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The Prime Rate—Part II*

The first part of this article, which appeared in this *Review* last month, reviewed the history of the prime rate and its relation to other lending rates. We now turn to changes in the prime rate and their causes. The behavior of the prime rate is subject, of course, to a great variety of influences, some essentially long run in nature, others cyclical. To explain the timing of particular prime rate changes, furthermore, one must take into account the complex decision-making process in the banks that exercise rate leadership and the competitive relations among these institutions.

UNDERLYING SUPPLY AND DEMAND FACTORS

Although it is only fourteen years since the first change in the prime rate, the general pattern of the forces to which it is subject seems fairly well established. The basic trend of the rate during these years, like that of other interest rates, has been upward. Demand for bank loans has expanded greatly, reflecting the growth of the economy and the drawing-down of liquidity reserves accumulated during World War II. Moreover, although most prime borrowers have access to other means of financing, bank loans offer significant advantages in terms of the flexibility of amounts, timing, and other arrangements. Even the highly rate-sensitive national sales finance companies are careful to maintain their bank credit lines at all times.

While demand for bank loans has been expanding, the growth of funds has not kept pace. Throughout the postwar years, except during periods of cyclically slack demand, loans have been replacing Government securities in bank portfolios, with the total size of bank assets increasing comparatively slowly. Each business upswing has seen loans rise to occupy a more prominent position in bank portfolios than in the preceding expansion, and these increases have been only partly reversed during recessions. In December 1961, ten months after the February trough in the general business situation, the ratio of loans to total deposits at large banks was 56.4 per cent, compared with 52.1 per cent and 44.1 per cent at the corresponding stages (February 1959 and June 1955) of the two previous business cycles.[1]

In order to obtain funds for lending, banks have had to step up competition for deposits. In recent years, a relatively large share of deposit gains has consisted of time deposits on which, in contrast to demand deposits, banks of course normally pay interest. In turn, the rates charged by banks, including the prime rate, also have gone up. The rise in the prime rate during the postwar years appears to have been of the same order of magnitude as the increase in the yields on other outlets for bank funds. However, just as bank loans often have special advantages for borrowers, so lending to prime borrowers often yields banks substantial returns, in the form of deposits or additional business, over and above the actual interest receipts.

The pressure of growing demand on relatively limited supply has probably been more severe on the large banks in New York and Chicago that "make" the prime rate than on any other group of banks. The city banks have traditionally taken the lead in servicing the national firms that make up much of the prime borrower group. During the 1950-60 period, total deposits at these banks have increased only about 20 per cent, compared with a rise of some 50 per cent at all other member banks. Over the same period, the bank debt of large manufacturing corporations (with assets of over $100 million) has more than tripled.

CYCLICAL FACTORS

The direction and timing of changes in the prime rate are determined largely by the ramifications of the cyclical behavior of loan demand and supply. The fact that the prime rate rises and falls later than most other business-cycle indicators seems due at least in part to the time it takes for shifts in the business situation and monetary policy to be translated into changes in the loan supply-demand balance. Because of the nature of bank credit and of the market in which it is sold, the prime rate

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

[1] The figures refer to the ratio, at weekly reporting member banks, of total loans, excluding loans to securities brokers and dealers and interbank loans, to total deposits less cash items in process of collection.

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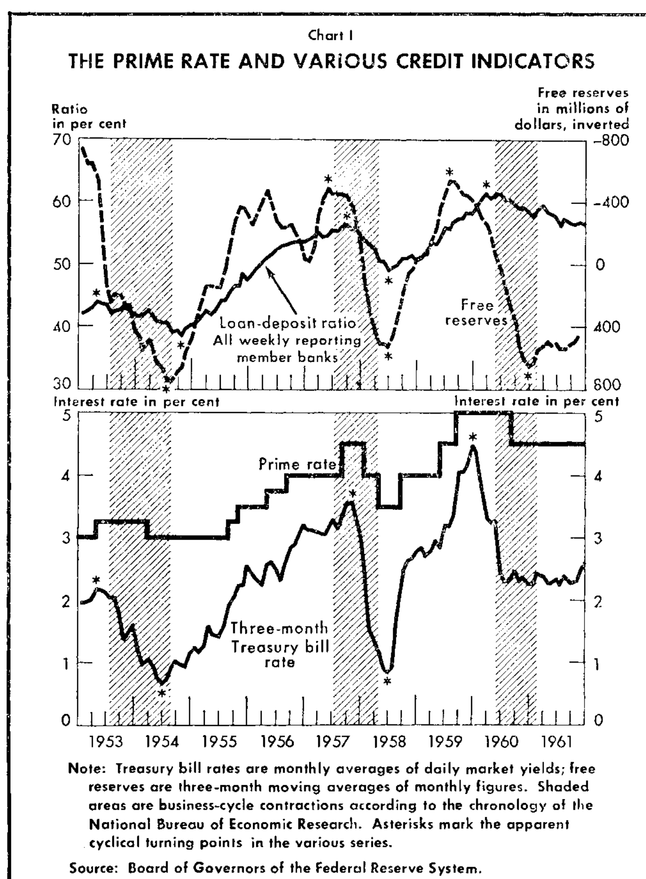

Chart I

THE PRIME RATE AND VARIOUS CREDIT INDICATORS

Note: Treasury bill rates are monthly averages of daily market yields; free reserves are three-month moving averages of monthly figures. Shaded areas are business-cycle contractions according to the chronology of the National Bureau of Economic Research. Asterisks mark the apparent cyclical turning points in the various series.

