FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

MARCH 1965

Contents

Volume 47 No. 3

Treasury and Federal Reserve Foreign Exchange Operations*

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As noted in the previous report covering the period March-August 1964, the Federal Reserve had completely liquidated its outstanding swap drawings by the end of June while drawings made by other central banks amounted to no more than $65 million. Such diminished use of international credit facilities reflected a reduced deficit in the United States balance of payments and a general narrowing of payments imbalances throughout the world. This general movement toward international payments equilibrium suffered a setback during the second half of 1964, however, mainly owing to the eruption of the sterling crisis, heavy outflows of United States bank credit and long-term investment, and the continuation and even further tightening of the credit squeeze in continental European markets. The risk of sudden, heavy strains upon the gold exchange system had been well anticipated by the central banks and treasuries of the major industrial countries, but the severity of the pressures developing in late 1964 required a further reinforcement of intergovernmental defenses against currency speculation.

During the reporting period September 1964-February 1965, the Federal Reserve swap network was strengthened by increases in the swap arrangement with the National Bank of Belgium from $50 million to $100 million and in the arrangement with the Bank of England from $500 million to $750 million. The swap network now covers reciprocal credit lines totaling $2,350 million, as shown in Table I. The short-term credits extended to the Bank of England by the central banks of Europe, Canada, and Japan in November 1964 provided further impressive evidence of the solidarity of central bank defenses when confronted with a currency crisis. Also during the period, the authority of the International Monetary Fund (IMF) to borrow from its member countries was invoked for the first time, and much progress was made toward the scheduled 25 per cent increase in IMF quotas during 1965. This process of challenge and timely response will no doubt continue to guide the further evolution of the international financial system.

The sterling emergency necessitated sizable drawings by the Bank of England upon the Federal Reserve which more or less concurrently drew heavily upon its swap lines with the continental European central banks in order to cushion the impact of heavy dollar inflows arising from both the British and United States deficits. Bank of

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

March 1, 1965

Institution	Amount of total facility (in millions of dollars)	Term of arrangement (in months)
Austrian National Bank	50	12
National Bank of Belgium	100	12
Bank of Canada	250	12
Bank of England	750	12
Bank of France	100	3
German Federal Bank	250	6
Bank of Italy	250	12
Bank of Japan	150	12
Netherlands Bank	100	3
Bank of Sweden	50	12
Swiss National Bank	150	6
Bank for International Settlements	150	6
Total swap facilities	2,350	

* This is the sixth in a series of reports by the Vice President in charge of the Foreign Department of the New York Reserve Bank and Special Manager, System Open Market Account. The Federal Reserve Bank of New York acts as agent for both the Treasury and the Federal Open Market Committee of the Federal Reserve System in the conduct of foreign exchange operations.

England drawings on the Federal Reserve swap line rose to a peak of $700 million on November 27 but have subsequently been greatly reduced. To absorb part of the dollar flows to the continental European central banks, the Federal Reserve made drawings upon the swap lines with the central banks of Switzerland, Germany, Belgium, the Netherlands, and Italy and with the Bank for International Settlements (BIS). Of these drawings, $380 million remained outstanding as of the end of February 1965. Further assisting the financing of both British and United States payments imbalances, the central banks and governments of other countries provided short- and medium-term financing through accumulations of dollars, extension of credits to the United Kingdom, purchases of United States Treasury foreign currency securities, and provision of credit through the IMF.

In addition to central bank swap operations, both the Treasury and Federal Reserve also engaged in forward operations in Dutch guilders and Swiss francs in order to calm market fears and encourage an outward flow of short-term funds from Amsterdam and Zurich. The Swiss National Bank took steps to help cushion the effects of anticipated year-end pressures on the Swiss franc. The German Federal Bank also made available swap facilities to German commercial banks for investments in United States Treasury bills in order to reduce or offset temporary pressures on the exchange market resulting from short-term capital flows. Similarly, extensive use of forward operations was made by the Bank of England in December 1964 to reassure the market and relieve pressure on the spot rate.

The foreign currency bonds issued by the United States Treasury rose from a total of $1,035 million outstanding as of the end of August 1964 to $1,137 million as of early March 1965 (see Table II). Additional issues of $50 million were made to the German Federal Bank and $50 million to the National Bank of Austria to absorb surplus dollars on the books of these central banks.

While these central bank and intergovernmental credit operations provided partial and temporary financing of the payments imbalances developing during the period, gold continued to play its traditional role. During the third and fourth quarters of 1964, sales of gold by the United States Treasury amounted to $442 million, against gold purchases of $338 million.

The international financial system was thus confronted with a major challenge in late 1964 which was successfully countered. The unprecedented mobilization of $4 billion of international liquidity in defense of sterling was a striking illustration of the strength and flexibility of the central bank and IMF defenses against currency crises.

Table II

UNITED STATES TREASURY BONDS DENOMINATED IN FOREIGN CURRENCIES

March 3, 1965

Issued to	Amount (in millions)	
	Foreign currency	United States dollar equivalent
Austrian National Bank	2,600 Austrian schillings	100.6
National Bank of Belgium	1,500 Belgian francs	30.1
German Federal Bank	2,700 German marks	679.0
Swiss National Bank	1,112 Swiss francs	257.5
Bank for International Settlements	300 Swiss francs	69.5
Total		1,136.7

Perhaps even more remarkable is the fact that the international defense of sterling was accomplished in the face of a serious deterioration in the balance of payments of the other major reserve currency center, the United States. Such a rallying of governmental and central bank support for the present system depended, however, upon one basic assumption: that both the British and the United States Governments would quickly put in motion forceful corrective programs to eliminate their payments deficits. These corrective programs are now under way and, if pursued with determination, will soon relieve the international financial mechanism of the enormous pressures generated by simultaneous deficits in the two major reserve currency countries. Under such conditions, the gold exchange standard, adapting as it has in the past to changing world conditions, can efficiently facilitate a continuing growth of world trade and payments.

The successful response to the challenge of the sterling crisis has unfortunately been marred by the widespread and exaggerated publicity given to the French Government's call for the return to the gold standard and the elimination of dollars and sterling from official reserves. This approach has found no support among central banks and treasuries of other countries. The main effect has been to stir up some previously dormant private speculation in the London gold market, to the detriment of official acquisitions of newly mined gold.

STERLING

Early in 1964 sterling showed weakening tendencies as a result of the deteriorating trade position of the United Kingdom and various uncertainties connected with the

general election to be called sometime during the year. A timely increase of the Bank of England discount rate from 4 per cent to 5 per cent in late February temporarily relieved market pressures, while delay of the general election until October induced some short covering by commercial interests.

Late in May, however, tight conditions in several Continental money markets exerted new pressure on sterling. These pressures became strong toward the end of June because of heavier-than-usual midyear window dressing by Continental banks. To temper the impact of these movements of funds on official reserves, the Bank of England on June 30 drew $15 million against its $500 million swap line with the Federal Reserve; it repaid the drawing on July 13.

As the credit squeeze in the Continental money market centers extended into July, moderate selling of sterling continued, and the spot rate moved downward with a minimum of official support to a low for the month of $2.7874 on July 20. The decline in the spot rate was taken in stride by the market without any speculative reaction developing. Indeed, market confidence in the sterling parity at that time was such that the discount on forward sterling tended to narrow as the spot rate declined.

As the discount on forward sterling was reduced, the covered interest-arbitrage differential on Treasury bills in favor of London became correspondingly more attractive and by July 13 had reached 0.44 per cent per annum. To forestall private covered outflows in response to this arbitrage inducement, the Federal Reserve, with the agreement of the Bank of England, intervened in the market to reduce the arbitrage differential. This intervention, amounting to a total of $54 million equivalent in mid-July and again in late August, was accomplished by swap transactions in the New York market, with the Federal Reserve buying sterling spot and selling sterling forward against United States dollars. These operations had the dual effect of protecting the dollar against short-term flows of funds from New York to London while at the same time lending useful support to the spot rate on sterling.

In September, sterling came under increased pressure, mainly owing to increasingly widespread recognition of the mounting balance-of-payments deficit of the United Kingdom, which became further aggravated by the usual seasonal weakness during the autumn and early winter months. Uncertainties connected with the general election called for October 15 further unsettled the sterling exchange market, and the problem of maintaining confidence in sterling seemed likely to become increasingly difficult. In anticipation of reserve losses, the Bank of England in mid-September made timely arrangements to supplement the $500 million swap line with the Federal Reserve by another $500 million of short-term credit facilities with other central banks in Europe and with the Bank of Canada. This reinforcement of the British reserve position cushioned the impact of recurrent, and increasingly forceful, waves of selling during September and October. Net drawings by the Bank of England on the Federal Reserve swap line and on short-term facilities provided by other central banks rose to $415 million by the end of October.

The new Labor Government elected on October 15 was thus immediately confronted with a grave balance-of-payments situation. The announcement on October 26 of emergency surcharges of 15 per cent on a wide range of imports brought only brief relief as critical reactions appeared among Britain's trading partners world wide, more particularly the European Free Trade Association (EFTA) group. In a formal budget presented to Parliament on November 11, the government proposed certain new welfare benefits, to be financed by tax increases, and announced that it intended to introduce a capital gains tax and to substitute a new corporation tax for the existing application of the income tax to corporations. These proposals created uncertainty in business circles, in part because the immediate deflationary influence of the increased tax on fuel as well as the import surcharge was to some extent obscured by the other measures. These uncertainties in domestic financial markets were, in turn, communicated to the exchange market. During this period, the exchange market began to anticipate bank rate action on each successive Thursday, and thus a pattern developed of a strengthening of sterling prior to Thursday of each week, followed by a major selling wave on Friday as the bank rate remained unchanged. When the bank rate remained unchanged on Thursday, November 19, reserve losses by the Bank of England on the following day reached such proportions that action could no longer be postponed. On Monday, November 23, the Bank of England raised its discount rate from 5 per cent to 7 per cent.

