FEDERAL RESERVE BANK
OF NEW YORK

MONTHLY REVIEW

NOVEMBER 1965

Contents

Priorities in International Finance—
An Address by Alfred Hayes 223
The Business Situation 229
The Money and Bond Markets in October 231
Banking and Monetary Developments—
Third Quarter of 1965 236
Recent Monetary and Financial Policies Abroad.... 239
The New York City Banks' Share in Commercial
Banking 246

Volume 47 **No. 11**

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Priorities in International Finance*

By ALFRED HAYES
President, Federal Reserve Bank of New York

Ever since my early days as a commercial banker and investment man, I have thought of "The Money Marketeers" as one of the most sophisticated groups of financial experts to be found anywhere. I am honored to have been given this opportunity to speak to you tonight, particularly as this enables me in a sense to pay tribute to my old friend, Marcus Nadler, for whom all of us felt such respect and affection, and whose death meant such a very real loss to the New York financial community and the whole financial world.

The name of your organization might suggest that I should talk tonight about the money market. But surely there are few aspects of that market on which you are not more expert than I am, and those few involve questions of official policy on which, as you can readily understand, I would not be able to comment very freely in any case. Furthermore, it occurs to me that, whereas international financial matters have been receiving much attention in our press and elsewhere in recent months, this is an area where there is great confusion about what is at stake and what practicable courses are open to us. Please don't jump to the conclusion that I think myself capable of drawing a clear blueprint of future international financial arrangements. All I would like to do tonight is to offer a few observations on a few key issues.

Perhaps a reasonable starting point is the much-tortured subject of the United States balance of payments—for the disposition of our deficit is central to almost all the major issues. While international payments equilibrium has been a recognized goal of official United States policy for five or six years, it has not been the only goal of policy, and the attainment of the balance of payments goal has indeed been elusive. There are few who would deny that our large-scale deficits have continued much too long. Under these circumstances, I found most heartening the pronouncements of the highest American authorities, on the occasion of the recent Bank-Fund meetings in Washington, that whatever measures are needed to achieve balance will be taken. I have never doubted our country's ability to balance its accounts if we were sufficiently determined to do so—and I feel sure that the continuing high degree of foreign confidence in the dollar reflects a similar conviction. But having said this, I hasten to add that the road will not be easy.

Of course one of the most important things we must do is to continue the rather remarkable stability of costs and prices achieved in the past five or six years. Without this stability, notwithstanding the considerable inflation in the principal European countries, we would be in a really parlous state today. And we should bear in mind that continuing inflation in Europe is unlikely, for the Europeans are understandably bending every effort to bring it under control. Since keeping costs and prices stable is indeed vital, those who feel a natural repugnance toward Government intervention in our free market economy would do well to consider the contribution of the Administration's wage-price guideposts to our recent successes and to ponder unwanted alternatives.

Despite my emphasis on this need for cost and price stability, I would add that our balance of payments experience over the last five years or so makes one thing very clear: No attack on the problem will be effective unless it is persistent, and unless it deals in concerted fashion with all the major elements in our international accounts rather than with one or two alone. Time and again we have made pronounced progress in one sector,

* An address before the fall meeting of The Money Marketeers of New York University, New York City, October 27, 1965.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

only to find new weaknesses developing elsewhere. Our trade balance has improved, but our capital outflows have burgeoned; or our military and aid payments have been reduced, but our net tourist outlays have reached new highs; or foreign bank lending has been sharply curtailed, but direct investment has risen to a new record. This year we have had the satisfaction of seeing an overall surplus reported for the second quarter, the first quarterly surplus in eight years. But, as Secretary Fowler has stressed so often, there were special factors acting in our favor in this period, and for the year as a whole another deficit is expected, although undoubtedly smaller than that of 1964, or than the average of recent years.

The point of all this is that we can't afford to let up for a moment in our efforts to eliminate the deficit, nor can we assume that we can deliver on our assurances of equilibrium without exerting greater effort than we have done to date. But obviously the effort must be made in the most careful way, keeping in mind at all times both the importance of domestic economic needs and the desirability of continuing to work toward a world of freer rather than more restricted trade and investment flows.

To borrow at this point a favorite term of the international economists, what we are dealing with here is the "adjustment process." We cannot assume that this "process" is automatic or painless. The crux of the problem is this: How can we adjust our policies, wisely and with sufficient speed, to eliminate our deficit? Of course, the fact that it is largely up to us to take corrective actions does not absolve the surplus countries of responsibility. Quite the contrary. There is much they could be doing in the way of enlarged contributions to economic aid and joint defense arrangements, development of better capital markets, reduced restrictions on borrowing by foreigners, reduced barriers to imports, etc. The surplus countries could also most usefully put more emphasis on firmer fiscal policy when they face the need to restrain domestic inflationary pressures, rather than relying too heavily on monetary policy. Monetary restraint too often increases their surpluses by pulling in additional short- and long-term funds from abroad. But, granted all this, we can profitably devote most of our thinking and energy to the possibilities that lie within our own hands; we can't afford to rely on anyone else but ourselves for the solution.

Our efforts in the last few years to solve our payments problem have brought to a head a basic underlying question of philosophical approach. As we approached the problem, we had to ask ourselves to what extent should we use specific measures designed to place obstacles in the way of international movements of trade and investment, and to what extent should we use more impersonal generalized policies which may—in fact, must—have important domestic as well as international repercussions? Fortunately, we have eschewed outright interference with foreign trade, for it is widely recognized that restrictions in this area, which so clearly hamper the efficient allocation of resources, could start a chain of counterrestrictions with disastrous consequences throughout the trading world. However, capital movements are something else again. Here there is even a sort of international sanction for setting up obstacles, as the Articles of Agreement of the International Monetary Fund specifically permit restrictions on capital flows. And certainly our European friends in recent years have often urged us to limit our capital outflows through specific measures, just as most of the major European countries themselves have done more or less consistently since World War II. In passing, I might add that their motives for urging limitations on our capital outlays have been strongly reinforced, on occasion, by nationalistic resentment of our heavy equity investments in European enterprises.

While we cannot overlook this general background of pressure for capital restrictions, let us not lose sight of what I would consider an even more important fact of the world's postwar development, namely, the yearning and effective striving for a world system with minimum restrictions on international payments. The whole philosophical background of such great postwar achievements as the Marshall Plan, NATO, EPU, OECD, etc., was one of building a wider, better integrated community of nations. In practice, it proved possible to dismantle a vast array of trade and exchange restrictions, some of the latter dealing with capital movements; and our own Government has frequently urged the principal European countries to relax their barriers to capital outflows. The advent of exchange convertibility at the end of 1958 was of enormous influence in enhancing confidence in European currencies and markets, and in stimulating a sharp rise in flows of capital between countries, especially short-term flows. With the emergence of this confidence and with the development of the Common Market, there was, of course, also a sharp growth in United States equity and direct investment on the Continent. This great increase in the mobility of capital funds of all kinds has compelled governments on both sides of the Atlantic to revert to various restraints on the flow of capital funds to or from their domestic markets. It is greatly to be hoped that these restraints will prove temporary.

Through the last few years of heavy United States deficits, the financial authorities of this country have engaged in more or less continuous soul-searching on the question to what extent we should advocate steps that were clearly

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

backward steps in terms of this broad postwar sweep toward more liberal payment flows. I think it is accurate to say that both the interest equalization tax, in the summer of 1963, and the President's Voluntary Credit Restraint Program of last February were adopted reluctantly and only after it was concluded that general policies, including monetary policy, could not under the circumstances yield results fast enough to deal with the threat of a serious weakening of the dollar's international standing. There was no doubt in my mind last winter, for example, that some kind of voluntary restraint was essential for the defense of the dollar. Yet over all this span of time there were voices urging that monetary policy be given more of a chance to show what it could do.

In saying this, I don't want to minimize what monetary policy already has done, and is continuing to do, to help our payments problem. During the last business recession, for example, the extremes of monetary ease that had characterized earlier recessions were avoided. On a technical level a number of devices have been adopted to support short-term interest rates, including open market operations outside the bill area and the use of reserve requirement reductions as a means of supplying reserves without putting direct downward pressure on interest rates. Last, but not least, general monetary policy has itself made a contribution by gradually cutting back on the degree of monetary ease, particularly when the economy began to pick up steam after mid-1963 and moves toward a less easy policy were both feasible and desirable. To an important extent the recent strength of the domestic economy has reflected an easier fiscal policy. In such a context, monetary policy could, and in fact did, move toward reduced ease, while still providing a flow of bank credit that facilitated the gratifying expansion of the United States economy.

The Voluntary Credit Restraint Program as applied to the banks, which is of course a Federal Reserve responsibility, has been extremely successful in meeting its objectives, and I should like to acknowledge the splendid spirit in which the banks have cooperated to make the program work. And to me, because of its flexibility and adaptability, this voluntary approach to this type of problem has been preferable to legislative measures which often have too sweeping an effect and have a tendency to remain in force beyond the time they are essential. But I am also well aware what the Restraint Program has meant in the way of sacrifice of normal and profitable activities. A number of nonfinancial corporations have likewise taken on significant costs in pursuance of the related Commerce Department program.

The Voluntary Credit Restraint Program was always thought of as a temporary measure. Yet its very success points up the difficulties we shall face when we make the transition to a more permanent state of affairs. For we shall have to be reasonably sure that underlying forces affecting our international payments will rapidly assume the role of these special restrictions in achieving balance. To me this means that we should see some of the underlying corrective forces commencing to work even while the voluntary program is still operative. It thus is reassuring that the upsurge in domestic demand for bank loans may already be having some impact in this respect by making foreign loans less attractive. It is quite clear to me that the voluntary program must find continuing support from more general policy measures of benefit to our payments position. An additional reason for such support is the risk that the longer the voluntary program remains in force the less effective it may prove to be in the face of normal market pressures.

When I speak of more general policy measures to benefit our payments position, I would not want to be interpreted as losing sight of the requirements for domestic growth. I cannot help reverting to earlier developments during the current business upswing in which a change in policy mix facilitated an underlying readjustment. Easier fiscal policy, accompanied by a less easy monetary policy, provided during 1963 and 1964 a viable method by which underlying forces could be brought to work on a more permanent solution of our balance of payments problem.

We in this country have much work ahead of us in solving these problems of ours. While there is no reason why we cannot also devote considerable attention to the future shape of the international payments system, the priorities seem to me reasonably clear. However, let's take a quick look at the current status of the movement toward reform of the international financial system. In passing, I might point out that some of the more vociferous advocates of reform talk as if the present system were completely static. In fact, it has been changing rather remarkably in the last four or five years, both through the International Monetary Fund and with the addition of many new forms of useful cooperation among leading central banks and governments. The central bank swaps and other types of foreign exchange cooperation, in particular, have demonstrated their flexibility and adaptability to changing needs. The facilities available under the Federal Reserve swap network, which now stand at the not inconsiderable total of almost $3 billion, for example, have been swiftly expanded whenever such an expansion was indicated. The network can now provide routine financing in response to seasonal flows of funds or to divergent money market developments in different centers; it can equally mobilize huge resources

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to help beat off speculative attacks on one currency or another. Since its inception, the total activity under its facilities—drawings and repayments by both the Federal Reserve and by foreign central banks—has exceeded $5½ billion.

Most of these new developments have involved better means of providing international credit where and when it is needed, and in appropriate amounts. After all, the meaning of "international liquidity" is merely the aggregate of the monetary reserves, and the ready access to additional reserves, of all the world's national monetary authorities together. Thus credit plays as much of a part as owned reserves—and when we analyze the matter more closely, the line between credit and owned reserves other than gold is very thin indeed.

Another way of classifying forms of liquidity is to think of a whole spectrum from unconditional liquidity, i.e., liquidity that can be used by the country in question quite freely, without satisfying conditions or answering questions, through various degrees of "conditionality". For example, access to one of our swap lines is virtually automatic, whereas a large drawing on the International Monetary Fund beyond the gold tranche may require lengthy discussions, negotiations, and assurances of future performance by the borrowing country.

I am sure you are fully familiar with the principal lines of reasoning that have given rise to the widespread examination of possible new sources of liquidity. On the one hand, the surplus countries of Continental Europe have long felt that a way must be found to force the United States to stop running deficits which, it is said, have the effect of producing an unwanted and inflationary growth in Europe's monetary reserves and money supply. Because of the role of dollars in their reserves, and the fact that their central banks buy and sell dollars in order to stabilize their exchange rates in accordance with the rules of the Fund, they contend that the United States tends to obtain automatic financing of its deficit through additions to foreign holdings of dollars. In actual practice, the leading central banks of Europe have become increasingly reluctant to add to these holdings in the last five years and have worked actively with us in developing the various arrangements—Federal Reserve swaps, debt prepayments, foreign currency bonds, etc.—that have enabled them to avoid increasing their uncovered dollar holdings. They could, of course, always demand gold from the United States in exchange for their dollars but—with one notable exception—the European countries have refrained from pushing too hard in this direction for fear of unduly disturbing the whole international financial structure. They remain most anxious to see our deficit considerably reduced or eliminated and believe that future monetary arrangements should be set up so as to make this kind of large-scale deficit financing impossible.

As against this view, which essentially wishes to force greater discipline on the major deficit countries, there has been an opposite approach by those who, at the extreme, welcome new liquidity schemes as a means to escape discipline. Then there are a large number who, while not in this extreme camp, lean toward the view that the greatest problem over the coming years will be inadequate liquidity to support world economic growth.

