

FEDERAL RESERVE BANK OF NEW YORK



MONTHLY REVIEW

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No. 1

The Business Situation

Economic activity remained on a high plateau toward the close of 1962. Business sentiment continued to display an improved tone, but the major economic indicators showed little change after adjustment for the usual seasonal variations. Industrial production and employment remained steady in November. For December, currently available data suggest some increase in automobile and steel output, but new car sales and department store volume fell back somewhat from the high levels of the previous month. Among the more forward-looking indicators, the latest surveys of business spending plans for the first quarter of 1963 pointed to some reduction in expenditures for new plant and equipment and to some slowing-down in inventory building by manufacturers. On the other hand, new orders for durable goods and private housing starts were maintained at advanced rates in November. Of course, discussion about the prospects for a tax cut continues to loom large in the business outlook.

RECENT DEVELOPMENTS

The index of industrial production remained at 119.5 per cent of the 1957-59 average in November, and thus continued to mark time at about the high level first reached last July. In contrast to earlier months, the overall stability did not mask crosscurrents but was shared by most major industries. The notable exception was the steel industry, in which ingot production moved up sharply in response to renewed strength in orders placed by automobile manufacturers. In the preceding months, the auto industry had drawn a significant portion of its steel needs from inventories that had been accumulated early in the year. In December, auto assemblies (seasonally adjusted) rose very slightly beyond the average of the past several months, and seasonally adjusted steel ingot production appears to have advanced further.

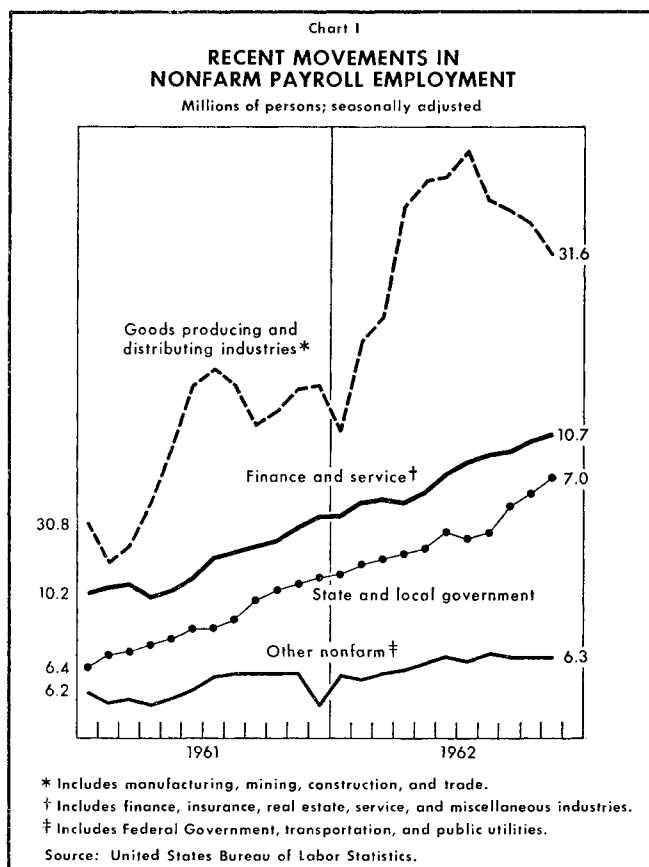
The employment situation has remained virtually unchanged. Indeed, total payroll employment, seasonally adjusted, showed no net change between June and November, the latest month for which payroll data are available. Gains in the service and financial sectors over this period and a particularly sharp rise in state and local government

employment—mainly reflecting the increased hiring of teachers—have been offset by a decline of almost 250,000 in the number of persons employed in the goods producing and distributing industries (see Chart I). Unemployment climbed to 5.8 per cent of the civilian labor force in November, largely because many teen-age students were apparently unable to find part-time jobs before Christmas. Weekly data on unemployment insurance claims filed through mid-December suggest little change after seasonal adjustment in unemployment during that month.

Recent developments in the key demand sectors have been mixed and show little in the way of a clear trend. Consumer spending, which had picked up with the introduction of the new auto models in October, continued to boost the economy in November, as retail sales rose by over 2 per cent to an all-time high. The November increase, moreover, was achieved despite some lessening in the pace of auto sales following the bunching of deliveries in October. Sales gains among retailers other than automobile dealers were widespread, with seasonally adjusted department store sales reaching a record level. In December, however, department store volume fell slightly short of registering its usual Christmas surge; nevertheless, sales bettered the year-ago level despite the newspaper strikes in New York and Cleveland. The number of new cars sold in December (seasonally adjusted) was somewhat below the extraordinary pace that had been set in recent months by the 1963 models, but held fairly close to the average sales rate for the whole of 1962.

Business spending has not shown much buoyancy. To be sure, the recent Commerce Department-Securities and Exchange Commission survey, taken in late October and early November, suggested a higher level of capital expenditures in the second half of 1962 than had been projected earlier. However, plans for the first quarter of 1963 point to a 2 per cent decline in plant and equipment outlays from the projected fourth-quarter rate, largely because of anticipated cutbacks by durable goods manufacturers. If this decline materializes, it will be the first since the second quarter of 1961 when the economy was just pulling out of the recession.

The Commerce-SEC survey has missed projecting the



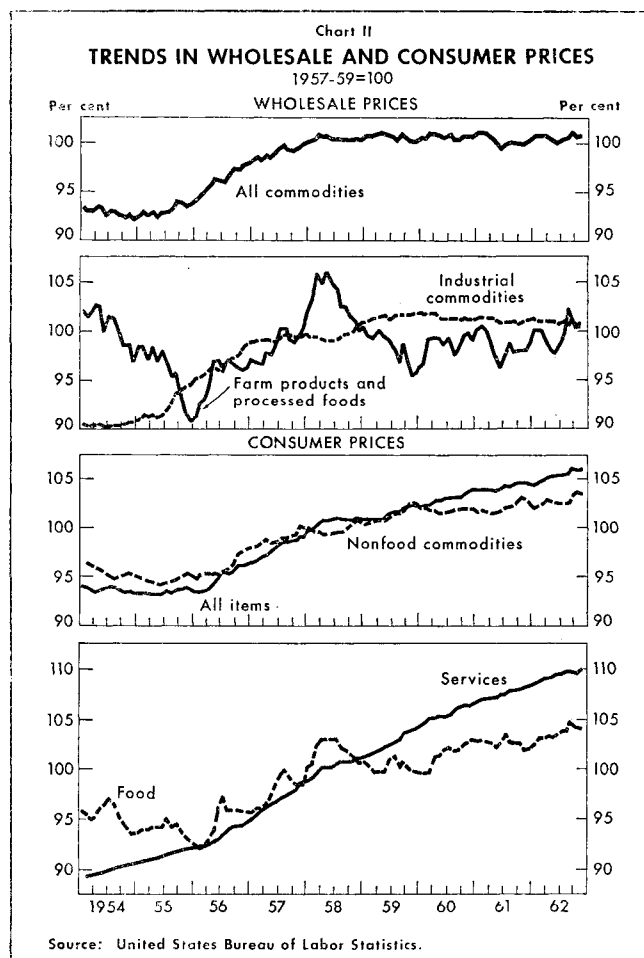
direction of change in capital expenditures in only three quarters since 1953. However, the recent survey may have been taken too soon to reflect fully the improvement in business sentiment that developed toward the end of October. Furthermore, recently developed investment plans—including some of those stimulated by the new investment credit legislation and the revised depreciation schedules—may not be reflected in actual disbursements until later in 1963. Thus, even if a dip in capital outlays does develop in the current quarter, it would not necessarily preclude achievement of an increase in capital spending in 1963 as a whole, as projected by the McGraw-Hill survey taken a month earlier.

