

FEDERAL RESERVE BANK OF NEW YORK



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The Business Situation

Economic activity was continuing a rise of almost four years' duration as 1964 drew to a close, and most forecasts pointed to further gains in 1965. Production, employment, and personal income all recovered in November from the depressing effects of widespread strikes in the automobile industry in the preceding months, and output in both the auto and steel industries continued to climb in December. Unusually heavy Christmas shopping resulted in an appreciably greater than seasonal rise in retail sales in December, and businessmen's outlays for new plant and equipment apparently were also increasing. On the other hand, residential construction still showed some weakness. Price developments continued to be a cause for some concern. Both consumer and industrial wholesale prices rose slightly in November, and some additional rise in the industrial component of the wholesale price index apparently occurred in December. Moreover, a number of further price rises announced by the steel industry in late December undoubtedly added to the recently emerging climate in which businessmen seem to be less reluctant to probe markets to determine whether price increases can be made to stick.

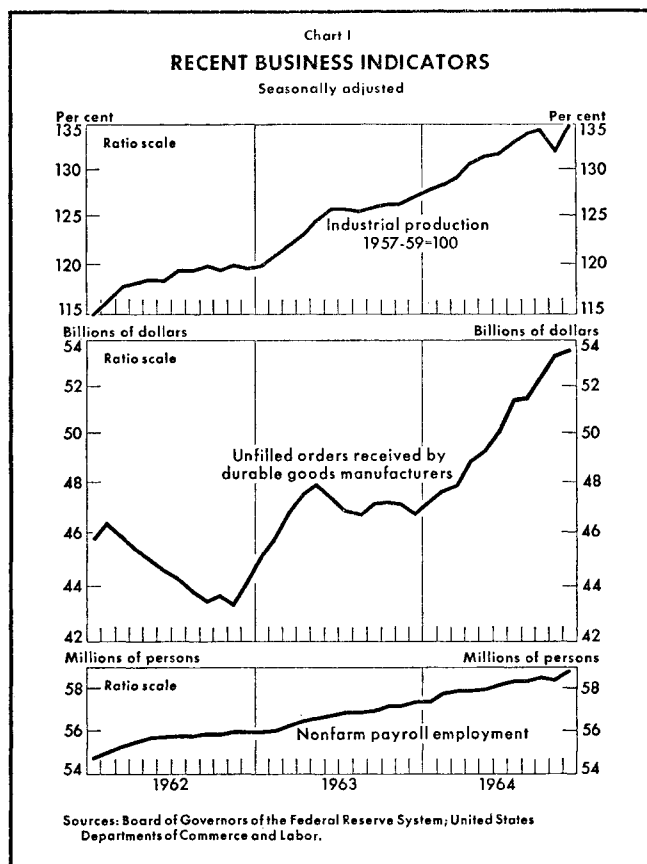
Assessment of the economic outlook for the new year is, of course, beset with the usual collection of complicating uncertainties, not the least of which is the possibility of disruptions as a result of labor disputes. The strike of East and Gulf Coast dock workers will have serious effects unless it proves to be of short duration. There are also the lingering possibilities of a nationwide railroad tie-up during the winter as well as of a strike in the steel industry on or after May 1. Another determinant of the course of over-all activity in the months ahead is likely to be business spending. A Commerce Department survey taken in November, which may not fully reflect the possible hedge buying of steel, indicated that manufacturers already anticipated a substantial increase in their inventory holdings in the final quarter of 1964 and a somewhat more moderate expan-

sion in the first quarter of 1965. Capital spending plans for 1965, on the other hand, appear to have strengthened since the initial surveys early last fall.

Economic developments in the months ahead will, of course, also be influenced heavily by the Administration's budgetary decisions that are about to be revealed. Most business analysts seem to believe that these decisions will result in some net expansionary impact on the economy and thus will help extend further the current over-all advance.

RECENT INDICATORS

After a strike-induced dip in October, industrial production rose strongly in November: the Federal Reserve Board's seasonally adjusted index advanced by more than 3 full percentage points to 134.9 per cent of the 1957-59 average (see Chart I). The bulk of this advance was attributable to the return of most automobile workers to their assembly lines, though final settlement of issues at a number of local Ford Motor Company plants was not reached until late in November. In addition, most other industries—including primary metals, furniture and fixtures, and machinery—registered moderate increases in output in the month. In December, most of the automotive industry mustered everything at its command in an effort to work down the backlog in consumer orders and to restock dealers' showrooms. December data indicate that assemblies rose about 6 per cent above the pre-strike level and 12 per cent over December 1963. The stepped-up pace of activity in the automobile industry also influenced steel ingot production, which continued to rise in December. Steel ingot output for the year as a whole is now estimated at 127 million tons, 9 per cent more than the previous record reached in 1955 and 16 per cent above 1963. Strength in over-all production during the months ahead is suggested by the high level of unfilled orders on



the books of durables manufacturers. Such backlogs rose for the eleventh consecutive month in November, to a level 13 per cent higher than a year ago.

Reflecting the turnabout in production, nonfarm payroll employment also turned sharply upward in November, following a decline the month before (see Chart I). Employment gains were scored by all major industry groups, though the return to work in the automobile industry accounted for two thirds of the over-all rise. Total employment expanded further in December, according to the Census Bureau's household survey, and the rise was somewhat greater than the expansion in the civilian labor force. As a result, the over-all unemployment rate (seasonally adjusted) fell to 4.9 per cent, a substantial improvement over the 5.5 per cent figure for the final month of 1963. For one of the most important groups in the labor force, the improvement has been relatively even more substantial: the jobless rate for married men stood at only 2.7 per cent in December, as against 3.3 per cent a year ago.

