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The Prime Rate*

Of all the interest rates charged by banks, only one is widely publicized and uniform throughout the country—the prime rate on business loans. The prime rate is the rate that banks charge their most credit-worthy customers; other borrowers must pay more. Rightly or wrongly, changes in the prime rate are often regarded by the public and the banks as one of the chief indexes of credit conditions. The present article reviews the history of the prime rate and assembles the available statistical evidence concerning its role in the lending process. A second article to be published in a later issue will deal with changes in the prime rate and their causes.

THE EVOLUTION OF THE PRIME RATE

While banks have always had rates reserved for their best customers, a nationally publicized and uniform rate apparently did not emerge until the depression of the 1930's. The rate set in that period of slack loan demand and swollen reserve positions, 1½ per cent, represented a floor below which banks were said to regard lending as totally unprofitable, given the administrative costs involved. The rate remained unchanged through the war and until December 1947, at which time it was raised to 1¾ per cent. In the ensuing fourteen years, there have been eighteen changes in the rate (all but four of these upward). Over several intervals of approximately a year's duration (or more) there were no changes at all. Indeed, the rate currently prevailing, 4½ per cent, has been in effect since August 23, 1960.

Prime rates are "officially" posted only by the largest banks; changes in the rate become effective by means of announcements by these banks. Normally one bank announces a change in rate; the other banks follow suit within a day or two. On all but one occasion, the bellwether has been a New York City bank, and three such banks—First National City Bank, The Chase Manhattan Bank, and Bankers Trust Company—have initiated fourteen of the nineteen changes recorded. Through August 1956, rate changes were in steps of ¼ of a percentage point; subsequent movements have been in steps of ½ a point.

* Albert M. Wojnilower and Richard E. Speagle had primary responsibility for the preparation of this article.

It is clear that the prime rate is not a sensitive, open market rate (such as, for example, the Treasury bill rate) fluctuating from day to day in response to the changing intensities of demand and supply channeled into, and measured by, a national market. Movements in the prime rate lag appreciably behind changes in the general business situation and open market money rates. The practice of moving only in half-point steps has lengthened this lag, since it has meant that larger shifts in open market rates and credit conditions are now the prerequisite for a change in the prime rate.

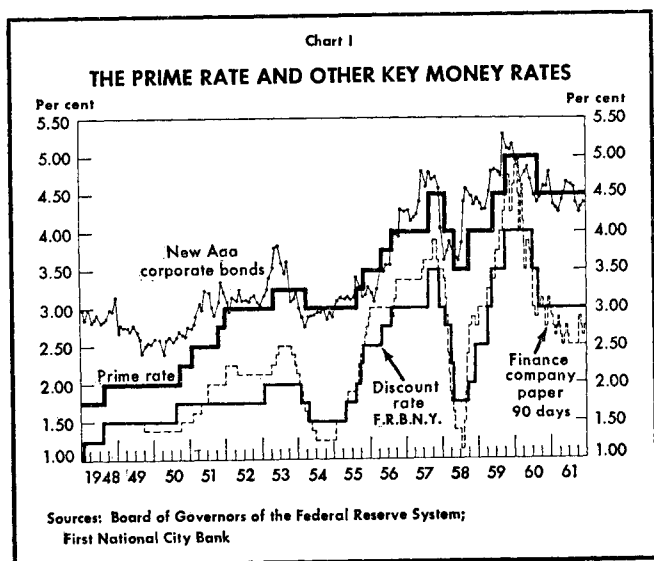
The lag, however, appears to be characteristic of bank loan rates in general, rather than of the prime rate in particular. Loan rates were "late" movers relative to other business and credit market indicators long before the rise to prominence of the prime rate. According to the figures of the National Bureau of Economic Research, fluctuations in loan rates charged by banks have been trailing cyclical changes in business at large at least since 1919, when the statistical record begins. The median lag in the post-World War II period has, however, been somewhat longer than in earlier years.

Until late 1953, the prime rate was almost always lower than the prevailing yield on new issues of high-grade corporate bonds, by and large the principal alternative source of outside financing available to prime borrowers. Since 1953, however, the prime rate has at times exceeded the yield on new issues of Aaa-rated corporate bonds (see Chart I). Bond yields have generally turned upward or downward ahead of the prime rate, but the differential between the two interest rates has been at most ½ of 1 per cent and normally much smaller.

The prime rate has generally been in the range of 1 to 2 percentage points above the Federal Reserve discount rate. In recent years, changes in the prime rate have been less frequent than changes in the discount rate, which has been more closely related to short-term open market rates, but the general pattern of movements has been similar.

BREADTH OF APPLICATION

The criteria that borrowers must meet if they are to qualify as "prime" cannot be precisely defined. Over the long run, at banks in the nineteen cities included in the



the competitive realities of the situation would demand.

The Quarterly Interest Rate Survey does not analyze term loan rates in the same detail as short-term rates. Only rate averages are calculated, and only the New York City data are published. These New York results imply that a large proportion of term loans is made at the prime rate. Since 1951 the average rate on new term loans in New York City has only once exceeded the prime rate by more than ½ per cent (March 1954), and then by an insignificant margin. Indeed, on numerous occasions since mid-1956 the average rate on new term loans in New York has been below the prime rate, apparently because loans were being taken down under fixed-interest commitments entered into at previous times of lower rates (Chart II). Recently, there has been an effort to avoid such occurrences through the more frequent use of “escalator” clauses that tie the rate on term loans to some fixed relation with the prime rate at the time of take-down.

THE PREVALENCE OF THE PRIME RATE

Federal Reserve Quarterly Interest Rate Survey, approximately half the total dollar volume of reported short-term business loan extensions (and renewals) has carried the prime rate.¹ This proportion is much higher, however, for large loans and far lower for small loans (detailed figures are given later in this article), so that the number—as opposed to the dollar amount—of loans granted at the prime rate is much less than half the total. Since large loans are normally made to large businesses, and small loans to small firms, it is clear that, whatever the formal standards that may be required of a “prime” borrower, the prime rate is extended principally to large firms.

Indeed, interest rates on loans exceeding \$200,000 are dominated by the prime rate. Since 1951, the differential between the prime rate and the average interest rate on these large loans has never been larger than 0.5 percentage point and usually smaller, normally ranging from 0.20 to 0.35 of a percentage point. Differentials between the prime rate and average interest rates on smaller loans have been much larger and more variable, as shown in Table I.

As mentioned earlier, a formal prime rate is apparently posted only by the larger banks. The question therefore arises whether the short-term rate levels and changes established by the leading banks are adhered to by smaller banks as well. Data for average new loan rates from the Federal Reserve Commercial Loan Surveys of 1955 and 1957 suggest that loans to large firms are made principally at the prime rate by small banks as well as by large—as

The argument is sometimes made that the posted prime rate may be a facade hiding a much more flexible interest rate structure. The available statistical evidence, however, suggests the contrary. Changes in the prime rate seem to be a reliable index of what is happening to the average level of business loan rates paid; indeed, prime rate fluctuations are generally larger than changes in rates on other business loans. The following discussion explores the relevant evidence and its implications.

