

1914 FIFTIETH ANNIVERSARY 1964

FEDERAL RESERVE BANK OF NEW YORK



MONTHLY REVIEW

OCTOBER 1964

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Volume 46

No. 10

Monetary Policy and a Liberal International Economy*

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It is indeed a privilege and pleasure for me to be with you today. With our nation's attention increasingly turned to contacts with other nations, I particularly welcome an opportunity to comment on the underlying philosophy behind our commercial and financial relationships, and on the important role of monetary policy in helping to achieve our economic goals. It is all too easy in a world where each day's news may bring fresh problems, and needs for adaptations of policy, to lose sight of the broad guidelines that we would like to follow, and it is to these objectives that I would like to direct your attention today.

I think it would be generally agreed that, by and large, the international economic ideals of the Free World since World War II could be regarded as "liberal" in the best sense of the term. Under the leadership of the United States and the other major industrialized nations, there has been a more or less consistent pursuit of greater freedom of international trade and international investment. The autarkic and restrictive record of the thirties convinced most thoughtful people that the road to world economic progress lay in the opposite direction; and even before the end of World War II the foundations for a "liberal" economy were being built through such farsighted innovations as GATT, the International Monetary Fund, and the World Bank.

Two decades have passed since these beginnings, and as we look back on the vast growth of economic well-being in the Free World during this period we can hardly fail to feel much satisfaction. The record among individual countries has varied widely, both in the extent of economic growth and in the methods used to achieve it; thus, with respect to the domestic economies both the proponents of

free enterprise and the backers of "dirigisme" can point to considerable success. But as far as international economic relationships are concerned, the postwar development has been unequivocally in the direction of greater freedom and the abandonment of controls inherited from the war and prewar years. At the same time, world trade and international investment flows have grown enormously—at a pace far exceeding that of most individual domestic economies. This growth has been most heartening, and I am confident that there is ample opportunity for further progress.

The financial background for these remarkable economic gains is fairly clear. Gold has continued its centuries-old role of providing a highly convenient basis for monetary values; and the dollar, tied firmly to gold at the fixed price of \$35 per ounce, has been a most useful partner for gold, together with sterling, in providing monetary reserves needed to support the far-flung structure of world trade and payments. As I have pointed out on other occasions, the key role of the dollar as a reserve currency is not something deliberately sought or created. Rather it has been the inevitable result of the American economy's strength, and the usefulness of the dollar as a medium of international payment and as a standard against which other countries could measure their own currencies.

When we examine the nature of our progress toward greater freedom of world trade and payments, we must admit that it is not a matter of smooth and uninterrupted gains. Belief in such continuous progress could lead only to disillusionment. If we are to maintain a levelheaded view and if we are to retain our faith in ultimate progress, we must recognize that forward steps are interspersed with backward steps and that at any one time there are conflicting forces and crosscurrents at work. Often the great advances in themselves create problems which may cause remedies to be sought in a restrictive direction—but what

* An address before the eighth International Forex Congress at the United Nations, New York City, October 3, 1964.

counts is the net result of all these forces, which we hope will continue to be expansion rather than the reverse.

The achievement of currency convertibility some six years ago was an example of a great advance leading to some problems and some restrictive countermeasures. Convertibility made possible, for the first time in many years, large-scale movements of short-term funds from country to country; and these movements could, and occasionally did, reach a size great enough to threaten the stability of one or more major currencies. Even the dollar was not immune to such threats. The flows of funds also frequently interfered with the current domestic objectives of the monetary authorities, and this at a time when monetary policy was taking on greater importance in country after country. In the classical economic model, the answer to excessive international flows lay in monetary countermeasures; but classical economics reckoned without the kind of conflict between domestic and international objectives that has become so active and sharp in these post-convertibility years in both the United States and Europe. Hence an urgent need arose for reviewing the techniques of monetary policy to see whether both domestic and international needs could be served at once; and, as the possibilities along these lines were necessarily limited, there was a new impetus to finding an appropriate "mix" of monetary and other general governmental financial policies, notably fiscal policy. But in addition there was some recourse to specific restrictions on capital movements to help to keep them within bounds.

The other avenue of response to the problems emerging in the wake of convertibility took the form of a tremendously improved and intensified system of cooperative measures entered into by central banks and treasuries, either bilaterally or on a collective basis. The history of this cooperation has been written so fully that I need not go into any detail—least of all before this sophisticated audience—but it did effectively remove the threat that short-term capital movements might unleash speculative forces sufficiently strong to undermine some of the major currencies. Fortunately, the monetary authorities most active in constructing these lines of defense never lost sight of the fact that cooperative extension of credit does not *solve* a payments imbalance but merely provides time in which orderly forces can be marshaled to achieve a basic remedy. I should add, at a time when international liquidity is receiving so much attention, that in the Federal Reserve Bank of New York we have consistently felt that the most promising approach to adequate liquidity in the future lies in the further development of international credit facilities, both short and medium term and both bilateral and multilateral, along the lines clearly marked

out in the last few years. The proposed 25 per cent increase in IMF quotas, for example, is a useful and appropriate step in keeping up with the growing volume of world trade and payments, and expanding needs for liquidity.

So far I have been speaking of problems that would have arisen even in a postwar world characterized by basic equilibrium of international payments. But in fact the problem has been greatly complicated by the emergence around 1958 of a large United States deficit and a similarly large—and related—European surplus. The reasons for this disequilibrium are hard to disentangle in any precise fashion—but I would number among the primary causes: (1) the remarkably vigorous recovery and advance of the European economy, partly as a result of massive American aid; (2) the unavoidable assumption of major responsibility by the United States for military leadership in the postwar world, plus major responsibility for assistance to the less developed countries; and (3) insufficient attention in the United States of the 1950's to the importance of keeping United States costs and prices highly competitive in an increasingly competitive world. Indeed there was a sublime overconfidence at that time on the part of Americans in the dollar's immunity to balance-of-payments problems. And we were not alone in our illusions; all of you can remember the days when the "intractable dollar gap" was believed in even more fervently abroad than in our own country.

Perhaps we should include among basic causes of the disequilibrium the avid interest in foreign travel of an affluent American society, the quite understandable wish of American industry to preserve and extend its activities abroad through direct investment, and the natural attractions of the huge American capital market, fed by a vast flow of savings, to all the potential borrowers in a rapidly growing world economy. Movements of short-term capital should perhaps not be regarded in quite the same light as other segments of our deficit, but it must be remembered that any sizable outflows of short-term capital, such as we have had during recent years, are a continuing serious problem when these outflows are superimposed on an already large underlying deficit.

Efforts to reduce the United States payments deficit have made notable progress in some directions, but we still have a considerable way to go before we reach equilibrium. There is no doubt that the payments problem is still serious—requiring intensive remedial efforts on the part of the United States Government and American citizens in general.

This is not the time nor place to go into detail on the many-pronged attack on the United States balance-

of-payments deficit that has been undertaken and intensified in the last few years. Of primary importance has been the achievement of stable costs and prices, in contrast to the marked inflation of costs and prices in most European countries. It would be my hope that over the next few years we could not only maintain but even improve on this record of stability by achieving some reduction in costs and prices. Indeed, in some industries where productivity gains have outpaced wage increases there have actually been unit cost reductions. We have yet to see the follow-up in the form of price cuts on any significant scale, but I can think of no more potent method of working toward basic international equilibrium, while at the same time providing our own consumers directly with some of the fruits of over-all productivity gains. Unfortunately, recent wage settlements warn us not to generate overoptimism on this score, however, and we shall have to work harder than ever to maintain the record of stability of the last few years.

