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FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

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The Business Situation

The economy's gradual but solid advance has continued in the past few weeks. Employment, production, and retail sales posted good gains in May, while backlogs of unfilled orders rose to the highest levels since around the end of the steel strike in early 1960. Auto output apparently rose slightly on a seasonally adjusted basis in June, while steel ingot production moved down. Although the unemployment rate rose in June after a sizable decline in May, there has been a distinct improvement in the labor market situation as a whole during the second quarter as compared with the first quarter and with a year ago. Incomplete data on retail sales in June suggest a slight weakening from the May level, underscoring the fact that, although such sales have shown a good gain since the tax cut went into effect, there have been no signs of a rapid surge in consumer spending. Furthermore, the broad price indexes have changed little.

The steady pace of the expansion so far and the most recent showing of several important leading indicators continue to point toward an orderly rise in business activity over the near term. Recent surveys of business plans for capital spending still indicate a substantial gain in 1964, but do not suggest the type of sudden spurt in capital outlays that characterized the 1955-56 investment boom. Businessmen also plan to step up their rate of inventory accumulation over the next few months, but only at a pace well in line with expected gains in sales. At the same time, recent developments in the residential construction industry suggest that demand may have leveled off in that sector of the economy.

PRODUCTION, ORDERS, AND EMPLOYMENT

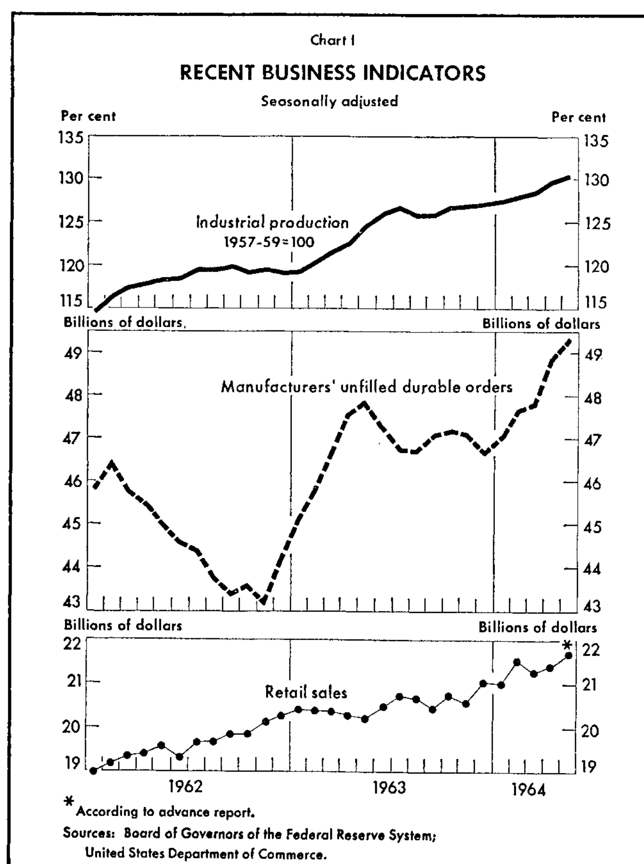
The Federal Reserve's index of industrial production posted its eighth consecutive monthly advance in May, rising by 0.7 percentage point to reach 130.3 per cent of the 1957-59 average (see Chart I). The advance brought the over-all gain since December to nearly 3 per cent. This is not so large as the 4.5 per cent rise recorded in the first five months of 1963, but it will be recalled that part of last year's increase was attributable to the strengthening effects on steel output of fears of a possible midyear strike. The May rise this year was centered largely in materials and equipment-producing industries, although consumer goods output also posted a modest pickup.

In June, steel ingot production declined slightly, but producers in the automobile industry raised the already high rate of automobile assemblies a bit further in an attempt to end the 1964 model run with sufficient inventories for the model change-over period. Seasonal inventory needs have been enlarged this year as a result of

Chart I

RECENT BUSINESS INDICATORS

Seasonally adjusted



* According to advance report.

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

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plans by most major producers to make extensive styling changes, which will entail a somewhat longer shutdown period than is usually required. Another factor that may be influencing inventory demand is the imminence of labor negotiations. The present contracts expire at the end of August, and bargaining on new contracts is scheduled to start in July.

The prospects for future strength in production were reinforced in May by the fifth consecutive monthly advance in unfilled orders held by manufacturers of durable goods (see Chart I). The volume of incoming new orders for durables, to be sure, slipped somewhat, but it was still at the second highest level on record. The small month-to-month decline that did take place in May, moreover, largely reflected a slackening in steel orders, which was probably induced by the earlier-than-usual summer shutdown in the automobile industry.

After substantial increases in April and May, total employment fell in June. Large month-to-month movements in this series are not unusual, however, and it is encouraging that for the second quarter as a whole total employment averaged more than 800,000 above the average for the quarter before. The second-quarter increase in the civilian labor force was also quite sizable, perhaps reflecting in part the entrance into the job market of persons who had previously felt that jobs would not be available for them. A more-than-seasonal rise in unemployment among college students and recent college graduates contributed to a 0.2 percentage point rise in the unemployment rate, to 5.3 per cent, in June. The second quarter nevertheless ended with a rate somewhat below the 5.4-5.6 per cent range which prevailed early this year and for much of 1963.

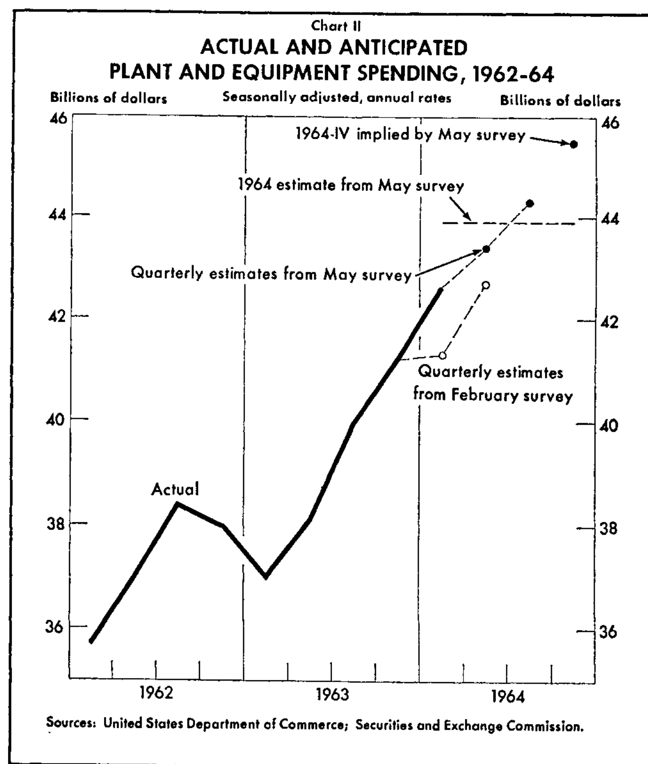
CONSUMER SPENDING AND RESIDENTIAL CONSTRUCTION

Consumer spending at retail outlets registered a good gain in May, moving up by 1.4 per cent to reach a record $21.7 billion, seasonally adjusted (see Chart I). The May advance, following a small April increase, was largely attributable to a substantial rise in sales of nondurable goods, which had been somewhat sluggish in the previous four months. Sales of durable goods were essentially unchanged in May, despite a slight advance in new automobile sales. Fragmentary data for June suggest that total retail sales may recently have edged off a bit, although automobile sales apparently continued strong.

On the basis of present evidence, the rate of gain in retail sales in the April-June quarter appears to be somewhat less than the January-March advance, despite the fact that the tax reduction was in effect for the entire second quarter. The absence of an accelerated gain in sales, however, does not mean that the tax cut has been without an impact on consumer spending. It is quite possible that the considerable strength of retail sales early in the year may have reflected consumer anticipations of the tax cut. Furthermore, it is by no means certain that the tax cut has as yet had its full effect on consumer spending.

