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Techniques of Member Bank Borrowing at the Federal Reserve

When the Federal Reserve System was founded fifty years ago, one of the primary objectives was to provide the United States with an elastic supply of money and credit that would expand and contract with the legitimate needs of business and agriculture. The System's founders envisaged that these objectives could be attained largely through the discount mechanism, with member banks obtaining short-term credit accommodation at the "discount window" of the Federal Reserve Bank—in times of stress, to meet seasonal needs, and in other times of rising credit demands.

With the far-reaching changes in the economy and in the financial structure of the country that have taken place since 1913, the System's basic objectives have become considerably broader. For many years these have been to promote sustainable economic growth, a high level of employment, and reasonable price stability. More recently, the defense of the international position of the dollar has also become a major consideration. The instruments and techniques used to seek these goals have also undergone a significant evolution; most notably, open market operations have become a major instrument for implementing monetary policy.

This article does not attempt to discuss in any detail these changes in objectives and instruments, but merely seeks to focus attention on certain technical aspects of member bank borrowing at the Federal Reserve—that is, on the potential use, in today's financial environment, of customer paper as collateral with the Federal Reserve. To provide some perspective, however, it should perhaps be briefly noted that the discount mechanism nowadays continues to fulfill a key function. In particular, the availability of Federal Reserve credit enables member banks to maintain their reserves at the levels required by law in the face of sudden withdrawals of deposits, of seasonal demands for credit beyond those which can reasonably be met by the use of the bank's own resources, or of other unusual situations and exceptional circumstances. By lessening greatly the risk to member banks of having to liquidate assets precipitately, the smooth day-to-day functioning of the credit and capital markets is facilitated. Furthermore, shifts in monetary policy are likely—in the first instance—to have an uneven effect on different individual banks or groups of banks. By enabling member banks to effect orderly adjustments in their asset positions in response to changes in over-all reserve availability, the discount mechanism enables the System to change the direction of policy more readily than might be the case in the absence of the discount window.[1]

GOVERNMENT SECURITIES AS COLLATERAL

Under the original Federal Reserve Act of 1913, member banks could obtain credit accommodation from the Federal Reserve only through the rediscount of "eligible" paper—in effect, the member banks endorsed and sold to the Reserve Banks short-term commercial, industrial, or agricultural paper. It soon became apparent, however, that the detail involved in rediscounting large numbers of individual notes and other kinds of paper was burdensome to all concerned. For administrative convenience and to effect economies in operation—and presumably also to aid in the financing of World War I—Congress in 1916 amended the Federal Reserve Act to permit the Federal Reserve Banks to make short-term advances to member banks against their own notes secured by eligible paper or by bonds or notes of the United States. As a result, the mechanics of the use of the discount window were simplified considerably, and in due course rediscounting was supplanted very largely by advances.

Advances against Government securities proved to be particularly convenient. It is not surprising, therefore,

[1] The System's discount objectives, and the conditions under which banks may properly borrow from their Federal Reserve Banks, are discussed in "Borrowing from the Fed", this Bank's *Monthly Review*, September 1959, pp. 138-42.

that by the early 1920's such advances accounted for a substantial proportion of member bank borrowings at the discount window. Nevertheless, with a relatively small Federal Government debt—only \$24 billion in 1920 and declining to \$17 billion by the end of the decade—many banks did not hold sufficient Government securities to cover all their borrowing needs. During this era, moreover, banking practices still cast much customer borrowing in the form of eligible paper. Partly for these reasons, and also because the custom was firmly ingrained, commercial banks throughout the 1920's did not hesitate to use eligible customer paper in large amounts to obtain credit accommodation from the Reserve Banks. For example, total member bank borrowings came to about \$687 million (month-end averages) during the 1925-29 period. Of this amount, some \$396 million was on average secured by Government obligations, while the balance of \$291 million was obtained through the rediscount of eligible paper or advances collateralized by such paper.

Member bank borrowing fell off sharply during the Great Depression and generally remained negligible thereafter through the immediate postwar years. In the middle and late 1930's, the volume of bank reserves was substantially in excess of legal requirements. During World War II member banks could obtain reserves readily by selling their holdings of short-term Government obligations to the Federal Reserve. Since 1951, however, when the System ceased relatively rigid support of Government securities, member banks once again have placed greater reliance on the discount window for temporary accommodation.

In sharp contrast to the 1920's, when member banks continued to use large amounts of eligible paper to borrow from the Federal Reserve, borrowings since World War II have been almost entirely in the form of advances secured by obligations of the United States. This situation reflects no reluctance on the part of the Reserve Banks to accept eligible paper as collateral for advances, but results from the preference of the borrowing banks themselves. Commercial banks had acquired large amounts of Government securities during World War II and, as long as such securities were readily available in their portfolios, banks naturally chose this convenient method of borrowing. The composition of bank portfolios, however, has changed gradually but markedly over the postwar period. There has been a substantial decline in the aggregate amount of member bank holdings of Government securities. Between the end of 1945 and the end of 1963, member bank loans and investments other than in Government securities expanded by approximately \$132 billion to a level of \$160 billion; over the same period, their holdings of Government securities fell by about \$29 billion to a level of \$49 billion. The decline, moreover, has been concentrated at banks in the financial centers. Holdings of Governments at the New York City banks declined by \$12 billion to about \$6 billion between the year ends of 1945 and 1963, while holdings at other reserve city banks fell by \$15 billion to a total of \$18 billion; the decrease at "country" banks, on the other hand, was only \$2 billion to \$25 billion.

In recent years, moreover, public deposits—including Treasury Tax and Loan Accounts—which generally must be secured by a pledge of collateral have risen substantially. This factor, in turn, has tended to immobilize large amounts of Government securities, since banks have widely used such securities as collateral for public deposits for much the same reasons that apply in the case of securing advances at the Federal Reserve.

The decline in bank holdings of Government securities and the rise in public deposits have combined in recent years to reduce the amount of Government securities banks have available as collateral for borrowing at the discount window to the point where some banks on occasion have actually felt an acute shortage of Government securities for this purpose. Although the shortage so far has been limited to individual banks, principally in the money centers, the situation could become more general.