The Government has made a good start in attacking the balance-of-payments deficit through a reduction of net military outlays abroad. Much has also been done through the tying of the largest part of our economic aid, but it should be recognized that tying is no final answer since aid funds may merely be substituted for other sources of exchange in many instances. With regard to the aid question, I feel that there is a valid case for greater sharing of these burdens by European countries enjoying a surplus in their international payments—for even if per capita wealth is the most important criterion for burden-sharing, this is no reason to ignore the balance-of-payments aspects as an additional basis for sharing, just as the transfer problem loomed very large in our own early postwar assistance programs. Moreover, there are weighty reasons for a better sharing of aid, which transcend balance-of-payments considerations altogether—in terms of broadening the base of Free World cooperation.

The other two principal lines of attack on the payments problem have been (1) monetary policy (together with some considerable assistance from debt management and fiscal policy) and (2) direct measures to influence the volume of long-term capital outflows. Whether monetary policy has done its part adequately is, of course, a question to which there is no agreed answer. There are those who tend to attribute our payments deficit almost entirely to an excessive creation of credit and money, but there are also those who argue that preoccupation with our international deficit has produced an insufficiently easy credit policy, not responsive enough to the needs of the domestic economy.

I would have to reject both of these extremes. I would not be so immodest as to contend that our policy has been exactly right, but I do believe that through innovation and development of varied techniques we have been able to contribute a good bit to payments equilibrium, largely by reducing incentives to short-term capital outflows. Doubtless we could have done more had it not been necessary at the same time to encourage greater use of the economy's unused resources. And this would be particularly true of our role with respect to longer term capital flows, for we have been rightly concerned about too much upward pressure developing on longer term interest rates—given the great importance of the long-term capital market to the well-being of domestic business. I should add, however, that the possibilities are not unlimited for cushioning long-term rates against the impact of developments in the short-term area.

Notwithstanding these constraints, I think there can be no question that monetary policy has made a valuable contribution to the economic expansion of the past forty-odd months. And that contribution is continuing; bank reserves, bank credit, and the money supply have continued to grow in 1964 at about the same substantial pace as in 1963. I can see no evidence that the economy has been short of required money and credit. On the contrary, the question could be raised whether continued increases on the scale of recent years might not be a little too generous even from a domestic point of view. On the international side, the fact that interest rates have been consistently lower here than in most major foreign countries, the indications of substantial placements abroad of United States investment funds, the readiness of banks to lend abroad in large volume and for a variety of purposes, and the continuing outflow of short-term capital—all suggest that a lesser degree of monetary ease can at any time, if needed, make a significant contribution to the balance of payments.

The conflict of domestic and international goals is, as I have said before, more apparent in the short run than over an extended period, for in the long run a strong economy and a balanced international position are surely complementary goals. But this does not prevent a very real conflict and a need for choice at specific times and under certain circumstances; and such circumstances have been all too frequent in recent years, not only in the United States but also in Europe. Two special factors have made and will continue to make the problem particularly hard to deal with in our own country: (1) international trade and payments form a much smaller share of our total national economic activity than in other major industrial nations, so that many Americans have trou-

ble conceiving of any international factor as even approaching the importance of strictly domestic economic considerations; (2) but at the same time the dollar's role as the leading world currency and, more generally, this country's role in world affairs require us to give particular weight to international factors in our policy formulation.

While the conflict of domestic and international aspects has been especially troublesome in the United States, it has appeared in so many major countries in recent years that there has been a widespread effort to find ways of relieving monetary policy from a part of its domestic burden in order to free it for a role in which it could be obviously highly efficient and useful—namely, in influencing international capital flows. Hence the emphasis both here and abroad on finding a better “mix” of monetary policy and other generalized and “impersonal” national economic policies, notably fiscal policy. Unfortunately this search has been up against a serious handicap—the fact that fiscal policy, although potentially more powerful than monetary policy as a means of affecting the domestic economy, at least in this country, is still sadly lacking in the flexibility needed to make it an instrument of comparable usefulness. We have only to recall the period of some two and a half years between the initial moves toward a major personal and corporate income tax cut in this country, and the enactment of the law early this year, to feel some sense of frustration with the flexibility of fiscal policy. More than once, and in more than one country, I have heard it said that monetary policy would have to take on added burdens at a particular time because of the political difficulty of working effectively through fiscal action.

I would hope, however, that there would be no letup in the efforts to find a proper way in each country of making fiscal policy more flexible and thereby more usable as a means of achieving over-all domestic goals. One important reason why I strongly favored the last tax reduction was the belief that it would free monetary policy to give more attention to our international responsibilities. That argument is as valid today as it was two or three years ago. There is evidence that the tax cut is already achieving its objective. With domestic business going ahead at a very healthy pace—in part doubtless because of the tax cut—the Federal Reserve System is clearly in a better position to use its powers, as needed, in defense of the dollar's international strength.

With respect to the remaining avenue of attack on our payments deficit, i.e., direct influence on capital flows through selective measures, we are in the midst of an experiment with a novel variant of such measures, the interest equalization tax. With the tax so recently enacted, it is perhaps too early to assess its full effects, although it has obviously had an important impact on the volume of new foreign issues in this market. In any case, it is essential that by the end of 1965, when the tax is scheduled to expire, we shall have dealt effectively with our deficit by means which are conducive to expansion of world trade and investment.

Fundamentally we must recognize that recourse to the United States market by borrowers all over the world is a perfectly natural response to heavy capital needs and limited savings abroad, combined with a great abundance of savings in this country. Capital flows reflecting such fundamental economic factors should not be cut too drastically just because we have a payments deficit, any more than foreign aid participation should be decided mainly on balance-of-payments grounds. Of course, there is the problem of financing such capital outflows, but it is part of the general problem of our payments deficit and should not be mistaken for a specialized sectoral problem that must be solved within the confines of this one sector.

Perhaps the greatest risk of all in selective measures for influencing capital flows is the danger that they may lull us into a comfortable feeling that monetary policy can now relax and focus all its attention on domestic affairs. In my judgment nothing could be further from the truth. Regardless of whether selective controls are being used, monetary policy cannot escape its duties as a partner, and a powerful one, in our concerted effort on many fronts to rid ourselves of the payments deficit that has persisted for seven years, imposing such a burden on our energies and our efforts to promote sound economic growth. Maintenance of stable costs and prices is probably of first importance in this concerted effort; and monetary policy must be prepared to act promptly and effectively, in the light of unfolding events, both to help preserve this vital cost-price stability and to bring a better equilibrium in international capital flows. Monetary policy cannot do this job single-handed, but I believe that the Federal Reserve System is, as it must be, ready to do its full part to preserve the dollar as a source of economic strength at home and as the financial keystone for the liberal international economy which we all seek.

The Business Situation

The economy came through the summer months with few of the signs of hesitation that had marked that season in 1962 and 1963, and in spite of unsettled labor disputes in some sectors business was continuing its brisk advance as the autumn began. Industrial production and retail sales moved ahead in August, and although nonagricultural employment held at about the July level, hours worked in manufacturing—particularly in durable goods industries—moved up. Weekly data for September suggest that steel production continued to rise, while auto production and retail sales edged down from their August levels.

It is probably too early to assess the eventual impact on the economy of the conclusion of labor negotiations between the United Auto Workers and Chrysler and Ford in September and the signing of a national agreement with General Motors early in October. The terms of these agreements, to be sure, included increases in wages and fringe benefits in excess of the economy's average productivity gain in recent years, but the current exceptionally good level of profits in the auto industry, together with the industry's above-average rate of productivity increase, provides a cushion with which to meet the cost increases. Hence, the labor settlement apparently raises no immediate threat to the stability of automobile prices. Yet, there is the possibility that similar wage adjustments may spread to other industries, including those less able to absorb higher costs. The agreements also have a potential psychological impact on pricing decisions and could become an inducement to increased inventory building. On the other hand, productivity growth over the past two years has been unusually rapid for an expansion more than a year old. The continuation of such rapid growth, while it should not be taken for granted, would of course be of substantial help in offsetting the cost-price pressures arising from wage settlements.

