

# FEDERAL RESERVE BANK OF NEW YORK



## MONTHLY REVIEW

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## Treasury and Federal Reserve Foreign Exchange Operations \*

By CHARLES A. COOMBS

During the period covered by this report, March-August 1965, the exchange markets reflected not only the shifts taking place in underlying balance of payments positions, but more particularly the speculative pressures focusing on the pound. During the summer months, the market became increasingly skeptical of the outlook for sterling, largely discounting each new measure taken by the British Government to right its payments position and thus failing to reflect the over-all improvement that was gradually taking place. For the first eight months of this year, compared with the same period in 1964, British exports, for example, rose by about 6 per cent while imports grew by 1 per cent, cutting the trade deficit by well over a third. On the other hand, the turnabout in the United States balance of payments following introduction of the Voluntary Foreign Credit Restraint Program and other measures in February was so sharp as to have a major effect on the exchanges. Lingering doubts about the stability of the dollar evaporated, and the United States Treasury and Federal Reserve were able to make good progress in reducing the foreign currency commitments that had been undertaken the previous fall and winter when a massive United States deficit had coincided with the sterling crisis. To be sure, gold sales by the United States Treasury reached very high levels despite the striking improvement in the United States payments position. These sales, however, to a large extent resulted from the overhang of dollars that had accumulated in official reserves in earlier months, as well as the persistent surplus position of France whose gold pur-

chase policy has been widely publicized. Italy also continued to experience very large surpluses, but policies were adopted by the Italian authorities that minimized the impact of these surpluses on the exchanges and on official reserves.

It was against this background that the Federal Reserve swap network was further strengthened by increases in the swap arrangements with the Bank of Italy (from \$250 million to \$450 million), the Bank of Japan (from \$150 million to \$250 million), and the Bank for International Settlements (from \$150 million to \$300 million). The swap network now covers reciprocal credit lines totaling \$2.8 billion, as shown in Table I.

Table I  
FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS  
September 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 .....	450	12
Bank of Japan .....	250	12
Netherlands Bank .....	100	3
Bank of Sweden .....	50	12
Swiss National Bank .....	150	6
Bank for International Settlements .....	300	6
<b>Total swap facilities .....</b>	<b>2,800</b>	

\* This is the seventh in a series of reports by the Vice President in charge of the Foreign Department of the Federal Reserve Bank of New York and Special Manager, System Open Market Account. The Bank 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.

**Table II**  
**DRAWINGS AND REPAYMENTS BY FEDERAL RESERVE SYSTEM**  
**UNDER RECIPROCAL CURRENCY ARRANGEMENTS**  
**March 1962-August 1965**  
 In millions of dollars equivalent

Institution Year	Amount	Repaid within				Outstanding on August 31, 1965
		3 months	3-6 months	6-9 months	9-12 months	
<b>Austrian National Bank</b>						
1962 .....	50.0	50.0				
Total .....	50.0	50.0				—
<b>National Bank of Belgium*</b>						
1962 .....	30.5	30.5				
1963 .....	25.0	25.0				
1964 .....	145.0	62.5	37.5	45.0		
1965† .....	140.0	45.0	35.0	5.0		
Total .....	340.5	163.0	72.5	50.0		55.0‡
<b>Bank of Canada</b>						
1963 .....	20.0	20.0				
Total .....	20.0	20.0				—
<b>Bank of England</b>						
1962 .....	50.0	50.0				
1963 .....	35.0	35.0				
Total .....	85.0	85.0				—
<b>Bank of France</b>						
1962 .....	50.0		50.0			
1963 .....	21.5	21.5				
Total .....	71.5	21.5	50.0			—
<b>German Federal Bank</b>						
1963 .....	286.0	143.5	142.5			
1964 .....	105.0	105.0				
1965† .....	15.0	15.0				
Total .....	406.0	263.5	142.5			—
<b>Bank of Italy</b>						
1962 .....	50.0	50.0				
1965† .....	350.0	82.0	168.0			
Total .....	400.0	132.0	168.0			100.0‡
<b>Netherlands Bank</b>						
1962 .....	60.0	50.0	10.0			
1963 .....	150.0	60.0	90.0			
1964 .....	100.0		55.0	45.0		
1965† .....	25.0					
Total .....	335.0	110.0	155.0	45.0		25.0‡
<b>Swiss National Bank</b>						
1962 .....	50.0				50.0	
1963 .....	80.0	5.0	20.0	55.0		
1964 .....	25.0	25.0				
1965† .....	150.0	90.0	12.0			
Total .....	305.0	120.0	32.0	55.0	50.0	48.0§
<b>Bank for International Settlements</b>						
1962 .....	80.0	40.0	5.0	19.5	15.5	
1963 .....	150.0	5.0	65.0	80.0		
1964 .....	100.0		35.0	65.0		
Total .....	330.0	45.0	105.0	164.5	15.5	—
<b>All banks</b>						
1962 .....	420.5	270.5	65.0	19.5	65.5	
1963 .....	767.5	315.0	317.5	135.0		
1964 .....	475.0	192.5	127.5	155.0		
1965† .....	680.0	232.0	215.0	5.0		
Total .....	2,343.0	1,010.0	725.0	314.5	65.5	228

\* Data relate to disbursements and repayments under the \$50 million fully drawn portion of the swap facility and to utilization of the \$50 million standby portion available since December 1964.

† First eight months.

‡ Outstanding less than three months.

§ Outstanding more than six but less than nine months.

As noted in the previous report covering the period September 1964-February 1965, Federal Reserve drawings on the swap lines amounted to \$380 million equivalent at the end of February 1965. Subsequently, such drawings rose to a peak of \$585 million equivalent on April 6 but, by the end of July, all but \$48 million had been repaid. However, partly as a result of intensified pressures on sterling, new Federal Reserve drawings on the swap network became necessary in August, and as of September 17 the System was indebted under the swap lines to the extent of \$228 million, including \$100 million to the Bank of Italy, \$55 million to the National Bank of Belgium, \$48 million to the Swiss National Bank, and \$25 million to the Netherlands Bank.

During the period under review, the Bank of England was the only foreign central bank to draw on its swap facility with the Federal Reserve. Bank of England drawings had declined from a peak of \$700 million on November 27, 1964 to only \$105 million at the end of February 1965. Further drawings in March and April brought the net amount outstanding on May 25 to \$230 million, which was completely repaid on that date out of the proceeds of the \$1.4 billion equivalent British drawing on the International Monetary Fund (IMF). To offset speculative pressures developing during the summer months, the Bank of England made new drawings of \$360 million during June, and had further recourse to the swap line in July and August.

On September 10 the Bank of England announced that new facilities for support of sterling had been provided by the United States monetary authorities together with nearly all the other central banks that had joined in the November 1964 rescue operation. This new assistance came at a time when further corrective measures had just been announced by the British Government and growing confidence in sterling was evident in the market. Rather than representing a defensive measure taken at a time of pressure on sterling, the current arrangements permit acceleration of a favorable trend. They demonstrate the solidarity of the cooperative arrangements linking the major central banks and treasuries of the Free World. Within this defensive network any government which is fully prepared to defend its currency should be able to mobilize sufficient financial resources to beat off any speculative attack.

A comprehensive view of drawings and repayments under reciprocal currency arrangements between the Federal Reserve System and foreign monetary institutions from March 1962 through the summer months of 1965 is provided in Tables II and III. As indicated in Table II, nearly half of all Federal Reserve drawings of \$2.3 billion during the period was repaid within three months, and al-

**Table III**  
**DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS**  
**UNDER RECIPROCAL CURRENCY ARRANGEMENTS**

March 1962-June 1965

In millions of dollars equivalent

Institution Year	Amount	Repaid within		Outstanding on June 30, 1965
		3 months	3-6 months	
<b>National Bank of Belgium</b>				
1963 .....	45.0	40.0	5.0	
Total .....	45.0	40.0	5.0	—
<b>Bank of Canada</b>				
1962 .....	250.0		250.0	
Total .....	250.0		250.0	—
<b>Bank of England</b>				
1963 .....	25.0	25.0		
1964 .....	1,370.0	1,370.0		
1965* .....	1,215.0	855.0		
Total .....	2,610.0	2,250.0		360.0†
<b>Bank of Italy</b>				
1963 .....	50.0		50.0	
1964 .....	100.0		100.0	
Total .....	150.0		150.0	—
<b>Bank of Japan</b>				
1964 .....	80.0	30.0	50.0	
Total .....	80.0	30.0	50.0	—
<b>All banks</b>				
1962 .....	250.0		250.0	
1963 .....	120.0	65.0	55.0	
1964 .....	1,550.0	1,400.0	150.0	
1965* .....	1,215.0	855.0		
Total .....	3,135.0	2,320.0	455.0	360.0†

\* First half only.

† Outstanding less than three months.

most three quarters of such drawings were liquidated within six months. Similarly, nearly three quarters of foreign drawings of \$3.1 billion under the arrangements were paid off within three months, thus confirming that in practice the swap network has been used—as intended—as a means of providing temporary financing.