POTENTIAL USE OF ELIGIBLE PAPER AS COLLATERAL

Member banks could of course use eligible paper rather than Government securities to secure advances and, with minor exceptions, Treasury Tax and Loan Accounts as well.[2] With respect to advances, legal eligibility requirements have remained virtually unchanged since the System's early days, and these confine eligible paper to types of credits which nowadays account for a much smaller proportion of commercial bank assets than in the 1920's. To avoid a possible shortage of collateral—and to bring requirements as to collateral in line with modern banking practices—a proposed amendment to the Federal Reserve Act, now pending in Congress (S.2076, H.R.8505, 88th Congress), would eliminate the obsolete eligibility rules. The legislation would remove existing requirements and authorize the Reserve Banks to make advances to member banks secured by any asset satisfactory to the Reserve Banks, subject to such regulations as the Board of Gov-

[2] In the case of Treasury Tax and Loan Accounts, other collateral may also be used—see United States Treasury Department Circular No. 92 (revised).

ernors of the Federal Reserve System might prescribe. The enactment of this legislation would minimize the possibility that banks might not be able, for want of collateral, to borrow at the regular discount rate to meet legitimate needs.[3]

There is a risk, however, that another obstacle to the use of customer paper as collateral might arise from the reluctance of many banks to use such paper. This attitude was highlighted on occasions in the recent past when certain Second District banks, short of Government securities but holding eligible paper, reportedly refrained from using such paper—either to obtain accommodation at the discount window in times of legitimate reserve needs, or to serve as collateral for Tax and Loan Accounts.

The reluctance appears to have been caused by some concern on the part of the banks that their customers might react unfavorably to the use of their paper as collateral. Customer paper is usually made payable to the order of the lender; and to be effectively pledged in negotiable form, either as collateral for an advance or for a Treasury Tax and Loan Account, "order paper" must be endorsed. This endorsement, in turn, eventually indicates to the bank's customer that his paper has been used as collateral. Some bank customers reportedly have indicated that they would tend to question the managerial capacity of a bank that might find itself in a position of being required to use their paper as collateral.

In actual fact, such a conclusion is entirely unwarranted. If the use of the discount window is appropriate by Federal Reserve standards, it is immaterial whether the advance is secured by Government securities or by eligible paper. Similarly, the securing of Treasury Tax and Loan Accounts by commercial and agricultural paper does not in any way reflect unfavorably on the management or financial position of a bank which thus employs it. For convenience, the bank is merely using customers' notes in lieu of some other form of collateral.

Prior to accepting a given piece of customer paper as collateral for an advance, Federal Reserve Banks also consider the financial condition of the original borrower. As a result, in earlier years, when it was common for a customer's paper to be discounted or used as collateral, the acceptance of such paper by the Federal Reserve was traditionally regarded as indicative of that customer's favorable credit standing. This implication is apparently overlooked by the borrowing bank's customer who today objects to the transfer of his paper.

The discount mechanism plays an important role in facilitating member bank operations and in the smooth implementation of monetary policy. Possible misconceptions on the part of banks and their customers regarding the implications of using eligible paper as collateral should not interfere with the proper functioning of this mechanism.

[3] Actually, under Section 10 (b) of the Federal Reserve Act, any Federal Reserve Bank may make advances to any member bank on that bank's note secured to the satisfaction of the Federal Reserve Bank, but at a rate not less than ½ of 1 per cent per annum higher than the discount rate in effect.

The Business Situation

Economic activity was continuing to expand as the first quarter drew to a close, and business sentiment remained confident of substantial further gains in the months ahead. Industrial production inched ahead in February, payroll employment rose considerably, and average hours worked recovered to the advanced December level. Although still high, the unemployment rate edged down in February to its lowest point in over a year and was maintained at that rate in March. Retail sales appear to have fallen off somewhat from their record February level, while preliminary production data for March are somewhat mixed.

One key factor in the current strong business outlook is the prospect for capital spending. Expanded capital spending programs have recently been announced by several large firms, and—according to the latest Government survey—businessmen as a group plan to increase their outlays for plant and equipment by 10 per cent in 1964. This figure confirms (indeed, slightly exceeds) the year-to-year increase in planned spending reported by McGraw-Hill following a special survey taken in January.

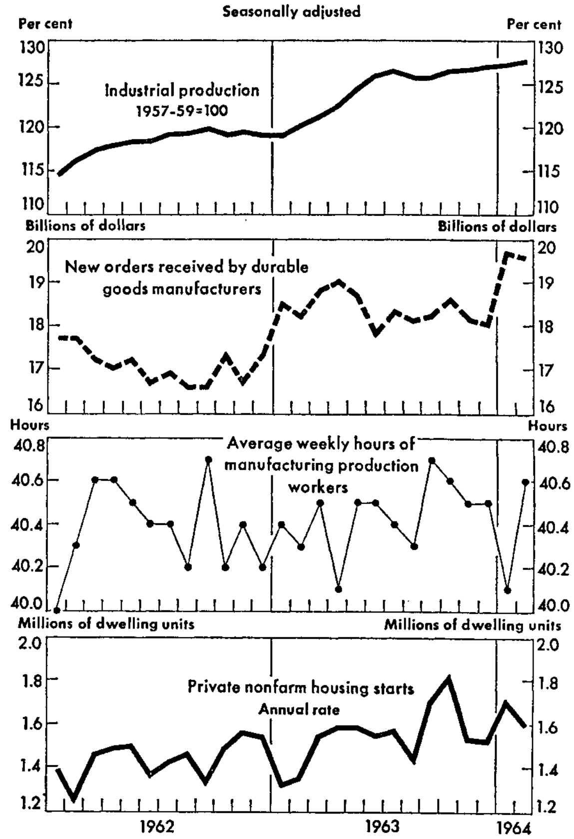
Manufacturers' inventory plans for the second quarter call for a rate of accumulation higher than in the first quarter and about the same as achieved in the final quarter of 1963. Although new orders received by durables manufacturers in February only about matched their January record, they were still above sales, so that the backlog of unfilled orders rose for the second month in a row.

Price-wage developments thus far in 1964 have continued to be highlighted by a number of announcements of price increases for certain industrial commodities, as well as by preliminary discussion of bargaining positions to be taken in key labor negotiations later in the year. Developments in these areas will clearly bear close watching in a generally expansionary economic environment. As in 1963, however, movements in the over-all price indexes have been moderate; indeed, the over-all consumer price index actually edged downward in February. Wholesale food prices fell off in February and apparently were about unchanged in March, while the index for industrial wholesale prices has remained stable since December.

Chart I

RECENT BUSINESS INDICATORS

Seasonally adjusted



Sources: Board of Governors of the Federal Reserve System; United States Departments of Commerce and Labor.