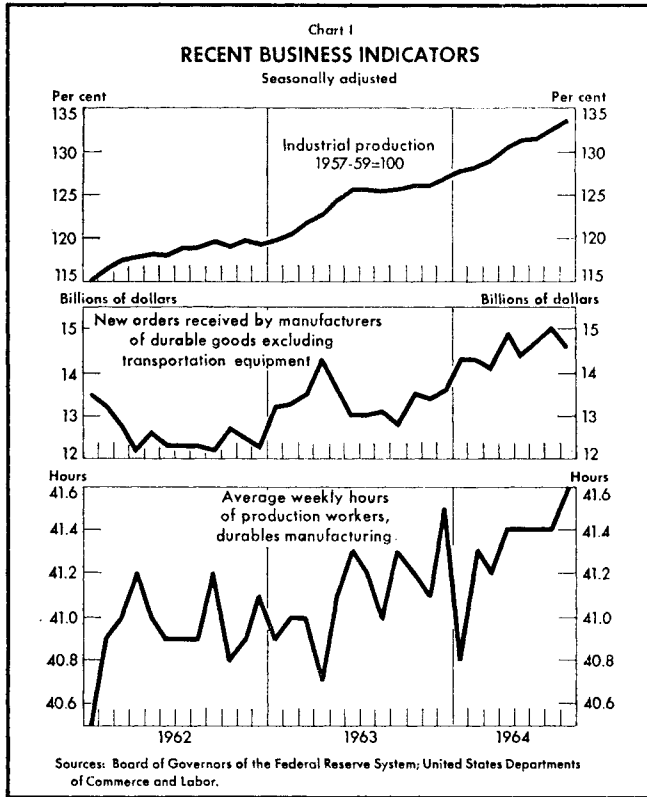
While the auto settlements and the sustained economic advance have served to focus attention on the behavior of prices, there is still no sign of any immediate change in the relative stability that has generally characterized broad indexes of price behavior for several years. The consumer price index held virtually steady in August, and the increase in percentage terms so far this year has been

somewhat smaller than the moderate rises in the first eight months of 1962 and 1963. A decline in food prices was too small to cause any significant movement in the overall wholesale price index in August, as average prices of commodities other than farm and food products held steady at a level about equal to those prevailing at the end of 1963 and the beginning of 1964. Weekly data indicate little change in this broad indicator of industrial commodity prices in September. At the same time, however, prices of some sensitive industrial commodities, particularly nonferrous metals, pushed up the Bureau of Labor Statistics index of thirteen raw industrial commodities in September. The advances in this index in recent months, which have totaled about 11 per cent since the beginning of the year, partly reflect special supply situations in individual commodities, but may also indicate some tendency toward generally increased demand pressures both in the United States and abroad.

PRODUCTION AND EMPLOYMENT

Industrial production (as measured by the Federal Reserve's seasonally adjusted index) rose by 0.8 percentage point in August, the ninth consecutive monthly gain, to reach 133.5 per cent of the 1957-59 average (see Chart I). So far in 1964 industrial production has risen 5 per cent, about equal to the advance during the comparable months of 1963. The August gains were widespread; equipment production registered a rise of 1 per cent, while output of both durable and nondurable materials advanced. Automobile production—drastically curtailed by the model change-over and the lack of any continuation of 1964 model production—actually recorded a small increase, after a necessarily rough allowance for these seasonal influences. Steel production showed a less-than-seasonal rise in August, but weekly data point to some seasonally adjusted advance in September. Auto output declined somewhat in September, reflecting the General Motors' strike during the last days of the month.

Prospects for further production gains remain good, although a 9 per cent August decline from the record July level in new orders received by manufacturers of durable



goods does provide a cautionary note. Most of the August fall in orders reflected a sharp drop in the erratic aircraft orders series; new orders for durable goods excluding transportation equipment fell only 2.9 per cent in August (see Chart I). Even at the reduced August level, new orders continued to run ahead of shipments, and the backlog of orders on the books of durables manufacturers thus climbed for the eighth month in a row.

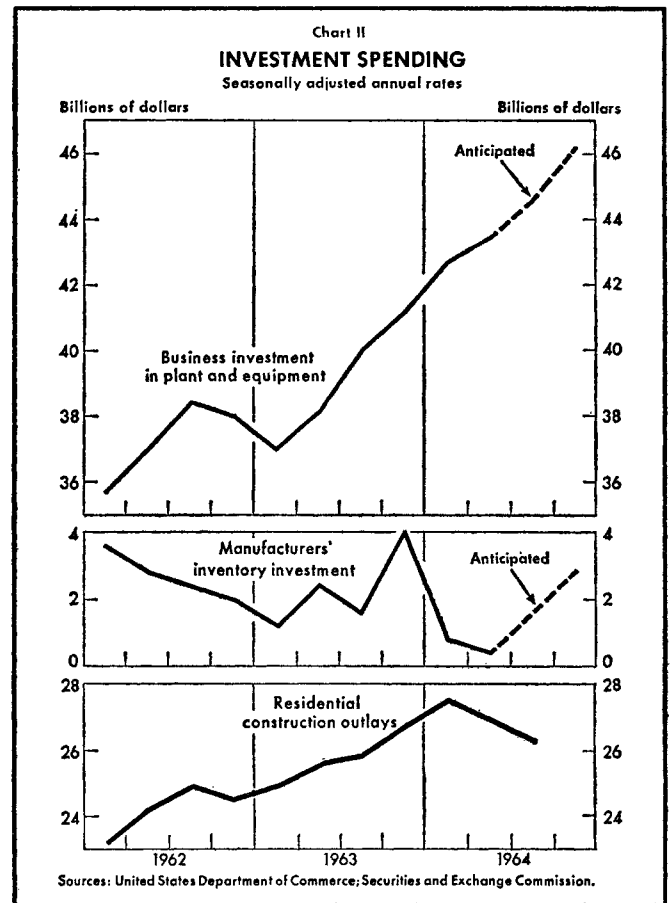
Total nonagricultural employment in August held at about the July level, although in the manufacturing sector employment (along with mining and construction employment) showed a small decline. Average hours worked per week by manufacturing production workers, however, moved up by about ½ per cent to 40.7 hours, seasonally adjusted. Average hours in the durable goods industries—at 41.6 hours (see Chart I)—in fact reached a peak for the current expansion. The increases in average hours worked may indicate that employers are utilizing existing employees to the fullest before hiring new workers and also that the sustained pace of the expansion has quite possibly now come close to creating labor shortages in some lines.

According to the Census Bureau's household survey, total farm and nonfarm employment moved down a bit in

August while unemployment edged up, reflecting primarily a failure of unemployment among teen-agers to show the normal seasonal drop. As a result, the over-all unemployment rate increased to 5.1 per cent from 4.9 per cent in July. In September, a fractional advance nudged the rounded unemployment rate up to 5.2 per cent. Unemployment among teen-agers registered some drop, but the rate for married men rose to 2.9 per cent. On a quarterly average basis, the unemployment rate in the third quarter was at its lowest level since October-December 1957.

BUSINESS AND CONSUMER SPENDING

While spending for plant and equipment is strong and expected to show a good advance at least through the remainder of the year (see Chart II), business spending for additions to inventories remains moderate. According to an August Commerce Department survey, manufacturers estimate that stocks of goods on hand will rise at a seasonally adjusted annual rate of \$1.6 billion in the third



quarter of the year and by \$2.8 billion in the final quarter (see Chart II). According to the same survey, however, shipments are also expected to advance over the remainder of the year at such a rate that the inventory build-up will serve only to maintain the generally tight relationship between stocks and sales that has characterized the current economic expansion.

Residential construction activity continues to slip back from the advanced levels reached earlier in the year. With some further decline in September, outlays for the third quarter as a whole—at a seasonally adjusted annual rate of \$26.3 billion—were about 4 per cent below the advanced first-quarter rate (see Chart II) and 2 per cent below the second quarter. Housing starts declined again in August, putting the July-August average of starts 14 per cent below the first-quarter rate, while new housing

permits issued moved up only slightly from the relatively low July level.

