FEDERAL RESERVE BANK OF NEW YORK

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Treasury and Federal Reserve Foreign Exchange Operations*

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As of early March 1963 the Federal Reserve reciprocal credit, or "swap", network covered ten foreign central banks, plus the Bank for International Settlements, and involved a total amount of $1,100 million. In May 1963 the reciprocal currency agreement with the Bank of England was increased from $50 million to $500 million, thereby raising the total of these short-term swap lines to $1,550 million.

From the first use of the Federal Reserve swap program in March 1962 through the end of August 1963, total drawings on these swap lines by the Federal Reserve and other central banks amounted to $978 million. Over the same period, total repayments of $876 million were made, each generally within six months from the date of the drawing. The net debtor position of the Federal Reserve under all these agreements combined was $92 million as of the end of August 1963, compared with $65 million at the end of February 1963. During the first week of September, the net debtor position of the Federal Reserve was reduced to $73 million.

At the end of February 1963, there were outstanding United States Treasury issues of $481 million in foreign currency bonds and of $48 million in foreign currency certificates. During the next six months, all of the foreign currency certificate issues were converted into foreign currency bonds, while additional bonds were issued in the amount of $177 million. Of this total of $705 million of foreign currency bonds outstanding at the end of August 1963, $50 million has in one instance been employed to refund Federal Reserve swap drawings into medium-term obligations of the Treasury.

* This third joint interim report reflects the United States Treasury-Federal Reserve policy of making available additional information on foreign exchange operations from time to time. The Federal Reserve Bank of New York acts as agent for both the Treasury and the Federal Open Market Committee of the Federal Reserve System in the conduct of foreign exchange operations.

This report was prepared by Charles A. Coombs, Vice President in charge of the Foreign Department of the New York Reserve Bank and Special Manager, System Open Market Account. It covers the period March through August 1963. Previous reports covering operations during March 1961-August 1962 and September 1962-February 1963 appeared in the September 1962 and March 1963 issues of the Federal Reserve *Bulletin* and in the October 1962 and March 1963 issues of this *Monthly Review.*

BELGIAN FRANCS

Unlike the other swap arrangements, which are now on a stand-by basis, the Federal Reserve-National Bank of Belgium swap remains fully drawn, as it has been from the beginning. The swap thus provides the National Bank of Belgium with a supplementary dollar balance of $50 million and the Federal Reserve with an equivalent balance of 2½ billion Belgian francs.

During the period under review, disbursements of the

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY AGREEMENTS

End of August 1963

Other party to agreement	Amount of facility (in millions of dollars)	Date (of original agreement)	Term (in months)
Bank of France*	100	1962: March 1	3
Bank of England†	500	May 31	12
Netherlands Bank	50	June 13	3
National Bank of Belgium	50	June 20	6
Bank of Canada	250	June 26	3
Bank for International Settlements‡	100	July 16	3
Swiss National Bank	100	July 16	3
German Federal Bank§	150	August 2	3
Bank of Italy‖	150	October 18	3
Austrian National Bank	50	October 25	3
Bank of Sweden	50	1963: January 17	3
Total for all banks	1,550		

* Increased from $50 million to $100 million on March 4, 1963.
† Increased from $50 million to $500 million on May 29, 1963.
‡ In Swiss francs.
§ Increased from $50 million to $150 million on January 17, 1963.
‖ Increased from $50 million to $150 million on December 6, 1962.

reciprocal balances created by the swap were made by both parties for a combined total of $25 million equivalent. These exchange operations were quickly reversed, as the payments balance of Belgium oscillated around equilibrium.

In May 1963 the United States Treasury issued to the National Bank of Belgium 24-month bonds denominated in Belgian francs in the amount of $30 million equivalent. These bond issues were timed to coincide with Belgian Government borrowings of dollars in London and New York, which would otherwise have resulted in an accrual of surplus dollars on the books of the National Bank of Belgium. These dollars were immediately absorbed, however, by the Treasury with the Belgian franc proceeds of the bond issues.

Over the past year, payments swings in the Belgian dollar position totaling $175 million have been financed through the Federal Reserve swap facility and the United States Treasury issue of Belgian franc bonds, thereby dispensing with the use of existing reserves by an equivalent amount. Although limited in scale, these coordinated exchange operations by the United States and Belgian exchange authorities provide a clear illustration of the technical feasibility of readily financing, through the flexible use of the international financial machinery that has recently been developed, the payments swings that inevitably accompany even a balanced growth of trade and payments.

NETHERLANDS GUILDERS

From mid-November 1962 through February 1963 the dollar-guilder market remained quiet, with no need for intervention by the Federal Reserve Bank of New York for either the Federal Reserve System or the United States Treasury. Renewed buying pressure on the guilder developed, however, in mid-March 1963 and continued for over two months thereafter. Part of the dollar influx into the Netherlands apparently originated in foreign direct investment. But a more important cause appeared to be a gradual tightening of money market conditions in the Netherlands.

As Dutch commercial banks began to be squeezed for liquidity, the call money rate in the Netherlands rose sharply from 1 per cent to 3 per cent, and rates on Treasury paper also advanced. To ease the pressure on the banks, the Netherlands Bank in March agreed to accept certain Netherlands Treasury paper under repurchase agreements and, for the monthly reserve period ended April 21, reduced the banks' cash reserve requirements by one percentage point to 4 per cent. Nevertheless, the tightness continued, and Dutch commercial banks repatriated short-term investments from abroad in order to bolster their strained domestic liquidity positions. The return flow of short-term funds was reflected both in a strengthening of the spot guilder rate and in a narrowing of the forward guilder premium.

In these circumstances, it seemed appropriate to prevent through central bank swap operations the potential unloading of such repatriations on the Netherlands Bank. Accordingly, from April 10 through May 28, the Federal

Table II
UNITED STATES TREASURY FOREIGN CURRENCY BONDS
Outstanding at the end of August 1963

Investor	Amount (in millions of $ equivalent)	Original maturities (in months)	Currency
German Federal Bank	275	15 to 24	German mark
Bank of Italy	200	15 to 24	Italian lira
Swiss Confederation	127	15 to 18	Swiss franc
Swiss National Bank	48	15 to 18	Swiss franc
National Bank of Belgium	30	24	Belgian franc
Austrian National Bank	25	18	Austrian schilling
Total	705		

Table III
FEDERAL RESERVE AND NATIONAL BANK OF BELGIUM RECIPROCAL CURRENCY AGREEMENT
Through August 1963

Date		Disbursements	Repurchases	Closing balances
Federal Reserve Operations in Belgian Francs* In millions of $ equivalent				
1962:	June 20	—	—	50.0
	August 7	10.5	—	39.5
	September 17-21	—	10.5	50.0
	October 11	10.0	—	40.0
	November 19	10.0	—	30.0
	December 19	—	5.0	35.0
1963:	January 2-4	—	14.4	50.0
	January 31	5.0	—	45.0
	February 11	—	5.0	50.0
	April 2	5.0	—	45.0
	June 11	—	5.0	50.0
National Bank of Belgium Operations in United States Dollars In millions				
1963:	January 16	5.0	—	45.0
	January 31	—	5.0	50.0
	February 21	10.0	—	40.0
	March 11	10.0	—	30.0
	March 27-April 2	—	20.0	50.0
	June 27	10.0	—	40.0
	August 2	—	5.0	45.0

* Closing balance includes interest earnings.

Reserve gradually disbursed a total of $44 million equivalent in guilders acquired through drawings upon the $50 million swap line with the Netherlands Bank. The great bulk of these disbursements was effected through exchange market operations, with the dual purpose of preventing the spot rate for the dollar from declining to the floor and of simultaneously absorbing dollars that would otherwise have flowed to the Netherlands Bank.

By early June the tide began to turn, as the Netherlands Bank again reduced the commercial banks' cash reserve requirements by one percentage point to 3 per cent and money market conditions eased in the Netherlands. With the decline in Dutch money rates and the strengthening of their liquidity positions, Dutch commercial banks resumed placements of short-term funds abroad, thereby pushing up the spot rate for the dollar and widening the forward premium on the guilder. Between July 1 and July 3 the Federal Reserve was able to acquire $5 million of guilders through market operations conducted by the Netherlands Bank, and the dollar rate continued to strengthen gradually throughout the summer months.