PRODUCTION, EMPLOYMENT, AND RETAIL SALES

The Federal Reserve Board's seasonally adjusted index of industrial production edged upward in February to a record level of nearly 128 per cent of the 1957-59 average (see Chart I). A strike in the farm machinery industry during most of February caused a decline in equipment production, and mining output also fell slightly. These decreases, however, were more than offset by relatively sizable gains in automobile assemblies and iron and steel production, combined with somewhat smaller increases in output of nondurables manufacturers and utilities. With dealer inventories of new cars at a record level, preliminary data for March, after making allowance for seasonal factors, suggest that automobile producers are cutting back assemblies somewhat from their exceptionally high February level. Steel ingot production, on the other hand, remained as strong in March as in February. The outlook for additional increases in over-all industrial production was strengthened by the continued advance in February in the backlog of unfilled orders held by manufacturers of durables. Although the volume of incoming new orders actually slipped a bit in February, it was still at the second highest level on record, with the January-February average for new orders well above the level reached in the final quarter of 1963 (see Chart I).

Nonfarm payroll employment rose by 280,000 persons in February (seasonally adjusted). This gain, the largest in nearly two years, in large part reflected a substantial rebound in construction employment following a January decline. At the same time, however, employment in all other major sectors save mining showed some increase in February. In the manufacturing sector, for example, payrolls rose by 55,000 persons, while the average workweek clocked by production workers moved up to 40.6 hours (seasonally adjusted). This increase raised the average workweek once more to the high level that, except for January, has prevailed in the last six months (see Chart I). Hours of overtime are reportedly above the year-ago level in many manufacturing industries, and it is possible that further output gains may to an important extent be translated into increased hirings. Such a development, of course, would tend to reduce unemployment, which according to the Census Bureau's household survey edged down to 5.4 per cent of the civilian labor force in February and remained at that level in March. This rate is at the lower end of the range of unemployment that has prevailed during the past two years. The decline from January reflected small but rather widespread improvements among the various groups in the labor force; in particular, unemployment among married men edged down, and teen-age unemployment reached its lowest level in over a year.

Retail sales increased substantially in February, with most of the push coming in sales of durables. Preliminary data suggest a possible drop in over-all retail sales volume in March, though there have been reports of good pre-Easter sales of apparel and other spring merchandise. The tax cut affected consumer take-home pay during the month, since it went into effect with the first pay checks received on and after March 5, but it is too early to appraise the impact of this factor on retail sales. Furthermore, the variability of the date of the Easter holiday always makes assessment of sales figures at this time of the year somewhat difficult.

Despite what appears to have been a slight decline in March, sales of domestically produced cars for the first quarter as a whole were at a seasonally adjusted annual rate of about 7.8 million units—a level somewhat above the pace that most manufacturers had forecast. With auto sales already at such high levels, some observers have expressed skepticism as to the possibility of substantial further gains even with the tax cut. Nevertheless, a Census Bureau survey of consumer buying intentions taken in January showed that plans to purchase new cars within the next six months, and within the next twelve months, were both higher than at the start of 1963 (see March *Review*). The results of the latest University of Michigan survey of consumer buying attitudes—conducted about the same time as the Census Bureau survey but covering a different (and smaller) sample of households—suggest that consumers generally regarded the next six months as a good time to buy. The Michigan survey also indicated, however, that plans to purchase new cars within twelve months were noticeably lower than a year earlier—a result at variance with that of the Census survey.

RESIDENTIAL CONSTRUCTION AND INVENTORIES

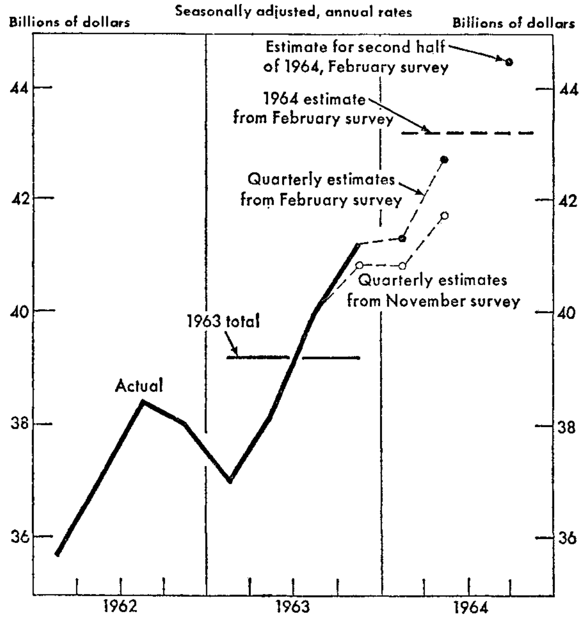
Activity in the housing sector has continued at a high level, as residential construction outlays edged up for the third month in a row in March. For the first quarter as a whole, outlays were 1 per cent above the advanced level reached in the fourth quarter of 1963. Although housing starts fell off by 6 per cent in February (see Chart I), the average for the first two months of this year was actually above that in the final quarter of last year—a quarter that included a record level of starts in October. Some further gain in outlays may therefore be in prospect, a view supported by a sharp rise in the number of new building permits issued in February.

As regards business inventories, a Commerce Department survey taken in February suggests that manufacturers planned an inventory increase of only $300 million in the first quarter of 1964, a substantial drop from the $1 billion recorded in the last quarter of 1963. Plans for the second quarter, however, call for an accumulation once again of $1 billion. These planned additions to stocks are about in line with manufacturers' sales expectations, and point to a second-quarter inventory-sales ratio that is virtually the same as that prevailing at the end of 1963—a level that manufacturers holding 85 per cent of the inventories covered in the Commerce survey judged to be about right. Except for a good part of 1962, manufacturers' inventory-sales ratios have declined rather persistently throughout the current expansion. Earlier cyclical expansions, in contrast, showed some recovery in inventory-sales ratios following an initial period of decline.

CAPITAL SPENDING

The economic outlook has received a major boost from evidence of developing strength in businessmen's capital spending plans. The February Commerce Department survey (undertaken jointly with the Securities and Exchange Commission) points toward a rise in plant and equipment

Chart II
ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING
Seasonally adjusted, annual rates



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

outlays in 1964 that is larger in both absolute and percentage terms than any of the actual annual gains since the advance recorded in the investment boom year of 1956. A special McGraw-Hill survey taken in January already had confirmed that spending plans had been revised upward substantially since first reported last fall, and these findings are now reinforced by the 10 per cent rise shown in the Government survey.

Actual spending in the fourth quarter of 1963 turned out to be somewhat higher than had been indicated in the Government's survey taken last November (see Chart II). A similar upward revision is evident in the estimated level of spending for the first quarter of this year, but this revision still implies little change over the fourth-quarter level. Plans for the second quarter of 1964 call for an increase in outlays of nearly $1.5 billion, or 3½ per cent over the first quarter; and, if the projected full-year total is to be reached, outlays in the second half of 1964 will have to climb about 6 per cent above the first-half average. The record of this survey in previous years suggests that plans reported at the beginning of the year are in large part carried out—indeed bettered in years of business expansion. The understatement in the February survey was, however, rather small for 1962 and 1963.