Apart from housing, the consumer continues to provide a major push to economic activity. Retail sales, rising almost 1 per cent in August, reached a record high of \$22.1 billion, seasonally adjusted. Sales of automobiles contributed substantially to the advance, and dealers substantially cut their inventories of 1964 model cars. Nondurables sales, particularly apparel, also contributed to the August advance. Data for the early weeks in September suggest that retail sales declined somewhat from their August record. As noted in last month's *Review*, consumer intentions to buy are reported to be strong and, with the March tax cut continuing to provide an incentive for increased spending, further strength in the consumer sector can indeed be expected.

The Money Market in September

The money market remained generally firm in September. Federal funds traded predominantly at 3½ per cent, although there was trading at rates below that level on occasion. Member bank borrowing from the Federal Reserve Banks was temporarily high prior to the Labor Day holiday, and after the midmonth quarterly corporate dividend and tax payment dates which brought relatively heavy pressures on reserve positions at banks in the leading money centers.¹ Rates posted by the major New York City banks on new and renewal call loans to Government securities dealers were in a 3½ to 4 per cent range during the first half of the month but most frequently in a 3⅞ to 4¼ per cent range thereafter.

Offering rates for new time certificates of deposit issued by the leading New York City banks remained virtually

steady, while the range of rates at which three- and six-month certificates of deposit traded in the secondary market edged slightly higher. Several upward adjustments in the rates of other short-term money market instruments occurred during the month. Thus, at the end of September, the major sales finance companies were quoting a 3¾ per cent offering rate on 30- to 89-day directly placed paper as against a 3⅞ per cent rate at the end of August. Similarly, at the month end commercial paper dealers posted a 4 per cent offering rate on prime 4- to 6-month paper, compared with a 3⅞ per cent rate at the end of August.

Treasury bill rates worked irregularly higher in September. This trend reflected additions to the supply of bills, seasonal pressures over the quarterly corporate dividend and tax dates, and the spreading view that monetary policy had shifted slightly toward less ease. Dealer holdings of bankers' acceptances rose sharply in September, as seasonal influences brought about increased bank selling of these instruments and a contraction in demand for them. Rates on bankers' acceptances, however, remained unchanged throughout the month.

The gradual downward drift in prices of Government notes and bonds which began late in August extended into early September, as market participants continued to react with caution to the uncertainties in the balance-of-

¹ As announced in the August issue of the *Federal Reserve Bulletin*, the Board of Governors is now releasing on a weekly basis a new set of statistics giving information on reserve positions and purchases and sales of Federal funds by forty-six major money-center banks, eight of which are in New York. Certain information on the financing of Government securities dealers by these banks is also provided. The *Bulletin* gives data for the period September 1959 through July 1964, and subsequent data can be obtained from the new current release and from future *Bulletins*. An analysis of the historical data and other related material will be published by the Board this fall in a special monograph.

payments outlook and auto labor negotiations, to the possibility of rising credit demands over the fall season, and to the view that a slight shift in Federal Reserve policy might be taking place. Subsequently, as the distribution of securities acquired in the July and August Treasury financings proceeded in an orderly fashion, a firmer atmosphere reappeared. Prices of coupon issues generally edged higher from September 16 through September 22, and then moved narrowly through the end of the month. In the markets for corporate and tax-exempt bonds, prices came under downward pressure as underwriters probed for yield levels at which the month's large supply of new securities could be distributed. Investment buying appeared at the higher yield levels and prices were generally firm at the end of the month.

BANK RESERVES

Nation-wide net reserve availability averaged somewhat lower over the five-week period ended September 30 than in the four preceding statement weeks. On a weekly average basis, market factors absorbed \$292 million of reserves from the final statement period in August through the final week of September while System Account operations released a somewhat smaller volume of reserves. Banks throughout the country increased their borrowing from the Federal Reserve Banks around the September 7 Labor Day holiday as they guarded against uncertainties over the long week end. After a brief subsequent easing, reserve pressures built up on money-center banks significantly around midmonth during the dividend and tax period. These banks experienced a runoff of time certificates of deposit as well as expanded loan demand from business corporations. In addition, finance companies and Government securities dealers were increasing their borrowing from banks, as finance company paper matured and corporate repurchase agreements were terminated. While the money-center banks were able to cover most of their increased needs through the Federal funds market, their borrowing from the Reserve Banks also rose during the week ended September 23. Subsequently, a shift of reserves in favor of the money centers led to a decline in such borrowing, and to the appearance of considerable ease in the money market around the September 30 reserve settlement date for "country" banks.

System open market operations helped to offset most of the effects of the fluctuations in market factors and reserve distribution that occurred during September. At the beginning of the period the System sought to avoid augmenting the already heavy demand for Treasury bills that was present in the market and injected reserves mainly through purchases of Treasury notes and bonds. The

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

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

| Factor | Daily averages—week ended | | | | | Net changes |
|-----------------------------------------------------------|---------------------------|--------------|--------------|--------------|--------------|--------------|
| | Sept. 2 | Sept. 9 | Sept. 16 | Sept. 23 | Sept. 30 | |
| Operating transactions | | | | | | |
| Treasury operations* | + 74 | - 7 | - 66 | - 64 | + 42 | - 15 |
| Federal Reserve float | - 298 | + 112 | + 282 | + 619 | - 522 | + 223 |
| Currency in circulation | - 8 | - 233 | - 182 | - 233 | + 118 | - 77 |
| Gold and foreign account | - 19 | + 33 | - 11 | + 11 | - 31 | - 17 |
| Other deposits, and other Federal Reserve accounts (net)† | + 12 | - 18 | + 51 | + 110 | - 5 | + 150 |
| Total | - 210 | - 116 | + 81 | + 908 | - 397 | + 206 |
| Direct Federal Reserve credit transactions | | | | | | |
| Open market operations | | | | | | |
| Purchases or sales‡ | | | | | | |
| Government securities | + 215 | + 30 | + 28 | - 358 | + 253 | + 228 |
| Bankers' acceptances | - 1 | + 2 | - 1 | - 3 | - | - 3 |
| Repurchase agreements | | | | | | |
| Government securities | - 104 | + 359 | - 242 | - 135 | + 29 | - 93 |
| Bankers' acceptances | + 3 | + 23 | - 8 | - 12 | + 36 | + 42 |
| Member bank borrowings | - 14 | + 163 | - 253 | + 194 | - 131 | - 51 |
| Other loans, discounts, and advances | - | - | - | + 1 | + 1 | + 2 |
| Total | + 99 | + 636 | - 475 | - 323 | + 189 | + 120 |
| Member bank reserves | | | | | | |
| With Federal Reserve Banks | - 111 | + 529 | - 294 | + 585 | - 208 | + 392 |
| Cash allowed as reserves§ | + 21 | - 362 | + 354 | - 72 | + 10 | + 51 |
| Total reserves¶ | - 90 | + 167 | + 60 | + 513 | - 198 | + 443 |
| Effect of change in required reserves¶ | + 7 | - 49 | - 186 | - 405 | + 24 | - 609 |
| Excess reserves§ | - 63 | + 109 | - 126 | + 108 | - 174 | - 166 |
| Daily average level of member bank: | | | | | | |
| Borrowings from Reserve Banks | 215 | 478 | 225 | 409 | 278 | 341 |
| Excess reserves§ | 588 | 497 | 371 | 479 | 305 | 498 |
| Free reserves§ | 73 | 19 | 146 | 70 | 27 | 67 |

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 five weeks ended September 30, 1964.

temporary reserve needs over the Labor Day holiday were supplied largely through the purchase of Government securities under repurchase agreements. Subsequently, as movements in market factors began adding to the reserve base, the System absorbed reserves through the effects of the termination of outstanding repurchase agreements as well as through outright sales of Treasury bills. In the final week of the month the System again provided reserves as an offset to the month-end absorption of reserves by market factors. Over the five-week period as a whole, the weekly average of System outright holdings of Government securities rose by \$228 million, while average holdings of Government securities under repurchase agreements fell by \$93 million. Average total System holdings of bankers' acceptances increased by \$39 million. From

Wednesday, August 26, through Wednesday, September 30, System holdings of Government securities maturing in less than one year fell by \$117 million, while holdings maturing in more than one year rose by \$388 million.