Perversely enough, market reaction to such forceful use of monetary policy by the Labor Government quickly degenerated into fears that the threat to sterling must have reached a truly crisis stage. Whether these reactions might have been averted by earlier bank rate action, more particularly on the usual Thursday date for bank rate announcements, may be debated for some time to come. In any event, the market seized on rumors that the $1 billion of short-term central bank credits at the disposal of the Bank of England in September had now been exhausted; that the $1 billion standby credit from the IMF secured by the British Government in August had accordingly been fully committed to repayment of such central bank

credits; and, hence, that the United Kingdom would have to fall back in defense of sterling upon its reserves of roughly $2 billion. (The still-substantial unused drawing rights on the IMF would have required longer to mobilize than events at that time allowed.)

This situation assumed increasingly grave significance on the London afternoon—and the New York morning—of November 24 when a virtual avalanche of selling developed. If sterling were to be rescued, it was clear that a major package of international credit assistance would be required. On the afternoon of the 24th, the Federal Open Market Committee—meeting through a telephone conference—committed itself to an increase in the Federal Reserve-Bank of England swap line from $500 million to $750 million if credit assistance on a roughly corresponding scale could be secured from other central banks. That evening the Export-Import Bank gave assurance of a $250 million standby facility. Beginning early on the morning of November 25, the Bank of England, the Federal Reserve Bank of New York, and the central banks of other major countries were in almost continuous telephone communication. At 2 p.m., New York time, it was announced that a $3 billion credit package provided by eleven countries and the BIS was at the disposal of the Bank of England.

As a result of the heavy reserve losses, the $500 million Federal Reserve swap and the additional $500 million of other central bank credit facilities made available to the Bank of England in September were not only fully exhausted, but immediate drawings of $200 million on the new credit facilities were also required. From the end-of-October figure of $415 million, recourse by the Bank of England to central bank credit facilities thus rose by $785 million during November to a total of $1.2 billion. Of this total, the Federal Reserve share was $675 million.

In early December the British Government drew the full amount of its $1 billion standby facility with the IMF and so repaid an equivalent amount of the central bank credits outstanding, including $500 million of the Federal Reserve credit. At the same time, Switzerland, which, although not a member of the IMF, is associated with the General Arrangements to Borrow, provided the United Kingdom with a three-year credit of $80 million; $50 million of the Swiss credit was used to repay an earlier loan from Switzerland, outstanding from the sterling crisis of 1961.

With its exchange reserves thus heavily reinforced, the British Government could face with confidence further temporary pressures on sterling during December. Selling was particularly heavy just prior to the long Christmas week end, and during the month the Bank of England increased its use of short-term central bank credit facilities from the $200 million outstanding early in December to $525 million at the year end. Of this $325 million increase, $25 million was secured by an increased use of the Federal Reserve swap line, raising the total outstanding from $175 million to $200 million, while $300 million was drawn from other central banks.

Beginning in late November heavy selling of sterling appeared in the forward market, mainly by commercial interests insuring their future exchange transactions. This selling threatened to move the forward sterling rate to an excessive discount and hence intensify sales of sterling in the spot market. Accordingly, the Bank of England gave firm support to the forward rate. This support not only served to lessen the drain on reserves from spot transactions at the time, but more generally helped to buttress confidence in sterling by providing official reassurance that the sterling parity would be maintained. The operation was comparable to the determined stand taken in the forward market by other central banks in recent years and promised to achieve the same useful results.

After the turn of the year, both the spot and forward markets for sterling returned to a more balanced position. Since then, sterling has shown an increasingly buoyant trend. On February 10 it was announced that those of the central bank credit facilities made available last November which were shortly due to expire would be replaced by new facilities, available to the end of May, thus reconstituting the entire $3 billion credit package. By the end of February the Bank of England was able to start repaying these debts.

In addition to direct swap transactions with the Bank of England, the Federal Reserve Bank of New York also moved into the market at various times during the autumn months to purchase sterling for both System and Treasury account. These acquisitions were made on both an outright and a swap basis; the particular technique used was determined by market conditions at the time, in consultation with the Bank of England.

SWISS FRANC

At the beginning of 1964, Federal Reserve swap drawings of Swiss francs under the swap lines of $150 million equivalent with both the Swiss National Bank and the BIS amounted to $220 million equivalent. By the end of June, these drawings had been completely liquidated through gold sales of $30 million to the Swiss National Bank, purchase from the Bank of Italy of the Swiss franc proceeds of a $100 million equivalent lira-Swiss franc swap, issuance by the United States Treasury of a $70 million

equivalent Swiss franc bond to the BIS, and purchases of Swiss francs from the Swiss National Bank. United States Treasury market commitments in forward Swiss francs were reduced during the course of the year from $121 million to $51.5 million. At the outset of 1964, the United States Treasury and the Federal Reserve also had outstanding a combined total of $53 million in swaps of third currencies into Swiss francs. These contracts had been reduced to $15 million by the end of February 1965.

Despite the progress thus made in liquidating Treasury and Federal Reserve commitments in Swiss francs incurred in late 1963, new problems arose when sizable short-term funds—mainly repatriated Swiss assets—again flowed into Switzerland, both at midyear and particularly toward the close of the year as the pound sterling came under pressure. During the spring of 1964, interest rates in Switzerland continued to rise as the heavy demands imposed on the Swiss money and capital markets by the continuing high level of economic activity further squeezed the liquidity position of Swiss banks and firms. The interest rate on three-month deposits reached 3.50 per cent in June, an increase of about 0.75 per cent per annum over the previous year, while the average yield on government bonds moved up to 4.05 per cent, compared with 3.15 per cent a year earlier. To relieve the squeeze on their liquidity positions, and to satisfy midyear window-dressing needs, the Swiss commercial banks made sizable repatriations of funds during June.

These commercial bank operations caused the Swiss National Bank once again to take in substantial amounts of dollars. In July the reversing of some window-dressing operations and an easing of the Swiss money market brought about only a partial reversal of the previous inflows. In these circumstances the United States Treasury issued to the Swiss National Bank on August 4 an additional Swiss franc bond in the amount of $52 million equivalent and used the proceeds to absorb an equivalent amount of dollars on the books of the Swiss National Bank. (This issue brought the outstanding amount of United States Treasury securities denominated in Swiss francs to $327 million equivalent.)

Generally easier conditions prevailed in the market for Swiss francs from mid-August to mid-October, and the Swiss franc declined from its ceiling for a while, only to firm again in late October as the Swiss money market tightened. Then in the early part of November, funds began to move into Switzerland in quantity—some directly out of sterling, some through the Euro-currency markets in response to the general uneasiness that pervaded the exchanges. Throughout the rest of the year, sizable increases occurred in the dollar holdings of the Swiss National Bank.

To absorb part of this intake of dollars, the Federal Reserve reactivated its $150 million swap with the BIS in early December by drawing $100 million of Swiss francs, which was simultaneously employed to purchase dollars from the Swiss National Bank. A further Swiss franc drawing of $60 million equivalent on the Swiss National Bank was made on January 19 for the same purpose. In addition, to calm the market and to encourage Swiss banks to invest abroad dollars that they might otherwise have sold to the Swiss National Bank, the Federal Reserve began in December to sell Swiss francs forward to the market through the Swiss National Bank. By January 8, 1965, such forward sales reached a peak of $32.5 million equivalent. Most of these contracts had been paid off by the end of February through spot purchases of Swiss francs. (The Swiss franc began to ease shortly after the year end as Swiss banks, finding themselves liquid, started to place funds abroad.) During the second half of 1964, the dollar acquisitions of the Swiss National Bank were further reduced by purchases of $51 million of gold from the United States Treasury.

NETHERLANDS GUILDER

At the beginning of 1964, Federal Reserve commitments in guilders amounted to $80 million equivalent, all in the form of outstanding swap drawings. These were fully repaid by early April, as earlier inflows of funds into the Netherlands were reversed.

In May the Dutch money market began to tighten, and in early June the Netherlands Bank raised its discount rate from 4 per cent to 4½ per cent. In July Dutch commercial banks began to repatriate funds in substantial amounts. Moreover, the Netherlands balance of payments strengthened, owing to a better trade balance and an inflow of long-term capital. By November the intensified pressures on sterling and the ensuing movement of some funds out of sterling and into guilders helped push the guilder to its ceiling.

Meanwhile, the Netherlands Bank had been taking in dollars in an effort to moderate the rise in the guilder rate. During the first week of August the Federal Reserve drew $20 million equivalent of guilders under the swap line and immediately used the guilders to absorb some of the Netherlands Bank's accruals of dollars. Further Federal Reserve drawings and sales of guilders followed in rapid sequence, and by mid-October the $100 million swap facility had been fully drawn. Additional dollars were purchased by the Federal Reserve and the United States Treasury from the Netherlands Bank in September and

December with guilders acquired through three-month swaps of sterling for guilders with the BIS, for a total of $50 million equivalent. As intensified buying pressures on the guilder developed in late December, a temporary swap arrangement for $35 million between the Netherlands Bank and the United States Treasury was agreed upon and fully employed.