The Money Market in March

The money market remained generally firm in March, handling smoothly the large flows of funds associated with the quarterly corporate tax and dividend payment dates and the impending April 1 Cook County, Illinois, personal property tax date. Although the reserve positions of banks in the leading money centers came under moderate pressures at times during the month, these banks were able to satisfy a large part of their reserve needs in the Federal funds market—where a 3½ per cent effective rate generally prevailed—and member bank borrowings from the Federal Reserve Banks declined slightly over the period as a whole. Rates posted by the major New York City banks on new and renewal call loans to Government securities dealers were mainly in a 3¾ to 4 per cent range. Offering rates for new time certificates of deposit issued by the leading New York City banks moved slightly higher in March, as did the range of rates at which such certificates were offered in the secondary market. Rates on some maturities of directly placed finance company paper also rose moderately over the month as a whole.

In the Treasury bill market, demand expanded in March and bill rates receded somewhat from the levels to which they had risen in late February in the wake of the British bank rate increase. Prices of Treasury notes and bonds, on the other hand, declined during most of the month, reflecting market expectations that interest rates would trend upward during the remainder of the year if economic expansion continued and rates moved higher in foreign countries. The same sentiment was evident in the corporate and tax-exempt bond markets, and prices in these markets also moved downward during the period.

After the close of business on Thursday, March 26, the Treasury announced the terms of a new cash borrowing operation. An additional $1 billion of the outstanding 3⅞ per cent notes due August 13, 1965 was offered at a price of 99.70 to yield approximately 4.10 per cent. Subscriptions were received only on Tuesday, March 31, with payment due April 8. Payments may be made through credit to Treasury Tax and Loan Accounts. (At the same time the Treasury announced another in the series of one-year bills—$1 billion of bills maturing March 31, 1965, to be auctioned April 3 for payment April 8, with commercial banks permitted to pay for 50 per cent of their purchases through crediting Tax and Loan Accounts.)

After the close of business on April 2, the Treasury announced that early reports indicated subscriptions for the reopened 3⅞ per cent notes of approximately $10.2 billion. The Treasury will allot in full subscriptions of $50,000 or less. Larger subscriptions will be subject to a 9 per cent allotment (with a minimum of $50,000).

BANK RESERVES

The month was characterized by sizable week-to-week movements in aggregate free reserve levels. These reserve fluctuations were not accompanied by any similar swings in money market conditions, however, as their effects were largely offset by movements in the distribution of reserves as between "city" and "country" banks. At the beginning of the month, money market banks made extensive preparations for anticipated mid-March seasonal reserve pressures. Typically, such pressures arise as a result of expanded bank loans to corporations, nonbank financial institutions, and Goverment securities dealers over the quarterly tax and dividend dates. Accordingly, in early March, banks in the money centers increased their offering rates on time certificates of deposit in order to minimize net time deposit withdrawals around the tax and dividend dates. In addition, these banks relied more heavily than usual on the sale of bankers' acceptances and of intermediate-term Government securities to acquire reserves. These transactions, together with an ample supply of Federal funds during much of the period, facilitated smooth midmonth adjustments on the part of the banking system.

CHANGES IN FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MARCH 1964

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

Factor	Daily averages—week ended Mar. 4	Mar. 11	Mar. 18	Mar. 25	Net changes
Operating transactions					
Treasury operations*	— 98	+ 39	+ 48	— 131	— 142
Federal Reserve float	— 306	+ 80	+ 149	+ 215	+ 138
Currency in circulation	— 37	— 193	— 154	+ 35	— 349
Gold and foreign account	— 3	+ 2	+ 5	— 16	— 12
Other deposits, etc.	+ 1	— 22	+ 64	+ 59	+ 102
Total	— 444	— 94	+ 112	+ 162	— 264
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 495	+ 192	— 242	+ 106	+ 551
Held under repurchase agreements	—	—	+ 75	+ 8	+ 83
Loans, discounts, and advances:					
Member bank borrowings	+ 162	— 109	+ 105	— 79	+ 79
Other	—	—	—	—	—
Bankers' acceptances:					
Bought outright	+ 2	+ 1	— 2	+ 1	+ 2
Under repurchase agreements	+ 6	+ 16	+ 11	+ 18	+ 51
Total	+ 664	+ 101	— 54	+ 55	+ 766
Member bank reserves					
With Federal Reserve Banks	+ 220	+ 7	+ 58	+ 217	+ 502
Cash allowed as reserves†	— 73	— 212	+ 178	+ 89	— 18
Total reserves†	+ 147	— 205	+ 236	+ 306	+ 484
Effect of change in required reserves†	— 10	+ 31	— 177	— 161	— 317
Excess reserves†	+ 137	— 174	+ 59	+ 145	+ 167
Daily average level of member bank:					
Borrowings from Reserve Banks	362	253	358	279	313‡
Excess reserves†	490	316	375	520	425‡
Free reserves†	128	63	17	241	112‡

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

* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for four weeks ended March 25, 1964.

Market factors absorbed excess reserves on balance from the last statement period in February through the final statement week in March. Reserve drains arose primarily from an increase in currency outside the banking system[1] and from a rise in required reserves which partly reflected loan expansion over the quarterly corporate tax and dividend dates. An expansion in float partly offset these drains. System open market operations supplied reserves over the period as a whole, offsetting reserves absorbed by market factors. System outright holdings of Government securities rose on average by $551 million from the last statement period in February through the final statement week in March; System holdings of Government securities under repurchase agreements averaged $83 million in the final statement period of the month, whereas none had been outstanding in the last week of February. From Wednesday, February 26, through Wednesday, March 25, System holdings of Government securities maturing in less than one year rose by $429 million, and holdings maturing in more than one year increased by $22 million.

