FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

JUNE 1963

Contents

Volume 45 No. 6

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Certificates of Deposit*

During the past two years the financial community has witnessed the extraordinary growth of a new money market instrument: the negotiable time certificate of deposit. While certificates of deposit existed for many years prior to 1961, they were offered only on a relatively small scale. Indeed, many commercial banks were unwilling to issue certificates to corporate customers or, in fact, to accept time deposits in any form from corporations. The early certificates did achieve some importance in areas where they were aggressively offered, but they failed to acquire national significance. They were often non-negotiable, either by written notice on the face of the instrument or by tacit understanding between the issuing bank and its customer. Even if they were negotiable, transfers of these early certificates were severely limited by the lack of a secondary market.

In February 1961, however, a large New York City commercial bank announced that it would offer negotiable certificates of deposit to both its noncorporate and corporate customers. At the same time, a Government securities dealer indicated that he would maintain a secondary or trading market for these new instruments. Shortly thereafter, many other commercial banks throughout the country began to bid for time deposits by offering negotiable certificates of deposit to corporate and other customers. At the same time, other Government securities dealers began to participate in the secondary market. The two years since 1961, in which the growth of corporate cash flows outstripped the pace of business expansion, have provided a favorable atmosphere for the growth of the new instrument. By December of last year the volume of time certificates of deposit outstanding totaled more than $6 billion, of which about two thirds represented corporate deposits (see tables on the following pages).[1] More recently, some estimates have put the total outstanding at about $8 billion.

THE OFFERING OF CERTIFICATES AND REGULATION Q

Certificates were offered primarily in order to enlarge the issuing bank's lending power. The availability of reserves for the banking system as a whole is of course essentially determined by Federal Reserve policy. The individual banker could anticipate, however, that the offering of certificates would enlarge his share of total reserves by attracting a larger share of total deposits.

The offer of certificates also represented an attempt to increase the stability of deposits. Deposit totals had been increasingly subject to wide fluctuations as bank customers, especially corporate treasurers, became more adept in the methods of "scientific" cash management. Bankers felt that the money market character of the new certificates would enable them to compete for the interest-sensitive funds that corporations, state and local governments, and other public bodies were putting into the short-term securities markets. The time deposit funds thus acquired would become available for bank use during the life of the certificate, thereby providing a relatively stable pool of funds which would safely permit the extension of loan and investment maturities. This relative stability would be enhanced in cases where maturing certificates were rolled over into new certificates.

Such results, however, were by no means assured. The maximum interest rates payable to domestic depositors under Regulation Q of the Board of Governors of the Federal Reserve System posed the threat that the demand for new certificates would fade if money market rates approached the "ceilings". In such circumstances, outstanding certificates would be redeemed at maturity as depositors sought more attractive rates elsewhere. During 1961, therefore, bankers approached the issuance of certificates cautiously, and often limited the amount they were willing to create. Toward the end of that year, three-month Treasury bill rates edged upward and exceeded the 2½ per cent ceiling in effect for three- to six-month time deposits. As a result, commercial banks could no longer offer certificates of these maturities at competitive rates. (The 1 per cent ceiling on 30- to 89-day time deposits has effectively forestalled the issuance of certificates

* Richard C. Fieldhouse had primary responsibility for the preparation of this article. For a further discussion, see his *Certificates of Deposit,* Bankers Publishing Company, Boston, 1962.

[1] Results of a special Federal Reserve survey of 410 member banks were reported in the April 1963 *Federal Reserve Bulletin,* pp. 458-68.

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Table I

CERTIFICATES OF DEPOSIT OUTSTANDING ON SELECTED DATES, BY DENOMINATION

In millions of dollars

Denomination	Total certificates outstanding	Distribution by total deposits of issuing banks				Distribution by issuing banks' volume of certificates outstanding		
		Under $100 million	$100-$500 million	$500-$1,000 million	$1,000 million and over	Under $10 million	$10-$50 million	$50 million and over
December 5, 1962								
All denominations	6,181	296	1,400	1,744	2,742	839	1,336	4,005
Denominations of:								
$500,000 and over	4,606	69	832	1,225	2,480	326	844	3,435
$100,000 to $500,000	978	94	321	352	211	240	309	429
Less than $100,000	597	133	247	167	51	273	183	141
December 30, 1961								
All denominations	3,223	151	690	804	1,578	430	710	2,083
Denominations of:								
$500,000 and over	2,156	25	354	449	1,329	144	400	1,613
$100,000 to $500,000	614	57	205	234	117	151	193	270
Less than $100,000	330	67	127	121	15	134	113	83
December 31, 1960								
All denominations	1,095	139	366	477	114	306	329	461
Denominations of:								
$500,000 and over	450	28	156	235	31	85	137	228
$100,000 to $500,000	328	49	118	138	23	107	99	122
Less than $100,000	265	61	92	104	8	111	93	60

Source: Board of Governors of the Federal Reserve System. For 1960 and 1961, the totals reported for denominational ranges are smaller than over-all totals, because some banks were unable to provide a breakdown for these years.

of this term at any time in recent years.) Only the six months' or longer certificate, on which a 3 per cent maximum rate applied, remained competitive. Even in this maturity category, certificates began to lose their investment appeal as rates on six-month Treasury bills approached 3 per cent. Banks faced the prospect of losing the sizable time deposits that they had built up through the issuance of negotiable certificates.

On January 1, 1962, the schedule of maximum rates under Regulation Q was raised. The ceiling for six-month time deposits was raised from 3 to 3½ per cent, and a 4 per cent ceiling was placed on a new maturity category of twelve months or longer. Rates for 30- to 89-day and 90-day to six-month deposits were left unchanged at 1 and 2½ per cent, respectively. These new ceilings have permitted commercial banks to issue six months' or longer certificates at competitive rates, but not shorter certificates. The possibility remains, of course, that ceiling rates under Regulation Q may at some point again limit the banks' ability to attract, or retain, interest-sensitive money.