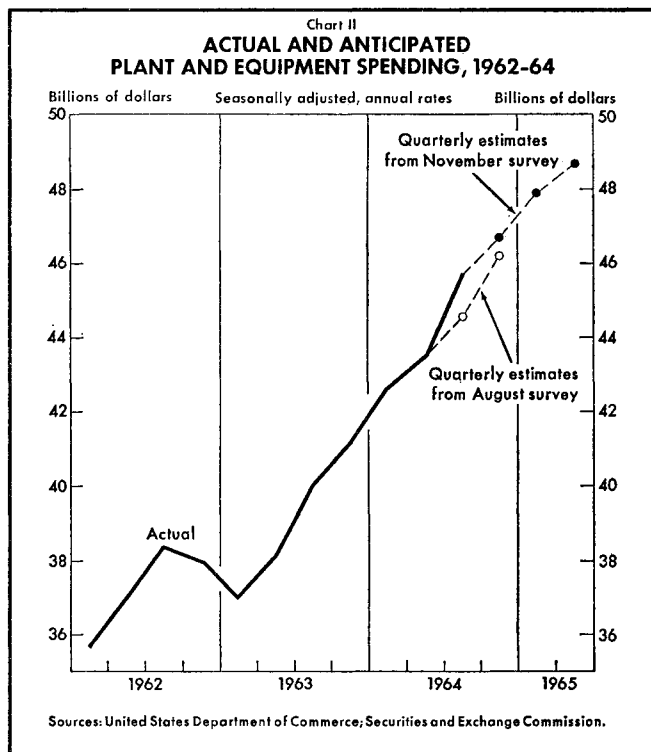
Retail sales declined in November, the third successive month of slippage, as unusually warm weather apparently

sharply curtailed sales of winter apparel. Personal income, however, recorded a considerable advance in November, with the result that Christmas shoppers were in good financial shape to carry out the buoyant buying plans that had shown up in recent surveys. Glowing trade reports suggest that heavy consumer spending did in fact occur. Indeed, according to the advance report, retail sales in December rose to a record \$22.8 billion (seasonally adjusted), 5 per cent higher than in November and 9 per cent above December 1963. The substantial gain reflected largely a marked pickup in durable goods sales. These, in turn, were sparked by a very considerable advance in automobile sales as new-model cars were in better supply.

Outlays for nonfarm residential construction in December were off by less than 1 per cent. Such outlays edged downward in the closing months of 1964 but for the year as a whole amounted to \$26.6 billion, compared with \$25.8 billion in 1963. Building permits issued rose by 3 per cent in November and the dollar value of residential construction awards was up by 12 per cent, although nonfarm housing starts declined after moving up in the preceding two months. A recent forecast by the Commerce Department places nonfarm housing outlays in 1965 slightly above the 1964 figure.

BUSINESS SPENDING PLANS

As the new year began, most business analysts were increasingly focusing attention on the probable course of business spending in 1965. One area of immediate interest is investment in inventories, especially in view of indications that steel users have already begun to stockpile finished products in anticipation of a possible strike. A Commerce Department survey taken in November—which may not fully reflect the possible hedge buying of steel—indicated that manufacturers already anticipated a substantial \$1.2 billion increase in their inventory holdings in the final quarter of 1964 and a somewhat more moderate expansion of \$0.6 billion in the first quarter of 1965. At the same time, manufacturers expected their sales in the final quarter of 1964 to remain unchanged from the quarter before, but did anticipate a considerable rise in sales in the first quarter of 1965. In October and November inventories held by manufacturers recorded the two largest monthly advances in the current upswing, which suggests that manufacturers would actually carry out fourth-quarter inventory building plans. If inventory and sales expectations for the first quarter of 1965 are realized, the inventory-sales ratio for manufacturers at the end of the first quarter will be no higher than the reading for the third quarter of 1964, a figure that was relatively low by historical standards.



for a 4.2 per cent advance in 1964, compared with the 13.9 per cent increase over 1963 now expected for 1964.

There are now other indications that capital spending will show strength through the first half of the new year. According to a Commerce Department-Securities and Exchange Commission survey taken in November—i.e., somewhat later than the McGraw-Hill survey—businessmen's spending plans for the first quarter of 1965 were \$1.2 billion above the expected figure for the final quarter of 1964. At the same time, businessmen expected their spending for plant and equipment to expand by an additional \$0.8 billion in the second quarter of 1965. The indicated advance in the first half of the year was projected to come largely from the manufacturing sector. If the expected average gain in the first and second quarters were to be extended over the rest of the year, the estimated year-to-year gain for 1965 would be approximately 10 per cent.

The National Industrial Conference Board has recently reported that, according to its survey, capital appropriations by manufacturers were up strongly in the third quarter. Such appropriations tend to lead capital spending by two to three quarters. Thus, manufacturers' plans for enlarged capital spending through the first half of 1965 may well be firm.

As in previous years, business capital spending in 1965 will be an important determinant of the course of business activity. Such outlays, of course, tend to increase productivity and to accelerate real economic growth, in addition to their immediate influence on aggregate economic activity. The first clue with regard to the course of plant and equipment spending in 1965 was provided by the fall 1964 McGraw-Hill survey of businessmen's capital spending plans, which pointed to about a 5 per cent over-the-year gain for 1965. When this projected 1965 level of plant and equipment spending is compared with the \$46.7 billion annual rate of spending now expected in the final quarter of 1964 (see Chart II), the advance amounts to only 0.3 per cent. However, the fall McGraw-Hill survey has in past years of uninterrupted business expansion tended to understate the mark on average by about 7 percentage points. For example, the 1963 fall McGraw-Hill survey had called

PERSPECTIVE ON 1964

Early each year the Federal Reserve Bank of New York publishes *Perspective*, a nine-page review of the course of the economy during the preceding year. Many businessmen find the booklet useful as a layman's summary of the economic highlights treated more fully in the Bank's *Annual Report*, available in mid-March. If you would like to receive without charge *Perspective on 1964*—it is available now—write to Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y., 10045.

The Money and Bond Markets in December

In early December, the money and Government securities markets continued making an orderly adjustment to the increases in late November of official discount rates abroad and at home. The markets soon steadied, however, and the atmosphere improved, particularly following substantial System purchases of Treasury bills and other Government securities. The timing and extent of these purchases were regarded in the market as indicative of an official intention to maintain credit availability and avoid a buildup of seasonal pressures. Thereafter, aided by advance preparation on the part of money market banks and timely System action, the money market handled without undue stress the heavy financial flows and enlarged credit demands stemming from midmonth corporate dividend and tax payments and from preparations for the year-end statement date. Federal funds were generally available in good volume at 4 per cent or below. Rates on Treasury bills edged higher over the midmonth period, but largely declined over the rest of the month as corporate and bank demand revived.

In the market for Treasury coupon securities, the improvement in sentiment early in December brought prices of most issues to near their highest levels of the year by December 11. Subsequently, prices of longer term issues drifted irregularly lower on talk of a possible long-term Treasury financing and also on continuing uncertainty about the pound sterling. The announcement by the Treasury on December 30 of an advance refunding operation (see below) was followed by an improvement in market atmosphere on the final day of the year, when market participants took the Treasury's decision as indicating official confidence in the market outlook and in the outlook for sterling. In fact, toward the end of the year there was growing awareness in financial markets here and abroad that the steps taken by the British authorities during the two preceding months added up to a much stronger program in defense of sterling than had been generally recognized. Corporate bond prices in December generally recovered the losses experienced in late November, while prices of tax-exempt issues rose to new highs for the year in the wake of the Federal Reserve's increase in Regulation Q ceilings.