Although such favorable market conditions would probably have permitted further gradual liquidation of most of the swap drawing, the Netherlands Bank and the Federal Reserve both deemed it preferable to take advantage of a $70 million debt prepayment by the Netherlands Government to the United States Government on July 22. This debt prepayment, which resulted in an equivalent draft upon the dollar reserves of the Netherlands Bank, enabled the Federal Reserve to buy directly from the Netherlands Bank a sufficient amount of guilders to liquidate its remaining commitment under the swap drawing.

STERLING

Sterling strengthened in early January 1963, and there were numerous indications at that time that seasonal inflows of dollars might considerably augment British official reserves during the first half of 1963. Accordingly, the Federal Reserve drew £9 million, or $25 million equivalent, of its $50 million swap facility with the Bank of England and subsequently used £2 million, or $5.6 million equivalent, of this drawing to support the dollar rate.

Late in January, however, the exchange market situation was abruptly transformed when the British bid for Common Market membership was rejected. The Federal Reserve reversed gear and on February 1 purchased sufficient sterling to replenish its sterling balance to £9 million, or $25 million equivalent. Simultaneously, as speculative pressure on sterling gathered force, the Bank of England disbursed the $25 million credited to its account at the Federal Reserve under the initial swap drawing. Despite sizable intervention by the Bank of England, the sterling rate gradually declined during February and March and slipped below par. On March 29 the Federal Reserve Bank of New York purchased in the market for United States Treasury account £3 million, equivalent to $8.4 million, thereby reinforcing the support operations of the Bank of England.

The Bank of England might have readily drawn on the remaining $25 million of the $50 million swap line, which the Federal Reserve was prepared to increase, but the nature of the speculative selling of sterling suggested to the Bank of England that recourse to other short-term facilities would be more appropriate. As far as could be ascertained, the speculative outflow from London was directed largely to Continental financial centers rather than to New York. The Bank of England accordingly negotiated short-term credits of $250 million equivalent with several continental European central banks in order to reinforce British official reserves. These short-term credits, which cushioned the decline in British reserves during February and March, were reported early in April by Chancellor Maudling. This announcement immediately strengthened sterling, as the markets realized that cooperative action by central banks to defend sterling was under way, and the sterling rate stabilized slightly above par.

Between May 6 and 20 during temporary declines in the sterling rate to slightly below par, the Federal Reserve Bank of New York, on behalf of both the System and the Treasury, accumulated £6.5 million, equivalent to $18.2 million, in order to build up United States official holdings. No immediate need to employ these balances for intervention in the dollar-sterling market was anticipated, however, and several weeks later it appeared advantageous to swap £9.3 million, or $26.0 million, of the combined Treasury and Federal Reserve holdings into Swiss francs. This was done to accelerate repayment of earlier Federal Reserve drawings upon its swap line with the Swiss National Bank. In August, as sterling weakened again, the Federal Reserve Bank of New York acquired in the market additional sterling balances of £2.7 million, or $7.5 million, for the account of the Federal Reserve and the Treasury.

Perhaps the most important single development during the period under review, however, was the announcement on May 29 that the swap line between the Federal Reserve and the Bank of England had been increased from $50 million to $500 million. The magnitude of this increase in the reciprocal credit arrangement between the Federal Reserve and the Bank of England has greatly reinforced market confidence in the stability of the sterling-dollar parity relationship and may well mark a milestone in the development of international financial cooperation. The $25 million swap operation initiated in January was fully liquidated on July 16, and the $500 million swap arrangement is consequently on a stand-by basis immediately available in its entirety to either party in case of need.

GERMAN MARKS

From early March through late July there was almost continuous buying pressure on the German mark, which strengthened from a quotation of $0.2500¼ on March 1 to a peak rate of $0.2515⅛ on June 20. Although some improvement in the German foreign trading position seemed to be involved, there were numerous indications of sizable inflows of capital. Throughout the period relatively tight money market conditions prevailed in Germany. In June in particular, the German banks found their reserve positions squeezed, owing to the coincidence of the quarterly tax date and the customary midyear "window-dressing" needs. Reflecting this tightness, the rate for call money traded among the banks remained above the central bank discount rate of 3 per cent, and on occasion rose to over 4 per cent. These relatively high short-term rates appeared to be pulling in funds from other European financial centers and from New York. In addition, there was evidence of quite substantial foreign investment in German bonds, on which yields were also relatively high, as well as in German equities. Subsequent statistical reports have confirmed these early impressions.

The pressures on the mark-dollar exchange market were resisted by closely coordinated action by the German Federal Bank and the Federal Reserve Bank of New York. From early March through August, the German Federal Bank took in a substantial amount of dollars at rates well below the ceiling on the mark and thus helped to maintain a calm and orderly atmosphere in the market. On the United States side, the Federal Reserve Bank of New York intervened heavily for both Treasury and Federal Reserve account. It used mark balances available at the beginning of the period and, in addition, drew on the Federal Reserve-German Federal Bank swap line and placed with the German Federal Bank additional issues of United States Treasury mark bonds.

In April, combined Treasury and Federal Reserve disbursements of previously accumulated mark balances amounted to $16.5 million equivalent. A further mark supply of $13.2 million equivalent became available and was disbursed in June and July, as a weakening of the Swiss franc facilitated a partial reversal of the $30 million Treasury swap of marks for Swiss francs that had been arranged in December 1962 following the Cuban crisis. Most of the intervention operations by the Federal Reserve Bank of New York for both the System and the Treasury, however, were financed by bilateral credit arrangements. In May and June the Federal Reserve drew the entire $150 million equivalent of marks available under its swap line with the German Federal Bank, and by July 5 it had disbursed $143 million of such drawings. At this point, in the face of continuing pressure, it appeared advisable to shift to medium-term United States Treasury financing through a $25 million issue on July 11 of a two-year mark bond, which provided funds for further intervention during the remainder of July.

Early in August, buying pressure on the mark tapered off considerably, partly because of an easing of the German money market, and over the next few weeks the Federal Reserve System was able to purchase a total of $25 million equivalent of marks, which was immediately employed to reduce the swap by that amount. The German Federal Bank would have been agreeable to an extension of the Federal Reserve Bank swap drawings pending the expected reversal of the flow of funds. As this appeared likely to take some time, however, the Federal Reserve and the Treasury, in line with the general policy of reserving swap facilities for countering flows that give evidence of being quickly reversible, felt it desirable at this point to substitute, for a portion of short-term obligations of the Federal Reserve to the German Federal Bank, a medium-term United States Treasury borrowing in the form of a further issue of two-year mark bonds. Accordingly, on August 28 the Treasury issued to the German Federal Bank a $50 million two-year mark bond, the proceeds of which were immediately sold by the Treasury to the Federal Reserve System and were used to reduce the Federal Reserve swap drawing to $75 million equivalent. This is the first instance of a refunding of a Federal Reserve swap drawing through medium-term Treasury borrowing.

SWISS FRANCS

On March 1, the short-term commitments of the United States in Swiss francs amounted to $153 million equivalent. These comprised Federal Reserve swap drawings of $100 million on the Swiss National Bank and the Bank for International Settlements, and Treasury forward contracts of $53 million. By June 20, these short-term commitments had been fully liquidated.

As pointed out in previous reports in this series, as well as by Swiss official spokesmen, the strength of the Swiss franc in recent years has been mainly attributable to recurrent inflows of short-term capital funds associated with international political tensions. Whenever these short-term inflows have tapered off, the underlying deficit in the Swiss balance of payments has emerged and generated sizable demands for dollars to finance imports and other payments. During the spring and early summer of 1963, such a demand for dollars reappeared and brought about a strengthening of both the spot and forward dollar rates against the Swiss franc. Under these conditions, the Federal Reserve and Treasury made more or less simultaneous progress in rapidly reducing their short-term debt in Swiss francs.