In mid-December recourse was also had to forward operations in Dutch guilders for both Federal Reserve and Treasury account in order to provide reassurance to the market and induce covered capital outflows from the Netherlands. These operations, together with Dutch provision of dollar credits to the Bank of England and purchases of gold from the United States Treasury, reduced the dollar holdings of the Netherlands Bank sufficiently to permit complete liquidation of the Treasury-Netherlands Bank $35 million swap by early January and repayment of $30 million of the Federal Reserve swap drawings in early February. As of the end of February, Federal Reserve drawings upon the swap line with the Netherlands Bank had thus been reduced to $70 million equivalent. During the second half of 1964, gold purchases by the Netherlands Bank from the United States Treasury amounted to $60 million.

GERMAN MARK

During 1963 and early 1964, there had been almost continuous upward pressure on the German mark. This pressure reflected a substantial increase in the German foreign trade surplus, large inflows of long-term capital, and occasional inflows of short-term funds in response to tight money market conditions or hedging operations. To ease the strain, the German Federal Bank, the Federal Reserve, and the United States Treasury jointly conducted various spot and forward exchange operations, as outlined in previous reports in this series.

On March 23, 1964, an important turning point occurred, as the German Government announced its intention to propose to Parliament the imposition of a 25 per cent withholding tax on income from German fixed-interest securities held by nonresidents. This action not only checked the long-term capital inflow, but also actually induced liquidation of a considerable volume of foreign investments in fixed-interest securities. Earlier surpluses on trade account also diminished as the year progressed and helped to restore a stable equilibrium in the exchange markets.

The effect on the exchange market of these basic shifts in the German balance of payments was reinforced by a number of technical measures initiated by the German authorities to reduce temporary pressures on the exchange market resulting from short-term capital flows. The special swap facilities made available by the German Federal Bank to German commercial banks for investments in United States Treasury bills were used flexibly throughout the second half of the year, with maturities providing the banks with liquidity at the year end. In addition, under a special temporary arrangement in December, German commercial banks were permitted to borrow against collateral from the central bank at an effective cost lower than the posted rate. Nevertheless, the sterling crisis led to some inflow of funds to Germany in late December. Consequently, the Federal Reserve reactivated its $250 million swap facility with the German Federal Bank by drawing $50 million equivalent of marks in order to absorb $50 million of German dollar reserves. This drawing was reversed in late January 1965, as short-term outflows from Germany combined with German military purchases in the United States enabled the Federal Reserve to acquire $50 million of marks from the German Federal Bank. Another small drawing of $15 million equivalent was made by the Federal Reserve on February 4 to help control any speculative tendencies resulting from President de Gaulle's press conference on the same date.

During the six-month period through February, the United States Treasury issued to the German Federal Bank in October 1964 a $50 million equivalent mark-denominated bond. This latest issue raised the total of such mark bonds outstanding to $679 million equivalent. The mark proceeds of this bond, together with $7 million of Treasury mark balances remaining from United States drawings of marks from the IMF, were sold to Canada to enable that country to make an IMF repayment. Subsequently, in early December when the United States Treasury drew $125 million equivalent of marks from the IMF, it used $50 million equivalent to purchase excess dollars from the German Federal Bank, in effect compensating for the fact that marks derived from the earlier bond issue had been used in conjunction with Canada's repayment to the IMF.

ITALIAN LIRA

Italy's balance-of-payments deficit had assumed major proportions in the fall of 1963, and the Federal Reserve and United States Treasury joined forces with the Bank of Italy in defense of the lira. As outlined in the previous report, Federal Reserve and Treasury operations in the autumn of 1963 and the first quarter of 1964 cushioned the decline in the Bank of Italy's reserves to the extent of some $350 million and thereby helped to restrain speculative pressures against the lira.

During the week of March 9 through March 14, 1964, an Italian delegation headed by Governor Carli of the Bank of Italy visited Washington to discuss with the World Bank and the IMF various possible sources of financing for Italy's longer term investment requirements and its expected further balance-of-payments deficits. In the midst of these discussions, the lira was suddenly struck by a burst of speculation. This brought heavy pressures not only on the spot rate but also on the forward rate, which for a three-month maturity moved to a discount of 7 per cent per annum. In this dangerous situation, an immediate and massive reinforcement of the Italian reserve position was clearly called for. Within forty-eight hours the Italian authorities were able to announce that they had arranged for approximately $1 billion of external assistance provided by the United States, the Bank of England, and the German Federal Bank.

One of the most satisfactory aspects of this display of international cooperation in beating back a speculative attack on the Italian lira was that the provision of massive credit assistance to Italy more or less coincided with a turning point in the Italian economic and financial scene. During the first quarter of 1964 the Italian balance of payments had registered a deficit of $436 million. A surplus of $226 million was recorded in the second quarter, as corrective policy measures initiated by the Italian authorities began to take effect and as a reversal in the leads and lags in payments brought about the covering of short positions in lire. In early July, a governmental crisis generated a temporary speculative flurry, but forceful operations in the forward market by the Bank of Italy through the agency of the Federal Reserve Bank of New York provided reassurance, and the speculation quickly subsided.

Italy continued to run a payments surplus during the third and fourth quarters of 1964, and by the year end Italian official reserves, which had dipped $233 million during the first quarter, were $389 million higher than at the outset of 1964. The reappearance of political uncertainties in the late summer triggered some selling of forward lire, and discounts for three-month maturities tended to widen at times to 4 per cent per annum. In such instances, the Federal Reserve Bank of New York again intervened for account of the Bank of Italy to support the forward lira in the New York market and thus helped to relieve market uncertainties. By early October the discount on the three-month forward lira had narrowed to less than 1 per cent per annum.

Continuing heavy flows of dollars to Italy in the closing months of 1964 and early 1965 may have partially reflected the sterling crisis. To absorb part of these dollar inflows, the Federal Reserve on January 22 reactivated its $250 million swap arrangement with the Bank of Italy by drawing $50 million equivalent of lire.

CANADIAN DOLLAR

The spot market for Canadian dollars was relatively quiet through the first half of 1964, but there was considerable activity in the forward market as a result of grain sales to the Soviet Union beginning in the previous autumn. These sales generated heavy demands on the part of grain dealers for Canadian dollars for future delivery against United States dollars. In order to offset some of these pressures, the Bank of Canada sold United States dollars spot and purchased them forward, thus providing some counterpart to the commercial banks' swap needs, while the Federal Reserve also intervened on a small scale. By the end of July, Canadian grain shipments to the Soviet Union had been fairly well completed, and pressures on the forward market eased.

In August, heightening tensions in Vietnam generated some buying of spot Canadian dollars by Continental interests and, as the spot rate rose in a thin market, Canadian exporters began to sell out United States dollar balances. New grain purchases by several Eastern European countries exerted further upward pressure on the spot rate. At about the same time there was a tightening of the Canadian money market, which induced a temporary flow of short-term funds into Canada from the United States on a covered basis.

Substantial Canadian long-term borrowings in the United States market, the sterling crisis, and fiscal-year-end positioning by Canadian banks in October and November pushed the spot rate for the Canadian dollar to its effective ceiling by November. As the Canadian dollar strengthened, the Bank of Canada intervened to moderate the rise in the rate, with the result that Canadian reserves increased by $210 million during the August-November period despite repayments of $107 million to the IMF in September and October. By December the market had returned to a more balanced position.

In early February the Canadian dollar softened, as press discussion of prospective United States balance-of-payments measures lead to some apprehension in the markets that Canada might be unfavorably affected. The United States balance-of-payments program, announced on February 10, made it clear that there was no United States intention to deprive the Canadian economy of essential inflows of capital. Nevertheless, the Canadian dollar weakened somewhat further in the second half of the month, reportedly reflecting Canadian commercial buying of United States dollars and unfavorable seasonal factors.

BELGIAN FRANC

Early in July 1964 the Belgian franc strengthened, following the announcement of new measures designed to curb the growth of credit in Belgium. On July 3 the National Bank of Belgium raised its discount rate by ½ percentage point to 4¾ per cent and announced that, effective August 17, it would impose a cash reserve requirement against commercial bank deposits for the first time. Tighter money market conditions developed, and, in conjunction with long-term investment in Belgium, an improved trade balance beginning in the third quarter and the sterling crisis later in the year contributed to substantial dollar inflows into Belgium.

Early in August, the Federal Reserve used $7.5 million equivalent of Belgian francs drawn under the $50 million swap arrangement to absorb dollars on the books of the National Bank of Belgium. By mid-October the entire $50 million equivalent of franc balances had been so utilized. Effective October 22 the Federal Reserve and the National Bank of Belgium expanded the existing $50 million swap facility with an additional $50 million arrangement to be available on a standby basis. As dollars continued to flow into Belgium, the Federal Reserve made further drawings on this additional swap and by the end of November had used the full amount.

The Federal Reserve was able to reduce its swap commitments to Belgium to $25 million equivalent in early December, when the National Bank of Belgium purchased $75 million from the Federal Reserve to make special outpayments. On December 30, however, the Federal Reserve again drew $20 million equivalent of francs in order to absorb further inflows of dollars into Belgium, and further utilization of $40 million equivalent under the swap arrangement became necessary in January and February 1965. As of the end of February, total Federal Reserve use of the $100 million swap arrangement with the National Bank of Belgium amounted to $85 million equivalent. Meanwhile, during the second half of 1964, the National Bank of Belgium had purchased $40 million of gold from the United States.

OTHER CURRENCIES

JAPANESE YEN. On April 30, the Bank of Japan drew $50 million under the $150 million swap arrangement with the Federal Reserve in order to cushion a decline in Japanese reserves. This drawing was renewed on July 30, as reserve pressures continued, and a further drawing of $30 million was made on July 31. In August, however, domestic restraint measures began to take effect: import demand diminished and, with a continued growth in exports, the trade balance improved considerably. With this improvement in Japan's balance-of-payments and reserve position, the Bank of Japan began repaying its swap obligations at the end of September and, by early November, had liquidated them in full.