THE MONEY MARKET AND BANK RESERVES

A relatively comfortable tone prevailed in the money market through mid-December and, although a somewhat firmer tone was evident thereafter, Federal funds were available at 4 per cent most of the time, and frequently traded at lower rates. Rates posted by the major New York City banks on call loans to Government securities dealers were largely in a 3 to 4¼ per cent range during the first third of the month; they moved up to a 4½ to 4¾ per cent range around the dividend and tax period and remained in that range until the end of the month when rates as high as 4½ per cent were posted. With net reserve availability averaging somewhat higher than in recent months, member bank borrowing from the Reserve Banks averaged considerably lower, although it did expand in the last statement week of the year. Offering rates for new time certificates of deposit issued by the leading New York City banks declined somewhat during the early part of the month but rose in the latter part of the period. The range of rates at which such certificates traded in the secondary market was little changed early in the period but edged slightly higher later in the month. Rates on bankers' acceptances remained at the higher levels reached in late November, stimulating strong investment demand that temporarily depleted inventories before a supply of acceptances came into the market prior to the year-end statement date. On December 21, commercial paper dealers increased their rates on prime four- to six-month paper by ⅛ of a per cent to 4¼ per cent (offered).

The December corporate tax date and the most popular dividend payment date fell within a single statement week this year for the first time since 1959, but the banks and the money market handled with facility the large deposit and loan expansion and the shifts in the ownership of money and securities that were required. A few figures illustrate the magnitude of the task. Over the week ended December 16, demand deposits (adjusted to exclude cash items in process of collection and certain other items) at weekly reporting member banks rose \$3.2 billion while their negotiable time certificates of deposit declined \$408 million. Commer-

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

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

Factor	Daily averages—week ended					Net changes
	Dec. 2	Dec. 9	Dec. 16	Dec. 23	Dec. 30	
"Market" factors						
Member bank required reserves*	- 186	+ 135	- 145	- 440	- 4	- 640
Operating transactions (subtotal)	- 540	- 652	+ 222	+ 741	- 110	- 339
Federal Reserve float	- 276	+ 90	+ 134	+ 823	- 23	+ 748
Treasury operations†	- 347	- 118	- 171	+ 33	- 31	- 634
Gold and foreign account	- 119	+ 38	+ 45	- 3	- 76	- 115
Currency outside banks*	- 144	- 328	+ 81	- 153	- 49	- 593
Other Federal Reserve accounts (net)‡	+ 346	- 335	+ 135	+ 42	+ 67	+ 255
Total "market" factors..	- 726	- 517	+ 77	+ 301	- 114	- 979
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities ...	+ 800	+ 668	- 315	- 360	- 90	+ 703
Bankers' acceptances ...	+ 1	+ 4	+ 2	+ 2	+ 1	+ 10
Repurchase agreements:						
Government securities ...	- 125	-	+ 315	- 49	+ 100	+ 241
Bankers' acceptances ...	- 34	+ 2	- 23	-	+ 2	- 53
Member bank borrowings ...	+ 216	- 253	+ 12	+ 123	+ 247	+ 345
Other loans, discounts, and advances	- 1	-	+ 26	+ 6	- 3	+ 28
Total	+ 857	+ 421	+ 18	- 280	+ 257	+ 1,273
Excess reserves*	+ 131	- 96	+ 95	+ 21	+ 143	+ 294
Daily average levels of member bank:						
Total reserves, including vault cash*	21,376	21,145	21,385	21,846	21,993	21,549§
Required reserves*	20,987	20,852	20,997	21,437	21,441	21,143§
Excess reserves*	389	293	388	409	552	406§
Borrowings	375	122	134	257	504	278§
Free reserves*	14	171	254	152	48	128§
Nonborrowed reserves*	21,001	21,023	21,251	21,589	21,489	21,271§

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

* These figures are estimated.

† Includes changes in Treasury currency and cash.

‡ Includes assets denominated in foreign currencies.

§ Average for five weeks ended Decemr 30, 1964.

cial and industrial loans by these banks rose \$754 million. Loans to sales finance companies increased \$677 million, and loans to brokers and dealers for purchasing or carrying securities rose by \$744 million. Early in the statement week the major money market banks—in New York City and elsewhere—benefited temporarily from the inflow of corporate money for dividend payments that exceeded \$1.1 billion on December 10, but the heavy loan demands and certificates-of-deposit losses of December 15 brought a sharp buildup in reserve pressures. System purchases of Government securities under repurchase agreements at rates of 3.85 per cent and 3⅞ per cent were used to increase reserve availability at the point of maximum need and to reduce the pressures reflected in the higher lending rates against Gov-

ernment securities that were being posted by major money market banks.

Pressure on the reserve positions of the money market banks persisted throughout the remainder of the month, contributing to a somewhat firmer tone in the Federal funds market. With the System continuing to inject reserves in substantial volume through repurchase agreements against Government securities at 3⅞ per cent, however, serious strains were avoided. Member bank borrowings rose in the final statement week of the month, largely reflecting precautionary borrowing over the long Christmas holiday week end.

Over the five-week December period as a whole, nationwide reserve availability averaged \$128 million, compared with \$3 million (revised) in the four weeks ended November 25. System open market operations provided \$901 million in reserves, on balance, over the period as the weekly average of System outright holdings of Government securities rose by \$703 million from the final week of November to the last week of December, and average System holdings of Government securities under repurchase agreements increased by \$241 million. Average net System holdings of bankers' acceptances, both outright and under repurchase agreements, declined by \$43 million during the period. From Wednesday, November 25, through Wednesday, December 30, System holdings of Government securities maturing in less than one year rose by \$382 million, while holdings of issues maturing in more than one year increased by \$101 million.

THE GOVERNMENT SECURITIES MARKET

As the month opened, the Government securities market remained cautious after making an orderly adjustment to the increases in the British bank rate and the Federal Reserve discount rate announced on November 23. Opinion soon swung to the view that the discount rate increases themselves were not to be followed by a significant rise in long-term interest rates above the levels prevailing before the increases. This feeling gained adherents in the early days of the month, when substantial System purchases of Government securities suggested to market observers that reserve and credit availability would be maintained at about its level prior to the discount rate increase. At the same time, market participants were encouraged when several banks rescinded previously announced increases in their prime rates. Following these developments, prices of Government securities as well as corporate and tax-exempt bonds rose.