In addition to central bank swap transactions, the monetary authorities in a number of countries continued to refine and develop further the use of forward exchange operations as an efficient instrument for dealing with pressures in their markets. The Bank of England continued to exert a strong stabilizing effect on the dollar-sterling forward market, while temporary cushioning operations were also undertaken by the Swiss National Bank, the German Federal Bank, and the Netherlands Bank. In addition, forward operations by the Italian authorities had the effect of reducing Italian reserve gains, and of simultaneously preventing an excessive buildup of domestic liquidity in Italy by channeling dollar inflows back into the Euro-dollar market. Otherwise a severe squeeze on

Euro-dollar credit availabilities might have been produced by the United States Voluntary Foreign Credit Restraint Program. In connection with this operation, the United States Treasury once again undertook to share with the Italian authorities sizable commitments in forward lire, which will subsequently be reported in some detail.

The foreign currency bonds issued by the United States Treasury rose from a total of \$1,137 million as of early March to a new peak of \$1,259 million as of September 17. Additional issues of \$125 million were made to the Bank of Italy and \$23 million to the Bank for International Settlements (BIS) for purposes of absorbing dollars on the books of the Italian and Swiss central banks. On the other hand, as the German balance of payments moved into deficit, it proved possible for the United States Treasury to accumulate marks and, on July 12, \$25 million equivalent was employed to retire a maturing mark-denominated bond for that amount previously issued to the German Federal Bank.

Extensive use thus continued to be made by the United States and other major industrial countries of the spectrum of international credit facilities available for financing payments imbalances. One of the more significant developments during the period under review was the United States drawing from the IMF. This drawing, which provided medium-term financing, permitted repayment of earlier drawings under the swap network as well as the absorption of dollars temporarily accumulated by foreign central banks, thus economizing on the use of gold in international settlements.

#### STERLING

By mid-January 1965, sterling began to show signs of recovery from the speculative onslaught of late 1964, and this improvement continued through February. In March, however, the market once again became beset by doubts as to whether the British Government's pledge to defend the sterling parity would be matched by truly effective measures to curb excessive domestic demand and to restrain the inflationary trend of wage settlements. New complications arose as the United States Voluntary Foreign Credit Restraint Program led to some withdrawal of funds from London. Large forward commitments previously entered into by the Bank of England also began to mature, but firm defensive operations in both the spot and forward markets facilitated the rolling-over of most of these commitments. For those interested in the technical complexities of official intervention in the forward markets, a useful summary may be found in the Bank of England's *Quarterly Bulletin* for June 1965, pages 107-108.

With the announcement of new restraint measures in Chancellor Callaghan's budget message on April 6, sterling moved strongly upward and this trend was reinforced as the Bank of England on April 29 introduced special deposit requirements for the London clearing and Scottish banks and on May 5 requested the London clearing banks to limit the increase in their advances to the private sector to no more than 5 per cent during the year ending March 1966. The other banks operating in London and a wide range of other financial institutions were also asked to exercise comparable restraint. However, following the announcement in mid-May of disappointing trade figures for April, the sterling rate once more began to drift downward. The British drawing on May 25 of \$1.4 billion equivalent from the IMF and full repayment with the proceeds of \$1,097 million of short-term central bank credits did little to bolster market sentiment. On the contrary, publication of figures showing a continuing deterioration in the British trade position during the second quarter further undermined market confidence, and substantial support had to be given to both the spot and forward markets. By late July, the market had become convinced that a new crisis was shaping up for the autumn months. Against this ominous background, the British Government took further corrective action on July 27, announcing cut-backs and deferments in public sector spending programs and a further tightening of instalment credit.

Unfortunately, an initially favorable market reaction to the July 27 measures was quickly swamped by the report on August 3 of a reserve loss for July that was much larger than the market had anticipated. As a result, sterling was again heavily offered in both the spot and forward markets, requiring substantial official support. By mid-August, however, the market began to take on a more balanced look, no doubt reflecting in part the improved July trade figures but also suggesting that sterling had become grossly oversold. From time to time, the market gave clear evidence of a squeeze for sterling balances.

Against these mixed developments during August, the British Government on September 2 announced its intention to seek statutory authority to require advance notification and, if deemed appropriate, temporary deferment of wage and price increases. This basic policy action went a long way toward relieving the market's apprehension of a progressive undermining of the sterling parity by wage and price inflation. Meanwhile, negotiations were progressing among the central banks with the objective of providing additional facilities in order to further the recovery of confidence. On Friday, September 10, the Bank of England announced that these negotiations had been completed, stating that

There is increasing evidence that the measures taken by Her Majesty's Government to restore the United Kingdom balance of payments are having their effects. Sentiment towards sterling in the exchange markets is improving. To further this trend the Bank of England with the full authority of Her Majesty's Government has entered into new arrangements with the central banks of Austria, Belgium, Canada, Germany, Holland, Italy, Japan, Sweden, Switzerland, the United States, and the Bank for International Settlements who co-operated in the support of sterling last November.

These new arrangements take various forms and will enable appropriate action to be taken in the exchange markets with the full co-operation of the central banks concerned.

Immediately following this announcement concerted market action was initiated. As the spot rate for sterling moved up, short covering developed causing a further jump in the rate. The recent measures thus appeared to be yielding good results.

#### SWISS FRANC

In late 1964, the Swiss National Bank had taken in a sizable amount of dollars as funds moved into Switzerland during the sterling crisis. These dollars were partially absorbed by a Federal Reserve drawing of \$100 million equivalent in Swiss francs in December under the System's swap line with the BIS. Further Swiss franc drawings, amounting to \$60 million equivalent on January 19 and \$90 million equivalent on March 1, were made for the same purpose—this time under the swap line with the Swiss National Bank. Thus, by March 1, the System had utilized \$250 million of its \$300 million credit facilities in Swiss francs. In addition, further dollars were absorbed through Swiss purchases of gold from the United States Treasury totaling \$50 million during the first four months of the year.

The operations just mentioned, though carried out for the most part during the early months of 1965, were made necessary by the overhang of dollars accumulated by the Swiss National Bank during the latter part of 1964. In point of fact, the Swiss franc began to ease shortly after the year-end as Swiss banks, finding themselves liquid, started to place funds abroad, and the United States Treasury was able in February to purchase \$10 million equivalent of Swiss francs in order to reduce by that amount a \$25 million equivalent sterling-Swiss franc swap with the BIS. By March, the rate had moved below \$0.2300 and the Swiss National Bank sold dollars to the market for the first

time since 1962. Swiss commercial demand for dollars accentuated the effects of the continued ease in the money market, and this softness in the franc rate persisted through the early summer. Moreover, by the end of April, the Bank of Italy had fully repaid its \$100 million equivalent Swiss franc-lira swap with the Swiss National Bank initiated in June 1964. The Swiss National Bank thus found itself in need of dollars to cover its lira requirements for remittances by Italian workers in Switzerland. Under these circumstances, the United States authorities were able to acquire a total of \$175 million equivalent in Swiss francs during the period April-July, to some extent through market purchases but mainly through direct transactions with the Swiss National Bank. These acquisitions were used to reduce a variety of Swiss franc obligations of the System and the Treasury.

At the end of March a start was made on repayment of the System's Swiss franc drawings when \$20 million equivalent of francs was acquired from the Bank of England in connection with a credit to the latter by the Swiss National Bank. These francs, along with \$82 million equivalent purchased during subsequent months, were used to reduce the System's liability under its swap line with the Swiss National Bank from \$150 million to \$48 million equivalent. In addition, the System fully repaid its \$100 million drawing on the BIS, partly with francs acquired through spot purchases and partly with the proceeds of a \$40 million equivalent swap of German marks for Swiss francs with the BIS. (This latter transaction illustrated once again the flexibility of third-currency swaps, where available balances in one foreign currency can be used to acquire other needed currencies.)

Treasury commitments resulting from forward sales of Swiss francs in the Swiss market, which had been reduced from \$121 million to \$51.5 million equivalent during 1964, were paid down further by \$29 million equivalent to \$22.5 million equivalent by late June. In addition, System forward sales of Swiss francs were completely liquidated. These sales which had been initiated in December to calm the market and to encourage Swiss banks to invest abroad dollars they might otherwise have sold to the Swiss National Bank, reached a peak of \$32.5 million equivalent by January 8. (The bulk of these contracts were paid off by mid-February through spot purchases of Swiss francs.) Through all these operations, official United States commitments in Swiss francs were thus reduced by a total of \$233 million during January-July.

In June, the Swiss franc began to firm, rising to a range of \$0.2307-10, in conjunction with the approach of mid-year positioning by Swiss commercial banks. The usual pressures associated with such operations were absent this

year, however, as the Swiss authorities acted in both the money and foreign exchange markets to mitigate the seasonal liquidity squeeze. Swiss Confederation bonds falling due at the end of June were only partially refunded and the Swiss National Bank undertook substantial swap operations with Swiss commercial banks, buying United States dollars spot against Swiss francs and selling them back to the banks for delivery after midyear. Consequently, the Swiss franc remained below its effective ceiling during June, and United States authorities continued to acquire Swiss francs from the Swiss National Bank. Opportunities for further acquisitions diminished considerably after midyear, however, as the unwinding of the mid-year swaps brought about a tightening in the Swiss money market and the Swiss franc advanced to its effective ceiling. Under the circumstances, the Swiss National Bank decided to repurchase part of the foreign exchange that it had sold on a covered basis to Swiss commercial banks earlier in the year when the domestic market had been excessively liquid. The liquidity thus injected into the market by the reversal of these earlier swaps helped to reduce dollar repatriations by these banks.