Since the prime rate moves infrequently, later than other rates, and only in sizable steps, one might expect “shading” of the rate to become fairly prevalent from time to time. Unpublicized discounts might be offered at times of slack demand, with “gray market” premiums appearing when supplies are tight. This, at least, is what is fairly commonly observed in other markets where the published “list price” is established by a few large sellers, but where there are also many small sellers, as well as

Table I
DIFFERENTIALS BETWEEN THE PRIME RATE AND AVERAGE INTEREST RATES ON SHORT-TERM BUSINESS LOANS

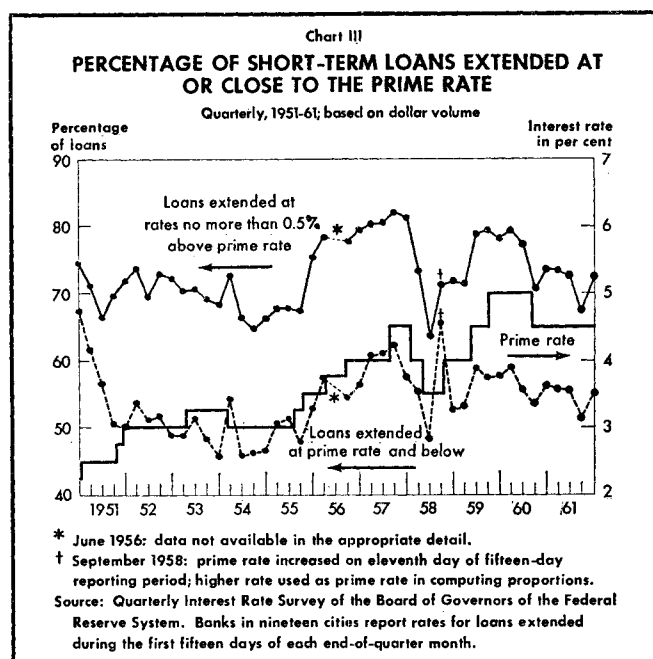
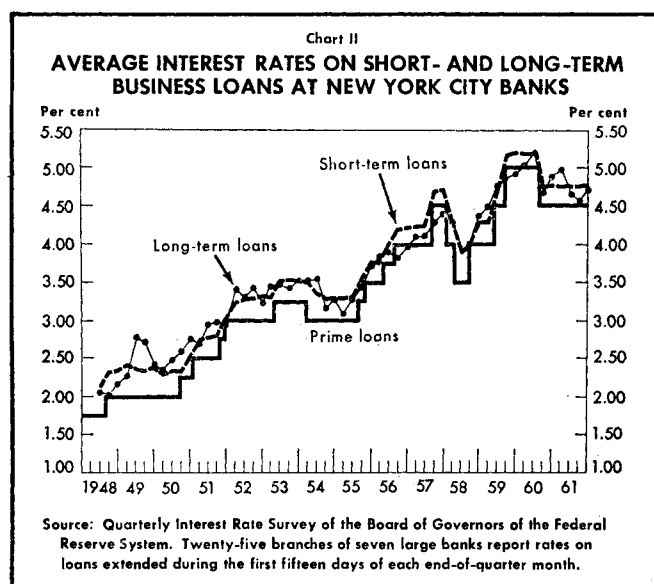
Size of loan	Range of differentials, 1951-61 (in percentage points)
\$200,000 and over	0.15 to 0.50
\$100,000 to \$200,000	0.43 to 0.97
\$ 10,000 to \$100,000	0.66 to 1.49
\$ 1,000 to \$ 10,000	0.92 to 2.24
All loans	0.27 to 0.71

Source: Quarterly Interest Rate Survey of the Board of Governors of the Federal Reserve System.

¹ This proportion is subject to cyclical fluctuations described later.

numerous large and small buyers. With respect to the prime rate, however, such unpublicized concessions appear to be rare. While there are always a few short-term loans (ranging up to about 2 per cent of the total at the banks reporting in the quarterly survey) which are extended at rates nominally below the prime rate, these consist largely of special arrangements in which the effective interest cost is easily shown to be at least as high as the prime rate.

The equivalent of rate "shading" could, of course, be accomplished through adjustment of one or more of the many other dimensions of a loan contract. An obvious expedient, virtually equivalent to a rate change, would be the variation of the standards established for the "prime" rating. If loan demand were slack, for example, these standards might be lowered, making more borrowers eligible for the prime rate. The average level of rates actually paid would thereby be reduced, even though the prime rate remained unchanged. Conversely, these standards might be stiffened at times of tight money, resulting in a higher level of rates actually paid. Such accommodations to market forces could also occur through a multitude of other nonrate factors—such as adjustments of the size of the compensating deposit balances borrowers are expected to maintain, the collateral they must post, the duration for which loans are granted, the accompanying services the bank undertakes to render, and many others. Furthermore, it is conceivable that, at those times when the market is "moving away" from the prime rate, rates to less-than-prime borrowers are adjusted while prime borrowers are left untouched, so that the level of the prime rate becomes



less representative of the true loan rate structure. Despite all these possibilities, the available evidence, both statistical and as obtained in interviews, suggests that "undermining" of the prime rate, at least through those "non-rate" aspects that affect true interest costs in an obvious and easily measured way, has been of minor significance in the aggregate.

FLUCTUATIONS IN THE PROPORTION OF LOANS QUALIFYING FOR THE PRIME RATE. The proposition that more borrowers qualify for the prime rate when money is easy and fewer when it is tight can be tested against data collected in the Quarterly Interest Rate Survey as to the amounts of business loans extended at various interest rates.² Chart III shows, for the last decade, the percentage of short-term loans extended at the prime rate or less (lower line) as well as the proportion extended at rates within 0.5 per cent of the prime rate (upper line). Because of the irregular fluctuations, little can be said about changes in the proportion of prime loans during periods when the prime rate remained unchanged. What does seem clear, however,

² The Federal Reserve Quarterly Interest Rate Survey gives information on the average interest rate, for various loan sizes, charged by the sample banks (or branches) on short-term business loans made during the first fifteen days of each end-of-quarter month. Data are also compiled giving the percentage distribution of the dollar volume of loans extended at selected interest rate levels.

