

# FEDERAL RESERVE BANK OF NEW YORK



## MONTHLY REVIEW

OCTOBER 1961

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Volume 43

No. 10

## The Vienna Meeting of the International Monetary Fund

The International Monetary Fund has made substantial progress toward enlarging its capacity to meet the financial problems of the evolving world economy. At this year's annual meeting, held in Vienna toward the end of September, there was unanimous agreement that the most practical and effective way to deal with the serious foreign exchange disturbances that sometimes arise from major balance-of-payments pressures is to strengthen the existing machinery for international cooperation. The governors rejected various schemes for a drastic remodeling of the international payments system. Instead, they reached agreement in principle on arrangements under which the Fund, in case of need, would augment its holdings of certain major currencies and thus strengthen its ability to cope with possible international payments strains. Details of these arrangements, which are necessarily complicated, are to be worked out in the course of the fall and winter.

In so acting the governors have recognized, as the IMF's latest annual report states, that "the international monetary system cannot consist of fixed arrangements expected to be suitable forever" and that "the Fund must, within the framework of its Articles of Agreement, develop in keeping with the evolution of its members' financial and monetary needs and potentialities". It was in this spirit that the Fund's usefulness was enhanced both by the introduction in the early 1950's of more flexible policies in the use of its resources by members and by the increase toward the end of the decade in the resources contributed by its members.<sup>1</sup>

Now a new need to strengthen the Fund further has arisen from recent and profound changes in the world economy. Industrial nations abroad have emerged from their postwar difficulties and have attained a high degree of economic vitality. Western Europe's currencies have become freely convertible into dollars for nonresidents. Investors and borrowers alike are again in a position to take advantage of differences in relative interest-earning possibilities and borrowing costs in the various international financial centers. International movements of capital

funds on this account have expanded. Also, political and economic disturbances have on occasion led to additional large-scale shifts of funds across national frontiers. Thus, various types of money flows have at times exerted heavy pressure on major currencies.

The Fund has been keenly aware of these problems and has initiated action to deal with them. This summer its executive directors clarified their interpretation of the Articles of Agreement regarding the use to which Fund resources may be put and removed any doubt that the Articles permit the use of these resources to deal with capital transfers. Now, with the agreement reached at Vienna, the Fund has taken an even more important step toward redressing the serious imbalance that has developed in the composition of its resources.

Although the Fund has, since the time of its establishment, had large dollar resources, it has been provided with only limited amounts of the currencies required to deal with the problems that have actually arisen since convertibility. In integrating its operations into the multilateral payments system, the Fund has directed members' drawings toward the currencies of countries that are accumulating reserves or that have relatively large reserves. Whereas in the early postwar years drawings were almost exclusively in dollars, in 1960 almost half of the drawings were in other currencies and in recent months the proportion has been even higher. As a result, the Fund's holdings of some major currencies have been reduced to levels that seem quite inadequate in relation to the potential demand for them (see chart).

Against this background, the Fund's Managing Director, Per Jacobsson, proposed last spring that the Fund should use its borrowing authority to strengthen its resources. Under this proposal, which represented the culmination of much thought and discussion by central bankers and other financial experts in recent years, Mr. Jacobsson envisaged the establishment of

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

<sup>1</sup> These and other developments relating to the Fund were discussed in greater detail in the September 1961 issue of this *Review*, p. 153.

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.<sup>2</sup>

This suggestion was strongly supported at the Vienna meeting by Secretary of the Treasury Douglas Dillon, who urged that such a multilateral arrangement be worked out in order to give the Fund access to additional supplies of the major industrial countries' currencies. These sup-

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

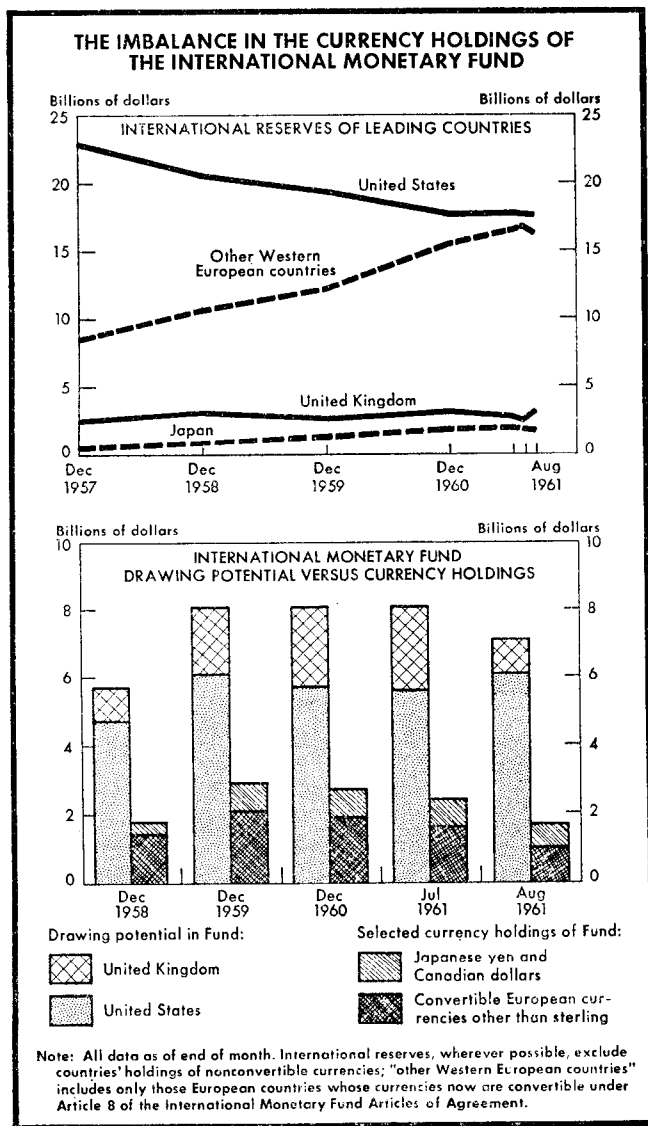
plies would then be on tap if "balance-of-payments pressures involving these countries ever impair or threaten to impair the smooth functioning of the world payments system". For its regular requirements, as distinct from its needs in the face of unusual threats to the international payments system, the Secretary said, the Fund might use its existing authority to borrow bilaterally from one or more of these countries whenever its holdings of their currencies were depleted. He went on to suggest that the possibility of crediting such a bilateral borrowing against any commitment that the lending country had made under the multilateral arrangement might reasonably be considered.