Renewed nervousness about sterling in the exchanges held the franc at its ceiling until the latter part of August. Under the circumstances, the Swiss National Bank had to buy additional dollars in the market, and the United States authorities in turn absorbed part of this inflow by purchasing dollars from the central bank against Swiss francs. The francs needed for this operation were obtained by sale to the BIS on July 30 of a \$23 million equivalent fifteen-month Swiss franc-denominated United States Treasury bond. (This sale raised the Treasury's Swiss franc bond indebtedness to \$350 million equivalent.) As the period closed, renewed Swiss commercial demand for dollars and easier Swiss money market conditions brought about a moderate decline of the franc below its ceiling.

#### NETHERLANDS GUILDER

Official United States commitments in Netherlands guilders reached a peak of \$348 million equivalent on January 8 as a result of operations undertaken during August 1964-January 1965 when the basic Dutch payments position was strong and when, in addition, funds were moving into the Netherlands as a result of pressures on sterling. Thus, the \$100 million Federal Reserve swap facility with the Netherlands Bank had been fully utilized, a temporary \$35 million swap between the United States Treasury and the Netherlands Bank had been arranged, another \$50 million of guilders had been acquired through sterling-guilder swaps with the BIS for sale to the Nether-

lands Bank to absorb dollars, and \$163 million equivalent of guilders had been sold forward in the Netherlands market.

Early in January the \$35 million United States Treasury-Netherlands Bank temporary swap was liquidated as Federal Reserve and Treasury sales of forward guilders, initiated in mid-December, induced covered outflows of funds from the Netherlands by the Dutch commercial banks, thus facilitating the acquisition of spot guilders by the United States authorities. Commitments on these forward contracts through the market reached a peak of \$197 million equivalent on January 19, but by early February \$10 million of short-dated contracts had been paid off at maturity. Moreover, in the early part of February, the Federal Reserve started to repay its drawings under the swap arrangement, reducing the amount outstanding to \$70 million equivalent by the end of the month. However, major reductions in United States commitments had to wait until the early spring and summer months, when the Netherlands balance of payments was seasonally less strong and guilder purchases could be made in size. A Dutch payments deficit did begin to emerge in March, and by late July the United States authorities had acquired a sufficient amount of guilders, mainly through purchases from the Netherlands Bank as it sold dollars in its market, to reduce outstanding commitments by a total of \$225 million equivalent. These acquisitions were made despite the persistence of generally tight money market conditions in the Netherlands and occasional pressures arising from shifts of funds out of sterling. Thus, during March and April, the System purchased enough guilders from the Netherlands Bank to repay a further \$25 million equivalent of its swap drawings. The remaining \$45 million equivalent of drawings was paid off in late May with guilders acquired in conjunction with the United Kingdom drawing from the IMF.

In addition to reducing Federal Reserve swap drawings, the United States authorities paid off at maturity a total of \$68 million equivalent of forward contracts by late April. As the guilder continued on offer, another \$62 million equivalent was acquired by the Federal Reserve and the Treasury in June and July to repay forward contracts at maturity, thereby reducing the total outstanding to \$57 million equivalent. Some of these repayments, occurring as they did prior to midyear, helped relieve tight money market conditions in the Netherlands. In addition, in June the System and the Treasury liquidated a total of \$25 million equivalent of sterling-guilder swaps. Finally, the Netherlands Bank also undertook exchange transactions in July to alleviate the money market pressures generated by a seasonal increase in currency in circulation, buying dollars spot from the Dutch commercial banks and selling them back forward, mainly for one-month maturities.

Toward midsummer, renewed nervousness regarding sterling contributed to flows of funds into the Netherlands. These flows coincided more or less with the abatement of seasonal pressure on the Netherlands' payments position, and the Netherlands Bank consequently began to buy dollars to prevent too rapid a rise in the guilder rate. Its dollar acquisitions soon raised its total holdings above usual levels, and some absorption of the excess dollar holdings accordingly was called for. Consequently, the United States Treasury purchased \$25 million at the end of July with guilders drawn from the IMF under a \$300 million equivalent multicurrency drawing (see section on United States drawings on the International Monetary Fund), and in August the Federal Reserve reactivated its swap arrangement with the Netherlands Bank to the extent of \$25 million equivalent. By the end of August, buying pressure on the guilder diminished as the exchange markets calmed and the Dutch money market eased.

#### GERMAN MARK

In late December 1964, the Federal Reserve had drawn \$50 million equivalent under its \$250 million swap facility with the German Federal Bank to absorb dollars taken in by that bank at the time of the sterling crisis. This drawing was reversed in late January, 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 in February was likewise quickly reversed.

Beginning in May, the mark began to display an increasingly softer tone. For some time, German import demand had been outpacing export growth, with the result that the previously very sizable trade surplus that had helped to keep the mark close to its ceiling for nearly two years began to decline. Indeed, by June, the trade account had swung into deficit for the first time since 1958, and the mark was quoted below its par of \$0.2500 for the first time since February 1963. Apart from the sharp shift in the German trade account and the related change in the pattern of leads and lags, there were some indications that the United States Voluntary Foreign Credit Restraint Program had had some influence on capital movements, reinforcing the downward pressure on the mark rate. Under these conditions, first the Treasury and then the Federal Reserve began in June to purchase marks systematically, in the market as well as from the German Federal Bank, with a view toward employing the marks to liquidate other foreign currency commitments. Thus, the Federal Reserve purchased \$39 million of marks

in June and early July and on July 8 swapped \$40 million equivalent of marks for Swiss francs with the BIS in order to repay the remaining Federal Reserve Swiss franc commitment under the swap drawings from that institution. Additional marks were purchased by the Federal Reserve during July and August, part of which were used on two occasions to acquire a total of \$12.5 million equivalent of Dutch guilders through a third-currency swap with the BIS; an equivalent amount of sterling which had been previously swapped with the BIS for Dutch guilders was simultaneously reacquired.

For its part, the Treasury also employed mark acquisitions to modify its third-currency swaps with the BIS. In late July, the Treasury swapped with that institution \$15 million equivalent of marks for Swiss francs and \$5 million equivalent for Dutch guilders, and used the francs and guilders to liquidate equivalent outstanding sterling-Swiss franc and sterling-Dutch guilder swaps with the BIS. At the end of August, the Treasury swapped an additional \$7.5 million equivalent of marks for guilders with the BIS, similarly liquidating an equivalent sterling-guilder swap. Earlier, on July 12, the Treasury had redeemed at maturity a \$25 million equivalent mark-denominated bond. This represented the first reduction in the Treasury's mark-denominated bonds, which were first issued to the German Federal Bank in January 1963 and which reached a total last year of \$679 million equivalent.

#### BELGIAN FRANC

The diminished rate of growth of Belgian economic activity first evident in 1964 carried over into 1965 and contributed to a slowing-down in the rise of Belgian import demand. Belgium continued to run a surplus on its balance of payments during the first eight months of 1965, and with the Belgian franc generally at its ceiling Belgian official reserves increased by some \$47 million. In addition, Belgium's position in the IMF improved by \$108 million during the first seven months of the year.

At the end of 1964, System drawings under the \$100 million swap arrangement with the National Bank of Belgium amounted to \$45 million equivalent. Continued dollar inflows during January and February were partly absorbed through additional drawings of \$40 million equivalent, and in early March the Federal Reserve utilized the remaining \$15 million of its Belgian franc facility. In addition, the National Bank of Belgium purchased a total of \$62 million in gold from the United States Treasury during the first half of the year.

In the latter part of March, demand for dollars in Belgium enabled the System to acquire \$10 million of



Belgian francs and reduce its drawings by that amount. However, with the Belgian franc back at its ceiling in April, \$10 million was again drawn to absorb dollars from the National Bank of Belgium. The first major reduction in the Federal Reserve's Belgian franc commitments occurred in late May when the Federal Reserve purchased \$40 million equivalent of Belgian francs from the National Bank of Belgium, following a United Kingdom conversion into dollars of Belgian francs acquired under its \$1.4 billion multicurrency drawing from the IMF.

During July and August, there was a succession of drawings and repayments, reflecting in part temporary swings in Belgium's balance of payments position and in part special transactions. In early July, the System once again increased its drawings in Belgian francs—from \$60 million to \$80 million equivalent—before a temporary demand for dollars in Belgium enabled the Federal Reserve to buy the equivalent of \$40 million of Belgian francs from the National Bank of Belgium. In late July, the Federal Reserve liquidated its remaining uncovered Belgian franc position by purchasing from the United States Treasury \$40 million equivalent of Belgian francs which the Treasury had acquired under its \$300 million equivalent multicurrency drawing from the IMF. As indicated elsewhere, this operation represented the first funding of a System swap drawing through use by the United States of an IMF drawing. No sooner had the System reconstituted its franc position than dollars once again began to move into the reserves of the National Bank of Belgium on a substantial scale, mainly as a consequence of the renewed pressures on sterling, and the Federal Reserve during August utilized Belgian francs available under its swap facility with that bank to absorb a total of \$55 million.