NEW CERTIFICATES

Certificates of deposit are designed to compete for funds that have already found, or are seeking, employment in the short-term securities markets. For this reason, bankers are reluctant to issue certificates if there is reason to believe that the customer plans to draw down his demand balances below "normal" levels in order to purchase a certificate. There is, of course, no desire to pay interest for funds that ordinarily would be held as noninterest-bearing demand deposits. Most banks, to avoid such competition with normal balances, have set minimum limits to the size of the individual certificates they will issue.[2] These limits are frequently related to bank size. As bankers to national corporations and other large organizations, the money market banks generally issue certificates in denominations no smaller than $0.5 million or $1.0 million. Smaller banks issue certificates for $100,000 or less. It is felt that these relatively high dollar limits discourage large-scale shifts out of demand balances. Any funds available in these amounts, over and above the customer's operating requirements, probably

[2] Upper limits to individual certificate denominations are a matter of concern only to relatively small banks. These banks are often unwilling to issue large certificates, for they believe that by doing so their deposit totals might become subject to the decisions of a few customers who may not wish to renew maturing certificates. For the large money market banks, in contrast, even very sizable certificates are not likely to exert an important influence on deposit totals.

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have already found employment in the short-term securities markets.

The deposit of time funds at commercial banks is guided both by interest rate considerations and by bank-customer relationships. Many corporations prefer to place funds only with banks at which they maintain working balances or important credit lines. Within this framework of bank-customer relationships, these firms put their funds with the banks offering the highest certificate rates.[3] Some corporations, in addition to setting a limit on their over-all certificate holdings, have set limits to their holdings of certificates of individual banks. These limits are often directly related to the importance of each bank within the pattern of the corporation's over-all banking relationships. Such corporate guidelines apply not only to new certificates acquired by the placement of time deposits, but also to the purchase of certificates in the secondary market. On the other hand, some corporations are guided almost entirely by interest rate considerations in their placement of time funds. They may go rather far afield to locate banks offering the highest certificate rates.[4] These differing approaches to the placement of time funds seem to be related to the preferences of individual investment officers rather than to the nature of the corporation itself.

The frequent preference for the certificates of banks with which "important" account relationships exist has tended to create two classes of certificates: "prime" and "nonprime". These designations do not necessarily imply evaluations of bank soundness, but generally are appraisals of the relative marketability of bank certificates. Prime certificates are those that many large corporations purchase for their certificate portfolios; they are issued by large, nationally known banks, commonly called prime-name banks. Since a relatively large number of the most active participants in the certificate market are authorized by their investment committees to buy these certificates, such instruments can be sold and resold in the market more quickly than those of less well-known or nonprime name banks. Many observers recognize degrees within the prime category itself; some prime certificates are "more prime" than others, i.e., more readily marketable.

The lesser marketability of nonprime certificates is reflected both in the interest rates at which they are originally issued and in the rates at which they trade in the secondary market. Smaller commercial banks are obliged to offer certificates at rates generally ⅛ to ½ of 1 per cent higher than those offered by prime money market banks. In the secondary market, nonprime certificates are usually traded at rates from 5 to 25 basis points (1/20 to ¼ of 1 per cent) above rates on prime certificates of comparable maturity. This spread may be larger if the denomination of the certificate is less than $1 million, since the large corporations active in the secondary market usually avoid small denominations unless interest rates provide an incentive for their purchase. The certificates of many strictly regional banks, though negotiable, are essentially nonmarketable. Unless they carry unusually high coupon rates, they are not likely to enter the secondary market, since dealers have no desire to acquire instruments for which there is only limited likelihood of resale. Normally, therefore, such certificates must be held until maturity.

Market rates for prime certificates are often about ¼ of 1 per cent higher than rates for Treasury bills of comparable maturity.[5] Spreads between prime and nonprime certificates and, more generally, between certificates and Treasury bills vary from time to time, chiefly in response to changing appraisals of the outlook for short-term interest rates. These spreads tend to narrow when a trend toward lower interest rates (higher prices) is anticipated. At such times, market participants feel more assured of the relative marketability of higher yielding (though less liquid) instruments—e.g. certificates as compared with Treasury bills. Accordingly, they bid actively for these higher yielding instruments in order to maximize income and with an eye to their greater potential for future rate profits. When higher interest rates (lower prices) are expected, instruments providing a lesser degree of liquidity become relatively less attractive and spreads tend to widen.

THE SECONDARY MARKET

The secondary market for certificates has expanded as the volume of outstanding certificates has mounted. Today most Government securities dealers make markets

[3] There is no evidence that large corporations expect favored rates from their banks of account when these banks are not actively seeking time deposit funds.

[4] Occasionally, a bank aggressively seeks time deposit funds outside its normal sphere of customer contacts by offering its certificates, both directly and through brokers, at particularly attractive rates. The deposits thus gained will in all likelihood be withdrawn at the maturity of the certificate if issuing rates for new certificates are lowered or permitted to become less competitive, compared with other short-term rates. This very aggressive offering of certificates has been an important source of deposits to the relatively few banks that have pursued this technique.

[5] Certificates of deposit are issued and traded on a yield-to-maturity basis while Treasury bills are issued and traded at a rate of discount from face amount. The rate-of-discount basis understates the actual investment return of Treasury bills. Hence, comparisons of market rates overstate the actual yield differential between Treasury bills and certificates.

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in certificates. While only fragmentary statistical information on the secondary market is available, it is likely that dealers' inventories of certificates have ranged between $100 million and $500 million during the past few months, with an average level probably between $200 million and $250 million. The daily volume of certificate trading by dealers has varied widely, probably ranging on most days between $15 million and $75 million, with an average of perhaps $20 million to $30 million. This compares with inventories of United States Government obligations maturing within one year (largely Treasury bills) which range between $2.7 billion and $4.0 billion, with daily trading volume typically ranging between $1.1 billion and $1.8 billion during the fourth quarter of 1962.

Despite its moderate size, the certificate market is broad enough to assure certificates a considerable degree of liquidity, especially if they are prime or nearly prime. Most corporations with certificate holdings apparently view them as a source of secondary liquidity, and rely on their holdings of short-term Treasury securities to provide funds for emergency needs. Day-to-day adjustments between cash and short-term investments are likely to be conducted in the Treasury securities market, either through outright purchase or sale or via repurchase arrangements with United States Government securities dealers. In these circumstances, certificates need not be sold until it is convenient to do so. In fact, many corporations hold their certificates until maturity and rarely, if ever, enter the secondary market; it is enough to know that the certificates can be sold if necessary. (Other firms, for reasons to be described shortly, are much more active in the certificate market.) Of course, the liquidity of time certificates has not been tested in a period of marked decline in general liquidity and rising interest rates, when perhaps many holders would be seeking to reduce their certificate commitments.