Table II
SHORT-TERM BUSINESS LOANS EXTENDED AT THE PRIME RATE
AT TIMES OF CREDIT TIGHTNESS AND EASE

Percentage of loan volume extended at the prime rate (or less)				
Size of loan	September 1957 (tightness)	June 1958 (ease)	June 1959 (tightness)	December 1960 (ease)
\$200,000 and over	73	60	69	66
\$100,000 to \$200,000	31	21	28	25
\$ 10,000 to \$100,000	12	6	11	8
\$ 1,000 to \$ 10,000	5	1	6	2
All loans	62	48	59	56

Percentage of loan volume extended at no more than 0.5 per cent above the prime rate				
Size of loan	September 1957 (tightness)	June 1958 (ease)	June 1959 (tightness)	December 1960 (ease)
\$200,000 and over	89	75	86	83
\$100,000 to \$200,000	67	44	62	52
\$ 10,000 to \$100,000	45	20	44	28
\$ 1,000 to \$ 10,000	23	5	24	12
All loans	82	64	79	74

Source: Quarterly Interest Rate Survey of the Board of Governors of the Federal Reserve System.

is that periods of tight money and rising rates have most often been times when the proportion of loans made at, or close to, the prime rate has increased. Conversely, periods of easy money and reduced prime rates have been accompanied by declines in the proportion of loan volume transacted at the prime rate. When money is tight, more of the loan volume carries the prime rate; when it is easy, a smaller proportion of loans qualifies. Thus, changes in the prime rate appear to overstate rather than understate the extent of actual changes in the average rate level.

The same finding holds not only for total loan extensions, but also "within" each of the loan-size classes distinguished by the statistics. Table II illustrates the prevailing pattern for two periods of credit ease and tightness. The same pattern held for the whole period under review. In all size groups, a larger proportion of the dollar volume of loans qualified as prime when the prime rate was rising, while a smaller share qualified when the prime rate was low.

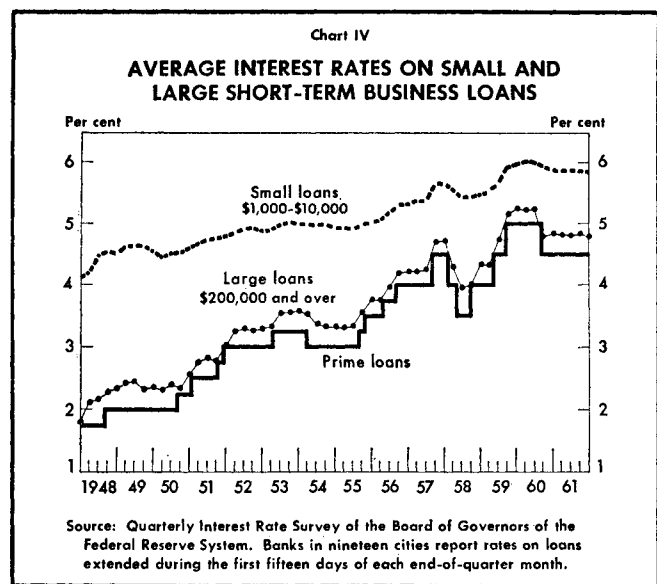
The growth in the proportion of prime loans when rates rise, as well as its contraction as rates fall, appears to reflect two major influences. One is the cyclical behavior of bank loan demand by prime borrowers. At times of business expansion and rising interest rates, credit demand by these borrowers increases and, because they are preferred customers, is more likely to be satisfied than loan requests by other firms. Thus, the proportion of prime loans rises within each loan-size category (and the dollar volume of large loans, which contains the highest proportion of prime loans, rises relative to the volume of smaller loans). Conversely, at times of economic slack these borrowers normally make repayments, reflecting larger net cash flows

and the often greater availability of other means of financing, such as open market (commercial) paper. The share of these borrowers in the loan total is thus reduced.

A second important factor is the traditional "stickiness" of loan rates. When the prime rate is raised from, say, 3½ to 4 per cent, some borrowers who previously paid 4 per cent are apparently allowed to renew loans at the same rate, expanding the proportion of prime rate loans in the loan total. Conversely, when the prime rate falls, some borrowers may not have their rates reduced; as a result, the proportion of prime loans drops. While the influence of the demand and stickiness factors cannot be segregated, bank interviews as well as the statistics on average rates paid (see below) strongly suggest that both factors are significant.

THE PRIME RATE AND RATES ON OTHER BUSINESS LOANS.

Comparison of the behavior of the prime rate with average interest rates on new business loans (Chart IV) yields corresponding results. When the prime rate has advanced, the average rate also has increased, but by a smaller amount. Thus, when the prime rate rises, rates on nonprime loans do not increase correspondingly. Conversely, when the prime rate has been lowered, the average rate for all loan extensions has not declined to the same extent; rates on nonprime loans have fallen by less than the prime rate. To summarize, changes in the average level of rates charged have always been smaller than the prime rate change. Moreover, there has been little movement in



average loan rates except at times of a change in the prime rate.

These relations also hold within each loan-size class taken separately; changes in the actual average rate have been smaller than changes in the prime rate. The pattern is illustrated in Table III for two characteristic periods, during one of which the prime rate rose 1 per cent, while during the other it fell 1 per cent.

It is evident that, when the prime rate falls, small-loan rates do not drop as much as large-loan rates. Conversely, when the prime rate rises, small-loan rates do not increase correspondingly, partly because they may be close to the legal rate ceilings prevailing in many areas. This pattern, too, held throughout the entire ten-year period. Indeed, the pattern of a narrowing in rate differentials as rates rise, and a widening as they fall, is observable over the entire historical span of loan rate statistics, which begins in World War I.

To some extent, the pattern of these rate changes merely reflects the cyclical changes in the proportion of loans at the prime rate (in combination with the greater prevalence of the prime rate for larger loans) already described. If in any loan aggregate the proportion of prime (low-rate) loans rises, the average rate for that group must fall, and conversely. As a result, given the cyclical behavior of the proportion of prime loans, we should expect that a 1 per cent fall in the prime rate will lower average rates by something less than 1 per cent and, similarly, that a 1 per cent rise in the prime rate will raise the over-all rate average of any loan group by less than that amount. The effect of such shifts in loan distribution on the average rate can be arithmetically isolated, however: the actual degree of rate sluggishness was found to be clearly greater than could be accounted for by shifts in loan distribution alone. Even when the changes in the proportion of prime loans are attributed solely to the demand factor, a significant part of the gap between the change in the prime rate and the smaller change in average rates remains unaccounted for. Thus, rate stickiness appears to be an independent factor tending to stabilize rates.⁸

FINDINGS AT INDIVIDUAL BANKS. These results based on statistical aggregates do not imply, of course, that all

⁸ It is conceivable that, in addition to the cyclical rise and fall of prime loans relative to nonprime loans, it is also the case that nonprime loans cyclically rise and fall relative to others of still lower quality. If this should be the case on a large scale, all of the stickiness might be explained away. But the pattern of the data and the interview results make it appear unlikely that this actually happens.