Source: Board of Governors of the Federal Reserve System.

responds only to shifts in the credit situation that are unmistakable and are expected to persist.

The demand for new loans waxes and wanes roughly in rhythm with the cyclical swings in private investment, particularly investment in inventories. The supply of additional loans that a bank can extend, on the other hand, depends primarily on the growth of its deposits and, with a given deposit volume, the extent to which it is willing to liquidate other assets to accommodate loans. The aggregate of deposits for all banks is, of course, largely determined by Federal Reserve policies, as a result of which the rate of growth of bank deposits has tended, on the whole, to be faster in times of recession and slower in times of boom. During recession periods, in sum, loan demand is slack but the supply of bank funds is growing; in boom periods, by contrast, peak loan demands are pressing on a limited credit supply.

The ratio of loans to deposits, referred to earlier, is a convenient summary measure of the shifting balance over the cycle between loan demand and availability, and is known to play a significant role in the formation of loan policy by individual banks. Since in most large banks the bulk of the deposit liabilities are payable on demand, some margin must be invested in assets that, in contrast to loans, can be quickly converted into cash. Consequently, a high loan-deposit ratio, whether for an individual bank or for the banking system, indicates a state of being largely "loaned up": considerations of liquidity then dictate restraint in lending. Conversely, a low ratio suggests that a bank may be having difficulty in finding acceptable loans and is probably more receptive to new requests. Of course, the loan-deposit ratio is only an approximate measure of liquidity, since loan portfolios may be more or less liquid depending on the types and turnover rate of the loans involved while the deposits themselves may be more or less volatile.

As a result of the relationship between loan and deposit movements over the cycle, the loan-deposit ratio shows pronounced cyclical swings (Chart I). The ratio falls during recessions, when loan volume contracts while deposits generally increase. The ratio rises during business expansions, when loan volume is growing while deposits increase slowly or not at all. During the past decade, as Chart II shows, the relation between the loan-deposit ratio of city banks, indicating the pressure of loan demand on supply, and the prime rate has been very close. Largely similar results are obtained when the ratio of short-term liquid assets to deposits is substituted for the loan-deposit ratio (Chart III), as would be expected on the basis of the close relationship of the two ratios (a high

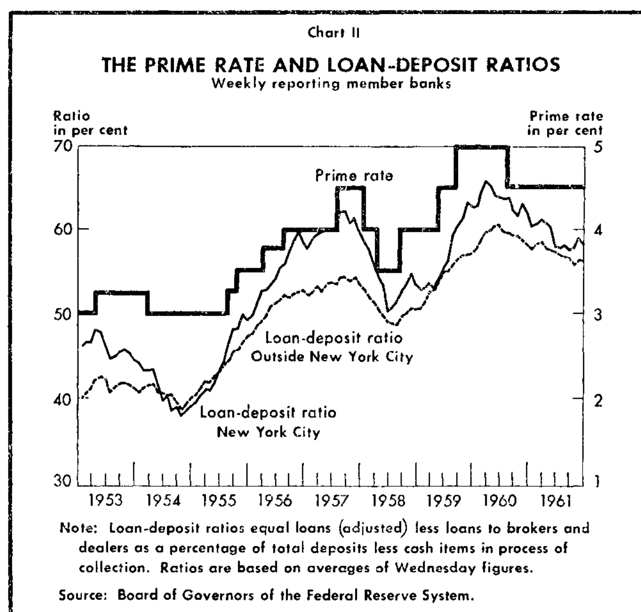

Chart II

THE PRIME RATE AND LOAN-DEPOSIT RATIOS

Weekly reporting member banks

Note: Loan-deposit ratios equal loans (adjusted) less loans to brokers and dealers as a percentage of total deposits less cash items in process of collection. Ratios are based on averages of Wednesday figures.

Source: Board of Governors of the Federal Reserve System.

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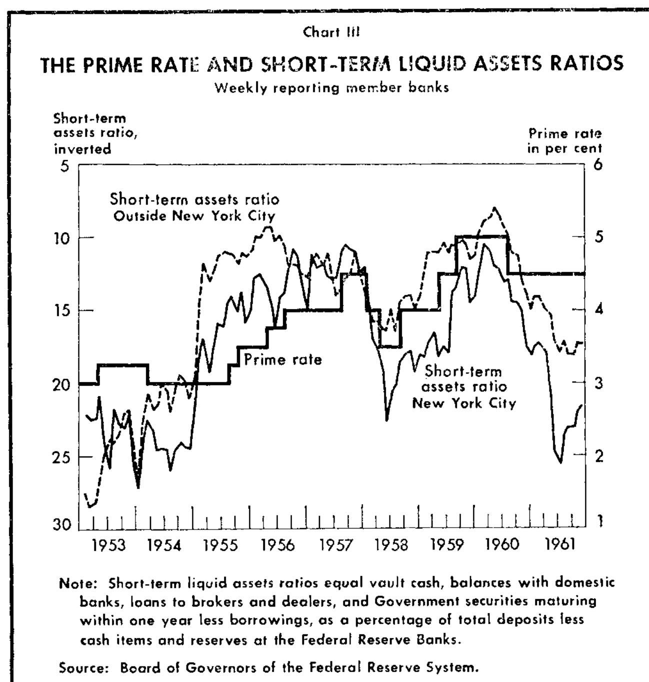

short-term assets ratio corresponds, in general, to a low loan-deposit ratio).[2]

To the extent that the prime rate and loan-deposit ratios are related, some of the "laggardness" of the prime rate is explained. Loan-deposit ratios do not respond immediately to changes in the direction of monetary policy (Chart I). At least since 1953, turning points in the cyclical course of loan-deposit ratios have in almost all instances lagged several months behind turns in free reserves, and often also behind Treasury bill rates. At business-cycle troughs (and at the 1957 peak), turns in loan-deposit ratios also have trailed behind the turning points in business at large.