The Secretary emphasized that the additional resources to be provided under the multilateral arrangement should be sufficient in amount to "add decisively" to the Fund's power to lend and "be promptly available in case of need". He especially noted that, in the multilateral arrangement,

safeguards will be required to ensure that there will be effective consultation between the Fund and the lenders and that the Fund will only actually borrow under the commitment arrangements after taking full account of the current reserve position of the lending country.

Mr. Dillon also stressed that acceptance of the proposal should in no way change either the Fund's existing principle of treating all applications for assistance according to the same terms and conditions or its standing requirement that use of its resources be accompanied by adequate measures to deal with the borrower's balance-of-payments difficulties.

In their statements at the meeting, individual governors naturally emphasized various aspects of the multilateral borrowing arrangement. Like Secretary Dillon, representatives of the major Continental countries stressed that Fund assistance could only supplement but could never replace appropriate domestic economic policies. As the governor for the Netherlands said, "Both surplus countries and deficit countries will have to concentrate on re-establishing balance-of-payments equilibrium by the use of internal policies appropriate to that end." The governors also stressed the desirability of making the multilateral borrowing arrangement reversible so that, if a lending country's balance of payments were to deteriorate, it could obtain from the Fund virtually automatic assistance equivalent in amount to its loan. They likewise agreed that the mere adoption of the proposal would act to strengthen the international financial system. Similarly, Wilfrid Baumgartner, France's Minister of Finance and Economics, suggested that the proposed multilateral bor-



rowing arrangement should, in effect, be considered as a strategic reserve and that the first line of defense against disruptive short-term money flows should be the "Basle-type" central bank cooperation, which was so successfully employed following the revaluations of the Netherlands and German currencies last March.

On other points, there was some difference of emphasis among the representatives of Continental countries. In activating any multilateral borrowing arrangement, M. Baumgartner stressed, there must be assurance that the situation is appropriate for general action of that kind and that the existing condition of each committed currency will be taken into account before an actual borrowing by the Fund is completed. The governor for Germany expressed the view that, under conditions to be specified and subject to advance consultations, the participating countries should make "firm commitments" for the granting of credits to the Fund. Others, including the governor for the Netherlands, held that the collective judgment of the lending countries should be given special weight in any Fund decision to borrow at a particular juncture. He felt, moreover, that such credits should be granted for only relatively short periods but should be renewable.

These comments indicated both the areas of agreement in principle and the questions of precise formulation that still remain to be ironed out in negotiations during the next few months. In any event, Germany and Italy have apparently indicated informally the possibility of granting the Fund sizable bilateral loans to replenish its depleted holdings of their currencies.

The clearest summary of the broad agreement reached in Vienna was set forth in the closing remarks of Mr. Jacobsson in these words:

I am glad to be able to say that all the Governors who touched on this subject expressed a positive interest in the Fund making suitable borrowing arrangements to meet this contingency, and it is particularly heartening to find a broad measure of agreement among the countries that would be the expected lenders under such borrowing arrangements. As a result of this week's Meeting, I am confident that an arrangement can be worked out, large enough to be a powerful deterrent to any threat to the stability of our system. By its very existence,

such an arrangement may indeed be expected to have a calming effect.

I mentioned in my Opening Statement that general safeguards for the lending members would have to be provided in any borrowing arrangement which would be established. Much attention has been devoted to this aspect in the discussion—and this is certainly a matter to which a great deal of attention must be given in the coming negotiations. Much work remains to be done, but my hope is that this work could be concluded by the Executive Directors before the end of this year. If that aim is achieved, there would be sufficient time for the member countries who will participate in this borrowing arrangement to seek early next year whatever authorizations are needed to give effect to the arrangement in their own countries.

In addition, several Governors, including those for Canada, France, Germany, the United Kingdom and the United States, referred to the possibility of the Fund borrowing currencies from one or more of its member countries when, for other requirements of the Fund, the Fund's holdings of those currencies need to be replenished. Of course if the Fund needed to replenish its holdings in this way it would agree with the lender on all the terms on which this would be done.

The prospect for a further strengthening of the international financial system was thus greatly improved at Vienna. There was increased recognition among the assembled governors that, with economic power more equally distributed among the Free World's industrial countries and with no nation immune to sudden strains in a world full of political and economic uncertainties, countries with balance-of-payments surpluses today may well become the deficit countries of tomorrow. The governors agreed that the foreign exchange disturbances that sometimes arise out of rapid shifts in money flows are a mutual problem, and they achieved a wide range of agreement on how to cope with these disturbances. With negotiations for this purpose scheduled to start in the near future, there is every reason to expect that the IMF will soon be in a better position to assist its members and thus provide them with the time to adjust in an orderly fashion to the ever-changing pressures of the world economy.