AUSTRIAN SCHILLING. There were no System operations in Austrian schillings during the period. Although the Austrian balance of payments registered a considerable deficit in the last quarter of 1964, the figures for 1964 as a whole continued to show a surplus. Therefore, on February 23 and March 3, 1965, the Treasury issued to the Austrian National Bank two $25 million equivalent eighteen-month bonds denominated in Austrian schillings, using the proceeds to absorb some of that bank's dollar holdings. These issues brought the outstanding total of United States Treasury Austrian schilling-denominated bonds to $100 million equivalent.

SWEDISH KRONA AND FRENCH FRANC. There were no Federal Reserve or Treasury operations in Swedish kronor or French francs during the period under review.

UNITED STATES DRAWING ON THE INTERNATIONAL MONETARY FUND

Over the course of several years before 1964, foreign countries had been repaying more dollars to the IMF than the IMF had been paying out in new drawings. As a result, the IMF's dollar holdings rose to a point where they equaled the amount that the United States had paid into the IMF as part of its quota. At this point the IMF, under its rules, could no longer accept dollars in repurchase, and countries having repurchase obligations could make repayments only with gold or with other eligible convertible currencies. So as to be able to sell such currencies to countries having repurchase obligations, the United States Treasury on February 13 and June 1 made two drawings on the IMF—predominantly in German marks and French francs—in the amount of $125 million equivalent each under the $500 million standby agreement with the IMF announced by President Kennedy in July 1963. By September 1, the bulk of these currencies had been sold to various countries effecting repayments to the IMF.

On July 23, 1964, the original standby arrangement expired, and the Treasury announced that it had made a further standby arrangement with the IMF for another year. This restored the amount available to $500 million. The first drawing under the new standby arrangement was made on September 1, when the United States drew $50

million in five European currencies. Unlike the first two drawings under the original arrangement, which were used to cover a number of transactions that took place during ensuing weeks, this drawing was occasioned by Italy's repurchase of $65 million equivalent of lire from the IMF. Again, on September 30, the United States Treasury drew equal amounts of Dutch guilders and German marks totaling $100 million equivalent, half of which was immediately sold to Canada in connection with a repayment to the IMF. The remaining balances were disbursed in subsequent weeks. On December 7 a third drawing of $125 million equivalent was made, this time solely in German marks.

Since this program was initiated, the United States Treasury has drawn $525 million equivalent of seven continental European currencies, of which some $15 million equivalent remained undisbursed as of the end of February 1965. The effect of these drawings on the United States position in the IMF has been offset to a considerable extent, however, by drawings of dollars by other countries. The largest single dollar drawing was $200 million, under the $1 billion equivalent multicurrency drawing in December by the United Kingdom. As a result, the United States repayment obligation to the IMF as of the end of February 1965 had been reduced to $256 million.

THE GOLD MARKET AND UNITED STATES GOLD TRANSACTIONS

Throughout the first eight months of 1964 the London gold market was generally stable, with the gold-fixing price ranging between $35.06 and $35.10. With the improvement in the United States balance of payments, and consequent strengthening of confidence in the dollar, speculative demand for gold receded and, as new production also increased, the Gold Pool regularly absorbed surpluses of output reaching the market. The Pool took in further sizable amounts of gold from Russian sales which were heavily concentrated over a few weeks' span in late March and early April.

Over the closing months of 1964, various political and financial disturbances tended to rekindle speculative buying of gold. International tensions arising out of the Vietnam conflict have continued to generate market apprehension. But renewed speculation in the gold market was also attributable to the increasing pressures on sterling during the latter part of the year. In addition, the sharp deterioration in the United States balance of payments during the closing months of 1964 contributed to market uncertainties, especially after the turn of the year. In February, various pronouncements emanating from Paris further stimulated speculative buying of gold by private interests. Both the United Kingdom and the United States have now taken forceful action to deal with their balance-of-payments deficits, and if these corrective programs are vigorously pursued, speculative pressures in the gold market may be expected to subside.

The Bank of England, on behalf of the Gold Pool, continued to exert a stabilizing influence on the market and to moderate price movements. Although private demand for gold increased during the closing months of 1964, over the year as a whole the Pool once again acquired and distributed to its members more than $600 million.

During the fourth quarter of 1964, Continental central banks took in sizable amounts of dollars and several sold part of their acquisitions to the United States Treasury for gold. These conversions, as well as the continued French monthly gold purchases, more than offset United States acquisitions from other sources. As a result, the United States became a net seller of gold in its international monetary transactions after having been a net purchaser earlier in the year (see Table III). For 1964 as a whole, taking into account sales of about $89 million to domestic users, total United States gold holdings—including Stabilization Fund holdings as well as the Treasury gold stock—declined by $125 million. During the first two months of 1965, the Treasury gold stock declined by an additional $450 million.

Table III

UNITED STATES NET MONETARY GOLD TRANSACTIONS WITH FOREIGN COUNTRIES AND INTERNATIONAL INSTITUTIONS

July-December 1964

In millions of dollars at $35 per fine troy ounce; United States net sales(—), net purchases(+)

Country	Third quarter	Fourth quarter
Belgium	—	— 40.1
Brazil	— 1.1	+ 28.2
France	— 101.4	— 101.4
Germany	— 25.0	—
Netherlands	—	— 60.0
Spain	—	— 30.0
Switzerland	—	— 51.0
Turkey	—	— 12.5
United Kingdom	+ 162.5	+ 125.0
All other	+ 6.0	— 2.8
Net sales or purchases	+ 41.0	— 144.6

The Business Situation

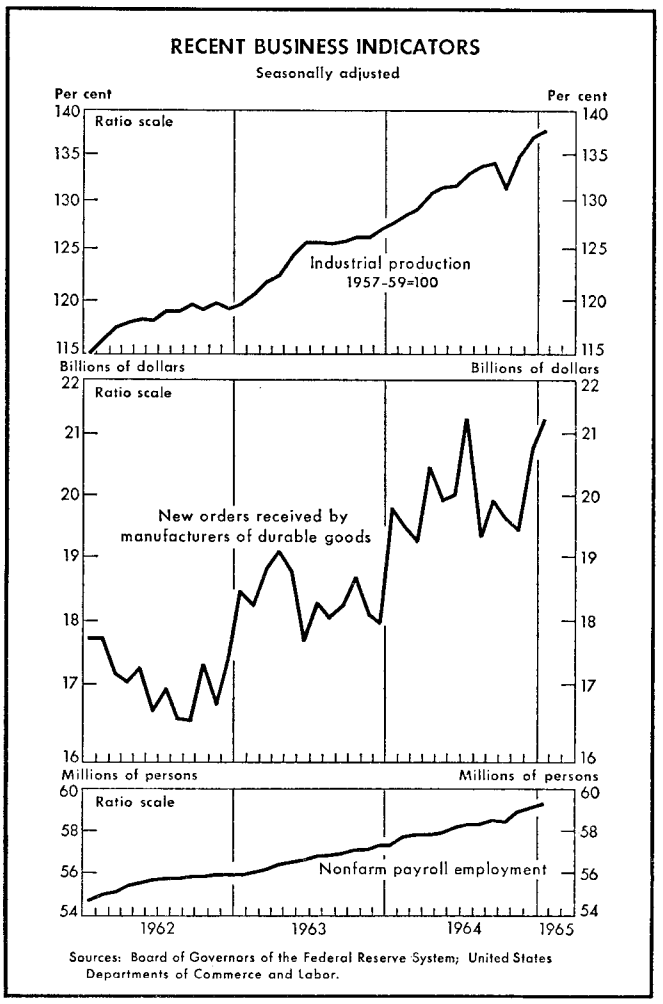
Business activity expanded at a good rate in January, and most newly available evidence, on balance, points to further gains in the immediate months ahead. Reflecting this upward momentum, such broad current indicators as industrial production, nonfarm payroll employment, new orders received by manufacturers of durable goods, and outlays for residential construction all increased in January, while spending at retail outlets remained near its advanced December level. Early returns for February suggest that the automobile and steel industries were both still straining their facilities to meet pressing demands and that retail sales moved up somewhat. The unemployment rate, moreover, continued within the lower range that has prevailed in recent months. With the economy continuing to advance from already high levels, the price indicators bear close watching. The consumer price index increased again in January, while the industrial component of the wholesale price index (seasonally adjusted) was unchanged. However, weekly data for February suggest that the industrial component moved up in that month.

Labor-management negotiations have continued to occupy much of the business news. In early February, East and Gulf Coast longshoremen who had already signed wage contracts returned to their jobs after an extended and costly work stoppage. Although the strike continued at some ports, activity in the opened ports immediately surged as shippers sought to make up for the business lost during the walkout. Meanwhile, with the results of the presidential election in the steel union still being contested, there is some question as to when meaningful contract negotiations can be resumed. Indeed, the uncertainty over the election was probably a contributing factor in the breakdown of the union's negotiations with major can producers on March 1, which resulted in the first strike in this industry in eleven years. Many observers have urged that the present contract in the steel industry be extended beyond its April 30 termination date. To do so would remove one significant short-term uncertainty but would also prolong the period of inventory stockpiling as a hedge against a possible strike.