Manufacturers' sales expectations and plans for inventory investment show a pattern rather similar to that for plant and equipment. Although the overhang of steel inventories has been pretty much worked off, manufacturers, according to the November Commerce Department survey, expected their inventory investment to increase only slightly in the fourth quarter and then to slip back somewhat in the current quarter. These plans appear to be closely geared to the expected trends in manufacturers' sales.

STABILITY IN PRICES

Price changes during the past year were rather moderate. Despite some increase in farm prices during the year, aggregate wholesale prices at the end of 1962 were virtually unchanged from a year earlier; indeed, such prices have hovered within a very narrow range since the beginning of 1958 (see Chart II). In the consumer sector, prices through November 1962 had increased slightly more than in 1961. The larger rise, however, was primarily attributable to food prices, rather than to those components of the over-all consumer price index which are more sensitive to general business trends.

The stability of wholesale prices during a period of economic advance of course reflects in part the more intense competition resulting from the failure of demand in this country to approach productive capacity. Other factors have also contributed to a more competitive climate, with competition from foreign producers, in particular, remaining strong, even though in the past two years prices



in other major industrial nations have risen more than in the United States. Increased competition has also played a role in the recent slowdown in the rate of increase in wages, which in turn has helped to hold down upward pressures on prices. Collective bargaining agreements negotiated last year in manufacturing industries tended to provide smaller increases than were obtained in earlier contracts. Since productivity also rose during the period, direct wage costs per unit of output remained virtually unchanged in 1962, and indeed at the end of the year were no higher (and possibly slightly lower) than the level reached more than five years earlier at the peak in business activity in 1957.

Among the important components of the price structure that are not greatly affected by cyclical changes in business activity are the prices of consumer services. These prices, which account for more than one third of the total consumer price index, have been rising continuously, in part because of the steady shift in demand to the service sector. In addition, productivity gains in many service sectors appear to be relatively hard to achieve or at least to measure. It is noteworthy, however, that even in this area price rises in most of the recent months have been more moderate than they had been for some time.

To some extent, furthermore, the magnitude of the rise in service prices over the postwar period is probably overstated because of the special difficulties of taking improvements in the quality of services into full account. For example, while the "medical care" component of the consumer price index has shown a much more rapid rate of advance than most other "service" components of the index, the price equivalent of higher quality medical care is exceedingly difficult to define, much less to measure.

Farm prices in recent years also have been largely insensitive to the over-all level of business activity. The chief cause of these fluctuations in the aggregate level of farm prices seems to be the livestock cycle. During the two upswings in general business activity preceding the present one, from mid-1954 to 1956 and from early 1958 to 1960, the timing of the livestock cycle brought to market a large increase in the supply of cattle and hogs and thus drove down food prices at both the wholesale and retail levels, offsetting rising prices for manufactured goods. In the current upswing, however, livestock production has stabilized at a fairly high level. As a result, wholesale prices of farm products and processed foods on balance have dipped only slightly since the business upswing began in early 1961, and retail food prices have risen. Food prices in general were stronger in 1962 than in 1961, reflecting increases in meat prices and continuing uptrends in cereal and bakery product prices.

Prices of goods other than food have not shown the sizable increases in the current business expansion that occurred in previous postwar upswings. Retail prices of nonfood consumer goods, to be sure, have risen somewhat since the upturn began (in February 1961), but the increase has been less than in the comparable period of the preceding economic expansion. At the wholesale level, moreover, industrial commodity prices (i.e., wholesale prices other than farm products and processed foods) have changed little since the last recession trough, in contrast to a mild rise in the previous cyclical expansion and a considerable advance in the 1954-57 upswing. In all major categories, industrial wholesale prices are currently below their peak levels of the late 1950's.

The Money Market in December

The money market was moderately comfortable in the first half of December but became firmer in the second half, as the distribution of reserves first tended to favor the money centers and then shifted toward the country banks. The shift in atmosphere was associated in good part with the midmonth tax date, as corporations sold securities to dealers, both outright and as a result of maturing repurchase agreements, while the dealers in turn resorted to heavy borrowing from the money market banks in New York to finance their enlarged inventories. Thus, the effective rate on Federal funds was generally $2\frac{7}{8}$ per cent

through December 13, but moved to 3 per cent thereafter while member bank borrowing from the Federal Reserve increased. Similarly rates posted by the major New York City banks on new and renewal call loans to Government securities dealers were quoted within a $2\frac{3}{4}$ to $3\frac{1}{4}$ per cent range in the first half of December, and largely in a $3\frac{1}{4}$ to $3\frac{1}{2}$ per cent range in the latter part of the month.

On December 20, the Treasury issued a public invitation for bids on \$250 million of Treasury bonds. The operation represents the first sale of Treasury bonds through competitive bidding by underwriters for reoffering

to the public. The bonds will be dated January 17, 1963 and will mature on February 15, 1993 but may be called for payment on February 15, 1988 or on any interest payment date thereafter. Under the terms of the offering, the successful bidder will be required to make a bona fide re-offering of all of the bonds to the investing public. On January 2, the Treasury indicated that underwriters would be offered the option of bidding on either a 4 per cent or $4\frac{1}{8}$ per cent coupon rate and that each bidder might submit only one bid, specifying one of the two coupon rates. Bids were received until 11 a.m., January 8, 1963. Shortly thereafter the Treasury announced that the successful bid carried a price of 99.85111 for a 4 per cent coupon, making the cost to the Treasury equal to 4.008210 per cent. The winning underwriting group reoffered the bonds at par.