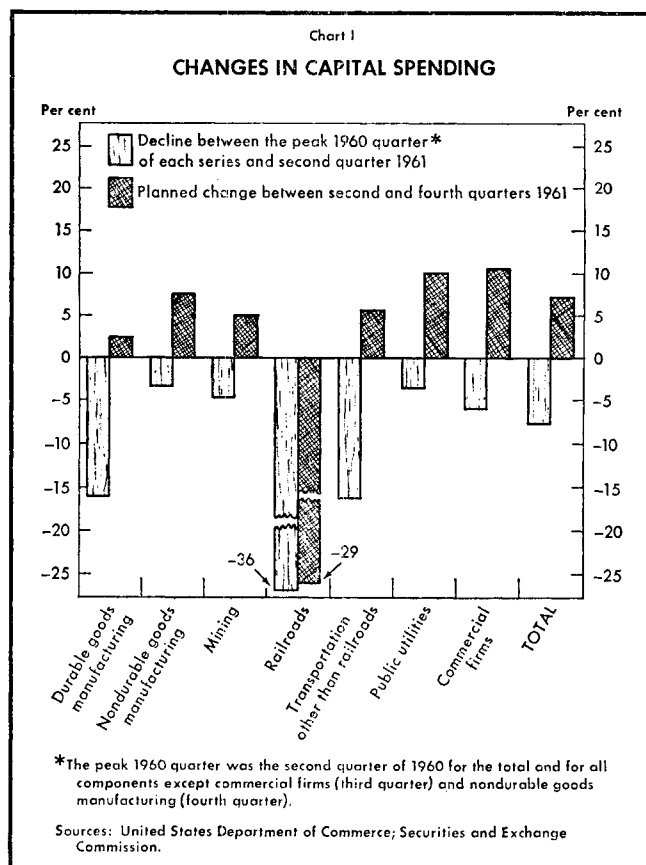
## The Business Situation

The economic advance slowed during the last weeks of summer, but special influences such as strikes in the automobile industry and intemperate weather were at least partly responsible. Retail sales were apparently adversely affected by unseasonable heat and violent hurricanes; and an actual drop in sales of the few remaining 1961-model cars was to some extent attributable to less aggressive selling by dealers who thought strikes by auto workers might cause prolonged delays in the receipt of 1962 models. The strikes, moreover, held down production not only in the auto industry but also in the steel, tire, and other industries heavily dependent upon auto manufacturing. These dampening influences largely offset the stimulus the economy received from a step-up in Government defense orders and in materials and equipment orders from private business. Toward the end of September, however, there were signs of a renewed strengthening of the expansion. At the same time, industrial prices continued relatively stable. While quotations rose for a number of commodities, there were also announcements of price cuts in several areas, induced by both foreign and domestic competition.

### THE ADVANCE CONTINUES

Industrial production rose in August for the sixth consecutive month, but the seasonally adjusted increase of about  $\frac{1}{2}$  of 1 percentage point was the smallest since March. Primarily this reflected a leveling-off in consumer goods output, following sharp advances in previous months. Production of most types of consumer goods edged only slightly above July levels, while the output of television sets and home radios, which had been expanding at a rapid pace, slumped sharply. The failure of consumer goods output to continue to rise in August reflected slack in consumer demand. Total retail sales had declined almost 1 per cent in July, and in August had risen merely back to the June level, with only sales of nondurables showing strength. Partial sales data suggest that there was little improvement in September as a whole. It may be significant, however, that department store sales, which were very poor during the first half of the month, made impressive gains later on. Auto sales in the latter part of the month, moreover, pointed to relatively strong consumer interest in the 1962 models.

The production of materials and of equipment, in contrast to consumer goods output, continued upward in August. A rise of  $2\frac{1}{2}$  per cent in new orders received by manufacturers during the month, after two months of little change (and a further strong rise in September, according to a survey conducted by the National Association of Purchasing Agents) suggested there would be even larger increases in the output of materials and equipment in subsequent months. The August rise in materials output alone, it is true, was relatively small, as a slight decline in iron and steel output partly offset expansion in other categories; and the rebound in iron and steel production during September was quite modest. Nevertheless, the steel mills did receive larger orders from an increasing number of industries in September, and were expecting a substantial rise in orders from the auto industry following completion of the Detroit labor contract negotiations.



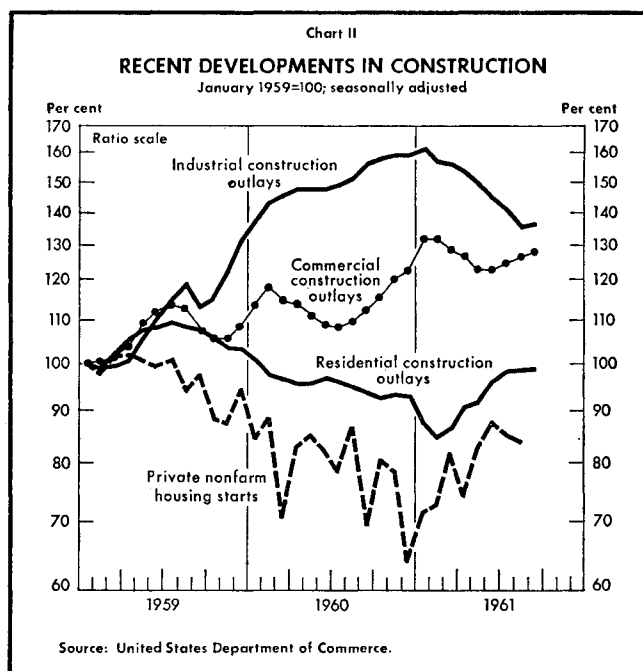
The rise in the production of equipment, unlike that of materials, continued very brisk in August, under the stimulus of orders from both the Government and private business. Government orders will increase further in the coming months, as recently expanded space and defense programs assume more definite shape. Private businessmen, who cut back plant and equipment outlays by almost 8 per cent during the twelve months ended June (see Chart I), can also be expected to increase their orders for equipment. According to the quarterly Securities and Exchange Commission-Commerce Department survey taken in late July and August, businessmen were planning to step up their capital spending by 4 per cent during the third quarter, and by an additional 3 per cent during the fourth quarter. This would bring total capital expenditures during the year to within 3 per cent of the 1960 volume—the same level that had been indicated in the spring survey before it was known that second-quarter spending would be lower than planned. The largest percentage increases in outlays were scheduled in the public utilities and commercial sectors, and the smallest in durable goods manufacturing. Railroads were the only group to expect a further drop, with anticipated expenditures for the year as a whole cut back to almost half the 1960 figure.