#### ITALIAN LIRA

During 1965, the Italian balance of payments continued to show the effects of the stabilization measures introduced during the two preceding years to deal with the severe payments deficit that had emerged in 1963. In fact, during the first seven months of this year Italy had a balance of payments surplus of over three fourths of a billion dollars, attributable to record high earnings on invisibles and a much reduced trade deficit. With the Italian financial markets relatively easy as a result of lagging internal demand and a consciously stimulative monetary policy, Italian banks purchased sizable amounts of foreign exchange from the Italian authorities on a swap basis and used the funds to reduce their indebtedness in the Euro-dollar market as well as to finance external trade. Nevertheless, Italian reserves increased, particularly

during the summer months when seasonal factors are favorable to Italy. Under the circumstances, the United States authorities employed a variety of techniques to absorb official Italian holdings of dollars.

The Federal Reserve reactivated its \$250 million swap arrangement with the Bank of Italy on January 22 by drawing \$50 million equivalent in lire and selling the proceeds to that bank for dollars. An additional drawing of \$50 million equivalent was made in March. With \$100 million of the \$250 million swap line already utilized and with the prospect of further increases of Italian holdings over the seasonally strong summer months, it was thought desirable to increase the size of the System's swap facility with the Bank of Italy. Thus, on April 1, it was announced that the arrangement had been expanded to \$450 million, and a further \$100 million was immediately drawn. (Of the \$200 million increase in the swap line, \$100 million replaced a standby swap facility for a like amount made available to Italy by the United States Treasury in March 1964 as part of a \$1 billion credit package.) In May, the System increased its swap drawings by another \$50 million equivalent in order to absorb additional dollars from the Bank of Italy.

As reported in previous articles, the United States Treasury in January 1962 had undertaken to share with the Bank of Italy contracts to purchase forward dollars which that institution had entered into with the Italian commercial banks in order to encourage a re-export of dollars during a period of heavy balance of payments surpluses. The last of these contracts had been reacquired by the Italian authorities in March 1964, thus fully liquidating the Treasury's forward lira commitments. In view of the reappearance of substantial Italian payments surpluses, the United States Treasury in 1965 began once again to share contracts to purchase forward dollars with the Bank of Italy. In addition, the Treasury sold to the Bank of Italy \$80 million of gold in April, thus absorbing a further part of the dollar inflow and reconstituting part of the gold which Italy had sold to the United States the preceding year.

An opportunity to begin reducing the Federal Reserve's swap drawings became available in late May when the United Kingdom drew \$82 million equivalent of lire from the IMF and sold them to the Federal Reserve, thus permitting the System to reduce its swap drawings by that amount on May 25. A similar operation in connection with a subsequent drawing of lire from the Fund by another member enabled the System to make an additional repayment of \$5 million on July 2. However, as sizable Italian balance of payments surpluses continued, it seemed appropriate to fund the drawings still outstanding. Accordingly, in July the United States drew \$180 million

equivalent of lire as part of its \$300 million multicurrency drawing from the IMF (see section on United States drawings on the International Monetary Fund). Of this amount, \$163 million equivalent was employed to liquidate outstanding Federal Reserve swap drawings and the balance to absorb uncovered dollars from the Bank of Italy. Another \$125 million was purchased from the Bank of Italy with proceeds from an eighteen-month lira-denominated bond which the Treasury issued to the Bank of Italy. In August, inflows partly associated with continuing pressures on sterling caused the Federal Reserve to reactivate its swap facility with the Bank of Italy by drawing \$100 million of lire in order to absorb an equivalent amount of dollars.

#### CANADIAN DOLLAR

Canada's strong balance of payments performance in late 1964, sustained in part by long-term borrowing in the United States and repatriation of funds from the United Kingdom, gave way to a deficit early in 1965, and by March the spot Canadian dollar had fallen below par. This turnabout was in part related to seasonal factors and to a sharp deterioration in Canada's trade account. The United States Voluntary Foreign Credit Restraint Program left untouched essential long-term capital flows to Canada but did have the initial effect of inducing United States corporations to repatriate an important amount of previous short-term investments in Canada. The great bulk of their withdrawal of short-term funds was apparently met by reduced placement of funds by Canadian banks in New York or other foreign markets and, therefore, had little impact on Canadian reserves.

As a result of a deterioration in the trade and capital accounts, Canadian reserves dipped \$120 million during the first quarter of 1965. However, during the second quarter if allowance is made for Canada's participation in the United Kingdom's IMF drawing, the net effect of which was to reduce Canadian reserves by \$72.5 million in May, Canadian reserves remained steady on balance, helped by Canadian bond sales in the United States during April and May. (The British IMF drawing, together with net use of Canadian dollars by other IMF members brought about an improvement in Canada's Fund position of \$129 million during the first six months of the year, thus compensating for a good part of the reserve drain during this period.)

Around midyear, demand for Canadian dollars once again subsided and the spot rate gradually declined to its low for the period by mid-July, before turning around once again. The renewed firmness in the Canadian dollar

appeared linked primarily to the flotation of further bond issues in the United States and the successful negotiations for substantial Russian purchases of Canadian wheat and flour announced in mid-August. Grain houses, anticipating future United States dollar receipts from Russia, purchased Canadian dollars forward. In the spot market, the rate advanced to well above par as banks purchased Canadian dollars spot to cover forward commitments to the grain houses, and commercial interests moved into the market in anticipation of a further strengthening in the rate.

During the period under review, no official United States operations in Canadian dollars were undertaken.

#### OTHER CURRENCIES

**JAPANESE YEN.** The series of measures aimed at restraining domestic demand that were initiated by the Japanese authorities as early as October 1963 led to a noticeable improvement in Japan's trade position beginning in the latter part of 1964. While import demand this year has remained fairly steady at a high level, exports have set new records. This improved trade performance has largely offset the effects on Japan's reserves of diminished inflows of foreign capital, and has permitted the reversal of previous restrictive measures.

On April 1 the Federal Reserve and the Bank of Japan agreed to increase their reciprocal swap arrangement from \$150 million to \$250 million. In view of the above-mentioned balance of payments developments, no recourse to the swap facility has been necessary during the period under review.

**FRENCH FRANC.** France continued to register a substantial balance of payments surplus during the first eight months of 1965 under the influence of a strong export performance and lagging import demand. This development in the trade account reflected, to a considerable extent, the reduced rate of domestic economic expansion associated with the official stabilization program. Official French reserves rose \$241 million during this period notwithstanding a debt prepayment of \$179 million to the United States in July. (In addition, the French position in the IMF improved by \$247 million during the same period.) Most of the dollar gains were used to purchase gold from the United States Treasury. Moreover, substantial amounts of dollars acquired prior to 1965 also were converted into gold. Total French gold purchases consequently constituted the largest single element in United States gold sales to foreign countries during the first half of the year, accounting for a little over one half of total sales. In August, the United States Treasury used the francs obtained from

its \$300 million equivalent multicurrency drawing from the IMF to purchase \$40 million from the Bank of France, thus reducing French dollar reserves by that amount.

**AUSTRIAN SCHILLING.** As reported in the March 1965 *Monthly Review*, the Treasury on February 23 and March 3 issued to the Austrian National Bank two \$25 million equivalent eighteen-month bonds denominated in Austrian schillings, and used the proceeds to absorb some of that bank's dollar holdings. Following these transactions, total Treasury bond indebtedness denominated in Austrian schillings amounted to \$100 million equivalent.

**SWEDISH KRONA.** On July 30, the United States Treasury used kronor obtained from its \$300 million equivalent multicurrency drawing from the IMF to purchase \$15 million from the Bank of Sweden.

#### **UNITED STATES DRAWINGS ON THE INTERNATIONAL MONETARY FUND**

Over the course of several years prior to 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 Fund'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 Fund, under its rules, could no longer accept dollars in repurchase, and countries making repurchases could do so only with other eligible convertible currencies or with gold. In order to be able to sell eligible currencies to countries making repurchases, the United States Treasury has itself drawn such currencies from the IMF on a number of occasions beginning in February 1964. By the end of 1964, the Treasury had made five drawings totaling \$525 million equivalent in seven continental European currencies. A sixth drawing of this type in the amount of \$75 million equivalent (\$25

million each in Canadian dollars, German marks, and Italian lire) was made on March 22. As in the case of previous drawings, the bulk of the currencies drawn was sold to countries making repurchases during the ensuing months. No further drawings for the technical purposes described above were made by the United States through the month of August.

As indicated elsewhere, dollars continued to accumulate in the official reserves of certain European countries during the first half of the year. Some of these dollars were temporarily absorbed by use of the Federal Reserve short-term swap arrangements. Since in certain cases there subsequently appeared to be little near-term prospect for any reversal in these dollar inflows, the United States authorities decided to draw on the Fund to acquire foreign exchange on a medium-term basis for use in paying off some of the short-term credits, and otherwise to reduce official holdings of dollars abroad by purchasing dollars with the currencies drawn. In this drawing on July 30, the first occasion on which the United States had made an ordinary, nontechnical drawing on the IMF, the Treasury acquired \$300 million equivalent of five European currencies: Italian lire, \$180 million; French francs, \$40 million; Belgian francs, \$40 million; Netherlands guilders, \$25 million; and Swedish kronor, \$15 million. As detailed elsewhere in this report, the Belgian francs and the bulk of the Italian lire were used to liquidate in full the Federal Reserve swap drawings in the respective currencies. The French francs, Netherlands guilders, Swedish kronor, and remaining lire were used to absorb dollars from the respective central banks.