The effects on the prime rate of the cyclical fluctuations in the balance of loan demand and supply are reinforced by movements in the more sensitive, open market interest rates. While the path of open market rates, like that of loan-deposit ratios, reflects primarily the over-all credit situation, each rate is also subject to forces and anticipations specific to its own market. As a result, differentials among the various open market rates and loan rates are by no means constant. Interviews with leading banks indicate that the actual and anticipated standing of other relevant interest rates, along with loan-deposit ratios, plays a key role in decisions to change the prime rate. Long-term rates, such as those on corporate bonds (including rates on private placements with insurance companies and other nonbank investors), are considered by some banks to be more relevant than short-term rates.

When credit demand is expanding, rates on the various instruments through which borrowers may obtain access to nonbank funds—such as commercial paper and bond issues—rise promptly, and further rises are normally anticipated. With the prime rate still low, borrowing from banks becomes more attractive and pressure develops on the available supply of bank funds. At the same time, the costs banks must incur to raise additional funds increase. Rates on time deposits tend to rise toward the legal maxima. Sales of securities, at rising rates (declining prices), mean capital losses. Temporary reserve deficiencies become more frequent and must be offset at higher Federal funds or Reserve Bank discount rates. Such conditions appear ripe for the raising of the prime rate.

When credit demand is contracting, the sequence is reversed. As open market rates fall, borrowing at the established prime rate becomes less attractive. Some outstanding loans may be prepaid with the proceeds of open market financings. For the banks, the costs of attracting new deposits, and the returns offered by other investment outlets, decline. Sooner or later, the prime rate gives way.

INDIVIDUAL BANK DECISIONS TO CHANGE THE PRIME RATE

The preceding broad considerations describe the environment propitious to a change in the prime rate. They are not sufficient, however, to predict with any confidence the precise timing of rate changes. The changing of the rate represents a major decision. A considerable time interval may elapse between the conclusion by some officials of a given bank that a rate change is appropriate and the decision of its management to take action. Elements of "gamesmanship" are necessarily involved, both among competing interests within a given institution and with respect to efforts to anticipate the reaction of customers and competitors.

Any actual change must be initiated by one particular bank. This is a risky step, for if the others do not follow, the lead bank faces a flood of loan requests perhaps in excess of lending capacity (if its rate is below the market) or a rapid exodus of customers to other banks (if its rate is above the market). It is not surprising, therefore, that most prime-rate moves have been initiated by the two

[2] Unlike the loan-deposit ratio, the proportion of liquid assets does not show a pronounced longer term trend, reflecting the fact that loans have displaced mainly long-term rather than short-term securities. For a discussion of concepts and measures of bank liquidity, see "Recent Developments in Bank Liquidity", *Monthly Review,* November 1961, pp. 185-88.

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largest New York banks, The Chase Manhattan and First National City. These two banks have been particularly prominent in initiating changes upward. Three of the four rate reductions during the postwar period, on the other hand, originated with other, somewhat smaller banks.

It is clear that a bank assumes leadership in a rate change only upon considerable deliberation among its top officials, whose views need by no means be unanimous. In one instance studied, two and a half months intervened between the initial proposal by a high official that the rate be changed and the ultimate action. However, less than two weeks elapsed in another case, in which consideration of a rate shift was reportedly touched off by a change in the Federal Reserve discount rate. At times noneconomic motives, such as the desire for leadership or publicity, appear to play an important part. When some other bank has already announced a change, on the other hand, the decision to follow along can normally be taken promptly and with little travail.

There was some indication that, at times when the existing rate seemed out of line, a move in the Federal Reserve discount rate might be interpreted as calling for, or giving sanction to, a changing of the prime rate. At other than such pivotal times, however, judging from the statistical record, discount rate changes have had little influence.[3]

CONCLUDING OBSERVATIONS

Bankers as well as the public tend to view the prime rate as the principal index of conditions in the bank loan market. So far as the interest rate on such loans is concerned, this view appears to be accurate: the extent and timing of all types of business-loan rate changes is governed closely by changes in the prime rate. It is doubtful, however, that the prime rate is a reliable indicator of fluctuations in loan availability, which reflects, in addition to rate, other credit terms, standards of credit-worthiness, and the like.

Quite strikingly, the prime rate is among the last indexes of the credit situation to register a change in the credit climate. A number of reasons explain this. Because of the many dimensions of a loan agreement, rate is probably a less significant factor in a business-loan transaction than in other large-sized credit transactions. Since every loan is to some extent unique and since, as a related matter, there is no secondary market in which existing loans may be traded, there are no standard reference points or market quotations to which rates on new loans can be mechanically geared. Moreover, changes in the supply-demand balance in the loan market, as reflected by loan-deposit ratios, generally do not occur until after turning points in reserve positions and short- and long-term rates. A further lag is introduced by the necessarily cautious and complex price-making procedure of a market in which leading banks compete for the business of large national borrowers.

In sum, changes in the prime rate do not normally occur ahead of, or even concurrently with, shifts in the credit situation. Rather, a change in the prime rate may usually be interpreted as confirming that a sizable shift has already taken place and that no early reversal is expected.