Essentially there is no difference of opinion between European governments and the United States Government on the need for eliminating our deficit. As I indicated earlier, the statements of President Johnson and Secretary Fowler in Washington last month left no doubt on this score. But major differences of view around the world emerge on the question as to how much of a problem the elimination of this source of additional liquidity will create for the rest of the world, and how soon. At one extreme there are fears that we may face an imminent crisis of deflation and depression—at the other extreme the view of more than one European central bank that there will be no problem for a good many years, in view of the fact that we have been flooding the world with dollars for some time and that it should take quite a while before the resulting excess of liquidity is absorbed as the world economy grows. While I believe there is no likelihood of an imminent shortage of liquidity, I do believe that it is a sound idea to explore now what we ought to do should a shortage become perceptible—and this, as I understand it, is the essence of Secretary Fowler's initiative last summer regarding an international monetary conference.

In any case, regardless of the question of a possible liquidity shortage, I strongly believe our international financial system has to continue to evolve. As I have said, we have not stood still and we cannot afford to do so in the future but must continuously adapt existing arrangements to meet changing needs. This does not mean, however, that we can hope to find through new liquidity schemes a means to escape discipline. No monetary system, however ingenious, can be designed to permit continuing imbalances that are bound to flow from unsound policies. On the contrary, it seems to me that in the future a greater degree of discipline than we have had in the recent past is inevitable.

Last month's annual IMF meeting in Washington produced some measure of agreement on procedural steps for getting ahead with a study of how to meet liquidity needs. On the substantive questions, some of the speeches were notable for the frankness and clarity with which they propounded sharply differing views. And to a considerable

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

extent these differences carried over into the procedural debate, with some of the major industrial countries, whose currencies would presumably be importantly involved in any new liquidity scheme, reluctant to see decisions taken by too large a group of countries—whereas the less developed countries, fearful that diminished world liquidity could damage their own expansion plans, were equally reluctant to see decisions taken anywhere except in the Fund itself, where all these less developed countries are represented. While I can readily understand their interest in adequate liquidity, I cannot but feel that comments from some of these countries have tended to confuse the issue of development finance with international liquidity. These issues involve distinct problems and they can be effectively tackled only through separate approaches.

As you know, the Ministers of the Ten instructed their Deputies to get on with the work of determining what basis of agreement can be reached on any needed changes in the monetary system, and at the same time urged that consultations proceed as to how these recommendations might best be brought up for review in a wider forum. It was noticeable and—it seems to me—quite appropriate, that the Fund spokesmen themselves made very clear the Fund's own special concern with the whole problem of international liquidity.

Without trying to go into detail on the many schemes that have been proposed for improving the international monetary system, let me merely point to a few principles that I think are worth keeping in mind:

(1) Granted that United States deficits certainly cannot continue to provide new reserves on a large scale as they have in the past, it does not follow that there will be a severe shortage of owned reserves within the next few years. For one thing, there is no fixed rule as to the need for reserves in relation to the total amount of world trade and other financial transactions. Transactions between countries are financed in national currencies, with the dollar and sterling playing key roles. It is only in settling net payment imbalances between countries that reserves come into play. It may well be that these imbalances may grow as the volume of world trade and payments increases. But there is always the hope that progress in developing flexible corrective policies will accelerate the adjustment process and thus reduce the size of the payments swings to be financed.

(2) I am impressed by the way in which credit extensions in recent years have provided very effectively for liquidity needs arising out of adverse payments swings. The experience with exchange crises in the United Kingdom, Canada, and Italy demonstrates dramatically that liquidity may be needed in very large amounts at a specific time and place, and such needs can be met only by the extension of credit, both bilaterally and through the International Monetary Fund. While we have made great progress with enlarged and improved credit facilities, we have by no means explored all the potentialities of this approach. Offhand, I would guess that in dealing with needed additional liquidity there is far more promise in a growth of international credit than in the creation of a synthetic international currency.

(3) Advocates of new international currency units have not yet fully acknowledged the political authority that would have to be vested in the international institution administering the creation of these units in order to avoid both excessive expansion and undue rigidity. Creation of such a currency, which would essentially involve the allocation of new purchasing power to recipient countries, without the obligation of repayment, obviously would not automatically provide the same discipline that credit arrangements impose upon deficit countries and, for that matter, also upon surplus countries extending the credits. Corresponding disciplines under a system embodying a synthetic currency would require a full-fledged international central bank, for which the world is not yet ready.

(4) It would seem to me unwise to look elsewhere than to the International Monetary Fund for major additions to international liquidity, although these might usefully be complemented by further expansion of other credit arrangements among governments and among central banks. The Fund has served us well as it has continued to evolve in the twenty years since Bretton Woods. Building onto it fits in with the evolutionary approach I have long favored. The latest quota increases now in process of ratification are a big step toward making it better able to cope with major disequilibria. Also, let us not forget that there is a great store of experience and expertise in the Fund which should continue to be brought to bear on these problems.

(5) More specifically, if it should be later concluded that some new form of reserve asset is required, even after taking account of the vast possibilities for improved credit facilities, the most logical starting point would appear to lie in the direction of developing the automaticity of drawings that now exists for each country's regular gold tranche and super-gold tranche in the Fund. As the Ossola Report has emphasized, these are already international reserve assets of the countries concerned. But there may be possible technical changes that would enhance their status for this purpose, as well as special measures that would enlarge their volume, and thus offer the hope of supplementing other forms of reserve assets.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(6) Above all, I think we should vigorously resist any effort to downgrade or replace the dollar as the principal reserve currency. It is noteworthy that apart from sterling, whose use as a reserve asset is confined largely to the sterling area, no other currency has presented itself as a candidate for the role. We should bear in mind that other major currencies lack many of the dollar's attributes. Only the United States sells gold freely to foreign monetary authorities against its own currency. As a practical matter, other currencies are convertible into each other only through the dollar. Money markets in other countries (with the notable exception of the United Kingdom) are so narrow that it would not be at all easy to find an adequate volume of instruments to earn an adequate return on reserves if they were accumulated in other currencies. Also, most countries resist the idea of placing foreign holders of their currency in a position to exercise any significant influence on their own financial markets and domestic economies by disposing of these holdings as they might see fit. Thus we would do well to recognize that the dollar is not just one of many more or less similar strong currencies. It is in fact unique, and our world of international finance is by its very nature asymmetrical.

(7) Despite the inadequacies of any composite reserve unit, the markets could interpret proposals for such units as involving a downgrading of the dollar. Thus, I find in most of the proposed new units the great risk of damage to the dollar as the key currency in the present system. I have yet to see any adequate assurance that the introduction of the proposed units would not lead, directly or indirectly, to increased pressure for conversion of dollars into gold, either after the scheme is put into practice or even while it is under negotiation. Of course, some of the schemes are avowedly inimical to the dollar as a reserve currency—but all should be scrutinized very carefully from this point of view. Any plan that weakens the dollar's reserve currency standing could destroy far more international liquidity than it would create.

(8) Whatever may be decided in the way of enlarging world liquidity, it seems to me quite probable that the best way would be to proceed gradually, step by step, rather than to seek some full-blown new plan that would drastically change a system which, on the whole, has proved to be workable and flexible. Early agreement on initial steps would be highly desirable. Thus, for example, if it were decided that greater Fund automaticity would be useful, a change along these lines could be put into effect without delay with the understanding that a study of further possible steps, to meet new contingencies, would be carried on in the ensuing year or years. In other words, the approach would be evolutionary rather than revolutionary.

In closing, let me revert to the major point I tried to stress earlier. Our most pressing task is to find lasting equilibrium in our balance of payments. If we deal effectively with this problem, there is little reason for worry about the role of the dollar. If we do not, the dethronement of the dollar and our discomfiture in many foreign and domestic activities are a foregone conclusion. It is often overlooked that our whole political and economic position abroad is very closely intertwined with the strength of the dollar. I have no doubt at all in my mind that, once the American people understand fully what is at stake, they will show the will and ability to preserve the dollar as the keystone of the whole international financial system.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Business Situation

Domestic economic activity has continued to post substantial gains so far this fall. To be sure, the overhang of steel inventories had an adverse effect on the industrial production index in September and probably also in October. Nevertheless, the underlying forces of business expansion remain dominant. The economy advanced vigorously in the third quarter, as gross national product rose to a seasonally adjusted annual rate of $677 billion. Consumer sentiment is buoyant, and business investment plans point to continued gains in capital outlays over the coming months. Government spending is also expected to advance further, to a considerable extent because of stepped-up military operations in Vietnam.

Economic expansion is currently taking place against a background of a fairly small margin of unutilized capacity and labor resources. No serious bottlenecks seem to have developed over recent months, but with unemployment down to the lowest levels in eight years, employers have generally experienced some difficulty in recruiting skilled personnel. The further growth expected in the labor force over coming months, and the additions to capacity that will stem from the currently high level of capital spending, will work to preserve balance between over-all supply and demand forces in the market. This balance, however, is a delicate one and requires that businessmen, labor, and fiscal and monetary authorities make a constant effort to maintain the orderly pace of the expansion in a noninflationary environment.

Consumer prices resumed their upward trend in September, bringing the rise in the consumer price index to 1.7 per cent for the past twelve months. In contrast to increases earlier this year, which had resulted largely from higher food prices, the latest advances were primarily among nonfood items. Increases in the prices of services were exceptionally large. Seasonally adjusted industrial wholesale prices also rose in September, but appear to have edged down in October.

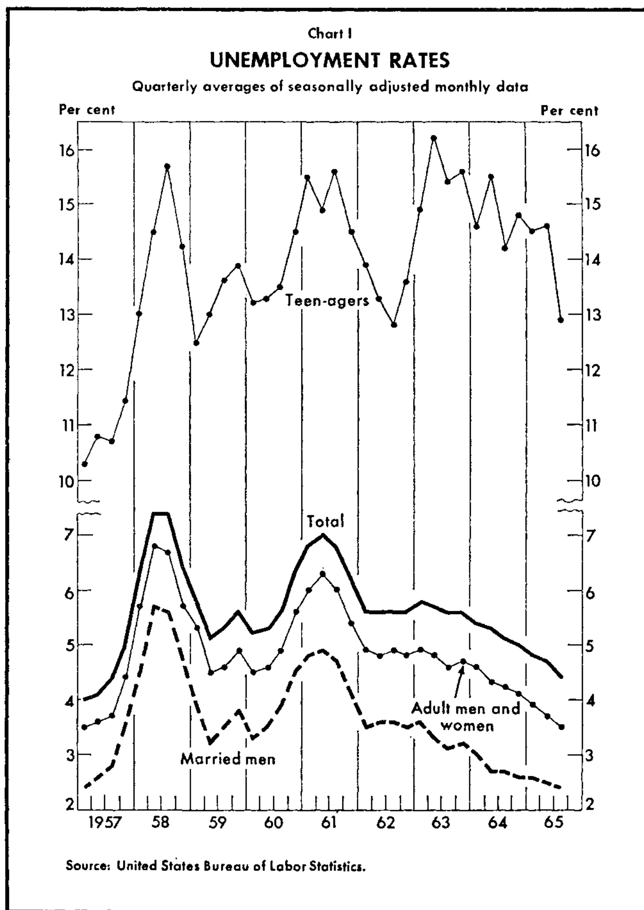
PRODUCTION, ORDERS, AND EMPLOYMENT

The Federal Reserve Board's seasonally adjusted index of industrial production declined as expected in September—by 1.5 percentage points to 142.8 per cent of the 1957-59 average. This decrease, the first since last October when strikes in the automobile industry cut into industrial production, resulted largely from a sharp reduction in steel output after the signing of the steel labor contract on September 6. The iron and steel component of the index declined by nearly 13 per cent in September, accounting for over two thirds of the drop in the total index. Production was also curtailed by strikes in the aircraft, automobile, newspaper, and coal industries, while hurricane effects caused a drop in crude oil output in the Southern states. On the other hand, output of business and defense equipment continued to rise in September, reflecting the persistent uptrend in business capital spending and the military buildup.

Despite the September decline in over-all industrial production, for the third quarter as a whole manufacturing industries continued to operate on average at around 90 per cent of estimated capacity. This level of operation, maintained since the start of 1965, is the highest since the first quarter of 1956 and is in the range usually associated with optimum efficiency. It was first reached in the opening quarter of the year, when demand for steel began to surge and when the automobile industry worked a substantial amount of overtime in order to make up for output lost during the late-1964 strike. Capacity itself has steadily grown under the impetus of businessmen's capital spending programs. Since output has also rapidly grown over the year, however, utilization rates have remained high. Indeed, according to a recent McGraw-Hill survey, operating ratios are equal to, or greater than, the "preferred" rates in the automobile and parts, rubber, textile, nonferrous metals, machinery, pulp and paper, food and beverages, and petroleum and coal industries.