Table III
CHANGES IN THE AVERAGE INTEREST RATE
ON SHORT-TERM BUSINESS LOANS

Size of loan	December 1957-June 1958 Fall in average rate (as prime rate fell 1 percentage point)	March 1959-December 1959 Rise in average rate (as prime rate rose 1 percentage point)
\$200,000 and over	0.76	0.92
\$100,000 to \$200,000	0.61	0.80
\$ 10,000 to \$100,000	0.41	0.65
\$ 1,000 to \$ 10,000	0.21	0.46

Source: Quarterly Interest Rate Survey of the Board of Governors of the Federal Reserve System.

banks behaved uniformly. Investigation of the recent behavior of a few New York City banks as regards fluctuations in the proportion of loans made at the prime rate revealed a degree of diversity but, on the whole, gave results consistent with the broad statistical findings. Thus, at one large institution, the proportion of loans granted at the prime rate moved in accord with the national pattern. The same was true of term loans at a second bank (this was the only class of loans studied at this bank). At a third institution, however, the 1960 cut in the prime rate was followed by an increase in the proportion of new loans made at the prime rate, contrary to the pattern shown by the aggregate statistics. Nevertheless, officers of this bank agreed, a larger proportion of loans *normally* carries the prime rate when money is tight than when it is easy, and conversely. This was explained in terms of the difficulty of raising rates that are already at, or close to, the 6 per cent statutory ceiling. On the other hand, rates on such loans are not reduced when the prime rate falls.

The use of variations in loan terms other than interest rates, such as compensating balances, maturity, etc., as alternatives to rate changes was not directly investigated. Such little evidence as is available suggests, however, that systematic variation of loan contract terms in lieu of rate changes has not played a generally prominent role except for certain classes of bank customers, notably sales finance companies.

TERM LOANS. Rates charged on term loans behaved somewhat differently. Comparing the New York City average rate with the out-of-town averages, which probably include relatively fewer large and/or prime borrowers, it appears that, as in the case of the short-term rate, a rise in the prime rate exerts its largest impact on rates paid by prime borrowers and has less effect on rates paid by others. As compared with changes in average short-term rates, however, the average term rate tends to lag a few months, possibly reflecting a longer gap in the case of term loans between the negotiation of the loan and the actual drawing.

A divergence between short-term and term loan rates has occurred during the later part of rate upswings, as in mid-1953, mid-1956 to mid-1957, and mid-1959 to mid-1960. Short-term rates advanced in step with the prime rate at these times, but term loan rates rose more slowly (Chart II). As a result, there have been periods of as long as a year in which the average rate on new term loans has been lower than that on even the largest (\$200,000 or more) short-term loans.

NONRATE ASPECTS OF BANK-CUSTOMER RELATIONS

Although the present study was not directly concerned with the nonrate aspects of bank loan allocation, it provided some insights consistent with the results of other recent studies. In particular, a critical factor considered by banks in ruling on particular credit requests seems to be the past and expected profitability of the customer relationship as a whole, including prominently its deposit as well as its loan aspect. At one large bank, for example, the rise in the proportion of prime loans as money tightened was attributed partly to the fact that "many good customers [depositors], nonborrowers for years, seemed to come in for loans". Conversely, when deposits are abundantly available, the banks become less concerned about the deposit side of the customer arrangements and more willing to make loans to other credit-worthy borrowers. Much more investigation into lending terms and practices is needed, however, to justify any firm conclu-

sions on these points. Indeed, there may be considerable differences in basic philosophy and policy among individual banks and among banks of different sizes.

It should be kept in mind that the prime rate originated as a floor to lending rates in a period of excess liquidity and slack bank loan demands. For many years thereafter, banks operated in an atmosphere of ample liquidity and historically low interest rates. Over the past decade, however, this liquidity has been largely used up, to the extent that some large banks may at times find themselves unable to accommodate fully the loan demands (including demands for advance commitments) of all their prime customers. Under these more recent circumstances, nonrate elements have gained importance in rationing bank credit among eager borrowers of highest credit standing.

It is vital to recognize, furthermore, that the importance of nonrate factors in individual transactions does not necessarily imply that rate changes play an insignificant role in the aggregate. Borrowers with access to several sources of funds, such as large utilities and finance companies, are often quite sensitive to rates and rate differentials. Their reaction to rate movements may at times substantially affect the over-all loan situation. Moreover, all borrowers may be marginally influenced by rate levels, and anticipations of rate changes, in the size of their bank loan requests. Since most loan proceeds are quickly spent on goods and services, even a relatively small response of the pace of loan extensions to a change in interest rates can have significant effects on total economic activity.

The Business Situation

Business expansion in the first quarter of the year apparently was less rapid than expected, and slower than at comparable stages of the two previous business cycles. To be sure, the major economic series that turned down in January had generally recovered their losses by February, and early indications are that additional gains in production and sales may have occurred in March. But the advances in these series over year-end levels that have been recorded so far have been quite moderate.

That the economy will continue to expand seems indicated by a number of developments. Federal spending is scheduled to increase throughout the months ahead. Per-

sonal income is rising, and while consumers have been somewhat hesitant in their spending during recent months, the brisk pace in automobile sales in March may mean that purse strings have now been loosened. The latest survey of businessmen's capital spending plans, moreover, points to increases in plant and equipment outlays throughout the year, although at a slower rate than during the comparable stages of both the 1954-56 and 1958-59 expansions. Finally, the steel wage settlement that was reached at the end of March should significantly add to the long-run strength of the economy. Not only does it remove the threat of erratic inventory movements, but its reported

terms definitely appear to enhance the prospect that business expansion will continue to take place against a background of relative price stability.

While on balance the various "foreshadowing" statistics suggest further economic gains, they do raise questions as to whether the pace of the advance will be sufficiently vigorous to meet the economy's requirements for growth. This is a particularly serious problem because of the possibility that increases in the labor force this year may be substantially larger than in 1961, thus greatly complicating the task of reducing an unemployment rate that still remains much too high.