Also on January 2, the Treasury announced that it would auction \$2.5 billion of one-year Treasury bills for new cash and in exchange for \$2 billion of one-year bills maturing on January 15, 1963. The new bills will be dated January 15, 1963 and will mature on January 15, 1964. Tenders were to be received through 1:30 p.m., January 9, 1963.

On December 17, the Treasury announced that holders of \$75 million of the \$458 million of outstanding Series F and G savings bonds maturing from January 1, 1963 through April 1, 1964 had elected to convert their holdings into the two marketable Treasury issues offered in the exchange. Conversions into the $3\frac{7}{8}$ per cent bonds of 1971 totaled \$41 million, while \$34 million was exchanged for the 4 per cent bonds of 1980.

In the market for Treasury bills, rates moved slightly lower in early December under the impact of a persistent investment demand. Around the midmonth tax and dividend period, however, the rate decline was reversed, as demand contracted and the volume of offerings grew. Over the balance of the month, rates moved irregularly higher, with the three-month bill closing at 2.93 per cent (bid) compared with 2.86 per cent at the end of November. Prices of Treasury notes and bonds showed small declines in the opening days of the month. This trend, however, was subsequently reversed, reflecting the strong technical position of the market. In the closing days of the month, prices receded again as increased caution developed about current price levels. For the month as a whole, prices of most intermediate issues were up on balance while some of the longest term issues showed slight declines. In the market for corporate and tax-exempt bonds, prices were unchanged to slightly lower in early December but moved higher until the closing days of the month, as demand expanded and the supply of new issues contracted.

BANK RESERVES

Market factors absorbed reserves in December, on balance, as seasonal expansions in float and vault cash were more than offset by the effects of the holiday-induced outflow of currency into circulation and a substantial expansion in required reserves. This latter increase reflected the usual December rise in loans to corporations making quarterly tax and dividend payments, together with the related increase in borrowing by Government securities dealers, as the dealers took on securities from corporations raising cash to make quarterly payments. Reserves drained by market factors were partially offset by System open market operations. Average outright System holdings of Government securities increased by \$495 million from the last statement week in November through the last statement period in December, while holdings under repurchase agreements rose by \$3 million and net holdings of bankers' acceptances (both outright and under repurchase agreements) increased by \$38 million. From Wednesday, No-

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

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

Factor	Daily averages—week ended				Net changes
	Dec. 5	Dec. 12	Dec. 19	Dec. 26	
Operating transactions					
Treasury operations*	- 3	+ 19	- 187	+ 12	- 159
Federal Reserve float	- 277	- 77	+ 688	+ 399	+ 733
Currency in circulation	- 51	- 372	- 140	- 105	- 668
Gold and foreign account	+ 6	-	-	- 2	+ 4
Other deposits, etc.	- 98	+ 47	+ 48	- 33	- 36
Total	- 423	- 381	+ 408	+ 270	- 126
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 229	+ 380	- 110	- 4	+ 495
Held under repurchase agreements	+ 170	- 93	- 95	+ 21	+ 3
Loans, discounts, and advances:					
Member bank borrowings	- 3	+ 15	+ 56	+ 144	+ 212
Other	- 7	+ 1	- 1	-	- 7
Bankers' acceptances:					
Bought outright	+ 2	+ 5	+ 2	+ 2	+ 11
Under repurchase agreements	-	+ 24	- 6	+ 9	+ 27
Total	+ 391	+ 333	- 154	+ 171	+ 741
Member bank reserves					
With Federal Reserve Banks	- 32	- 48	+ 254	+ 441	+ 615
Cash allowed as reserves†	- 69	+ 46	+ 170	- 64	+ 83
Total reserves†	- 101	- 2	+ 424	+ 377	+ 698
Effect of change in required reserves†	- 69	+ 68	- 356	- 328	- 685
Excess reserves†	- 170	+ 66	+ 68	+ 49	+ 13
Daily average level of member bank:					
Borrowings from Reserve Banks	92	107	163	307	167‡
Excess reserves†	380	446	515	563	376‡
Free reserves†	288	339	352	256	309‡

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 December 26, 1962.

vember 28, through Wednesday, December 26, System outright holdings of Government securities maturing in less than one year expanded by \$313 million while holdings maturing in more than one year rose by \$262 million.

Over the four statement weeks ended December 26, free reserves averaged \$309 million, compared with \$447 million (revised) in the four weeks ended November 28. Average excess reserves declined by \$93 million to \$476 million, while average borrowings from the Federal Reserve Banks rose by \$44 million to \$167 million.

THE GOVERNMENT SECURITIES MARKET

Treasury bill rates edged lower over the first ten days of December, as a persistent investment demand, including some commercial bank buying in a slightly easier money market, encountered only a limited volume of offerings. A fairly good interest was evident in the regular weekly auction held on December 10, when the new issues carried attractive mid-March and mid-June maturities. Average issuing rates were set at 2.807 per cent for the new three-month bill and 2.861 per cent for the six-month bill, down 5 and 8 basis points, respectively, from the previous week. Rates moved irregularly higher from December 11 through the balance of the month, reflecting a combination of investor sales associated with mid-December corporate tax and dividend payments and a firmer money market which raised dealers' financing costs on their enlarged inventories and induced some bank selling of bills. Despite this atmosphere, dealers bid aggressively in the auction on December 21 (advanced to Friday because of the Christmas holiday the next week), especially for the three-month bills, and won exceptionally large awards. The dealers' eagerness to acquire bills apparently reflected the anticipation of a strong resurgence of investor demand after the midmonth tax date. Some net demand did emerge, but dealers' inventories remained relatively high and the atmosphere continued hesitant—based on the sustained firmness in the money market, on related market discussion of the possibility that credit policy may have shifted to slightly less ease, as well as on the heaviness of dealers' portfolios. In the final auction of the month, held on Friday, December 28, because of New Year's Day, average issuing rates were set at 2.926 per cent for the new three-month issue and 2.966 per cent for the six-month bills—7 and 3 basis points, respectively, above the rates established in the last auction in November and the highest auction rates since July and August, respectively.

Prices of Treasury notes and bonds declined in the first few days of December, as retail and professional offerings outweighed a limited investment demand. Activity was

largely confined to switching operations, including the usual year-end exchanges for tax purposes. By December 5 a stronger tone began to emerge and prices worked higher until the closing days of the month, buoyed by the good technical position of the market, by talk of Congressional opposition to an early-1963 tax cut, as well as by some renewed misgivings regarding the strength of the economic advance. Against this background, a moderate outright investor demand, professional short covering, and a broadening volume of switching operations developed. By December 24 a number of intermediate and longer term issues had reached new highs for the year, and the single remaining 4 per cent yield in the Treasury's bond list (available on the 4¼'s of 1987-92 marketed last August) had disappeared. After the Christmas holiday a more cautious atmosphere developed, and prices moved down over the rest of the month, as some profit-taking was induced by reappraisals of the interest rate outlook, particularly in light of the firmer money market atmosphere and discussions of the possibility of a slight shift in monetary policy. Over the month as a whole, prices of Treasury notes and bonds generally ranged from $\frac{1}{8}$ lower to $\frac{1}{4}$ higher.