The Treasury accelerated the liquidation of the $53 million of forward contracts outstanding on March 1 by issuing to the Swiss Confederation an additional $46 million of Swiss franc bonds. By providing the Swiss Confederation with franc-denominated assets, these bonds correspondingly reduced the need for the Confederation to invest in dollar assets abroad and, consequently, its need to have recourse to the forward market to acquire Swiss franc cover for such investments.

The Federal Reserve System, for its part, liquidated $75 million of the $100 million of swap drawings outstanding in early March by buying Swiss francs, both from the market and directly from the Swiss National Bank, and by drawing down existing United States official balances in Swiss francs. To speed up liquidation of the final $25 million of the swap drawing, the Federal Reserve in cooperation with the Treasury made use of the technique of swapping outright holdings of one currency for another. As mentioned above, the System and the Treasury swapped with the Bank for International Settlements $26 million of previously acquired sterling for Swiss francs. This swap technique, discussed in the preceding report, was first employed in December 1962 to enable the United States Treasury to swap $30 million of marks for Swiss francs to deal with buying pressure on the Swiss franc resulting from the Cuban crisis. In such transactions involving third currencies, the Federal Reserve has worked out its operations in consultation also with the central bank responsible for that currency.

In late July, the Swiss franc strengthened once more as the Swiss money market became somewhat tighter. To counter the liquidity squeeze, Swiss commercial banks repatriated funds placed abroad, and this inflow—combined with some renewed speculative pressures—created a heavy demand for Swiss francs. In closely coordinated operations in New York and Zurich, the Swiss and United States authorities tempered these market pressures and prevented unduly sharp rate movements. Intervention took the form mainly of renewed United States Treasury placements of forward Swiss franc contracts and market purchases of dollars by the Swiss National Bank, both on a moderate scale. With some easing of the Swiss money market, the exchange market returned to a more balanced position in August and the dollar rate held slightly above the floor.

FRENCH FRANCS

Between July 19 and 23, in an effort to test the market, the Federal Reserve drew and disbursed for the first time a total of $12.5 million equivalent of French francs under the $100 million swap line with the Bank of France. This intervention lifted the dollar slightly off the floor, but it quickly became apparent that very sizable disbursements would be required to bring about any appreciable improvement of the dollar rate. Intervention was accordingly suspended to await a more favorable opportunity. Since then, the French franc obligation incurred by the Federal Reserve through the swap drawing in July has been fully covered by purchases of French francs in the forward market.

ITALIAN LIRE

During the period under review, no spot operations in lire were conducted by the Federal Reserve Bank of New York for either the Federal Reserve or the Treasury. Forward operations in lire for Treasury account were continued with satisfactory results and will be reported in detail in due course.

In March and June a total of $100 million equivalent of 15-month lira bonds issued to the Bank of Italy by the United States Treasury in 1962 was converted into 24-month obligations carrying the privilege of conversion into shorter maturities in case of need.

CANADIAN DOLLARS, SWEDISH KRONOR, AND AUSTRIAN SCHILLINGS

No exchange stabilization operations in Canadian dollars, Swedish kronor, or Austrian schillings were conducted during the period by the Federal Reserve Bank of New York for either the Federal Reserve or the Treasury. In April, however, the Treasury issued a $25 million equivalent 18-month bond denominated in Austrian schillings to the Austrian National Bank, and used the schilling proceeds to absorb dollar holdings of the Austrian National Bank which had been increasing, owing to Austria's balance-of-payments surplus.

Recent Capital Market Developments in the United States

Although 1963 appears to be shaping up as another year of heavy over-all demand for funds in the financial markets, supplies have again been ample so that, with the exception of yields on short-term open market instruments, interest rate movements have been mixed and quite narrow. Thus, despite growing business activity and a somewhat less easy monetary policy, yields on long-term obligations of corporations and governments have edged up only slightly this year and are still below early-1962 levels. Moreover, home mortgage rates have actually declined, while rates charged by commercial banks on short-term loans to businesses have remained stable (see Chart I). The commercial banking system has continued to play an important part in financing heavy demands for credit without sharp advances in interest rates. Growth in total bank credit has again been rapid, with little convincing evidence of any significant slowdown from the high rate of increase experienced in 1962. As in that year, the most rapid gains have been in bank acquisitions of state and local government securities and in real estate loans, while growth in business loans has continued slow.

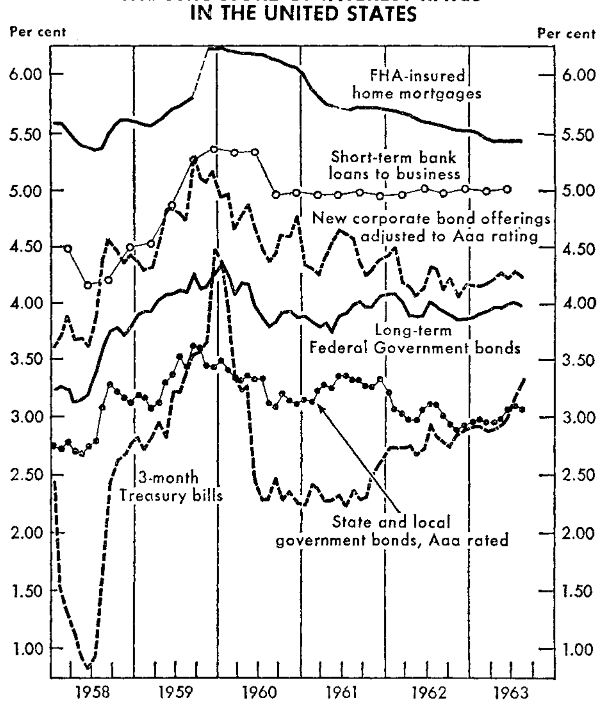
BUSINESS CREDIT DEMANDS

Businesses experienced record sales in the first half of 1963, and their spending on new plant and equipment for the six-month period as a whole was not far below the all-time high set in the second half of 1962. Nevertheless, demands for additional debt and equity funds have continued to be relatively low. The volume of net long-term business capital raised by nonfinancial corporations through sales of securities during the first half of this year was below that raised in the first half of 1962. It remained considerably under the record amounts raised in early 1957 when, despite the smaller size of the economy, fixed investment was running only slightly below current levels (see Chart II).

The demand for outside capital has remained light in recent years, primarily because businesses have been able to finance an enlarged part of their investment expenditures through internally generated funds—that is, retained earnings plus depreciation and other amortizations. In contrast to the general pattern of earlier years, these corporate flows of funds actually exceeded corporate fixed investment during most of the period from late 1958 through 1962. The estimated excess of internally generated funds over fixed investment expenditures for nonfinancial corporations was nearly $4 billion during the first half of 1963, at a seasonally adjusted annual rate (see Chart II). While fixed investment by these corporations during the period was running only 3 per cent above the rate in the first half of 1957, internally generated funds available for financing these expenditures were more than 40 per cent larger than in the earlier year.

Chart I

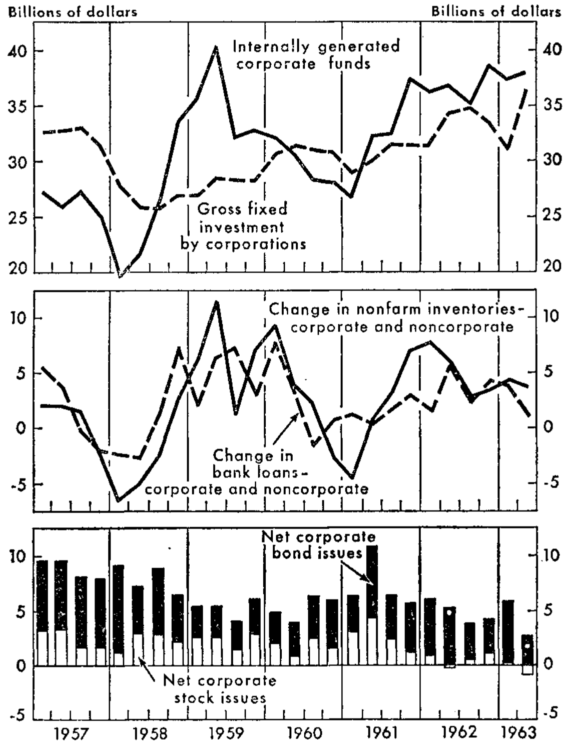
THE STRUCTURE OF INTEREST RATES IN THE UNITED STATES



Note: Bank loan data are plotted through June 1963; all other series through August.