JANUARY-FEBRUARY MOVEMENTS OFFSETTING

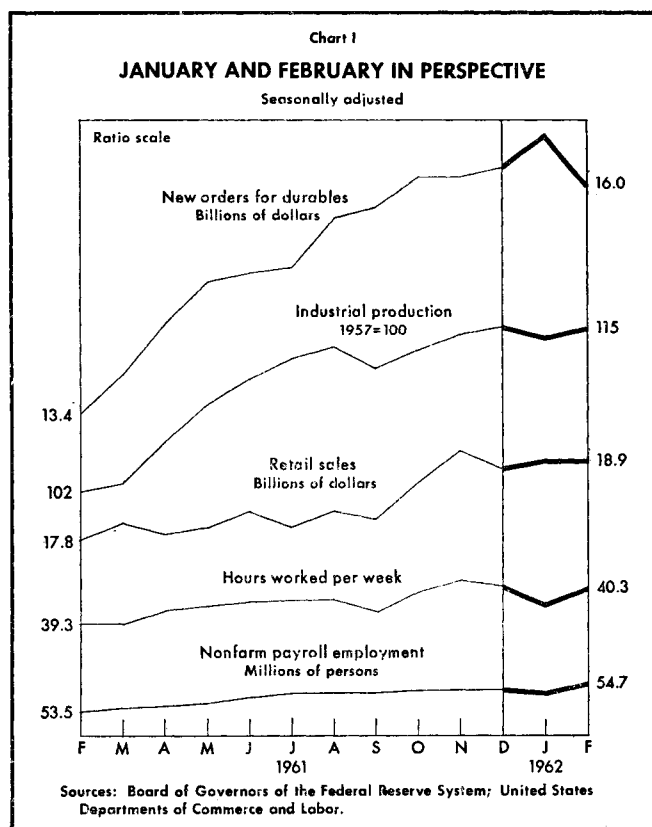
Industrial production in February (seasonally adjusted) recouped the loss suffered in January. Output moved up one point to 115 per cent of the 1957 average (see Chart I). Iron and steel production, which had been a major source of strength in each of the preceding three months, rose 5 per cent, and output of such final products as commercial and industrial equipment, television sets, and apparel also increased. Even with the February gains,

however, total industrial production was only 1¾ per cent above the level attained six months earlier. Moreover, it was only 12½ per cent above the level at the beginning of the upswing in February 1961, contrasting with increases of 15 per cent and 22 per cent, respectively, during the comparable phases of the 1954-55 and 1958-59 expansions. Although the information thus far available for March is fragmentary, total production may have increased again in that month. Auto assemblies, for instance, appear to have shown a slight gain from the February level, and iron and steel production may also have moved upward.

New orders received by manufacturers of durable goods in February dropped by 2¼ per cent (see Chart I). While this represents the first decrease in this forward-looking series since the business cycle trough in February 1961, it is also true that the series tends to be somewhat erratic and a steady upward trend is unusual. Furthermore, the downward movement of the series in February was largely attributable to a drop in steel orders caused by the progress in the steel wage negotiations.

The rise in industrial production in February carried employment and hours worked to higher levels. Nonfarm employment, seasonally adjusted, rose by 269,000 persons, according to the Bureau of Labor Statistics payroll survey, and seasonally adjusted average weekly hours clocked by production workers in manufacturing increased from 39.8 to 40.3 (see Chart I). The Census Bureau's household survey indicated that agricultural employment also rose in February and that seasonally adjusted total employment (farm and nonfarm) reached a record level of 67.9 million. This gain in employment was greater than the large rise that occurred in the civilian labor force, so that the number of unemployed persons fell by 150,000 persons to 4.0 million (seasonally adjusted), the lowest level since July 1960. Consequently, unemployment as a percentage of the civilian labor force declined again, but at 5.6 per cent it still was above the levels at the comparable stage of the two preceding expansions—5.2 per cent in April 1959 and 4.3 per cent in August 1955. Partly in response to the continuing high rate of unemployment, the Administration in late March proposed a \$600 million program of public improvements to provide jobs for workers in economically depressed areas.

Whether the unemployment total can be significantly lowered in the months ahead will depend primarily on the pace of future economic expansion, the gains in productivity, and the trend of the labor force. In 1961 the labor force showed virtually no net change, whereas in both of the two preceding years it had grown by more than a million. A variety of factors was responsible for



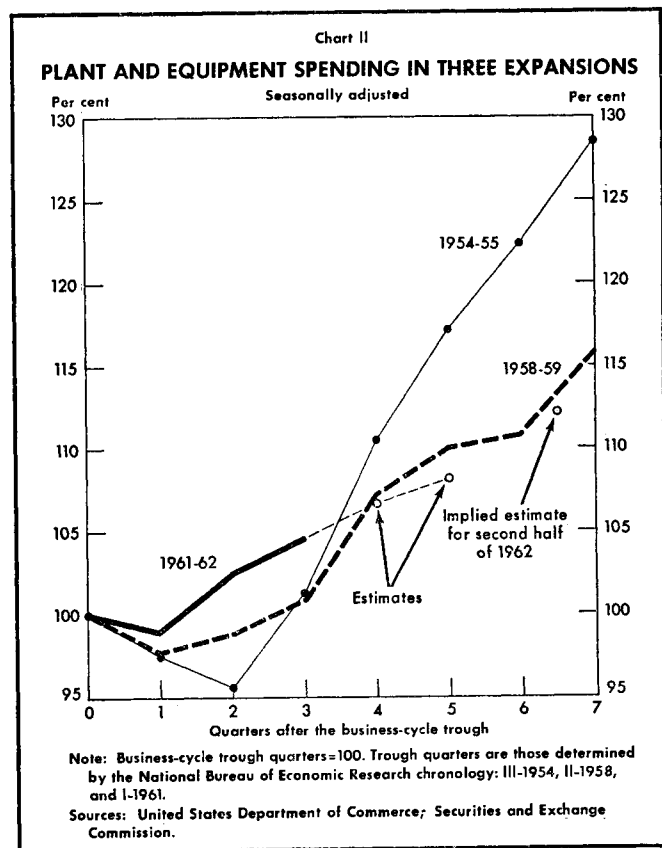
this lack of growth during 1961, including an increase in the number of students remaining in school, a large influx of persons into the armed forces, and the fact that changes in legislation permitted elderly people to choose earlier retirement with immediate social security benefits. Similar factors may not be present in as large a degree this year, and the labor force may well resume its more normal growth trend.

FORCES OF FUTURE EXPANSION

One factor that should contribute to expansion in coming months is consumer spending. Throughout the past year personal income has grown at a rate approximately in line with the patterns experienced during previous upswings, the most recent increase of \$2.7 billion (seasonally adjusted annual rate) in February more than offsetting the January decline. Despite these higher incomes, consumer spending on goods (as opposed to services) has been somewhat hesitant in recent months. Thus, retail sales in February, according to preliminary indications, increased only 1/2 of 1 per cent, seasonally adjusted (see Chart I), with sales of durable goods declining. Some change in consumer attitudes in March, however, may be indicated by the sharp rise in automobile sales. The March data on department store sales similarly appear to show strength, although these statistics are difficult to assess because of the late date of Easter this year.

Business spending will, of course, also play an important part in determining the configuration of economic expansion in the months ahead. For a while it appeared that inventory accumulation, spurred on by steel stockpiling as a hedge against the possibility of a steel strike, might provide a strong push to the expansion. In part because of the early start of the steel wage negotiations, however, such a build-up of inventories seems to have been moderate. Even the two-week recess in negotiations early in March did not budge steel users from a wait-until-April attitude. Such an attitude had already been reflected by a Department of Commerce survey taken in February (i.e., before the break-off and resumption of negotiations). The survey showed that, although manufacturers planned to add \$1.2 billion (seasonally adjusted) to their inventories during the first quarter of the year, they expected to accumulate only \$0.8 billion in the second quarter. During the 1959 steel negotiations, by contrast, manufacturers' inventories had risen by \$1.3 billion in the first quarter and by \$1.7 billion in the second quarter.