OTHER SECURITIES MARKETS

Prices of seasoned corporate and tax-exempt bonds moved somewhat lower at the beginning of December under the pressure of continuing investor resistance to recent price levels and the heavy volume of dealer inventories. A better tone subsequently emerged, however, reflecting some of the same factors that underlay improvement in the Government securities market as well as a decline in the volume of new offerings. Investor interest quickened in both newly offered and outstanding issues, and prices of both corporate and tax-exempt bonds edged higher until the last few days of the period. In the final days, as in the Treasury bond market, a more cautious atmosphere developed. For the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds declined by 3 basis points to 4.22 per cent at the close of the period, while the average yield on similarly rated tax-exempt bonds rose by 5 basis points to 2.94 per cent. (These indexes comprise only a limited number of issues, and do not always constitute an accurate guide to the tone of the market.)

The total volume of new corporate bonds reaching the market in December amounted to \$245 million, compared with \$295 million the preceding month and \$205 million in December 1961. The largest corporate issue marketed during the month was a \$60 million Aa-rated utility issue of 4¾ per cent first and refunding mortgage bonds maturing in 1992. The issue, which was reoffered early in the

month to yield 4.33 per cent and is not refundable for five years, encountered some initial investor resistance. Later in the month, however, a similarly rated \$45 million utility issue yielding 4.32 per cent was very well received, and interest also picked up in the aforementioned \$60 million issue. New tax-exempt flotations during the month totaled \$455 million, as against \$470 million in November 1962 and \$625 million in December 1961. The Blue List of advertised dealer offerings of tax-exempt securities declined by \$45 million during the month to \$514 million on the final day in December. The largest tax-exempt offering of the period was the \$95 million (Aaa-rated) New Housing Authority issue. Awarded at a net interest cost of 3.114 per cent and reoffered to yield from 1.50 per cent in 1963 to 3.35 per cent in 2003, the bonds were well received. Most other new corporate and tax-exempt bond issues marketed during the period were accorded fairly good receptions by investors.

PERSPECTIVE ON 1962

The Federal Reserve Bank of New York has just published *Perspective on 1962*, a nine-page review of economic and financial developments. Many businessmen and teachers find *Perspective* useful as a layman's summary of the economic highlights treated more fully in the Bank's *Annual Report*. Copies of *Perspective* are available without charge in quantity to teachers for classroom distribution and in limited quantities to others as long as the supply lasts. Requests should be addressed to the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York 45, N. Y.

Recent Monetary Policy Measures Abroad

During the last four months of 1962 and early in 1963, the monetary authorities in a number of foreign industrial countries reduced discount rates and relaxed other monetary restraints.¹ Like the numerous discount rate reductions earlier last year, the recent moves generally reflected the continued strengthening of the international positions of these countries. To an important extent, however, the easing of monetary restraints toward the year end also occurred against a background of slower growth in domestic economic activity. In some cases, moreover, the measures taken were not merely designed to stimulate economic activity in general but were deliberately intended to channel available savings from short-term investments into the capital market.

The lowering of the Belgian National Bank's discount rate on December 6 to 3.5 per cent from 3.75 per cent—the sixth such reduction in less than sixteen months—appears to have completed the process of aligning the Belgian rate with those of other Common Market countries. The move was also intended to bring about a further

reduction of short-term rates relative to long-term rates, thus providing increased resources for longer term investment. This policy reflects the belief of the Belgian central bank that industrial investment, operating within a framework of appropriate monetary policies, should be the main factor in the achievement of a faster rate of Belgian economic growth.

The quick recovery in Canadian reserves since the financial crisis of last spring permitted some easing of the austerity measures introduced in June. The discount rate was reduced, in three steps, from the 6 per cent crisis rate to 4 per cent on November 13 (see table). These moves, which were made largely in response to the continued recovery of Canada's exchange reserves and to the authorities' desire to accommodate the growing demand for short-term credit, were reflected in a decline in Treasury bill rates from 5.47 to 3.91 per cent. The reductions may also have indicated official recognition that the pull of higher rates on foreign short-term capital was no longer needed now that an economic climate conducive to an inflow of longer term capital from abroad had been re-established.

The \$731 million reserve gain since midyear owes much of its strength to the return flow of short-term funds and to the revival of foreign investment in longer term Canadian securities. The reserve gain, in turn, has facilitated

¹ For a discussion of the first eight months of 1962, see "Recent Monetary Policy Measures in Western Europe", this *Review*, April 1962, pp. 64-66 and "Recent Monetary Policy Measures Abroad", this *Review*, September 1962, pp. 125-27.

**CHANGES IN FOREIGN CENTRAL BANK
DISCOUNT RATES**
In per cent

Date of change	Country	New rate	Amount of change
1962: January 9	Philippines	6	+3
January 18	Belgium	4½	-¼
March 8	United Kingdom	5½	-½
March 22	Belgium	4	-¼
March 22	United Kingdom	5	-½
March 30	Finland	8	+1¼
April 6	Sweden	4½	-½
April 25	Netherlands	4	+½
April 26	United Kingdom	4½	-½
April 28	Finland	7	-1
May 26	Rhodesia and Nyasaland	5	-½
June 8	Sweden	4	-½
June 13	South Africa	4	-½
June 24	Canada	6	•
August 9	Belgium	3¾	-¼
September 7	Canada	5½	-½
October 12	Canada	5	-½
October 27	Japan	6.935†	-0.365
October 29	Jamaica	5½	-½
November 13	Canada	4	-1
November 27	Japan	6.57†	-0.365
November 27	South Africa	3½	-½
December 6	Belgium	3½	-¼
1963: January 3	India	4½	+½
January 3	United Kingdom	4	-½
January 5	Rhodesia and Nyasaland	4½	-½
January 8	Netherlands	3½	-½

* From November 1956 through June 21, 1962, the discount rate of the Bank of Canada was set at ¼ per cent above the latest average tender rate for Treasury bills. The rate stood at 5.17 per cent on June 21, 1962.