Sources: Board of Governors of the Federal Reserve System; First National City Bank of New York; Moody's Investors Service.

Chart II
COMMERCIAL AND INDUSTRIAL BUSINESS INVESTMENT AND FINANCING



Note: All figures are seasonally adjusted annual rates. Second-quarter 1963 figures are preliminary estimates.
o Indicates net total of bond and stock issues for the second quarters of 1962 and 1963.
Source: Board of Governors of the Federal Reserve System.

The ability of corporations to generate funds internally was given a significant boost by the 1962 tax changes, permitting businesses to charge off the cost of machinery and equipment over a shorter number of years and to deduct from current profit tax liability up to 7 per cent of the cost of certain types of capital equipment. The Department of Commerce estimates that these changes, which were effective from the beginning of 1962, reduced corporate tax liabilities by about $2.3 billion in that year. At the current rate of capital expenditures and with perhaps more widespread use of the shortened depreciation schedules, the 1963 tax saving may well be running somewhat larger.

The reduced need for external financing by nonfinancial corporations is particularly reflected in their flotations of new corporate stock issues. Such flotations actually fell short of company repurchases of outstanding stock in the first half of 1963 after allowing for seasonal influences. Thus, larger internal flows of funds appear to have substituted much more extensively for external equity financing than for debt financing. This decline in stock issues relative to bond issues, however, is probably also due in part to the lack of market interest in the speculative new issues of small companies—a market attitude that has been in evidence ever since the sharp break in stock prices in the spring of 1962. Prior to that decline, such new issues accounted for an important part of total stock offerings. They have not yet regained that position, even though stock price averages recovered about two thirds of the 1962 decline by the end of the year and have reached new highs in 1963.

Although net offerings of new corporate bonds in the first six months of this year remained below the peak levels of 1957-58, they were substantially above the low amounts recorded in the last half of 1962, after allowing for seasonal factors. Despite this recent increase in supply, offering yields on these securities have shown only a minor increase this year, paralleling a similar small rise in yields on long-term Treasury bonds. The yield spread between new corporate and lower risk long-term Treasury obligations continues to be quite narrow, compared with earlier years, indicating that institutional demand for new corporate bond issues remains an important force in this market.

Demands for short- and intermediate-term credit by nonfinancial firms have also been light this year relative to the level and growth of economic activity. To some extent, this development may also be related to the trend toward a lessened need for long-term funds from outside sources. For many companies, increased flows of internally generated funds may have resulted in a build-up of liquid resources beyond desired levels, owing to the temporary lack of offsetting increases either in capital expenditures or in dividends. Such firms are able to apply these liquid resources to uses that would otherwise call for short-term borrowing, particularly from banks. Further, because interest rates on short-term bank loans have recently exceeded long-term market rates by a wide margin, even the use of new funds obtained through additional long-term borrowing may represent an alternative to bank financing of inventory increases—particularly when the higher inventory level is expected to be permanent. But, although a substitution of long- for short-term financing may be an element in the slow demand for bank loans, the relatively small total need for funds to finance the currently moderate rate of inventory growth is a more important factor. The relationship between changes in inventories and changes in bank loans has been rather close in the past (see Chart II), because inventory build-ups are conventionally financed in the first instance by short-term bank loans.

GOVERNMENT FINANCE

State and local governments made heavy demands on the capital markets during the first half of 1963, with net borrowings apparently amounting to a near record. Favorable borrowing conditions and the continuation of the postwar trend toward expanded government services at the state and local levels contributed to this large volume of new debt offerings. Reflecting the substantial new supplies of state and local obligations, market yields have moved up somewhat more rapidly than interest rates on corporate and long-term Treasury issues. This greater rise in yields, however, may also have been related to the prospect of a reduction in Federal income taxes, a development that would reduce the relative advantage to the investor of the tax-exempt status of state and local securities.

The rise in yields on tax-exempt issues would almost certainly have been greater had there not been a heavy demand for these securities by commercial banks. Bank acquisitions of state and local bonds normally decline during periods of economic expansion. This year, however, the slow demand for business loans and the continuing need to obtain high-yielding assets in the face of increased interest costs on time and savings deposits have pushed these acquisitions to record levels. In the first half of this year, commercial bank purchases of state and local bonds apparently exceeded 80 per cent of the net new supply of these securities.

In contrast to state and local governments, the financial requirements of the Federal Government have applied little upward pressure on capital market yields so far in 1963. The Treasury's total outstanding marketable debt was about unchanged over the first seven months of the year. Furthermore, the average maturity of the debt was about the same in August as at the end of last year.[1] The Treasury has, however, maintained a high level of outstanding conventional money market instruments (i.e., bills and certificates). This factor and a further movement toward less ease in monetary policy—marked by the July rise from 3 to 3½ per cent in the discount rate of the Federal Reserve Banks—resulted in a substantial increase in rates on Treasury bills and other money market instruments. At the same time, the Treasury made extensive use of the advance refunding technique: the swapping of new long-term issues for shorter term outstanding issues.[2] The use of this technique helped moderate interest rate increases in the capital markets by avoiding the more direct impact of cash sales of long-term issues that would otherwise have been needed to achieve a comparable effect on the maturity structure of the debt. Partially as a result of these various policy moves, the spread between average yields on long-term Government bonds and three-month Treasury bills narrowed further, from 95 basis points at the end of 1962 to 67 basis points at the end of September 1963.

DEMAND FOR CREDIT BY INDIVIDUALS

Individuals expanded their holdings of financial assets at a very high rate in the first six months of 1963, but they also added to their debts at a record pace. In fact, increases in financial assets and in debt obligations have both outpaced the growth of personal disposable income over the past two years or so. The increase in financial assets has been strongly concentrated in one particular area—interest-bearing deposits—while the growth in individuals' total borrowing has been reflected throughout all of the various media of personal credit, including consumer instalment credit, securities credit, and home mortgage loans.

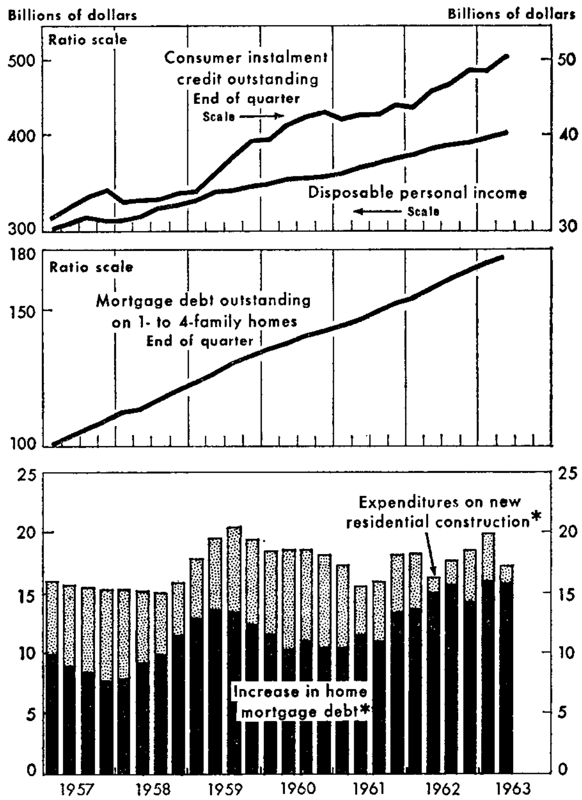
Although repayments on instalment loans climbed to a record 13.6 per cent of disposable income in the first half of the year, consumers have continued to add to their instalment debts at a substantial rate—coinciding with a strong demand for durable consumer goods, particularly automobiles. At the same time, large flows of savings into certain types of financial institutions granting consumer loans, notably commercial banks, have kept up the supply of this type of credit and the trend toward easier consumer instalment lending terms appears to have continued.