PRODUCTION, ORDERS, AND EMPLOYMENT

Industrial production rose further in January, as response to broad-based demand brought a 0.7 percentage point advance in the Federal Reserve's seasonally adjusted index. Following on the heels of the unusually large gains in November and December, which reflected efforts to make up for production lost during the earlier automobile strikes, the January advance brought the index to 137.7 per cent of the 1957-59 average (see chart), or 8 per cent higher than the reading a year earlier. The production increase included advances in consumer goods and materials output, which were all the more significant since they did not depend on a further push from the auto and steel industries.

In the steel industry, new bookings appear to have risen only about seasonally in January. Trade sources, however, reported that orders for some types of steel had to be turned down because forward commitments made earlier in response to strike-hedge ordering had already filled the books at some mills for several months ahead. It was also reported that steel shipments, although rising, have recently tended to fall considerably behind delivery dates promised earlier. Ingot production, which had been limited to levels that could be handled by the industry's finishing facilities for flat-rolled products, edged up a bit further in February in response to increased demand for pipe and wire products, but with operations already at such a high rate the gain was less than is usual for that time of year. In the auto industry, dealers continued to press manufacturers for deliveries. However, a severe Midwest snowstorm that



kept many automobile production workers off their jobs for several days apparently caused assemblies in February to edge off a bit from the unprecedented height of the previous month.

Prospects for further gains in over-all production appear good. Despite a lack of push from steel orders in January, total new orders received by manufacturers of durable goods (seasonally adjusted) advanced again (see chart). Backlogs of unfilled orders also were up and currently amount to more than two and a half times the monthly rate of shipments. Orders booked by machinery- and equipment-producing industries rose in January and reached a level 8 per cent higher than a year ago. Increases in such orders tend to confirm the indications of the November Commerce Department-Securities and Exchange Commission survey that business capital spending will continue to climb in the first half of 1965. A more up-to-date reading of spending plans should be available in early March with the publication of the results of the Government's February survey.

Although the absence of dock workers from their jobs in January curtailed employment in transportation industries, the expansion in over-all economic activity helped push total nonfarm payroll employment (seasonally adjusted) up by 93,000 persons in that month. Except for the brief interval during the automobile strikes last fall, payroll employment has risen virtually without interruption for three years (see chart). The number of persons at work in manufacturing rose to 17.7 million in January, the highest level since mid-1953, and the average workweek clocked by manufacturing production workers climbed to 41.4 hours. This represented an average of 3.3 hours of overtime per production worker, the highest overtime rate for January since this series began in 1956. According to the Census Bureau's household survey, the unemployment rate was 5.0 per cent in February, up slightly from 4.8 per cent in January, but close to the range that has prevailed since mid-1964. Total employment was about unchanged in February, while the civilian labor force rose somewhat.

RESIDENTIAL CONSTRUCTION AND RETAIL SALES

Developments in the residential construction sector continue to present a mixed picture. Vacancy rates for the nation as a whole on both rental and for-sale units in the fourth quarter of 1964 were exactly the same as a year earlier. Building permits issued in January advanced markedly and outlays for new buildings rose in February for the third month in a row. On the other hand, the dollar value of residential construction awards (seasonally adjusted) moved down in January after a two-month rise, and the number of nonfarm housing units started in January dropped sharply after a surge in December. The major area of weakness in starts, compared with the high levels of about a year ago, apparently continues to be in multifamily units on the West Coast.

Consumer spending at retail outlets eased a bit in January from the record December level, but remained nevertheless almost 7 per cent above the year-earlier performance. Weekly data for February suggest that retail volume in that month probably more than made up the decrease of the month before. It should be noted that the sharp advance in personal income in January, partly reflecting early payment of dividends to veterans holding Government life insurance, buttressed consumers' ability to spend. While new car sales appear to have dipped a bit in February fol-

lowing their surge in January, they remain at a very high level.

The Census Bureau's latest survey of consumer buying plans, taken in January, suggests that auto sales will continue at a good rate over the near term. The January results do show a decline in the proportion of consumers planning to buy new cars within the next six months, compared with the results reported last October. However, such plans are usually reduced in the interval between these two surveys, with October plans probably biased upward because of the introduction of the new car models. Plans to buy a new car within six months were higher in January 1965 than a year earlier, and the 1964 survey was, of course, followed by a year of record sales. Plans to purchase household durables, on the other hand, were off somewhat from their high level at the start of 1964.

The Money and Bond Markets in February

Attention in the money and bond markets during February focused on the implications of the nation's balance-of-payments problem and the official actions proposed to deal with it. The money market's tone became somewhat firmer during the month and this, combined with the publication of lower average levels of nationwide reserve availability, led many observers to conclude that a slight shift in monetary policy had taken place. In the firmer money market atmosphere, Treasury bill rates edged upward and at the end of the month the three-month bill was bid at 3.99 per cent, just under the discount rate.

In the market for Treasury notes and bonds, caution arising from the balance-of-payments problem and the situation in Vietnam led to a gradual decline in prices through mid-February. Thereafter, prices steadied and moved narrowly. Prices of corporate and tax-exempt bonds also receded during the month, as investors resisted the lower yield levels that had developed on new issues in January.

THE MONEY MARKET AND BANK RESERVES

The tone of the money market gradually became slightly firmer during February, reflecting in part the decline in nationwide reserve availability from the levels prevailing in December and January. Rates posted by the major New York City banks on call loans to Government securities dealers rose a bit and generally fluctuated between 4⅛ per cent and 4½ per cent. At the same time, offering rates for new time certificates of deposit issued by the leading New York City banks, and the range of rates at which such certificates traded in the secondary market, edged higher during the month. On February 4, dealers in bankers' acceptances raised their rates by ⅛ of a percentage point making the new offering rate on ninety-day unendorsed acceptances 4⅛ per cent. In the course of the month, the major sales finance companies increased their offering rates on various categories of directly placed paper by ⅛ to ¼ of a percentage point. At the end of the period they were offering 4⅛ per cent on 30- to 59-day paper and 4¼ per cent on 60- to 270-day paper. Toward the end of the month, commercial paper dealers raised their rates by ⅛ of a percentage point, making the new rate on prime four- to six-month paper 4⅜ per cent (offered).

As the month opened, the money market continued to exhibit about the same steady tone that had prevailed toward the end of January. System open market operations about offset the effects of a withdrawal of reserves stemming from movements in market forces. Although reserve positions at major money market banks as a group came under slightly increased pressure, these banks were able to cover a good part of their reserve needs in the Federal funds market where funds were readily available at 4 per cent. Subsequently, as nationwide reserve availability contracted, pressures on the reserve positions at these banks mounted, and the over-all tone of the money market became slightly firmer. Banks bid strongly for Federal

funds and, on two days, funds traded predominantly at 4⅛ per cent. Total member bank borrowings at the Reserve Banks bulged over the February 5-7 week end, helping to produce a temporary abundance of excess reserves, and Federal funds became available below the discount rate toward the close of the February 10 statement week. A portion of these funds was purchased by "country" banks and carried into the second week of their statement period.

Over the midmonth statement week, nationwide reserve availability declined further as System open market operations more than offset the reserves provided by market factors. The money market was quite firm, but member bank borrowings from the Reserve Banks declined when the large reserve excesses built up by the country banks a week earlier were redistributed. In the latter part of the month, member bank borrowings from the Reserve Banks once again rose substantially as many banks sought to avoid accumulating reserve deficiencies over the three-day Washington's Birthday week end. These heavy week-end borrowings again led to an overabundance of reserves toward the end of the statement week, and country banks were once more buyers of Federal funds late in the February 24 reserve averaging period at rates below the discount rate.

Over the month as a whole, market factors drained $450 million of reserves while System open market operations provided $329 million. The weekly average of System outright holdings of Government securities increased by $384 million from the final statement week in January through the last week in February, while average System holdings of Government securities under repurchase agreements declined by $12 million. Average net System holdings of bankers' acceptances, both outright and under repurchase agreements, fell by $43 million during the period. From Wednesday, January 27, through Wednesday, February 24, System holdings of Government securities maturing in less than one year rose by $1,631 million, while holdings of issues maturing in more than

Table I

CHANGES IN FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1965

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

Factor	Daily averages—week ended				Net changes
	Feb. 3	Feb. 10	Feb. 17	Feb. 24	
"Market" factors					
Member bank required reserves*	— 101	+ 205	+ 78	+ 84	+ 266
Operating transactions (subtotal)	— 380	— 687	— 3	+ 354	— 716
Federal Reserve float	— 230	— 139	+ 68	+ 190	— 111
Treasury operations†	+ 50	+ 5	— 91	+ 97	+ 61
Gold and foreign account	— 27	— 116	— 97	+ 3	— 237
Currency outside banks*	— 14	— 320	+ 131	+ 84	— 119
Other Federal Reserve accounts (net)‡	— 158	— 117	— 13	— 21	— 309
Total "market" factors	— 481	— 482	+ 75	+ 438	— 450
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 435	+ 364	— 45	— 376	+ 384
Bankers' acceptances	+ 2	+ 1	— 2	— 2	— 1
Repurchase agreements:					
Government securities	+ 1	+ 32	— 76	+ 31	— 12
Bankers' acceptances	+ 14	+ 8	— 20	— 44	— 42
Member bank borrowings	+ 75	+ 194	— 119	+ 167	+ 317
Other loans, discounts, and advances	— 4	—	—	—	— 4
Total	+ 522	+ 600	— 263	— 217	+ 642
Excess reserves*	+ 41	+ 118	— 188	+ 221	+ 192
Daily average levels of member bank:					
Total reserves, including vault cash*	21,401	21,314	21,048	21,185	21,237§
Required reserves*	21,019	20,814	20,736	20,652	20,805§
Excess reserves*	382	500	312	533	432§
Borrowings	278	472	353	520	406§
Free reserves*	104	28	— 41	13	26§
Nonborrowed reserves*	21,123	20,842	20,695	20,665	20,831§