† "Basic" rate for commercial bills.

the repayment of foreign credits obtained by Canada last June. By the end of December, the Bank of Canada had repaid the \$100 million assistance from the Bank of England and the \$250 million obtained through a swap with the Federal Reserve System.²

In Japan, the rise in official reserves since the tightening of credit in July 1961 has been large enough to permit a relaxation in monetary restraint. In view of the need for measures to relieve the continued sluggishness of the economy, the central bank reduced its basic discount rate on October 27 from 7.3 per cent to 6.935 per cent. It followed up a month later with a further cut to 6.57 per cent, the rate in effect prior to July 1961. The bank's other lending rates (except on export bills) were similarly reduced. In addition, the penalty rates applicable to borrowings from the Bank of Japan in excess of certain limits set for each commercial bank were reduced to their previous levels, and reserve requirements for the large banks were cut. In another move aimed at lessening the excessive dependence of the commercial banks on borrowing from the central bank, the latter broadened the scope for its open market operations. Henceforth, not only commercial paper but debt and equity securities of industrial firms and electric power companies, as well as bank debentures, will be eligible for pur-

² Canada and the Federal Reserve System still have a \$250 million stand-by agreement.

chases and sales by the central bank. This will give the Bank of Japan greater influence over the country's money supply, which until now has been regulated mainly by the Bank's lending policy.

The South African Reserve Bank on November 27 reduced its discount rate to 3½ per cent from 4, the third cut in a year. This was followed by reductions in the commercial banks' minimum overdraft rate and the rates paid on time deposits. These moves, which were facilitated by the continued improvement in the country's balance-of-payments position, reflected the authorities' recognition of the need for an expansionary monetary policy, particularly in view of the fact that the increase in general liquidity last year had failed to spark the desired rise in investment or consumption.

The Bank of England announced on November 29 that the remaining special deposits held with it by the commercial banks would be released. This move, together with the ending of the informal restraints on bank lending in October, apparently reflected a desire to overcome the recent sluggishness of bank credit expansion without exerting a downward influence on short-term rates that might jeopardize the country's external position. Subsequently, however, the continuing favorable balance-of-payments position also encouraged the Bank of England to lower its discount rate to 4 per cent from 4½. These steps coincided with a number of fiscal policy measures to stimulate activity, such as a cut in the purchase tax on cars, appliances, and cosmetics to 25 per cent from 45 per cent and significant tax concessions to encourage investment.

In the first discount rate reduction in four years, the Netherlands Bank on January 8 lowered its rate from 4 to 3½ per cent, thus aligning it with the rates in other Common Market countries. At the same time, the ceiling on commercial bank credit imposed in mid-1961 was removed. As in the United Kingdom, these measures were facilitated by the country's satisfactory balance of payments and by some lessening of pressures on the domestic economy.

The Italian authorities in late 1962 introduced a series of measures aimed both at increasing the liquidity of the banking system and at fostering the development of a short-term money market. As of November 1, Italian banks were no longer required to maintain a balanced position between short-term assets and liabilities denominated in convertible currencies.³ The new measure is designed to improve the

³ This reverses, at least temporarily, the policy inaugurated in August 1960 when the banks were instructed to achieve balance in their convertible-exchange position. That move had reduced the banks' liquidity and neutralized the inflationary effects of foreign exchange borrowed abroad. The banks, in fact, repaid such borrowing with convertible currencies obtained from the Italian Exchange Office in return for lire.

banks' liquidity by permitting them to increase their borrowing of foreign currencies. A further injection of liquidity will come from the government's decision to repay in cash, rather than roll over, the \$310 million equivalent of nine-year government bonds maturing in early 1963.

At the same time, a new system of issuing Treasury bills was adopted in Italy. The previous "tap" issue of bills in unlimited quantities and with maturities ranging from two to twelve months was abandoned; henceforth, twelve-month bills will be issued according to the Treasury's cash needs and offered once a month at auction—except for the amount needed to meet the banks' minimum reserve requirements,⁴ which will be sold at a fixed rate of 3.5 per cent. Apart from laying the groundwork for future open market operations by the Bank of Italy, this measure also is aimed at redirecting some funds into the capital

market, since Treasury bills will no longer be available in unlimited quantities at a fixed rate as in the past.

Finally, the authorities took steps to reduce the substantial amount of interbank deposits that had become a conspicuous feature of the Italian financial landscape. Heretofore, smaller banks had been accustomed to deposit with the larger banks excess funds that they could not conveniently place directly in the market. The larger banks in turn used these funds to buy Treasury bills or make other investments, and competition among large banks to attract such funds tended to raise short-term deposit rates. The maximum rate payable on interbank deposits henceforth cannot exceed the latest auction rate for Treasury bills; moreover, banks can be directed to place funds received from other banks in special six-month deposits with the Bank of Italy. The Italian authorities hope that, by checking the competition for interbank deposits, the new measure will lower short-term interest rates and redirect savings deposited with small banks toward longer term investments, both public and private.

⁴ Beginning in December, banks must hold at least 10 per cent of the total 22.5 per cent of required reserves in cash, as against the previous option of determining their own mix of cash and bills.

Monetary Policy and International Payments *

By WILLIAM MCCHESENEY MARTIN, JR.

Chairman, Board of Governors of the Federal Reserve System

The task of the Federal Reserve, like that of all parts of our Government, is (in the words of the Employment Act of 1946) "to foster and promote free competitive enterprise" as well as "to promote maximum employment, production, and purchasing power". These four purposes may well be summarized under the single heading of orderly and vigorous economic growth.

The Federal Reserve has recently been criticized for neglecting these goals in favor of another—the achievement of balance in our international payments. Other critics of the Federal Reserve, however, charge us with neglecting the international payments problem and with concentrating too much on domestic goals. Both criticisms overlook what seems to me an obvious fact, namely, that

our domestic and international objectives are inextricably interrelated. We simply do not have a choice of pursuing one to the virtual exclusion of the other. Both must be achieved together, or we risk achieving neither.

Thus, our domestic economic growth will be stimulated when our external payments problem is resolved. And our payments situation will be eased when the pace of our domestic growth has been accelerated. With more rapid growth, the United States will become more attractive to foreign and domestic investors, and this will improve our payments balance by reducing the large net outflow of investment funds.

In particular, accelerated growth will presumably lead to larger internal investment and credit demand, and so to some gradual rise in interest rates, not through the fiat of restrictive monetary policy, but through the influence of market forces. With rising credit demand pressing on the availability of credit and saving, the flow of funds from the United States to foreign money markets will be more

* Remarks at the joint luncheon of the American Economic Association and the American Finance Association, Pittsburgh, Pennsylvania, December 28, 1962.

limited. In addition, a closer alignment of interest rates internationally can be expected to result and this will help to reduce the risk of disturbing flows of volatile funds between major markets.