THE GOVERNMENT SECURITIES MARKET

In the market for Treasury notes and bonds, an important background factor during much of the month was a persistent feeling that continuing economic expansion at home and tendencies toward higher interest rates abroad might be accompanied by an upward trend in domestic interest rates. In the early part of the month, increased offerings—particularly of intermediate-term securities from commercial banks—encountered little demand from either investor or professional sources, and prices of intermediate- and long-term Treasury issues generally declined. The market atmosphere firmed slightly prior to midmonth, as participants began to feel that no immediate tightening in monetary policy was likely. Commercial bank offerings contracted, a modest investor demand emerged, and some professional short covering took place. After midmonth, confidence in the stability of current interest rate levels weakened once again amid further indications of business expansion and in response to the rise in stock market averages to record heights. Offerings expanded, and prices of coupon issues fell further. In the final few days of the month, a steadier atmosphere re-emerged. Some investor demand and dealer short covering developed, and in this setting the Treasury's offering of additional 3⅞ per cent notes attracted good interest. Nonetheless, reflecting declines earlier in the period, prices of notes and bonds at the

[1] "Currency in circulation" less "cash allowed as reserves".

end of March were generally unchanged to 20/32 below late February levels.

After a moderate February rise, Treasury bill rates edged irregularly lower in March. In the opening days of the month, there was an abatement of market concern that the late February increase in the British bank rate might soon trigger a shift toward a less easy monetary policy in the United States. Investment demand emerged, partly reflecting temporary reinvestment of the proceeds of sales of longer term issues; increased demand in turn contributed to a rapid improvement in the technical position of the bill sector. At the same time, the market was bolstered by reports that a foreign central bank might be taking steps to encourage its local commercial banks to purchase United States Treasury bills. Against this background, bill rates generally declined in the first week of the month. This trend was interrupted around the March 10 dividend payment date when corporate offerings of bills expanded modestly, demand temporarily diminished, and bill rates edged slightly higher. Subsequently, however, moderate investment demand reappeared, corporate selling over the midmonth quarterly tax date proved to be quite light, and bill rates moved narrowly during the rest of the month.

Over the month as a whole, rates on outstanding bills were generally 3 to 7 basis points lower for comparable maturities. At the last regular weekly auction of the month held on March 30, average issuing rates were 3.525 per cent for the new three-month issue and 3.710 per cent for the new six-month bill—2 basis points lower and 1 basis point higher, respectively, than the rates established in the final auction in February. The April 3 auction of $1 billion of new one-year bills—for which banks may pay through Tax and Loan credit to the extent of 50 per cent—resulted in an average issuing rate of 3.719 per cent, compared with an average issuing rate of 3.765 per cent at the preceding month's one-year bill auction. The newest outstanding three-month bill closed the month at 3.54 per cent (bid) as against 3.60 per cent (bid) at the end of February, while the newest outstanding six-month bill was quoted at 3.72 per cent (bid) on March 31, compared with 3.77 per cent (bid) on February 28.

OTHER SECURITIES MARKETS

Prices of seasoned corporate and tax-exempt bonds generally declined in March, as investors—appraising the outlook for interest rates cautiously in the light of optimistic business forecasts and an upsurge in stock prices—appeared reluctant to commit funds to fixed-income securities. In the tax-exempt sector, where the volume of new issues continued heavy and dealer inventories were large, reoffering yields on a number of slow-moving recent flotations were adjusted upward by 5 to 15 basis points. At the same time, several syndicate terminations occurred in the corporate sector, boosting reoffering yields as much as 6 basis points. Over the period as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds increased by 5 basis points to 4.40 per cent and the average yield on similarly rated tax-exempt bonds rose by 7 basis points to 3.16 per cent.

The volume of new corporate bonds floated in March amounted to approximately $355 million, compared with $270 million in the preceding month and $490 million in March 1963. The largest new corporate bond issue marketed during the month consisted of $50 million of A-rated[2] 4½ per cent finance company debentures maturing in 1992. The debentures, which were offered to yield 4.58 per cent and are not refundable for eight years, were accorded a fair reception. New tax-exempt flotations in March totaled approximately $770 million, as against $740 million in February 1964 and $930 million in March 1963. The Blue List of tax-exempt securities advertised for sale declined by $113 million during the month to $520 million on March 31. The largest new tax-exempt bond issue marketed in March—a $135 million flotation—included $61 million of 4 per cent term bonds maturing in 1992 and $74 million of 4.10 per cent term bonds due in 2003; both portions were reoffered at par and received good initial investor receptions. Other new corporate and tax-exempt bonds floated in March were accorded mixed receptions by investors.

[2] Rated by Standard & Poor's.

Recent Economic Policy Measures Abroad

During the closing months of 1963 and in the early part of this year inflationary pressures intensified in a number of industrial countries abroad.[1] In the face of rapid increases in prices and wages which were threatening both domestic and external equilibrium, some countries adopted comprehensive stabilization programs while others relied on selective restraint measures. International consultation on these national financial policies continued through the established channels of cooperation.

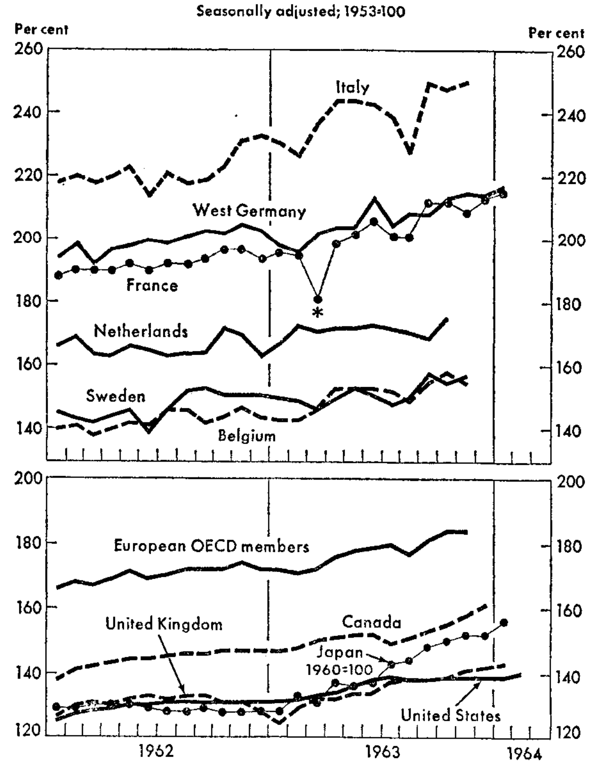
GENERAL ECONOMIC BACKGROUND

In virtually all major industrial countries abroad, the pace of economic activity has quickened since the summer of 1963 (see Chart I), making for impressive gains in production and output for last year as a whole. Thus, industrial production in 1963 increased by close to 10 per cent in France and the United Kingdom, by over 8 per cent in Italy, and by over 5 per cent in Germany. For the entire European Economic Community (EEC), gross national product grew by an estimated 4 per cent (in real terms) and is expected to rise by about 4.5 per cent this year.