In the residential construction sector, activity has continued at a high level but without providing much additional stimulus in recent months. After moving up slightly in April, outlays on housing declined substantially in May and June. Moreover, the recent behavior of leading indicators in this sector does not suggest a renewed upward push in such expenditures for the near future. The seasonally adjusted value of residential contract awards, to be sure, was slightly above April in May, but April had declined markedly below March, so that awards in both April and May were significantly under the first-quarter average. Furthermore, the level of nonfarm housing starts in May was virtually unchanged from April, and the April figure was revised downward to a level distinctly below the first-quarter average. Similarly, the number of new building permits issued in May was about the same as in April, and both months were significantly below the first-quarter average.

Chart II
ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING, 1962-64



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

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BUSINESS SPENDING PLANS

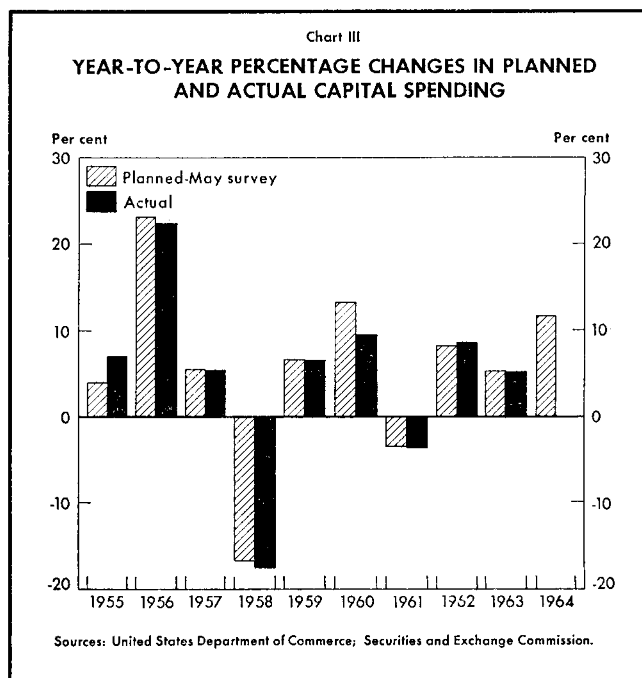
Recent surveys of businessmen's spending plans reinforce widely held expectations of strong support for the economy from this sector over the balance of the year. According to a May survey by the Department of Commerce, manufacturers plan to add $700 million to their inventories during the third quarter of this year as against an expected increase of $400 million in the second quarter. Much of the planned additions to inventories are in the durables sector, where producers are looking forward to a substantial sales gain. Despite anticipations of a stepped-up rate of inventory accumulation, therefore, the expected rise in sales, if realized, will be sufficient only to maintain the inventory-sales ratios of both durables and nondurables manufacturers at roughly the low levels that have recently prevailed, suggesting that over-all inventory policies remain cautious.

In another May survey, taken by the Department of Commerce and the Securities and Exchange Commission, business plans for capital spending in 1964 were reported at a level 12 per cent above 1963 outlays (see Chart II). This increase was somewhat above the 10 per cent advance reported in the February Commerce-SEC survey and was about in line with the rise reported in the spring McGraw-Hill survey taken in March-April. The latest survey, of course, is still not necessarily an accurate forecast; however, in previous years of business expansion—such as 1959, 1962, and 1963—the May survey has proved to be highly accurate (see Chart III).

The upgrading in spending plans for 1964 as a whole in the May, as compared with the February, Commerce-SEC survey represents in part a substantial ($1 billion) upward revision in the first-quarter estimate. Planned outlays reported for the second half of the year are about $0.5 billion higher than had been indicated in the February report but, because of the first-quarter revision, the expected increase between the first and second halves of the year is slightly smaller than had been estimated in February.

Chart III

YEAR-TO-YEAR PERCENTAGE CHANGES IN PLANNED AND ACTUAL CAPITAL SPENDING



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

The Money Market in June

The money market once again demonstrated in June its capacity for accommodating without undue strain the large flows of funds and securities associated with heavy corporate dividend and tax payments. Aided by the expansion of bank credit to securities dealers and to nonbank financial institutions, corporations managed to shift Government securities to dealers and to redeem finance company paper. In addition, business corporations borrowed from commercial banks to meet their quarterly obligations. The money market retained a steadily firm tone throughout the month, with Federal funds trading almost exclusively at 3½ per cent. Rates posted by the major New York City banks on new and renewal call loans to Government securities dealers were generally in a 3¾ to 3⅞ per cent range. Treasury bill rates edged upward around midmonth, but declined subsequently when demand reappeared. Offering rates for new time certificates of deposit issued by the leading New York City banks held generally steady during the month, reflecting in part steps taken by the banks in May to compensate for certificates

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maturing in June; rates at which such certificates traded in the secondary market varied little over the month. In early June, the major finance companies lowered their offering rates on short-term directly placed paper by ⅛ of a per cent. Prior to the midmonth tax date, these rates were readjusted upward by ⅛ of a per cent. Subsequently, however, rates on short-term finance company paper were lowered again, presumably as the finance companies recouped funds they had lost over the tax date. The offering rates on some longer maturities were raised by ⅛ of a per cent in the latter part of the month.

The increased financial demands of the period did bring additional pressure on banks in the major money centers, especially around mid-June. With nation-wide reserve availability adequately provided by System operations, however, these banks were able to meet the demands through advance preparation and the smooth functioning of the Federal funds market. Toward the end of the month, reserve pressures on these banks diminished.

In the market for Treasury notes and bonds, price changes in early June were narrowly mixed in generally listless trading. Subsequently, demand for coupon issues expanded, and prices of intermediate- and long-term issues registered modest gains in the latter part of the month. Prices of corporate and tax-exempt bonds moved lower in the opening days of June, but later stabilized and then rose as investment demand improved while the near-term calendar of new offerings remained moderate.

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

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

Factor	Daily averages—week ended				Net changes
	June 3	June 10	June 17	June 24	
Operating transactions					
Treasury operations*	+ 13	+ 12	+ 38	— 5	+ 58
Federal Reserve float	— 218	— 50	+ 352	+ 313	+ 397
Currency in circulation	— 134	— 230	— 126	+ 39	— 451
Gold and foreign account	— 13	+ 9	+ 3	— 7	— 8
Other deposits, and other Federal Reserve accounts (net)†	— 30	— 53	+ 71	— 40	— 52
Total	— 382	— 312	+ 337	+ 301	— 56
Direct Federal Reserve credit transactions					
Open market operations					
Purchases or sales‡					
Government securities	+ 508	+ 203	— 92	— 11	+ 608
Bankers' acceptances	— 2	+ 1	+ 1	—	—
Repurchase agreements					
Government securities	+ 34	+ 173	— 74	— 153	— 20
Bankers' acceptances	—	+ 25	— 12	+ 11	+ 24
Member bank borrowings	+ 56	+ 25	+ 38	— 95	+ 24
Other loans, discounts, and advances	—	— 1	+ 1	— 1	— 1
Total	+ 596	+ 425	— 138	— 249	+ 634
Member bank reserves					
With Federal Reserve Banks	+ 214	+ 113	+ 199	+ 52	+ 578
Cash allowed as reserves§	— 134	— 121	+ 229	+ 64	+ 38
Total reserves§	+ 80	— 8	+ 428	+ 116	+ 616
Effect of change in required reserves§	— 116	+ 43	— 305	— 211	— 589
Excess reserves§	— 36	+ 35	+ 123	— 95	+ 27
Daily average level of member bank:					
Borrowings from Reserve Banks	264	289	327	232	278‖
Excess reserves§	295	330	453	358	359‖
Free reserves§	31	41	126	126	81‖

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ May also include redemptions.
§ These figures are estimated.
‖ Average for four weeks ended June 24, 1964.