Similarly, the maintenance of reasonable stability in average prices, with progressive gains in productivity, is more than a basis for sustained domestic growth. It is also a necessary prerequisite for improving the international competitive position of our export industries and our industries competing with imports, and thus for increasing our trade surplus so that it can cover a larger part of our international commitments. This is not to deny that prices and costs of some of our individual industries may be out of line with those of foreign producers. There are doubtless industries where grievous competitive problems exist for international reasons, and in these cases a strong enterprise economy expects the necessary adjustments to be made through the efforts of such industries themselves.

Even if our country did not suffer from an international payments deficit, our Government would still have to pursue the twin goals of orderly and vigorous economic growth and over-all price stability. The payments deficit provides merely another circumstance that the Federal Reserve must consider if it is to make an effective contribution to the fulfilment of the goals set by the Employment Act.

INTERNATIONAL ROLE OF THE DOLLAR

In reaching our decisions on domestic monetary policy then, the Federal Reserve cannot ignore our international financial problems. There might be countries or times in which there could be enough leeway to do so. But the United States is not such a country and the present is not such a time.

The United States at present is the financial leader of the free world, and the United States dollar is the main international currency of the free world. As long as this leadership exists, we are obliged to keep our policies compatible with the maintenance of the existing international payments system.

The increase in the volume of world trade and finance since World War II has led to an unprecedented integration of the world economy. This economy has become ever more closely bound together by ties of trade, investment, communication, transport, science, and literature. Financially, the world economy has become coordinated by an international payments system in which the dollar serves both as a major monetary reserve asset and as the most important international means of payment. And the reliance that the world has come to place on the dollar

requires that the dollar be always convertible into all major currencies, without restriction and at stable rates, based on a fixed gold parity.

It is in the light of the special international role of the United States and its currency, and therefore of the responsibilities of the Federal Reserve, that a Federal Reserve concern with maintenance of our gold stock, our balance of payments, and stability of the dollar exchange rate must be understood.

Above all, we must always have in mind that the role of the dollar in the international payments system is founded upon freedom from exchange restrictions. Whatever temporary advantage might be gained for our payments deficit by controls over capital movement or other international transactions would be more than offset by the damage such controls would do to the use of the dollar internationally.

ROLE OF THE UNITED STATES GOLD STOCK

A persistent decline in our gold stock is harmful to the United States economy for two reasons: First, it endangers our international liquidity position, i.e., our continuing ability to convert on demand any amount of dollars held either by foreigners or by United States residents into any other currency they may need to settle international transactions. Second, because of our long-established domestic reserve requirements, a declining gold stock fosters uneasiness about a curtailed Federal Reserve flexibility to pursue domestic monetary policies otherwise regarded as appropriate and desirable.

Sometimes it is suggested that the decline in our gold stock could be avoided if we gave up our policy of selling gold freely to foreign monetary authorities for monetary or international settlement purposes. But a decline in our gold stock stems from the deficit in our international payments rather than from our gold policy.

A payments deficit initially means an accumulation of dollars in the hands of foreigners, as virtually all of their commercial or financial transactions with residents of the United States are settled in dollars. If foreign corporations or individuals choose not to hold dollars, they convert them into their own or into other foreign currencies; in either case, the dollars fall eventually into the hands of one foreign central bank or another.

If in turn the foreign central bank acquiring dollars chose not to enlarge its dollar holdings, and if it could not convert its dollar receipts into gold, it would present dollars to us for redemption into its own currency. Once United States holdings of that currency, including credit availabilities, were exhausted, we could acquire the cur-

rency only by selling gold. If the United States declined to sell gold in such circumstances, foreign private recipients of dollars could no longer count on converting dollars at par into their own or other foreign currencies.

Thus, a gold embargo would terminate the convertibility of the dollar at fixed values, not just into gold, but into any foreign currency. This would obviously be the end of the dollar as a currency that bankers, merchants, or investors could freely use to settle their international obligations.

Since there is a statutory linkage between gold and our domestic money supply, through the minimum gold certificate reserve requirements of the Federal Reserve Act, consideration must also be given to the effect of changes in the United States gold stock on the gold certificate reserve ratio of the Federal Reserve Banks. At present, this ratio still exceeds the required minimum of 25 per cent both against Federal Reserve Bank deposits and against Federal Reserve notes. Should it fall below that minimum, the Board of Governors would have full authority to suspend the Reserve Bank gold certificate reserve requirements.

Some interest has been expressed in the mechanics of suspending these requirements. Let me summarize them at this point in briefest form. Upon action to suspend requirements, the Board of Governors would have to establish a tax on the Reserve Banks graduated upward with the size of their reserve deficiencies. The tax could be very small for as long as the reserve deficiencies were confined to the reserves against deposits and the first 5 percentage points of any deficiencies against Federal Reserve notes. If the reserve deficiencies should penetrate below 20 per cent of Federal Reserve notes outstanding, the tax would undergo a fairly steep graduation in accordance with statutory specifications.

The Federal Reserve Act further specifies that, should the reserve deficiencies fall below the 25 per cent requirement against notes, the amount of the tax must be added to Reserve Bank discount rates. But, if the reserve deficiencies were confined to reserves against Reserve Bank deposits, the required penalty tax could be nominal and no addition to Reserve Bank discount rates would be necessary.

It is perhaps easier to talk about this subject just now when the gold stock has shown no change for two months. But our progress this year in rectifying our international payments disequilibrium has fallen short of our target, in part because of a rise in our imports of \$1½ billion. Hence, we must now intensify our efforts to re-establish payments balance. And until we have regained equilibrium, we shall have to be prepared to settle some part of any deficits experienced through sales of gold.

Nevertheless, any decline in our gold stock large enough to bring its level significantly below the gold certificate reserve requirement of the Federal Reserve could raise further questions about maintenance of dollar convertibility. And it could also lead to heavy pressures on the United States monetary authorities to take strong deflationary action that might be adverse to the domestic economy or, alternatively, to pressures on Congress to devalue the dollar, a subject to which I return later. It is of utmost importance, therefore, to shorten as much as possible the period in which further large decline in our gold stock will occur and to hasten the arrival of a period in which our gold stock may from time to time increase.

The point I should like most to emphasize here is the following: No question exists or can arise as to whether we shall pay for the debts or liabilities we have incurred in the form of foreign dollar holdings, for that we most certainly must do—down through the last bar of gold, if that be necessary. What is in question is how we best manage our affairs so that we shall not incur debts or liabilities that we could not pay.