THE GOVERNMENT SECURITIES MARKET

In the market for Government notes and bonds, the hesitant atmosphere which had appeared in late August remained in evidence in the early part of September. In part, this cautious tone reflected some feeling that the Federal Reserve System had permitted a slightly firmer tone to develop in the money market. At the same time, there was continued concern on the part of some participants over the balance of payments and over the possible implications for price stability of the automobile labor negotiations and contract settlements, as well as some discussion of the likelihood of increased credit demands stemming from the fall pickup in business activity.

Against this background, professional offerings expanded somewhat and prices of notes and bonds generally receded in the early part of September, with the largest losses occurring in the long-term maturity area. Offerings from nonprofessional sources remained modest, however, and some investment demand appeared at the lower price levels. At the same time, professional offerings gradually contracted as the technical position of the market strengthened, and a steadier tone emerged toward midmonth. The improvement in tone also reflected a renewed sentiment in the market that long-term interest rates were likely to remain relatively stable in the period immediately ahead. Although a consensus gradually developed that monetary policy had shifted slightly, most participants felt that such a move was aimed primarily at raising short-term rates and would not have significant effects on long-term yields. The feeling that rates in the longer maturity areas might remain fairly stable was reinforced by press comments that the Treasury's refunding and new money needs over the coming year would be relatively modest. In this improved atmosphere investment demand expanded, particularly for high-coupon securities in the five- to ten-year maturity category, while a good professional short-covering demand also developed for notes and bonds of various maturities. Accordingly, prices of most intermediate- and long-term issues edged higher from September 16 through September 22. Price movements thereafter were narrowly mixed. At the close of the month, prices of Treasury notes and bonds were generally $\frac{3}{32}$ lower to $\frac{1}{32}$ higher than end-of-August levels.

In the Treasury bill market, rates edged higher through midmonth partly in response to seasonal pressures over

the quarterly corporate dividend and tax payment dates and to additions to the regular weekly bill auctions.² As was the case in the bond market, the bill sector was influenced during this period by market discussion of a possible shift in monetary policy. Following the midmonth tax date, bill offerings tapered off, demand increased somewhat—particularly from commercial banks—and the tone of the market strengthened. Against this background, bill rates edged lower through September 18. During the remainder of the month rates edged irregularly higher as dealers—faced by higher financing costs—attempted to lighten their positions. Over the month as a whole, rates on outstanding bills were generally 5 to 22 basis points higher.

The September 24 auction of \$1 billion of new one-year bills resulted in an average issuing rate of 3.773 per cent, compared with an average issuing rate of 3.688 per cent on the comparable issue sold in August. At the last regular weekly auction of the month held on September 28, average issuing rates were 3.555 per cent for the new three-month issue and 3.711 per cent for the new six-month bill, 4 and 8 basis points higher, respectively, than the average rates at the final weekly auction in August. The newest outstanding three-month bill closed the month at 3.55 per cent (bid), as against 3.50 per cent at the end of August, while the newest outstanding six-month bill was quoted at 3.72 per cent (bid) on September 30, compared with 3.63 per cent at the close of the preceding month.

OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices of new and seasoned issues were little changed in quiet trading during the period immediately preceding the September 7 Labor Day holiday. Subsequently, a cautious atmosphere developed in both sectors in response to some uncertainty over the posture of monetary policy as well as to the usual September increase in the calendar of scheduled corporate and tax-exempt issues. Neither the more attractive pricing of new bonds nor some price cutting on recent issues remaining on dealers' shelves sparked any significant expansion in demand, and prices of new and seasoned issues generally edged lower through midmonth. Toward the end of the month, however, the improved atmosphere of several weeks' duration in the Government securities market began to influence the corporate and tax-exempt bond markets, and these markets

² See this *Review*, September 1964, p. 176, for details.

firmed. A stronger tone was particularly evident in the corporate sector where aggressive syndicate bidding for new issues pushed reoffering yields down and stimulated demand for higher yielding older issues still on dealers' shelves. The corporate sector was also buoyed by the light calendar of new corporate flotations on tap in the coming weeks. In the tax-exempt sector, investor demand generally expanded during this period following the very successful marketing of a large housing authority bond issue. At the same time, however, the tax-exempt sector continued to be restrained by the large volume of dealer inventories, and by a heavy calendar of forthcoming flotations. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 1 basis point to 4.42 per cent, while the average yield on similarly rated tax-exempt bonds increased 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 September amounted to approximately \$365 million, compared

with \$170 million in the preceding month and \$280 million in September 1963. The largest new corporate bond flotation during the period consisted of \$60 million of 4½ per cent utility company first and refunding mortgage bonds maturing in 1994. The bonds, which were Aa-rated by Moody's, were reoffered to yield 4.53 per cent. They were initially accorded only a fair investor reception but sold out later in the month when the market atmosphere brightened. New tax-exempt flotations in September totaled approximately \$850 million, as against \$705 million in August 1964 and \$415 million in September 1963. The Blue List of tax-exempt securities advertised for sale closed the month at \$673 million, compared with \$611 million on August 31. The largest new tax-exempt bond issue during the period was a \$130 million Aaa-rated series of housing authority bonds. Reoffered to yield from 2.05 per cent in 1965 to 3.50 per cent in 2005, the bonds were well received. Other new corporate and tax-exempt issues floated in September were accorded mixed investor receptions.

International Monetary and Financial Developments

THE TOKYO MEETING OF THE INTERNATIONAL MONETARY FUND

The question of international liquidity and of future world liquidity needs again dominated the annual meeting of the International Monetary Fund (IMF), which this year was held in Tokyo during the week of September 7.¹ In order to expand the Fund's resources and thus strengthen its ability to meet any contingencies that might arise, the Fund's governors agreed in principle on an increase of members' quotas. Several speakers suggested a 25 per cent increase in most quotas, and there were also suggestions that the quotas of Canada, Germany, and Japan might be raised somewhat more than proportionately, in recognition of the growing share of these three countries in international trade and payments. Individual quotas—which were last raised in 1959 and currently total \$15.6 billion—de-

termine the limitations on the use of the Fund's resources, as well as the voting power, of each member country.

This year's discussions were held against the background of two studies of the international monetary system and international liquidity needs that were prepared by the IMF and the Group of Ten as a result of resolutions taken at the Washington meeting of the IMF last year.² The discussions, which produced a thorough analysis of the past performance and the likely evolution of the international monetary system, showed a large measure of agreement on the basic issues. It was generally felt that the present gold exchange standard has served past needs well and has contributed to an orderly expansion of international trade and finance. The several speak-

¹ For a discussion of the 1963 meeting, see "The Question of International Liquidity at the Fund Meeting", this *Review*, November 1963, pp. 167-69.

² International Monetary Fund, *Annual Report of the Executive Directors for the Fiscal Year Ended April 30, 1964*, Part II, and *Ministerial Statement of the Group of Ten*, August 10, 1964. The group consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, United Kingdom, and the United States, with Switzerland an unofficial member.

ers endorsed the conclusions of the study by the Group of Ten, including those on the need for increases in IMF quotas, multilateral surveillance of the present bilateral liquidity arrangements, and coordination of monetary and fiscal policies by the major Western nations. There also was unanimity that the question of international liquidity is closely related to the need for balance-of-payments discipline. Domestic inflationary pressures must be checked by each country, and the provision of ample credit resources should not be viewed as a substitute for national action to correct payments imbalances.