BANK RESERVES

Market factors[1] had a sizable impact on member bank reserves during the interval from the last statement week in May through the statement week ended June 24. These factors first absorbed reserves over the Memorial Day holiday and the following week, and then turned around sharply to supply reserves in the final two weeks of the period. The net effect of these fluctuations over the month as a whole was to drain $607 million in reserves. During the early part of the period, the drains largely reflected a substantial seasonal increase in currency outside banks, in part to meet needs for cash over the May 30-May 31 holiday week end. Some of this currency returned to the banking system in the latter two weeks of the period and, coupled with the usual midmonth bulge in float, more than offset reserves absorbed by an increase in required reserves. (The rise in required reserves reflected the expansion in bank credit which accompanied a build-up in deposits by corporations preparing to make quarterly dividend and tax payments.)

To offset the effects of these large fluctuations in market factors, System open market operations provided reserves in the two-week period ended June 10 and absorbed reserves in the following two weeks. Over the four-week period as a whole, the weekly average of System outright holdings of Government securities rose by $608 million, while holdings of Government securities under repurchase agreements declined by $20 million. Total System holdings of bankers' acceptances rose by $24 million. From Wednesday, May 27, through Wednesday, June 24, System holdings of Government securities maturing in less than one year expanded by $420 million, while holdings maturing in more than one year increased by $88 million.

[1] Operating transactions, cash allowed as reserves, and required reserves.

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THE GOVERNMENT SECURITIES MARKET

Prices of Government notes and bonds rose during June in response to moderate investment demand, which was not counterbalanced by any significant selling pressure. In the early part of the month, prices fluctuated narrowly in generally light trading, as market participants appeared unable to generate any conviction that interest rates were likely to move far in either direction in the months just ahead. Subsequently, the pace of trading activity quickened somewhat, and prices of most issues rose except for a brief period in the latter part of the month when discussion of a possible July Treasury financing outside the bill area produced a more cautious atmosphere. Thus, from June 23 to June 25 some downward pressure developed on prices of issues maturing in approximately five years—the area in which many thought additional supplies might be forthcoming. Prices strengthened in the final days of June, however, following reports that the Treasury's cash needs for July and the second half of the year would be less than previously expected and that the Treasury would defer announcing any financing plans until July. Through most of June, there was continuing interest in the recently issued 4¼ per cent bonds of 1974 from pension funds, banks, and others, while the 2½ per cent wartime issues were also in considerable demand. At the close of the month, prices of Treasury notes and bonds were generally 2/32 to 16/32 above end-of-May levels.

Treasury bill rates edged lower in early June. During this period, a moderate demand for bills tended to favor longer maturities as market confidence in the near-term stability of interest rates apparently stimulated investor willingness to commit funds to such issues. Subsequently, investment demand tapered off while market supplies—particularly of shorter maturities—expanded around the quarterly corporate dividend and tax dates, reflecting both outright selling and the return of securities from repurchase agreements with corporations. Consequently, bill rates edged irregularly higher from June 9 through June 17 and dealers' inventories increased. In the latter part of the month, however, a broad and active demand from public funds, banks, and other sources cut the dealers' seasonal accumulations, and bill rates receded. The popularity of December bill maturities for dividends, taxes, and year-end statement date purposes contributed to a decline in the yield spread between the three- and six-month Treasury bills to as little as 4 basis points late in the month. Rates on most outstanding short-term bills were 2 to 5 basis points higher over the month as a whole, while long-term bills were generally 1 to 6 basis points lower.

At the last regular weekly auction of the month held on June 29, bidding was aggressive, especially for the new December 31 maturity. Average issuing rates were 3.479 per cent for the new three-month issue and 3.528 per cent for the new six-month bill, virtually unchanged and 7 basis points lower, respectively, than the average rates at the final weekly auction in May. The July 1 auction of $1 billion of new one-year bills resulted in an average issuing rate of 3.691 per cent, compared with an average issuing rate of 3.719 per cent on the comparable issue sold in May. The newest outstanding three-month bill closed the month at 3.48 per cent (bid), as against 3.47 per cent at the end of May, while the newest outstanding six-month bill was quoted at 3.52 per cent (bid) on June 30, compared with 3.59 per cent at the close of the preceding month.

OTHER SECURITIES MARKETS

A cautious atmosphere pervaded the corporate bond market in early June, reflecting considerable investor resistance to the lower reoffering yields on new and recent offerings still bound by syndicate price restrictions. A steadier tone emerged prior to midmonth, after several corporate issues had been released from syndicate and adjusted upward in yield. The corporate sector was also encouraged by the enthusiastic reception accorded the largest new bond issue of the month—$150 million of finance company debentures—offered on June 10 and by the moderate calendar of new public flotations on tap. Over the remainder of the month, investor interest expanded somewhat and corporate bond prices rose. In the tax-exempt bond sector, a comparatively heavy volume of new offerings added to the accumulations on dealers' shelves through much of June. In the first half of the month, investor demand for new issues was rather limited, price cutting on older issues failed to spark any general increase in demand, and prices of outstanding state and local bonds generally edged lower in quiet trading. In the latter part of the month, a large new tax-exempt issue was well received and investor interest generally expanded, while the near-term calendar of new offerings diminished somewhat. Against this background, prices of outstanding issues steadied and then rose fractionally. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds declined by 1 basis point to 4.40 per cent, while the average yield on similarly rated tax-exempt bonds rose by 3 basis points to 3.11 per cent. (These indexes are based on only a limited number of issues.)

The volume of new corporate bonds floated in June amounted to approximately $460 million, compared with $470 million in the preceding month and $455 million in June 1963. The largest new corporate bond issue mar-

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keted during the month consisted of $150 million A-rated (Standard & Poor's) 4⅝ per cent finance company debentures maturing in 1986. The debentures, which cannot be redeemed for eight years, were offered to yield 4.643 per cent and were very well received. New tax-exempt flotations in June totaled approximately $780 million, as against $625 million in May 1964 and $990 million in June 1963. The Blue List of tax-exempt securities advertised for sale closed the month at $595 million, little changed from the end-of-May level. The largest new tax-exempt bond issue during the period consisted of about $120 million of Aaa-rated (Moody's) housing authority bonds. The bonds were reoffered to yield from 2.10 per cent in 1965 to 3.50 per cent in 2004, and were enthusiastically received. Other new corporate and tax-exempt issues floated in June met with mixed investor receptions.

Foreign Exchange Markets, January-June 1964

Foreign exchange markets during the first half of 1964 continued to reflect increased confidence in the stability of the international financial system. To be sure, there were several occasions when speculative activity played a part in market developments during the first half of the year, including movements from the Italian lira, inflows of funds into Germany, and occasional pressures on sterling. But the effects of these pressures were for the most part confined to the particular currencies involved, and did not develop into threats to the dollar or to general currency stability.

The virtual cessation of United States gold losses in the early part of the year was quickly taken as a sign of further improvement in the United States balance of payments, and contributed to the strength of the dollar. In point of fact, the United States international accounts came close to balance, on a seasonally adjusted basis, during the first quarter of 1964. By far the most important factor contributing to the reduction in the deficit between the first quarters of 1963 and 1964 was the sharp increase in the trade surplus, with exports rising approximately twice as fast as imports. Part of the striking improvement was clearly due to special factors, and it is already apparent that the first-quarter rate cannot be sustained throughout the remainder of the year. On the other hand, part of the improvement appears to represent real progress toward the elimination of the United States payments deficit.