Dealers' spreads in certificate trading (the difference between bid and offered rates) recently have been about 3 to 5 basis points, which amounts to $75-$125 per million dollars for a 90-day maturity. By comparison Treasury bill trading spreads usually range between 1 and 3 basis points. Certificate trading spreads have less bearing on dealer profits if the certificate has been part of the dealer's inventory for a number of days or weeks. In these cases, trading profits—as for other instruments—are increasingly related to interest accruals, financing costs, and any movement of short-term interest rates.

Dealers not only maintain a spread in favor of certificates, compared with Treasury bills, but also take into account the rates at which banks are currently issuing new certificates. For example, if prime-name banks are offering six-month certificates at 3⅛ per cent (i.e., 3.125 per cent), a dealer may not wish to bid lower in rate than 3.20 per cent for a certificate of this maturity. His bid must be high enough above bank-issuing rates to permit him to offer the certificate at a rate (sale price)—in this example, probably about 3.15 per cent—that would provide him with a trading profit.

Table II

CERTIFICATES OF DEPOSIT OF $100,000 AND OVER OUTSTANDING ON DECEMBER 5, 1962, BY CATEGORY OF ORIGINAL PURCHASER

In millions of dollars and in per cent of total

Purchaser	Total certificates outstanding		Distribution by total deposits of issuing banks								Distribution by issuing banks' volume of certificates outstanding					
			Under $100 million		$100-$500 million		$500-$1,000 million		$1,000 million and over		Under $10 million		$10-$50 million		$50 million and over	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
All purchasers	5,584	100	163	100	1,153	100	1,577	100	2,691	100	566	100	1,153	100	3,864	100
Corporate and other businesses	3,851	69.0	78	47.9	690	59.8	963	61.1	2,121	78.8	309	54.6	699	60.6	2,842	73.6
Individuals	143	2.6	11	6.7	54	4.7	48	3.0	30	1.1	32	5.7	35	3.0	76	2.0
States and political subdivisions	867	15.5	65	39.9	303	26.3	350	22.2	149	5.5	174	30.7	321	27.8	372	9.6
Foreign governments, central banks, international financial institutions	348	6.2	—	—	25	2.2	42	2.7	283	10.5	17	3.0	38	3.3	294	7.6
Other foreign	41	0.7	—	—	7	0.6	5	0.3	29	1.1	3	0.5	9	0.8	30	0.8
All other	335	6.0	9	5.5	75	6.5	169	10.7	82	3.0	31	5.5	52	4.5	252	6.5

Source: Board of Governors of the Federal Reserve System.

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Table III

CERTIFICATES OF DEPOSIT OF $100,000 AND OVER OUTSTANDING ON DECEMBER 5, 1962, BY MATURITY

In millions of dollars

Maturity	Total certificates outstanding	Distribution by total deposits of issuing banks				Distribution by issuing banks' volume of certificates outstanding		
		Under $100 million	$100-$500 million	$500-$1,000 million	$1,000 million and over	Under $10 million	$10-$50 million	$50 million and over
All maturities	5,584	163	1,153	1,577	2,691	566	1,153	3,864
Over one year	540	24	86	144	286	56	87	397
One year	1,304	54	372	477	402	187	341	776
Nine months to one year	931	10	65	133	723	33	81	818
Six to nine months	2,637	67	564	769	1,238	258	576	1,804
Less than six months	175	10	67	55	43	33	71	71

Source: Board of Governors of the Federal Reserve System.

The secondary market has performed an important function in providing certificates of less than six months' maturity to those organizations that prefer to hold only very short-term instruments. Since the maximum rates set under Regulation Q have effectively prevented banks from issuing short-term certificates, the market has provided the only means whereby investors can acquire short-term certificates at attractive rates. Buyers of such certificates in the secondary market may form the nucleus of a ready demand for certificates with original maturities of less than six months, if banks should again be able to offer such certificates at rates which are attractive, relative to other short-term instruments.

Some corporations, in fact, have made a practice of acquiring certificates maturing in six months or more, in order to take advantage of profit potentials that may develop when, with the passage of time, the certificates become due in less than six months. These corporations will offer their certificates for sale at lower rates (higher prices) than those at which they were acquired, thus establishing a profit over and above the interest earned during the period the certificates were held. The 2½ per cent maximum issue rate for 90-day to six-month certificates in effect provides a floor for rates of this maturity in the secondary market. Market rates have been sufficiently above this floor to permit considerable leeway for the establishment of rate profits. Corporations that employ this technique assume, of course, the risk that market rates may not move as expected. Those who favor this means of increasing their investment return usually obtain six-month certificates with attractive maturity dates, such as a tax or dividend date. Some dealers have purchased certificates that they originally prompted their customers to acquire; in this way, the dealer can acquire certificates in the volume he desires, in order to establish rate profits as described above. (Many banks, including the large money market banks, will not issue certificates to securities dealers.) This technique for increasing the effective return on certificate holdings enables banks to tap, at one step removed, the short-term funds for which they cannot compete directly, because of the ceiling rates prescribed by Regulation Q.

CONCLUDING COMMENTS

The successful offering of certificates of deposit has demonstrated that commercial banks can effectively compete for interest-sensitive funds, particularly those of corporations. It has also contributed importantly to the shift in deposit structure toward a heavier proportion of time deposits, which has tended to permit the extension of bank loan and investment maturities. As long as market interest rates remain below the Regulation Q ceilings, certificates are likely to experience further growth and to play an increasingly important role in providing funds for investing and lending purposes. If the issuance of new certificates were curtailed for any reason, the volume of certificates would decline, but only as outstanding certificates mature and are not replaced. The drain on deposits would thus be spread over a period of months. Banks experiencing this net certificate reduction would, of course, have to remain alert to the liquidity pressures that might be occasioned by these deposit withdrawals.

Certificates have also had an influence on the cost

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structure of the banking industry. Interest expenses have mounted as a result of both the enlarged volume of time and savings deposits and the higher rates paid on such deposits. In their annual reports to stockholders for 1962, many commercial banks pointed to higher deposit-interest costs as a significant factor contributing to higher bank expenses during the year. Certificate interest expenses, per deposit dollar, probably have been lower than those of savings deposits, since certificate rates, partly reflecting the value of the instrument's negotiability, are often lower than the rates paid for savings deposits. Certificate rates are also more flexible than those on savings deposits. They may be raised or lowered in response to money market rates and, most importantly, in response to the individual bank's desire for time deposit funds; by contrast, interest rates for savings deposits tend to be relatively inflexible. While certificate rates may demonstrate upward flexibility during a period of rising money rates, this trend probably will be resisted if deposit costs mount more quickly than the return on the bank use of these funds. Certificates can be offered aggressively when it is profitable to do so, and less eagerly when profitability declines. In the latter circumstances banks might permit issuing rates for new certificates to become noncompetitive, relative to other money market rates.