[3] It may be pointed out that in most advanced countries the rate structure of bank lending tends to be anchored in some key rate. In continental Western Europe, the principal commercial bank lending rates are in most cases set by consultation among the banks. In many of these countries, such as France and Germany, these rates are "linked" to central bank discount rates and are changed more or less automatically by the same amounts as the latter. (In France, however, full adjustment to changes in the discount rate is made only when the latter is in the 3½-4½ per cent range. Beyond these limits, only one half of any discount rate change can be reflected in the minimum commercial bank lending rate.) In the United Kingdom, the equivalent of the prime rate by custom stands in a fixed relation to the Bank of England's discount rate. For prime private borrowers, the rate is set ½ per cent above the discount rate (with a minimum of 5 per cent), but most private firms pay 1 per cent above the discount rate. In Canada, the prime rate is set by the chartered banks in consultation with each other and is changed quite rarely—partly because in recent years it has been close to the 6 per cent legal maximum on interest rates in general.

THE QUEST FOR BALANCE IN THE INTERNATIONAL PAYMENTS SYSTEM

In response to requests, the Federal Reserve Bank of New York has reprinted the seventeen-page section of its 1961 *Annual Report* entitled "The Quest for Balance in the International Payments System". Copies are available from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York 45, N. Y.

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The Business Situation

The economy displayed more vigor during March and early April than during the first two months of the year. Most encouragingly, consumer spending—especially on automobiles—picked up briskly. Residential construction seemed to be moving out of its recent doldrums. There were also signs of a somewhat faster growth in expenditures for plant and equipment for the balance of the year than had been indicated earlier.

Although the March gain in output helped to make some small inroads on unemployment, the unemployment rate was still significantly higher than at the comparable stage of the two preceding business expansions. At the same time, despite the drop in total unemployment the number of persons out of work more than half a year (the so-called "hard core" unemployment) increased further and stood well above the level at the trough of the recession in early 1961. And, despite the spurt in economic activity in March, gross national product in the first quarter of 1962 rose less than half as much as in the preceding quarter.

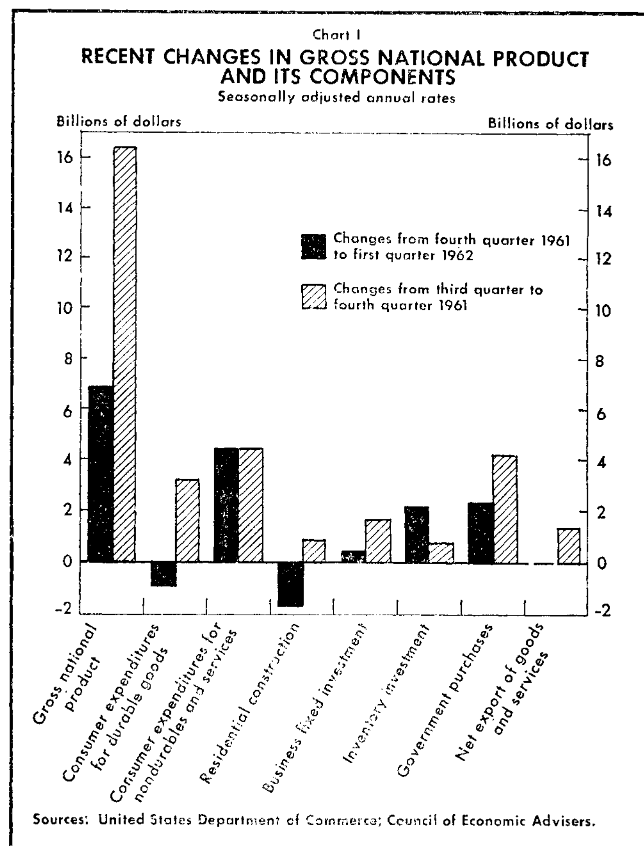
The expansion in economic activity continued to be accompanied by little change in prices. The wholesale price index was stable in March, as it had been in February, and remained below year-earlier levels. The consumer price index, after four months of stability, did advance in both February and March, but at least part of the rise could be attributed to increased food prices brought on by freezing weather in the South and by seasonally higher prices of apparel and used cars. The prevailing noninflationary atmosphere, which has been strengthened by the signing of the rather moderate steel wage contract at the end of March (from which, significantly, the cost-of-living escalation clause was eliminated), was only briefly disturbed in early April by the short-lived rise in the price of steel.

THE PATTERNS OF DEMAND

Through the final quarter of 1961 the growth in GNP in the current expansion had roughly paralleled its performance in the two preceding periods of upswing. However, with the relatively small advance of $6.8 billion to a seasonally adjusted annual rate of $549.0 billion in the first quarter of 1962 (see Chart I), the growth in GNP fell slightly behind the pace set in the earlier expansions.

The slowing-down in the first quarter stemmed largely from declines in consumer expenditures for durable goods, primarily automobiles, and in outlays for residential construction. In the comparable quarters of the two preceding upswings, demand in these two areas had continued to advance or had remained unchanged. In addition, the rate of increase in business expenditures for fixed investment slackened in the first quarter, whereas in the earlier expansion periods such spending had advanced rather sharply. Business investment in inventories, on the other hand, accelerated in the first quarter, putting total inventory accumulation in this expansion about midway between the two earlier periods; and government spending, although not increasing so sharply as a quarter earlier, continued to move ahead of both the 1954-55 and 1958-59 upswings.