Reflecting the shift in sentiment, a good investment and professional demand developed for Treasury notes and bonds—particularly for the 2½ per cent wartime issues

which offered an advantageous after-tax yield. This buying readily absorbed limited commercial bank offerings of intermediate-term issues, and by December 11 prices of most Treasury issues maturing after 1965 had recouped the losses suffered immediately following the discount rate increases in late November. Some coupon issues were, in fact, trading near their best levels of the year. As the rally progressed, activity receded and became more professional in character.

Just before midmonth, doubts began to appear regarding the sustainability of the higher price levels. The approach of the new year led to talk of a possible Treasury offering of longer term issues in January—perhaps through an advance refunding. Contributing to the caution was continued concern over the absence of any strong revival of confidence in the pound sterling following the announcement of major stabilization measures in Britain. Indeed, some market participants began to feel that, because of international uncertainties, the Treasury might not attempt an advance refunding in January, although other participants continued to expect an operation of this type. In this atmosphere, prices of longer term issues worked irregularly lower from December 14 onward. Activity was generally light although a fair volume of tax-swapping was undertaken by commercial banks. In the shorter term sector of the coupon market, however, a steadier tone was maintained during this period, owing to the persistence of fairly good investment demand and the possibility that some of the shorter issues might assume “rights” value should an advance refunding materialize.

After the close of business on December 30, the Treasury announced the terms of a major advance refunding operation. Holders of approximately \$33.1 billion of eight outstanding coupon issues were given the opportunity to exchange them for three issues of longer maturity. The securities eligible for exchange include the 2½ per cent bonds of February 15, 1965, the 3½ and 4 per cent notes of November 15, 1965, the 3½ and 3¾ per cent notes of February 15, 1966, the 3¾ per cent bonds of May 15, 1966, the 3¾ per cent notes of August 15, 1967, and the 3½ per cent bonds of November 15, 1967. The securities offered in the exchange are a new 4 per cent bond of February 15, 1970, a new 4½ per cent bond of February 15, 1974, and the reopened 4¼ per cent bond of August 15, 1987-92. Subscription books for the exchange were to be open from January 4 through January 8 with payment and delivery due on January 19, 1965. The Treasury also indicated that it would shortly offer \$1.5 billion to \$2.0 billion of June tax anticipation bills. (On January 6, it announced that the auction would take place on January 12 and be for \$1¾ billion of tax anticipation bills to be issued on January 18

and to mature on June 22, 1965. Commercial banks are to be permitted to make 50 per cent of their payments for the tax bills through credit to Treasury Tax and Loan Accounts.)

The Treasury's refunding announcement caused participants to make an immediate reappraisal of market outlook. In an abbreviated trading day on December 31, the view appeared to be developing that the sterling situation must be less threatening than had been feared, since the Treasury had gone ahead with its financing plans. Prices of the “rights” issues rose as much as ½, while the largest decline in the longer maturities was the ½ drop of the reopened 4¼ per cent bonds of 1987-92. Early indications were that the offer would result in a significant amount of debt extension.

The tone of the Treasury bill market also improved early in the month. Sizable System Account purchases in late November and early December absorbed a portion of the bill inventories accumulated on dealers' shelves, strengthening the technical position of the bill market and contributing to a more comfortable money market climate. In the face of a sharp improvement in market atmosphere and developing scarcities of bills—especially in the shorter maturities—bill rates declined by about 10 basis points in the early part of the month. Over the midmonth period yields edged higher in response to moderate offerings, particularly of short-dated bills, as investors raised funds to meet corporate dividend and tax obligations and dealers sold bills returning from repurchase agreements with corporations. The availability of System repurchase agreements at rates below the discount rate helped counterbalance the upward pressure on bill yields of bank call loan rates to dealers ranging from 4½ to 4¾ per cent.

Following the tax date a good investment demand developed from commercial banks building up their bill positions before the year-end statement date, and bill rates generally declined over the remainder of the month. A favorable interest developed at the December 23 auction of \$1 billion of new one-year bills, which will mature on December 31, 1965. An average issuing rate of 3.972 per cent was set, compared with a rate of 4.068 per cent on the one-year issue sold a month earlier, immediately following the Federal Reserve discount rate increase. At the last regular weekly auction of the month, held on December 28, average issuing rates were 3.867 per cent for the new three-month issue and 3.957 per cent for the new six-month bill—virtually unchanged and 7 basis points lower, respectively, than the average rates in the November 30 auction. The newest outstanding three- and six-month bills closed the month at 3.82 per cent and 3.92 per cent (bid), respectively.

OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices generally rose in fairly active trading through mid-month. Both sectors were buoyed by the favorable receptions accorded many of the new issues offered for sale during the period, as well as by market discussion that some investors might be shifting funds from equities into bonds. After midmonth an easier undertone developed in the corporate sector as a result of the talk of a Treasury refunding and international financial problems affecting the market for Government securities. Tax-exempt bond prices continued to rise, however, and closed the month at their highest levels for the year, in part because market observers interpreted the rise in Regulation Q interest rate ceilings as insuring continued large-scale commercial bank demand. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds declined by 1 basis point to 4.43 per cent, while the average yield on similarly rated tax-exempt bonds fell by 10 basis points to 2.99 per cent. (These indexes are based on only a limited number of issues.)

New tax-exempt bond flotations in December amounted to approximately \$975 million, which brought the 1964 total to \$9.5 billion exceeding the substantial 1963 total of \$9.3 billion. The Blue List of such securities advertised for sale closed the month at \$693 million, compared with \$576 million on November 30. The largest tax-exempt bond issue marketed during the month was a \$150 million Aa-rated state flotation consisting of \$100 million of construction bonds and \$50 million of school building aid bonds. Re-offered to yield from 2.20 per cent in 1966 to 3.33 per cent in 1991, the flotation was accorded a fair investor reception.

The volume of corporate bonds privately placed in 1964 amounted to \$6.3 billion (estimated), a slight rise from the \$6.2 billion in 1963. On the other hand, the volume of

new corporate bonds publicly floated totaled only \$3.6 billion in 1964, against a 1963 figure of \$4.7 billion. The year-to-year decline in the over-all total probably reflects, at least in part, the large volume of funds internally generated by corporations as corporate profits rose to record levels in 1964. In December, public corporate bond flotations totaled approximately \$305 million. The largest single issue was a \$65 million issue of 4½ per cent first and refunding mortgage bonds maturing in 1996. The bonds, which were Aa-rated by Moody's and may not be refunded for five years, were reoffered at par. They initially encountered some investor resistance, but subsequently attracted considerable interest and were quickly sold. Most other new corporate and tax-exempt bonds marketed in December were well received.