BALANCE OF PAYMENTS

To maintain the credit-worthiness of the United States, to support confidence in the dollar, to check the decline in our gold stock, to bring our international payments and receipts into balance without interfering with the convertibility of the dollar—these objectives are all synonymous one with another. We in the Federal Reserve are concerned about the balance of payments because it is vital that the full faith and credit of the United States not be questioned.

Our international payments deficit this year was less than ½ of 1 per cent of our gross national product. That deficit did not represent a decline in our international wealth because the rise in our foreign assets exceeded the drop in our net monetary reserves. Yet the deficit was of vital concern in that it extended by one more a series of large deficits, a series that has now persisted for five years.

A payments deficit means either a decline in United States gold or foreign exchange reserves, or an increase in United States short-term liabilities to foreigners. In either case, it worsens the ratio of reserves to liabilities; in other words, it weakens the nation's international liquidity position.

The United States, as the free world's leading international banker, can fulfill its role only if it keeps the confidence of its depositors. No banker can suffer a continuous decline in his cash-deposit ratio without courting danger of a run.

The best method to combat a payments deficit is to improve the competitive position of our export industries and our industries competing with imports. This method can be effective only in the long run, but in the long run it is bound to be effective. And its accomplishment will have an expansive rather than contractive influence on our domestic economy as a whole.

DOLLAR EXCHANGE RATE

Some economists have argued forcefully that as a general principle a country, suffering at the same time from external deficit and from domestic unemployment, should devalue its currency, either by a shift to a floating rate or by a change in its gold parity. But if there ever is any merit to that argument, say in the case of countries whose currencies are not extensively used in international transactions, it is not applicable to the United States. This is so because the United States, as the world's leading banker, is responsible for a large part of the monetary reserves of foreign countries and for the great bulk of the international working balances of foreign bankers, traders, and investors. We have accepted these balances in good faith and, as I said earlier, we must stand behind them.

Whatever other consequences would follow from a devaluation of the dollar, I am convinced that it would immediately spell the end of the dollar as an international currency and the beginning of a retreat from the present world role of the United States that would produce far-reaching political as well as economic effects. It would, in my judgment, invite the disintegration of existing relationships among the free nations that are essential for the maintenance and extension of world prosperity and even world peace.

It has sometimes been suggested that we could maintain the dollar as an international currency simply by giving a gold value guarantee to some or all foreign holders of liquid dollar assets. At first glance, it might seem a good idea for a foreign central bank or a foreign investor to own an asset that would be not only as good as, but actually better than, gold: a kind of interest-bearing gold. But I do not think that the suggestion for a gold value guarantee is realistic.

First, if foreign holders of dollars did not trust our repeated assurance that we would not devalue the dollar, they would hardly trust our assurance that, if we devalued the dollar contrary to our previous assurance, we would do it in such a way that some or all foreign holders would be treated better than domestic holders.

Second, I do not think it would be possible to limit effectively a gold value guarantee to the dollars held by

some or all foreign holders; and, if it were possible to make an effective distinction between foreign and domestic holders, this would amount to unjustified discrimination against domestic holders. In my judgment, neither Congress nor public opinion would tolerate any such discrimination.

In spite of our international payments deficit, the United States has refrained from drastically cutting Government expenditures abroad for defense or for economic aid, and from curtailing the freedom of capital movements. To have done otherwise would have undermined our position of economic and political leadership of the free world. So would any failure on our part to maintain the established par value of the dollar.

ROLE OF THE FEDERAL RESERVE

Within the limitations set by the international role of the dollar, what can the Federal Reserve do to achieve its domestic policy goals together with contributing to the achievement of international balance?

My friends sometimes accuse me of being a chronic optimist. But I believe that we can find ways of furthering our domestic economic aims while, at the same time, we are making progress in overcoming our payments problem internationally. And I believe that these ways will contribute better to sustainable economic growth than would flooding the economy with money.

Indeed, my present feeling is that the domestic liquidity of our banks and our economy in general is now so high that still further monetary stimulus would do little if any good—and might do actual harm—even if we did not have to consider our payments situation at all. This means that, if any additional governmental action is needed in the financial field in order to give fresh expansive impulse to the economy, it would probably have to come from the fiscal side. The part played by monetary policy, from both an internal and an external point of view, would then be mainly supplementary and defensive.

In this context, monetary policy would have to be on guard against two dangers: first, the danger that too rapid domestic monetary expansion would eventually produce rising domestic costs and prices as well as unwise speculation and in this way curtail exports and overstimulate imports; and, second, the danger that too easy domestic credit availability and too low borrowing costs would encourage capital outflows.

For the past few years, monetary policy has already contributed to the needed stability of the domestic price level, while prices in some other important industrial nations have been under steady upward pressure. In specific terms, Federal Reserve policy has been seeking to main-

tain a condition of credit availability that would be adequate for domestic needs while avoiding any serious deterioration of credit standards or any widespread speculative reliance on credit financing and at the same time limiting the spillover of credit funds—short term and long term—into foreign markets.

Nevertheless, our monetary policy has remained easier through this economic cycle than during previous cycles because that has seemed to be needed in a domestic situation of lagging longer term growth and a less-than-robust cyclical expansion. In balancing the scope and the limitations of our monetary policy, however, I am convinced that, within limits imposed by human imperfection, the Federal Reserve has paid neither too much nor too little attention to our international payments problem.

As I mentioned at the outset, criticism of our policy through this economic cycle has been about equally divided between two groups. The first complains that we have violated the classical principle of an international payments standard based on fixed exchange rates by failing to contract our money supply in the wake of a decline in our gold reserves. The second complains that we have neglected our duties to the domestic economy by permitting the decline in our monetary reserves to have some impact on our money markets, especially on short-term interest rates.

If all criticism had come from one side only, I would still believe it unjustified. But the very fact that criticism comes from both sides inclines me even more strongly to the comforting thought that we have been keeping to the golden mean.

FOREIGN CURRENCY OPERATIONS

The Federal Reserve has not been content to limit its participation in solving the country's payments problem to its traditional tools of monetary policy. It has felt a particular need to set up defenses against speculative attacks on the dollar pending an orderly correction of our payments disequilibrium. And it has felt a more general need to cooperate directly with foreign central banks in efforts to reinforce the international payments structure. Recognition of these needs underlies the decision that we took just a year ago to participate on Federal Reserve account in foreign currency operations.

Since the Treasury also engages in similar operations, Federal Reserve activities have had to be, and will continue to be, conducted in cooperation with those of the Treasury. Smooth coordination has been facilitated by the fact that the instructions of both agencies are carried out through the same staff members of the Federal Reserve

Bank of New York, headed by Mr. Charles A. Coombs, Vice President in charge of the Foreign Department of that Bank and Special Manager for Foreign Currency Operations of the Federal Open Market Committee. At the same time, both the Board of Governors and the Federal Reserve Bank of New York have endeavored to maintain close contact with the central banks of foreign countries, bilaterally as well as through regular meetings of the Organization for Economic Cooperation and Development in Paris and the Bank for International Settlements in Basle.