Consumer behavior in recent weeks raised hopes that consumption spending in general may be on the rise.



Sources: United States Department of Commerce; Council of Economic Advisers.

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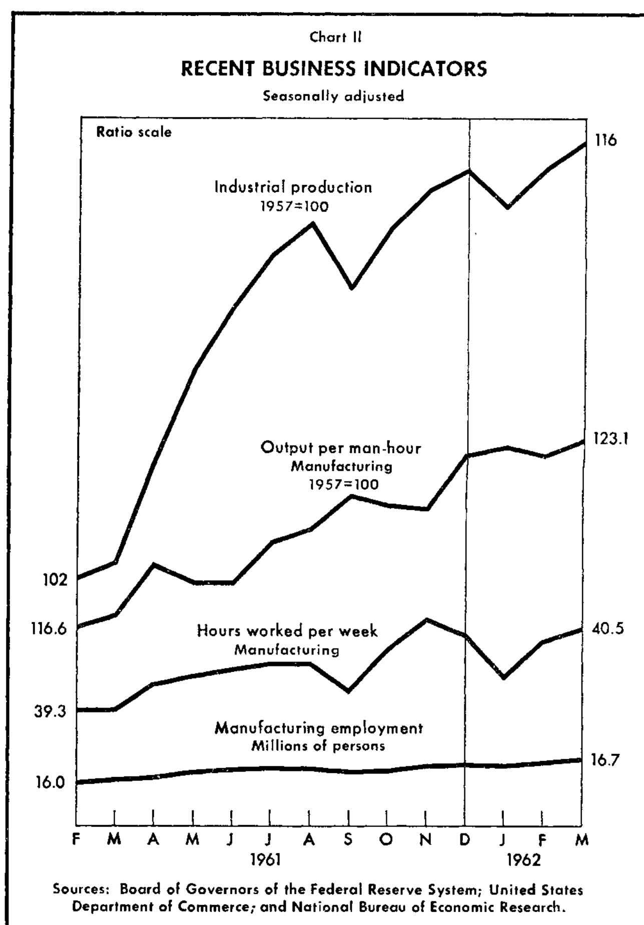
Total retail sales in March registered good gains for the second month in a row, and more than regained last November's high. The advance in March centered on automobile sales, which had been disappointingly weak in the first two months of the year. In April, auto dealers continued to chalk up sharp sales increases. Department stores sales in April may have slackened somewhat from the high March level, but the late date of Easter this year complicates analysis of movements between these two months. Taken together, the two months do represent a good gain over January and February, reflecting higher spending for both soft goods and household durables.

The home-building picture also appears to have improved since the end of February. The first quarter's decline in residential construction outlays may, at least in part, have resulted from adverse weather. While the number of new housing units started had fallen for four consecutive months through February, building permits—which reflect intentions to begin construction and which are less affected by weather—had moved generally upward. With better weather in March, the number of nonfarm housing starts jumped by one fifth to a seasonally adjusted annual rate of 1.4 million, only slightly below the October 1961 high. In addition, FHA applications plus VA appraisal requests rose for the second consecutive month in March and the mortgage market eased further.

In the business sector, the latest indications of fixed investment trends give some promise of a better showing after the rather sluggish pace set in the first quarter. The recent McGraw-Hill survey, taken in March and early April, found businessmen planning to increase their spending for plant and equipment in 1962 by 11 per cent above 1961 levels, somewhat more than the 8 per cent rise indicated by the Commerce Department-Securities and Exchange Commission survey taken two months earlier (see March *Monthly Review*). In comparable stages of previous cyclical upswings, the McGraw-Hill survey has generally shown a higher percentage gain than the Commerce-SEC survey, but both have tended to understate the volume of outlays actually rung up.

In contrast to consumer spending and business outlays on fixed investment, business investment in inventories rose more in the first quarter of 1962 than in the preceding quarter. A significant portion of the faster inventory build-up, of course, reflected steel stockpiling against the possibility of a strike. Steel inventories probably rose further in April, since the wage settlement at the end of March allowed little time for cancellation of April shipments. In the months following, however, steel users can be expected to work off at least part of their inventories.

Government spending also rose in the first quarter, as it had a quarter earlier. More than half of the increased spending in these two quarters was for national defense, reflecting the military build-up that started with the Berlin crisis last summer, and defense outlays are expected to rise further at least through midyear. State and local expenditures should continue their long-term upward trend.



Sources: Board of Governors of the Federal Reserve System; United States Department of Commerce; and National Bureau of Economic Research.

PRODUCTION AND EMPLOYMENT

Industrial production in March advanced by 1 point for the second month in a row, reaching 116 per cent of the 1957 average (see Chart II). The March rise was widespread with no major sector showing a decline. In April, auto production was rising briskly and schedules pointed to a substantial increase for the month as a whole. The weekly figures for steel-ingot production in April, however, suggested a more-than-seasonal decline, as output was cut back following the steel wage settlement.

The further decline in March in new orders received by manufacturers of durable goods partly reflected the

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special order situation in the steel industry. Since many of the heavy December and January steel orders were for shipments to be spread out over the whole first half of 1962, the need to place new orders for steel during February and March may have been somewhat reduced from what it would have been under more normal circumstances. Moreover, the early start of the steel contract negotiations may have dampened hedging demand for steel during those two months.

Total employment in March rose imperceptibly on a seasonally adjusted basis, the small increase being centered in the manufacturing, service, and government sectors. At the same time, the civilian labor force showed a slight decline. As a result, the total number of unemployed fell below 4 million for the first time since July 1960, and unemployment as a percentage of the civilian labor force edged off to 5.5 per cent; at the comparable stage of the 1958-59 and 1954-55 expansions, the unemployment rates were 5.1 per cent and 4.1 per cent, respectively.