**REPORTS ON
TREASURY AND FEDERAL RESERVE
FOREIGN EXCHANGE OPERATIONS**

A consolidated reprint is now available of five reports on Treasury and Federal Reserve foreign exchange operations written by Charles A. Coombs, Vice President of this Bank and Special Manager, System Open Market Account. These articles have appeared at half-yearly intervals since October 1962 in the *Federal Reserve Bulletin* and this *Monthly Review*.

Copies are available from the Publications Section, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y., 10045, at 50 cents each. Educational institutions may obtain quantities for classroom use at 25 cents per copy.

Recent Innovations in European Capital Markets*

In his foreword to a study of European capital markets prepared by the United States Treasury in late 1963, Secretary of the Treasury Dillon noted that many of the factors that have tended to limit the growth of these markets "are now receiving the attention of financial leaders in Europe", and that "progress toward improving the efficiency of these markets has begun". In particular, the Secretary noted that:

Several possible means of promoting international security issues, thereby broadening the potential market and bringing together larger aggregations of underwriting support and distribution facilities, are being actively explored. . . . New initiatives are being taken to eliminate barriers to foreign security offerings and to facilitate the use of the most developed markets within Europe as a kind of financial entrepôt for the use of borrowers and lenders of other nations.¹

The current renewal of European interest in long-term lending, the increasing interdependence of European financial centers, and the movements of capital between those centers can be traced back to the return to convertibility of the major European currencies at the end of 1958. They were given added impetus by the progress in relaxing restrictions on capital transactions made by most European countries during the last few years. But the marked increase in the volume and types of foreign issues in European capital markets during the past year and a half—the subject of this article—was sparked by two more

specific developments: in July 1963, President Kennedy proposed to Congress the imposition of an "interest equalization tax" on purchases of foreign securities by United States residents;² and at about this same time the British authorities were preparing the way for greater international use of the London capital market. These two developments had the effect of diverting new securities issues of industrial countries from the New York market, which had been heavily utilized by such borrowers. Concurrently, the international financial scene began to display some novel and noteworthy features, to be discussed here: the re-emergence of London as an important center for the underwriting of foreign issues; the growth of dollar issues placed outside the United States; the increase in foreign issues in Continental markets, especially Germany; the flotation of loans denominated in the so-called "unit of account"; the proposed flotation of different tranches of an issue in several centers; and increased international cooperation among financial institutions.

FOREIGN ISSUES IN THE LONDON MARKET

Participation by residents of the United Kingdom in foreign securities issues denominated in currencies other

* John Hein had primary responsibility for the preparation of this article.

¹ "A Description and Analysis of Certain European Capital Markets", Paper No. 3 of *Economic Policies and Practices, Materials Prepared for the Joint Economic Committee, Congress of the United States, 1964*, p. xi.

² The tax—which was enacted in September 1964, retroactive to July 1963—applies to foreign stocks and bonds, both new and outstanding, purchased from nonresidents. It specifically exempts, however, securities of international organizations of which the United States is a member, governments of less developed countries, and corporations whose principal activities are in such countries. New Canadian issues are also exempt by special Executive Order. The tax is 15 per cent on stock and other equity interests. On debt obligations (of three years or more) it ranges from 2.75 to 15 per cent, according to the remaining maturity, and is so calculated as to increase by about 1 percentage point the interest cost to foreigners of obtaining capital in this market. The legislation does not extend to bank loans made to foreigners in the ordinary course of banking operations, but grants stand-by authority to the President to apply the tax to such loans of over one year, if he should find that they "are being used to circumvent the purpose of the legislation".

than sterling remains severely limited by present British exchange controls. But this has not prevented the City of London from expanding the scale of its brokerage and underwriting activities, frequently in close cooperation with European banking houses. Its highly efficient machinery has enabled it to bring together borrowers and lenders in the underwriting of foreign issues.

As far back as October 1962 the London financial community, with the encouragement of the Bank of England, began to consider ways and means of acting as middleman between foreign borrowers and lenders. The objective was greater use of the City's capital market facilities without triggering substantial additional capital outflows from the United Kingdom to nonsterling countries. Loans of foreign-owned funds to foreign borrowers arranged in the London market have no adverse effect on the British balance of payments; in fact, they provide invisible earnings from the City's banking services, and quite possibly additional exports. Thus in early October 1962 the Governor of the Bank of England declared:

The time has now come when the City once again might well provide an international capital market where the foreigner cannot only borrow long-term capital but where, equally important, he will once again wish to place his long-term investment capital. This entrepôt business in capital, if I may so describe it, would not only serve this country well but would fill a vital and vacant role in Europe in mobilizing foreign capital for world economic development. It would be to the advantage of British industry in financing our customers.³

Specific moves in this direction were announced in the April 1963 budget, which included provisions for lowering the stamp tax on stock transfers and for the issuing of bearer, as well as registered, securities. The tax on bearer securities, previously set at 6 per cent of the nominal value, was reduced to 3 per cent of market value on securities issued by residents and to 2 per cent on those issued by nonresidents. For registered securities, the rate was reduced from 2 per cent to 1 per cent (calculated at market value). Bearer issues had generally been prohibited since World War II, for exchange-control reasons.

These changes, which became effective in August 1963, and the general encouragement of foreign issues by the British authorities have resulted in a considerable expansion

in the use of the London capital market by Continental European countries and Japan. Most of this activity has taken the form of dollar operations in which British financial institutions have acted as underwriters, gathering dollar funds owned by non-United States residents and putting them to work in longer term loans. (Previously, such funds might of course have been attracted into foreign issues floated in New York.) In a few cases, other nonsterling currencies have been used as well, and some issues have been denominated in sterling. (Countries belonging to EFTA—the European Free Trade Association, of which the United Kingdom is a member—have been given the right to raise loans in London in either sterling or foreign currencies.)

These foreign issues began in May 1963 with a private placing by the Belgian Government of \$20 million in three-year bonds, the first loan not denominated in sterling placed in London since World War II; a second similar Belgian placement followed in December 1963. Meanwhile, another important issue occurred in July 1963, when a London merchant bank agreed to float—jointly with three banks in Belgium, Germany, and the Netherlands—a \$15 million issue of a private Italian company engaged in operating and maintaining Italy's new national highway system. This issue attracted considerable attention as the first postwar nongovernmental (although government-guaranteed) issue in a foreign currency to be floated in London. The first postwar offering of sterling bearer bonds by a nonsterling-area country followed in August 1963 in the form of a £5 million refunding issue by the Government of Japan.