One particularly striking aspect of recent consumer financial behavior has been the sharp increase in borrowing on homes. Unlike the pattern of earlier years, mortgage debt has recently been expanding relative to outlays on new houses (see Chart III). Part of this relatively greater rise in mortgage debt is explained by the postwar inflation in real estate values, which causes a rise in mortgage debt as old homes change hands. But the available evidence also suggests that part of the explanation lies in the in-

[1] The average maturity of the Federal debt was lengthened in September through a refunding operation that is described in another article in this *Review* (see "The Money Market in September", pp. 160-63).

[2] For a fuller discussion of the Treasury's advance refunding operations, see Ernest Bloch and Joseph Scherer, "Advance Refunding: A Technique of Debt Management", this *Review*, December 1962, pp. 169-75.

Chart III
INDIVIDUALS' BORROWING PATTERNS



Note: All figures except instalment credit and mortgage debt outstanding are seasonally adjusted annual rates.

*Second-quarter 1963 figures are preliminary estimates.

Sources: Board of Governors of the Federal Reserve System; Department of Commerce.

creasing use of mortgage borrowing to finance nonhousing expenditures. In a number of instances, large current financial needs—such as those for college educations and major medical expenses—can be met most easily through mortgage borrowing, which makes possible longer repayment terms and lower interest rates for the borrower. Moreover, the unusually high current level of consumer instalment debt may be resulting in a need for sources of less burdensome credit, while the pressure of large supplies of funds seeking an outlet in the mortgage markets is encouraging aggressive "selling" of this form of credit by financial institutions.

Despite this additional demand for home mortgage credit, supplies of funds have continued to be more than adequate, with the result that rates charged on home mortgages declined in 1963 while other interest rates generally firmed. The explanation for the large supplies, in turn, is to be found in the pattern of individuals' investment in financial assets. Individuals, who supply the bulk of the funds made available in the financial markets, have persistently shown a strong preference for interest-bearing deposits at banks and other savings institutions. These deposits absorbed more than 50 per cent of consumer financial savings in the first half of 1963. The institutions receiving these deposits thus continue to have substantial resources to channel into their traditionally favored investments, including mortgages.

The high rate of accumulation of savings deposits is especially noteworthy, because consumers ordinarily shift more toward direct holdings of credit and equity market instruments as cyclical expansions develop. In the first half of this year, however, additions to consumer holdings of these instruments absorbed less than 5 per cent of new financial savings. In the 1958-60 upswing, by contrast, acquisitions of credit and equity market instruments ranged as high as 38 per cent of such savings.

THE ROLE OF THE BANKING SYSTEM

A sector-by-sector analysis of the capital markets suggests that commercial banks have played an important role in meeting stepped-up demands for funds in the financial markets with little or no advance in interest rates other than those on short-term open market instruments. The recent heavy bank participation in supplying funds to state and local governments by investing in their securities has already been noted. Commercial banks have been of similar importance in the mortgage market. Bank holdings of real estate loans rose at a seasonally adjusted annual rate of 12.9 per cent through August of this year, equal to the record gain of 1962 and more than double the 1961 increase. Shorter term bank lending to consumers, moreover, has advanced so far this year at an 11.5 per cent annual rate, the most rapid growth since 1959. The 5.0 per cent annual rate of increase in business loans, on the other hand, compares unfavorably with last year's 8.6 per cent growth—which was in fact only moderate for a period of economic expansion. This slow growth, however, appears to reflect mainly the special business demand factors noted earlier rather than a change in bank lending resources or preferences.

A key factor in shaping bank lending and investment practices has been the continuing rapid growth of time and savings deposits. The growth of these deposits, although somewhat slower this year than in the first half of 1962, has been at a rapid 14.2 per cent annual rate, about equal to the rate of increase in the last half of 1962. Further impetus to the growth of time deposits and negotiable time certificates of deposit was given by the July increase to 4 per cent in the maximum rate banks are permitted to pay on such deposits and certificates under the Board of Governors' Regulation Q. The new maximum of 4 per cent for 90-day to one-year maturities compares with the previous limits of 2½ per cent for 90 days to six months and 3½ per cent for six months to one year.

These increases in the limits on shorter term time deposit rates permitted commercial banks to continue to compete strongly for short-term funds and thus played a part in the recent upward trend of money market yields. Moreover, because banks must relend these funds at interest rates exceeding the rate paid the depositor, they have tended to invest them in longer term credit instruments. This transfer of funds from the short- to the longer term financial markets has contributed to the reduced spread between short- and long-term interest rates. Indeed, in view of the substantial expansion of bank credit this year and its increased concentration in capital market instruments, it may well be that such advances as have taken place in long-term rates over the past nine months have been more a reflection of expectational factors than of any real change in the availability of long-term credit relative to demand.

The Business Situation

After several months of sustained advance, the economy's upward movement appears to have slowed in late summer, although fragmentary September data suggest the possibility of a renewed pickup. Industrial production and manufacturers' new orders for durable goods declined a bit in August, while nonfarm employment and retail sales showed little change and personal income posted the smallest gain in six months. In almost every case, these signs of hesitation could be traced in significant part to the operation of special factors in the auto and steel industries. These factors were also operating in July, and there was thus an element of surprise in the buoyancy of the economy in that month. As it turned out, production declines in the steel and auto industries were more pronounced in August than in the earlier month. And, with car makers retooling for the 1964 models in August, shortages of some lines were apparently responsible for a slackening in the pace of sales and new orders.

As the new car models began to come off the assembly lines in September, auto output received a more-than-seasonal boost. Steel production, moreover, turned slightly upward, following the three-month decline that had occurred in the aftermath of the industry's labor settlement. Auto sales continued to be adversely affected by shortages of some new models, however, and department store sales declined somewhat from the record August rate.

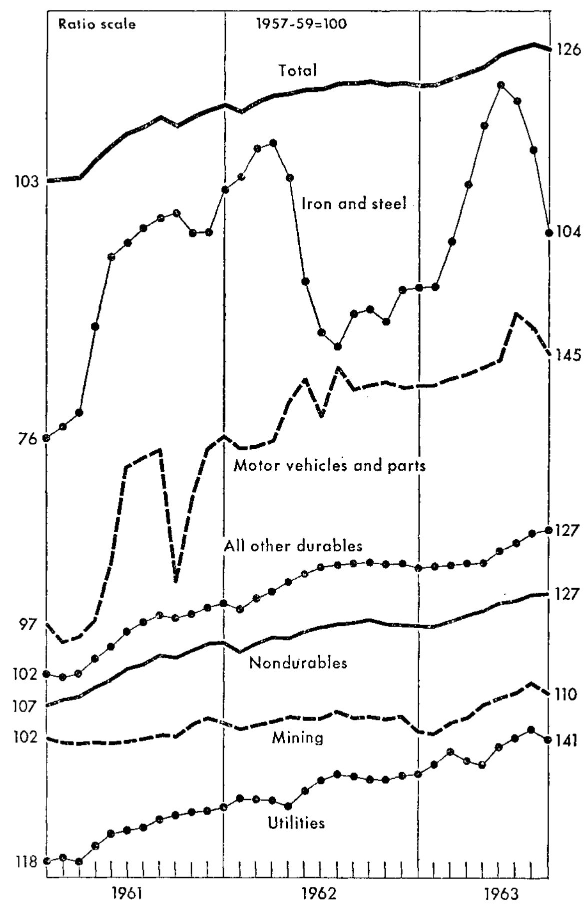
The broader questions with regard to the performance of the economy over the balance of the year of course remain—including the reception to be accorded the new auto models and the outcome of proposed tax legislation. Two positive factors are the anticipated rise in government spending—reflecting the recently enacted military-pay hike and a resumption of the uptrend in state and local government outlays—and the planned step-up in business plant and equipment spending. In any case, there continues to be little prospect of a significant near-term reduction of the current unemployment rate. In September, the rate edged up to 5.6 per cent of the civilian labor force (seasonally adjusted) and was just as high as the year-earlier figure.