In addition to their implications for the operations of commercial banks themselves, certificates have exerted an influence on interest rates. By absorbing funds that otherwise would probably have entered the markets for other short-term instruments, they have exerted an upward pressure on short-term interest rates, thereby contributing to Treasury and Federal Reserve efforts to maintain these rates and to reduce incentives for short-term investments abroad.

The Business Situation

The pickup in the strength of the domestic economy that began in the first quarter has carried over into spring. Retail sales were maintained at a record level in April, and such other monthly measures as industrial production, nonfarm employment, personal income, housing starts, and new orders for durable goods all continued strongly upward. To be sure, a significant portion of the April gains in production and orders was attributable to the special situation in the steel industry. It is noteworthy, however, that there were also widespread increases in industries other than steel. For May, the data at hand point to gains in automobile assemblies and a continued high level of steel ingot production. Retail sales apparently declined, but the latest survey of consumer buying intentions—according to which plans to purchase new cars and household durables within six months were appreciably above the advanced January level—suggests some strengthening in the consumer sector in the months ahead.

While the available evidence would thus seem to indicate that the economy has gained renewed momentum, aggregate activity continues to run well below capacity levels. Indeed, few forecasts for 1963 envisage that the rate of unemployment will be materially reduced over the balance of the year. The unemployment problem is, of course, likely to become more troublesome in the weeks ahead, since the number of teenagers leaving their classrooms to enter the labor market at the end of the current school year will probably be significantly larger than in the past.

CONTINUED GAINS IN PRODUCTION AND EMPLOYMENT

The Federal Reserve's index of industrial production moved up by nearly 2 percentage points in April and thus registered its largest increase in almost two years. This latest gain represented the third consecutive month of advance and brought output to 122.4 per cent of the 1957-59 average (see Chart I). About a third of the over-all April increase was attributable to a continued sharp rise in steel production, reflecting efforts to build up steel inventories as a strike hedge as well as some step-up in the rate of steel consumption. Resumption of publication of New York City and Cleveland newspapers, by contributing to the rise in the printing and publishing component of the index, was an additional factor in the over-all production gain. Even apart from such special factors, however, output in most industries registered rather sizable increases.

Fragmentary data on production in May suggest continued gains. Thus, although a strike-caused automobile

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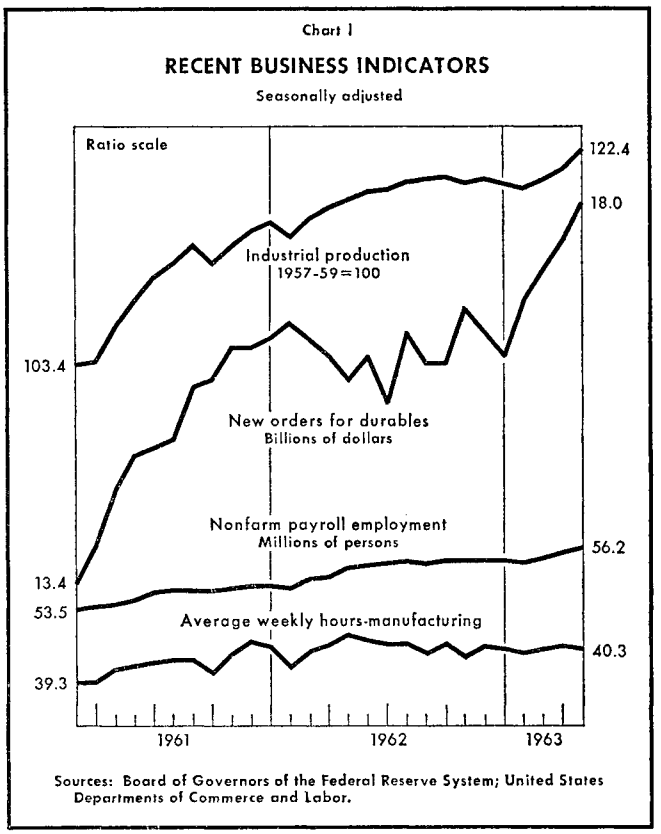
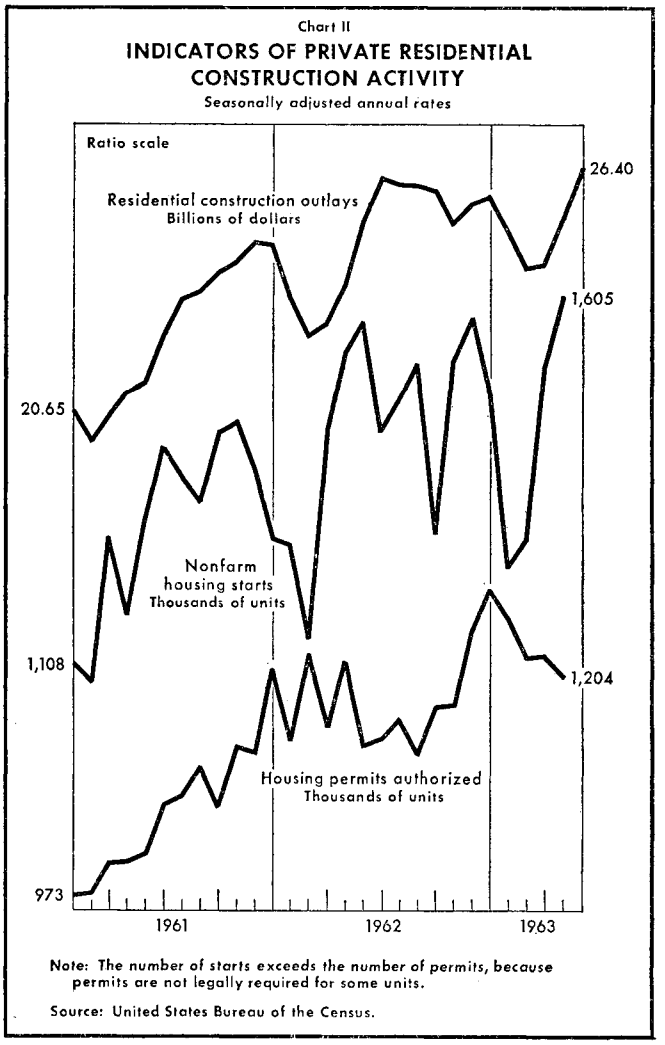


parts shortage temporarily cut back production on some assembly lines, May output in the automobile industry as a whole pushed somewhat above the high plateau of the previous ten months. At the same time, steel ingot production maintained its high April level. The delay of the steelworkers' union in reopening its labor agreement apparently led some steel users to reassess the need for a further build-up in steel inventories, but this occurred too late to have any significant effect on May ingot production.