Nevertheless, the delegates were aware of the possible future liquidity requirements of an ever-expanding world economy. In following up the studies of the past year, therefore, both the IMF and the Group of Ten will examine various proposals for the creation of additional reserve facilities. It is clear that the problem is both extremely important and difficult to resolve; there is a wide range of proposed solutions, several of which may have considerable merit. Hence, it is not surprising that there should be some divergence of opinion on the appropriate future course.

In his speech to the Governors of the Fund, Secretary of the Treasury Dillon emphasized the need for continuity and gradual evolution:

It is highly significant that both studies concluded that the present system is functioning well and that any changes should be designed, in the words of the Fund report, "to supplement and improve the system where changes are indicated, rather than to look for a replacement of the system by a totally different one".

On the other hand, French Minister of Finance and Economic Affairs Giscard d'Estaing criticized the prominent position of the key currencies in the present system and favored a system in which gold would constitute the core of international liquidity, supplemented if necessary by "deliberate and concerted creation of either reserve assets or credit facilities". British Chancellor of the Exchequer Maudling rose to the defense of the gold exchange standard and suggested that the future course of action should evolve from it:

I prefer to build on what has stood the test of time and experience, and has brought great benefits to the world. I know that some people question this, but I would not myself accept the views of those who think that the imbalance in world payments with which we have been faced has

been aggravated by the workings of the gold exchange standard. I do not believe that the sources of that imbalance lie solely in conditions of inflation in the deficit countries. Nor do I believe that adjustments in domestic economic conditions leading to improved international balance would come about quickly and smoothly if only the role of gold were strengthened, and if the only fresh supply of owned reserves allowed in the principal industrial countries in addition to gold was a strictly limited amount of some new form of reserve asset distributed to that restricted group of countries on some uniform basis without regard to their present payments position.

The fact that present provisions for world liquidity—including the various cooperative arrangements among the central banks and treasuries of major industrial countries—are deemed sufficient to meet foreseeable needs allows time for careful and deliberate study of the various possible alternatives. Meanwhile, abrupt and radical changes in the institutional arrangements or the operating mechanism of the international monetary system are clearly unnecessary.

RECENT ECONOMIC POLICY MEASURES ABROAD

During the second and third quarters of this year, inflationary pressures continued to be the prime concern in a number of industrial countries abroad.³ There were increasing signs that several countries which had initiated anti-inflationary programs earlier were meeting with success in controlling the upward movement of prices. Nevertheless, in many cases it was considered necessary to adopt further restraint measures during the period under review. In some countries, the lessening of inflationary pressures was apparently accompanied by a slackening in what previously had been very rapid advances of industrial activity. National economic and monetary developments and their interrelationships through the exchange markets and balances of payments were the subject of continual international consultation through the established channels of cooperation.

GENERAL ECONOMIC BACKGROUND. The over-all pace of economic activity remained vigorous in Continental Europe during the first half of the year. In the Common

³ For a discussion of foreign economic and financial developments during September 1963-March 1964, see "Recent Economic Policy Measures Abroad", this *Review*, April 1964, pp. 74-78.

Market countries, further economic expansion reflected both a continued high level of consumer demand and a higher rate of industrial investment and construction activity than a year earlier. In January-May, industrial production advanced steadily—at an annual rate of 7 per cent as against 11 per cent in 1963—and labor scarcities became more acute in most member countries. Consumer prices continued to rise, but at a somewhat less rapid pace than in 1963.

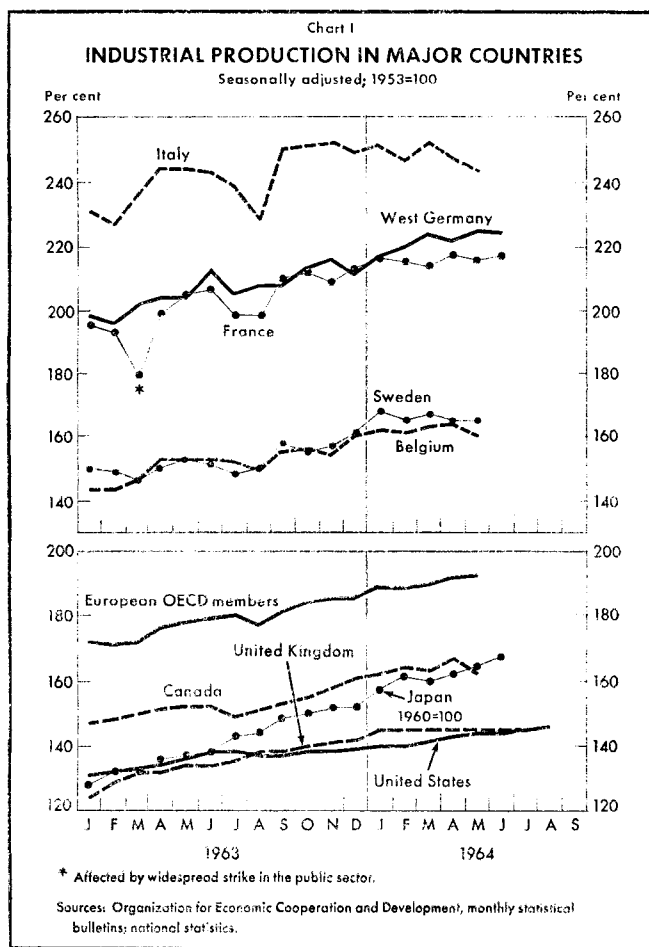
Individual countries within the Common Market experienced somewhat divergent developments. In Belgium and France, the rate of increase in industrial output during January-May was less than during the same period a year earlier, while in Italy industrial production actually decreased on a seasonally adjusted basis (see Chart I). In Germany and the Netherlands, on the other hand, large increases in consumer and investment demand led to further substantial advances in industrial output. France and Italy succeeded in containing the increases in con-

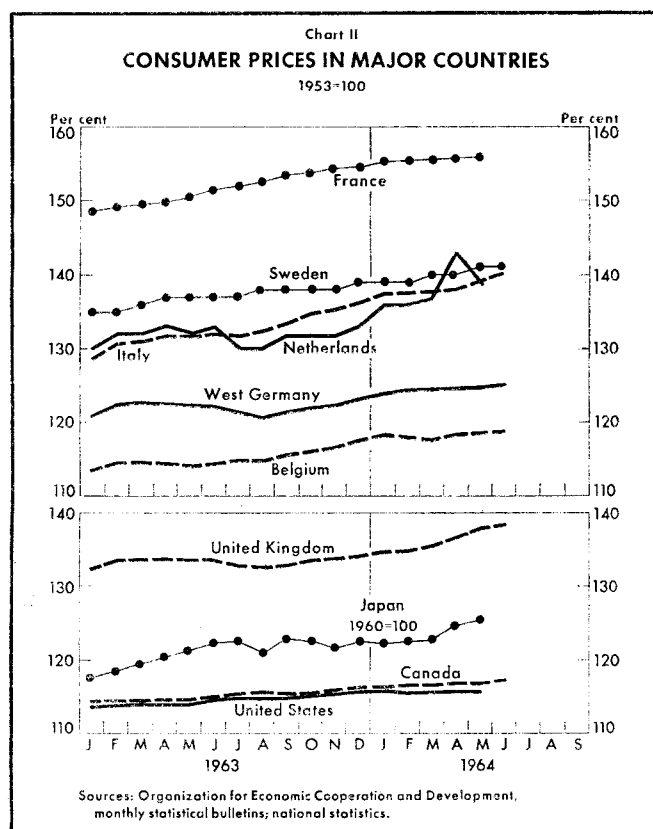
sumer prices during January-May to less than those registered a year earlier. In the Netherlands, on the other hand, large increases in wages and consumer purchasing power resulted in an accelerated increase in consumer prices (see Chart II).