During October, steel output continued to fall off because of the overhang of inventories built up earlier in the year, and newspaper and aircraft strikes persisted for at least part of the month. At the same time, some of the industries that helped to pull down total production in September—notably automobiles and coal—appeared to do better in October. In fact, weekly figures indicate that automobile workers assembled new cars at an annual rate

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

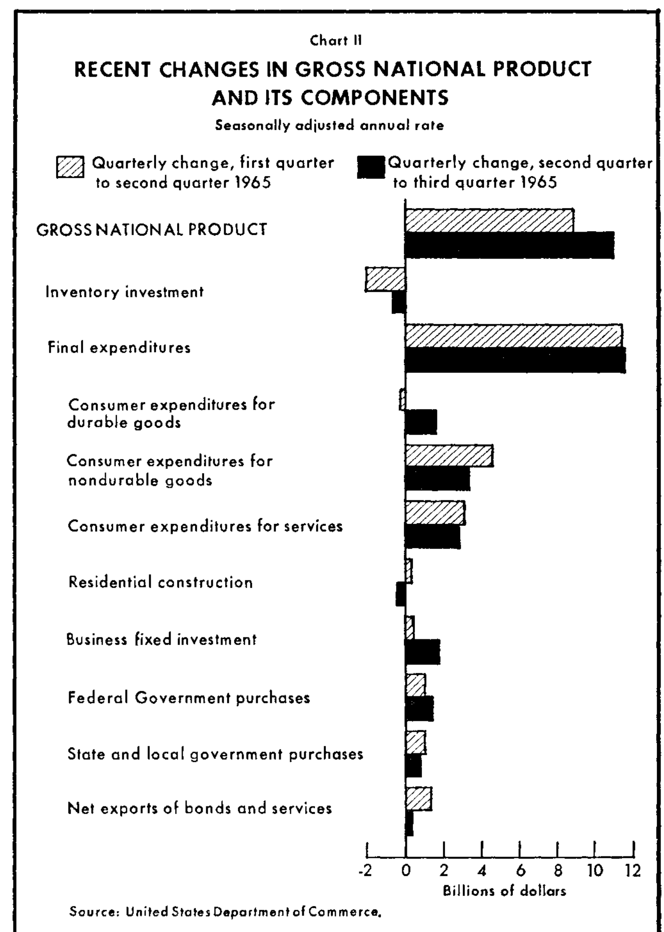


of 9.2 million units (seasonally adjusted). Moreover, except for the steel industry, the flow of new orders coming into durables manufacturers bodes well for production over the months ahead. Thus, bookings received by industries other than steel rose by about 3.0 per cent in September, and the over-all backlog of unfilled durables orders moved up for the twenty-first consecutive month. At current rates of output it would require nearly three months of production to fill these orders.

Despite the decline in industrial production in September, manufacturing as well as total nonagricultural payroll employment rose further during the month. Even in the steel industry, the adjustment to lower production levels was accomplished largely by cutting average weekly hours rather than by laying off workers. Reflecting the strength in employment, the total number of persons listed as unemployed in October fell to 3.3 million. The over-all unemployment rate for the month dropped to 4.3 per cent of the civilian labor force and the rate for married men declined to 2.1 per cent. It is both noteworthy and gratifying that these unemployment rates are the lowest in eight years (see Chart I). Moreover, the rate of unemployment has fallen more rapidly in the last twelve months than in any comparable period of the current expansion except in its earliest stages.

PATTERNS OF DEMAND

The nation's total output of goods and services (measured at a seasonally adjusted annual rate) rose by $11.0 billion in the third quarter, according to preliminary estimates of the Commerce Department (see Chart II). This was a slightly greater gain than in the preceding three-month period, and was also larger than the average quarterly advance during the preceding year. The rate of inventory accumulation fell off again in the third quarter, though considerably less than in the preceding three months. The incentives for building up steel stockpiles



were reduced as the threat of a steel strike faded and finally ended. The gain in final expenditures (total GNP other than change in inventories) in the third quarter was equal to the solid advance in the preceding three months, and substantially above the average increase of the previous four quarters.

Consumer spending rose in the third quarter by about the same amount as in the preceding quarter. There was a large gain in purchases of durable goods, accompanied by slightly smaller advances in spending for services and nondurable goods. Among the durables items, it was encouraging that there seemed to be continued interest in furniture and other big-ticket household items along with the sustained strength in sales of new automobiles. The rise in consumption outlays was accompanied by an increase in the rate of personal savings. It must be remembered that the increased savings reflect at least in part the September surge in incomes resulting from a lump-sum payment of higher social security benefits. Spending out of this income bulge will be one of the factors affecting both total consumption and the savings ratio during the fourth quarter.

Business investment in plant and equipment continued to advance in the third quarter. As noted, operations in many manufacturing industries have continued to run close to reasonably full rates of capacity utilization, helping to explain why businessmen have raised capital spending plans throughout the year. Moreover, according to a recent McGraw-Hill survey, plans for 1966 already point to capital outlays of $55 billion, or 8 per cent higher than the amount expected for this year. This gain, 3 percentage points above the first estimate for 1965, is McGraw-Hill's largest initial estimate for any year of the current expansion. Planned advances are spread among almost all major industries.

Among other demand sectors, outlays for residential construction, which had risen only slightly in the April-June period, slipped again in the third quarter. The decline in the number of housing starts from June through September reduces the possibility of a sustained upturn in housing outlays in the immediate future. The recent lack of advance in housing construction, however, falls into better perspective if it is recalled that third-quarter outlays were below only five other quarters of the current expansion of more than 4½ years' duration.

In the government sector, the combined total of Federal, state, and local outlays on goods and services was up by $2.2 billion during July-September, with the entire $1.4 billion advance in the Federal sector accounted for by increased defense spending. The military commitment in Vietnam points to still further increases in defense outlays in the months ahead. Decisions on the military budget reportedly will have a major influence on other Federal expenditure plans as well. Since defense needs necessarily rate the highest priority, any curbing of total expenditures will have to involve a full examination of other Federal expenditure plans.

The Money and Bond Markets in October

The note of caution which pervaded the Government securities market in September receded somewhat during the first half of October and a steadier tone gradually emerged. Market participants derived some encouragement from the widely circulated view that the Administration was continuing to emphasize the importance of interest rate stability, although the market also noted that selective interest rate increases were taking place. An undertone of uncertainty persisted and became more pronounced in the second half of the month. The continuing strength in the economy and in business demands for funds seemed to some observers to suggest the possibility that the balance of market forces might eventually work toward somewhat higher interest rates. The renewed air of hesitancy during the later period also reflected a pause in investment activity as the market awaited the announcement of the terms of the Treasury's November refunding.

Against this background, prices of Treasury notes and bonds moved generally upward in fairly active trading through mid-October, but then receded again in the last half of the month. A better tone was also evident in the corporate and tax-exempt markets in the first half of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, OCTOBER 1965

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

Factors	Changes in daily averages—week ended				Net changes
	Oct. 6	Oct. 13	Oct. 20	Oct. 27	
"Market" factors					
Member bank required reserves*	— 57	+ 205	— 381	+ 141	— 92
Operating transactions (subtotal)	— 632	— 216	+ 774	— 22	— 96
Federal Reserve float	— 177	— 4	+ 493	— 294	+ 18
Treasury operations†	— 70	+ 38	— 32	+ 88	+ 24
Gold and foreign account	+ 11	+ 9	+ 9	+ 8	+ 37
Currency outside banks*	— 364	— 291	+ 164	+ 172	— 319
Other Federal Reserve accounts (net)‡	— 33	+ 33	+ 139	+ 5	+ 144
Total "market" factors	— 689	— 11	+ 393	+ 119	— 188
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 776	— 101	— 325	— 132	+ 218
Bankers' acceptances	+ 4	—	—	—	+ 4
Repurchase agreements:					
Government securities	—	+ 30	+ 32	— 62	—
Bankers' acceptances	+ 27	— 19	— 18	+ 21	+ 11
Member bank borrowings	— 17	— 41	+ 96	— 253	— 215
Other loans, discounts, and advances	+ 5	+ 1	+ 8	+ 14	+ 28
Total	+ 795	— 131	— 207	— 411	+ 46
Excess reserves*	+ 106	— 142	+ 186	— 292	— 142
	Daily average levels				
Member bank:					
Total reserves, including vault cash*	22,053	21,706	22,273	21,840	21,968§
Required reserves*	21,613	21,408	21,789	21,648	21,615§
Excess reserves*	440	298	484	192	354§
Borrowings	536	495	591	338	490§
Free reserves*	— 96	— 197	— 107	— 146	— 136§
Nonborrowed reserves*	21,517	21,211	21,682	21,502	21,478§
	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 222	+ 109	— 700	+ 38	— 331
More than one year	—	—	—	—	—
Total	+ 222	+ 109	— 700	+ 38	— 331

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 October 27.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS OCTOBER 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended				Average of four weeks ended Oct. 27*
	Oct. 6	Oct. 13	Oct. 20	Oct. 27*	
Eight banks in New York City					
Reserve excess or deficiency(—)†	3	29	7	2	10
Less borrowings from Reserve Banks	—	83	32	11	32
Less net interbank Federal funds purchases or sales(—)	— 41	466	152	— 46	133
Gross purchases	*808*	*1,183*	*819*	*1,005*	*954*
Gross sales	*849*	*717*	*666*	*1,051*	*821*
Equals net basic reserve surplus or deficit(—)	44	— 520	— 177	37	— 154
Net loans to Government securities dealers	332	489	647	499	492
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)†	11	23	20	5	15
Less borrowings from Reserve Banks	290	193	238	29	188
Less net interbank Federal funds purchases or sales(—)	885	857	859	738	835
Gross purchases	*1,482*	*1,682*	*1,376*	*1,469*	*1,502*
Gross sales	*597*	*825*	*517*	*731*	*668*
Equals net basic reserve surplus or deficit(—)	— 1,164	— 1,026	— 1,077	— 762	— 1,007
Net loans to Government securities dealers	51	149	230	133	141

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—October 1965			
	Oct. 4	Oct. 11	Oct. 18	Oct. 25
Three-month	4.050	4.006	4.034	4.040
Six-month	4.201	4.180	4.214	4.192

Maturities	Monthly auction dates—August-October 1965		
	Aug. 24	Sept. 24	Oct. 26
One-year	4.006	4.236	4.192

* 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

October, but the tax-exempt sector subsequently weakened as an unusually heavy volume of new flotations drew a somewhat disappointing investor response. In the shorter term markets, demand for Treasury bills was strong during the first half of the month and bill rates generally declined. Around midmonth, rates edged a bit higher, but then fluctuated narrowly over most of the remainder of the month.

Conditions in the money market remained generally firm in October, although there were some variations in tone and sizable fluctuations in reserve distribution during the month. Nationwide reserve availability was little changed on average in October, as System open market operations offset reserves absorbed by "market" factors. Most Federal funds trading was at 4⅛ per cent, but limited amounts of funds traded at rates as low as 3½ per cent and as high as 4¼ per cent.

THE GOVERNMENT SECURITIES MARKET

In the wake of considerable declines in September, prices of Treasury notes and bonds first steadied and then moved higher in the first two weeks of October. (The right-hand panel of the chart on page 234 shows the decline in yields which accompanied this rise in bond prices.) As the month opened, market participants displayed some nervousness over the interest rate outlook. They warily assessed the announcement by a major New York City bank that it was boosting by ¼ of 1 per cent its lending rates on loans to nonbank financial institutions—a move which was followed by other selective lending rate adjustments by a number of banks. Moreover, traders continued to ponder the possibility that a shift in monetary policy might soon take place. A somewhat more confident tone gradually emerged, however, as participants apparently concluded that, at least in the short run, interest rates would remain generally stable and rate increases selective. Prices rebounded and trading was dominated by professionals, as aggressive short-covering operations by dealers pressed upon a rather light supply of coupon issues in the market. Modest investor demand was concentrated in purchases of the 2½ per cent deep-discount wartime issues, both on an outright basis and in connection with commercial bank switching operations. The biggest price gains during this period were recorded by selected issues at the longer end of the maturity scale.

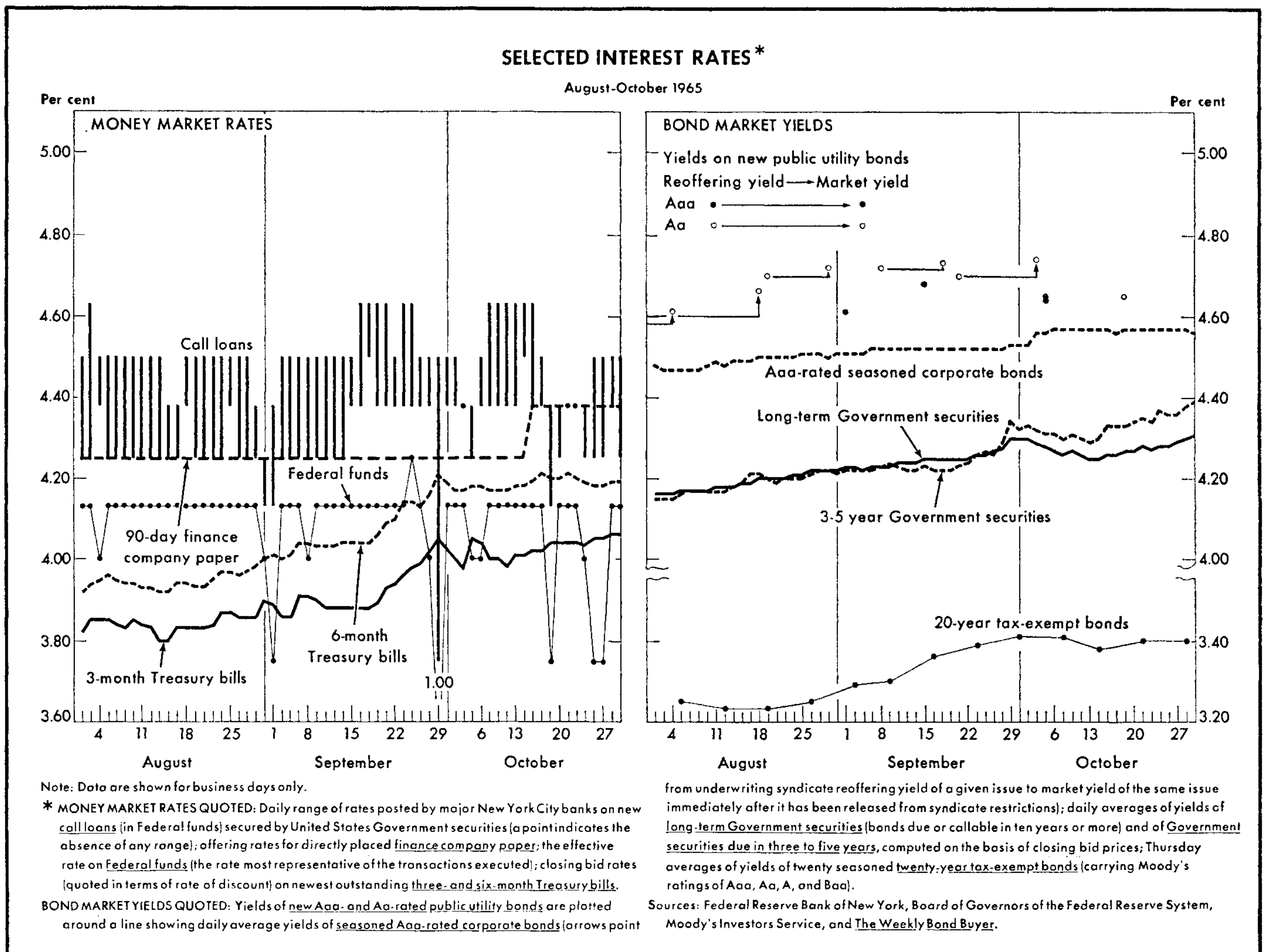
From midmonth onward, a hesitant tone again emerged in the coupon sector as participants awaited news about the Treasury's approaching mid-November refinancing. With investment activity light, prices tended to react to current news developments, including variations in reserve availability. The buoyancy of the economy and of stock prices, as well as the indifferent response accorded the sizable volume of new tax-exempt bond issues, tended to revive some uncertainty about the future course of interest rates. Against this background, offerings expanded and prices of notes and bonds again gave ground, carrying yields to their highest levels in five years.