As is usual during the early periods of business expansion, the rather sharp increases that have occurred during the past year in average hours worked and in productivity have tended to hold down the gains in employment. In manufacturing industries, average hours clocked by production workers in March rose close to the previous cyclical high set last November (see Chart II), when auto manufacturers were working overtime to make up for production lost during the strikes in September and October. Output per man-hour in manufacturing industries also rose in March, bringing the increase since the recession trough to more than 5 per cent (see Chart II). This is about in line with productivity gains in the comparable period of the 1954-55 expansion, although somewhat less than the gains experienced in 1958-59. Neither hours worked nor productivity can be expected to increase so rapidly in the months ahead as in the first year of the expansion; future gains in output may therefore begin to have a greater impact on employment. However, the extent to which this may result in a decline in unemployment will largely depend upon changes in the total labor force, which over the past year has shown almost no growth.

The Money Market in April

The money market was moderately firm during April, as reserve needs of money center banks, while not extreme, were fairly persistent throughout the month. New York City banks made substantial purchases of Federal funds, as their loans to brokers and dealers and their holdings of United States Government securities expanded at a brisk pace. Thus, except for three days, the effective rate on Federal funds stayed within a range of 2¾-3 per cent. Similarly, rates at major New York City banks on loans to Government securities dealers generally held within a 3-3¼ per cent range. Fluctuations in Treasury bill rates were minor during the month. An intermittent tendency for bill rates to decline, under pressure of fairly widespread demand, was offset in part by the continued additions of $100 million to the weekly offerings of three-month bills.

Demand for long-term bonds increased further during most of the month, as investors, apparently abandoning expectations of higher interest rates in the near future, placed a substantial volume of funds in new and outstanding issues. Prices of longer term United States Government obligations rose further to record levels for the year, while the market readily absorbed the Treasury's cash offering on April 9 of $1 billion of 3¾ per cent bonds due in August 1968. Prices of corporate bonds also rose in April, with even those recently marketed issues that were initially regarded as closely priced advancing notably. In the market for tax-exempt securities, prices reached their highest levels in nearly four years, despite somewhat less aggressive buying by commercial banks. On April 26, the Treasury announced that it would offer holders of 3 per cent certificates of indebtedness and 4 per cent notes, both maturing May 15, 1962, and of 2¼ per cent bonds maturing June 15, 1962, altogether totaling $11.7 billion, the right to exchange them for any of the following securities, all dated May 15, 1962: 3¼ per cent Treasury certificates of indebtedness maturing May 15, 1963, priced at par; 3⅝ per cent Treasury notes maturing February 15, 1966, priced at 99.80 to yield 3.68 per cent; 3⅞ per cent Treasury bonds maturing November 15, 1971, priced at 99.50 to yield 3.94 per cent. Subscription books for the exchange would be open April 30 through May 2. Cash subscriptions would not be received.

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MEMBER BANK RESERVES

On balance, market factors absorbed reserves over the four statement weeks of April. Reserve drains in the first two weeks, stemming mainly from a seasonal increase in currency in circulation and a decline in vault cash, were only partly offset by gains in the final two statement periods when float and vault cash expanded. System open market operations more than offset the effects of market factors, providing reserves over the four statement periods as a whole. From the last statement week in March to the final week in April, average System Account outright holdings of Government securities increased by $231 million, while average holdings under repurchase agreements rose by $123 million. Between Wednesday, March 28, and Wednesday, April 25, System holdings of securities rose by $183 million, with holdings maturing within one year increasing by $84 million and holdings maturing in more than one year rising by $99 million.

Over the four statement weeks ended April 25, free reserves averaged $421 million, compared with $376 million in the four statement weeks ended March 28. Average excess reserves rose by $28 million to $495 million, while average borrowings from the Federal Reserve Banks decreased by $17 million to $74 million.

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

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

Factor	Daily averages—week ended				Net Changes
	April 4	April 11	April 18	April 25	
Operating transactions					
Treasury operations*	+ 82	— 56	— 20	— 39	— 33
Federal Reserve float	— 219	+ 127	+ 256	+ 88	+ 252
Currency in circulation	— 99	— 224	— 82	+ 112	— 293
Gold and foreign account	— 80	— 32	+ 24	— 67	— 155
Other deposits, etc.	— 30	+ 19	+ 33	+ 7	+ 29
Total	— 345	— 168	+ 212	+ 101	— 200
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 345	+ 138	— 177	— 75	+ 231
Held under repurchase agreements	+ 126	— 7	— 74	+ 78	+ 123
Loans, discounts, and advances:					
Member bank borrowings	— 11	— 15	+ 15	+ 10	— 1
Other	—	—	—	—	—
Bankers' acceptances:					
Bought outright	— 2	—	— 1	— 2	— 5
Under repurchase agreements	—	—	—	+ 1	+ 1
Total	+ 459	+ 115	— 237	+ 12	+ 349
Member bank reserves					
With Federal Reserve Banks	+ 114	— 53	— 25	+ 113	+ 149
Cash allowed as reserves†	— 99	— 103	+ 203	+ 54	+ 55
Total reserves†	+ 15	— 156	+ 178	+ 167	+ 204
Effect of change in required reserves†	+ 43	+ 82	— 124	— 141	— 140
Excess reserves†	+ 58	— 74	+ 54	+ 26	+ 64
Daily average level of member bank:					
Borrowings from Reserve Banks	75	60	75	85	74‡
Excess reserves†	517	443	497	523	495‡
Free reserves†	442	383	422	438	421‡

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 April 25, 1962.