Among the major industrial countries outside the European Continent, economic expansion continued at a vigorous pace. In the United Kingdom, to be sure, the growth rate of gross national product (GNP) fell from the exceptionally high levels reached at the end of last year; nevertheless, it was sufficiently high to draw into the productive stream substantial amounts of remaining unused resources of labor and equipment. Public and private fixed capital formation—especially in housing and private manufacturing investment—made important contributions to the increase in total output. Industrial production, on the other hand, has remained steady since January, reflecting a relatively small rise in consumer expenditures and sluggish exports. The Canadian economy, bolstered by large outlays on plant and equipment and booming exports, is expected to grow this year by about 7 per cent in terms of GNP. Japan's growth continued to exceed that of all other industrial countries, with July industrial production 16 per cent above a year earlier.

As in 1963, rising economic activity this year again led to high levels of imports, which contributed to the weak current-account positions in the balances of payments of some European countries. In contrast to last year, however, the surpluses and deficits of some individual countries tended to narrow. Italy's trade deficit declined noticeably during the first half of the year, a development which contributed to the over-all improvement in the Italian balance of payments. Germany's trade surplus was less in the second quarter than in either of the two preceding quarters and continued to diminish further in July and August. In the United Kingdom, the Netherlands, and Denmark, however, a rise in imports, combined in the case of the United Kingdom with sluggish exports, made for the emergence of current-account deficits in the first quarter.

In recognition of the mutual benefits to be gained from coordinated efforts to achieve economic stability, the Council of Ministers of the European Economic Community (EEC) in April drew up a common anti-inflationary program aimed at the stabilization of prices and costs in the EEC by the end of 1964. The program called for a continuation of restrictive credit policies, but also emphasized the need to complement credit policy with appropriate fiscal measures. Thus, the program envisaged that the rise in public expenditures be limited to 5 per cent per annum and that, if necessary, taxes be raised to balance





budgets. In the event that a budget deficit should prove unavoidable, it was recommended that the deficit be covered by long-term borrowing. During the period under review, the Common Market countries (as well as some others) acted along the general lines of the EEC program.

ITALY, FRANCE, AND THE NETHERLANDS. In both Italy and France, the principal aim of policy was to reinforce previous restraint measures that were beginning to show favorable results. The effects of the Italian anti-inflationary program initiated last year were most apparent in an improved trade balance. In the second quarter, Italian imports were 1 per cent above a year earlier while exports had increased by 18 per cent. The resulting strengthening of Italy's current account, combined with a net inflow on capital account, reversed the previous decline in official reserves and enabled the authorities to repay in August \$65 million of the \$225 million drawn from the International Monetary Fund in March. This repayment liquidated Italy's obligation to the Fund by reducing the IMF's holdings of lire to 75 per cent of the Italian quota. During the first half of this year,

consumer prices increased somewhat less than a year earlier, and bank loans and deposits decreased noticeably. To be sure, economic expansion has also slowed down considerably, with GNP advancing during the first quarter at an annual rate of only 2.4 per cent in real terms.

Against this background, the Italian authorities moved to reduce further Italy's trade deficit and to dampen private consumption and public expenditures, while at the same time promoting industrial investment. In April, payment terms for imports of a number of durable goods were tightened, and measures to encourage exports were taken. These included a cut in the stamp tax on export bills, accelerated reimbursement to exporters of the sales tax, and a reduction in the premiums on export risk insurance. Supplementary measures introduced at the end of August were aimed at permitting increased manufacturing profits, which had been squeezed by the rapid advance in wages. A part of social security costs is henceforth to be financed by general fiscal revenues rather than by direct employer contributions. The general turnover tax is to be increased from 3.3 per cent to 4 per cent on most goods to finance the increased budgetary outlay. In other measures to encourage investment, a 100 billion lire (\$160 million) investment fund is to be established to aid small and medium-sized industries, and legislation is to be introduced to allow the establishment of investment trusts. The August measures also provide for increases in taxes on middle and high incomes, and the Government stated its intention to limit the annual increase in Government expenditures to 5 per cent.

French anti-inflationary measures likewise have shown results. In January-August the French cost of living increased by about 1 per cent as against 3 per cent a year earlier, while the money supply declined by 0.5 per cent during the first five months, compared with a 2.5 per cent increase a year earlier. Although the rate of increase in over-all economic activity this year is expected to match last year's satisfactory results, private industrial investment has fallen off and activity in some key industrial sectors weakened more than seasonally during the summer months. The official over-all growth target for 1965, moreover, has been reduced below the 6 per cent originally envisaged.

The French authorities took a number of steps to constrain further public and private demand and to reinforce credit restraint. Fiscal policy has been an important ingredient in the French stabilization program. This year's budget deficit—planned from the start to be lower than last year's—is now believed likely to end up considerably less than originally estimated, and plans for a balanced budget in 1965 were announced in September.

This goal is to be achieved by limiting the increase in expenditures to 7 per cent. As regards monetary policy, the 10 per cent ceiling on permissible annual increases in bank credit was extended for another twelve months (to September 1965). In a temporary move designed to ease the midyear seasonal tightness in the money market and thus to curb inflows of funds from abroad, the commercial banks' required reserves in the form of cash, Treasury bills, and medium-term paper were reduced in early summer from 36 per cent to 33 per cent—a move that was reversed by September. Within this over-all ratio, the portion to be held in the form of Treasury bills was reduced from 13 per cent to 10 per cent, thereby enabling the banks to use a larger part of their resources to grant medium-term credit. To emphasize the point that there was to be no relaxation in over-all credit restraint, the authorities raised from 6 per cent to 7½ per cent the penalty rate on bank borrowing from the Bank of France exceeding 110 per cent of rediscount quotas. Furthermore, the Bank of France reiterated its warning to the commercial banks that increases in their lending by a rate greater than 10 per cent a year might be penalized by a reduction in their rediscount quotas at the central bank. In an additional move toward tightening, the authorities in June required consumer finance institutions to limit their lending to eight times their own capital, as against nine times previously.

In the Netherlands, the authorities also continued to reinforce previously taken anti-inflationary measures. Buoyant consumer demand and a continuing labor shortage were reflected in substantial price and wage increases during the first five months of 1964 as well as in a deterioration in the Dutch current account during the first quarter. In January-June, imports rose 23 per cent and exports 15 per cent over a year earlier. During the same period, bank credit increased by more than 10 per cent and persistently exceeded the ceilings set by the authorities. Therefore, in accordance with the gentleman's agreement currently in force, the banks were obliged to make noninterest-bearing deposits at the central bank equal to the amounts by which they had exceeded the ceilings. In the face of these developments, the Netherlands Bank on June 4 increased its discount rate by ½ point to 4½ per cent, the second such increase this year (see table); and, to prevent banks from obtaining additional liquidity from abroad, the Netherlands Bank ruled that after July 31 the foreign liabilities of a bank must not exceed its foreign assets by more than 5 million guilders (\$1.4 million), unless prior approval has been obtained from the authorities. To achieve a steady degree of restraint, bank credit ceilings have been adjusted flexibly to changing seasonal

CHANGES IN FOREIGN CENTRAL BANK DISCOUNT RATES, 1964
In per cent

| Country | Date | New rate | Change |
|----------------------|-------------|----------|--------|
| Belgium | July 3 | 4¾ | +½ |
| Denmark | June 11 | 6½ | +1 |
| Japan | March 18 | 6.57 | +0.73 |
| Netherlands | January 6 | 4 | +½ |
| | June 4 | 4½ | +½ |
| Sweden | January 31 | 4½ | +½ |
| South Africa | July 15 | 4 | +½ |
| Switzerland | July 3 | 2½ | +½ |
| United Kingdom | February 27 | 5 | +1 |

demands for credit. During May-August, when the demand for credit is seasonally slack, bank lending was limited to the average amount of credit outstanding in the first half of 1963, while from September to the end of the year an increase of 5 per cent above that level is permitted. In order to reduce consumer purchasing power, taxes on cigarettes and gasoline were raised, and officially controlled rents were increased by 10-12.5 per cent.