With the improvement in the United States position early in the year, the focus of attention shifted across the Atlantic where problems of price-wage stability have become increasingly troublesome. The impact of these problems on the balance of payments of individual countries has varied greatly, but with the conspicuous exception of Germany there has been a general weakening in the trade balances of major European countries. In a number of cases, however, the trends on current account have been overshadowed by shifts in capital movements, mainly within Europe. Indeed, capital movements seemed to dominate the exchange markets during much of the first half of the year.

The first few weeks of the year are often characterized by a seasonal easing of certain Continental currencies (the German mark, the Swiss franc, and the Netherlands guilder) and a strengthening of sterling, as the customary year-end positioning by Continental commercial banks is reversed. Recently, however, the exchange market effects of these short-term capital flows over the year end have been offset to some extent by central bank action; furthermore, other capital flows during the first quarter tended to overshadow these seasonal movements. While there was some of the usual short-term flow out of Germany and Switzerland to the United Kingdom, there were also heavy speculative flows of capital from Italy into Switzerland and, to a lesser extent, Germany. In addition, funds moved to Germany from other European countries for investment in German securities. These heavy capital inflows reinforced Germany's growing trade surplus and resulted in substantial reserve gains that in turn contributed to some speculation on a possible revaluation of the mark. The counterpart to the strength of the mark appeared to be heavy Italian reserve losses, sharply reduced French reserve gains, and a weakening of sterling and the Dutch guilder.

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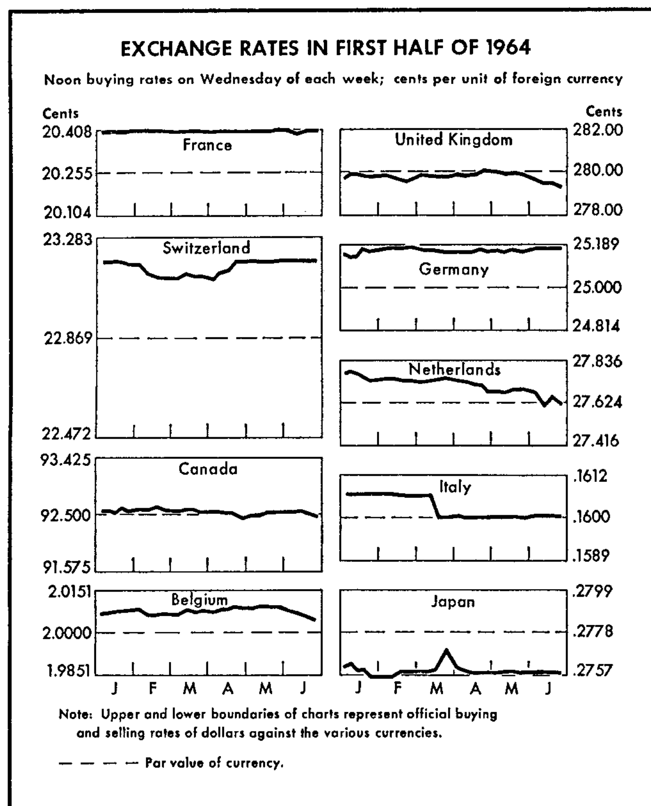

These pressures quickly abated in the case of sterling when the British authorities announced a 1 percentage point rise in the bank rate on February 27. Pressures on the lira were brought to a halt one month later by the announcement of a $1 billion package of official credits from abroad. At the same time, the German authorities took steps that led to some reversal early in the second quarter of the capital flows into Germany, thereby significantly moderating official reserve gains. Despite these measures, capital flows continued to exert a strong influence on exchange markets and the reserve positions of certain European countries during the second quarter. In particular, tight money market conditions in a number of European countries resulted in substantial shifts of funds, primarily from London to the Continent. In Switzerland, for example, very tight liquidity conditions early in the second quarter, followed by the usual midyear repatriation of funds by Swiss commercial banks, resulted in substantial inflows that kept the Swiss franc rate at the Swiss National Bank's unofficial buying rate for dollars. A similar situation developed later in the quarter, as pressures increased on the French commercial banks' liquidity positions, causing a repatriation of funds on a sizable scale. The fact that these and other capital movements during the first half of the year did not have more widespread repercussions in the exchange and gold markets was in large part attributable to continued international financial cooperation and increased confidence in the dollar.

STERLING

Early in January, sterling began to strengthen in its usual seasonal pattern, as Continental commercial banks reinvested funds in sterling assets following earlier repatriations to meet year-end liquidity needs. The inflow soon tapered off, however, and early in February sterling declined following the Board of Trade's announcement of January trade data showing an unusually large trade deficit. The trade figures, together with uncertainties generated by expectations of a spring general election, resulted in some outright selling of sterling and the emergence of "leads and lags" adverse to the pound. The rate weakened further later in February, as market rumors of a possible mark revaluation apparently pulled funds out of London. These various pressures on sterling quickly subsided, however, and on February 27, when the Bank of England's discount rate was raised from 4 per cent to 5 per cent, sterling recovered sharply. By the end of the month sterling had risen to $2.7982.

Sterling fluctuated narrowly around this level until early April, when it was announced that the British general elections would not be held until October. This decision immediately resulted in the covering of near-term sterling requirements by commercial interests that had previously postponed their purchases, and the spot rate rose to $2.8002 by the end of the month. This technical support for sterling, together with the strength of the payments positions of the overseas sterling area, bolstered sterling through the spring months. As a result, the rate held firm despite further evidence of some weakness in the British trade position. Sterling once again came under pressure toward the end of May, however, when the technical support for sterling faded and as very tight conditions in several Continental money markets drew funds from London. Banks in France and Switzerland, in particular, reduced sterling balances, and there was also some borrowing in the Euro-currency markets. The relatively high interest rates thus generated in the Euro-currency markets attracted some additional outflow of funds from London. Moreover, in early June there was a revival of speculation in favor of the German mark that again appeared to attract funds from sterling, and toward the end of the month the usual midyear Continental bank "window-dressing" put additional temporary pressure on sterling. With the persistent

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undertone of softness reflecting also market uncertainties about the pre-election outlook for sterling, the rate again fell below par, reaching its first-half low of $2.7909 near the end of June. Despite this relatively sharp decline in the rate, there was little evidence of speculation against sterling. Indeed, a good part of the spot sales of sterling to meet money market pressures on the Continent appeared to be covered by corresponding forward purchases, as the discounts on forward sterling narrowed during June to the lowest levels in recent months.

CANADIAN DOLLAR

The Canadian dollar moved narrowly just above par through most of the period. During the first quarter, the long-term capital inflow to Canada remained at a sharply reduced level while the inflow of short-term funds, though substantial, was inadequate to offset the enlarged current-account deficit. As a result, official reserves declined by about $70 million during the first three months in addition to the $60 million repayment to the International Monetary Fund (IMF). During the second quarter, for which little detailed balance-of-payments information is available, reserves rose by $68 million.

The spot market for Canadian dollars was relatively quiet through most of the six-month period, but there was considerable activity in the forward market as a result of grain sales to the Soviet Union. These sales generated heavy demands on the part of grain dealers for Canadian dollars against United States dollars for future delivery. (The contracts with the Soviets called for payment in United States dollars, whereas the grain companies had to purchase the wheat from the Canadian Grain Board with Canadian dollars.) After meeting the grain dealers' demands—and after covering these forward sales to some extent through spot purchases—commercial banks attempted to balance their positions by engaging in swap transactions, selling Canadian dollars spot against forward purchases timed to meet likely calls on their forward commitments to the grain dealers. Consequently, the forward Canadian dollar advanced to a premium while the spot rate tended to decline. In order to offset some of these pressures, the Bank of Canada sold United States dollars spot and purchased them forward, thus providing the counterpart to the commercial banks' swap needs. Nevertheless, the matching-off of commitments arising from the very large volume of grain sales continued to dominate transactions in the Canadian dollar market through the end of June, and the forward Canadian dollar remained at a premium of well over ¼ of 1 per cent while the spot rate moved narrowly around par.