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 four weeks ended February 24, 1965.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS FEBRUARY 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended				Average four weeks ended Feb. 24*
	Feb. 3	Feb. 10	Feb. 17	Feb. 24*	
Eight banks in New York City					
Reserve excess or deficiency(—)†	12	15	16	19	16
Less borrowings from Reserve Banks	69	51	131	100	88
Less net interbank Federal funds purchases or sales(—)	377	489	579	283	432
Gross purchases	*925*	*1,061*	*1,066*	*811*	*966*
Gross sales	*548*	*573*	*487*	*528*	*534*
Equals net basic reserve surplus or deficit(—)	— 434	— 525	— 695	— 364	— 505
Net loans to Government securities dealers	770	615	619	364	592
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)†	10	24	21	18	18
Less borrowings from Reserve Banks	106	233	77	225	160
Less net interbank Federal funds purchases or sales(—)	285	197	168	141	198
Gross purchases	*941*	*755*	*1,000*	*895*	*898*
Gross sales	*656*	*557*	*832*	*754*	*700*
Equals net basic reserve surplus or deficit(—)	— 381	— 406	— 223	— 348	— 340
Net loans to Government securities dealers	437	335	307	209	322

* Estimated reserve figures have not been adjusted for so-called "as of" debits and credits. These items are taken into account in final data.
† Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

one year contracted by $1,673 million. This shift in the maturity structure of Federal Reserve holdings largely reflected the passage of time.

THE GOVERNMENT SECURITIES MARKET

The cautious atmosphere which had developed in the market for Treasury notes and bonds toward the end of January continued in the early part of February. Growing awareness and discussion of the nation's balance-of-payments problem and of possible measures to deal with it —including the possibility of a shift in monetary policy— led to a cautious approach to investment decisions on the part of market participants. In this atmosphere, market professionals became increasingly eager to lighten inventories recently enlarged by the Treasury's January advance refunding and the February cash financing. Thus, a modest but general decline in prices of coupon issues took place, with offerings concentrated in the 2½ per cent wartime issues and the recently issued securities. Moderate investment demand was present throughout the period.

Subsequently, the market atmosphere improved for a time, following press reports suggesting that higher long-term interest rates would not be used in combating the balance-of-payments deficit. The President's February 10 message to Congress presenting a program to deal with the balance-of-payments deficit was received favorably by the market. However, increasing concern over the implications of unfolding developments in Vietnam, combined with a further drain on the United States gold stock and lower levels of free reserves published for the February 10 statement week, served to renew the market's caution. As a result, prices of most intermediate- and long-term issues edged irregularly lower from February 9 through midmonth, when a steadier tone reemerged in the market.

For most of the remainder of the month, the lower price levels generated some professional short covering and attracted additional investment demand. The improved market tone also reflected a reiteration of the Administration's view that long-term borrowing costs are not likely to rise significantly this year. Toward the end of the month, renewed hesitancy appeared in the market, based partly on official indications that monetary policy would be employed, as necessary, to correct the balance-of-payments deficit. However, moderate investment demand remained in evidence, and the distribution of recently issued Treasury securities continued.

The market for Treasury bills also had a hesitant undertone in early February, as market participants expressed uneasiness over the possibility of a shift in monetary policy to deal with the balance-of-payments problem. While moderate investment demand persisted throughout this period, widespread uncertainty generated an expansion in offerings from professional and other sources and bill rates moved irregularly higher through February 5. Offerings then contracted, and bill rates held generally steady from February 8 through midmonth in quiet trading. In the latter part of the month, the continuation of lower levels of net reserve availability tended to confirm the feeling among market participants that there had been a slight firming in monetary policy. Dealers in Treasury bills were willing sellers as rates edged higher but there was good demand, especially from public funds. Toward the end of the month, the approach of the March corporate dividend and tax dates contributed to the caution evident in the market.

At the last regular weekly auction of the month, held on February 19, average issuing rates were 3.989 per cent for the new three-month issue and 4.043 per cent for the new six-month bill—14 and 10 basis points higher, respectively, than the average rates at the final weekly auction in January. The February 23 auction of $1 billion of new one-year bills resulted in an average issuing rate of 4.062 per cent, compared with 3.945 per cent on the comparable issue sold a month earlier. The newest outstanding three- and six-month bills closed the month at bid rates of 3.99 per cent and 4.04 per cent, respectively.

OTHER SECURITIES MARKETS

Some apprehension was also present in the markets for corporate and tax-exempt bonds in February. Prices declined in both sectors during this period, with a continuing heavy flow of new tax-exempt flotations and rather large inventories of older tax-exempt issues contributing to the hesitant atmosphere in that sector. Declines in corporate bond prices were accompanied by the termination of syndicate price restrictions on a number of recent issues, with resultant yield increases of about 3 to 9 basis points. In the tax-exempt market, dealers' advertised inventories reached a record level of $827 million on the final business day of the month, and a heavy atmosphere prevailed. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds declined by 1 basis point to 4.41 per cent while the average yield on similarly rated tax-exempt bonds rose by 7 basis points to 3.03 per cent. (These indexes are based on only a limited number of issues and therefore do not necessarily reflect market movements fully.)

The volume of new corporate bonds publicly floated in February amounted to an estimated $185 million, compared with $160 million in January and $270 million in

February 1964. The largest publicly offered new corporate bond issue during the month consisted of $60 million of Aa-rated 4½ per cent first and refunding mortgage bonds maturing in 1990. The bonds which will not be refundable for five years were reoffered to yield 4.44 per cent and encountered some investor resistance. Syndicate price restrictions on this issue were terminated late in the month, and prices subsequently adjusted to somewhat lower levels. New tax-exempt flotations in February totaled about $850 million, as against $735 million in January 1965 and $740 million in February 1964. The Blue List of tax-exempt securities advertised for sale closed the month at a record $827 million, compared with $679 million on January 29. The largest new tax-exempt bond flotation during the period was a $100 million issue of state water bonds reoffered to yield from 2.90 per cent in 1975 to 3.58 per cent in 2012. The bonds, which were Aa-rated, were well received. Other new corporate and tax-exempt bonds publicly offered during the period were accorded mixed investor receptions.

FIFTIETH ANNUAL REPORT

The Federal Reserve Bank of New York has just published its fiftieth *Annual Report,* reviewing the economic and financial developments of 1964. It was transmitted to member banks by Alfred Hayes, President of the Bank, on March 1. The sixty-page *Report* tells of solid progress on the domestic front. However, the United States balance-of-payments deficit was again too large and remains a serious problem. Monetary policy during 1964 is described as essentially easy. The four major sections of the *Report* are: "Progress in 1964 and the Challenge of the Future", "The United States Economy and Financial Markets in 1964", "The International Economy in 1964", and "This Bank's Operations".

Copies of the *Annual Report* are available from the Publications Section, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

The President's Balance-of-Payments Program

On February 10, 1965, the President sent to Congress a message on the United States balance of payments in which he presented a program aimed at quickly achieving a substantial improvement in our balance-of-payments position. This program is clearly of major importance since the balance-of-payments deficit is a serious national problem.

A major responsibility in carrying out the President's program was placed on the Federal Reserve System and on the banking and financial community. The System has already taken the first measures in carrying out the program. On the day the Presidential message was delivered, the Federal Reserve Banks issued a circular soliciting the cooperation of the commercial banks and outlining specific steps to be taken by the banks. On February 18, in Washington, Chairman Martin and Governor Robertson discussed the request in detail with representatives of the banking and financial community, following a meeting of these representatives with the President of the United States. On March 3, Chairman Martin, in a letter to the chief executive officers of approximately 750 nonbank financial organizations, set forth tentative guidelines proposed by the Board for the foreign lending activities of these institutions. Because of the importance of these developments, this Bank's circular, the remarks of Chairman Martin and Governor Robertson, and Chairman Martin's letter to the nonbank financial organizations are reprinted below.

CIRCULAR NO. 5616—FEBRUARY 10, 1965

To All Member and Nonmember Banks
in the Second Federal Reserve District:

The President of the United States has today sent to Congress a message setting forth his program to improve the United States balance of payments.

In addition to stressing the vital importance of stability of domestic costs and prices, the President's program includes:

(1) Legislation to continue the interest equalization tax through December 31, 1967;

(2) Immediate action under the existing statute to impose the interest equalization tax on bank loans with maturity of one year or more;

(3) Legislation to apply the interest equalization tax, retroactive to February 10, 1965, to nonbank credits to foreigners if such credits have a maturity of one year or more;

(4) A call on the Federal Reserve System—in cooperation with the Treasury—to work with all banks to limit lending to foreigners;

(5) Legislation to provide immunity from antitrust laws for specified voluntary programs, if needed, with respect to foreign loans by banks;

(6) A call on the Department of Commerce to work with corporations with business interests abroad to effectuate a reduction of their capital outflows;

(7) A more vigorous export promotion drive;

(8) Encouragement of foreign investment in the United States through appropriate tax legislation;

(9) Legislation to reduce from $100 to $50 the duty-free allowance of tourists returning from abroad, and a "See the U.S.A. First" program designed to increase tourism in the United States;

(10) An intensified effort to reduce military expenditures abroad;

(11) Continued action to minimize adverse balance-of-payments effects of the foreign aid program.

The Federal Reserve System shares the President's concern about the deterioration in our balance of payments and his determination to improve our payments position and to strengthen confidence in the dollar. The System and the banking and financial community have been assigned major roles in the President's program.

