high in recent years, although below the 1957 level, fluctuating with economic conditions and market interest rates. In 1959, with consumer buying on the increase and market interest rates rising, redemptions once again rose sharply. Apparently this reflected the tendency of some holders to transfer funds into marketable securities when rates on these securities rise and of others to use accumulated savings to purchase "big ticket" consumer goods when the economic outlook appears promising. In 1958 and 1960, when consumer buying was more cautious and interest rates generally lower, redemptions on Savings bonds also were down. Indeed, during some of the early months of 1961, sales once again exceeded redemptions.

SAVINGS BONDS AND DEBT MANAGEMENT

Although the Savings bond program has not been a source of additional funds to the Treasury since 1951, when redemptions first exceeded sales, it has nevertheless made an important contribution toward easing the Treasury debt management burden. If the program had been terminated during the past decade—perhaps in an attempt to place that part of the public debt represented by Savings bonds in debt instruments which could not be redeemed at the option of the holder—the Treasury would have been forced to sell additional securities of other types. This would have been a financing task of substantial proportions, even if spread out over several years, complicating the already formidable task of providing for current cash needs and of refinancing securities coming due. Indeed, even assuming that such a financing had been accomplished, it is questionable whether the structure of the debt would have been improved. Formidable difficulties have been encountered in recent years in lodging large amounts of long-term debt with investors. The issuance of short-term securities, on the other hand, might have added to the future refinancing burden or might have swelled the volume of "near money" assets to inflationary proportions.

Of course, the Savings bond program has had its problems, as indicated above. Attrition from the excess of redemptions over sales has been a net drain on Treasury funds, with the total drain amounting to over $23 billion since 1951. This is still considerably less, however, than the financing that would have been required if Savings bonds had been replaced with marketable issues. The cash drain, moreover, has generally been of modest proportions in any one year, and within the year it typically has been well spread out, thereby avoiding the difficulties that arise when large amounts of debt mature at one time.

It is noteworthy that the practice of letting interest accrue on Savings bonds, rather than of paying it currently, has moderated the extent of the cash drain. Despite a sharp decline in the outstanding amount of Savings bonds since 1955, current interest accruals have in every year exceeded payments of accrued interest on redeemed bonds. Over the 1951-60 decade, the cash drain would have been about $4.5 billion larger if interest had been paid currently rather than on an accrued basis. On December 31, 1960, over $8 billion of the $47 billion of Savings bonds outstanding represented accrued interest.

CONCLUDING COMMENT

The role of the Savings bond program in Government finance has significantly changed since World War II, while the program has undergone various modifications to keep it abreast of current economic conditions. Nevertheless, the essential feature of providing small savers a medium for systematic investment in Government securities has remained the cornerstone of the program. The extremely broad base of ownership of Savings bonds, along with the widespread participation in payroll savings plans, testifies to the realization of the program's early goal of the "democratization of public finance".

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