ANTI-INFLATIONARY MEASURES IN OTHER COUNTRIES. In Switzerland, a high level of consumer and investment demand, particularly in the building sector, sharply boosted the demand for credit. Under an April agreement between the Swiss National Bank and the commercial banks, the growth of bank advances to domestic borrowers this year is to be equal to only 79 per cent of the absolute increase in 1961 or 1960 (whichever was higher), as against last year's permissible increase of 82 per cent of the base period. The allowable increase in mortgage loans, on the other hand, remained unchanged at 108 per cent of the increase in the base year. Priority is to be given to loans for residential building, agriculture, and imports. Switzerland also created a capital issues commission to program the permissible total of new issues on a quarterly basis. As of May 1, all new stock and bond issues exceeding 5 million francs became subject to authorization by the commission. The buoyant demand for bank credit—combined with previous measures to discourage the inflow of foreign funds, which had been an important source of liquidity—caused a tightening in the money and capital markets during the first half of the year. By midyear, both short- and long-term rates stood about ¾ of a percentage point above a year earlier, and in July the Swiss National Bank raised its discount rate to 2½ per cent from 2 per cent and its lending rate against security collateral to 3½ per cent from 3 per cent. Furthermore, in order to absorb bank liquidity by providing a

domestic short-term investment instrument, the National Bank in August sold a special issue of two-month Treasury securities to the commercial banks. The Swiss authorities also tightened consumer credit by increasing required downpayments to 30 per cent from 20 per cent and shortening the maximum repayment period to 2 years from 2½ years.

In Belgium, Germany, and Denmark the authorities also acted to restrain credit expansion. This year's vigorous business expansion in Belgium was accompanied by a 6 per cent increase in bank credit during January-May and by a continued increase in prices. To counter these developments, the Belgian National Bank in July raised its basic discount rate from 4¼ per cent to 4¾ per cent while tightening the eligibility requirements on the commercial paper it accepts for rediscounting. Also, the authorities used for the first time the powers granted under the 1961 banking reform law to require commercial banks to hold cash reserves with the central bank. Required reserves were initially set at 1 per cent of the banks' total deposit liabilities. In Germany, commercial bank reserve requirements on all types of deposits were increased by 10 per cent as of August 1. (The demand deposit ratio for large city banks, for example, rose from 13 per cent to 14.3 per cent.) At the same time, in order to discourage the banks from meeting any increased liquidity needs by borrowing abroad, the authorities announced that the banks' rediscount ceilings at the German Federal Bank would be reduced by an amount equal to any increase in their borrowings abroad. In an additional move to reduce domestic liquidity, the German Federal Bank on July 13 improved the terms on which it provides forward cover to commercial banks for investment in United States Treasury bills. In Denmark, vigorous economic expansion led to a renewal of upward price movements and a deterioration in the current account during the first quarter; and domestic liquidity—fed to a certain extent by large public and private borrowing abroad

—increased rapidly, while bank credit expanded sharply. Against this background, the National Bank of Denmark on June 11 raised its discount rate from 5½ per cent to 6½ per cent. At about the same time the government banned further long-term foreign borrowing by local authorities and public enterprises. As of October 1, the National Bank imposed a penalty rate of 6 per cent, over and above the 6½ per cent discount rate, on commercial bank discounts from the central bank which are outstanding for more than twenty days in each quarter (thirty days in the fourth quarter) and which exceed on the average 25 per cent of the borrowing bank's combined capital and reserves.

In the United Kingdom, the authorities acted to restrain consumer spending somewhat. The 1964-65 budget, presented by the Chancellor of the Exchequer in April, called for a 10 per cent increase in taxes on tobacco and alcoholic beverages, which is designed to yield an additional £100 million. At the same time, non-negotiable savings instruments were made more attractive. In this way, the authorities sought to curb the expected budgetary deficit and to improve the prospects for its non-inflationary financing.

In Japan, further measures were taken to control the commercial banks' foreign indebtedness and thus buttress the tighter credit policy in force since late 1963. In July, the Bank of Japan placed limits on the amounts of foreign short-term funds Japanese banks are permitted to accept. As of August, the central bank raised to 25 per cent from 20 per cent the ratio of liquid foreign assets that commercial banks must maintain against their short-term foreign liabilities. The previously imposed 35 per cent marginal ratio for foreign liabilities exceeding a prescribed amount remains in effect, but now applies to increases above the level of July 1964 instead of December 1962. Also, in April, June, and September, the authorities altered the suggested maximum rates commercial banks may pay on Euro-currency deposits.

Fiftieth Anniversary of the Federal Reserve System *

NAMING OF RESERVE BANKS AS TREASURY DEPOSITORIES AND FISCAL AGENTS

The authors of the Federal Reserve Act were aware that the methods employed in managing the Treasury's finances had serious defects. Many of the Government's fiscal affairs were handled by the Independent Treasury System, which had been established in 1846 to provide places other than private banks for the safekeeping of Government funds. The defects of that system had been described in a study published by the National Monetary Commission.

Most of the Treasury's revenues from customs and taxes were collected in currency and coin, and it was Treasury practice during most of the pre-World War I period to hold this money in the subtreasury offices located around the country until it was needed for disbursements. Hence, when Treasury receipts exceeded disbursements and the surplus was held in the subtreasury vaults, money in circulation declined. Since currency and coin were also an important component of bank reserves, its withdrawal from the banks contracted the reserve base, and there was no central banking mechanism through which this effect could have been offset at times when reserve withdrawals were inappropriate in the light of current economic developments.

Successive Secretaries of the Treasury had attempted on occasion to relieve undesirable contractions of the bank reserve base by transferring funds from the subtreasury to the national banks, which had been used as depositories since the passage of the National Banking Act. These attempts were only partially successful. The establishment of the Federal Reserve System itself was, of course, a major step in combating this and other inflexibilities in the country's money and banking structure.

An early version of the Federal Reserve bill required that all general funds of the Treasury be deposited in the Federal Reserve Banks within twelve months after passage of the act. This provision was successfully opposed by

Secretary of the Treasury McAdoo as being too rigid. Thus, the final version of the bill left the amount and timing of the transfer of funds up to the discretion of the Secretary of the Treasury, thereby permitting him to continue using the subtreasuries and national banks as depositories. This earlier draft of the bill also appointed the Federal Reserve Banks as fiscal agents, whereas the final act authorized the Secretary of the Treasury to require the Banks to act as fiscal agents at his discretion. In actual fact, the Secretary of the Treasury began using the new Reserve Banks as depositories in 1915 and as fiscal agents in January 1916.

At first, the fiscal services performed by the Reserve Banks were limited to receiving deposits of Government collectors of customs and internal revenue and to paying checks and warrants drawn upon the United States Treasury. However, after the United States entered World War I, Secretary McAdoo turned to the Reserve Banks for other services. In particular, the Banks were authorized to sell, issue, exchange, and convert Liberty bonds, and they became the focal points for local Liberty Loan committees, which made a vital contribution to the financing of the war.

Another useful service performed by the Federal Reserve Banks was the transfer of money around the country by wire and bookkeeping entries. This procedure—made possible through the deposit of gold and gold certificates by each Reserve Bank in the gold settlement fund in Washington—eliminated the necessity for expensive shipments of coin and currency between subtreasuries.

It soon became evident that the Reserve System could perform many of the fiscal agency functions at least as efficiently as subtreasuries, and that having both was an unnecessary expense. In May 1920, therefore, Congress passed a bill directing the discontinuance of the nine subtreasuries on or before July 1, 1921. The Secretary of the Treasury proceeded to carry out this task by transferring many of the remaining fiscal agency functions from the subtreasuries to the Reserve Banks. The last subtreasury, located in Cincinnati, was closed on February 10, 1921.

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