Capital spending plans surveyed by the Commerce Department-Securities and Exchange Commission in January and February suggest that such spending will move up



steadily during 1962 (see Chart II). Estimated outlays in the first quarter of \$36.1 billion (seasonally adjusted annual rate), although slightly below last November's expectations, represent a gain of almost 2 per cent over actual outlays in the final quarter of 1961, which had also been somewhat below earlier expectations. Outlays are expected to rise further to a \$36.6 billion rate in the second quarter of 1962, bringing the average for the first six months to a level that would be 3 3/4 per cent above that attained in the last half of 1961. For the year as a whole, capital spending is expected to total \$37.2 billion, implying that outlays during the second half of 1962 will rise to \$38.0 billion, or 4 1/2 per cent above the average for the first half. Such a gain, however, would still leave capital spending for the year at virtually the same volume as in 1957 when GNP was three-fourths as large as what is widely suggested for 1962.

While these quarterly estimates suggest that the rise in capital spending in the first five quarters of the 1961-62 business expansion (that is, through mid-1962) will fall slightly behind the increase during the comparable period in the 1958-59 upswing and substantially behind the

1954-55 performance, it is of course possible that actual outlays in 1962 will surpass the estimates. Such a better-than-planned performance was experienced in the 1954-55 expansion, although not in 1958-59 when outlays were held down by the steel strike. Assessment of the estimate implied for the second half of 1962 in terms of the experience in earlier business cycles is rather difficult. In part, this is because in each of the two previous business expansions such long-range estimates were made at a some-

what earlier stage of the advance. (It is worth noting, however, that these long-range estimates were surpassed by the volume of outlays actually rung up.) Moreover, this year there is a possibility that important changes in tax treatment of investments will be adopted—both through additional administrative rules and new legislation—and this could well provide an added stimulus to capital spending, even though pressure on available capacity is far from widespread.

The Money Market in March

The money market was generally comfortable during March, as the effective rate on Federal funds held to a narrow $2\frac{3}{4}$ -3 per cent range virtually through the entire month. Rates on loans to Government securities dealers posted by major New York City banks also held to a fairly narrow range, fluctuating between $\frac{1}{4}$ point above or below 3 per cent. The money market took the midmonth tax and dividend period easily in stride, although the money market banks came under some reserve pressure in the latter part of the month as Federal Reserve float fell short of anticipated levels and as Chicago banks made preparations for the April 1 Cook County tax date.

Treasury bill rates fluctuated relatively little over the month. A rising supply of bills provided by \$100 million increases in each of the regular three-month bill offerings in March was met by a growing demand. This demand was associated with the build-up of bill portfolios by financial institutions in Chicago in preparation for their tax date, and the reinvestment on March 23 of proceeds of tax anticipation bills held to maturity. To some degree, however, this demand may also have been related to the two reductions in the British bank rate, effective March 8 and 22, which reduced the attractiveness of investment in British Treasury bills. However, movements of short-term funds to the United Kingdom are not necessarily related to Treasury bill rate differentials alone, but can reflect rate relationships with a broader range of short-term instruments. Furthermore, a substantial rate incentive continued to exist for uncovered movements of funds to London on various types of instruments, including Treasury bills, although the covered arbitrage incentive in the case of Treasury bills was slightly in favor of New York after March 8.

A confident tone prevailed in the market for Treasury notes and bonds. Uncertainties concerning the strength of the business recovery, as well as the British bank rate reductions, gave rise to the view that longer term interest rates might continue to hold steady, or even edge lower in the period just ahead. The unusually narrow yield spread that developed by mid-March between Treasury obligations and high-grade corporate issues also tended to raise demand for Government securities. As prices of Treasury notes and bonds moved to highs for the year, the market continued without much strain the distribution of new and reopened bonds issued in the Treasury's regular and advance refunding operations in February.

MEMBER BANK RESERVES

Market factors (operating transactions, vault cash, and required reserves) absorbed \$472 million of member bank reserves on balance over the four statement weeks ended March 28 (see table). Reserves fell during the first week, as vault cash declined sharply. A rise in vault cash along with a decline in required reserves largely offset reserve losses from operating transactions, particularly a rise in currency in circulation in the second week. In the third week, a substantial increase in required reserves associated with tax and dividend borrowing by corporations, while offset in part by an expansion in float, nevertheless produced some temporary reserve pressures in the money market banks. During the fourth week of March, a contraction in float again drained reserves on balance.

System open market operations in March generally offset reserve losses stemming from market factors. System operations supplied \$394 million of reserves during the

**CHANGES IN FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, MARCH 1962**

In millions of dollars: (+) denotes increase,
(-) decrease in excess reserves

Factor	Daily averages—week ended				Net Changes
	March 7	March 14	March 21	March 28	
Operating transactions					
Treasury operations*	+ 69	- 58	- 8	- 7	- 4
Federal Reserve float	- 1	- 87	+ 194	- 198	- 92
Currency in circulation	- 53	- 153	+ 18	+ 97	- 96
Gold and foreign account	- 5	- 58	- 10	- 21	- 94
Other deposits, etc.	+ 58	+ 96	+ 36	- 95	+ 95
Total	+ 69	- 266	+ 232	- 225	- 190
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 134	+ 44	- 48	+ 236	+ 366
Held under repurchase agreements	+ 14	+ 25	+ 53	- 44	+ 28
Loans, discounts, and advances:					
Member bank borrowings	+ 34	- 37	+ 80	- 47	+ 30
Other	+ 14	- 1	-	-	+ 13
Bankers' acceptances:					
Bought outright	+ 1	- 1	- 1	- 1	- 2
Under repurchase agreements	-	-	-	-	-
Total	+ 197	+ 30	+ 65	+ 143	+ 435
Member bank reserves					
With Federal Reserve Banks	+ 266	- 236	+ 297	- 82	+ 245
Cash allowed as reserves†	- 267	+ 99	+ 21	+ 59	- 88
Total reserves†	- 1	- 137	+ 318	- 23	+ 157
Effect of change in required reserves†	- 73	+ 166	- 307	+ 20	- 194
Excess reserves†	- 74	+ 29	+ 11	- 3	- 37
Daily average level of member bank:					
Borrowings from Reserve Banks	90	53	133	86	91‡
Excess reserves†	446	476	486	483	473‡
Free reserves†	356	422	353	397	382‡

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 March 28, 1962.

four statement weeks ended March 28. Between Wednesday, February 28, and Wednesday, March 28, System holdings of securities increased by \$419 million, with holdings maturing within one year rising by \$106 million and holdings in the more-than-one-year category moving up by \$313 million.

Over the four statement weeks ended March 28, free reserves averaged \$382 million, compared with \$435 million the previous month. Average excess reserves declined by \$29 million to \$473 million, while average borrowings from the Federal Reserve rose by \$24 million to \$91 million.