The rapid turn-around in businessmen's capital investment plans has not only benefited machinery producers but also the construction industry. Outlays for commercial construction have been rising since the middle of the year, as can be seen in Chart II, and in September outlays for industrial construction inched up for the first time.

The outlook for residential construction does not appear to be as favorable, even though expenditures in this sector have been advancing since March. The August and September increases were quite small (see Chart II), while seasonally adjusted housing starts, a series that leads outlays, declined slightly during the summer.

#### UNEMPLOYMENT RATE STILL HIGH

Nonagricultural employment (as measured by the Bureau of Labor Statistics payroll survey) rose in August for the fifth straight month, on a seasonally adjusted basis. The gain was the smallest since the initial improvement, but this was primarily the result of temporary layoffs in the auto industry while assembly lines were being prepared for the production of 1962 models. (The BLS does not take account of such layoffs in its seasonal adjustment of employment data, owing to the uncertainties of the timing of model change-over periods.) More significant were the fairly sizable gains in seasonally adjusted employment in other durable goods industries (especially machinery and primary metals) and in the government sector.



Total employment (as determined by the Census Bureau's household survey), which had risen somewhat in August, dropped in September by 1 per cent, on a seasonally adjusted basis, as both farm and nonfarm employment declined. At the same time, however, the labor force also fell by 1 per cent, seasonally adjusted. Consequently, unemployment as a percentage of the civilian labor force dropped, but only very slightly; in fact, the decline from 6.9 per cent to 6.8 per cent left the rate just below 7 per cent for the tenth successive month. According to a Labor Department spokesman, the unemployment rate would probably have shown a more pronounced decline if it had not been for hurricane Carla. A breakdown of the unemployment statistics for September actually does show evidence of some improvement. There were rather substantial reductions in adult male unemployment, in long-term unemployment, and in the number of persons employed only part time.

While total personal income fell in August, this was attributable to the special insurance dividend payment that veterans received in the prior month. Other types of income rose, in the aggregate, but the advance was the smallest since the series started upward in the spring. Earnings of factory workers did not increase at all, chiefly because of a decline in the auto industry where employment was temporarily reduced. Additional declines in earnings occurred in the apparel and lumber industries. Sizable gains were scored, on the other hand, in the metals and machinery-producing industries, and there were fur-

ther small advances in most nonmanufacturing sectors, including agriculture.

#### **PRICES REMAIN STABLE**

The industrial goods component of the wholesale price index, which had leveled out in July following a three-month decline, remained unchanged in August, although individual series showed divergent movements. In September, price developments continued to be mixed, with virtually no change on the average. The BLS weekly index of wholesale prices of industrial goods edged downward, while the National Association of Purchasing Agents reported that an increased, although still small, percentage of their members had found prices higher in September than in August. Prices of steel scrap and of paperboard for packaging were among those that rose during the month, and the first price increase in several years was posted for polystyrene, one of the most widely used plastics. On the other hand, copper scrap prices fell after

the termination of the Chilean copper mine strikes and an easing of foreign demand had brought a decline in prices abroad. Prices of aluminum ingots and some fabricated aluminum products were also lowered, following a reduction in the prices charged American customers by a Canadian concern. These cuts in aluminum prices, made despite the fact that wages for aluminum workers were raised in August, may be an important factor restraining increases in the price of steel, since aluminum has recently been making heavy inroads as a substitute for steel in the production of various products.

Automobile producers, now bringing out their 1962 models, also have reduced some prices, notwithstanding higher wage rates. One firm, on the other hand, raised prices on several models, and in a few cases the lowest priced lines have been dropped. Price comparisons, however, are made difficult by the fact that many of the standard models now include equipment that was previously optional and thus bear higher price tags.

### **Pricing a Corporate Bond Issue: A Look Behind the Scenes**

Making markets for securities means setting prices. This is a demanding job, for it requires a continuous evaluation of the various factors acting and reacting in the markets. Securities dealers must make day-to-day, hour-to-hour, and sometimes minute-to-minute adjustments, and the dealer who falls asleep, even briefly, may find his snooze a costly one.

Underwriters engaged in competitive bidding for new corporate bonds have a special pricing problem in that each flotation involves the distribution of a relatively large supply of securities in the shortest time feasible. While the market for outstanding securities does provide some guidance to the pricing process, it is a rough guide at best. A new bond issue will be similar to, but rarely identical with, any securities being traded in the secondary market. Furthermore, the relatively large amount involved in many new offerings increases the difficulty of gauging the market. Finally, pricing decisions on new securities are not made at the actual time of sale to the ultimate investors but must be made a short time before the bonds are released for trading, while the distribution itself may stretch over a number of days during which market rates may be in motion. The pricing of a new issue even under the best conditions thus takes place at the edge of the unknown.

The specialized job of buying, selling, and pricing new corporate securities is primarily the province of investment bankers.<sup>1</sup> Not all issues are priced through a competitive bidding process, however, and the pricing of some flotations is negotiated directly between borrower and underwriter. But in all successful flotations, investment bankers function as quick intermediaries for new securities between borrowers and ultimate investors. This involves two distinct, although closely related, objectives. In cases of competitive bidding—formal or informal—the first objective is to “win” the right to offer the security to the public by paying the borrower more for it than any other underwriter. The second is to “reoffer” the security to investors at a price higher than that paid the borrower. If a number of underwriting groups are competing against

<sup>1</sup> These firms have traditionally been called “investment bankers” although they are now bankers in name only. As is well-known, the Banking Act of 1933 specifically prohibits commercial banks that accept deposits and make loans from underwriting corporate securities. Under the act, commercial banks are permitted to continue some “investment banking”-type activities, such as underwriting direct obligations of the United States and general obligations of States and political subdivisions. At present, underwriters for corporate issues perform none of the basic functions of commercial banks, but the term “investment bankers” continues in use, and this usage will be followed in this article.

each other for an issue, each must strike a balance between (1) pressing hard to win the issue by paying a relatively high price to the borrower and (2) increasing the risk that the issue cannot be sold to the public at a price to yield a profit.<sup>2</sup>

This article is concerned with the pricing problem in a competitive underwriting process, the resolution of which boils down to setting the bid price to the borrower. It illustrates how this price is set by following through the process for an actual issue of corporate bonds. Non-essential details that might serve to identify the borrower or the investment banking houses that underwrote the issue have been slightly altered.