The United States has thus drawn a total of \$900 million equivalent in foreign currencies from the IMF during the last two years. During the same period, other Fund operations in dollars resulted in net disbursements of \$508 million; consequently the United States repurchase obligation to the IMF as of the end of August was only \$392 million.

### The Business Situation

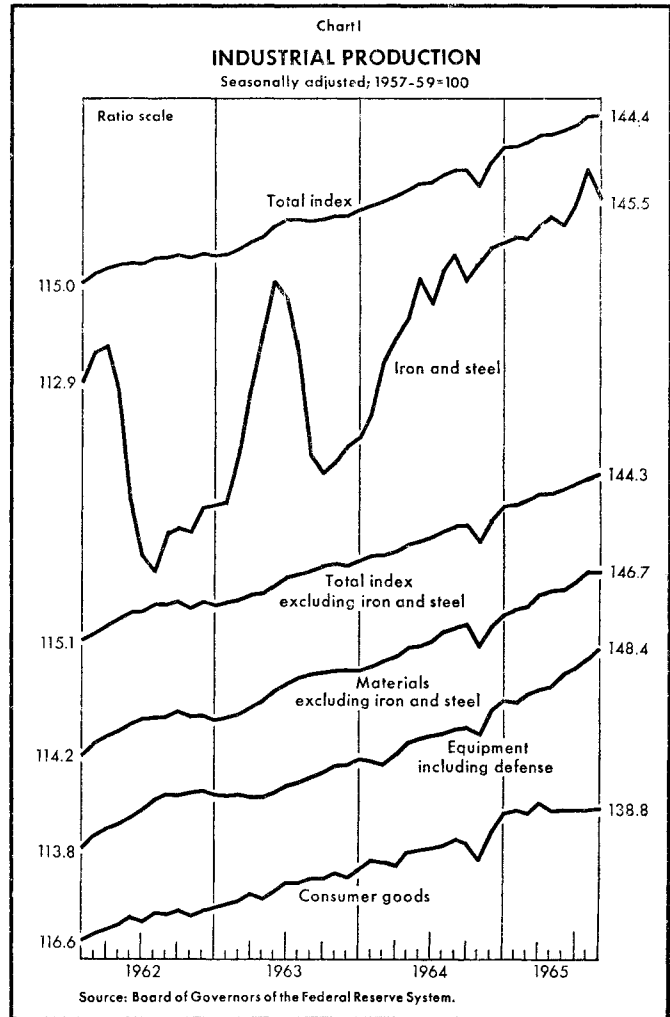
The economy has been spared the serious dislocations that would surely have stemmed from an extended steel strike. Nevertheless, the rate of economic expansion will clearly be influenced during the remainder of the year by readjustments in steel inventories and steel production. Early indications are that the readjustment has been moderate to date, and may possibly be milder than many observers had previously anticipated. While it must be expected that liquidation of steel inventories will continue for a time to have some slowing effect on industrial production and manufacturing employment, the dampening impact on the expansion of over-all demand should be readily absorbed by sustained strength in various other sectors. The prospects for consumer purchases and business capital spending remain favorable. Furthermore, recent defense and other Federal budgetary developments suggest that the net impact of Federal Government spending policies during the balance of the current fiscal year may turn out to be considerably more stimulative than earlier estimates had indicated.

Basically, the economy continues to be characterized by considerable strength in current and expected demand, and the margin of unutilized resources has shrunk substantially over the past year. The danger of upward pressure on prices therefore is real, although there has recently been an encouraging slowdown in the advance of the broad price indexes.

#### PRODUCTION, ORDERS, AND EMPLOYMENT

Industrial output edged up a bit further in August and pushed the Federal Reserve Board's seasonally adjusted production index to a record 144.4 per cent of the 1957-59 average, up by 0.2 percentage point from the upward-revised July level (see Chart I). The advance occurred despite a 4 per cent drop in the seasonally adjusted output of iron and steel, as this decline was more than offset by a moderate rise in the production of other industrial materials and by a sizable expansion in the output of business equipment, especially machinery. The continuing

uptrend of equipment production is in large measure a reflection of the sustained expansion of business capital spending. Since the start of the year, there has also been an upward push on industrial production from enlarged output of defense equipment, following a decline in 1964



and virtual stability in the two preceding years.

Consumer goods output, the remaining major component of the over-all industrial production index, was about unchanged in August at the advanced level that has prevailed since the recovery early this year after last fall's auto strikes. Actual production of automobiles in both August and September was, of course, affected by assembly line shutdowns for the annual model changeover. Although it is difficult to make an accurate assessment of the seasonally adjusted production rate during the changeover period, it appears that the rate in both months was about unchanged from the July level of 9.4 million units annually.

The expected reduction in steel inventories is currently under way, and resultant declines in the output of ingots and of finished steel will most likely persist for a while. Ingot production alone moved off in September by 10 to 15 per cent (seasonally adjusted). However, mills report that orders volume has held up better than had been expected, with new orders continuing to exceed cancellations. The consensus in the trade appears to be that the level of "excess" inventory is smaller than had generally been estimated so that the production decline may be less severe than the cutbacks following some of the industry's earlier labor settlements. Underlying these optimistic appraisals is the fact that steel consumption is high and expected by many to grow further.

The pace of steel ordering was already slowing in August, as the approach of the strike deadline reduced the time available for deliveries prior to the threatened work stoppage. The decline in steel orders was a major factor contributing to a contraction in new orders for durable goods, which dropped by 3 per cent from July's upward-revised record. The steel industry also reported a sharp reduction in its backlog of unfilled orders, but the over-all backlog on the books of durables producers nevertheless expanded fractionally to mark the twentieth consecutive month of growth.

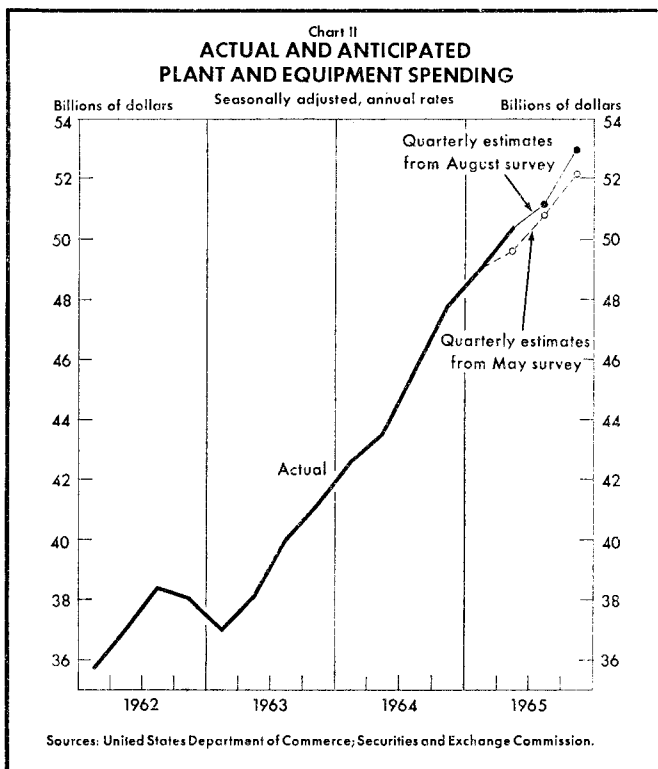
Nonfarm employment rose again in August, lifting the total number of persons on nonagricultural payrolls to 60.7 million (seasonally adjusted), up by 120,000 from July. Gains were experienced by all major industries except mining, but manufacturing employment advanced only fractionally as a modest rise in the nondurables sector was nearly offset by a small employment decline in the durables sector. However, the average weekly hours clocked by manufacturing production workers and their average overtime were both unchanged at the relatively high July levels. Indeed, a number of manufacturers, especially in the metal-working industries, reportedly continue to find that shortages of skilled labor necessitate the substantial use of overtime.

#### BUSINESS AND CONSUMER SPENDING

Further strength has developed in business capital spending plans for 1965 as a whole, according to the latest Commerce Department-Securities and Exchange Commission quarterly survey taken in August (see Chart II). Businessmen reported that outlays for new plant and equipment in the second quarter were \$750 million greater (at a seasonally adjusted annual rate) than had been estimated in May, and that plans for third- and fourth-quarter spending had been scaled up since May. If the plans reported in August are realized, outlays this year will total almost \$51 billion—an advance of 13.4 per cent. Previous surveys in February and May had estimated the 1965 gain at 11.7 per cent and 12.3 per cent, respectively. Thus far in 1965, there has been a pattern of gradual upward revisions in capital spending plans rather similar to that of 1964, when the year's final outcome was an increase larger than had been indicated even as late as the August survey. If the trend of upward revision again persists into the final quarter, this year's gain in spending may well approximate last year's increase of 14.5 per cent. Revisions for most industry groupings followed the over-all pattern, but were relatively large in the nonrail transportation, paper manufacturing, and motor vehicle industries. The automobile manufacturers, after upping capital expenditures by 42 per cent in 1964, foresaw in February a gain of 10½ per cent for this year; by May the figure had been pushed up to 25 per cent, and in August it reached 31 per cent.