THE GOVERNMENT SECURITIES MARKET

In the market for Treasury notes and bonds the upward price movement that became evident in February gathered further strength in March. Among the factors underlying the price rise were the market interpretations placed on the two ½ per cent reductions in the British bank rate; the absence of a significant pickup in the demand for busi-

ness loans, and the very moderate improvement in most other significant indicators of business activity; the continued hesitation of the stock market; and the narrow yield spread between long-term Treasury and corporate bonds. Finally, some demand for intermediate-term securities by public funds seeking a placement for proceeds of new flotations, and demand for long-term bonds by institutional and savings-type investors, also contributed to the strength of the market. Over the month as a whole, prices of long-term issues were generally ¼ points higher, while intermediate-term issues rose from ½ to ¾ point.

Against this background, the substantial volume of market churning associated with the placement of the newly issued and reopened securities involved in February's two large refundings was accommodated with little difficulty. Thus the price of the new 4 per cent notes due August 1966 rose by 2½/32 to 101²⁰/32, and the price of the new 4 per cent bonds of August 1971 rose by 1¼ points to 101. Among the reopened issues, the 4's of 1980 rose by 1²⁷/32, while the 3½'s of 1990 and 1998 rose by 2½/32 points each.

Treasury bill rates fluctuated within a relatively narrow range during the month. A strong demand developed, buttressed by greater confidence in current rate levels and by the reductions in the British bank rate. Through the first half of March, rates on three-month and six-month bills edged up by about 5 basis points each to reach their highs for the month at 2.80 and 2.97 per cent, respectively, in the March 12 auction. This rise in rates followed the Treasury's announcement at the close of the market on March 8 that it would auction \$1.8 billion of September 1962 tax anticipation bills on March 20, and that offerings of bills in the regular weekly auctions might continue to be increased. As little strain developed in the market over the mid-March tax and dividend period, however, bill rates tended to move down and by the close of March 16 were back to, or below, their March 8 levels.

A fairly strong interest developed in the regular auction of March 19, and the special auction on March 20 of \$1.8 billion of September tax anticipation bills. Average issuing rates in the regular March 19 auction of about 2.69 and 2.85 per cent turned out to be about 12 basis points less than in the prior auction. In the special auction of six-month tax anticipation bills maturing September 21, 1962, and sold without the Tax and Loan Account privilege, the average issuing rate was 2.90 per cent, or about halfway between the rates carried by regular six-month bills in the two prior auctions. During the fourth week of the month, bill rates edged up a bit, and at the end of March rates on three-month and six-month bills were less than 5 basis points away from end-of-February rates.

OTHER SECURITIES MARKETS

The markets for seasoned corporate and tax-exempt bonds continued to gain in strength during the first half of March, and good progress was made in the distribution of a number of large issues that, when offered initially, had been considered closely priced. The Blue List of advertised dealer offerings dropped from the February 28 record level of \$560 million to \$335 million at mid-March, although it rose once more in the second half of the month to reach \$480 million on March 30. Growing investor confidence was based in part on the factors that strengthened the market for Government securities. At the same time, the volume of publicly offered new corporate and tax-exempt issues was relatively light. An estimated \$600 million of State and local securities reached the market during the month, or slightly more than half the record \$1.1 billion of new flotations in the preceding month. (In March 1961, tax-exempt flotations aggregated \$690 million.) The \$340 million of corporate flotations compared with \$490 million in the prior month and \$150 million in March 1961. In the second half of the month, however, as the calendar of new flotations scheduled for later issue began to build up

and market demand slackened somewhat, bond prices tended to stabilize. For the month as a whole, Moody's average yield on seasoned tax exempts declined by 7 basis points to close at 3.01 per cent, and the average of Moody's Aaa-rated corporate bonds declined 4 basis points to 4.38 per cent.

Market reception of new issues during the month ranged from fair to excellent, with some closely priced new issues moving particularly slowly while other issues, providing more attractive yields in relation to the current market, were quickly distributed. The largest new tax-exempt issue was a \$54 million (Aaa-rated) 2.60 per cent Connecticut highway bond issue reoffered March 14 to yield from 2.20 per cent in 1968 to 2.70 per cent in 1975. The issue was accorded only a fair investor response initially, and at the month end 70 per cent of the issue still remained unsold. Among the larger corporate offerings was a utility issue of \$65 million (Aa-rated) 4 $\frac{3}{8}$ per cent refunding mortgage bonds, due in 1994 and reoffered at par on March 13. Initial demand for the bonds was light, because the issue was regarded as rather closely priced in relation both to available corporate issues and to outstanding Treasury bonds.

Recent Monetary Policy Measures in Western Europe

The measures taken by Western European monetary authorities during recent months have reflected continuing efforts both to correct imbalances in international payments and to cope with diverse domestic economic conditions.¹ In some countries that had relatively strong external payments positions and faced little or no threat of domestic inflation, the authorities moved to bring domestic money rates more closely into line with rates in other financial centers, with a view toward moderating the movement of short-term funds across national frontiers. In a number of other countries, by contrast, where persisting domestic inflationary pressures had been accompanied by some weakening in balance-of-payments positions, steps were taken to restrain internal credit expansion. The authorities in these countries, however, pri-

marily tended to employ quantitative policy instruments rather than changes in interest rates.

In both the United Kingdom and Belgium, external considerations were the major factor in the authorities' decision to lower short-term interest rates, although in Britain lagging domestic production and employment also played a role. The Bank of England's discount rate, which in October-November had been reduced in two steps to 6 per cent from the 7 per cent "crisis" level set last July, was cut again in March in two steps to 5 per cent (see table). Except for one short period, sterling had displayed great strength since the announcement of Britain's emergency program last summer. From July 31, 1961 to February 28, 1962 the country's gold and convertible-currency reserves rose \$971 million to \$3,424 million, despite Britain's repayment of the bulk of its "Basle" debts and the advance repayment of \$630 million on its \$1,500 million August 1961 drawing from the International Monetary Fund. Sterling's strength reflected in part

¹ For a discussion of monetary policy abroad during the summer and fall of 1961, see "International Economic and Financial Developments", *Monthly Review*, December 1961, pp. 198-201.

the improvement in Britain's current and long-term-capital account, a seasonal upturn in overseas-sterling-area exports, and the success of various measures adopted during 1961 by several sterling-area countries to bolster their over-all payments positions. The reserve gains were, however, also attributable to substantial inflows of short-term capital into London as a result of the cessation of speculation against the pound during the latter part of 1961 and the attractiveness of the relatively high interest rates offered in England. The March 8 discount rate reduction evidently failed to stem this influx, since sterling strengthened further thereafter. Following the March 22 reduction, sterling dropped sharply but then quickly recovered.