After the close of business on October 27, the Treasury announced the terms of its November refinancing operation. It offered for cash a new issue of 4¼ per cent notes dated November 15 and maturing in May 1967 priced at 99.83 to yield 4.37 per cent, the highest initial yield for any Treasury offering in some time. The proceeds from the sale of the new notes will be used to redeem $9.7 billion of Treasury notes maturing on November 15. Subscription books for the new notes were open only on November 1. The refunding terms were closely in line with earlier market expectations, but only moderate interest in the new issue developed. In the final days of the month, prices of outstanding issues due in from one to two years were only slightly changed. At the same time, prices of other outstanding issues continued to decline as professional offerings increased.

On November 3, the Treasury announced the results of the refunding. Subscriptions for the new 4¼ per cent notes totaled approximately $12 billion, of which $9.7 billion was accepted. Subscriptions in amounts of $200,000 or less were allotted in full, as were subscriptions from various official organizations. All other subscriptions were subject to a 48 per cent allotment (but assured of a minimum award of $200,000).

The tone of the Treasury bill market also improved in early October, following the sharp upward adjustment in rates which had occurred in late September. Demand from investor and official sources expanded, so that dealer inventories contracted and the technical position of the bill market strengthened markedly. At the Treasury's October 5 auction of $3 billion of March and $1 billion of June tax anticipation bills, a lively interest developed, particularly from commercial banks which were permitted to pay for their purchases in full by crediting Treasury Tax and Loan Accounts. The market valued the Tax and Loan deposits that would be created in connection with the operation at approximately 40 to 45 basis points for the March bills and 25 basis points for the June bills. In recognition of this factor, the average issuing rates of 3.783 per cent and 3.938 per cent, respectively, for the March and June tax bills were far below prevailing market rates for outstanding bills of comparable maturities. A strong corporate and professional demand appeared for the new bills in "when-issued" trading prior to the Oc-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields of new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields of seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield of a given issue to market yield of the same issue immediately after it has been released from syndicate restrictions); daily averages of yields of long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields of twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

tober 11 payment date, and commercial bank offerings were readily absorbed at prevailing market rates. Investor interest in outstanding bills was also good during this period—particularly for those bills maturing within three months. As market supplies were rapidly absorbed, acute scarcities developed in certain bill maturities, and rates generally moved lower. During this period, the shorter maturities generally recorded the larger declines.

Around midmonth, bill rates edged a bit higher on increased bill offerings from commercial banks and dealers. Late in the month, bill rate movements were narrowly mixed. Although investor interest was modest, dealers appeared willing for a time to maintain their inventories in the expectation that enlarged bill demand would soon arise from the Treasury's November refunding and from anticipated seasonal bill purchases by the System Account. Rates tended to edge higher at the close of the month, reflecting some professional disappointment that the Treasury's refunding would be on a cash basis rather than on a "rights" basis and, consequently, would not generate any immediate reinvestment demand from holders of the maturing issues. The three- and six-month Treasury bills closed the month at 4.06 per cent and 4.19 per cent bid, respectively.

OTHER SECURITIES MARKETS

The same factors which bolstered the tone of the Government securities market in early October also contributed to the emergence of a steadier atmosphere in the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

markets for corporate and tax-exempt bonds. In the corporate sector, there was a resurgence in the demand for recent issues with relatively attractive yields. At the same time, the excellent reception accorded two high-grade utility bonds marketed at the beginning of the month, coupled with the light calendar of scheduled flotations, resulted in a more confident tone which prevailed during most of the month. Toward the end of October, however, caution emerged again in the corporate sector when investor demand became more restrained as the calendar of scheduled flotations expanded. In the tax-exempt sector, dealers made considerable headway in reducing their inventories of state and local bonds as demand expanded following the recent downward price adjustments. Some hesitancy persisted in the tax-exempt sector, however, as participants were faced with an unusually heavy calendar of impending issues. This cautious tone became more prevalent later in the month when a substantial volume of new issues encountered a lackluster investor response. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 3 basis points to 4.56 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) declined by 1 basis point over the month to 3.40 per cent. (See right-hand panel of the chart.) These indexes are based on only a limited number of issues and do not necessarily reflect market movements fully.

THE MONEY MARKET AND BANK RESERVES

Nationwide net reserve availability was little changed on average in October, while member bank borrowings from the Reserve Banks fluctuated from week to week in response to sharp shifts in the distribution of reserves from reserve city to "country" banks and then back again. The over-all tone of the money market was slightly more comfortable on average in the first week of the month, turned firm over most of the remainder of the period, and then eased slightly late in the month. The major sales finance companies raised their offering rates on 60- to 270-day directly placed paper by ⅛ of a percentage point to 4⅜ per cent on October 15. Rates on new call loans to Government securities dealers posted by the major New York City banks were generally in a 4¼ to 4⅝ per cent range, while rates on renewal call loans were quoted in a 4¼ to 4½ per cent range.

System open market operations released substantially more reserves to the market during the week ended October 6 than were absorbed by net movements of market factors, with the result that net borrowed reserves contracted by $123 million to $96 million. This was accompanied by the accumulation of a small basic reserve surplus at the major New York City banks. The bulk of the remainder of the available reserves, however, was lodged at country banks, while money market banks outside New York City found themselves under reserve pressure. Since these other reserve city banks turned increasingly to the "discount window" to meet their reserve needs, total member bank borrowings receded only slightly to an average of $536 million for the week.

Reserve positions at money center banks outside New York City remained under pressure in the following week, and pressures also mounted on the New York City banks. These developments reflected both the increased financing provided to Government securities dealers (who acquired from the commercial banks the March and June tax anticipation bills auctioned by the Treasury on October 5) and the sharp expansion in required reserves as the banks paid for the bills by crediting Treasury Tax and Loan Account deposits. Nevertheless, as country banks unloosed a part of the reserve excesses built up in the preceding week, the reserve city banks were able to fill a sizable portion of their reserve needs through purchases of Federal funds generally at 4⅛ per cent. Total member bank borrowings from the Reserve Banks actually declined a bit during the October 13 statement week.

In the second half of the month, the sequence of events in the money market closely mirrored the pattern of early October. Thus, once again the alternative accumulation and redistribution of excess reserves by the country banks contributed to opposite movements in net borrowed reserves and in member bank borrowings from the Federal Reserve. Early in the statement period ended October 20, country banks built up a substantial volume of excess reserves and the reserve positions of the New York City banks improved somewhat as nationwide reserve availability expanded. At the same time, pressures upon the reserve positions of other reserve city banks remained heavy, and consequently member borrowings from the Federal Reserve Banks bulged temporarily. Subsequently, as country banks released a portion of their reserve excesses, the flow of Federal funds improved and reserve pressures on the money center banks slackened. Thus, in the later part of the month the tone of the money market was relatively comfortable—with the effective rate on Federal funds varying from 4⅛ per cent to as low as 3¾ per cent—and member bank borrowings from the Federal Reserve contracted.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Banking and Monetary Developments—Third Quarter of 1965

Commercial bank credit and private deposits again displayed vigor during the third quarter. Demands for business and other nonfinancial loans continued to show sustained strength in line with the broad expansion in over-all economic activity. On the other hand, a substantial decline in securities loans took place, and the growth of loans to nonbank financial institutions slowed considerably. Both these loan categories had increased sharply earlier in the year as these borrowers turned to the banking system for a larger share of their credit needs. Bank loan terms continued to firm.

On the deposit side of bank balance sheets, a large portion of the considerably more than seasonal rise in Government deposits during the first half of the year was paid out to private holders in the third quarter. These transfers were a factor in pushing up appreciably both the private money supply and commercial bank time deposits. Indeed, total liquid asset holdings of the nonbank public continued to expand at a faster pace than the growth of gross national product. On a net basis, the shift of deposits from Government to private ownership showed up especially in time deposits. Since these deposits have a lower required reserve ratio than Government or private demand deposits, total member bank required reserves actually declined in the third quarter after a sizable increase in the first half of the year.

BANK CREDIT AND LIQUIDITY

Total loans and investments at all commercial banks moved irregularly upward over the summer months, with the increase in the third quarter amounting to $3.9 billion (seasonally adjusted). Over short periods, the erratic fluctuations in the bank credit series obscure underlying trends; however, it does appear in retrospect that the rapid surge in bank credit that marked the early months of the year began moderating around mid-April. Since then, the rate of growth of bank credit has dropped lower, to around roughly 8 per cent per annum or approximately the rate of growth experienced during the first four years of the current business expansion (1961-64). Nevertheless, for the first nine months of 1965 as a whole, the bank credit growth rate exceeded that of the corresponding period a year earlier.

Along with a somewhat slower growth in the total, there have been several sharp shifts in the composition of the credit growth since early in the year. Perhaps the most marked shift has been in commercial bank securities loans and in loans to other nonbank financial institutions. Such loans expanded quite sharply during the early months of the year and were up appreciably for the whole first half of the year. During that period, some of the bank credit growth was at the expense of competitive sources of funds. With the higher rates permitted on time deposits under Regulation Q after November 1964, corporations placed larger shares of their short-term funds in time certificates of deposit, restricting what otherwise might have been a flow of funds into commercial paper and repurchase agreements. At the same time, securities dealers found that the New York agencies of foreign banks could no longer grant them lines of credit as ample as before the institution of the President's balance of payments program in February 1965. As interest rates on commercial paper and repurchase agreements rose, nonbank financial institutions and securities dealers relied more heavily on commercial banks for their short-term credit needs. Although the surge in total bank credit began moderating around mid-April, the growth in these financial loans remained strong throughout most of the first half of the year.

During the third quarter, in contrast, commercial bank securities loans dropped sharply, and indeed the decline apparently completely offset the first-half increase. At the same time, it appeared that the growth of loans to nonbank financial institutions slowed to less than half the pace of the first six months of the year. The growth of bank credit aside from these two loan categories, on the other hand, remained quite substantial. Indeed, for the third quarter as a whole, total bank credit excluding securities loans and loans to nonbank financial institutions increased at about an 8½ per cent annual rate—somewhat below the pace of the first quarter of the year, but virtually identical to the rate for the second quarter and for all of 1964.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

As an echo of the lack of interest earlier in the year on the part of corporations in commercial paper and repurchase agreements with securities dealers, the amount of such obligations maturing around the September dividend and tax dates was smaller than usual. Thus the need on the part of securities dealers for bank loans to replace the maturing repurchase agreements was much less than on earlier dividend and tax dates. Moreover, with generally firm conditions prevailing in the money market, dealer financing costs at the banks rose significantly. This factor, along with expectations of higher interest rate levels, led dealers to lighten their over-all positions and thus reduced their over-all credit needs. At the same time, there was a further tightening in the terms of bank credit available to nonbank financial institutions. Even the prime borrowers among these institutions had to face higher bank loan rates by the end of the quarter. In response to the tightening in terms, the nonbank financial institutions began to rely more heavily on sources other than banks for their short-term financing needs.

As already noted, most other loan categories apparently continued to expand rapidly during the third quarter, albeit not quite so fast as during the very early months of the year. The growth rate of business loans in the third quarter, at 14 per cent per annum, continued to run ahead of the almost 12 per cent increase in 1964—although it was less than the very rapid annual rate of nearly 23 per cent over the first half of this year. Banks have made large amounts of term loans to businesses throughout the year in helping to finance expanded capital expenditures. There also appeared to be some increased interest on the part of banks in high-yielding consumer and real estate loans.