Continued strength in production over the near term was suggested by the growing volume of new orders placed with manufacturers of durable goods. In April, such orders moved upward by 3 per cent (seasonally adjusted), marking the fourth consecutive month of advance (see Chart I). Backlogs of unfilled orders held by durables manufacturers also rose for the fourth month in a row. While the volume of new bookings received by the steel industry jumped further in April, this accounted for only about half of the over-all increase in new orders. Indeed, total orders received by durables industries other than steel moved up appreciably.

Paralleling the gain in production, seasonally adjusted nonfarm payroll employment rose by 276,000 persons in April, the third sizable advance in a row (see Chart I). Almost one third of the April increase was in construction employment, as warmer weather permitted some step-up in outdoor activity. Most of the rest was attributable to a strong rise in the number of persons at work in manufacturing. Indeed, factory employment has been restored to its high level of last July. In contrast to typical past experience, these gains in manufacturing employment were not foreshadowed by any particularly noticeable rise in the average workweek. Thus, average weekly hours in manufacturing have remained between 40.2 and 40.4 since last November and are somewhat below the April 1962 peak (see Chart I). Fragmentary data on claims filed for unemployment compensation in May suggest that employment in that month may at least have held near its advanced April level.



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DEVELOPMENTS IN SELECTED DEMAND SECTORS

Like industrial production, activity in the housing sector has shown renewed buoyancy in recent months. After being curtailed by unusually severe weather during the winter—a factor not fully taken account of in the seasonal adjustment procedures—outlays for private residential construction rose by about $1 billion (seasonally adjusted annual rate) in April and by an even greater amount in May (see Chart II). A prospect of still further advances over the near term is suggested by the 28 per cent jump from February to April in the number of housing units started. Moreover, despite the sharp increase in starts and recent declines in the number of building permits issued, the backlog of unused permits has apparently remained at a high level.

In the area of capital spending, the winter survey of the Commerce Department and the Securities and Exchange Commission and the spring McGraw-Hill survey had pointed to increases in outlays for plant and equipment of 5 per cent or more for the year as a whole. A later reading of such plans will be available with the release of the second-quarter Commerce-SEC survey in early June. In the meantime, available monthly indicators related to capital spending show a mixed pattern. In April, output moved up in industries producing construction materials and business equipment, and orders placed with manufacturers of machinery and equipment edged somewhat above the plateau that had been maintained in the preceding five months. Despite their latest gains, however, these indicators are still below, or only slightly above, the high levels already attained during the second half of last year. Moreover, outlays for commercial and industrial construction continued sluggish in May, and were below their level at the end of 1962, having declined in three of the five months so far this year. The performance of these various indicators thus continues to raise questions as to the extent of the rise in actual plant and equipment spending that can be expected in 1963.

Developments in the consumer sector, on balance, appear to be encouraging. To be sure, in recent months the net increase in consumer credit outstanding has been somewhat below its rate in the fourth quarter of 1962, as repayments of existing loans have increased at a faster rate than new loan extensions. Moreover, retail sales apparently declined somewhat in May. Their volume remains at an advanced level, however, and consumer incomes have continued to expand—with the April gain the largest of any this year. In addition, consumer buying plans moved up in April, according to a survey conducted by the Census Bureau. Intentions to purchase new cars and household durables increased from their already high levels at the start of this year and were above the levels reported in April 1962.

The Money Market In May

The money market became somewhat firmer during May. Federal funds traded almost entirely at 3 per cent, and in the last half of the month the demand for Federal funds at that rate often exceeded their availability. Average member bank borrowings from the Reserve Banks—at $190 million—were accordingly somewhat higher than in other recent months. Rates posted by the major New York City banks on call loans to Government securities dealers were quoted predominantly within a 3¼ to 3½ per cent range. Treasury bill rates moved up moderately after midmonth in the firmer money market atmosphere.

On May 15, approximately $9.0 billion of the $9.5 billion of Treasury notes and certificates eligible for conversion in the May refunding were exchanged for the two issues included in the offering. Subscriptions for the new 3¼ per cent certificates of May 1964 and for the reopened 3⅝ per cent notes of February 1966 totaled $5.7 billion and $3.3 billion, respectively. Only $0.5 billion of the three maturing issues was redeemed for cash, with redemptions by the public amounting to about 8½ per cent of its maturing holdings.

Prices of outstanding Treasury notes and bonds moved irregularly higher in the first half of May, as the market reacted favorably to the short-term offerings in the Treasury's May refunding. Demand was also buoyed by the market's feeling that there would be no further Treasury financing operations in the immediate future, by the lowering of the Canadian bank rate on May 7, and by a feeling that interest rates would change little over the near term, whatever might be their movement over the longer term.

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Prices receded in the latter half of the month, however, when news of further business improvement and the continuing large balance-of-payments deficit, combined with market discussion of a possible shift in monetary policy, once again turned the attention of market observers to the possibility of a rise in interest rates. Prices of corporate bonds moved fractionally higher during May in the face of a relatively light calendar of new offerings, but prices tended lower toward the close of the period. In the tax-exempt sector, where the volume of new issues continued heavy, prices held generally steady in the first half of the month but weakened in the latter part of May. Both markets were restrained, however, by the sluggish distribution of two large, fully priced new issues reoffered during the period.