On the occasion of the Lord Mayor's dinner in October 1963—one year after the Governor of the Bank of England had called for the re-establishment of the City of London as a financial entrepôt—the Chancellor of the Exchequer praised the London market for its contribution to invisible earnings in Britain's balance of payments and declared that "for the future, foreign currency loans, i.e., those which are no drain on the reserves, are being allowed almost without restriction". The Chancellor thus indicated that the authorities were satisfied with the initial response of the City, but also that they were not yet ready to permit a further relaxation of controls over the outflow of British funds to the nonsterling world. This also meant that the proceeds of sterling loans raised by nonsterling-area borrowers were to be spent on purchases of goods and services in the United Kingdom, but such loans have in fact been negligible.

Since late 1963, British underwriters have arranged in the London market a fairly continuous series of nonsterling issues, all but one of which have been denomi-

³ Speech delivered at dinner given by the Lord Mayor to the Bankers and Merchants of the City of London, October 3, 1962.

Table I
UNITED STATES DOLLAR ISSUES IN EUROPE
 July 1963-December 1964

Borrower or country of borrower	Amount (millions of dollars)	Number of issues	Comment
Japan	132.0	10	\$22.5 million by city of Tokyo; remainder by private industry
Denmark	107.0	8	All by public sector or nationalized industries
Norway	92.0	7	All by public sector or nationalized industries
Italy	50.0	3	\$25 million by state holding company; \$15 million by national highway system; \$10 million five-year issue by official long-term lending institution
European Coal and Steel Community	30.0	1	
Austria	28.0	2	\$18 million by government; \$10 million by nationalized steel company
Finland	26.0	3	All by private industry
European Investment Bank	25.0	1	
Belgium	20.0	1	Privately placed three-year government issue
Portugal	20.0	1	National government
Council of Europe	10.0	2	European Resettlement Fund
Israel	5.0	1	Private development corporation
Total	545.0	40	

nated in dollars.⁴ In this connection it is worth recalling that London has an underwriting mechanism developed over a period of about 150 years and can provide quotation on Europe's largest stock exchange. Furthermore, various recent British steps, such as the resumption of bearer securities, should go a long way toward inducing international investors to make use of London's financial facilities. Finally, the London market has shown its ability to attract funds from a number of financial centers for investment in securities issued by borrowers with excellent international credit standing.

In the past year or so, British financial institutions have also participated in the sizable amount of dollar

issues outside the United States that were arranged and underwritten by consortia headed by banks on the European Continent or by United States underwriters. Several of these issues have subsequently obtained quotation on the London Stock Exchange, and some have also been listed on the New York Stock Exchange, which permits the listing of certain foreign issues even when no distribution takes place to United States investors. New dollar issues outside the United States and underwritten by institutions in London and other centers rose from \$35 million in the second half of 1963 to \$330 million in January-June 1964 and amounted to an additional \$180 million in the second half of 1964. About two thirds of this grand total of \$545 million was arranged and placed in the London market. These bonds have generally been of 15 or 20 years' maturity, carrying a 5½ to 6½ per cent coupon. The major borrowers have been governments, municipalities, and industrial firms of the Scandinavian countries, Finland, and Japan, with Japanese issues alone accounting for some \$132 million or 24 per cent of the total (see Table I).

FOREIGN ISSUES IN CONTINENTAL MARKETS

In addition to dollar issues arranged and placed on the European Continent, there has been a rise recently in foreign issues floated in certain Continental European markets and denominated in national currencies. The most noteworthy development in this respect has been the sharp increase in foreign issues in Germany. Such issues (all of which were denominated in German marks) rose to nearly \$225 million equivalent last year, from only \$40 million in 1963 and \$25 million in 1962. As in the case of dollar-denominated issues placed in Europe, the bulk of the foreign loans floated in Germany was accounted for by Scandinavian, Finnish, and Japanese borrowers, with Japan alone taking \$75 million or one third of the total (see Table II). The remainder consisted of issues by international institutions, including the Inter-American Development Bank. Again, as in the case of European dollar issues, these German mark loans generally are bonds of 15 or 20 years' maturity carrying a 5½ to 6½ per cent coupon.

This record activity in the German market seems to have been stimulated not only by the United States interest equalization tax, but also by proposed German legislation. In order to curb the inflow of long-term capital and thereby alleviate the German payments surplus, the German authorities in March 1964 proposed a 25 per cent withholding tax on nonresidents' interest income from German bonds. It was announced subsequently, however, that the tax—which has not yet been enacted—would not

⁴ The exception was a 60 million Swiss franc loan floated by the city of Copenhagen in October 1963. This issue met with objections by the Swiss authorities. Its denomination in Swiss francs was regarded as interfering with Swiss controls over domestic liquidity and new issues in the Swiss market, and as contributing—to an undesirable degree—to the use of the Swiss franc as an international currency. A \$25 million loan by IRI, the Italian state holding company, in June 1964 could be subscribed to (and issued) in either dollars or German marks.

Table II
FOREIGN ISSUES IN GERMANY IN 1964

Borrower or country of borrower	Amount (millions of dollar equivalent)	Number of issues	Comment
Japan	75.0	2	\$50 million by government; \$25 million by city of Osaka
Finland	47.5	4	\$23 million by government; rest by long-term lending institutions
European Coal and Steel Community	25.0	1	
European Investment Bank	20.0	1	
Denmark	18.8	1	City of Copenhagen
Inter-American Development Bank	15.0	1	
Eurofima	12.5	1	Company established by sixteen European national railway administrations to finance rolling stock
Norway	10.0	1	City of Oslo
Total	223.8	12	

apply to income from German mark issues of foreign borrowers. This provision greatly stimulated demand for such issues, presumably to a large extent by foreigners (who during the second quarter sold sizable amounts from their German domestic bond holdings). It also enabled foreign borrowers to place their issues in the German market on somewhat more favorable terms than German borrowers could receive. In addition, the German authorities have proposed abolition of the 2½ per cent tax which foreign and private domestic borrowers currently have to pay on new issues; this should further facilitate the placement of foreign securities on the German market.

In France, where no issues by borrowers outside the franc area had been permitted since World War II, the authorities in November 1963 announced their intention to authorize the reopening of the capital market to foreign borrowers. Such issues (whose proceeds are to be spent largely in France) initially have been limited to international institutions. Accordingly, in December 1963 the European Investment Bank was able to place a 60 million franc (\$12 million) issue with French insurance companies and other institutional investors. This was followed in July 1964 by a 150 million franc (\$30 million) flotation of the European Coal and Steel Community. In Belgium—where until 1960 most foreign issues were those of the Congolese colonial authorities and of companies active in the Congo—the European Investment Bank in December 1963 made a further private placement of 400

million francs (\$8 million).