In Belgium, similarly, the central bank's basic discount rate was reduced in two steps to 4 per cent from 4½ in January and March, apparently in response to favorable balance-of-payments developments. The reductions were the third and fourth since the rate was raised to 5 per cent in August 1960 to check an outflow of short-term funds. The substantial improvement in Belgium's underlying external position during the second half of 1961, foreign borrowing by the Belgian Treasury, and an apparent inflow of private short-term funds were reflected in a 13 per cent increase in Belgium's reserves to \$1,656 million during the eight months through February 1962. This strengthening in turn contributed to easier conditions on the domestic money market, as evidenced by the recent

decline in the volume of the central bank's discounts and an appreciable downward trend in short-term rates.

In Italy, the achievement of a comfortable balance-of-payments surplus in 1961, together with continuing price stability and the absence of serious pressures on the labor supply, permitted the authorities to give further encouragement to domestic economic expansion. Effective February 1, commercial bank cash reserve requirements were reduced to 22.5 per cent from the 25 per cent rate prevailing since 1947, thereby releasing an estimated 190 billion lire (\$300 million) for industrial investment. The change was prompted by the substantial decline of the banking system's liquidity in 1960 and 1961 as a result both of the heavy credit demands accompanying the high level of domestic economic activity and of the central bank's efforts in 1961 to reduce the banks' short-term foreign indebtedness through liberal sales of foreign exchange for lire.

In France, on the other hand, external and domestic considerations conflicted. The combination of an exceptionally favorable foreign trade year and large invisible earnings apparently resulted in a record balance-of-payments surplus on current account for 1961. Since the capital-account position was also very strong, France's gold and convertible-currency reserves rose almost \$870 million to \$2,939 million in 1961, despite substantial repayments of external debts. This favorable trend continued into early 1962. Indeed, the French franc retained its strength even as the Algerian crisis intensified. However, the persistent rise in domestic costs and prices during the latter half of 1961 caused concern about the maintenance of price stability at home. Monetary policy was therefore directed at holding the over-all credit expansion within limits, while encouraging the flow of credit into productive investment. Effective January 17, the Bank of France increased to 32 per cent from 30 per cent the banks' liquidity ratio, which has to be met by specified holdings of cash, short-term government securities, and medium-term commercial paper. Then, effective March 31, the minister of finance announced two measures designed to facilitate the flow of medium-term credit into new private investment. First, the percentage of deposits that banks must invest in Treasury paper was reduced from 17½ to 15 per cent. Secondly, the interest rate on two-year Treasury paper subscribed by the banks was cut from 3¾ to 3¼ per cent. These measures were generally expected to induce the banks to shift some of their required reserves out of government paper into medium-term credits. The minister also forecast the early introduction of steps to promote the flow of long-term credit into the capital goods industries.

**CHANGES IN FOREIGN CENTRAL BANK
DISCOUNT RATES IN 1961-62**
In per cent

Date of change	Country	New rate	Amount of change
1961: January 20	Germany	3½	-½
January 26	Ceylon	4	+1½
January 26	Japan	6.57*	-0.37
March 23	New Zealand	7	+1
May 5	Germany	3	-½
May 5	South Africa	5	+½
May 15	Philippines	3	-2
May 23	Denmark	6½	+1
June 9	Spain	5†	-¾
June 24	El Salvador	6	+½
July 1	Turkey	7½	-1½
July 22	Japan	6.94*	+0.37
July 25	United Kingdom	7	+2
August 24	Belgium	4¾	-¼
September 29	Japan	7.3*	+0.37
October 5	United Kingdom	6½	-½
November 2	United Kingdom	6	-½
December 7	South Africa	4½	-½
December 28	Belgium	4½	-¼
1962: January 9	Philippines	6	+3
January 18	Belgium	4¼	-¼
March 8	United Kingdom	5½	-½
March 22	Belgium	4	-¼
March 22	United Kingdom	5	-½
March 30	Finland	8	+1¼

Note: Since November 1956, the discount rate of the Bank of Canada has been set at ¼ per cent above the latest average tender rate for Treasury bills. The rate stood at 3.37 per cent on March 29, 1962.

* "Basic" rate for commercial bills.

† Rate for private nonbank borrowers.

In Austria, a country whose external position has also been strong, the authorities acted to restrain internal credit expansion in the face of a marked increase in bank liquidity, continued upward pressures on prices and wages, and full utilization of capacity in many sectors of the economy. On February 1 the central bank: (1) raised minimum reserve requirements by $\frac{1}{2}$ per cent to 9.5 per cent and 7.5 per cent, respectively, for most sight and savings deposits; (2) boosted the penalty rate for reserve deficiencies to 3 from 2 per cent above the discount rate (i.e., to 8 per cent); (3) for the first time engaged in open market operations by selling to the banks, out of its 1,160 million schilling portfolio of Treasury paper, 560 million schillings (\$22 million) of $3\frac{1}{2}$ per cent Treasury certificates, to be held by the banks for one year; and (4) lowered to 50 per cent from 75 per cent the share of new deposits that would be available for credit expansion. The last step was taken under the agreement on credit ceilings of April 1957, which had set a credit institution's maximum permissible loan volume at 75 per cent of its deposits. On March 1, moreover, the Austrian authorities for the first time imposed controls on consumer instalment credit.

In a number of other European countries, where persisting domestic inflationary pressures had weakened balance-of-payments positions during 1961, the authorities also moved to restrict credit availability. In the Netherlands, the commercial and agricultural-credit banks agreed, after consultations with the central bank, to limit their credit expansion to a maximum of $\frac{1}{2}$ per cent a month during the first four months of 1962; a previous agreement concluded

in July 1961 had set a monthly norm of 1 per cent.² Moreover, the Dutch finance minister asked parliament for new powers to regulate capital spending by local authorities. In Norway, the central bank and the finance ministry concluded an agreement in January with the private credit institutions to limit credit expansion in 1962 to about the 1960 amount. The agreement provided in particular that: (1) commercial banks would not increase their outstanding loans by more than 500 million kroner (or 8 per cent) during 1962, or permit their investments in government or government-guaranteed bonds to fall below the end-of-1961 level; (2) savings banks would not raise their outstanding loans by more than 8 per cent during the year and would increase their investments in government or government-guaranteed bonds by 25 per cent of the rise in their deposits; (3) life insurance companies would invest 100 million kroner in new government issues and would increase their holdings of government or government-guaranteed bonds by an equal amount; and (4) all institutions would observe particular restraint in granting personal and consumer credit. And in Denmark, the central bank announced that as of March 21 its advances against bonds quoted on the Copenhagen Stock Exchange would be limited to 60 per cent of their market value, as against 70 per cent previously; on May 21 the ratio is to be cut further to 50 per cent. Similar cuts have been announced on loans against certain other fixed-interest-bearing securities.

² If a bank's credit expansion exceeds the norm, the bank is obligated to maintain an interest-free deposit at the Netherlands Bank.