Because the offering discussed below was quite sizable, the pricing problem involved an added dimension. The pricing decision was made not by a single underwriter, but by a large underwriting group acting jointly as a syndicate. The pricing decision thus was to be hammered out among the members of the underwriting group, each of which had been tentatively assigned a share of the new issue. And this pricing decision, if successful, had to better that of the strong rival syndicate.

#### PREPARATION FOR A LARGE ISSUE

When a corporation plans a large financing, it customarily gives fair warning as a means of preparing the capital market. In line with this practice, the firm to be called Large Company, Inc., had announced its intention to borrow \$100 million *several months* before the date of actual issue. The early announcement gave potential investors, such as insurance companies, pension funds, and bank trust accounts the opportunity to adjust their financial commitments so as to make room, if they wished, for sizable chunks of the Large Company issue. At the same time, other potential corporate borrowers were made aware that the Large Company underwriting would bring special pressures on the market, making it unwise to schedule other sizable flotations around that period.

A light calendar of flotations makes possible a more eager participation in the underwriting by syndicate members because their over-all market commitments during the

flotation period will be less. And the better the demand for bonds among syndicate members, the stronger their bid will be, and the lower the borrowing cost to the borrowing firm. As noted, in the underwriting of the Large Company issue two competing syndicates were formed. One of the groups, managed by X Investment Bank, consisted of more than 100 investment firms, and the competing syndicate, led by Y Investment Bank, was about as sizable.

Managing such large syndicates has become the business of about a half dozen large investment banking houses. Only the largest among them have the capital, the manpower, and the market contacts necessary to propose the proper price for a large offering. If a given house, acting as syndicate manager, wins what the market considers a fair share of the bidding competitions in which it participates, it gains in a number of ways. Not only is its prestige enhanced—which helps in managing future syndicates—but the house that is continuously proving the high quality of its market judgment may be more successful in attracting *negotiated* financings. This concern for the future tends to intensify present competition among managing underwriters.

But while the half dozen syndicate leaders are rivals, they are also potential allies because a grouping of underwriters exists only for a given flotation, and the next offering on the market will involve a different group. Indeed, during the preparation for the Large Company issue, two of the major firms in the rival syndicate led by Y Investment Bank knew that they would be associated with X Investment Bank in a large secondary stock offering within two weeks. As a consequence of the shifting associations and combinations of firms from syndicate to syndicate, the current associate in an underwriting insists on conserving his own independence of action, and this has an important bearing on the pricing process, as we shall see below.

The first informal "price meeting" on the forthcoming issue took place at X Investment Bank two days before the actual bidding date set for the issue. Fifteen senior officers of X Investment Bank actively engaged in trading and underwriting met at this point to discuss pricing recommendations that would win the issue and at the same time find ready acceptance in the market. The terms of the new issue were discussed in the light of current market factors, and each pricing suggestion was, in effect, an answer to a double-barreled question: first, how attractive was the issue in terms of quality, maturity, call provisions, and other features; and, secondly, how receptive was the market at this time? Among the factors discussed as leading to a lower yield was the new bonds'

<sup>2</sup> In a negotiated flotation, the problem of reaching an optimum bid between (1) and (2) would appear to be less than it is under the competitive bidding process. And a negotiated deal clearly offers the short-run advantage to the underwriter that he cannot "lose" the issue to another syndicate. A negotiated underwriting will not necessarily carry a higher borrowing cost, however, for many large borrowers have some degree of choice between competitive and negotiated flotations. If borrowing costs in, say, negotiated deals were to rise out of line with costs on competitively priced flotations, the cheaper method of raising funds would be used to a greater extent.



Aaa rating, while factors leading to a higher yield included the lack of call protection and the large size of the issue.

The preliminary discussion of the offering price then shifted to the "feel of the market". Even the proponents of a relatively high yield recognized that the final bid should be close to current market yields on similar securities, owing to the relatively light calendar of forthcoming new corporate flotations. Another sign pointing to aggressive bidding was a relatively light dealer inventory of corporate securities. The discussion of competitive demands for funds was not confined to the corporate securities market, however, but extended to the markets for municipal and Treasury issues as well. Here the picture was mixed. The light calendar of forthcoming municipal issues was cited by proponents of a lower yield, while those in favor of a higher yield pointed to expectations of a relatively heavy volume of Treasury financing. Finally, the discussion moved on to assess the possibility of changes in significant market rates such as the prime loan rate and Federal Reserve Bank discount rates during the flotation period. It was agreed that the likelihood of such changes during the financing period was small. Each of the officers of X Investment Bank then independently set down his opinion of the proper pricing of the issue (i.e., the combination of coupon rate and price offered the borrower) and the reoffering "spread" (i.e., the difference between the bid price and the reoffering price to the public).

The majority of the fifteen members of the group agreed that the new bonds should carry a rate of  $4\frac{1}{4}$  per cent to the borrower with the bonds priced at par, and with a reoffering spread of about \$7 per \$1,000 bond.<sup>3</sup> One member of the group thought that a lower yield might be needed to win the bid, and two or three others indicated yields higher than  $4\frac{1}{4}$  per cent. The aggressiveness of X Investment Bank's price ideas can be judged from the fact that newspaper comment on the likely level for the winning bid on the day of this meeting indicated a yield in the neighborhood of 4.30 per cent.

#### MARKETING STRATEGY

Simultaneously, assessments of the market for the purpose of establishing a proper bid for the issue were under way in the offices of the allied syndicate members. The comparison of various opinions of the "best" bid of the syndicate members took place a day later, the day before the actual opening of the bids by the borrower.