The substantial buildup in loans as business borrowers continued to be accommodated, combined with a very modest accumulation of total securities (and actual declines in Government securities), resulted in a further marked shift in the composition of bank assets. Although the volume of total investments at commercial banks is now higher than at the beginning of the current expansion, holdings of Government securities were down by the end of September to only $56.2 billion on a seasonally adjusted basis, about the lowest level since mid-1960. Holdings of short-term Governments have declined quite sharply over the past year. The shift in the composition of bank earning assets toward loans and longer term price-sensitive securities has taken place against a general economic background in which prospective credit demands of bank customers are considerably larger than at the beginning of the present business expansion.

The reduction in bank liquidity positions is also reflected in steadily rising loan-deposit ratios. By the end of the quarter, the loan-deposit ratio at all commercial banks as a group was up to 62.5 per cent, 1.1 percentage points higher than at midyear and 4.0 percentage points higher than a year earlier. At weekly reporting banks in New York City, the loan-deposit ratio was up to 69.8 per cent by the end of the quarter as against 61.8 per cent a year earlier. While the loan-deposit ratios for banks outside the money centers increased over the quarter, they remained lower than the ratios at the money market banks. Nevertheless, the banks outside the money centers felt sufficient pressure on their liquidity positions to step up their requests for participation by big-city correspondents in meeting local loan demands.

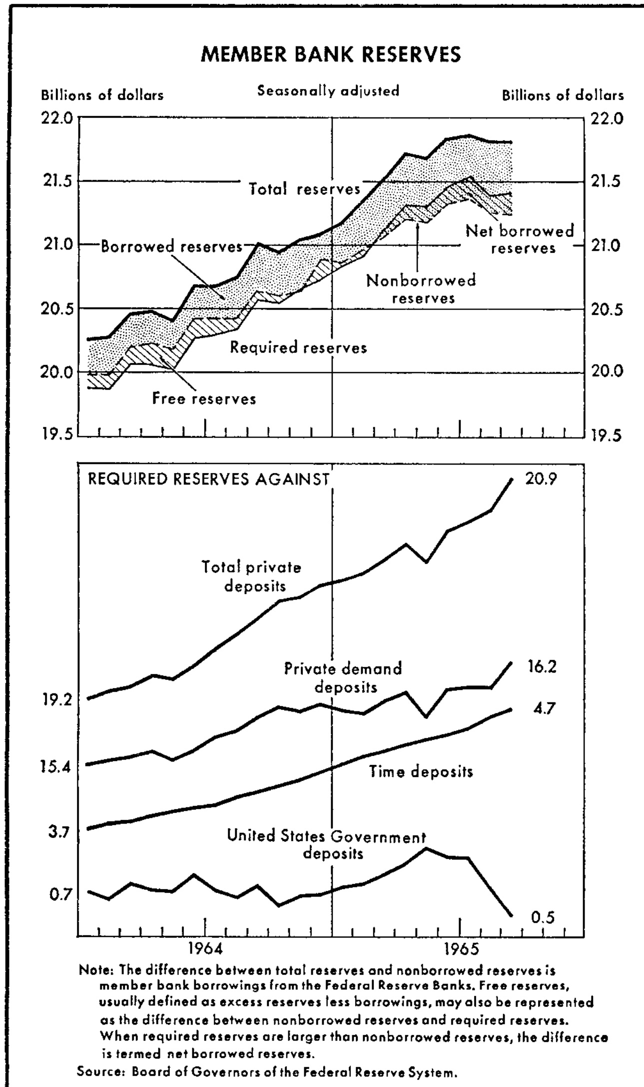
Large loan demands and the increased pressure on bank liquidity have led to a gradual tightening of bank loan terms over the year. As noted earlier, some banks have announced selective increases in loan rates, especially to nonbank financial institutions but also to other borrowers. According to the most recent quarterly survey of interest rates, the average rate charged by New York City banks on short-term loans in the first two weeks of September, at 4.68 per cent, was about 4 basis points higher than in June, while the rate on term loans was up by 7 basis points to 4.77 per cent.

DEPOSITS, TOTAL LIQUID ASSETS, AND BANK RESERVES

Total private deposits rose sharply in the third quarter. Indeed, the growth in the seasonally adjusted daily average money supply (which includes currency outside banks as well as private demand deposits) amounted to a 6.2 per cent annual rate, considerably above the pace earlier in the year and also above the 4.3 per cent growth in 1964. At the same time, daily average time deposits rose at a seasonally adjusted annual rate of 16.8 per cent. Thus, the growth of the money supply plus time deposits was at an annual rate of 11.5 per cent in the third quarter, well above the 8 per cent rate of 1964 and the first half of this year. On the other hand, United States Government deposits—which had expanded by almost 70 per cent in the first six months of the year—fell to near the beginning-of-the-year level during the third quarter as the Treasury used the large balances accumulated earlier to meet heavier than seasonal expenditures. The transfer of these deposits from Government to private ownership contributed substantially to the rapid rise in the money supply and in private time deposits.

Along with the rapid growth in private deposits at commercial banks, there were also fairly sharp gains in other forms of liquid assets owned by the nonbank public. Thus,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Note: The difference between total reserves and nonborrowed reserves is member bank borrowings from the Federal Reserve Banks. Free reserves, usually defined as excess reserves less borrowings, may also be represented as the difference between nonborrowed reserves and required reserves. When required reserves are larger than nonborrowed reserves, the difference is termed net borrowed reserves.
Source: Board of Governors of the Federal Reserve System.

savings and loan shares, deposits at mutual savings banks, and postal savings deposits, as a combined aggregate, grew at an annual rate of 9.0 per cent (seasonally adjusted) during the quarter, compared with 7.3 per cent in the first half of the year. Total liquid asset holdings of the private nonbank sector[1] were also up by nearly 9 per cent annually during the quarter, somewhat more than in the first half of the year. In the year ended in September 1965, the growth of total nonbank liquid assets has been more rapid than even the substantial growth of GNP, which over that period amounted to about 6½ per cent.

Although bank credit and deposits both increased during the third quarter, these gains took place without an increase in member bank reserves. Indeed, total member bank reserves actually declined slightly over the quarter as did required reserves (see chart). These developments reflected the sharp shift in deposit composition that occurred during the period. As noted earlier, Government deposits expanded rapidly during the first half of the year, accompanied by an accelerated growth of total reserves partially destined for the support of these deposits. Thus, while the growth of required reserves against private deposits during the first half of the year was about in line with earlier years of the current business expansion, total required reserves (which include reserves required against Government deposits) expanded at an annual rate of 7.0 per cent, nearly half again the rate of earlier years.

During the third quarter, in contrast, the sharp decline in Government deposits freed some $460 million of member bank reserves that had been built up earlier in the year. Because private deposit growth was concentrated in time deposits—which have of course a lower required reserve ratio than demand deposits—the increase in private deposits absorbed only about $410 million of the reserves released by declining Government deposits. Consequently, there was a net reduction of about $50 million in total required reserves over the period. Thus, a reduced need for reserves to meet requirements against deposits, combined with some restraint on the part of the banks in meeting loan requests, resulted in bank demands for nonborrowed and total reserves that were less than in the previous quarter.

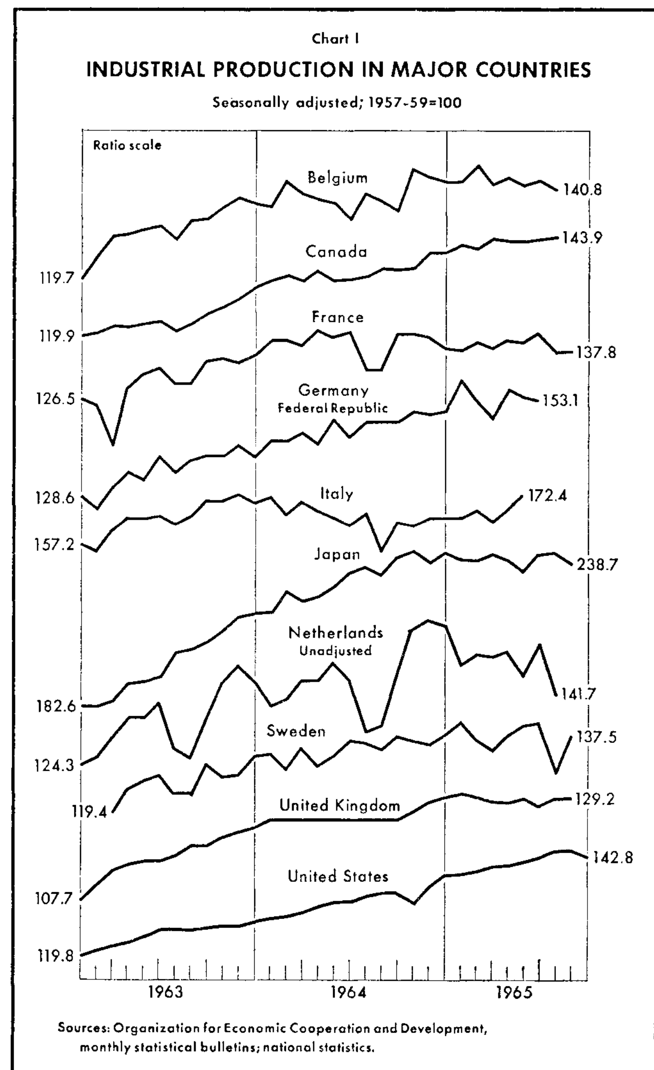
[1] Total nonbank liquid assets include demand deposits and time deposits (adjusted) at all commercial banks, currency outside banks, deposits at mutual savings banks, savings and loan shares, postal savings, United States Government savings bonds, and the public's holdings of United States Government securities maturing within one year.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Recent Monetary and Financial Policies Abroad

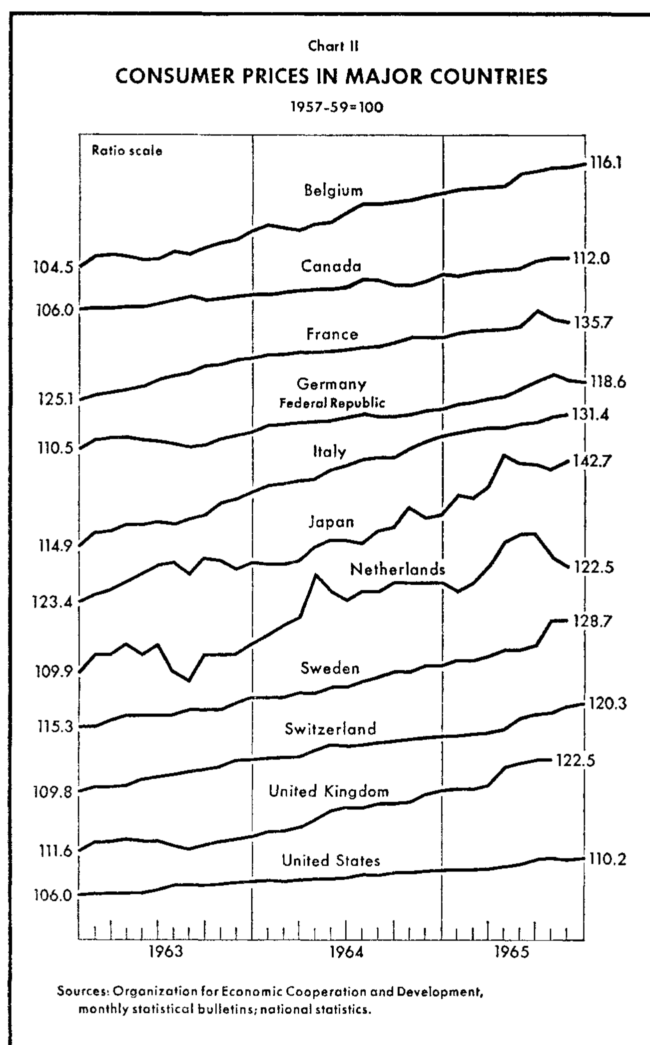
The strong measures adopted by the United Kingdom to curb the country's serious balance of payments deficit commanded the most attention among the various policy measures taken by the major industrial countries abroad during April-October of this year.[1] Other countries, too, leaned in the direction of restraint during the spring and summer—particularly Germany, but also Austria, Sweden, the Netherlands, Switzerland, and Canada. In other major countries—France, Belgium, Italy, and Japan—economic conditions permitted some relaxation of previously instituted restraint policies and led in some cases to the adoption of monetary and fiscal stimuli.

Economic trends in major industrial countries have been quite mixed recently. High-level activity and some price pressures continue in most of these countries, but in a few instances industrial production has declined and gross national product growth slowed. Thus, there is some evidence of a cyclical pattern abroad, although recessions have typically remained short and shallow with expansion dominant on balance. The timing of fluctuations in economic activity has varied considerably from country to country (see Chart I). For example, Italy reached a production peak in late 1963, followed by a recession from which the country is still recovering. Production leveled off in mid-1964 in France, peaked later in the year in Japan and Belgium, and apparently slowed down in early 1965 in the United Kingdom and Sweden. Throughout the past two years, on the other hand, industrial production continued to rise in Canada and Germany, and probably also in the Netherlands, although at slower rates in 1965 than before. Consumer prices moved upward in all these countries and in some—particularly the United Kingdom, the Netherlands, Germany, and Japan—the price increases threatened to gain momentum this year; in Italy the rise in prices has been slower than in 1964 (see Chart II). These variations in the rate of growth of economic activity and in price developments have substantially influenced external payments positions. In some of the countries



[1] For a discussion of foreign economic policy measures in 1964 and early 1965, see "International Monetary and Financial Developments", this *Review* (October 1964), pp. 196-201, and "Recent Economic Policy Measures in Industrial Countries Abroad", *ibid.* (April 1965), pp. 74-78.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



where domestic output has grown more slowly—such as France and Italy—the trade account improved, while in most countries that have experienced exceptional growth or inflationary pressures, the trade account deteriorated.