PRODUCTION, EMPLOYMENT, AND SALES

After advancing by more than 7 percentage points in the previous six months, the Federal Reserve's seasonally adjusted index of industrial production fell by nearly a point in August to 125.6 per cent of the 1957-59 average (see Chart I). Most of the decline was attributable to a 12 per cent reduction in iron and steel output, the sharpest of the year, but production of motor vehicles and parts also dipped significantly from the unusually high July rate. Outside these two industries, rises and declines were generally small and just about offsetting, whereas in previous months there had been sizable gains on balance. Early data for September point to a moderate advance in automobile output (seasonally adjusted), with preliminary schedules suggesting the possibility of a more substantial gain in October. Data on steel output for September indicate a small increase, after seasonal adjustment, from the August level. In the June-August period, declines in the iron and steel component cost the total industrial production index about 1.1 points, and a bottoming-out in the steel industry would thus remove a significant drag on over-all production. The strength of the industry for the near term, of course, depends in part upon how much longer it will take steel users to reduce their inventories to desired levels.

Reflecting dampened industrial production, nonfarm payroll employment (seasonally adjusted) showed a small decline in August, the first since February 1961. Gains in service and government employment failed to offset a reduction in manufacturing payrolls which was concentrated mainly in the transportation and primary metals fields and was therefore related to cutbacks in steel and autos. In other areas of the economy, however, payroll employment, like production, showed less buoyancy than in earlier months. In September, according to the Census Bureau's household survey, total employment moved up again, after seasonal adjustment, but a proportionately greater rise in the labor force resulted in a small increase in the unemployment rate.

Chart I
DEVELOPMENTS IN INDUSTRIAL PRODUCTION
January 1961 - August 1963; seasonally adjusted



Source: Board of Governors of the Federal Reserve System.

Total retail sales were about unchanged in August (seasonally adjusted), after climbing appreciably in the two preceding months. Excepting autos, however, sales continued to rise significantly, with advances posted particularly by stores featuring back-to-school and other fall items. Incomplete data for September suggest that over-all retail sales moved downward, in part reflecting continued limitations on new-car availabilities in some popular lines. Public response to the 1964 models cannot as yet be assessed with any confidence. Industry spokesmen have suggested that auto sales may reach or exceed 7 million units for the third successive year.

Since the statistics on new orders received by the automobile industry reflect mainly deliveries of new cars to dealers, the August decline in automobile sales also had a marked impact on new orders data. Thus, despite little net change in orders outside the motor vehicle industry, total new orders received by manufacturers of durable goods declined by 2 per cent in August (seasonally adjusted) to the lowest level since January. Total unfilled orders of durables manufacturers (seasonally adjusted) were virtually unchanged in August.

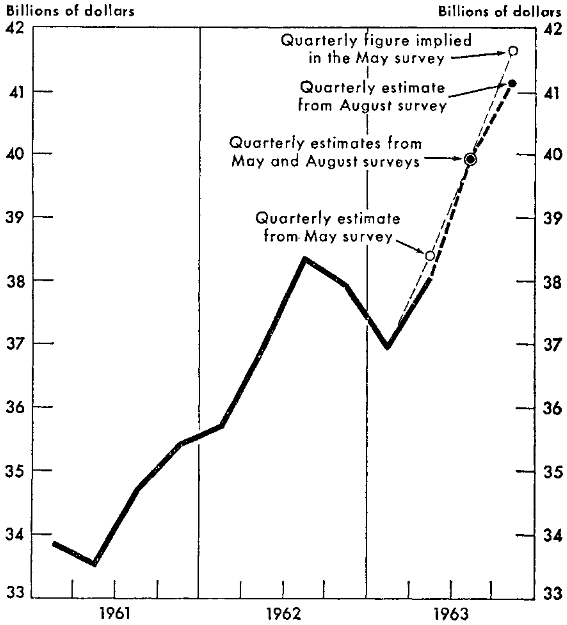
FIXED INVESTMENT

The latest survey of businessmen's plans for plant and equipment spending, taken in August by the Commerce Department and the Securities and Exchange Commission, points to substantial gains over the balance of the year (see Chart II). After declining in the first quarter, business fixed capital outlays rose by $1.1 billion in the April-June period to $38.1 billion (seasonally adjusted annual rate). While this was a bit below the levels businessmen were planning in May—mainly because of a shortfall in nonmanufacturing industries—the latest survey indicates no change from the earlier report in outlays planned for the third quarter. As a result, the second-quarter to third-quarter gain of $1.9 billion indicated in the latest survey is somewhat greater than had been suggested previously. Although the latest plans for the final quarter of the year indicate a somewhat lower level of spending than was

Chart II

RECENT DEVELOPMENTS IN PLANT AND EQUIPMENT SPENDING

Seasonally adjusted, annual rates



Sources: United States Department of Commerce; Securities and Exchange Commission.

implied in the May survey, they nevertheless call for a further \$1.2 billion advance from the third quarter. In appraising the likelihood that spending plans for the rest of the year may be realized, it is noteworthy that corporate profits (after taxes) rose to a twelve-year high in the second quarter of the year. Such a level of profits should help provide the financial resources and the incentive for a further expansion of plant and equipment spending.

Indicators of residential construction activity are continuing to ease off from their earlier exceptionally high levels. Private nonfarm housing starts moved slightly lower in August, marking the third consecutive setback in this monthly series. These movements appear to be in line with the Commerce Department's revised forecast for 1963, which implied a moderate reduction in housing starts over the last half of the year from their high spring levels. Although the backlog of unused permits remains substantial, new home building permits also moved down further in August, following an initial decline in July. Against the background of these declines in leading indicators, private residential construction outlays edged down slightly in September. Despite these declines, new home construction is still proceeding at a rapid pace. Moreover, the underlying demand for housing continues to be bolstered by a number of factors, including rising family incomes, an upward trend in new household formations, and the ready availability of mortgage credit at relatively low rates.

SECOND DISTRICT DEVELOPMENTS

In comparison with the many available indicators of national economic trends, statistical data for analysis of activity in the Second District are somewhat limited.[1] Data on employment and unemployment, sales, personal income, and construction activity are available for the region, however, and these series provide a fairly reliable measure of over-all developments within the District.

Since the first quarter of this year most measures of business activity in the Second District have kept pace with their national counterparts. Thus, both personal income and nonfarm employment advanced in the District during the April-July period at the same rate as in the nation, while department store sales, which had been adversely affected by the first-quarter New York City newspaper strike, showed a greater than national improvement. Unemployment in two of the District's three states—New York and Connecticut—averaged somewhat below the national rate during the recent period. The only notable exception to this generally good record is activity in the District's construction industry. While recent gains in construction employment have paralleled the national rate of advance, District employment in the industry is below a year ago. To a substantial degree, this reflects the combined effect of several large-scale construction strikes in upstate New York and the aftermath of last year's surge of activity in New York City, during which many builders "borrowed" from future projects in order to beat the deadline set under the City's new, more stringent, zoning law.[2] At the same time, however, several areas outside New York City also continue to report disappointing levels of building activity.

Total nonfarm employment in the District increased at the national rate of 1 per cent during the April-July period. Some divergences from the national pattern are noteworthy, however. Thus, in the apparel industry, which

[1] The Second District includes all of New York State, twelve primarily industrial counties of northern New Jersey (Sussex, Passaic, Bergen, Hudson, Essex, Warren, Morris, Union, Hunterdon, Somerset, Middlesex, and Monmouth), and Fairfield County, Connecticut.

[2] Although the actual deadline is not until the end of 1963, the surge in activity prompted by this deadline came in 1962.

employs more of the District's manufacturing labor force than any other, the employment increase was larger than in the nation as a whole. Trade sources, moreover, suggest the prospect of further gains during the fall and winter seasons. Employment in the transportation equipment industry, however, showed a smaller rise in the District than in the nation. The automotive segment of the industry apparently is still performing well, but shipbuilding and aircraft producers have been reducing work forces. An exception in the aircraft industry is Fairfield County, Connecticut, which has shown rising employment in recent months.