GERMAN MARK

The German mark eased early in January, as German commercial banks reinvested abroad part of the funds previously repatriated at the year end. By mid-January this reflux of bank funds apparently came to a halt, and as the continuing inflow of long-term funds from other European countries intensified, the mark rate turned upward. This rise in the rate, coupled with projections of a very large German trade surplus in 1964, touched off revaluation rumors. Thus, the already large German payments surplus was swollen during February by outright speculative capital inflows. This heavy demand for marks subsided in March; in fact, the mark came under some selling pressure when a proposed withholding tax on interest income of nonresidents from German bonds resulted in withdrawals of long-term funds from the German securities markets, and the German Federal Bank sold a substantial amount of dollars in market operations. At the same time, the German Federal Bank moved to encourage an outflow of German funds into dollar investments: beginning March 10, the Bank provided dollars on a swap basis—selling dollars spot and repurchasing them forward—to German commercial banks for purchases of United States Treasury bills at a preferential discount on the forward purchases of ½ per cent per annum, compared with the current market discount of over ¾ per cent. Through most of April and May the mark fluctuated narrowly in a relatively balanced market, as further substantial liquidations of German bond holdings by foreigners and short-term outflows into the Euro-dollar market apparently offset the surplus on current account. In the month of April alone, there was a net long-term private capital outflow from Germany of $62 million equivalent, the first such outflow since mid-1962. In June, however, the mark again strengthened with a reappearance of revaluation rumors, and remained in heavy demand through the end of the month as German banks repatriated funds for midyear positioning.

SWISS FRANC

The Swiss franc eased below the central bank's buying rate for dollars in February, as the heavy net capital inflows of earlier months diminished and once again exposed the large Swiss current-account deficit. The rate soon firmed, however, and a subsequent succession of temporary and not necessarily related factors kept the franc under upward pressure for most of the six-month period. Initially, this pressure came from the movement of funds into Switzerland from Italy. By mid-April, when the in-

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flow from Italy had eased, Swiss banks and corporations began to repatriate funds from abroad to meet pressures generated by a liquidity squeeze in Switzerland. Swiss funds were withdrawn from investments in the German bond market, and some Swiss interests also borrowed abroad at short term. These inflows pushed the spot Swiss franc up to the Swiss National Bank's buying rate for dollars, but the forward franc weakened at the same time as Swiss interests purchased foreign currencies foward to cover their borrowing abroad. With liquidity conditions in Switzerland remaining relatively tight through May, Swiss residents continued to repatriate funds. Furthermore, interest rates in the Euro-Swiss franc market rose sharply. As a result, foreigners began to purchase Swiss francs to pay off maturing Swiss franc loans rather than renew them at relatively high interest rates, and thus reinforced the strength of the spot rate. Finally, just as this demand for francs was tapering off, it was replaced by the usual mid-year demand for francs by Swiss commercial banks and a resumption of inflows from Italy, with the result that the Swiss franc held at its ceiling throughout most of the second quarter.

ITALIAN LIRA

The Italian lira was under heavy selling pressure in the early months of the year, as a result of a wider current-account deficit, an outflow of capital, and further repayments of foreign indebtedness by Italian commercial banks. Thus, the Italian authorities lost a substantial amount of dollars in supporting the rate at about $0.001607. The downward pressures were reinforced early in March by increasing speculation against the lira, and Italian reserve losses accelerated. On March 14, the Italian authorities announced that approximately $1 billion in external assistance was at their disposal to supplement official reserves and to back up the fiscal and monetary measures already taken to correct the underlying balance-of-payments deficit. This credit package included: (1) a $100 million swap arrangement with the United States Treasury (in addition to the partly drawn swap facility with the Federal Reserve System for $250 million), (2) a $200 million stand-by credit from the Export-Import Bank, (3) $250 million in three-year credits from the United States Commodity Credit Corporation, and (4) additional credit facilities from the Bank of England and the German Federal Bank. The speculative pressures on the lira abated immediately following the announcement of this package, and the Bank of Italy temporarily withdrew its support from the market, permitting the spot lira to drop to about $0.001600½ where it settled in relatively balanced trading. At the same time, the discounts on forward lire immediately narrowed; the discount for the three-month maturity, which had widened to nearly 7 per cent just prior to the announcement, narrowed to about 3 per cent. Since the announcement of the credit package and the subsequent Italian drawing of $225 million on the IMF, the lira has held just above its par value. In late June, there was some renewed selling pressure on the lira, but there were also signs of some strengthening of Italy's payments position during the second quarter. Italian commercial banks continued to reduce their net foreign indebtedness, and the Bank of Italy announced a reduction in its net drawings under the swap arrangements with the Federal Reserve System and other foreign central banks.

OTHER CONTINENTAL CURRENCIES

The Netherlands guilder gradually declined during most of the first half of 1964 after having reached its high for the year to date on January 6, when the Netherlands Bank raised its discount rate from 3½ per cent to 4 per cent. At times exchange market developments were dominated by the short-term capital movements of Dutch commercial banks, which customarily place temporary excess funds abroad and repatriate them as required to meet liquidity needs. However, the guilder's decline during the half year fundamentally reflected the deterioration in the Netherlands trade position. Even after a further increase in the discount rate to 4½ per cent on June 4, the guilder strengthened only momentarily. By June 10 the rate had fallen below par for the first time since the revaluation of March 1961, and it continued to fluctuate around par for the remainder of the month.

The French franc remained at, or close to, its ceiling throughout the first half of the year. However, French official gold and foreign exchange reserves rose by only $76 million during the first four months of the year—a considerably smaller increase than during the comparable period a year earlier—as a wider trade deficit, capital flows to Germany, and the reversal of previously favorable "leads and lags" reduced the over-all French payments surplus. In May, however, French reserves jumped by nearly $150 million, with French banks repatriating funds to meet extremely tight conditions in the Paris money market and commercial interests shifting their payments terms once again in favor of the franc. In view of these developments, the Bank of France early in June announced changes in credit and reserve regulations designed to reduce the squeeze on the commercial banks' cash positions without relaxing the general policy of restraint. The franc rate immediately eased off its ceiling

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but, by the middle of June, was again at, or close to, its ceiling despite a further reduction in reserve requirements.

The Belgian franc moved within a narrow range through most of the first half of the year, but declined fairly rapidly after mid-May, and was slightly below its early-January level at midyear. The Swedish krona was slightly below par ($0.1933) through the first two months of the year. In March, however, when the authorities introduced several measures to supplement the restrictive effects of the discount rate increase announced at the end of January, money market conditions tightened, and Swedish commercial banks began to repatriate foreign assets. As a result, the krona strengthened sharply to about $0.1947 at the end of March and remained at, or close to, its ceiling through most of the second quarter.

OTHER CURRENCIES

The Japanese yen remained at, or close to, its floor against the dollar throughout most of the first half of 1964. A continuing increase in Japan's current-account deficit was only partially covered by long- and short-term capital inflows. The yen strengthened briefly in mid-March, when the Bank of Japan raised its discount rate to 6.57 per cent, but then returned to its floor and remained there through midyear.

In January, Venezuela ended exchange controls and moved toward unification of its exchange rate structure. The central bank's buying rate for transactions with the petroleum companies was raised from 3.09 to 4.40 bolivars per dollar, thus reducing the implicit "exchange rate tax" on the companies' local-currency outlays. In addition, the exchange rate for imports was raised from 3.35 to 4.50 bolivars per dollar. Also during the first half of the year, Korea replaced its complex multiple exchange rate system with a single fluctuating rate; the initial new rate of 255 won per dollar compares with a previously fixed official rate of 130 won per dollar. Brazil eliminated preferential exchange rate treatment for imports of wheat, petroleum, and newsprint by requiring that exchange for such imports be purchased at the free market rate of about 1,200 cruzeiros per dollar rather than at the Bank of Brazil's official selling rate of 620 cruzeiros per dollar.