Some European countries, such as the Netherlands and Switzerland, have of course long been substantial exporters of long-term capital. But the Netherlands closed its market to foreign borrowers in 1963, and except for two issues totaling 55 million guilders (\$15 million) by the European Investment Bank and the European Coal and Steel Community the market remained closed in 1964 as well. This decision largely reflected the desire of the Dutch authorities to prevent the capital outflow and the upward pressures on domestic interest rates that might have resulted from foreign flotations. And in Switzerland, which maintains strict controls over all new issues, a heavy demand for capital by domestic borrowers led the authorities to adopt a somewhat stricter attitude toward foreign issues. As a result the 379 million francs (\$88 million) of such issues authorized last year was noticeably below the 588 million francs (\$136 million) permitted in 1963.

NEW TYPES OF FOREIGN ISSUES IN EUROPE

The search for ways to attract long-term funds into foreign issues led at one time to the flotation of bonds denominated in European "units of account". However, there have been only six such issues, totaling \$68 million, and none has been floated since April 1964 (see Table III). The issues, with maturities ranging between 15 and 20 years and coupons between 5½ and 6 per cent, were generally offered in Luxembourg, with a Belgian or Luxembourg bank heading the underwriting syndicate. United States underwriters participated in two issues.

Units of account, which were first used in the bookkeeping of the former European Payments Union,⁵ are a composite of seventeen European currencies. They serve as a common denominator for issues floated in several markets and provide a limited guarantee against exchange rate changes for debtors and creditors with liabilities and claims in foreign currencies.

The unit of account is an entirely artificial yardstick that is used solely to measure the value of contractual loan

⁵ The European Payments Union was established in 1950 under the aegis of the Organization for European Economic Cooperation, and continued to function until the advent of convertibility at the end of 1958. It was designed to achieve transferability of the currencies of its seventeen members through monthly settlements of each member's current payments with the other members as a group. The net debtor or creditor positions resulting from the clearing were expressed in "units of account" (1 unit = 0.888671 grams of fine gold = US\$1) and were settled partly in gold or dollars and partly by credits granted to or received from the Union.

Table III
UNIT-OF-ACCOUNT ISSUES

Borrower	Amount (millions of dollar equivalent)	Date	Comments
SACOR (Portugal)	5.0	February 1961	Partly state-owned
	5.0	May 1962	oil refinery
Norges Kommunalbank (Norway)	12.0	January 1963	State-owned long-term credit institution
Imatran Voima (Finland)	5.0	July 1963	State-owned electric- power company
Cassa per il Mezzo- giorno (Italy)	18.0	October 1963	Official development fund for southern Italy
Banco de Fomento Nacional (Portugal)	13.0	November 1963	Official development bank
Greater Copenhagen (Denmark)	10.0	April 1964	Seven Copenhagen municipalities
Total	68.0		

obligations. It is not a means of exchange, but is designed to minimize exchange risks by keeping the value of claims and liabilities as constant as possible. As under the European Payments Union, each of the seventeen Western European currencies that are included—the so-called reference currencies—bears a fixed relationship to the unit of account through its own gold/dollar parity as communicated to the International Monetary Fund.⁶ Since its appearance in early 1961, the unit-of-account formula has taken a number of different forms. It has always provided that the value of the unit would change only if the values of all seventeen reference currencies changed; however, under the terms of the more recent loan agreements at least two thirds of these changes must be in the same direction. Under these conditions, the value of the unit—and hence of the securities denominated in these units—would be adjusted, after a lapse of two years, in the same direction and proportion as the currency among the two thirds (or more) that had changed the least. The protection afforded by this complex formula is of course not absolute. It does not cover the borrower if his currency is devalued, or the lender if his is revalued, vis-à-vis all the others.

Belgian bankers who are the original sponsors of this new means of financing—in particular Fernand Collin of the Kredietbank—readily admit that “the system is not

⁶ Thus, one unit of account equals 0.357 pound sterling or 4 German marks or 4.937 French francs, and so on.

simple and certainly not for people who are unfamiliar with monetary problems”. The scheme “had to be complicated, because every possibility had to be foreseen—even those that will probably never occur”,⁷ but it was hoped such a multicurrency unit would provide a means of weaning the Continental investor away from his preference for local issues (or for the hoarding of gold).

It is important to note that all unit-of-account issues have been floated by either nationalized companies or private companies in which the government is the main shareholder. Moreover, in four of the issues (the second through fifth in Table III) payment of interest and principal is guaranteed by the government—which adds to the attraction that such issues may have for the lender. The borrower can probably raise funds in this fashion in larger amounts and on more favorable terms than in any one national capital market, but he can also incur commitments in foreign currencies that few private borrowers may wish to take on.⁸

An additional procedure that would permit foreign borrowers to obtain a larger amount of savings than could be tapped in any one Continental market has been proposed though not yet implemented. This is the so-called European parallel loan, which would involve the simultaneous flotation on different markets of different tranches of an issue, with each tranche denominated in the national currency of the country in which it is placed. This proposal was put forward in the fall of 1963 by Hermann J. Abs of the Deutsche Bank. In Mr. Abs' view,

each individual loan could be raised within the limits of each country's financing capacity in different amounts varying between the equivalents of, let us say, \$5, \$10, \$20, or even \$50 million. In spite of their plurality, the European capital markets could then represent themselves as one

⁷ F. Collin, “Europe's Unit of Account”, *Statist*, February 28, 1964, p. 635.