In fact, public and private demand for goods and services has expanded at a rate which, in the second half of 1963, caused consumer prices—shown in Chart II—and wholesale prices to turn up sharply in many Continental countries. Moreover, labor has become so scarce that increases in wage costs have tended to accelerate. These boom conditions have generated stresses in a number of Continental countries that have tended to spread beyond national frontiers. Although it is admittedly difficult, if not impossible, to single out factors of special importance in each country, private consumption expenditures and construction activity appeared to be dominant in France, Italy, and Switzerland. Booming exports and construction expenditures emerged as the most significant factors contributing to the further rise in domestic activity in West Germany.

Among the major industrial countries outside the European continent, strength in the construction sector and in consumer expenditures on durable goods was recorded in the United Kingdom and led to fairly full utilization of resources. But there was little evidence of inflation, with

Chart I
INDUSTRIAL PRODUCTION IN MAJOR COUNTRIES
Seasonally adjusted; 1953=100

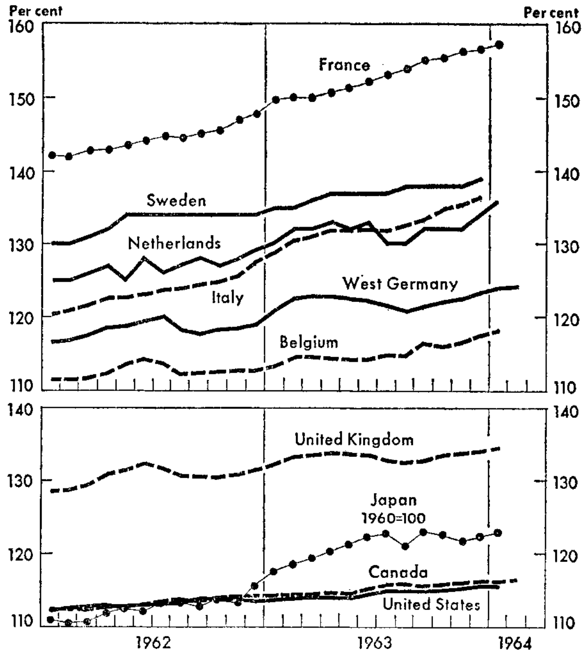


* Affected by widespread strike in the public sector.

Sources: Organization for Economic Cooperation and Development, monthly statistical bulletins; national statistics.

[1] For a discussion of foreign economic and financial developments in January-August 1963, see "Recent Financial Policy Measures Abroad", this *Review*, September 1963, pp. 131-36.

Chart II
CONSUMER PRICES IN MAJOR COUNTRIES
1953=100



Sources: Organization for Economic Cooperation and Development, monthly statistical bulletins; national statistics.

retail and wholesale prices advancing modestly between 1962 and 1963. Nevertheless, by the end of last year output was growing at a more rapid pace than the 4 per cent annual rate that the authorities consider a sustainable target. In addition, wage increases were frequently exceeding the official guideline of 3½ per cent per annum. Canada's economy also was operating at a high level by the year end. In December, industrial production set a record and unemployment fell below 5 per cent for the first time since mid-1957. However, with capacity still ample, price increases have tended to be very modest. Japan's growth again topped that of all other countries last year, with the increase in industrial production accelerating to 18 per cent.

Buoyant economic activity often led to substantial increases in imports, which tended to weaken the current-account positions of several major foreign industrial countries. In addition, varying degrees of inflation on the Continent have tended to move the surplus and deficit positions of individual countries somewhat further apart. The deterioration in Italy's current account—leading to a large over-all deficit last year—and the sharp contraction in the French current-account surplus stand in marked contrast (and may be partly related) to the increasing strength of Germany's external position. In the United Kingdom, rising incomes led to an expansion of imports—partly for inventories—in the second half of 1963 that exceeded the growth of exports, thus widening the trade deficit. As a result, the British current-account surplus contracted sharply toward the end of the year. On the other hand, Canada, helped by grain sales to the U.S.S.R., last year recorded a trade surplus for the third year in succession and the largest since 1952. Canada's current-account deficit in 1963 was cut by one third from 1962.

Against this general background of high-level economic activity and rising prices, a number of countries—including France, Italy, and the Netherlands—introduced a broad range of monetary, fiscal, and direct measures. Other countries adopted more selective and specific measures in their fight against domestic and external disequilibrium.

FRANCE, ITALY, AND THE NETHERLANDS

In France, the authorities extended and reinforced the monetary restraints—including curbs on borrowing abroad by French residents—that had been introduced earlier last year. In September, the ceilings on permissible annual increases in bank credit were again lowered—from 12 per cent to 10 per cent for March 1963-February 1964. Moreover, minimum downpayments for instalment purchases of a number of durable goods were raised. In the case of cars, the minimum downpayment is now 30 per cent, compared with 25 per cent previously, while the maximum repayment period has been lowered to twenty-one from twenty-four months. In November, the Bank of France raised its basic discount rate to 4 per cent from the 3½ per cent level that had been in effect since October 1960. In a follow-up early this year, the Bank of France raised (also to 4 per cent from the previous 3 per cent) its rate on thirty-day advances against short-term government paper and, in addition, extended to March-September the credit ceilings that were scheduled to expire in February.

Apart from these moves to raise the cost and reduce the availability of credit, the French authorities also continued their earlier efforts to channel more resources into the longer term market. Thus the authorities reduced the portion of the commercial banks' over-all liquidity ratio that has to be held in Treasury bills, thereby permitting the banks to put a larger part of their earning assets into medium-term credit. In a parallel move designed to increase the flow of investment funds to savings institutions, the maximum savings deposit which individuals may hold was raised from 10,000 to 15,000 francs ($2,000 to $3,000), while the rates on competing three-year government securities were reduced. These savings deposits are administered by the official Caisse des Dépôts et Consignations, which normally invests them in mortgage loans, public securities, and loans to various public agencies and entities. With the government having a strong voice in the management of these resources, it was anticipated that long-term funds would become more readily available to finance government-sponsored capital projects. In the fiscal field, the planned over-all deficit for calendar year 1964 was cut back by close to 2 billion francs below last year's nearly 6 billion, mainly as a result of downward revisions in spending plans.

To reduce pressures on consumer prices, the French government last September temporarily lowered customs duties on a large number of manufactured goods and foodstuffs imported from both the EEC and other countries.[2] In addition, the government canceled scheduled rent increases, froze the prices of manufactured goods and of a wide range of foodstuffs, and in some cases even rolled back prices. In order to cope with the pressure of wages on prices, the government formed within the High Planning Council (Commissariat au Plan) a committee to prepare the gradual introduction of policies designed to keep income growth within a range supportable by productivity increases, and in the meantime has limited wage and salary increases in the public sector to 4 per cent per annum.