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New Central Banks*

Sixteen new central banks have opened their doors since the beginning of 1959—the Central Bank of the States of Equatorial Africa and of Cameroon, the Central Bank of the States of West Africa, the Bank of Morocco, and the Central Bank of Nigeria in 1959; the Bank of Sudan, the Bank of the Republic of Guinea, and the Somali National Bank in 1960; the Bank of Jamaica, the Malagasy Bank of Issue, and the Bank of the Republic of Mali in 1962; the Central Bank of Algeria and the Central Bank of Cyprus in 1963; the Bank of Lebanon, the National Bank of Rwanda, the Bank of the Kingdom of Burundi, and the National Bank of the Congo (Leopoldville) in 1964. The central banks of Morocco, Nigeria, Sudan, and Guinea were described in a previous article in this *Review;*[1] the other twelve new central banks will be discussed here.[2]

The Central Bank of the States of Equatorial Africa and of Cameroon serves the newly independent states of Cameroon, the Central African Republic, Chad, Congo (Brazzaville), and Gabon. (This bank will be referred to as the Equatorial African central bank.) The Central Bank of the States of West Africa serves Dahomey, Ivory Coast, Mauritania, Niger, Senegal, Togo, and Upper Volta. (This bank, which will here be termed West African central bank, also served Mali until 1962.) Both of these institutions were organized under French auspices before the independence of the countries concerned. After becoming independent in 1960-61, these countries signed agreements with France (during 1960-62) under which all (except Mali) have continued to use the facilities of the existing central banks, whose organization and powers have been considerably modified to conform to the changed situation.

All but two of the countries served by the twelve new central banks had a monetary authority or currency board prior to the establishment of the new banks; the exceptions were the Malagasy Republic and Lebanon, where the note-issuing privilege had in each case been held by a commercial bank. While all the new central banks retain some of the attributes of the institutions they replace, they have generally been given a wide variety of additional monetary control powers.

The countries served by the new central banks vary considerably with respect to the degree of their financial and economic development. In some of the new states many economic transactions take place outside the monetary sphere, while in others such as Lebanon and Jamaica the banking systems are highly developed. The share of currency in the total money supply—a rough inverse measure of the use of banks in a country—varies from roughly 30 per cent in Lebanon and Jamaica to around 40 per cent in Cyprus and Senegal, 50 per cent in Somalia, and reaches about 65 per cent in Mali and Upper Volta. (The United States figure is about 20 per cent.)[3] There is also considerable variation in the degree to which financial institutions other than commercial banks have taken

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* Dorothy B. Christelow had primary responsibility for the preparation of this article.

[1] See "International Developments", this *Review*, October 1960, pp. 181-83. The article also treated the Bank of Ghana, established in 1957, and the Central Bank of Malaya and the Central Bank of Tunisia, established in 1958.

[2] Another group of new central banks—not here discussed—will begin operations in the near future. These include central banks for Sierra Leone, Jordan, and Trinidad and Tobago. Furthermore, with the coming into being of the Federation of Malaysia in 1963, the Central Bank of Malaya became the Central Bank of Malaysia, with responsibility for the entire new country. Conversely, the breakup of the Federation of Rhodesia and Nyasaland into three countries will lead to the emergence of three separate central banks to replace the Bank of Rhodesia and Nyasaland. One of these, the Reserve Bank of Rhodesia (for Southern Rhodesia), has already opened its doors. While its powers and functions resemble those of the predecessor institution in most respects, it has been given the added power to require banks to maintain cash reserves against advances rather than against deposits.

In another group of countries—including Ethiopia, Iceland, Iran, Nicaragua, and the United Arab Republic—where the central banks had exercised both central banking and commercial banking functions, these institutions have in recent years been converted into central banks proper and their commercial banking operations transferred to existing or newly established commercial banks. These central bank reforms and conversions are also outside the scope of this article.

[3] The uniform definition of the money supply used for this comparison is that of the International Monetary Fund in its *International Financial Statistics:* currency outside banks, demand deposits, post office checking deposits, and private-sector deposits with the central bank where these exist; government deposits are excluded.

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root. On the other hand, almost all the countries concerned display certain common characteristics: they are notably dependent on international trade; foreign capital has played or is expected to play a considerable role in their economic development; and foreign commercial banks are a major element in their banking systems.

The objectives of the new central banks as set out in their statutes are to assure the external and internal stability of the currency and to foster a monetary environment conducive to economic development. To this end, all the central banks are given the exclusive right of note issue, the obligation to act as fiscal agent and banker for the government, the power to buy and sell gold and foreign exchange, and the authority to discount, purchase, and sell specified types of financial obligations. In addition, most of the new banks have at least some of the following powers of control and supervision over commercial banks: to establish minimum cash reserve requirements, to set limits on lending and deposit rates, to prescribe the asset distribution and the total volume of credit outstanding, to examine the books and to require statistical reports, and to set minimum capital requirements.

CENTRAL BANK-GOVERNMENT RELATIONS

All the new banks are owned by the respective governments (except that the French government still holds all the capital of the Equatorial African central bank and half the capital of the Malagasy bank). In most cases, the presiding officer and the boards of management are appointed by the respective governments for a fixed period and are subject to reappointment. The exceptions are the three central banks whose member countries—all former French colonies—belong to the African Financial Community. The West African central bank's administrative council includes a minority appointed by the French government, and its presidency rotates every two years among council members representing the member states. Half the council members of the Malagasy Bank of Issue are appointed by France, and the president is chosen by the council, subject to the approval of the governments of the Malagasy Republic and France. The French government also appoints one half the members of the governing council of the Equatorial African central bank and, in addition, the President of the French Republic appoints the president of that institution.

Many of the new central bank statutes include further provisions to assure the harmonization of central bank action with the government's general economic policy. Some statutes provide that government officials or their representatives are to be members of the central bank's policy-making body. In Lebanon, two high government officials are minority members of the central bank's governing board; in Algeria, the law is sufficiently flexible to allow the chief of state to appoint government officials to a minority or majority position on the governing board. In Mali, five of the ten-member governing board represent government departments and two represent the national assembly. Other statutes provide for government approval or supervision of certain aspects of central banking. In Cyprus approval by the finance minister is required, if commercial bank reserve requirements are to be raised above a certain level. In Jamaica, the finance minister may "from time to time after consultation with the governor give to the bank in writing such directions of a general nature as appear to the minister to be necessary in the public interest". In Somalia, a committee consisting of the prime minister and key cabinet members is designated to supervise the operations of the central bank. In Burundi, major policy decisions of the central bank must be approved by the finance minister. In the Congo, a representative of the ministry of finance attends meetings, but is not a member, of the bank's governing board.

At the same time, a majority of the statutes limit central bank financing of their governments; the limitations typically apply to direct financing (i.e., through short-term advances or direct purchases of securities) and to indirect financing (i.e., through open market purchases or discounting of government securities offered by banks or others). Algeria, the West African countries, and Malagasy all limit the total volume of government indebtedness that may be held by the central banks to a specified proportion (varying from 10 per cent to 15 per cent) of ordinary government revenues during the previous fiscal year. In the Congo, direct and indirect advances may each equal 20 per cent of average government receipts over a past three-year period. Cyprus and Jamaica set more complex limits. Thus, in Cyprus the government's total direct and indirect indebtedness to the central bank may amount to 20 per cent of annual revenues plus 6 per cent of the bank's sight liabilities plus the government securities the bank took over from a note security fund. In Jamaica, in addition to central bank short-term advances up to 15 per cent of annual government revenue, 50 per cent of the assets backing the currency may be in securities of the Jamaican government; moreover, the bank may hold government securities in amounts up to seven times the bank's capital (which itself may be increased by the bank's board of governors with approval of the Jamaican House of Representatives). The Burundi bank's limit is an absolute amount. The Somali National Bank is limited only with respect to direct short-term advances to the government,

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while the Bank of Lebanon and the National Bank of Rwanda are subject to limits that may be exceeded in circumstances of "exceptional gravity". The remaining two central banks (namely, the Bank of the Republic of Mali and the Equatorial African central bank) are not limited as to the total government indebtedness they may hold.