District employment in primary metals, particularly steel and wire production, also has shown slower than national growth since the first quarter—in part reflecting the temporary shutdown of some upstate operations and the closing of a plant in western New York that was attributed by the company to the impact of foreign competition. As a result of this closing and an over-all reduction in steel demand since just before the settlement of the industry's labor dispute, the Buffalo index of steel production during July and August averaged 80.7 per cent of its 1957-59 base, compared with a United States average of 99.7 per cent.

Unemployment in the District as a whole showed about the usual seasonal decline during the April-July period. In both New York and Connecticut, however, the total unemployment rate averaged lower than the national figure, while the New Jersey total unemployment rate was higher. As was true of the country as a whole, the unemployment rates in each of the District's three states were slightly above their year-earlier levels. Two of the District's major labor market areas—Newark and New Brunswick-Perth Amboy—have been removed from the national list of areas with "substantial" unemployment (6.0 per cent or more) and reclassified to the category of "moderate" unemployment (3.0 to 5.9 per cent). Heightened activity in the transportation equipment industry and the expansion of employment in the chemical and electrical equipment industries were the major factors bringing about the reclassification. As a result of these changes, only three of the District's thirteen major areas remain in the substantial unemployment category. In Rochester a reduction in unemployment, largely attributable to employment gains in the photo-optical industry, resulted in a reclassification of that area to the category of "relatively low" unemployment (1.5 to 2.9 per cent). Only fifteen other major areas out of 150 in the country currently are classified in this category.

District store sales advanced more rapidly during the April-July period than nationally, with notable gains recorded in New York City and Rochester. Much of the recent New York City gain represents merely a return to a more normal sales level following termination of the newspaper strike in March. The Rochester situation, however, reflects a generally expanding local economy, as measured by a local index of business activity which is now at a record high. District sales during the April-July period were 6 per cent higher than a year earlier. Nationally, the gain was 4 per cent.

Construction activity in the District, measured in terms of the average level of employment in the April-July period, equaled the national gain of 3 per cent over the first-quarter average. Nevertheless, construction employment and contract awards showed a decline from the year-earlier level, while nationally there was an increase. Some over-the-year decline in construction activity in the District, of course, reflects the slowing-down from an exceptionally high level of activity in the New York City area during 1962, when, as already noted, builders rushed work on projects in anticipation of the effective date for more stringent building regulations. During recent months, however, District construction has also suffered from several strikes in upstate areas—the largest one involving some 11,000 workers in twenty-eight New York State counties.

Reflecting these and other developments, the value of total construction contract awards in the April-July period was 9 per cent below the record 1962 level, while for the nation as a whole contract awards during the period were 12 per cent greater than a year ago. The District's volume of nonresidential building awards, which in the first quarter was still above the corresponding period of 1962, has recently joined the residential and heavy engineering categories in showing an over-the-year drop as a result of slackened activity in New York City. Through the first seven months of 1963, however, District awards have remained above their 1961 level and that of earlier years.

The Money Market in September

The money market remained generally firm in September. Reserve positions of banks in the money centers came under pronounced pressure at times as a result of heavy borrowings by corporations and Government securities dealers in connection with midmonth tax and dividend payments and the Treasury's refunding operation. These pressures were met without serious strain, however, particularly through very heavy purchases of Federal funds, and average borrowings from the Federal Reserve Banks actually declined for the month as a whole. As in August, Federal funds traded predominantly at the 3½ per cent ceiling. Rates posted by the major New York City banks on new and renewal call loans to Government securities dealers rose to a 3¾ to 4 per cent range in the early part of September, and then receded to a 3⅝ to 3⅞ per cent range over the remainder of the month.

While Treasury bill rates were generally unchanged for the month as a whole, upward rate adjustments on several other short-term money market instruments continued. Rates on various maturities of directly placed sales finance company paper generally were advanced by ⅛ to ¼ of a percentage point. The offering rates for new time certificates of deposit of leading New York City banks rose further, while the range of rates at which such certificates were offered in the secondary market rose by about 10 basis points on three-month maturities and by a somewhat lesser amount in the six-month category.

Interest in the market for Government notes and bonds was dominated during September by the largest Treasury advance refunding offer ever made. In a combined "prerefunding" and "junior" advance refunding, $32 billion of outstanding Treasury issues, maturing from May 1964 through August 1967 and including $23 billion held by the public, became eligible for conversion into securities maturing from 1968 through 1989-94.[1] The refunding was highly successful, with more than $6.5 billion—or 28.3 per cent—of the eligible securities held by the public exchanged for the Treasury's offerings of securities maturing in 1968, 1973, and 1989-94 (details given below). The large investor response, particularly for the 1973 and 1989-94 maturities, was generally taken in the market as a sign of investor confidence in current rate levels, and was particularly gratifying in view of some recent comments suggesting that current rate levels had been rendered artificial because of official purchases of intermediate- and long-term issues.

The Treasury estimated that the refunding extended the average maturity of the marketable debt by over four months, to more than five years and three months as of the end of September, the longest average maturity since July 1956. The Treasury also expressed the view that the success of the refunding should enable the Government securities market to accommodate readily the additional securities that must be sold to meet Treasury cash needs for the remainder of the calendar year. At the time of the refunding offering, the Treasury had made clear its intention to rely mainly on the bill market in filling these further needs.

Prices of outstanding Government notes and bonds receded during the opening days of the month in response to persisting expectations that an advance refunding was imminent. Market reaction to the September 4 refunding announcement was quite favorable, and lively trading ensued as investors adjusted their portfolios in light of the new investment opportunities presented by the exchange operation. Prices of outstanding issues declined in partial adjustment to the higher yields available on the newly offered securities, but a firm tone quickly emerged in the favorable atmosphere surrounding the financing. After the results of the refunding were announced on September 18, prices turned up, edging higher over the remainder of the period. In the market for Treasury bills, rates declined in the opening days of September, moved higher around the middle of the period, and then tended slightly lower toward its close, showing little net change for the month as a whole. Prices of corporate bonds adjusted downward in early September in response to the attractive yield available on the long-term bond of 1989-94 included in the Treasury's refunding package. The market recovered

[1] In a prerefunding, the securities eligible for conversion mature in not more than one year; a junior advance refunding might be defined as an operation where the securities eligible for exchange mature in from one to five years.

after midmonth, however, and prices edged up over the balance of the period. In the tax-exempt sector, prices declined over much of the month primarily under the weight of large dealer inventories and a heavy schedule of future offerings. Late in the month, however, a somewhat steadier tone emerged.

BANK RESERVES

Market factors provided reserves on balance from the last statement period in August through the final statement week in September. Reserve gains—stemming mainly from the usual September rise in float and from a contraction in Treasury deposits at the Federal Reserve Banks—more than offset excess reserves drained by a seasonal expansion in required reserves and by an outflow of currency into circulation. System open market operations during the month more than offset the net reserves released through market factors. System outright holdings of Government securities contracted on average by $34 million from the last statement period in August through the final statement week in September, while holdings under repurchase agreements declined by $68 million. Net System outright holdings of bankers' acceptances increased by $2 million. From Wednesday, August 28, through Wednesday, September 25, System holdings of Government securities maturing in less than one year decreased by $130 million, while holdings maturing in more than one year remained unchanged.

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

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

Factor	Daily averages—week ended Sept. 4	Sept. 11	Sept. 18	Sept. 25	Net changes
Operating transactions					
Treasury operations*	+ 112	— 22	— 127	+ 115	+ 78
Federal Reserve float	— 70	+ 139	+ 508	— 58	+ 519
Currency in circulation	— 151	— 187	+ 50	+ 166	— 122
Gold and foreign account	— 9	+ 18	+ 10	+ 3	+ 22
Other deposits, etc.	— 6	— 19	+ 77	+ 27	+ 79
Total	— 121	— 73	+ 516	+ 255	+ 577
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 190	+ 86	— 141	— 169	— 34
Held under repurchase agreements	+ 106	+ 120	— 294	—	— 68
Loans, discounts, and advances:					
Member bank borrowings	+ 51	+ 29	— 161	+ 195	+ 114
Other	— 1	+ 1	+ 1	— 2	— 1
Bankers' acceptances:					
Bought outright	+ 2	— 1	— 1	+ 2	+ 2
Under repurchase agreements	—	—	—	—	—
Total	+ 349	+ 234	— 596	+ 27	+ 14
Member bank reserves					
With Federal Reserve Banks	+ 228	+ 161	— 80	+ 282	+ 591
Cash allowed as reserves†	— 98	— 15	+ 134	+ 34	+ 55
Total reserves†	+ 130	+ 146	+ 54	+ 316	+ 646
Effect of change in required reserves†	— 58	— 109	— 239	— 186	— 592
Excess reserves†	+ 72	+ 37	— 185	+ 130	+ 54
Daily average level of member bank:					
Borrowings from Reserve Banks	325	354	193	388	315‡
Excess reserves†	480	517	332	462	448‡
Free reserves†	155	163	139	74	133‡

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

* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for four weeks ended September 25, 1963.