The central focus of the program is on measures that will reduce the outflow of United States capital. Such flows have been heavy in recent years, and were particularly so in recent months. In the fourth quarter of 1964, for example, bank credit to foreigners expanded by $1 billion.

To assure the success of the program, the System is requesting all banks to limit credits to foreigners that are not clearly and directly for the purpose of financing exports of United States goods and services. Over all, the objective is to hold outstanding credits (including export credits) to foreigners during 1965 to a level not over 5 per cent above the December 31, 1964 outstandings. In most instances, this should be the minimum goal for individual banks. Within the over-all limits, certain countries may need to be given preferential treatment. You will be advised later concerning this.

Outstanding credit to foreigners includes loans, acceptance credits, deposits with foreign banks (including foreign branches and subsidiaries of United States banks), and investments and acquisitions of assets abroad regardless of maturity, whether or not they are subject to the interest equalization tax.

The Federal Reserve program will be further explained under the following procedures:

(1) The President is asking representatives of the financial community to meet with him to discuss the program set forth in his message to the Congress;

(2) The Chairman of the Board of Governors is asking the bank representatives present at the President's meeting to confer with him and the other members of the Board of Governors, and presidents of the Reserve Banks following that meeting;

(3) Each bank that has foreign loans and investments outstanding in excess of $5 million will be requested to meet individually with representatives of the Reserve Bank of its District for further discussion of the program;

(4) Technical advisory committees may be invited to meet with Federal Reserve officials concerning problems that arise under the System's program.

Implementation of the program limiting lending to foreigners will result inevitably in some hardships for individual lenders and borrowers. This is unfortunate, but the overriding long-run international position of the dollar is dependent upon your wholehearted cooperation.

I am confident that the financial community stands prepared to join with the Federal Reserve System in this urgent national effort to restore balance-of-payments equilibrium and to maintain the dollar "as good as gold". In good part, the success of the President's program depends on us.

ALFRED HAYES,
President.

REMARKS BY WILLIAM McC. MARTIN, JR.
CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

The Board has invited you here so that we can present in more detail the part the Federal Reserve and the banking system as a whole have to play in helping to achieve the very important balance-of-payments objectives that President Johnson talked about to you earlier today.

Since you are, for the most part, bankers, let me speak in bankers' terms. As a reserve currency country, the United States occupies a financial position very similar to that of a bank. On the whole, the position is a good one, like that of a very solvent bank, with an enviable capital structure. Over all, we have international assets amounting to about $96 billion. Our total liabilities amount to only $56 billion, leaving an equity position of $40 billion, or a ratio of more than 40 per cent. Our reserve position also is strong. We have gold reserves of $15 billion, against liquid claims of about $32 billion, the equivalent of almost 50 cents of cash in the till for every dollar of "demand" deposits.

On the other hand, we are having a problem that is, basically, one of secondary liquidity. Our loans and in-

vestments have increased more rapidly than has the desire of others to hold with us "deposits" or dollar claims. We are therefore faced with "adverse clearing balances", and the international liquidity position of our country has worsened, particularly in the period since 1957. Over the seven years ending with 1964, our monetary reserves declined by $7 billion and our net position in the International Monetary Fund by $1 billion. At the same time, our short-term liabilities to foreign central banks and governments—liabilities we must always be ready to redeem in gold on demand—rose more than $6 billion, while our liquid liabilities to private foreigners rose by nearly $5 billion.

In the circumstances we, like a bank faced with a similar problem, can do either or both of two things. We can try to increase the willingness of depositors to leave money with us by offering higher interest rates and other inducements, or we can cut back, for the time being, on our lending and investing, or we can do both. We have already done quite a bit to enhance rate and other attractions. Since 1960, United States bill rates have moved up from around 2.25 per cent to nearly 4 per cent, and rates paid by commercial banks on foreign deposits and other short-term rates have increased correspondingly. We have offered foreign central banks the so-called "Roosa Bonds", payable in foreign currencies, to afford them protection against any fluctuation in the dollar's exchange rate.

When it comes to lending and investing, however, we have not so far made any move toward curtailment. The fact is our loans and investments, already at a high level following a long climb, began showing a further marked rise a few months ago. It is a sharp but necessary reduction in the elevation of this rate which the President now proposes, and which we should like to work with you to effect. I think you will all agree that this course would be a sound and prudent one for any bank to follow in similar circumstances.

It is in the interest of all of us to explore new means of dealing with the problem before us so that we can find a correction that is reasonable and workable and that will not start us down a path whose course and end we cannot foresee. Perhaps there is no form of action feasible, including that the Administration is urging, that is without pitfalls. The President's balance-of-payments proposals, on the other hand, have been chosen in part because they will not impinge severely on the functions of the market as the final regulator of business, and also because they will not burden unduly our domestic prosperity and growth nor be disruptive of international trade.

Under the President's new program, the banks are being asked to assume a central responsibility for restraint. This has not been an arbitrary decision. It necessarily follows from the relationship that bank lending has to the persistent redundancy of dollars in international markets and the consequent deterioration in our international liquidity.

I'm sure that all of you here will agree with me that unless we preserve the integrity and strength of the dollar throughout the world we cannot possibly sustain the prosperous economies here and abroad that depend upon the dollar and the trade it finances. And I'm also sure that we can count upon your aid in our efforts to see to it that confidence in the dollar is maintained the world over.

Let us now come down to some particulars of what the President's program means for your institutions. For that, I am going to turn the meeting over to Governor J. L. Robertson, to whom the Board has delegated responsibility for the day-to-day conduct of our program.

REMARKS BY J. L. ROBERTSON
MEMBER OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Let me discuss more closely what the President's program means for banks and other financial institutions—bearing in mind, of course, that what is asked of them is only part of the over-all attack on the balance-of-payments problem.

Given the urgent need for a decisive cutback in capital outflows this year, what is an appropriate and realistic target for the *banking* community? After a great deal of thought, the Federal Reserve has concluded that any expansion of bank lending abroad in 1965 should not be greater—and preferably should be less—than the rate of growth of domestic lending. Last year, in contrast, foreign bank lending rose three times as rapidly as domestic loans and investments.

More dollars are needed abroad day by day, month by month, to finance trade throughout the free world—but not as many dollars as we have been providing. Hence the need for voluntary restraint on dollar outflows—the need for a curtailment of the rate of expansion of the outflow. Here is a situation in which we can make progress by standing still awhile—as the need for dollars abroad increases.

Therefore, we have asked all banks to restrict credits to foreigners that are not clearly and directly for the purpose of financing exports of United States goods and services. While all exports must be financed, we seek to have outstanding credits to foreigners (*including* export credits) held during 1965 to a level not over 5 per cent above the amount outstanding on December 31, 1964. In most instances, individual banks should do better—especially the larger ones—to offset the fact that some bona fide export credits to foreigners may be granted by banks that had no outstanding foreign credits at all last year.

This target must apply to all foreign credits—loans and investments, acceptances, and deposits. And the target must be aimed at by all banks. The institutions represented in this room account for most of the outstanding United States bank credit to foreigners, but of course we expect the smaller banks also to participate in this program.

This target will take care of any possible increase in bona fide export credits. The National Foreign Trade Council has estimated that United States exports in 1965 will be about 5 per cent higher than the rate for the fourth quarter of 1964. Hence, an increase in export credits by 5 per cent of the amount outstanding at the year end should cover the requirements of export expansion, assuming no change in the proportion of exports financed by credit. Thus, even if *all* credits granted by banks to foreigners were export credits, the 5 per cent target would still be realistic.

Actually, as you know, only a fraction of bank credits to foreigners are used to finance exports of United States goods and services. In the case of long-term credits, we know that this fraction is only around 15 per cent. In the case of acceptances, it is about 40 per cent. In the case of other short-term credits, it may well be less than in acceptances, but assuming for argument's sake that the fraction were equally high, this would mean that altogether only $3 billion of the total of $10 billion of bank credits to foreigners outstanding on December 31, 1964 was for the purpose of financing exports of United States goods and services. An increase of $500 million in such credits would thus finance an export expansion, not by 5 per cent, but by more than 15 per cent—an expansion that, unfortunately, is highly improbable.

And in fact, this calculation is still too conservative. All of your short-term credits and a substantial part of your long-term credits will be repaid in 1965. Assuming—quite conservatively—that only half of your total nonexport credits outstanding will fall due this year, an additional $3½ billion would become available this year to expand your export credits. Although it is unrealistic to expect that extensions or renewals of nonexport credits could be cut back to zero, in theory you could (within the Federal Reserve target) increase your export credits outstanding from $3 billion to $7 billion—enough to finance an export expansion of 133 per cent!

You will understand, therefore, that I do not intend to lose any sleep about the possibility that our target might prove to be too restrictive to permit the granting of all bona fide export credits. You will have plenty of opportunity to cut down your nonexport credits, if that should prove necessary in order to make room for any imaginable expansion of export credits. We recognize that in some cases this adjustment cannot be made overnight, especially if the credits granted or committed during the first six weeks of this year have already taken you over the target. But you should be able to get within the limit in a reasonably short period of time. In fact, you will probably be able to maintain your nonexport credits to foreigners at a level which will not impose a serious burden either on you or on your domestic or foreign customers, since the target level will be one-third higher than your outstanding credits were at the end of 1963.