THE GOVERNMENT SECURITIES MARKET

In the market for Treasury notes and bonds, the sustained upward price movement that began in late February and gained strength in March continued through most of April as well, albeit at a lesser rate. Yields on most issues fell to their lowest levels of the year (see chart). Uncertainties regarding the vigor of the business expansion, the absence of strong demand for business loans, and the downward trend of stock prices continued to be significant factors in the background of the price rise. The labor agreement reached in the steel industry and the cancellation of announced steel price increases, which apparently were interpreted as diminishing the prospects for inflation, also helped to strengthen the market.

On the opening days of the month prices rose steadily, and by April 4 yields on all long-term Government securities were below 4 per cent. Demand for long-term bonds by institutional investors and for intermediate-term issues by commercial banks was augmented at times by professional demand, as dealers sought to maintain or rebuild inventories. At the same time, offerings in the market generally remained light. Prices declined fairly sharply on April 5, however, largely on rumors of an impending Treasury financing operation in either the intermediate- or long-term maturity areas.

After the close of business on April 5, the Treasury announced that it would offer for cash subscription on Monday, April 9, $1 billion of 3¾ per cent bonds at par, to be dated April 18, 1962 and to mature August 15, 1968, with commercial banks permitted to pay through credit to Treasury Tax and Loan Accounts. Market response to the announcement was enthusiastic, and the entire market strengthened again, with the new bonds ending their first day of "when-issued" trading, on April 10, at 100[13]⁄64 bid. The success of the financing was later confirmed by the Treasury announcement that total public subscriptions had amounted to $6.8 billion. Under the terms of the allotment, subscriptions up to $50,000 were allotted in full and subscriptions over that amount were allotted 15 per cent with a minimum allotment of $50,000—about in line with market expectations.

Prices again declined temporarily in immediate response to news of the steel-price increase after the close of business on April 10, which was interpreted as possibly

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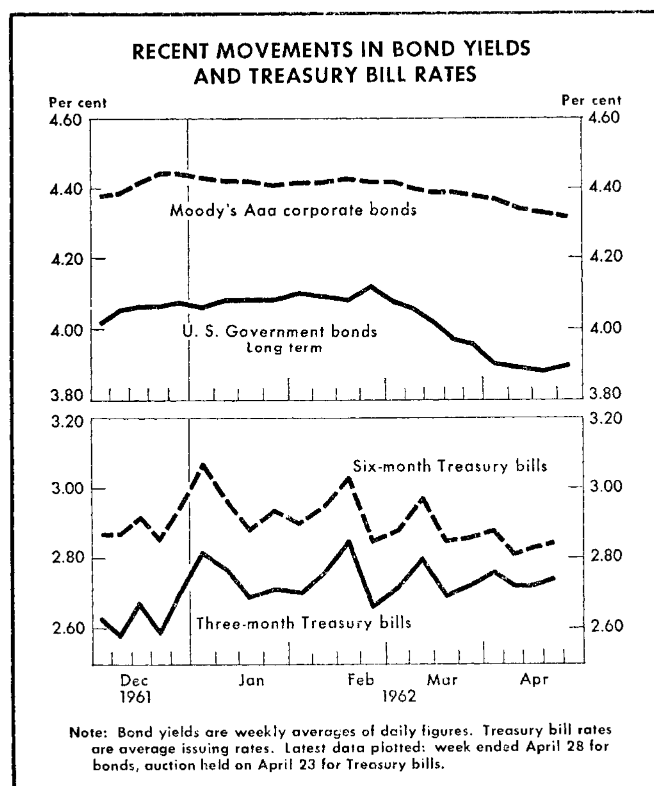

Note: Bond yields are weekly averages of daily figures. Treasury bill rates are average issuing rates. Latest data plotted: week ended April 28 for bonds, auction held on April 23 for Treasury bills.

setting off new inflationary pressures. However, the bond market began to recover even before the steel price rise was rescinded, and further gains were recorded through April 18. Over the next week, prices moved somewhat lower in quiet activity as the market awaited the announcement of the terms of the Treasury's May refinancing.

The terms of the refinancing were quite well received, and on April 27 prices of outstanding longer term Treasury bonds rose from $^{10}/_{32}$ to $^{18}/_{32}$ of a point, reflecting the fact that the longest dated issue included in the refinancing matures in 1971. However, the outstanding 4 per cent bonds of 1971 also rose in price about $^{13}/_{32}$ of a point, while the maturing issues continued to carry a "rights" value. Over the month as a whole, prices of intermediate- and long-term Treasury issues rose from $^{2}/_{32}$ of a point to $1\frac{1}{4}$ points.

In the market for Treasury bills, rates fluctuated within an unusually narrow range during the month. In the regular weekly auction on Monday, April 2, average issuing rates were set at 2.757 per cent and 2.875 per cent for the 91- and 182-day bills, about 4 and 2 basis points, respectively, above the previous week. Following the auction, rates adjusted downward, mainly reflecting the relatively light awards received by dealers.