<sup>3</sup> It should be noted once again that these rates have been changed from those placed on the actual bond issue.

This was the "preliminary price meeting", to which each firm in the syndicate was invited. At the meeting each participant firm named the price it was willing to pay for the number of bonds tentatively assigned in the underwriting.<sup>4</sup> The poll of the 100-odd allied syndicate members revealed far less aggressiveness (i.e., willingness to accept a low yield) by the smaller firms than was shown by the syndicate manager. Relatively few ideas were at  $4\frac{1}{4}$  per cent, while one of the "major underwriters" (i.e., a firm tentatively assigned \$3 million of bonds or more) put his offering yield at 4.35 per cent, and a small firm went as high as 4.40 per cent.

In this particular underwriting, X Investment Bank seemed quite eager to win the bid, partly because of its optimistic appraisals of the state of the bond market and partly because it is the syndicate manager's responsibility to push for a winning bid and to exercise the proper persuasion to carry his syndicate along. Prestige is peculiarly the concern of the syndicate manager because, rightly or wrongly, the market apparently does not attach nearly so much significance to membership as to leadership in a losing syndicate.

This factor explains the paradox that the followers, rather than the manager, may be more responsible for the failure to win a bid for lack of aggressiveness, even though the market tends to place the blame on the manager. But smaller syndicate members may be reluctant participants at lower yields because their commitment of funds for even a relatively small portion of a large underwriting may represent a larger call (or contingent liability) against the small firm's capital than it does for a bigger firm. Even though the larger firm's capital may be as fully employed as that of the smaller firm in its *total* underwriting business, the commitment of a large portion of capital for a single underwriting may make the smaller firm more hesitant to take that particular marketing risk.

In preparing for the final price meeting, the syndicate manager held the first of a number of behind-the-scenes strategy sessions. At these meetings, some basic decisions were made about ways and means of holding the syndicate together. During the final price meeting, any firm believing that the market risk of the proposed group bid was too great (i.e., that the yield was too low to sell well) had the right to drop out of the syndicate. Conversely, if the syndicate member liked the group bid, he could raise the extent of his participation. Of course, if many

<sup>4</sup> In this meeting, as in the final price meeting, a number of security measures were taken to prevent a leak of information to the competing syndicate.

syndicate members drop out, particularly major underwriters, too much of a burden is placed on the remaining members, and the result is, in effect, to veto the proposed bid. The aggressive manager thus is placed squarely in the middle of a tug of war: if his bid is too aggressive, and carries a relatively low yield, the syndicate may refuse to take down the bonds; if the bid is too cautious and carries too high a yield, the syndicate may lose the bidding competition to the rival group. This conflict was resolved at the final price meeting.

### SYNDICATE TACTICS

On the morning of the day on which the final bids were made to the borrower, the officers of the syndicate manager held their final conference at which decisions were reached regarding their willingness to raise their own share of the underwriting. In effect, a manager who believes in an aggressive bid puts up or shuts up by expressing his willingness to absorb a greater or a lesser share of the total underwriting as firms drop out of the syndicate at lower yields. A strong offer to take more bonds by the manager may induce a number of potential dropouts to stay at a lower yield, partly because their share of the flotation won't be raised by a given number of dropouts since the manager is picking up the pieces. But beyond the arithmetic effect, a strong offer may have a psychological impact, and some reluctant participants may decide that the manager knows more than they do, and that his willingness to raise his share at a given yield is his way of backing the strength of his judgment.

This "psychological" downward push on yields may be small, but sometimes even a tiny difference between two competing bids can spell the difference between success and failure. For example, in late 1959, the winning syndicate for a \$30 million utility issue bid  $\frac{1}{100}$  of a cent more per \$1,000 bond than the loser; the borrower received exactly \$3 more from the winning syndicate for the \$30 million issue than was offered by the loser.<sup>5</sup>

Another important factor in holding the syndicate together is the strength of the "book" for the new issue. The "book" is a compilation of investor interest in the new bonds. This interest may have been solicited or unsolicited, and may have gone directly to X Investment Bank from, say, institutional investors or to other members of the syndicate. Thus the book is a sample of market strength. All the interest in the book is tentative

since no lender would commit funds for an issue of unknown yield. Nevertheless, it is impossible to exaggerate the importance of a large book to an aggressive syndicate manager in holding his group together at the lowest possible yield. Because reluctant participants in an underwriting are particularly concerned about the selling risk, the larger the book the more reassured they will feel at any given rate. Put another way, the better the book, the more bonds a firm will take at a given rate, thus absorbing more dropouts. Indeed, the size of the book was considered so important that the final price meeting on the Large Company underwriting was interrupted a number of times by the latest indications of interest in the issue.

### THE FINAL PRICE MEETING

As a means of preventing information leaks, representatives of the firms attending the final price meeting were locked in a room. The meeting was opened by a vice president of X Investment Bank with a brief review of the good state of the "book"—about half the issue had been spoken for, tentatively. He derived further encouragement for an aggressive bid from the healthy state of the bond market. Thus he proposed to make his bid at the  $4\frac{1}{4}$  per cent rate agreed upon at the X Investment Bank preliminary meeting two days earlier.

The immediate reaction to this statement was a chorus of moans. Apparently, the book was not sufficiently broad to carry the doubters along with the first bid, nor did the manager indicate any other action that would have made his proposal more acceptable. When the group was polled, large and small dropouts cut the \$100 million underwriting by about a third. The failure to carry the syndicate at the first go-round was later attributed by some X Investment Bank people to the fact that three dropouts occurred among the first set of major underwriters polled (i.e., the eight largest firms, each of which had been tentatively assigned \$3 million of bonds). And in the second set (\$2 million assigned to each firm) another few had fallen by the wayside.

Thus a new bid proposal had to be presented to the group. Following another behind-the-scenes consultation of the senior officers of the managing underwriter, a  $4\frac{3}{8}$  per cent coupon was proposed with a bid yield of 4.27 per cent. Amid continued grumbling of the majority of the members of the meeting, this was readily accepted by nearly every firm.