CHANGES IN FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1963

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

Factor	Daily averages—week ended					Net changes
	May 1	May 8	May 15	May 22	May 29	
Operating transactions						
Treasury operations*	+ 33	– 2	– 69	+ 114	+ 265	+ 341
Federal Reserve float	– 397	+ 23	– 74	+ 428	– 453	– 473
Currency in circulation	+ 104	– 174	– 178	+ 37	– 15	– 226
Gold and foreign account	+ 24	– 18	– 20	– 34	+ 13	– 35
Other deposits, etc.	– 14	+ 12	+ 8	– 166	+ 10	– 150
Total	– 249	– 161	– 332	+ 379	– 179	– 542
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 57	+ 467	+ 98	– 297	– 4	+ 321
Held under repurchase agreements	+ 162	+ 75	– 115	– 122	—	—
Loans, discounts, and advances:						
Member bank borrowings	– 63	+ 16	+ 89	+ 82	– 15	+ 109
Other	– 1	+ 1	– 1	– 7	– 23	– 31
Bankers' acceptances:						
Bought outright	– 1	– 2	+ 1	+ 1	– 1	– 2
Under repurchase agreements	—	—	—	—	—	—
Total	+ 154	+ 558	+ 70	– 342	– 43	+ 397
Member bank reserves						
With Federal Reserve Banks	– 95	+ 397	– 262	+ 37	– 222	– 145
Cash allowed as reserves†	+ 22	– 335	+ 205	– 14	+ 110	– 12
Total reserves†	– 73	+ 62	– 57	+ 23	– 112	– 157
Effect of change in required reserves†	– 33	– 107	+ 154	– 29	+ 90	+ 75
Excess reserves†	– 106	– 45	+ 97	– 6	– 22	– 82
Daily average level of member bank:						
Borrowings from Reserve Banks	94	110	199	281	266	190‡
Excess reserves†	407	362	459	453	431	422‡
Free reserves†	313	252	260	172	165	232‡

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for five weeks ended May 29.

BANK RESERVES

Market factors absorbed reserves on balance from the last statement period in April through the final statement week in May. Reserve absorption, primarily resulting from a contraction in float, from a routine Treasury interest payment to the Federal Reserve Banks on May 15, and from an expansion in currency in circulation, more than offset the release of reserves stemming from reductions in required reserves and in Treasury deposits with the Federal Reserve Banks. System open market operations only partially compensated for the net reserves absorbed by market factors. System outright holdings of Government securities increased on average by $321 million from the last statement period in April through the last statement week in May, while holdings under repurchase agreements were unchanged over the month as a whole, leaving the balance in that account at zero. Net System holdings of bankers' acceptances declined by $2 million. From Wednesday, April 24, through Wednesday, May 29, System holdings of Government securities maturing in less than one year rose by $3,462 million, while holdings maturing in more than one year fell by $2,910 million.

THE GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds continued to rise gently in early May from their mid-April lows on fairly broad investment demand. Market confidence was bolstered by the favorable response accorded the Treasury's May refinancing operation, in which the two issues offered in exchange were of relatively short maturity, and by market expectations that debt-limit considerations would prevent further Treasury financing in the near future. The May 7 reduction from 4 per cent to 3½ per cent in the Canadian bank rate reinforced this improvement in atmosphere, as did the more optimistic sentiment in the corporate bond market. Against this background, prices of intermediate and longer term Treasury obligations moved generally higher through midmonth, with only a brief interruption from May 8 through May 10, when reports were received of the poor reception accorded a large utility issue and of a renewed outflow of gold. Prior to the midmonth settlement date for the Treasury's refinancing operation, a fairly broad volume of switching activity developed featuring demand for the reopened 3⅝ per cent notes of 1966 and also for the 4⅛ per cent bonds of 1989-94 sold by the Treasury in April. By mid-May the price of the 4⅛'s had risen almost to the 100¾ level at which the underwriting syndicate had originally reoffered the bonds.

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A weaker tone was evident in the last half of the month, as market participants pondered the implications for interest rates of reports indicating further advances in business indicators and a continuation of a large balance-of-payments deficit during the first quarter. Market discussion of the future course of monetary policy also contributed to a more hesitant tone. There was some selling by investors and others late in the month—particularly after the publication of reserve statistics for the week ended May 22, which indicated reduced levels of reserve availability in a period marked by persistent firmness in the money market. The decline in bond prices was moderated by Treasury buying for trust fund accounts. Over the month as a whole, prices of outstanding intermediate and longer term issues ranged from $^{13}/_{32}$ lower to $^{10}/_{32}$ higher.

In the market for Treasury bills, activity was relatively light during May. Bill rates held in a fairly narrow range until late in the month when they rose to close generally 7 to 10 basis points above the rates prevailing at the end of April on comparable maturities. Early in the month, demand centered on short May and June maturities while there was some selling of late July and early August issues. Over the midmonth period, a substantial volume of longer term bills was purchased by corporations and public funds while some offerings of near-term issues appeared from commercial banks. Rates moved up moderately after the middle of the month partly because the somewhat firmer money market conditions in the last half of the month led to higher dealer financing costs. A fairly good interest was evident at the regular weekly auctions held during the month. In the first two auctions in May, the Treasury sold $100 million more of bills than were maturing, as it had through the preceding month. At the final auction of the month, held on May 27, average issuing rates were 2.974 per cent for the new three-month issue and 3.055 per cent for the new six-month issue—8 and 7 basis points, respectively, higher than the rates established in the last auction in April, and the highest auction rates since mid-1962. The three-month bill closed the month at 3.00 per cent bid, the highest closing quotation since 1960.

OTHER SECURITIES MARKETS

Prices of corporate and tax-exempt bonds moved narrowly in May and the views of investors and underwriters frequently diverged as to the appropriate levels of rates for new issues. In the corporate sector, prices strengthened slightly through most of the month under the influence of moderate investment demand and a light calendar of prospective offerings. Tax-exempt bond prices, on the other hand, continued to be restrained by a heavy volume of new financing, which pushed the Blue List of advertised dealer offerings to successive new highs. Both markets were also adversely affected by investor resistance to the downward movement in yields on new issues as typified by the month's two largest new issues which were rather fully priced. Investors were slow to acquire these new bonds and turned instead to other recent, lower rated flotations that offered higher returns. Prices moved lower in both the corporate and tax-exempt bond markets toward the close of the month, as concern over the outlook for interest rates spread from the Government securities market. Over the month as a whole, prices of corporate bonds were little changed while prices of tax-exempt bonds were down slightly. The average yield on Moody's seasoned Aaa-rated corporate bonds was unchanged at 4.23 per cent at the close of May, while the average yield on similarly rated tax-exempt bonds was also unchanged, at 3.00 per cent.