Within the limits set, we must avoid creating more problems than we can solve. Hence, it is assumed that, while abiding by the target, you will exercise discretion in allocating loans. Since it would be in your own best interest, undoubtedly you will concentrate on credits that are exempt from the interest equalization tax. This would mean that in the medium- and long-term field you will give preference to the less developed nations. Moreover, again in your own interest as well as in that of the United States economy at large, you will presumably avoid any cutback that would inflict a serious burden on less developed countries, whose economic growth is especially in our national interest, or on such developed countries as Canada or Japan (both of which are heavily dependent on United States finance) and the United Kingdom (which, as we all know, is going through a difficult period in its own balance of payments). But again, I am sure this problem will hardly arise in practice since you will be able to stay within the target limit and still meet the real needs of these countries.

The 5 per cent target is simple and straightforward. It requires a minimum of interference with your operations and no elaborate machinery or detailed supervision. With the understanding that bona fide export financing is to be given priority and met adequately, and that serious cutbacks in other credits may need to be avoided for certain countries, within this 5 per cent target each bank would be free—subject only to any guidelines that may be developed—to use its resources as it thinks best.

We will need some informational reporting, mainly of a kind already supplied to the Treasury. Without adequate information, we could not spot points at which threats to the effectiveness of the program or problems of its equitable execution might arise; we could not gauge the success of the program and hence the possibility of relaxation; and we could not become aware that an uncooperative institution was taking advantage of the voluntary character of the program to compete unfairly with other banks. But let me emphasize that we have no desire to burden you with unnecessary reporting.

We are aware that a number of difficult problems are likely to arise in carrying out the program. For instance, relationships with your foreign branches will certainly pose complicated questions. Another major problem will be domestic credits which would affect the United States payments balance as much as credits to foreigners. I am thinking, for example, of credits to domestic borrowers that the borrower is going to use for financing operations abroad other than those directly connected with exports. Or some of your customers may be eager to increase the amount of their borrowings for export financing so as to free their own funds for uses inconsistent with our program. These are areas in which we will be working closely with you, and with the Department of Commerce in its efforts to limit foreign credits and investments of nonfinancial corporations.

In the case of the so-called Edge Act and Agreement corporations, the guiding principle, of course, is that banks with such subsidiaries be neither favored nor penalized in comparison with other banks. The most equitable solution, as a rule, seems to be to combine the parent bank and its subsidiaries for the purpose of calculating the 5 per cent target. Equity investments abroad, which are not available to banks without Edge Act subsidiaries, may require special treatment, but we are in a position to deal with that problem.

In connection with these investments and with banks' holdings of foreign securities or other foreign assets, problems may arise with respect to the disposition of those assets. It would obviously undermine the program if banks were to sell such assets domestically so as to free more of their own funds for investment abroad.

Transactions of banks for account of their customers and fiduciary accounts will also require attention.

I am sure that you will avoid encouraging customers to extend any credit to foreigners that you could not extend yourself within the target limits, and that you will avoid acting as brokers or intermediaries by diverting to them credits that you would normally finance out of your own funds in the usual course of business.

We will endeavor to develop, very soon, appropriate guidelines to deal with these and other problems. In doing so, we may request representatives of the banking community to serve on a small technical advisory committee to assist us. In any event—whether or not we issue guidelines or have an advisory committee—officers of our Reserve Banks will be in touch with you on an individual basis to assist in working out problems that you encounter.

As you know, this is not the only group that is being asked to make a strenuous voluntary effort to implement the President's program. You were joined at the White House today by representatives of leading business corporations that are being asked to make similar efforts. But the contribution that the banking system itself can make is crucial. And your economic interest in the success of the whole program and in the consequent continuing strength of the dollar is particularly strong.

The place of nonbank financial institutions in the President's program is somewhat different. To the best of my knowledge—which is admittedly imperfect in this field—most of these institutions have played a minor role in the recent expansion of credits to foreigners, although some of them have purchased large amounts of IET-exempt foreign bonds and also have placed part of their liquid funds abroad. What we must ask from them, at this time, is that their foreign credits and investments in 1965 also be kept within limits comparable to those we are suggesting for the banking community, and that no additional liquid funds be placed abroad.

Obviously, any potential foreign borrower whose credit application must be rejected by a commercial bank on account of the voluntary restraint program will be tempted to tap other credit sources. The pressure on investment houses, finance companies, insurance companies, and pension funds to extend foreign credits not subject to the IET —perhaps even credits that are—will no doubt increase considerably. Many if not most of these potential borrowers will be excellent risks and will offer excellent terms. It is asking a great deal when we request these institutions to resist the temptation. But, of course, we must do so. If such credits were granted, restraint by the banking system would be in vain. From the point of view of our payments balance, it makes no difference at all whether a credit to a foreigner is extended by a bank or by some other lender.

One problem involved in charting a course for nonbank financial institutions is the relative lack of data regarding their foreign lending. Only a few of them have undertaken transactions that are reportable on Treasury foreign exchange forms. We shall certainly have to request additional reports from these institutions.

Moreover, in the case of some nonbank institutions the problem of customer accounts will probably be even more troublesome than in the case of banks. And in the case of insurance companies, obvious exceptions must be made for foreign investments connected with foreign coverage requirements—exceptions that will have to be analogous to those made for the same reason in the IET legislation. But there is no denying that the Federal Reserve is far less conversant with the practices and problems of nonbank lenders than with those of banks. Hence, discussion of doubtful points with us in the System by the representatives of these financial institutions will be particularly important.

As you see, the success of this entire sector of the President's program depends on your acceptance, your dedication, and your unremitting effort to achieve its purpose. Given the present circumstances of our nation's economy —and the desire of all of us to avoid rigid controls—the Government believes that, in this area, it would be in the best interest of all to rely on voluntary restraint—rather than on laws and regulations—to reduce the outflow of dollars on capital account. With your cooperation, the country's balance of payments in 1965 can be leveled in the direction of full equilibrium. Your actions could have a decisive effect, and world confidence in the dollar would reflect it.

LETTER OF CHAIRMAN MARTIN TO THE NONBANK FINANCIAL ORGANIZATIONS

As you know, the President has launched a program designed to improve our international balance-of-payments position. An important element of the program is the President's request that banks, other financial institutions, and business corporations exercise all practicable restraint in their foreign lending and investment activities. The Department of Commerce has the responsibility for administering this voluntary program, so far as business corporations are concerned. And the Federal Reserve System, in cooperation with the Treasury, has been asked to carry the program to the financial institutions of the country. Governor J. L. Robertson is coordinating the System's activities in this matter here at the Board.

The purpose of my letter is to acquaint you with the tentative guidelines on foreign lending that we are proposing for 1965. These are detailed in the attached circular. In addition, within a few days you will receive a statistical questionnaire from the Federal Reserve Bank in your District designed to supply some bench-mark information on the extent of your foreign lending and investment activities, if any. This information will help us judge the appropriateness of our guideline objectives.

If you have questions concerning the actions that can be taken to effectuate the program, we urge you to contact the Federal Reserve Bank. Its officers will be glad to counsel with you. Your support in achieving the President's goal—one which is essential to the continued strength of the dollar at home and abroad—will be deeply appreciated.

Sincerely yours,

(Signed) WM. MCC. MARTIN, JR.

TENTATIVE GUIDELINES ON FOREIGN LENDING AND INVESTING NONBANK FINANCIAL INSTITUTIONS (PURSUANT TO THE PRESIDENT'S BALANCE-OF-PAYMENTS PROGRAM)

1. *Deposits and money market instruments.* Holdings of liquid funds abroad should be limited to the 1964 year-end total, and the longer term objective is to reduce such investments in a gradual and orderly manner to the December 31, 1963 level. Included in this category of liquid investments are dollar-denominated deposits held in foreign banks and foreign branches of United States banks; short-term securities of foreign governments and their instrumentalities; foreign commercial paper, finance company credits, and bankers' acceptances; and all other negotiable instruments maturing in one year or less. Foreign bank deposits denominated in local currencies may be maintained to the extent needed to support ordinary business operations in that country.

2. *Foreign credits with original maturities of five years or less.* Holdings of investments other than those listed above, and written to have final maturities in five years or less, should not be increased by more than 5 per cent during calendar 1965. Included in this category are securities, mortgage and other loans, and credits of all other types. The 5 per cent growth ceiling is to be measured against the total of all such holdings at the end of 1964, without regard to type of instrument or country of origin. Priority should be given to credits that directly finance United States exports, however, and special care should be taken to avoid the extension of credit to borrowers who would have been accommodated by commercial banks in the absence of the voluntary restraint program.

3. *Foreign credits with original maturities over five years.* In the area of long-term financing, there would seem to be no present need for a guideline under the voluntary restraint program. Developments in the long-term credit area will be followed closely, however, so that we may be alert to excessive foreign financing demands if they should materialize. The issues of industrialized countries are subject to the Interest Equalization Tax, and have been very small in volume since that tax became effective. Borrowing by the less developed countries has been relatively light also, and in any event should not be substantially restricted in view of our national policy encouraging productive investment in these countries. In the case of Canada and Japan, separate agreements will serve to limit aggregate financing in United States capital markets.

4. *Direct investment in foreign branches and subsidiaries.* Some types of financial institutions may conduct operations abroad through foreign offices, branches, and subsidiaries. In such cases, institutions are urged to limit their additional investment in these operations to the fullest extent practicable during 1965. Particular care should be taken to restrict any increase in net loans and advances outstanding to foreign branches and subsidiaries; ordinarily, expansion in such credit during 1965 should be held within 5 per cent.

In the case of insurance carriers doing business abroad, these guidelines are not applicable to holdings of foreign investments in amounts up to 110 per cent of foreign policy reserves.

Board of Governors,
Federal Reserve System.
March 3, 1965.