UNITED KINGDOM

During the period under review, the British government sought to develop a combination of domestic and foreign economic policies that would be stringent enough to curb excess domestic demand, retard the increase of prices and costs, and diminish the serious external payments gap. Restrictive measures adopted since last October have attacked these problems on a very broad front; they have included tax increases and reforms, tightening of domestic credit, retrenchment of government spending programs, curbs on imports, tighter exchange controls, improved assistance to exporters, and a firmer incomes policy. In general, the government has placed major emphasis on rapid progress toward external balance and on regenerating full confidence in sterling. Cumulatively, the British program has come to represent a formidable restraint package, and its effect on the domestic economy has been increasingly felt in recent months.

Several measures, described in the April issue of this *Review,* were taken by the new British government last fall, and by early 1965, the balance of payments did in fact begin to show some improvement. But wage increases continued well in excess of the 3½ per cent per annum official guideline, while retail prices advanced at an annual rate of 3.8 per cent in the six months ended March 31, 1965, and wholesale prices of manufactured goods rose at a 4.6 per cent annual rate during this period. Thus, the need for further corrective action was evident.

This need has been recognized in a sequence of actions taken over recent months. The April budget provided for tax increases, and tighter controls on capital outflows were introduced at the same time. Through May and June, monetary policy was tightened by several notches. Toward the end of July, government expenditures were cut back (with a moratorium on the placing of new contracts), and further measures were introduced to lend strength to the foreign trade and capital accounts. Most recently, incomes policy has been strengthened, and a move has been made toward long-range planning for sound growth of the British economy.

In the April budget the basic income tax rate was raised to 41¼ per cent from 38¾ per cent, and the capital gains tax was broadened to include longer term gains. Also, taxes on tobacco and alcoholic beverages were increased, as were motor vehicle license fees. In the area of tax reform, the government introduced a major revision of business income taxation, which favors reinvestment of corporate earnings in the United Kingdom while tending to discourage British corporate investment abroad.

Several steps taken at the time of the April budget message were designed specifically to improve the external position. The standards for making foreign exchange available for British direct investment abroad were tightened, and United Kingdom residents who wished to convert into sterling the foreign exchange proceeds of certain capital transactions—sales of nonsterling securities and direct investments—were required to dispose of 25 per cent of these proceeds through the official market for sterling, rather than converting them entirely through the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

"investment dollar" market.[2] Moreover, controls over foreign travel allowances and the repatriation of foreign exchange proceeds of exports were stiffened.

On the expenditures side of the April budget, government current and capital spending programs called for substantial increases despite certain savings in military aircraft procurement. Nevertheless, if one takes account of the proposed increases in taxation together with the restrictive measures adopted earlier, external payments balance during the course of 1966 was anticipated.

Over the next few months, however, the economy remained on a fairly expansionary path, and this development—judging from the monthly foreign trade returns, growing wage pressure, and exceptionally tight labor market conditions—posed a threat to the government's schedule for restoring payments balance in 1966. To meet this threat, the authorities again tightened credit policy. At the end of April, the London clearing banks and the Scottish banks were asked to make special cash deposits with the Bank of England, amounting to 1 per cent and 0.5 per cent respectively of their total deposits. In early May, the clearing banks, along with a wide range of other financial institutions, were asked to limit the annual growth of lending to the private sector to 5 per cent in the year ending March 1966, and to curtail loans for imports and nonessential purposes while giving preference to exports and activities contributing directly to exports.

On June 3, the Bank of England lowered its discount rate to 6 per cent from the 7 per cent that had been in force since the previous November (see table). The move was designed more to demonstrate confidence in current policies than to signal a shift toward ease. At the same time, the government raised minimum instalment credit downpayments from 20 per cent to 25 per cent on automobiles, and from 10 per cent to 15 per cent on most other consumer durables.

Tangible evidence that the economy was responding to the restrictive measures was slow to emerge. Imports rebounded in March-May in response to the end of the United States dock strike and the reduction of the import surcharge from 15 per cent to 10 per cent on April 27; meanwhile, exports showed a tendency to remain level. Thus, the trade deficit widened in those months. In June, although imports fell back, exports fell also, thus seeming to confirm doubts as to whether the needed export growth would be forthcoming.

CHANGES IN SELECTED FOREIGN CENTRAL BANK DISCOUNT RATES, 1964-65

In per cent

Country	Date	New rate	Change
Belgium	1964: July 3	4¾	+½
Canada	1964: November 24	4¼	+¼
Denmark	1964: June 11	6½	+1
France	1965: April 8	3½	−½
Germany	1965: January 22	3½	+½
	August 13	4	+½
Japan	1964: March 18	6.57	+0.73
	1965: January 9	6.205	−0.365
	April 3	5.84	−0.365
	June 26	5.475	−0.365
Netherlands	1964: January 6	4	+½
	June 4	4½	+½
South Africa	1964: July 15	4	+½
	December 8	4½	+½
	1965: March 5	5	+½
Sweden	1964: January 31	4½	+½
	November 6	5	+½
	1965: April 9	5½	+½
Switzerland	1964: July 3	2½	+½
United Kingdom	1964: February 27	5	+1
	November 23	7	+2
	1965: June 3	6	−1

Consequently the British government took additional restrictive measures at the end of July to bolster the program already in force. Expenditures delays and cutbacks were announced for all levels of government, including especially outlays overseas but also current and capital spending of the local governments and the nationalized industries. Furthermore, certain welfare programs—such as the guaranteed income plan, completely free health service, and favorable interest rates on mortgages for owner-occupied residential buildings—were postponed. Thus, tightened fiscal policy was added to the existing monetary stringency. Private spending was also curbed through a reduction in local government mortgage lending, stricter licensing of private construction projects, and a reduction of the maximum repayment period on almost all instalment sales to thirty months from thirty-six months.

Also in July, the external payments gap was again tackled specifically: it was required that all new direct foreign investment by British residents outside the sterling area be financed by funds obtained from the investment dollar market or from abroad; and the sale of certain for-

[2] The authorities use this market to limit nonsterling investment by United Kingdom residents. The latter must obtain the foreign exchange needed for portfolio or direct investments by bidding for it in a market where the supply of foreign exchange is derived from approved sales by British residents of nonsterling-area securities or other approved assets.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

eign exchange receipts of United Kingdom residents (proceeds of life insurance policies, immigrants' assets, and savings from employment abroad) was shifted to the official market for sterling. In addition, the Bank of England ordered a curtailment of advance payments for imports, requested the banking community to extend no further loans when prima facie evidence suggested that the funds would finance imports, and announced stricter supervision of credit facilities available to the British subsidiaries of foreign corporations. To assist exports, the minimum size of loan contracts eligible for coverage by the government's Export Credits Guarantee Department (ECGD) was halved for the second time this year (to £25,000). Also, the banks agreed to provide short-term export credits, against an unconditional ECGD guarantee for all such credits of between thirty days and two years, at the official discount rate instead of about 1 per cent above that rate for credit which previously was not guaranteed.

The British government's most recent actions have been designed to make existing curbs more effective and to deepen its attack on the country's external payments problem. In September, the Minister of Economic Affairs sought and obtained a promise of union-management cooperation in a program designed to give "early warning" of impending price or wage increases in key sectors. The government intends to introduce legislation giving the National Board for Prices and Incomes broad investigatory responsibilities, and giving the government the power to delay wage or price increases until after the Board's report.

Late in September, the authorities published a National Plan calling for a 25 per cent increase in real output by 1970. A crucial aim of the growth program is a balance of payments sufficiently strengthened over the next five years to meet the repayment of maturing external debt and bolster official reserves. It is recognized that the achievement of these goals will require exceptional increases in productivity and a very substantial increase in industrial investment. The government asserted the crucial importance of concerted national action to eliminate restrictive practices by both management and labor and thereby improve the competitive performance of the economy.

It is now becoming evident that the measures taken by the British authorities over the past year have resulted in substantial progress toward eliminating Britain's external payments deficit. During the first half of 1965 the deficit on current and long-term capital account was only one third that of the same period last year, while the second quarter produced a surplus for the first time in two years. The improvement reflected both an improved trade balance and a sharp drop in capital exports. The recent strengthening of sterling and the third-quarter decline in the trade deficit suggest continued progress in eliminating the payments deficit.

RESTRAINT IN OTHER COUNTRIES

A number of other countries have found some degree of restraint necessary in the period under review. Germany and Sweden—faced with rising prices, deteriorating trade balances, and congested capital markets—have considerably reinforced restrictive measures in recent months. In Austria, the Netherlands, Switzerland, and Canada, where inflationary pressures have been somewhat milder or trends in payments balances more favorable, restraints have been less severe.

The German economy has long been operating at virtually full capacity, and the shortage of labor has been marked. Since the turn of the year, the upward movement of prices has apparently accelerated somewhat, and an over-all balance of payments deficit emerged during the second quarter. Money market conditions have tightened perceptibly, while heavy demands from both private and public borrowers, including the federal government, have pushed up long-term interest rates. In May, the German Federal Bank halted its price support operations for public-sector bonds, with a resulting rise in effective yields on 6 per cent public-authority bonds from 6.7 per cent in April to 7.6 per cent in July. In view of the mounting pressures on long-term rates, a stop on new flotations of federal, state, and municipal bonds was imposed at the end of July. This ban was lifted in September, but representatives of federal, provincial, and municipal governments and of the Federal Bank have held regular consultations with a view to limiting public-sector issues and hence preventing any further substantial rise in interest rates. Largely in recognition of developments in the financial markets, the Federal Bank on August 13 raised its discount rate from 3½ per cent to 4 per cent, the second increase in less than seven months.

Sweden, too, moved to offset inflationary pressures by both monetary and fiscal measures. On April 9, the central bank raised its discount rate (for the second time in six months) from 5 per cent to 5½ per cent, the highest level since the early 1930's. At the same time, it boosted from 10 per cent to 11 per cent the penalty rate for discounts in excess of the established ceilings. Soon thereafter, the government moved to make more resources available for residential construction and industrial investment by reducing its own construction expenditures by 10 per cent, and it urged the local authorities to make similar cutbacks. An increase in the general sales tax from 6.4 per cent to 10 per cent became effective on July 1, with increases in old-age pensions and children's allowances to ease the impact.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Austria has continued to experience price and wage pressures, and the policy of monetary restraint, initiated last fall, was intensified during the period under review. Commercial bank reserve requirements for the large banks were raised further, to 12 per cent of sight and time deposits and to 10 per cent of savings deposits. In addition, the central bank engaged in open market sales of Treasury paper. (Recent legislation provided for the conversion of a part of the National Bank's claims on the government into marketable securities.) On the fiscal side, government expenditures were cut back to avoid additional borrowing when tax receipts failed to come up to expectations.

In the Netherlands, economic policy has remained fairly restrictive in the face of rising domestic investment, pressure on the financial markets, and some inflow of funds from abroad. The Netherlands Bank has maintained the requirement that banks deposit with the central bank amounts equal to the excess of their loans over the established ceilings (although these ceilings were raised slightly in September). But despite the restrictive efforts the economy experienced sharp pressures on costs and prices during the first eight months of this year. These included a substantial wage increase in early 1965, the negotiation of a 2 per cent wage bonus payable partly in July and partly in December, and the inclusion of a cost-of-living escalator clause in recent longer term wage contracts. The pressures were reinforced by a reduction in income taxes at midyear (which had its inception in a wage-tax package worked out at the end of 1964). In view of the fact that the cost-of-living index rose by nearly 5 per cent in the first seven months of the year—equal to the increase expected for the whole year by the Dutch planning authorities—official price investigations in twenty-one economic sectors were initiated in September. In one sector, hotels and restaurants, prices have already been rolled back from a level of 10 per cent higher to one 4 per cent higher than that of October 1, 1964. As regards fiscal policy, the government's 1966 budget calls for a 9 per cent increase in expenditures and a tax reduction of $28 equivalent per taxpayer. However, increases in indirect taxes, the growing tax base, and obligatory purchases of savings certificates (in an amount equal to the tax reduction) are expected to make it unnecessary for the government to increase its market borrowings.

Swiss economic policy has also remained on the restrictive side, especially in view of the continued upward drift of prices and last year's decision to reduce the number of foreign workers (who account for about one third of the total Swiss labor force). The main elements of economic policy remain those introduced in 1964 and since extended by national referendum: limitations on increases in bank credit, limits on construction permits, control over the timing of new securities flotations of both domestic and foreign borrowers, and restrictions on the inflow of foreign funds. Since the present control powers are temporary, the Swiss National Bank has proposed legislation under which it would receive broader powers, including the right to establish minimum reserve requirements and the possibility of greater scope with respect to open market operations.

Conditions in the Canadian money and capital markets tightened somewhat during the period under review. The growth of aggregate demand has quickened during 1965, spurred by a rise in business investment, by inventory accumulation, and by a moderate rise in exports (to which the recent large wheat sales to Russia and China will be added). The resulting resources strain has apparently led to a slight shift in monetary policy aimed at moderating the pace of domestic expansion. Achievement of this objective was facilitated by some withdrawals of United States funds from Canada as a result of the United States Voluntary Foreign Credit Restraint Program. In September, the three-month Treasury bill rate reached 4.15 per cent, the highest since November 1962. As Canadian banks attempted to maintain their liquidity positions through sales of longer term securities, rising rates in the money market were transmitted to the medium- and long-term markets as well, and the Treasury nudged rates a bit higher by a mid-August bond offering priced below the market. Also in August, Prime Minister Pearson called for restraint in public and private capital spending and, to set an example, announced the postponement or spacing-out of some government construction projects.