The most important foreign currency activity of the System thus far has been the conclusion of reciprocal currency arrangements with leading foreign central banks and the Bank for International Settlements. Under these arrangements, the System acquires, or reaches agreement that it can acquire on call, specified amounts of foreign currencies against a resale contract, usually for three months. Concurrently, the foreign central bank acquires, or can acquire on call, an equivalent amount of dollars under resale contract for the same period.

In these contracts, both parties are protected during the active period of a swap arrangement against loss in terms of its own currency from any devaluation or revaluation of the other party's currency. These arrangements, of course, are subject to extension or renewal by agreement. Interest rates paid on the deposit or investment of funds acquired through swaps are set at equal levels for both parties, in the neighborhood of the current rate for United States Treasury bills, so that, as long as neither party utilizes any of its currency holdings, there is no gain or loss of income for either.

So far, agreements have involved a total approximating \$1 billion. For the most part, they are stand-by arrangements. Only a small fraction of actual currency drawings has been utilized for market operations. And a large part of amounts so utilized has been reacquired, and used for repayment of the swap drawings.

In entering into swap arrangements, the Federal Reserve has had three needs in view. First, in the short run, swap arrangements can provide the System with foreign exchange that can be sold in the market to counter speculative attacks on the dollar or to cushion market disturbances that threaten to become disorderly.

Second, swap arrangements can provide the Federal Reserve with resources for avoiding undesired changes in our gold stock that may result when foreign central banks accumulate dollars in excess of the amounts they wish to hold, especially if these accumulations seem likely to reverse themselves in a foreseeable period.

Third, when the United States balance of payments has returned to equilibrium, swap arrangements with other

central banks may be mutually advantageous as a supplement to outright foreign currency holdings in furthering a longer run increase in world liquidity, should this be needed to accommodate future expansion of the volume of world trade and finance.

CONCLUDING REMARKS

As long as the United States balance of payments is in over-all deficit, and we are therefore losing rather than gaining monetary reserves, on balance, the Federal Reserve cannot expect to accumulate outright large amounts of foreign exchange. Meanwhile, System holdings of foreign currencies will necessarily be limited to relatively small amounts, swollen on occasion by swaps.

But over the longer run, the System may find it useful to increase gradually its foreign currency holdings and

operations. This development could be modified, of course, by further changes in the institutional framework of our international payments system. For this reason, the Board's staff, in cooperation with the staffs of the Treasury and other interested agencies of the Government, is carefully scrutinizing the various recent proposals designed to adapt, strengthen, or reform this framework.

Whatever the fate of these reform proposals, it seems likely that Federal Reserve operations in the international field will need to be continued for the foreseeable future. The Federal Reserve's involvement in foreign exchange problems is the inevitable consequence of its role as the central bank responsible for the stability of the world's leading currency. Such a responsibility necessarily carries with it the responsibility for helping to preserve and improve the existing international monetary system, thus to contribute to the stability and prosperity of the free world.

Publications of the Federal Reserve Bank of New York

The following publications are available free (except where a charge is indicated) from the Public Information Department, Federal Reserve Bank of New York, New York 45, N. Y. Copies of charge publications are available at half price to educational institutions.

DOMESTIC MONETARY ECONOMICS

1. **MONEY: MASTER OR SERVANT?** (1954) by Thomas O. Waage. A 48-page booklet explaining in nontechnical language the role of money and banking in our economy. Includes a description of the structure of our money economy, tells how money is created, and how the Federal Reserve System influences the cost, supply, and availability of credit, as it seeks to encourage balanced economic growth at high levels of employment.

2. **THE MONEY SIDE OF "THE STREET"** (1959) by Carl H. Madden. A 104-page booklet giving a layman's account of the workings of the New York money market and seeking to convey an understanding of the functions and usefulness of the short-term wholesale money market and of its role in the operations of the Federal Reserve. 70 cents per copy.

3. **FEDERAL RESERVE OPERATIONS IN THE MONEY AND GOVERNMENT SECURITIES MARKETS** (1956) by Robert V. Roosa. A 105-page booklet describing how Federal Reserve operations are conducted through the Trading Desk in execution of the directions of the Federal Open Market Committee. Discusses the interrelation of short-term technical and long-range policy factors in day-to-day operations. Has sections on the role of the national money market, its instruments and institutions, trading procedures in the Government securities market, what the Trading Desk does, the use of projections and the "feel" of the market, and operating liaison with the Federal Open Market Committee.

4. **OPEN MARKET OPERATIONS** (1963) by Paul Meek. A 43-page booklet describing for the interested layman or undergraduate student how open market operations in United States Government securities are used to cope with monetary stresses and promote a healthy economy.

5. **DEPOSIT VELOCITY AND ITS SIGNIFICANCE** (1959) by George Garvy. An 88-page booklet discussing the behavior of deposit velocity, over the business cycle and over long periods, with emphasis on the institutional and structural forces determining its behavior. 60 cents per copy.

INTERNATIONAL ECONOMICS

6. **THE QUEST FOR BALANCE IN THE INTERNATIONAL PAYMENTS SYSTEM** (Reprinted from *Annual Report 1961*, Federal Reserve Bank of New York.) A 17-page article reviewing steps taken to strengthen the international financial system, the matter of dealing with basic payments difficulties, and the continuing task of achieving financial stability and economic balance.

7. **THE NEW YORK FOREIGN EXCHANGE MARKET** (1959) by Alan R. Holmes. A 56-page booklet primarily concerned with a description of the New York foreign exchange market as it exists today. Includes material on forward exchange and interest arbitrage. 50 cents per copy.

8. **FOREIGN CENTRAL BANKING: THE INSTRUMENTS OF MONETARY POLICY** (1957) by Peter G. Fousek. A 116-page booklet describing the development of central banking techniques abroad during the postwar period. Includes discussions on discount policy, open market operations, reserve requirements, liquidity ratios, and selective and direct credit controls. The final chapter describes foreign money markets, and outlines many of the measures taken in various foreign countries since the end of World War II to broaden these markets.

9. **MONETARY POLICY UNDER THE INTERNATIONAL GOLD STANDARD, 1880-1914** (1959) by Arthur I. Bloomfield. A 62-page booklet analyzing in the light of current monetary and banking theory, the performance and policies of central banks within the framework of the pre-1914 gold standard. 50 cents per copy.