The total volume of new corporate bonds reaching the market in May amounted to approximately $535 million, compared with $345 million in the preceding month and $240 million in May 1962. The largest new corporate issue publicly marketed during the month consisted of $250 million of 4⅜ per cent (Aaa-rated) telephone company debentures maturing in 1999, reoffered on May 7. Underwriters bid aggressively for the debentures—which are not redeemable for five years—but investors gave the issue a poor reception. It was reported that more than half of the issue remained unsold at the end of the month. New tax-exempt flotations during the month totaled approximately $830 million, as against $810 million in April 1963 and $865 million in May 1962. The Blue List of tax-exempt securities rose by $65 million during the month to $696 million on May 31, after reaching an all-time peak of $770 million on May 16. The largest new tax-exempt offering during the period was a $122 million state public power system revenue bond issue. The offering consisted of $59.6 million of serial bonds, reoffered to yield from 2.25 per cent in 1967 to 3.25 per cent in 1986, and $62.4 million of 3¼ per cent term bonds maturing in 1996 and reoffered to yield 3.35 per cent. Like the $250 million corporate flotation, this issue was enthusiastically bid for at the underwriting level but moved very slowly when reoffered to investors.

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Key Areas in Current Economic Policy *

By DOUGLAS DILLON
Secretary of the Treasury

I am well aware how difficult it is to gather and understand economic facts—let alone interpret them—when the facts themselves are constantly changing. For, in the fluid and intricate economic picture, appearances can be deceiving—and foresight must rely heavily upon a hindsight that is itself often elusive and uncertain. As a result, sound and imaginative evaluation of national economic policy is extraordinarily difficult. With this in mind, let me examine briefly with you today some areas of economic policy in which I have direct responsibility.

The most urgent economic business before this nation is the President's tax program. It has quite naturally dominated the public discussion of economic matters. That discussion has inevitably brought forth disagreements and misconceptions about the program. But it has also served to strengthen the widespread consensus among all segments of our society that the President's principal proposal —substantial tax reduction *this* year—is our best hope of accelerating the forward pace of our economy. Let me recall some of its main features:

The President has proposed a cut in the corporate tax rate from 52 to 47 per cent to supplement last year's 7 per cent tax credit for productive new investment and the liberalization of the rules and procedures governing tax treatment of depreciable equipment. Those two measures reduced business taxes by $2.5 billion a year. The proposed five-point corporate tax rate reduction would cut business taxes by another $2.5 billion by the time the program is fully in effect. This total of $5 billion would give business 40 per cent of the over-all tax reduction, provide a strong and continuing stimulus toward accelerated economic growth, and increase the profitability of new business investment by almost 30 per cent.

The effectiveness of last year's tax changes on capital investment is impressive indeed. The latest McGraw-Hill survey of capital spending estimates that expenditures for plant and equipment in 1963 will rise to $40 billion from a level of just over $37 billion for 1962. Last year's tax reforms are responsible for at least 43 per cent of the increase.

But the whole job cannot be done solely by stimulating business investment. No company will produce more goods without markets to absorb them. And the best way to assure those markets is to increase consumer purchasing power. The President's program would do that by reducing personal income tax rates from the present range of 20 to 91 per cent to a much lower range of 14 to 65 per cent. Such a cut in individual tax rates, combined with the proposed corporate rate reduction, would total $13.6 billion. When the various structural reforms that have been recommended are taken into account, the net reduction would amount to $10.3 billion.

The impact of that over-all cut would be felt much quicker than most people realize. If the President's program were to receive final approval by October 1, over $10 billion would be released into the economy within the following fifteen months—and some $8 billion of that amount would represent increased consumer purchasing power. The stimulus of a $10 billion tax cut would not stop there. For example, the Joint Economic Committee of the United States Congress had estimated that it would eventually increase our annual gross national product by $40 billion.

Those, then, are some of the main features of the President's tax program. As an inevitable result of the legislative process, that program will be somewhat revised by the time the tax bill emerges from the House Ways and Means Committee some weeks hence. However, I am confident that the bill the Committee reports out will be one that we can all support wholeheartedly.

Thus far, much of the discussion on tax reduction has centered, not on specific tax proposals, but on expenditure control. If the heat of that discussion has sometimes obscured the facts, I think they are now beginning to come through quite clearly—including the fact that an

* An address before the Sixth Annual University of Connecticut Loeb Awards Presentation luncheon, New York City, May 22, 1963.

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exceptionally large portion of the expenditure increases during this Administration has occurred in the areas of defense and space.

One particularly enlightening comparison shows that, leaving aside only defense and space, all other Governmental expenditures in the three-year period 1958-61 increased by $800 million more than they will in the first three years of the present Administration. That comparison shows, cogently and unanswerably, that this Administration has continually exercised a firm control over expenditures. And it offers the strongest possible endorsement of what is by far the most significant fact in the present discussion of tax reduction and expenditure control: the President's repeated commitment that, as the economy expands in response to tax reduction and Federal revenues increase, a substantial portion of those increased revenues will be used to reduce and eliminate the current deficit.

Last week, this issue of expenditure control was raised in an old and familiar context—when the House of Representatives debated the proposal to raise the temporary debt limit between now and the end of August, and once more brought a hardy perennial to the forefront of the news. As that debate made clear, there are few areas of fiscal policy as much in need of more light and less heat as the debt limit. I should like to try to supply some needed light:

First, let no one labor under the delusion that the debt ceiling is either a sane or an effective instrument for the control of Federal expenditures. No one is more conscious than I of the need to keep Government spending under firm control. But this cannot be done by trying to exert controls at the tag end of the expenditure process, when the bills are coming due. The debt limit is not and cannot be made a substitute for the control of expenditures at the decisive stage of the expenditure process—when the funds are being appropriated.

Second, since the Executive Branch cannot refuse to pay the bills incurred in carrying out the programs approved by the Congress, the only alternative is simply to delay paying them. That is exactly what happened in 1957, when an unrealistic debt ceiling forced the Executive to defer payment on its bills. No expenditures were cut back; they were simply postponed and Government contractors had to wait for their money. The unhappy economic effect of that unrealistic 1957 debt ceiling—in combination with other restrictive fiscal measures—needs no retelling here. But anyone who recalls the lesson of 1957—the year from which we date the pattern of slow economic growth which the President's tax program is designed to alter—is not likely to forget it.