The prospects are good that strength in actual capital spending will persist well into 1966. A recent National Industrial Conference Board survey indicates that manufacturers' capital appropriations continued to rise through the third quarter and that, despite the growth of outlays, backlogs of unspent appropriations are still expanding. The Conference Board has also reported that nearly 75 per cent of manufacturers expect to need additional capacity to meet demand a year from now. In fact, of the group so reporting, almost half find that capacity is inadequate at the present time.

Another midsummer survey, taken by the Commerce Department, found manufacturers optimistic regarding sales prospects. Sales gains in the neighborhood of 2 per cent each were generally expected for the third and fourth quarters. The survey results also pointed to generally favorable prospects for inventory demand by manufacturers. Manufacturers expected the rate of inventory accumulation to be slower in the fourth quarter, after a third quarter believed likely to equal the second-quarter pace. Nondurables manufacturers looked for modest step-



ups in the pace of accumulation in both the third and fourth quarters; the accumulation rate in the durables sector, on the other hand, was expected to slow down in both quarters.

The over-all rate of manufacturers' inventory investment rose sharply in the fourth quarter of 1964, reflecting partly the onset of steel stockpiling and partly a catching-up in nondurables stocks following a net decumulation over the first nine months of the year. In 1965, the actual accumulation rate in the first two quarters and that anticipated for the third quarter remained higher than in most quarters of recent years. The anticipated fourth-quarter slowdown in the pace of inventory accumulation reflects the expected swing to decumulation of steel stocks, which would be only partly offset by additions to other durables stocks and by the step-up in nondurables accumulation. Thereafter, the behavior of over-all inventory investment in manufacturing may gradually become free of the special effects of steel inventories.

Commercial and industrial construction has been advancing in recent months, reflecting the strength of capital spending. Residential construction, on the other hand, has remained a relatively weak sector in a generally strong business picture, and housing starts declined in both July

and August. Despite a modest upturn during the spring, the seasonally adjusted annual rate of starts for the first eight months of 1965 has averaged only 1.47 million units, off by 4 per cent from the 1964 total of 1.53 million.

In contrast to the sluggishness of housing demand, retail sales continue strong and sales volume in August was about equal to the record high reached in July. Retailers are reported to be experiencing a good fall upswing, and weekly data suggest that sales volume (seasonally adjusted) may have expanded a bit in September. As auto dealers carried out an apparently successful cleanup of the 1965 models, sales of new domestically produced cars ran at a seasonally adjusted annual rate of 8.9 million units in August and probably declined in September toward the end of the cleanup period. The new models are being introduced during the first two weeks of October, and their reception by consumers will, of course, have an important effect not only on the auto industry but also on the economy at large. Manufacturers remain confident of another good year with their 1966 models.

#### WAGE AND PRICE DEVELOPMENTS

The support gained for the principle of noninflationary wage behavior through a steel settlement approximately within the Administration's guideposts is a welcome development. However, over the year preceding the steel settlement, labor contracts clearly in excess of the guideposts were negotiated in a number of other major industries. Labor costs per unit of manufacturing output, after showing a gratifying downtrend during the earlier years of the current business expansion, have been virtually stable since last winter as productivity gains have no more than offset the rise in hourly labor costs.

There was no increase in the over-all wholesale price index in August—the first month without an increase in 1965—as a small decline in agricultural prices from the seven-year peak reached in July offset a slight further rise in prices of industrial commodities. Much of the 2.6 per cent advance in the over-all index in the twelve months ended with August reflected the run-up in agricultural prices in the first half of 1965. The combined price index for farm products and processed foods moved down last fall but then shot up by 6.7 per cent from December to July; the August-to-August advance was 5.7 per cent. This marked rise was mainly attributable to tight supply conditions: shortages of fruits and vegetables resulted from poor weather and harvesting delays, while marketings of hogs and cattle were curtailed as a result of stockmen's reactions to the low prices that prevailed in 1963 and 1964. However, supplies have recently expanded, and

weekly data indicate that agricultural prices may have declined slightly further in September.

Agricultural prices were not solely responsible for the upward movement of the wholesale price index through July. The index of industrial commodity prices in August was 1.5 per cent above its year-earlier level, although the uptrend in these prices appears to have slowed in recent months. The advance has been especially pronounced in metals and metal products, but most other major commodities have also moved higher. Although weekly data suggest that industrial prices may have been fairly stable again in September, it remains to be seen whether this favorable situation will persist. The prices of many industrial products are affected by world market developments in raw materials supplies, as well as by producers' attempts to offset rising costs and to widen profit margins during periods of strong demand. Specific industrial price announcements have recently been preponderantly on the upward side.

The over-all index of consumer prices fell in August for the first time in a year, but the decline was no larger than the expected seasonal movement. On a seasonally adjusted basis, therefore, the index was unchanged. The August decline in the unadjusted index was largely the result of reductions in consumer food prices, especially for produce. The previous sharp advance in food prices during the spring and summer was a major factor in the 1.7 per cent advance of the over-all index from August 1964 to August 1965—an annual rate of increase somewhat larger than has generally been experienced in recent years. The level of nonfood commodity prices did rise noticeably in the winter and spring, but then declined through the summer. However, this recent decline was

partly attributable to the excise tax cuts, from which little if any further moderating effect can be expected. The long-term upward trend in the price of services has continued throughout the past year at about the previous rate.

#### TRADING IN FEDERAL FUNDS

The Board of Governors of the Federal Reserve System has just published its second technical study on the Federal funds market, entitled "Trading in Federal Funds—Findings of a Three-Year Survey", prepared by Dorothy M. Nichols of the Federal Reserve Bank of Chicago. The 116-page report focuses on variations in the size and distribution of flows of Federal funds. It also shows the continued growth in the importance of these transactions in the money market. The survey on which the study is based included nearly 250 banks throughout the country. They supplied the System with data on daily transactions in Federal funds for the three years ended in September 1962.

Copies of the study are available, upon request, from Publications Services, Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at \$1.00 each up to 10 copies and 85 cents each for 10 or more copies in a single shipment.

## The Money and Bond Markets in September

The money market was generally firm during the month, but the large credit demands around the mid-September corporate dividend and tax payments dates led to increased pressure on the money market in the last half of the month. Treasury bill rates generally rose 13 to 24 basis points over the month, with the upward movement gaining momentum after midmonth as dealers aggressively sought to lighten positions in the face of higher financing costs and in anticipation of the Treasury's issuance of additional bills to meet its fall cash needs. Other money market rates also rose, including those on certificates of deposit and sales finance company paper.

An atmosphere of caution continued to characterize the markets for Treasury notes and bonds during September as well as the markets for corporate and tax-exempt bonds. Prices of Treasury bonds were adversely influenced by the prospects of further strong economic advance, the heavy credit demands experienced by the banks and in the capital markets, and the relatively wide yield spread in favor of corporate bonds. Both the corporate and tax-exempt bond markets also continued under pressure during most of the month, as the volume of new issues coming into the market remained substantial. A steadier tone temporarily emerged around midmonth in the corporate market after the quick sale of a large telephone company issue and the subsequent distribution of several issues that had been moving slowly, but then market prices again edged lower. The tax-exempt market remained under pressure throughout the month, with investors responding unenthusiastically to the large volume of new issues.

### THE MONEY MARKET AND BANK RESERVES

The money market remained quite firm during the month while accommodating the heavy demands placed on the short-term credit market around the corporate tax and dividend dates. Federal funds traded predominantly at  $4\frac{1}{8}$  per cent on nearly every day, although trading at  $4\frac{1}{4}$  per cent increased after midmonth. Aggregate reserve availability on average was about unchanged, but the money market banks were under greater reserve pressure

on average than in the previous month. These banks, however, were able to meet the bulk of their increased reserve needs in the Federal funds market, except in the period just after the midmonth tax payments when mounting reserve pressures led to a rise in member bank borrowings at the Federal Reserve Banks.

Rates posted by the major New York City banks on new call loans were mostly in a  $4\frac{1}{4}$  to  $4\frac{1}{2}$  per cent range in the first half of the month, but rose into the  $4\frac{3}{8}$  to  $4\frac{5}{8}$  per cent range thereafter (see the left-hand panel of Chart I on page 216). Rates on several other short-term instruments also rose during the period, as corporations reduced their liquid assets to make dividend and tax payments. Both the rates posted by the major New York City banks on new time certificates of deposit and the rates on prime certificates trading in the secondary market moved higher. The major sales finance companies also raised their rates on 60- to 89-day paper by  $\frac{1}{8}$  of a percentage point at midmonth and subsequently raised their rates on 30- to 59-day paper by the same amount.

The money market was temporarily well supplied with funds as the month opened, reflecting the high level of member bank excess reserves built up through heavy borrowings earlier in the September 1 statement week. A steadily firm tone returned to the market in the first full statement week of the month, but no unusual pressures developed over the Labor Day weekend as System open market operations provided reserves in volume to counter the substantial drains that stemmed from an increase in currency outside banks over that weekend (see Table I). Banks in the money centers outside New York, however, came under sharply increased pressure during the week and were large purchasers of Federal funds. The major New York City banks were net sellers of funds to other banks as their basic reserve positions improved following a sharp reduction in loans to Government securities dealers (see Table II), while "country" banks maintained relatively low excess reserve balances in the first week of their new settlement period.