Italy experienced an estimated over-all balance-of-payments deficit of some $1.2 billion equivalent last year, largely as a result of the rapid business expansion. In late summer, the Bank of Italy acted to curb the growth of liquidity. Therefore, the bank instructed the Italian commercial banks authorized to operate in foreign exchange to keep their foreign borrowing to the August level and, if possible, to reduce it. Such borrowing—mainly in the Euro-dollar market—had increased by over $760 million in the first eight months of last year and had supported a rapid increase in bank lending. As the Italian banks began to reduce their foreign borrowing, their liquidity position came under some strain. Moreover, Italy's international reserves began to reflect more fully the country's deteriorating balance-of-payments position. Between August 1963 and February of this year, official reserves fell by $751 million.

[2] In the case of EEC imports, the reductions were 15-20 per cent, while for other countries the reduction amounted to 50 per cent of the difference between present rates and the future EEC common external tariff.

To buttress Italy's external position, the authorities in mid-March obtained approximately $1 billion in credit facilities from the United States and from European central banks. In an official statement, the Italian government declared that these credits were

> immediately available to supplement the official holdings of the Bank of Italy and the Foreign Exchange Office to the extent necessary to meet whatever requirements may occur in 1964—the period during which Italy's program to correct its balance of payments is expected to become fully effective.

Shortly after obtaining these credits, Italy also drew from the International Monetary Fund (IMF) $225 million equivalent in eight currencies (other than United States dollars).

Prior to arranging for this assistance, the Italian authorities had already taken a number of anti-inflationary measures, mainly in the fiscal field. In September, the government reduced the planned deficit for fiscal 1963-64 to substantially below the level of the original estimate. This cut is to be achieved mainly through reductions in government spending and increases in sales taxes on a number of luxury goods. On the other hand, in an effort to stimulate the growth of productive capacity, the government program provided for more liberal tax treatment of business investment. In March, the government obtained legislative authority for a tax increase on gasoline and fuel oil, a new tax on cars and pleasure craft, and a reform of dividend taxes. The sales tax on cars is expected to have a significant effect on car purchases, particularly of foreign cars, which have bulked large in the recent rise in Italian imports. Mainly to discourage capital flight and help restore the flow of private savings to the investment market, the government also modified the regulations governing the tax on dividends. Up to March, dividends were subject to a 15 per cent withholding tax and could be paid out only if stock ownership was disclosed to the authorities. The withholding tax has now been reduced to 5 per cent provided investors declare their holdings; on the other hand, failure to reveal ownership will result in a withholding rate of 30 per cent. The authorities have also proposed the fixing of minimum downpayments and maximum repayment periods for consumer instalment credit, which would be the first instance of such controls for Italy.

The Dutch authorities, concerned over the large wage increases under recent wage negotiations, likewise adopted a broad range of restraint measures. Early in January, the

Netherlands Bank raised the discount rate to 4 per cent from the 3½ per cent rate that had been in effect for an entire year (see table). In addition, the ceilings on the expansion of bank credit to the private sector, which had been established for September-December, were retained for the first four months of this year, although the permissible rate of expansion was increased slightly. In the consumer credit field, the minimum downpayment for durable goods was raised by 5 percentage points, and banks were asked to refrain from advertising such loan facilities. To reduce the budget deficit, the Dutch government has postponed certain investment expenditures and suspended both investment allowances for industrial buildings and accelerated depreciation allowances in general. In addition, the government apparently intends to allow the share of tax revenues in national income to rise and to refrain from tax cuts designed to keep this share constant, as had been the stated policy previously.

In another move—to cope directly with wage and price pressures—the Dutch authorities early this year gave warning to both unions and employers that the government might use its power to limit any future wage agreements that provide for increases substantially in excess of the recently negotiated 10 per cent. The authorities have also asked for the power to control "undue" price increases of individual enterprises, in addition to existing powers to control prices in whole sectors of industry. Finally, the sanction of law for retail price maintenance is to be withdrawn for some goods.

CHANGES IN FOREIGN CENTRAL BANK DISCOUNT RATES, 1963-64
In per cent

Country	Date	New rate	Change
Austria	1963: June 27	4½	−½
Belgium	1963: July 18 October 31	4 4¼	+½ +¼
Canada	1963: May 6 August 12	3½ 4	−½ +½
Denmark	1963: August 19 November 13	6 5½	−½ −½
France	1963: November 14	4	+½
Greece	1963: January 17	5½	−½
Japan	1963: March 20 April 20 1964: March 18	6.205 5.84 6.57	−0.365 −0.365 +0.730
Netherlands	1963: January 8 1964: January 6	3½ 4	−½ +½
Sweden	1963: January 18 June 14 1964: January 31	3½ 4 4½	−½ +½ +½
United Kingdom	1963: January 3 1964: February 27	4 5	−½ +1

ANTI-INFLATIONARY MEASURES IN OTHER COUNTRIES

In raising the discount rate from 4 per cent to 5 per cent in February, the Bank of England made the first major move toward restraint since the British authorities began to relax their policy in the wake of the July 1961 crisis measures. The authorities stated that their purpose was to "steady" the pace of expansion in the economy. While it is true that the rapid expansion of economic activity in the United Kingdom in the latter part of 1963 was not accompanied by any excessive increase in bank credit, consumer instalment credit and construction activity have been buoyant. In addition, bank lending rose to a new peak in the quarter through mid-February, with manufacturers, retailers, and nonbank financial institutions the principal borrowers. The Bank of England's action effectively curbed the pressure on sterling that had developed toward the end of February in the wake of January's poor trade results. However, the authorities stressed that the move was not intended to attract funds from abroad, but rather to bring rates in the United Kingdom into alignment with short-term rates in other countries.

Belgium and Sweden also moved to restrain the rapid growth of domestic credit. The Belgian authorities suggested to the commercial banks the conclusion of a "gentleman's agreement" to reduce bank loans to 85-90 per cent of the average outstanding in 1963, with the cut slated to fall mainly on construction credit. In addition, downpayments on instalment purchases of consumer durables were raised and repayment periods shortened. These measures supplement the boost in the Belgian National Bank's basic discount rate from 4 per cent to 4¼ per cent last September and the subsequent sharper increases in money market rates in general. The Bank of Sweden, after raising its discount rate from 4 per cent to 4½ per cent last January, subsequently imposed a penalty rate of 9 per cent on discounts in excess of half of each commercial bank's own capital. To reduce over-all liquidity, the Swedish authorities in March successfully floated a three-year government loan issue, carrying a 6 per cent coupon (the highest since 1921).