On April 3, the Treasury announced that it would auction, on April 10, $2.0 billion of 365-day bills, to be dated April 15, 1962 and to mature on April 15, 1963. These bills, which replaced a like amount maturing on April 15, were sold at an average issuing rate of 2.943 per cent. After the announcement, rates on outstanding Treasury bills moved slightly lower over the next several days, as offerings contracted and demand broadened in a somewhat easier money market. In the regular auction on April 9, average issuing rates on the 91- and 182-day issues were down 4 and 6 basis points, respectively, from the preceding week, at 2.720 per cent and 2.814 per cent. The spread of 9 basis points (shown in the chart) was the narrowest of any auction since the six-month bill was first offered in December 1958—apparently reflecting, in part, the continuing weekly addition of $100 million to the weekly offerings of three-month bills.

Bill rates rose fairly sharply in reaction to the announcement of the increase in steel prices on April 10, as well as to increased selling in a firmer money market. The reaction was short-lived, however, as offerings tapered off and a rather broad demand appeared. In the two regular auctions on April 16 and 23, average issuing rates on both three- and six-month bills were set at levels very close to those established earlier in the month. A steady atmosphere was maintained toward the close of the month, as dealers were willing to hold large positions, partly in anticipation of a reinvestment demand from the Treasury's May refunding. In the auction on April 30, average issuing rates were 2.748 per cent and 2.845 per cent on three- and six-month bills, up about 3 basis points in each case from the rates set in the auction on April 9.

OTHER SECURITIES MARKETS

Prices of seasoned corporate and tax-exempt bonds strengthened further in April, under the influence of sustained investor interest in new and recent flotations. Over the month as a whole, Moody's average yield on seasoned corporate bonds declined by 7 basis points to 4.31 per cent while the average yield on similarly rated tax-exempt issues fell by 8 basis points to 2.93 per cent. New offerings in both sectors generally were well received, despite the fact that the volume of publicly offered new corporate and tax-exempt issues expanded considerably. An estimated $870 million of state and local securities reached the market in April, compared with $599 million in March and $661 million in April 1961. New corporate flotations totaled $640 million in April as against $340 million in March and $711 million in April 1961. The Blue List of advertised dealer offerings rose

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from $480 million at the end of March to $549 million toward the close of April.

The largest new corporate flotation of the month was a $90 million Aa-rated 4⅜ per cent sinking fund debenture maturing in 1987 and nonrefundable for five years. Yielding 4.36 per cent to investors, the issue quickly sold out. A large Aaa issue was reoffered during the month at a yield as low as 4.225 per cent. The largest new tax-exempt offering of the month was a $109 million A-rated New York City various-purpose bond issue. Reoffered to yield from 1.65 per cent in 1963 to 3.15 per cent in 1982, the bonds were well received.

International Financial Cooperation

Legislation to authorize the United States to join nine other countries in providing stand-by credits to enlarge the International Monetary Fund's potential resources[1] was passed by the House of Representatives on April 2 and is now in the Senate. The following comments on the significance of these new arrangements are taken from a speech by Per Jacobsson, Managing Director of the International Monetary Fund, before the Economic and Social Council of the United Nations on April 6, 1962:

> It is the great merit of these borrowing arrangements that they make it possible to mobilize quickly large additional resources for the defense of the international monetary system. The need for such resources arises not from any failure of this system, but, on the contrary, from its success—from the broader convertibility of currencies and the increased freedom of the exchange markets. As so often in life, success creates its own problems. More widespread convertibility, which is so important for the growth of world trade has, at the same time, made possible sudden and substantial shifts of funds from one country to another. Since large movements of funds are most likely to occur between the main industrial countries, it was not unnatural that it was precisely those countries, in the first place, which wanted to provide adequate safeguards against the untoward effects of these movements. The resources to be provided under the borrowing arrangements will make it possible to forestall or cope with the threat of any impairment of the international monetary system created by these movements or by any other circumstances. Thus, the resilience of that system, as well as the liquidity of the Fund, will be enhanced to the benefit of all member countries.
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> At an early stage of the discussions which led to the borrowing arrangements, it was found necessary to clarify the extent to which the Fund's resources may be used to meet deficits in the balance of payments that are attributable in whole or in part to capital transfers. By a decision adopted in July last year, the Executive Directors eliminated any doubt which may have persisted, despite the evidence of the established practices of the Fund, that the Fund's resources could be used to offset the effects of capital transfers in accordance with Article VI and other provisions of the Articles of Agreement. If a country faced with an outflow of capital turned to the Fund for assistance, such assistance would be granted on the basis of the Fund's accepted principles and practices, which would require, in the case of a disequilibrating outflow, that appropriate measures were being taken to arrest the outflow, so that the assisted country would be able to repay the Fund within a fairly brief period, and in any event not later than a maximum period of three to five years after the drawing.
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> The borrowing arrangements are to be seen as a manifestation of a growing tendency toward international solidarity in the monetary field. But these arrangements are not the only sign of such a tendency. . . . The Federal Reserve System is now in a position to undertake operations in the exchange market, and is in fact doing so, which certainly represents a new departure in postwar United States financial policies. The concerted steps being taken to prevent disturbing movements on the London gold market are also of interest in this context. I should add that these methods of cooperation are almost all still in the process of evolution, and none of them will, of course, replace the necessity for the authorities in the individual countries to safeguard their own position and sustain balance by pursuing appropriate policies. But these national policies have to be worked out in relation to world-wide developments. It is a healthy sign that more and more discussions are taking place either in international organizations or directly between interested countries, which contribute both to the adoption of appropriate national policies and to the harmonizing of these policies in the international field. I think that this working together has already met with a large measure of success.

[1] See *Monthly Review,* March 1962, p. 49.

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