The money market banks encountered increased reserve pressures over the two-week period surrounding the cor-



Table I

FACTORS TENDING TO INCREASE OR DECREASE  
MEMBER BANK RESERVES, SEPTEMBER 1965In millions of dollars; (+) denotes increase,  
(-) decrease in excess reserves

Factors	Changes in daily averages— week ended					Net changes
	Sept. 1	Sept. 8	Sept. 15	Sept. 22	Sept. 29	
	<b>"Market" factors</b>					
Member bank required reserves*	- 30	+ 105	- 79	- 559	+ 94	- 469
Operating transactions (subtotal)	+ 33	- 45†	+ 515	+ 839	- 491	+ 442
Federal Reserve float	- 265	+ 125	+ 269	+ 718	- 641	+ 206
Treasury operations†	- 21	+ 69	- 83	- 39	+ 67	- 7
Gold and foreign account..	- 22	- 3	+ 30	+ 26	- 12	+ 19
Currency outside banks*	+ 162	- 651	+ 233	+ 58	+ 89	- 109
Other Federal Reserve accounts (net)‡	+ 181	+ 7	+ 65	+ 76	+ 6	+ 335
<b>Total "market" factors</b>	<b>+ 3</b>	<b>- 349</b>	<b>+ 436</b>	<b>+ 280</b>	<b>- 397</b>	<b>- 27</b>
<b>Direct Federal Reserve credit transactions</b>						
<b>Open market instruments</b>						
<b>Outright holdings:</b>						
Government securities	+ 103	+ 265	- 251	- 467	+ 453	+ 103
Bankers' acceptances	-	-	- 1	-	+ 1	-
<b>Repurchase agreements:</b>						
Government securities	- 85	+ 63	- 141	+ 87	- 87	- 163
Bankers' acceptances	+ 19	+ 16	- 35	-	+ 10	+ 10
Member bank borrowings	- 9	- 54	+ 75	+ 69	- 74	+ 7
Other loans, discounts, and advances	- 1	-	+ 6	+ 2	- 2	+ 5
<b>Total</b>	<b>+ 26</b>	<b>+ 291</b>	<b>- 347</b>	<b>- 308</b>	<b>+ 301</b>	<b>- 37</b>
<b>Excess reserves*</b>	<b>+ 29</b>	<b>- 58</b>	<b>+ 89</b>	<b>- 28</b>	<b>- 96</b>	<b>- 64</b>

Member bank:	Daily average levels					
	Sept. 1	Sept. 8	Sept. 15	Sept. 22	Sept. 29	
Total reserves, including vault cash*	21,578	21,415	21,583	22,114	21,024	21,723§
Required reserves*	21,145	21,040	21,119	21,678	21,584	21,313§
Excess reserves*	433	375	464	436	340	410§
Borrowings	537	483	558	627	553	552§
Free reserves*	- 104	- 108	- 94	- 191	- 213	- 142§
Nonborrowed reserves*	21,041	20,932	21,025	21,487	21,371	21,171§

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					
	Sept. 1	Sept. 8	Sept. 15	Sept. 22	Sept. 29	
	Less than one year	- 269	+ 66	- 248	- 349	
More than one year	+ 68	+ 151	-	-	-	+ 219
<b>Total</b>	<b>- 201</b>	<b>+ 217</b>	<b>- 248</b>	<b>- 349</b>	<b>+ 950</b>	<b>+ 369</b>

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

\* These figures are estimated.

† Includes changes in Treasury currency and cash.

‡ Includes assets denominated in foreign currencies.

§ Average for five weeks ended September 29.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS  
SEPTEMBER 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages week ended					Average of five weeks ended Sept. 29*
	Sept. 1	Sept. 8	Sept. 15	Sept. 22	Sept. 29	
<b>Eight banks in New York City</b>						
Reserve excess or deficiency(-)†	78	5	49	4	57	39
Less borrowings from Reserve Banks	81	43	29	161	3	63
Less net interbank Federal funds purchases or sales(-)	196	- 15	395	518	70	233
Gross purchases	798	741	1,000	935	696	834
Gross sales	602	756	605	418	626	601
Equals net basic reserve surplus or deficit(-)	- 199	- 23	- 375	- 674	- 16	- 257
Net loans to Government securities dealers	560	337	608	606	443	511

## Thirty-eight banks outside New York City

Reserve excess or deficiency(-)†	30	32	39	4	29	27
Less borrowings from Reserve Banks	167	168	209	237	235	203
Less net interbank Federal funds purchases or sales(-)	306	641	783	833	712	655
Gross purchases	1,120	1,326	1,442	1,263	1,291	1,288
Gross sales	814	685	659	430	577	633
Equals net basic reserve surplus or deficit(-)	- 443	- 778	- 953	- 1,065	- 918	- 831
Net loans to Government securities dealers	224	154	85	195	97	151

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

\* 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.

Table III  
AVERAGE ISSUING RATES\*  
AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—September 1965			
	Sept. 3	Sept. 13	Sept. 20	Sept. 27
Three-month	3.898	3.887	3.905	3.983
Six-month	4.024	4.031	4.069	4.133
<b>Monthly auction dates—July-September 1965</b>				
	July 27	Aug. 24	Sept. 24	
One-year	3.875	4.006	4.236	

\* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

porate tax date. Corporations paid an estimated \$4.1 billion in taxes during the month, chiefly on September 15, while the corporate dividend payments for the month were centered around September 10. Corporations relied somewhat less heavily than in 1964 on the runoff of repurchase agreements with Government securities dealers and the maturity of finance company paper to meet these payments. In partial substitution for such runoffs, they increased their direct borrowings from banks and liquidated substantial amounts of negotiable time certificates of deposit, which had been timed to coincide at maturity with the tax and dividend dates. The volume of such certificates outstanding at weekly reporting banks declined by \$816 million in the week ended September 15, as against \$562 million in the comparable statement week of 1964.

The increased reserve pressures on the money market banks stemming from a shift of time deposits into demand deposits and from increased borrowings for tax and dividend payments were at first cushioned by the temporary accumulation of corporate deposits that were then shifted to the ownership of the Treasury and of dividend recipients. Subsequently, as these balances were drawn down, reserves flowed from the money centers, maintaining the pressures generated by credit demands on the reserve positions of the large money market banks (see Table II). The daily average basic reserve deficits for the major money market banks rose to \$1.7 billion in the September 22 statement week. Country banks built up large reserve excesses in the first week of their reserve-averaging period, not reoffering in full in the Federal funds market the reserves gained through the reserve redistribution. Accordingly, the money market banks experienced difficulty in covering their expanded needs, and average member bank borrowings from the Reserve Banks rose to \$627 million.

The money market was tight early in the September 29 statement week and Federal funds traded in volume at  $4\frac{1}{4}$  per cent on September 24. Subsequently, reserves moved back to the money market banks, particularly in New York City, as funds flowed from country banks at the end of their reserve-averaging period. By the end of the statement week, Federal funds traded predominantly at 1 per cent.

#### THE GOVERNMENT SECURITIES MARKET

An atmosphere of caution continued to pervade the market for Government securities in September. The hesitancy primarily reflected general expectations that the economy would expand well into 1966 and that the demands for credit would increase. The rising yields on corporate and tax-exempt bonds and the large calendars of

future financing in these markets reinforced concern about the course of interest rates over the coming months. These downward pressures on bond prices largely obscured the lessening concern over the war in Vietnam and the improved performance of the pound sterling in the foreign exchange market.

Against this background, Treasury bill rates moved irregularly higher over the month. Investment demand was moderate and, in an atmosphere of uncertainty, tended to favor the shorter maturities. Dealer holdings of longer term bills expanded, while their financing costs rose around the tax date and thereafter. Selling by investors over the quarterly tax date was not large, but dealers were increasingly aggressive in offering bills as demand proved slow to revive after the tax date.

Rates on Treasury bills moved sharply higher following the Treasury's September 22 announcement that it would offer \$4 billion of tax anticipation bills in early October—\$3 billion maturing in March 1966 and \$1 billion maturing in June 1966. The new one-year bill was auctioned two days later at an average issuing rate of 4.236 per cent, 23 basis points higher than the issuing rate in the August auction (see Table III). Subsequently, rates steadied temporarily and then rose again, as market participants became apprehensive that rising short-term rates might be confirmed by a shift in monetary policy. The three- and six-month Treasury bills closed the month at 4.02 and 4.19 per cent bid, respectively.

In the market for Treasury notes and bonds, prices of longer term issues declined  $\frac{1}{2}$  to  $1\frac{1}{4}$  points over the month, as investors continued to switch into high-grade corporate bonds with higher yields. During most of the month, however, offerings were not pressed on the market and the upward adjustment in yields proceeded gradually, cushioned to some extent by official purchases. The decline in prices gathered some momentum toward the close of September, as selling by investors and professionals expanded. Over the month, dealers were able to reduce still further their holdings of notes and bonds.