Judging that they might have leaned over too far in the direction of their reluctant followers, the officers of the syndicate manager consulted once again, and decided to

<sup>5</sup> At times, tie bids are received. On September 12, 1961, two underwriters bid identical amounts, down to the last  $\frac{1}{100}$  of a penny per \$1,000 bond, for a \$3 million issue of municipal bonds. Such tie bids are as rare as a golfer's hole in one, however.

present a somewhat more aggressive bid to the syndicate. In the third proposal, the bid price on the  $4\frac{3}{8}$  coupon was upped by 20 cents per \$1,000 bond. The underwriters, still grumbling, were polled again and, following a few minor dropouts, approved the new price. The final allocation of the bonds differed relatively little from the tentative original allocation except that the manager picked up the allotments of the dropouts by adding about \$3 million to his own commitment. By this time only a few minutes were left until the formal opening of the competitive bids by Large Company, Inc. The final coupon and price decisions were telephoned to the syndicate's representative at the bidding, who formally submitted the bid to Large Company.

Promptly at 11:30 a.m. the doors of the price committee meeting were thrown open, and within thirty seconds of that time the news was shouted from the trading room that the X Investment Bank bid had lost. The difference in the bid prices between the two syndicates

came to little more than \$1 per \$1,000 bond.

The bonds were released for trading by the Securities and Exchange Commission at around 4 p.m. and were quickly snapped up by market investors. At X Investment Bank the feeling of gloom hung heavy, particularly since the first bid offered to the price meeting would have won the issue.

Would a better X Investment Bank book have carried the defecting major underwriters along on the first bid? Should the manager have been willing to take more bonds to carry the group along in the first recommendation which would have won the issue? And would market acceptance of that bid have been as good as that accorded the actual winning bid of Y syndicate? These post mortems were bound to be inconclusive, and the unremitting pressures of the underwriting business soon cut them short. Within the next several days a number of other securities were scheduled to come to market. Tomorrow was another day, and another price meeting.

## The Money Market in September

The money market remained generally easy during September. The level of free reserves of member banks country-wide rose somewhat over the previous month, and while the reserve position of the money market center banks was under pressure through much of the month, these banks were able to obtain Federal funds to cover reserve deficiencies without difficulty at rates generally well below the 3 per cent discount rate. The effective rate on such funds generally remained within a  $1\frac{1}{2}$  to  $2\frac{1}{2}$  per cent range, while dealer loan rates posted by the major New York City banks were generally in a  $1\frac{1}{2}$  to  $2\frac{3}{4}$  per cent range. Moreover, bankers' acceptance rates and commercial paper dealers' rates were reduced during the month.

The Government securities market was strongly influenced during the month by the Treasury's advance refunding operation. The Treasury's offer to exchange approximately \$7.6 billion of two issues of  $2\frac{1}{2}$  per cent bonds maturing in 1970 and 1971 for additional issues of outstanding  $3\frac{1}{2}$  per cent bonds maturing in 1980, 1990, and 1998 was accorded an excellent market reception. The success of this operation, along with press discussion of the likelihood of a continuation of easy credit conditions and the relatively limited volume of corporate financing,

imparted strength to the entire list of outstanding intermediate and longer term Government securities. Treasury bill rates were relatively steady in September, following their sharp decline in the second half of August, with rates in the shorter term area moving irregularly to a slightly lower level by the end of the month than at its start, while longer term bill rates were about unchanged over the period.

### MEMBER BANK RESERVES

A substantial volume of reserves was absorbed in the first statement week by the increase in currency in circulation associated with the Labor Day week end, a contraction in float, and the sizable Treasury gold sales to foreign countries that followed the United Kingdom's large August drawing on the International Monetary Fund. Market factors released substantial amounts of reserves over the next three weeks, however, particularly during the third statement week when the midmonth expansion in float was exceptionally large as a result of hurricanes.

System open market operations in September largely offset these fluctuations in reserves stemming from market

factors. During the first statement week, System operations supplied the largest amount of reserves, on average, of any statement week in over ten years. System open market operations absorbed reserves during the last three statement weeks of the month, with much of the absorption taking place during the third week when the expansion of float reached its peak. On a Wednesday-to-Wednesday basis, between August 30 and September 27, System holdings of Government securities declined by \$178 million. Holdings maturing within one year contracted by \$156 million, those maturing in one to five years declined by \$36 million, and maturities in the over-five-year categories increased by \$14 million.

Free reserves of all member banks averaged \$549 million during the four statement weeks ended September 27, or somewhat more than the average for the five statement weeks of August. Excess reserves rose by \$22 million to \$588 million, and borrowings from the Federal Reserve Banks declined by \$28 million to \$39 million. The daily average level of borrowings was the lowest for any month since January 1950.

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

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

Factor	Daily averages—week ended				Net changes
	Sept. 6	Sept. 13	Sept. 20	Sept. 27	
<b>Operating transactions</b>					
Treasury operations*	+ 38	— 6	— 95	+ 135	+ 72
Federal Reserve float	— 102	+ 187	+ 657	— 120	+ 622
Currency in circulation	— 189	— 173	+ 61	+ 163	— 138
Gold and foreign account	— 168	— 5	— 7	— 14	— 194
Other deposits, etc.	— 7	+ 7	+ 46	— 8	+ 38
<b>Total</b>	<b>— 428</b>	<b>+ 9</b>	<b>+ 604</b>	<b>+ 155</b>	<b>+ 400</b>
<b>Direct Federal Reserve credit transactions</b>					
Government securities:					
Direct market purchases or sales	+ 564	— 37	— 483	— 123	— 79
Held under repurchase agreements	—	—	+ 10	— 7	+ 3
Loans, discounts, and advances:					
Member bank borrowings	+ 20	— 30	+ 17	— 17	— 10
Other	—	+ 1	—	+ 1	+ 2
Bankers' acceptances:					
Bought outright	+ 2	— 1	—	—	+ 1
Under repurchase agreements	—	—	—	—	—
<b>Total</b>	<b>+ 586</b>	<b>— 66</b>	<b>— 458</b>	<b>— 145</b>	<b>— 83</b>
<b>Member bank reserves</b>					
With Federal Reserve Banks	+ 158	— 57	+ 206	+ 10	+ 317
Cash allowed as reserves†	— 204	+ 140	+ 72	+ 34	+ 42
<b>Total reserves†</b>	<b>— 46</b>	<b>+ 83</b>	<b>+ 278</b>	<b>+ 44</b>	<b>+ 359</b>
<b>Effect of change in required reserves†</b>	<b>— 7</b>	<b>— 36</b>	<b>— 300</b>	<b>+ 46</b>	<b>— 297</b>
<b>Excess reserves†</b>	<b>— 53</b>	<b>+ 47</b>	<b>— 22</b>	<b>+ 90</b>	<b>+ 62</b>
<b>Daily average level of member bank:</b>					
Borrowings from Reserve Banks	57	27	44	27	39†
Excess reserves†	541	588	566	656	588†
Free reserves†	484	561	522	629	549†