THE GOVERNMENT SECURITIES MARKET

In the market for Treasury notes and bonds, longstanding expectations of an advance refunding were confirmed early in the month when the Treasury revealed on September 4 the details of a massive debt-extension operation combining a prerefunding with a junior advance refunding. In the prerefunding phase, holders of the 3¼ per cent certificates, 3¾ per cent notes, and 4¾ per cent notes all maturing on May 15, 1964 were given the opportunity to exchange their holdings for a new issue of 3⅞ per cent bonds of November 15, 1968, for new 4 per cent bonds of August 15, 1973, or for reopened 4⅛ per cent bonds of May 15, 1989-94 which had originally been sold through auction in April of this year. Public holdings of the $14.5 billion of securities eligible for prerefunding totaled about $8 billion.

In the junior advance refunding, holders of the 3¾ per cent bonds of May 15, 1966, the 4 per cent notes of August 15, 1966, the 3⅝ per cent notes of February 15, 1967, and the 3¾ per cent notes of August 15, 1967 were given the option of converting their holdings into the new 4 per cent bonds of 1973 or into the reopened 4⅛ per cent bonds of 1989-94. Public holdings of the approximately $17.6 billion of securities eligible in the junior advance refunding totaled about $15 billion.

Subscription books for the entire refunding operation were open from September 9 through September 13; the settlement date was September 18. Based on September 3 prices of the issues eligible for conversion and taking account of price adjustments paid by the Treasury in connection with the exchange, investment yields for the offerings were estimated at about 4.02 per cent on the new 3⅞ per cent bonds of 1968, 4.14 to 4.15 per cent on the new 4 per cent bonds of 1973, and 4.20 to 4.21 per cent on the reopened 4⅛ per cent bonds of 1989-94. On September 18, the Treasury announced that more than $6.5 billion, or 28.3 per cent, of the eligible securities held by the public had been exchanged for the refunding offerings.

Public holders subscribed for approximately $1.6 billion of the new 3⅞ per cent bonds of 1968, $3.7 billion of the new 4 per cent bonds of 1973, and $1.3 billion of the reopened 4⅛ per cent bonds of 1989-94.

The great size of the refunding took the market somewhat by surprise, as did the inclusion of a long-term bond in the offering. The market reacted quite favorably to the attractive new investment opportunities, however, and the quiet midsummer atmosphere quickly gave way to lively activity. Prices of "rights"—those issues eligible for refunding—advanced 2/32 to 4/32 in early trading, as a broadly based demand readily absorbed offerings. Prices of other outstanding issues adjusted downward on September 5, narrowing the spread between their yields and the yields offered on the new securities. Issues maturing through 1972 were generally unchanged to 8/32 lower, while most longer term bonds declined by 16/32 to 24/32, and the reopened 4⅛ per cent bonds of 1989-94 moved down by 1¾. Even after these price declines, however, yields available on outstanding maturities remained considerably below the yields available on the new Treasury securities. The market for outstanding bonds stabilized at the new levels, as offerings—which arose mainly out of demand for the new securities—were readily absorbed by professional short covering, some Treasury trust account buying, and demand from other investment sources.

In early trading of the new securities on a "when-issued" basis, interest centered on the 4 per cent bonds of 1973 and on the 4⅛ per cent bonds of 1989-94. Demand for the 3⅞ per cent bonds of November 1968 was light at first, but expanded somewhat toward the end of the subscription period. Pension funds and insurance companies were important buyers of the 4⅛ per cent bonds, while the 1968 and 1973 securities attracted commercial bank and other investment demand.

With the multitudinous price adjustments smoothly completed and with the success of the refunding virtually assured, a confident tone took root in the market and prices of outstanding notes and bonds fluctuated narrowly through September 17. Results of the exchange, announced before the market opened on September 18, surpassed Treasury expectations. Although exchanges for the new 4 per cent bonds of 1973 and for the reopened 4⅛ per cent bonds of 1989-94 were larger than most observers had anticipated, the market took the results in stride. After some initial hesitation, prices firmed when good professional and investment demand—both for the new refunding securities and for other outstanding issues—developed, while offerings remained light. Against this background, prices of Government notes and bonds generally moved higher from September 18 through September 23, and then fluctuated narrowly through the end of the period. Over the month as a whole, prices of intermediate- and longer term issues ranged from 15/32 higher to 1 18/32 lower.

Treasury bill rates declined moderately in early September, largely in response to a strong demand for bills from sellers of rights to the Treasury's prerefunding who were seeking reinvestment outlets. Beginning on September 9 a more cautious tone emerged, as demand tapered off and offerings expanded with the approach of the midmonth corporate tax and dividend dates. The absorption of these offerings by dealers subsequently added to the cost and volume of dealer financing. Caution was also induced by some feeling in the market that official concern might be aroused by the lower rate levels that had emerged earlier in the month and that the Treasury might soon offer a tax bill or a strip of bills. Therefore, rates edged generally higher from September 9 through September 17. During the remainder of the month, however, bill rates moved narrowly lower, as demand expanded moderately and offerings contracted after the passing of the tax date.

At the final auction of the month held on September 30, average issuing rates were 3.408 per cent for the new three-month issue and 3.515 per cent for the new six-month issue, about 2 and 3 basis points respectively above the rates established in the final auction in August. The outstanding three-month bill, which was the attractive December 26 maturity, closed the month at 3.37 per cent (bid) as against the end-of-August rate of 3.39 per cent (bid) for the three-month maturity. An average issuing rate of 3.586 per cent was set at the September 25 auction of the new one-year bills, compared with an average rate of 3.575 per cent at the first monthly auction of one-year bills on August 27. The bills, dated October 1, 1963 and maturing September 30, 1964, represented the second in the Treasury's new monthly series of one-year bills.

OTHER SECURITIES MARKETS

The inclusion of the 4⅛ per cent bonds of 1989-94 in the Treasury's advance refunding at a rate of return which reduced the existing yield advantage of corporate securities triggered substantial early-month price reductions in the corporate sector of the bond market. Syndicate price restrictions on several new utility issues were terminated during this period, and the resulting price reductions boosted yields by about 10 basis points. A firmer tone emerged over the midmonth period, however, as earlier price concessions attracted demand and the moderate calendar of forthcoming new issues contributed to an improved technical position in the market. Announcement of the large turn-ins for the longer term issues offered in the Treasury's refunding had little effect on the corporate sector, and prices of corporate bonds edged higher over the latter part of September.

In the tax-exempt market, price weakness persisted during much of the period, reflecting an expanding calendar of forthcoming issues and a heavy volume of dealer inventories which moved sluggishly even after sizable price concessions had been made. At the end of the month, however, a somewhat better tone emerged. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 3 basis points to 4.32 per cent while the average yield on similarly rated tax-exempt bonds increased by 6 basis points to 3.15 per cent.

The total volume of new corporate bonds reaching the market in September amounted to approximately $280 million, compared with $255 million in the preceding month and $155 million in September 1962. New tax-exempt bond flotations during the month totaled approximately $415 million, as against $710 million in August and $395 million in September 1962. The Blue List of tax-exempt securities fell by $137 million during the month to $494 million on September 30. New corporate and tax-exempt bond issues marketed during the period were accorded mixed receptions by investors.