Third, the temporary debt limit approved last week by the House, and currently before the Senate, would provide the absolute minimum levels needed by the Treasury for the proper management of the Federal debt and the Treasury's cash balance. These limits—$307 billion through June, and $309 billion throughout July and August—are tight, so tight that they provide little or no room for meeting unforeseen contingencies. The Treasury can attempt to operate within these limits only because it is likely that our expenditure estimates for so short a period will be reasonably accurate and our revenues are unlikely to fall below estimated levels. In addition, since Congress will be in session until some time in the fall, we could always obtain new debt limit legislation, should it be necessary, without having to call a special session of Congress.

And fourth, should we be required to operate between now and the end of August under the present debt ceiling of $305 billion, it would no longer be possible to handle the finances of the United States Government in a prudent and responsible manner. We would be forced to resort to an array of unusual financial procedures of the sort which had to be used in 1957-58—procedures which, in the end, would only add to the burdens of the taxpayers of this country. A $305 billion debt limit would also deprive us of one of our most important tools for keeping our short-term interest rates competitive with rates abroad: the ability to add to the market supply of short-term Government securities when the occasion demands. The timely use of this technique has undoubtedly helped reduce the outflow of short-term funds throughout the past two years by many hundreds of millions of dollars. It is no exaggeration to say that part of the price of an unrealistically restrictive debt limit would have to be paid in gold.

Those are but a few examples of the havoc that can be wrought in the name of fiscal responsibility. I think they make it obvious that the debt ceiling is not only the wrong instrument to use in attempting to control Federal expenditures, but that an unduly restrictive ceiling could place this country in an untenable fiscal situation. I suppose it would be unrealistic to expect that the seasonal storm over the debt limit through which we are now passing will not deluge us in future years. But I *do* hope, for the sake of fiscal sanity and prudence, that its intensity may clear the air and generate some fresh and lucid thinking about the whole question of the debt limit.

Another vital, if less incendiary, problem that is now receiving considerable attention is our balance-of-payments position. More specifically, some in this country have recently expressed concern over the adverse impact on

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our payments balance of foreign borrowing in the United States capital market, and have suggested that through one means or another, we make access to our market more difficult or more expensive.

Unquestionably, a large amount of money is being raised in our capital market by borrowers from countries which enjoy healthy surpluses in their own payments position. That is natural enough, since foreigners can find in our financial market what they often lack in their own: unmatched facilities and resources, and freedom from excessive government regulations. It is a market in which both borrower and lender can operate with maximum efficiency and minimum difficulty.

Although foreign borrowers undoubtedly contribute to our payments imbalance, it would be a short-sighted solution indeed if we were to make the facilities and resources of our capital market less available to them. The real solution—as I urged more than a year ago in Rome—is the development of capital markets in Europe and elsewhere that are better able to meet the needs of their own nationals, and that are more accessible to borrowers from other countries as well. That calls for removal of existing government restrictions, enlargement of capital resources, and improvement of facilities to increase the efficiency of doing business.

I am glad to say that some progress in this direction has been made and that more can be expected. But the development of markets more comparable to ours will take time. Meanwhile, there is every reason to maintain free access to our market, so that it can continue to function as an important part of the international payments system.

It is not enough, however, to encourage progress in improving markets abroad. We must equally encourage the participation of foreign capital in our own market. If we take full advantage of the possibilities of attracting foreign capital—as borrowers are now attracted—we can offset to a great extent the outflow of funds from the sale of foreign issues here.

We would, for example, like to see underwriters in this country seek actively and energetically to put the highest practicable proportion of their new foreign issues into the hands of foreign subscribers. Moreover, in order to give more foreign subscribers a greater opportunity to invest in these issues, we would like to see more of them publicly marketed, rather than privately placed.

When issues are privately placed—and private placements accounted for more than half of the new foreign issues in our market last year—they are offered almost exclusively to United States investors. Last year, for example, almost all of the Canadian and Latin American issues, which together accounted for a large part of the foreign use of our market, were private placements.

On the other hand the buyers of publicly placed new foreign issues are by no means all Americans. Last year foreigners purchased more than one third of the publicly offered foreign issues. The willingness of foreigners to purchase new foreign issues in our market reflects the attractiveness of our facilities to both borrowers and lenders. Because of that fact, we have every reason to strive to develop and exploit our techniques for selling not only goods, but also securities, to foreign buyers. We have undertaken a great drive to expand our exports—a drive that is imperative if our receipts from exports are to meet the irreducible cost of our defense and aid commitments abroad and match the outflow of American long-term investment. We need an equally determined drive by the financial community to sell its very unique range of products.

This, then, has been a brief look at some aspects of the current economic scene. The outlook for the future no one can predict with certainty. But I think most of us will agree that the signs are generally favorable.

In the short run, our economic picture looks bright, but not perhaps so gloriously rosy as some would paint it. Our present economic upturn is heartening. A number of economists, after scrutinizing the latest pattern of the indicators, and paying particular attention to the rising level of capital investment, are hoping for a long-run upswing to near boom-time levels. My feeling, while genuinely optimistic, is not quite so sanguine as this. Last January, the President's Council of Economic Advisers estimated that 1963 gross national product would fall within a range of $5 billion either side of the $578 billion figure that was used as the basis of our revenue forecasts. It now looks like the high side of that range might be about right. That is what I had in mind when I suggested earlier this month that, if the present improvement continues, Federal revenues might perhaps exceed our estimates for fiscal 1964 by as much as $1 billion. But even such a result would not lead to any appreciable improvement in our employment situation. For that, we must look to tax reduction.

The first-quarter balance-of-payments picture is perhaps less rosy, and I think it would be unrealistic to look for any sudden solution in this area. Because we are relying on the slower, but surer, solutions brought about by a market economy, it is entirely possible that this year's deficit will still be comparatively large. Obviously, the payments deficit is a stubborn problem but with the Trade Expansion Act of 1962, the Revenue Act of 1962, and particularly with the prospect of a meaningful tax

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program this year, we will certainly have the tools to work more effectively for a solution.

The answers to this and other vexing economic questions require close cooperation between the public and private sectors of our society. They also call for wider discussion of the major issues and broader understanding of their implications for the individual citizen and for the nation—the sort of informed public understanding that the specialists in the business and financial press can help to generate. With your help—and as President Kennedy said recently—"with the help of all of those in business, labor, and other professions who share your concern for the future, we shall build a future from which all Americans can take pride as well as sustenance".

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