⁸ Another type of bond issue that, in a very limited sense, can be compared to unit-of-account financing was offered in Europe in 1964. These are issues with an exchange option, which entitles the lender to request payment of interest and amortization in one or more currencies, including or excluding the currency in which the issue is denominated. The Finnish Government borrowed 40 million marks (\$10 million) in Germany on this basis, with investors having the option of receiving payment in marks or dollars; and the city of Turin raised £4 million (\$11 million) in London, with a repayment option in sterling or German marks. Although this issue was denominated in sterling, subscriptions had to be paid for in external sterling, i.e., sterling held by nonsterling-area residents, which for all practical purposes is like any other foreign currency for British investors.

market well capable of raising a total amount not falling short of that which the United States market could provide.⁹

In such issues, the terms and conditions of all tranches would be as uniform as possible. Variations in the issue price would take account of differences in long-term rates in the different markets. Since this type of issue is largely designed to appeal to institutional investors—such as insurance companies and pension funds—that are limited to or prefer investment of their funds in securities denominated in their national currencies, the risk is reduced that investor demand would tend to concentrate on the highest-yielding tranche.¹⁰

INTERNATIONAL COOPERATION AMONG FINANCIAL INSTITUTIONS

Recent years have also witnessed a general broadening of cooperation among financial institutions, both within Europe and between Europe and other continents. Indeed, it can be said that a more truly international financial community is gradually coming into being, stimulated no doubt in good part by the new worldwide money market in dollars and European currencies. (One of the important characteristics of this market is that funds in a given currency may be deposited with banks in various countries and traded actively among nonresidents.) This internationalization of financial markets is reflected in the proliferation of foreign branches and agencies of commercial banks; in the cooperation across national frontiers among financial institutions in such sectors as mortgage and real estate financing, international investment trusts, instalment credit, and equipment leasing; and in the setting up of international banking groups.

For example, new links have been forged between British financial institutions and their counterparts outside the United Kingdom. In December 1963, the Midland Bank announced two separate moves in this direction. The first was an agreement with the largest commercial bank in each of three Continental countries—the Amster-

damsche Bank (since merged with the Rotterdamsche Bank), the Société Générale of Belgium, and the Deutsche Bank—to form a “European Advisory Committee”. Under this agreement, the four banks are pooling information about investment and credit conditions in their countries and have set up arrangements for giving special attention to each other’s customers.

The second move, announced a few days later, was the creation of Midland and International Bank Ltd. by the Toronto-Dominion Bank, the Standard Bank (South Africa), the Commercial Bank of Australia, and the Midland Bank itself. In this grouping—which is backed by £3.4 billion of resources and a combined network of 5,000 branches—the links are considerably more formal. The Midland Bank will hold about 45 per cent of the £10 million issued share capital and the Canadian, South African, and Australian members about 25, 20, and 10 per cent, respectively. In addition to the continuing exchange of information, the operations of the new institution will include medium-term export financing (up to ten years), the financing of projects in the four countries, participation with outsiders in larger scale financing, and—“in appropriate circumstances”—underwriting of new issues. These operations will be financed by the acceptance of deposits from the public for up to twelve months. Despite the Commonwealth slant of the new group, the four founding banks have noted that they stand ready to admit new partners from any quarter.

Both of these moves are significant in many respects. Especially noteworthy is the fact that under the first arrangement the Midland Bank will be linked with “universal banks” on the Continent—that is, with institutions able to engage in a much wider range of banking activities than British clearing-bank conventions allow. This arrangement joins not only banks but also capital markets—that of London, with acknowledged expertise, and those of three Continental countries, with various institutional inflexibilities but wider latitude for commercial banks. There can be little doubt that the greater internationalization of banking implied by these steps portends greater mobility of capital, which may in turn contribute toward a lowering of barriers between individual European markets.

CONCLUDING OBSERVATIONS

The recent growth in foreign issues in European capital markets suggests that Europe may eventually become again an important exporter of long-term capital. It will be recalled that prior to 1914 Europe played a key role in this respect and made a major contribution to the early development of public facilities (such as transportation) in

⁹ Hermann J. Abs, “Parallel Loans to Mobilize Continental Funds”, *The Times* (London), March 11, 1964.

¹⁰ A variant of this type of financing, actually used in two Belgian issues in 1960 and 1961, is an exchange-option issue in which the investor has the choice of subscribing in one of the currencies included in the option, in addition to the choice as to interest and amortization payments. Investors in countries whose currency is so included could then consider the bonds as denominated in their national currency.

Eastern Europe, the Western Hemisphere, and other then-underdeveloped countries. Subsequently, Europe's ability to function as a long-term capital exporter was curbed by a series of events—World War I and its aftermath, the economic disturbances of the 1930's, World War II, the needs of postwar reconstruction and, finally, the unprecedented investment boom in Europe itself. In the past year and a half, however, Europe has been able to increase markedly the volume of its foreign lending, partly as a result of the capital market techniques described in this article. These have the common characteristic of making it possible to mobilize the resources of several European financial centers at one time, with the issues expressed in dollars or in other currencies that have considerable investor appeal across national frontiers.

However, it is generally true that the net benefit of the international movement of capital will be more nearly assured if capital can move equally freely among different countries. To the extent that countries retain controls over foreign issues in their markets as well as over investor participation in issues abroad, the burden of providing capital internationally is shifted largely to other countries. And, in these countries, long-term funds may tend to flow out at times and in ways that create difficulties at home for the national authorities. In other words, the new types of financing described here, whatever their merits, cannot be considered a substitute for a more far-reaching development and strengthening of freer national capital markets. Although it is likely that recent foreign borrowings in Europe have attracted some long-term European funds over and above those that ordinarily would have participated in such issues in the New York market, the increased international capital flows within Europe have perhaps been stimulated more by the novel (and, to investors, attractive) features of these issues than by a genuine broadening of the individual European markets themselves.

Such a broadening requires the easing or removal of a host of inhibiting factors—legislative, institutional, and psychological—that still characterize various foreign mar-

kets. These factors not only tend to bar the flow of capital between countries, but also to limit the efficiency, growth, and diversification of domestic capital markets in general. Such factors, of course, vary in nature and degree of applicability from country to country. They include exchange controls, discriminatory treatment of foreign borrowers, strict regulations governing the composition of the portfolios of institutional investors (which often discriminate against foreign securities), various listing and trading restrictions on foreign issues that are stricter than those on domestic securities, and—on a more general plane—controls over new issues, the pre-empting of the market by the public sector, and official encouragement of specific types of financial investment. If the reform of national markets were to be accelerated, both their domestic activity and their internationalization might be furthered substantially.

As regards the United States, this country's balance of payments has benefited from the proposal and subsequent enactment of the interest equalization tax, which brought about a shift of new foreign issues by European and Japanese borrowers from the New York market to European financial centers. As a result, United States investors reduced their purchases of new European and Japanese issues from \$326 million in the first half of 1963 to \$110 million in the second half and to under \$40 million in 1964; they continued of course to invest in issues of other borrowers, while United States banks substantially increased their loans to foreigners in general. It is clear that the proximate cause of any balance-of-payments relief obtained by the shift in borrowing to Europe has been the influence of the tax, rather than subsequent European adjustments. Moreover, the United States is still carrying a major share of the burden of providing long-term capital to the underdeveloped world. Steps that tend to make national capital markets in Europe more liberal and more genuinely "international" in their lending activities are therefore to be welcomed.