DEVELOPMENT OF THE FINANCIAL SECTOR

All the new central banks have been given a general mandate for promoting economic development—often including special responsibilities for developing financial institutions, credit instruments, and domestic money markets. For this reason, these banks tend to have at their disposal legal powers going beyond the traditional tools of rediscounting and open market operations, which themselves can of course also be used to promote certain types of credit instruments and to encourage specific types of loan transactions by increasing the liquidity of the instruments involved.

Thus, central bank powers to prescribe the distribution of assets in commercial bank portfolios may be of considerable importance: the Bank of Jamaica has the power to prescribe a minimum ratio of domestic assets to total commercial bank deposit liabilities; the central banks of Cyprus and the Congo have the broader power to prescribe the purposes for which commercial bank advances and investments may be made; and the Rwanda central bank is empowered to enter into agreements with commercial banks in this same regard.

Furthermore, where the existing financial sector is relatively small, it may be deemed advisable—indeed necessary—for the central bank to be able to deal directly with the borrowing and depositing public. This power has been a feature of the early years of many established central banks. Limited direct central bank contact with the borrowing public through discounting and advances on government securities is provided by all the statutes discussed here, except those for Lebanon and Cyprus. And the Algerian and West African central banks may accept noninterest-bearing deposits from the public in certain cases, although such deposits have in fact been small.

Broader powers have been given the central banks of Jamaica, Somalia, Mali, and Burundi—namely to discount for and make advances to, as well as to accept deposits from, nonfinancial customers. The Bank of Jamaica, to be sure, has indicated its intention to abstain from such commercial banking operations. But, in Somalia, the central bank's claims on the private sector are about two-thirds as large as similar commercial bank claims, while its rediscounts for commercial banks are negligible. The Mali central bank's claims on private borrowers are approximately four times as large as those of commercial banks, and it also discounts heavily for the commercial banks. In many countries where the central bank has not been given such broad powers to deal directly with the public, as well as in some of the countries where the central bank has such powers, separate government development banks tend to perform some of the same functions.

The specific types of paper eligible for discounting, rediscounting, loan collateral, or outright purchase are in themselves of considerable importance in the process of financial development, as already noted. In addition to discounts of and loans against government securities, all the central banks here discussed may discount or loan against first-class paper drawn to finance trade, industry, and agriculture. The maximum allowable maturity of the underlying paper is 90 days in Lebanon, but more usual limits range from 180 days to one year.

A number of statutes also provide for longer term commitments on the part of central banks to assist in the growth of negotiable securities markets and to finance economic development. Following the French tradition, the Central Bank of Algeria, the Equatorial African and West African central banks, and the Malagasy bank may extend credit to commercial banks and other financial institutions for as long as five years in order to finance industrial exports, housing, or other projects included in national development plans. Cyprus permits central bank investment in first-class, fixed-maturity, fixed-interest securities in amounts up to 5 per cent of the bank's liabilities (exclusive of government deposits). The central bank of Mali has taken over the functions of the government-owned Popular Bank of Mali for Development. The Bank of Jamaica may, with the approval of the finance minister, buy and sell shares of companies specially authorized by the government to develop a local money or securities market or to improve "the financial machinery for financing of economic development". The Burundi bank may commit amounts equal to the sum of its capital, reserves, and amortization accounts to the purchase of long-term obligations issued or guaranteed by the government and, with agreement of two thirds of the bank's governing board, of long-term obligations of other borrowers and shares in newly organized government-sponsored financial institutions.

CREDIT CONTROL

The new central bank statutes suggest the existence of several distinct although overlapping approaches to the problem of general monetary control. In those countries

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that were formerly French colonies, primary reliance is placed on variation in central bank credit to banks and other financial institutions, mainly through changes in the discount rate and through variable ceilings on the over-all volume of such credit. The West African central bank and the Equatorial African central bank determine the discount rate and the credit ceilings for each state, while national monetary committees are responsible for the distribution of credit among the commercial banks and other eligible credit institutions in the individual states. It is therefore possible for these central banks to pursue differential credit policies in the individual member states, as circumstances may require, although the freedom of payments among these countries would tend to complicate such differential policies and, in fact, makes a concerted economic and monetary policy highly desirable. In all these former French colonies, commercial bank reliance on central bank credit is very heavy: the central banks tend to refinance from 30 per cent to 60 per cent of bank credit outstanding, there being of course considerable variation from country to country and over time. Changes in the commercial banks' external indebtedness to their French head offices or parent banks or to other French banks can, to be sure, offset changes in central bank credit to some limited extent. The statute creating the Burundi central bank, which commenced operations very recently, suggests a similar approach to credit control, although the concept of setting ceilings on the availability of central bank credit does not appear in the Burundi statute.

The new central banks in Lebanon, Somalia, Jamaica, Cyprus, Rwanda, and the Congo rely for purposes of credit control largely on a combination of variations in commercial bank reserve requirements, the rediscount mechanism, and open market operations, plus a varying array of direct controls. One reason for the addition of direct controls to the traditional central bank arsenal in less developed money markets is usually the problem of dealing with potentially large inflows of funds from abroad. These inflows can be offset by changes in required reserve ratios only within the limits set by law, while large central bank sales of commercial paper or government securities might prove unduly disruptive or altogether impossible in thin financial markets.

The statutes of five of the six central banks discussed in the foregoing paragraph specify the range or upper limit of permissible variations in reserve ratios. In Jamaica, the ratio may be varied from 5 per cent to 15 per cent of deposit liabilities. The upper limit in Cyprus, Rwanda, and the Congo is 20 per cent of deposit liabilities, with an additional 10 percentage points permitted in Cyprus in exceptional circumstances. In Lebanon, the maximum required reserve ratio is 25 per cent for demand deposits and 15 per cent for time deposits. As for direct controls, the Bank of Jamaica may set limits both upon the over-all volume of commercial bank credit outstanding and upon specific types of credit; the Cyprus and the Congo banks have the same power with respect to commercial banks and other designated financial institutions; and the Rwanda bank may accomplish the same end through agreements with commercial banks and other financial institutions. The Lebanon bank may set variable liquidity ratios and other asset-liability relationships for commercial banks and other financial institutions. The central banks of Cyprus and the Congo also may set commercial bank lending and deposit rates.

Central banks which make substantial use of their powers to deal with the nonbank public—those in Somalia, Mali, and Burundi—possess an additional instrument of monetary control. By altering the volume of central bank credit to the nonbank public, these banks have a direct means of influencing the liquidity of the nonbank sector as well as that of the bank sector of the economy.

INTERNATIONAL FINANCIAL RELATIONS

Many of the statutes specify the form in which the central banks' international reserves are to be held, as well as the minimum level to which these reserves may fall. These provisions are, of course, influenced by the special relation to a major currency area a country may have.