COUNTRIES TURNING TOWARD STIMULATIVE POLICIES

In four countries in which earlier restrictive measures had been followed by a substantial slowing-down of economic growth—France, Belgium, Italy, and Japan—mildly stimulative policies adopted in late 1964 or early 1965 were continued in the period under review. Because prices in all these countries still have been rising and because the margin of unemployed resources has been thin in most cases, stimulatory efforts have remained cautious.

The Bank of France lowered its discount rate from 4 per cent to 3½ per cent on April 8. Shortly thereafter the basic rate for calculating interest rates on commercial bank loans was lowered, for the second time in 1965. In April, the French government liberalized loan standards on government-subsidized low-interest home mortgage loans. Ceilings on the permissible annual percentage increase in commercial bank credit were eliminated in June; for

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

some months, however, they had not been reached. Other aspects of monetary policy—rediscount ceilings and liquidity ratios in particular—have remained relatively restrictive. In September a number of steps were taken to promote economic growth by altering the structure of French financial institutions (see the final section of this article). As to fiscal policy, the budget prepared for 1966 reflects the French government's firm commitment to maintain the balance between receipts and expenditures achieved in 1964 and, in all probability, in 1965. Estimates of budget receipts to meet larger expenditures are based on a higher rate of growth than has recently been realized, but the recent upturn in economic activity affords support for official expectations.

The Belgian authorities have proceeded with similar caution. Certain government investment projects—frozen the year before when inflation was more threatening—were resumed in April, and public works projects that had been scheduled for later this year were pushed forward. In July, both the 1 per cent commercial bank reserve requirement, imposed a year earlier, and the ceilings on bank credit expansion were removed. The central bank nevertheless requested the banks to observe caution in granting loans and not to increase loans for construction and consumer purchases.

The Italian economy has shown signs of a gradual recovery from the recession that developed early last year. So far, the recovery has been mainly limited to a group of export and consumer goods industries, such as iron and steel, automobiles, and chemicals. Activity in other key industries, especially textiles and construction, has not yet regained momentum. With a strong export performance, with import demand slow to recover to prerecession levels, and with excellent tourist receipts, Italy's external payments were in surplus by close to $1.1 billion in the first eight months of the year. This external surplus has increased commercial bank liquidity, and the banks have responded by reducing their net foreign indebtedness by about $500 million. There has been little increase, however, in bank loans to domestic borrowers, as loan demand has remained relatively slack. In view of the partial character of the recovery thus far, special efforts are now being applied to stimulate the weaker sectors of the economy. Thus, in August, the government approved a number of steps to aid the textile industry, including tax exemptions, official contributions toward modernization efforts, retraining of displaced workers, and extended unemployment benefits. Provisions for reviving the building industry are now being considered, as are measures for speeding up the government's investment program.

In Japan, the restrictive policy followed by the authorities through most of 1964 succeeded in reducing the country's balance of payments deficit, but the growth of output had virtually stopped by the end of the year, unemployment and excess plant capacity began to develop, and the stock market displayed considerable weakness. Although the Bank of Japan began to move toward an easier money policy in December 1964 and also lent its support to the stock market, the adverse trends continued into mid-1965. In these circumstances, some industrial and financial corporations found themselves overextended, and a few highly publicized bankruptcies occurred, which increased nervousness in Japanese financial markets. Thus, during the spring the Japanese authorities initiated a series of moves to reestablish confidence and promote recovery. In May, special credit arrangements were provided to securities houses while the central bank continued to support the securities market. The Bank of Japan's discount rate was reduced in April and again in June. It now stands at 5.475 per cent, the lowest since 1950. Ceilings on the expansion of commercial bank credit were abolished in June, and in July the minimum cash reserve requirements for banks and other financial institutions were reduced, while the Bank of Japan made substantial open market purchases. These monetary measures have substantially lowered the interest rates prime industrial and commercial borrowers must pay.

Japan's fiscal policy is also becoming more stimulative. Deficits in the investment budget have resulted in modest but increasing over-all budgetary deficits since 1962. This year's deficit is likely to be over $800 million equivalent, as a result of a decision taken in July to restore about $280 million of previously postponed expenditures and the enactment in August of a supplementary investment budget of roughly $560 million (including increased loans to finance exports, housing, public utilities, and small and medium-sized business enterprises). For the fiscal year beginning in April 1966, the government plans to introduce legislation permitting a deficit in the general account budget—prohibited since 1949—and substantially reducing the corporate income taxes levied by the central government. The size of the over-all deficit likely to result has not yet been determined.

SOME INSTITUTIONAL CHANGES ABROAD

The recent tapering-off in the rate of output growth in many countries at a time when prices have continued to drift upward has led to considerable thought abroad about changing institutional arrangements in ways which would lead to further productivity gains without imparting in-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

flationary impulses to national economies.

Several institutional changes of considerable general interest have in fact been introduced in major countries abroad in 1965. In Germany, two steps have been taken to promote workers' savings and to direct them toward productive investment. In April, the German parliament approved a partial transfer from government to private ownership of the shares of a large mining and utilities concern—the third such "privatization" in recent years. The new shares were sold in small denominations at attractive prices to encourage widespread ownership and to attract small savings. The following month a second law provided a limited tax exemption on benefits paid by employers into blocked savings accounts of their employees.

In France recent (and pending) tax legislation and rulings by the monetary authorities are designed to effect important structural changes in French financial institutions. The over-all objectives of these reforms are, first, to increase the proportion of income saved and, second, to promote more effective utilization of savings. The first objective is to be furthered by partial or complete tax relief on income from various kinds of personal savings. Specifically, tax exemptions are provided for the first 500 francs of bond interest, interest on savings accounts up to 15,000 francs, and income (and capital gains) accruing from ten-year savings plans that require regular investments in securities. Tax reductions are to apply to a broader range of interest and dividend income. To promote the second objective, the distinction between commercial banks and investment banks *(banques d'affaires)* will be reduced by allowing the former to accept deposits of more than two years and the latter to accept sight deposits without restriction. Both types of banks will be expected to adapt the structure of their assets to actual changes in the maturity of their deposit liabilities. Recent changes in Bank of France discount policy are designed to accomplish two objectives: first, to encourage the commercial banks to move into longer term and more varied lending and, second, to have them rely more heavily on private rather than on central bank resources. To promote the first objective, the Bank will rediscount medium-term paper with maturities of up to seven years (rather than the former five years) and also a wider variety of export paper. However, in line with the second objective, the central bank will in most cases limit rediscounts to paper with three years or less to run to maturity, rather than five years as previously, and will charge a 0.50 per cent penalty for discounts in the two to three years' maturity range.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The New York City Banks' Share in Commercial Banking

By FRANCIS H. SCHOTT AND RUDOLF THUNBERG*

The large New York City banks occupy a special position within the nation's banking system. In addition to providing local banking services, they extend a substantial part of the credit used by firms with nationwide operations and are a focal point of the country's network of correspondent banking. They also do the bulk of the country's international banking business — financing foreign trade, rendering financial services to foreign dollar holders, and trading in foreign exchange. Furthermore, as one of the primary sources of bank credit to dealers in United States Government securities, they are a major link in the transmittal of the impact of Federal Reserve System open market operations throughout the financial structure. This article discusses some recent developments in the share of this important group of banks in the nation's commercial banking.

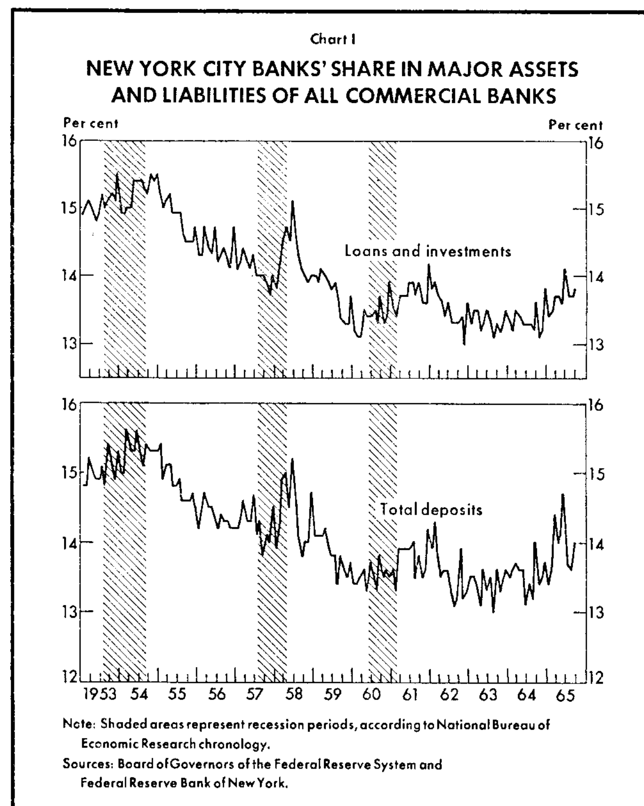
TRENDS IN THE NEW YORK CITY BANKS' SHARE IN COMMERCIAL BANKING

At its zenith, in 1941, the New York City weekly reporting banks' share in the total loans and investments and total deposits of the commercial banking system had risen to almost 25 per cent.[1] During the ensuing two decades, although the New York City banks grew substantially in absolute terms, their share in total credit and deposits followed a generally declining trend—as shown, for the years since 1952, in Chart I. During the 1960's, however, that downtrend has been arrested and to some extent reversed, as also shown in Chart I.

A number of factors contributed to the lagging relative growth of New York City banks until recent years. The population of the Northeast increased rather slowly in the postwar years. New York City's population, in particular, grew by only 4 per cent between 1940 and 1960, compared with an increase of almost 36 per cent for the nation as a whole. In addition, the composition of the population of the city underwent a change, as many middle-income depositors moved to the suburbs and were replaced by low-income groups. Laws covering branch banking prevented New York City banks from opening branches in the growing suburbs. Furthermore, corporate working

Chart I

NEW YORK CITY BANKS' SHARE IN MAJOR ASSETS AND LIABILITIES OF ALL COMMERCIAL BANKS



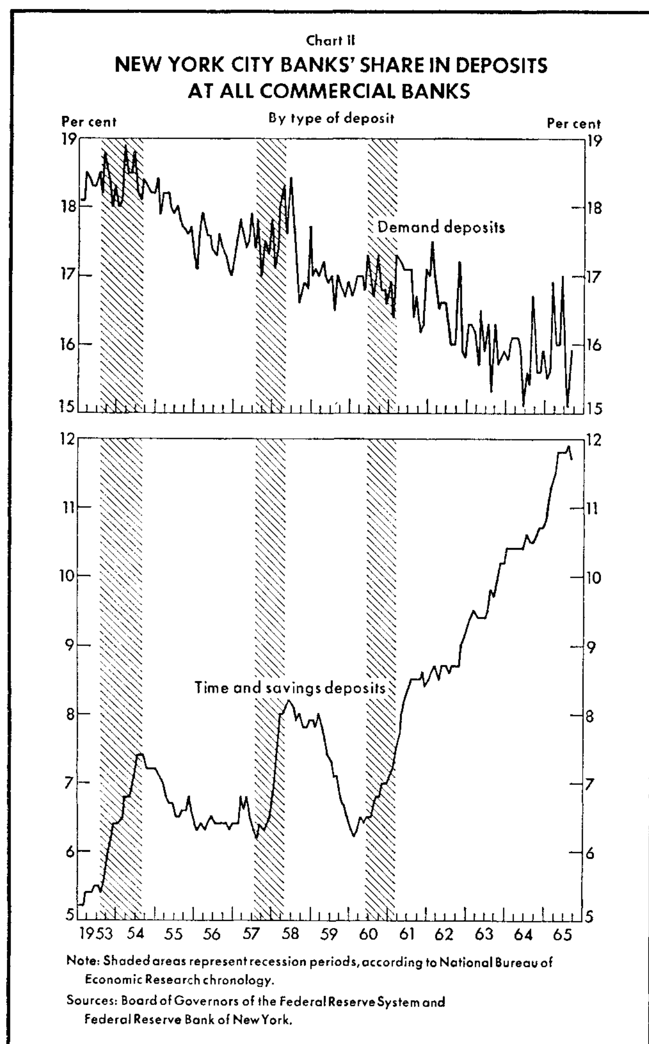
Note: Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.

Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York.

* Manager, Research Department, and Economist, Research Department.

[1] The New York City weekly reporting banks, presently thirteen in number, are those which provide the Federal Reserve with balance-sheet information each week. They include six of the country's ten largest banks, three other large banks, and four banks of intermediate size. All have their headquarters in New York City.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Note: Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.
Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York.

balances were gradually more widely spread through the nation's banking system since industrial growth was centered in the West and the South. Meanwhile, corporate treasurers became increasingly sophisticated in the management of liquid funds and tended systematically to minimize noninterest-bearing balances. The New York City banks—where corporations had traditionally held a large part of their liquid funds—for these reasons failed to participate as fully as previously in the growth of total deposits, although their share in total corporate deposits remained substantial.

Cyclical changes sometimes retarded and at other times reinforced the declining trend. Chart I shows that the percentage of total commercial bank loans and investments and deposits held in New York City tended to rise during recessions and to fall during expansions of economic activity. On the deposit side, the cyclical pattern was largely confined to time deposits, as shown in Chart II.[2] One possible explanation of this pattern is the following: prior to the introduction of negotiable time certificates of deposit (C/D's) at New York City banks in 1961 (discussed below), foreign holders of dollar assets and other interest-sensitive investors found time deposits an attractive outlet for their liquid funds primarily during recessions and not during expansions. Time deposit rates were considerably more stable over the course of the cycle than rates on Treasury bills and other money market instruments. This meant that time deposits became a relatively more attractive short-term investment medium as Treasury bill rates moved downward in recessions, and less attractive during expansions when bill rates moved upward.[3] The shifts in the form of holding liquid funds among different types of short-term assets that were thus induced had important implications for the relative shares of various groups of banks in total time deposits. In particular, the share of those banks that especially serve large and interest-sensitive customers tended to be enlarged during recessions and reduced during expansions.