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 27, 1961.

**THE GOVERNMENT SECURITIES MARKET**

Activity in the market for Treasury obligations was quite light in early September, as the market awaited an announcement of Treasury financing plans. Under the terms of the "senior" advance refunding announced after the close of business on September 7, holders of \$7.6 billion 2½ per cent bonds maturing in 1970 and 1971 were offered the opportunity to exchange these securities for any of the 3½ per cent outstanding bonds maturing in 1980, 1990, or 1998. Subscription books for the exchange were open from September 11 through September 15 for institutional investors, and through September 20 for individuals. At the same time, the Treasury announced it would raise \$5 billion in new cash through an issue of \$2.5 billion of June 22, 1962 tax anticipation bills, to be auctioned on September 20, by offering in early October approximately \$2 billion of Treasury notes maturing in the spring of 1963 and by auctioning, on October 10, \$2 billion of one-year Treasury bills to replace \$1.5 billion of maturing October 16 bills. The details of the early October borrowing, announced after the market's close on September 28, disclosed that the Treasury would sell an additional \$2 billion of the 3¼ per cent notes of May 1963 at a price of 99⅞, with commercial banks permitted to pay for 75 per cent of their allotments through credits to Tax and Loan Accounts. Subscriptions for the notes were received on October 2, with payment to be made on October 11.

The terms of the advance refunding were very favorably received by the market, with the "rights" in the refunding rising sharply following the Treasury announcement. The early expectation of a successful operation was subsequently confirmed, as some \$2.8 billion of the publicly held 2½ per cent issues — or slightly over half of the total amount publicly held — was exchanged for the re-opened 3½ per cent bonds. In addition, Government investment accounts exchanged approximately \$930 million.

The good reception given the refunding bolstered the entire market for notes and bonds. Moreover, the emergence of a somewhat more restrained outlook regarding the near-term economic prospects (which was also reflected in the sharp decline in stock prices after mid-September), the spreading feeling in the market that monetary policy would continue easy over the coming months, and the relatively small volume of corporate financing, all combined to give a firm tone to the market. These underlying factors had a particularly pronounced impact on longer term Treasury issues, which earlier in the month had undergone sizable price declines. After mid-

September these issues rose by as much as 1½ points. The largest gains were scored by the 3½ per cent issues reopened in the advance refunding. Price changes for notes and intermediate bonds generally ranged from ½ to ¾ higher over the month.

Following the sharp August decline, rate changes in the market for Treasury bills during September were relatively small. Rates in the three-month area continued to move moderately downward, with some interruptions, under the influence of sustained investment demand from both bank and nonbank sources in a generally easy money market. This included some reinvestment demand arising out of the redemption of the maturing September 22 tax bills which were not turned in for tax payments. At the same time, System sales of bills helped to fill some of the market demand and thus tended to restrain the decline in rates. In the final weekly bill auction of the month, on September 25, the three-month issue was sold at the relatively low average issuing rate of 2.23 per cent, compared with 2.32 per cent in the final auction in August. Longer term bill rates, on the other hand, remained about unchanged during September, in part reflecting the increased market supply in that area resulting from the auction on September 20 of \$2.5 billion of the new June 1962 tax anticipation bills. In consequence, the spread in rates between the three- and six-month bills reached 44 basis points in late September, the largest spread since October 1960. Bidding in that auction by commercial banks (which were permitted to pay for the bills through credits to Treasury Tax and Loan Accounts) was fairly lively, and the average issuing rate was established at 2.705 per cent. The new bills subsequently traded in the market at 2.84 per cent bid, around which level they remained for the balance of the

period. Over the month as a whole, rate changes generally ranged from 4 to 12 basis points lower for three-month bills and from 2 basis points lower to 6 basis points higher for longer term bills.

#### OTHER SECURITIES MARKETS

Prices of seasoned corporate and tax-exempt issues generally moved upward in September, reflecting the same factors underlying developments in the Government securities market. The volume of new corporate issues was seasonally light, as was the calendar of offerings scheduled for the immediate future. While there was some build-up in the calendar of new tax-exempt issues, investor demand was strong enough to keep prices in that market steady, although toward the end of the month tax-exempt issues met some investor resistance.

For the period as a whole the estimated volume of new publicly offered corporate issues totaled only \$120 million, or half of the sparse August total of \$215 million and roughly one third of the \$319 million September 1960 volume. The few corporates issued were generally well received at lower yields than in the recent past. The estimated volume of new publicly offered tax-exempt issues rose moderately in September to about \$660 million from \$525 million in August and as against \$632 million in September 1960. The new offerings generally met fair to good receptions. Over the month as a whole, Moody's average yield on seasoned Aaa corporate bonds declined 1 basis point to 4.44 per cent from 4.45 per cent at the end of August, while the average yield on similarly rated tax-exempt issues also declined, by 3 basis points to 3.31 per cent.