Jamaica and Cyprus are members of the sterling area and as such have generally tended to hold the bulk of their reserves in short-term sterling assets in London. Funds are freely transferable within the sterling area, while the sterling balances held by the area's monetary authorities are convertible into other currencies in accordance with each country's exchange regulations and general sterling-area policy. In Jamaica, the central bank law requires that reserves be held in the form of gold, sterling notes and coin, balances or money at call with banks in the United Kingdom, United Kingdom Treasury bills, or other securities issued or guaranteed by a government or territory of the British Commonwealth. The provisions in the central bank statute of Cyprus specify only that the bank's foreign assets are to consist of gold and such foreign exchange and foreign securities as the governing board shall from time to time designate. The statutory minimum level of foreign exchange reserves at the Jamaica central bank is stated in terms of its relation to the currency circulation. This reflects the practice of the former British-administered currency board which this new bank succeeds; but, whereas the currency board

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generally aimed at maintaining 100 per cent sterling cover for currency outstanding, the new central bank statute provides for 50 per cent cover in gold or eligible foreign exchange assets. In Cyprus, reserves must be 30 per cent of currency and central bank sight liabilities. These two statutes make no specific provision as to how and when the banks are to act to maintain these ratios.

Algeria, Mali, the countries of Equatorial and West Africa, and the Malagasy Republic are members of the French franc zone. With some exceptions, zone members hold most of their foreign exchange reserves in the form of French franc liquid assets. Algeria and Mali, whose central bank laws do not specify the form or size of their international reserves, may also hold gold and nonfranc foreign exchange. The countries served by the Equatorial African, West African, and Malagasy central banks, however, maintain their foreign exchange reserves in the form of "operations accounts" at the French Treasury, or they may hold French government securities. These members of the African Financial Community (CFA) have in exchange been given the guarantee of unlimited conversion of CFA currencies into French francs. The technical arrangement involves automatic overdraft facilities when a country's operations account shows a deficit. These accounts may be debited by CFA central banks for the purchase of nonfranc currencies by residents of CFA countries in conformance with these countries' exchange regulations, which generally resemble those of France.

French willingness to assure convertibility of CFA francs is related to the French voice in the management of the three above-named banks and to certain additional safeguards. For example, the statute for the West African central bank provides that an increase in the bank's discount rate and a reduction in rediscount ceilings must be considered when foreign exchange reserves remain for thirty days below 20 per cent of sight liabilities (currency and deposits combined); if the ratio falls below 10 per cent for the same period of time, these measures must be adopted immediately. Also, an agreement between the West African Monetary Union (the group of states served by the West African central bank) and the French Treasury provides that, if the operations account of the area as a whole is in debit for sixty consecutive days, the central bank's discount rate must be raised by 1 percentage point. For an individual country with a net debtor position in the operations account, the discount ceiling must be reduced by 20 per cent, while for a country whose operations-account credit amounts to less than 15 per cent of its currency outstanding, the ceiling is to be reduced by 10 per cent.[4]

The remaining five new banks—in Lebanon, Somalia, the Congo, Rwanda, and Burundi—are members of neither the sterling area nor the French franc zone, although the three last-named countries were members of the Belgian monetary area until 1960. The Lebanon bank is required to hold gold and foreign exchange reserves equal to 30 per cent of its currency and sight liabilities or 50 per cent of the currency issue, whichever is larger. The Somali bank must hold a reserve of gold and convertible currencies equal to 100 per cent of currency outstanding. Neither statute provides for special action in the event these ratios are not maintained. The Congo bank must maintain gold and foreign exchange reserves equal to 40 per cent of currency and sight liabilities, but this requirement may be suspended by the governing board of the bank for the first five years of the bank's operations. The Rwanda bank is to hold foreign exchange reserves in the form of gold, accounts with foreign central banks, or in readily marketable securities, but is under no obligation to maintain them at any specific level. The Burundi statute does not mention international reserves, although the bank has sufficient powers to acquire and maintain foreign exchange reserves.

CONCLUDING REMARKS

The broadening of the financial structure as a prerequisite for sustained economic development is one of the prime tasks of virtually all these new central banks. Such a broadening must in a number of cases necessarily accompany the effective exercise of central bank credit control. The tools given these institutions will, therefore, have to be used not only to encourage price and balance-of-payments stability, but also to promote the growth of sound and diversified financial institutions and to foster confidence in money and banks—efforts which will in turn aid economic growth in general. It may thus be expected that all the banks here discussed will gradually broaden their potential for judicious and flexible use of central banking instruments.

[4] It will be understood that ties concerning central banking are only one aspect of the continuing financial cooperation between France and her former African colonies. Thus, besides grants, the French also make loans, through the Caisse Centrale de Coopération Économique (CCCE), to CFA-area development banks, public corporations, and private enterprise. The CCCE is financed by French Treasury advances. It also serves as note-issuing authority for Saint-Pierre-et-Miquelon and in this connection maintains an operations account at the French Treasury.

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Fiftieth Anniversary of the Federal Reserve System— Early History of Earnings and Expenses*

Relying in part on the experience of other central banks, the legislators and banking experts who drafted the Federal Reserve Act expected that the earnings of the new Reserve Banks would tend to average higher than their expenses. The distribution of these earnings was therefore carefully specified in the act.

First there was provision for a 6 per cent cumulative dividend on capital stock purchased by member banks. Earnings in excess of these dividend payments were then to be paid to the United States Treasury (except that one half of the excess was to be retained until the surplus account equaled 40 per cent of paid-in capital). Until 1933 these payments to the Treasury represented a "franchise tax". In that year the tax was repealed to permit the Federal Reserve Banks to replenish their surplus, which was substantially reduced when an act of Congress required the Banks to subscribe $139 million to the capital of the new Federal Deposit Insurance Corporation. Since 1947, payments to the Treasury have been made as "interest on Federal Reserve notes".

Although the sources of potential Reserve Bank earnings—loans and rediscounts for member banks and interest on securities acquired in open market operations—were well known from the outset, a few member banks were pessimistic about the prospect of receiving the return specified by the statute. In New York State, the directors of one member bank stated publicly that they were writing down to zero the value of their Reserve Bank stock since they did not foresee any dividend payments.

In late 1914 and through 1915, such pessimism proved temporarily justified as total earnings of the Federal Reserve Banks were in fact small. The Federal Reserve Act had lowered reserve requirements of national banks, and this step, coupled with an inflow of gold, brought about conditions of monetary ease so that there was little need for rediscounting. Through the end of 1915, the twelve Reserve Banks accommodated 2,073 member banks, but these discounts had totaled only $183 million.

With respect to the acquisition of earning assets through open market operations, the New York Federal Reserve Bank noted that suitable investments were in strong demand, causing interest rates to decline. In its first *Annual Report,* the Bank stated:

> Realizing the influence which the reserve bank might have upon these rates if it pressed its funds upon the market, it has been the policy of the bank to follow rather than lead the market in its decline. In these circumstances, no thought could be given to earning dividends.

Thus, from the beginning, the System felt that central bank decisions should not be influenced by considerations of earnings.

In the aggregate, current expenses of all the Reserve Banks exceeded earnings by $141,000 between the beginning of operations in November 1914 and the end of 1915. Reflecting regional conditions, results varied among the Banks and two Banks actually posted sufficient earnings after expenses to initiate dividend payments. However, it was estimated that additional net earnings of approximately $3.4 million would have been needed to meet dividend requirements of all twelve Banks.

In 1916, earnings of the Banks rose while expenses, no longer affected by organizational outlays, remained steady. The twelve Banks were therefore able to declare partial dividends of $1.7 million on member bank stock. In 1917 war financing swelled earnings, and at the year end the Reserve Banks made their first transfers to surplus and payments to the Treasury. By June 1918 all the Reserve Banks had brought dividend payments up to date.

Since that time, there have been four years in which Reserve Bank earnings have not covered expenses and dividends. Over the past fifty years as a whole, however, the System has paid into the Treasury more than $7.8 billion—an amount that far exceeds the $559 million in dividends paid to member banks on capital stock during the same period. Last year the Reserve Banks' current earnings were $1.15 billion, their current expenses $187 million, dividends $29 million, transfers to surplus almost $56 million, and payments to the Treasury $880 million.

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

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