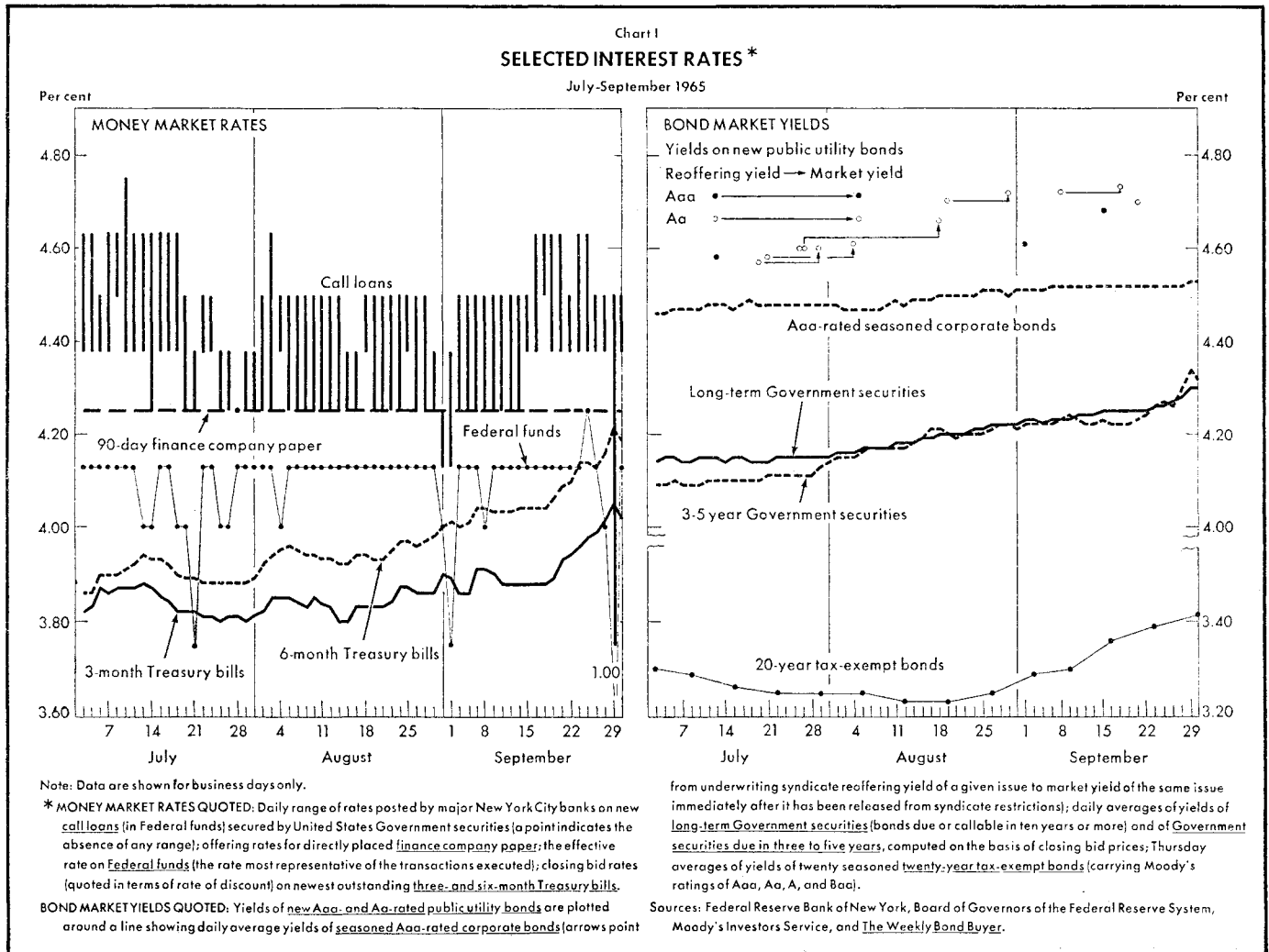
Intermediate-term Treasury securities were initially affected less by market developments than were the long-term issues. The lower price levels on the intermediate-term issues, resulting from the August declines, attracted some investment buying in the early part of the month. Bank selling of intermediate issues increased as the month progressed, partly in response to actual or projected demands for bank credit. The upward adjustment in yields on intermediate issues was accompanied by a further flattening of the yield curve. Most high-coupon issues maturing beyond five years ended the month with a yield to maturity of about 4.35 per cent (based on bid prices).

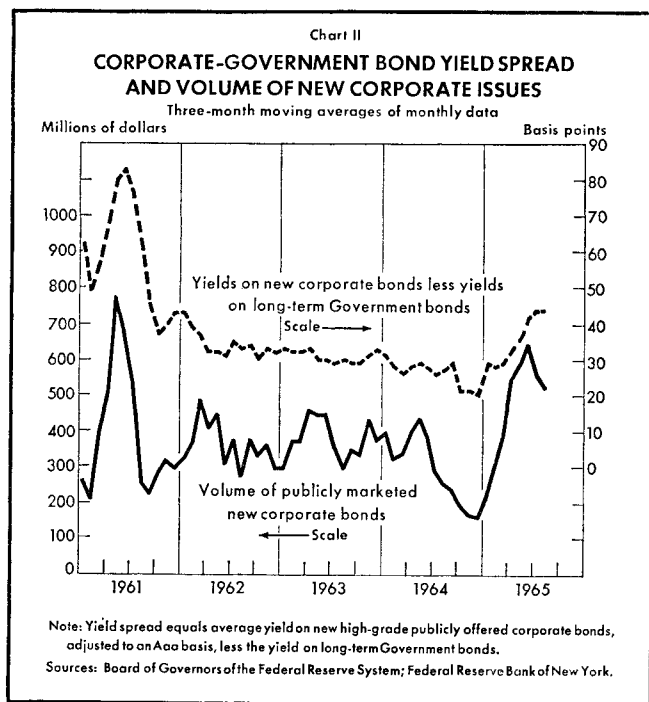
**OTHER SECURITIES MARKETS**

The rise in yields on corporate and tax-exempt bonds marked a continuation of the upward movement prevailing over most of the year (see Chart I). The corporate bond market, in particular, has been adjusting in 1965 to a rapid increase in corporate financing demands as investment expenditures by corporations expanded more rapidly than their internal flows of funds. A large portion of corporate needs has been accommodated by commercial bank loans, especially early in the year. Nevertheless, the volume of corporate bonds sold (either publicly or privately) has risen to almost \$7.8 billion over the first nine months, compared with \$6.4 billion in January-September 1964 and \$8.2 billion for all of 1964. Under

the influence of such a heavy volume of new corporate issues, the yields on these issues have gradually risen in spite of a continued large flow of long-term savings generated by the growing economy.

Signs of congestion began to develop in the corporate bond market as early as May. Since then, corporate bond yields have been ratchetting irregularly higher under the pressure of the corporate demand for funds. Investors, sensing the shift in demand, have shown some tendency to wait for higher yields, and changing expectations have played a major part in the 16 basis point advance in yields on new high-grade issues since May. Yields on new corporate issues have risen more rapidly than yields on long-term Government bonds, the supply of which the market judged unlikely to be increased at current rate levels. Accordingly,





the spread between yields on new corporate bonds and those on long-term Government securities has widened (see Chart II). Although it is not unusually wide by past standards, some investment demand has been diverted from long-term Governments into the corporate sector.

Yields of new tax-exempt bonds have also risen irregularly over the year. The volume of such securities coming into the market has been large by historical standards for the past several years, and it has increased to \$7.9 billion through the end of September, as against \$7.4 billion for the same period in 1964. The banks' demand for such issues for their own portfolios has been considerably stronger over the first nine months of the year than in

most of the previous years, but the demand of nonbank investors (including perhaps banks' purchases for their customers and trust accounts) has weakened in 1965. The lower income tax rates may well have reduced the relative attractiveness of tax-exempt issues in the case of individuals in the higher tax brackets. (For example, in comparison with common stocks, it now requires a smaller amount of expected capital gains and dividends to induce high-income individuals to divert their investment demand from tax-exempt securities into equities.)

During September, yields on both corporate and tax-exempt securities continued to move upward. New issues were floated in large volume in both markets during the month, but investors were frequently selective in committing funds. An expectation of further increases in capital spending and in corporate borrowing restrained investor demand. The prospect that banks would continue to experience heavy credit demands generated caution in the tax-exempt market. In the corporate sector, the market steadied around midmonth following the successful distribution of a large telephone issue. The market was also encouraged by the quick sellout of a large negotiated offering of a major finance company's bonds. Although several other issues met less enthusiastic receptions, prices of corporate bonds were generally steady until late in the month when prices again weakened. Over the month, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 2 basis points to 4.53 per cent.

For tax-exempt securities, investor demand was also selective, and price cutting continued as underwriters sought to distribute securities. As yields moved higher, investor buying picked up, and the tone of the market improved. Market participants remained cautious, however, and the market was edgy as the month closed. *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose by 16 basis points over the month to 3.41 per cent (see the right-hand panel of Chart I).

## Publications of the Federal Reserve Bank of New York

The following is a selected list of publications available from the Public Information Department, Federal Reserve Bank of New York, New York, N. Y. 10045. Copies of charge publications are available at half price to educational institutions.

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