In Switzerland and West Germany, the authorities' task of maintaining stable credit conditions has been complicated by the heavy influx of funds from abroad. To limit these inflows the Swiss authorities previously had relied exclusively on voluntary agreements concluded with the commercial banks. Under the terms of these agreements, the banks were to accept new foreign deposits only on a time basis, with a three-month minimum, pay no interest on larger new foreign deposits, and refrain from purchases of Swiss securities, real estate, and mortgages for foreign accounts. In addition, the banks were to observe ceilings on over-all credit expansion, and the authorities recommended that loans be granted only for essential activities. This year, the Swiss federal government sought and obtained from parliament the power to compel both commercial banks and other financial intermediaries to observe such restraints in accepting foreign funds. Moreover, the government now can ask financial institutions to deposit with the central bank funds that have been received since January 1 and have not been invested abroad. In addition, the authorities were given the power to establish broad credit ceilings and to regulate the flow of new domestic securities issues. The legislation also provided for closer controls over construction. An explicit permit will be required for all construction except maintenance work, publicly subsidized housing, and construction costing under 250,000 francs (about $58,000).

Concerned with the threat to stability posed by the renewed strength of the German balance of payments, the German authorities also have taken a number of steps to curb the inflow of foreign funds. The federal government lowered the coupon rate on two recent bond issues of public agencies and, moreover, permitted foreign subscriptions only after a week during which the books had been open to residents. In March, the German Federal Bank offered to provide commercial banks, through direct swap facilities, with forward cover for investments in United States Treasury bills; and as of April 1 the bank banned interest payments on foreign-owned time deposits, while imposing the maximum statutory reserve requirements of 30, 20, and 10 per cent, respectively, against foreign-owned sight, time, and savings deposits. (Domestic deposits currently are subject to reserve ratios ranging from 5 to 13 per cent.) In addition, the authorities have proposed a 25 per cent withholding tax on interest paid on German bonds held by nonresidents. However, the impact of this measure would be softened considerably by the fact that a tax credit against their domestic tax liability could be claimed by residents of countries with which Germany has concluded double-taxation agreements; moreover, the tax would not apply to income from foreign issues floated in Germany.

In December, Japan took several steps to ease the pressure on the country's external position resulting from the rapid pace of domestic expansion. Reserve requirements were doubled for all commercial bank demand and savings deposits, as well as for savings deposits with larger mutual loan and savings banks and credit associations. The Bank of Japan also advised the commercial banks to limit their credit expansion during January-March to 90 per cent of the expansion permitted during the corresponding period of 1963. In addition, the Bank of Japan in mid-March raised its discount rate to 6.57 per cent, the highest since November 1962. In the foreign exchange field, authorized banks were permitted to raise rates on Euro-dollar deposits; however, the banks will have to adhere to ceilings on foreign exchange loans and guarantees extended to overseas branches of Japanese firms. Also in March, the Japanese authorities obtained a $305 million stand-by agreement from the IMF; this assistance was linked in part to Japan's making the yen fully convertible for current-account transactions on April 1.[3]

The Canadian authorities have taken steps to prevent the country's strengthening current-account position and rising domestic activity from producing inflationary effects. In addition to the increase in the Bank of Canada's discount rate last August, the budget for fiscal 1964-65 provides for a deficit significantly lower than that of the previous year. Canada has also taken advantage of its favorable balance-of-payments position to reduce further its indebtedness to the IMF under the $300 million drawing of June 1962. Furthermore—in a move reflecting in part a more gradual approach toward limiting foreign ownership of Canadian industry—the Finance Minister withdrew the proposed increase from 15 per cent to 20 per cent in the withholding tax on dividends paid to foreigners by companies with less than 25 per cent of Canadian ownership.

[3] By so doing, Japan accepted the full obligations of currency convertibility under Article VIII of the IMF Articles of Agreement—the twenty-fifth country to do so. Thus, Japan will no longer be able to make use of the transitional arrangements under Article XIV of the Fund Agreement, which allow a country to maintain and adopt exchange restrictions on current-account transactions without prior approval of the Fund.

Fiftieth Anniversary of the Federal Reserve System—A Note on Gold in 1914*

Gold played a key role in the domestic as well as in the international payments system in 1914. This brief note touches on only a few facets of a vast and complex subject.

As a result of the resumption of specie redemption in 1879 (following its suspension during the Civil War) and with the enactment of the Gold Standard Act of 1900, the United States was on a full gold standard, characterized by free coinage and circulation of gold and the convertibility of paper currency into gold coin.

In November 1914, as the Federal Reserve Banks prepared to open for business, the United States had an estimated $1,835 million of monetary gold. Of this amount, $666 million was in the form of gold coin held by commercial banks and the public, $256 million in uncommitted Treasury balances, and $913 million in circulating gold certificates issued to the public and secured 100 per cent by gold in the Treasury. Gold coin and certificates outside the Treasury—roughly $1.6 billion—made up more than 40 per cent of the nation's supply of coin and currency. An estimated $800 million of the gold and certificates outside the Treasury was held by banks, serving as part of their legally required reserves.

The first *Annual Report* of the Federal Reserve Bank of New York stated that "gold is the most uneconomical medium of hand-to-hand circulation since, when held in bank reserves, it will support a volume of credit equal to four or five times its own volume". The Federal Reserve Act made possible more effective use of gold as a foundation for the domestic payments system. The expectation was that this improvement—and the base for a "more flexible" currency provided by Federal Reserve rediscounting of commercial paper—would contribute to the avoidance of money panics.

The Federal Reserve Act required that capital subscriptions of member banks be paid in gold or gold certificates. The Federal Reserve Board also urged member-banks-to-be to pay as much as possible of their required reserve deposits in gold or gold certificates. By December 31, 1914, the Reserve Banks held $229 million in these assets—more than 12 per cent of the nation's monetary gold. Required by the Federal Reserve Act to maintain gold reserves equivalent to at least 40 per cent of their outstanding notes and 35 per cent of their deposit liabilities, the Reserve Banks had, on this basis, excess gold reserves of about $138 million. One of the uses to which the Reserve Banks applied their gold was the establishment of an Interdistrict Settlement Fund, maintained in Washington. It was easy and inexpensive to settle payments between districts arising from check collections by notifying the Fund to transfer gold reserves from the account of one Reserve Bank to another. In time, these transfers replaced the expensive and cumbersome shipments of gold and gold certificates around the country that were common prior to the establishment of the System.

* The fourth in a series of historical vignettes appearing during the System's anniversary year.