The cyclical pattern of the share of New York City banks in the nation's banking business may also reflect differences among banks in the degree of utilization of available reserves. Large city banks manage their money position in such a way that they have minimal excess reserves at any time. During expansionary periods, therefore, these banks have typically had to satisfy at least part of any heavy loan demand by liquidating holdings of securities, merely substituting one form of bank credit for another. "Country" banks, on the other hand, have generally tended to hold excess reserves, which are usually especially large during recessions. Therefore, a portion of their portfolio growth during the ensuing economic expan-

[2] The demand deposit share of New York City banks (also shown in Chart II) appears to be affected only slightly by the cycle. One exception to this generalization occurred toward the end of the 1957-58 recession when the New York demand deposit share rose considerably along with the time deposit share. Unusually large Treasury financing operations in 1958 resulted in a temporary buildup of United States Government balances, concentrated for a time at large banks.

[3] See Richard G. Davis and Jack M. Guttentag, "Time and Savings Deposits in the Cycle", this *Review* (June 1962), pp. 86-91, as well as "Movements in Time and Savings Deposits, 1951-1962", Federal Reserve Bank of St. Louis *Review* (March 1963), pp. 5-10, and William R. Bryan, "Recent Trends in Time Deposits", *ibid.* (June 1964), pp. 7-11.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

sion could be financed by reducing excess reserves. Consequently, country banks have tended to be more able to increase their total credit during expansions than New York City banks, and hence have gained relatively on New York City banks in these periods.[4]

In striking contrast to these earlier patterns, the downtrend in the New York City banks' share of commercial banking has been arrested over the course of the current prolonged period of economic expansion. Following a rise in that share during the 1960-61 recession, which was in accord with the historical patterns, the rise in the New York share continued well into 1961 (the early phase of the expansion), which was contrary to the historical pattern. Furthermore, the decline which then began appears to have been arrested since about the end of 1962. Indeed, after a period of substantial stability lasting until roughly mid-1964, the New York share began to rise and this movement continued through mid-1965. As a consequence, the New York banks' share, at roughly 14.5 per cent of total deposits and 14 per cent of total loans and investments of all commercial banks, in June reached about the highest levels since early 1959.

PRINCIPAL REASONS FOR RECENT IMPROVEMENT IN POSITION OF NEW YORK BANKS

The growth of the commercial banking system as a whole is influenced by a host of variables. These include especially the amount of additional reserves supplied by the Federal Reserve and technical factors such as reserve drains into additional currency in circulation, as well as the required ratio of reserves to deposits, and the deposit "mix" (if a difference exists—as it does—between reserve requirements on various types of deposits). The relative growth of any one bank or group of banks within the banking system, however, is determined primarily by relative success in attracting deposits. Beginning in the early 1960's, New York City banks began to take positive steps to halt the decline in their relative position.

Perhaps the most important of these moves was a change in attitude toward time and savings deposits. Before 1961, the large New York City banks generally took a negative attitude toward time deposits of corporations, and some although not all were quite indifferent to savings deposits. Since then, they have been bidding aggressively for temporarily idle corporate funds as well as for savings of individuals. Practically all the deposit growth of large New York City banks in recent years has in fact been in the form of time and savings deposits. Between September 1960 and September 1965, total time and savings deposits of the New York City weekly reporting banks increased by about 240 per cent ($11.8 billion), while demand deposits at these banks grew by only 8 per cent ($1.9 billion). In terms of the New York share in total deposits, this time deposit gain more than offset a further relative decline in demand deposits, as is evident from a comparison of New York's total-deposit share (Chart I) with the breakdown of this share by type of deposit (Chart II).

For reasons already noted, cyclical variations in the deposit share of New York banks have tended to be confined largely to time deposits. Therefore, a downturn of the New York share in time deposits would have been predicted for early 1961—the beginning of the current economic expansion—but no such downturn materialized. On the contrary, that share has been rising almost continuously, from barely 7 per cent at the beginning of 1961 to almost 12 per cent by mid-1965.

Once their decision to compete aggressively for time deposits was made, the New York banks achieved success largely through the medium of negotiable time certificates of deposit (C/D's). After being used locally and regionally for some years, mostly in the West and Southwest, this new money market instrument was thrust into national prominence in February 1961—at the trough of the last recession—when the large New York banks began to issue negotiable certificates for time deposits of substantial size. Almost simultaneously, Government securities dealers established a secondary market in C/D's, and the other major New York City banks as well as large banks around the nation began issuing these instruments.[5] Within a few months, the C/D had become a major money market instrument, and by early 1964 the volume of negotiable C/D's exceeded that of commercial and finance company paper and bankers' acceptances combined. Since then, C/D's have continued to gain, both in absolute amounts outstanding and relative to other

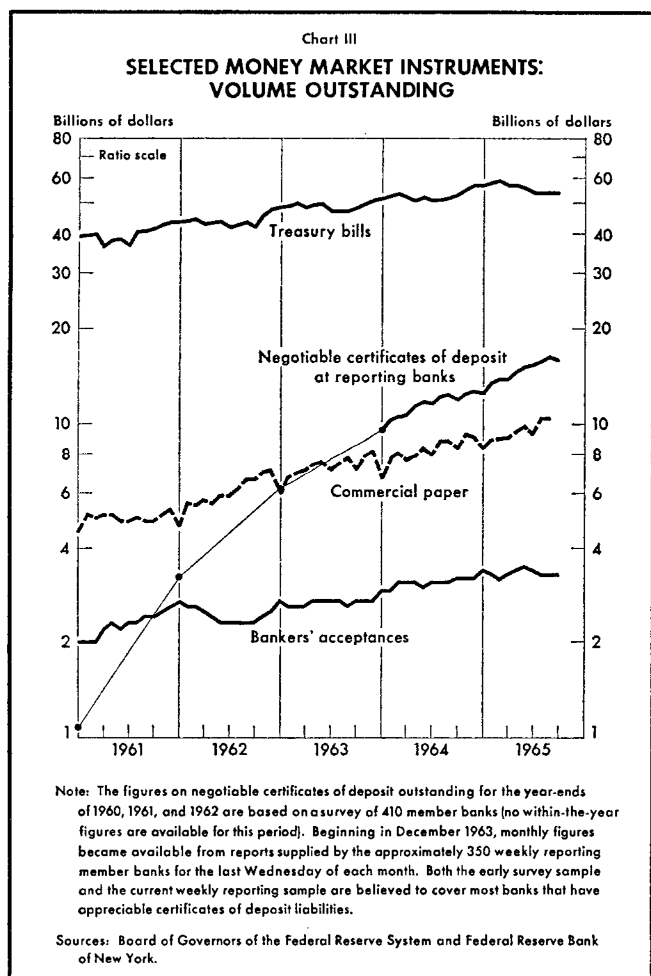
[4] The substitution of credit for excess reserves on the part of country banks during expansions may enlarge only their share in total bank credit and not necessarily their share in total deposits. Most likely, however, the banks at which the creation of additional credit takes place will retain a somewhat larger share of the deposits associated with this credit expansion than they generally hold, partly because of compensating-balance requirements against loans.

[5] See Richard C. Fieldhouse, "Certificates of Deposit", this *Review* (June 1963), pp. 82-87, and the updated version of that article in this Bank's *Essays in Money and Credit* (December 1964), pp. 42-46.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

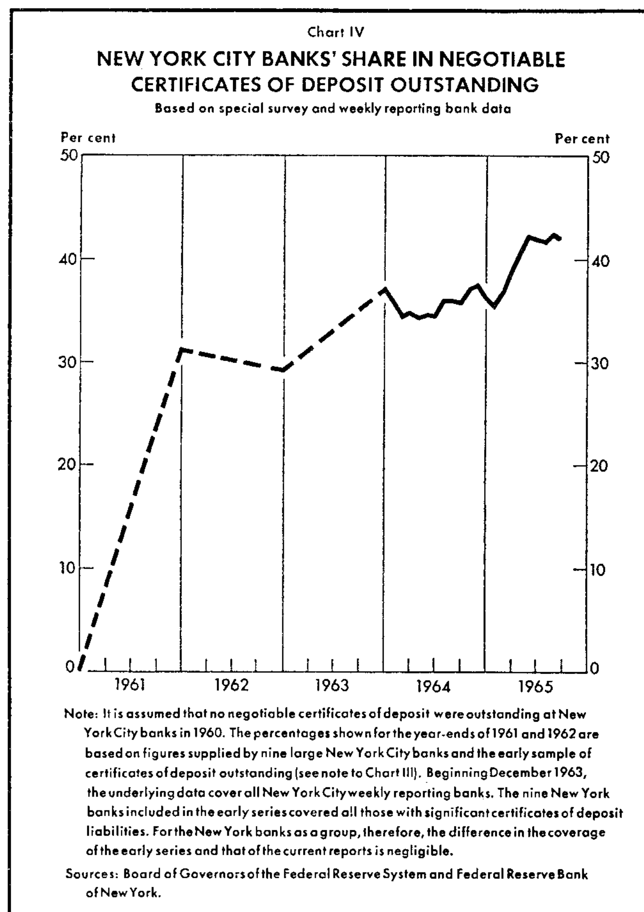
money market instruments (see Chart III). In mid-October 1965—after a seasonal dip in September—the total amount of negotiable C/D's outstanding at all weekly reporting member banks exceeded $16.3 billion.

The negotiable time certificate has greatly contributed to a broadening of the competition for bank deposits from the local and regional to the nationwide level. Furthermore, the competition for profitable loans and investments has also been broadened, since the C/D market facilitates the search for the needed resources once the lending opportunity arises. The large money market banks have turned out to be strong competitors, particularly because a C/D possesses greater marketability if it is issued by a bank of national repute. This criterion is readily met by the large New York banks, which are therefore able to obtain deposits by issuing C/D's at somewhat lower interest rates than smaller and less well-known banks. The competitive strength of New York "prime banks" is reflected in the absolute and relative growth of their outstanding C/D's. For all New York City weekly reporting banks, the total has grown from virtually zero in early 1961 to almost $7 billion in early September 1965; and the New York share among all weekly reporting banks has risen from a negligible percentage in early 1961 to more than 40 per cent by mid-1965 (see Chart IV).[6]



Note: The figures on negotiable certificates of deposit outstanding for the year-ends of 1960, 1961, and 1962 are based on a survey of 410 member banks (no within-the-year figures are available for this period). Beginning in December 1963, monthly figures became available from reports supplied by the approximately 350 weekly reporting member banks for the last Wednesday of each month. Both the early survey sample and the current weekly reporting sample are believed to cover most banks that have appreciable certificates of deposit liabilities.

Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York.



Note: It is assumed that no negotiable certificates of deposit were outstanding at New York City banks in 1960. The percentages shown for the year-ends of 1961 and 1962 are based on figures supplied by nine large New York City banks and the early sample of certificates of deposit outstanding (see note to Chart III). Beginning December 1963, the underlying data cover all New York City weekly reporting banks. The nine New York banks included in the early series covered all those with significant certificates of deposit liabilities. For the New York banks as a group, therefore, the difference in the coverage of the early series and that of the current reports is negligible.

Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York.

[6] The relative rate of growth of C/D's outstanding at various groups of banks appears to have become closely linked to the relative strength of various types of loan demand. The reason is of course that relative loan demand influences the degree of aggressiveness with which banks bid for C/D funds. For example, business loan demand has been very active in 1965, and New York banks make proportionately more business loans than other groups of banks. This factor has been particularly important during 1965 in leading New York banks to compete aggressively for deposits. As a consequence of this and several other factors, the rise in the New York City bank share in outstanding C/D's was especially pronounced in the first half of 1965.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

MAXIMUM RATES PAYABLE ON TIME AND SAVINGS DEPOSITS UNDER FEDERAL RESERVE REGULATION Q*

In per cent per annum

Type of deposit	Jan. 1, 1936– Dec. 31, 1956	Jan. 1, 1957– Dec. 31, 1961	Jan. 1, 1962– July 16, 1963	July 17, 1963– Nov. 23, 1964	Nov. 24, 1964– Present
Savings deposits:					
1 year or more	2½	3	4	4	4
Less than 1 year	2½	3	3½	3½	4
Other time deposits:					
1 year or more	2½	3	4	4	4½
6 months or more but less than 1 year	2½	3	3½	4	4½
90 days or more but less than 6 months	2	2½	2½	4	4½
30 to 89 days	1	1	1	1	4

* Since October 15, 1962, time deposits due to foreign official institutions have been exempt from interest rate ceilings under Regulation Q.
Source: Board of Governors of the Federal Reserve System.

The Federal Reserve has facilitated the spectacular growth of C/D's by allowing banks to pay time deposit rates competitive with those on other money market instruments, and this is precisely what the banks have been doing during the current sustained period of economic expansion. Since 1961, the maximum rates payable on time and savings deposits under the Board of Governors' Regulation Q have been raised three times (see table). The most recent revisions, in July 1963 and November 1964, have emphasized liberalization of rates on time deposits of short-term maturities. Although these Federal Reserve policy changes were occasioned by the need to keep permissible time deposit rates in line with other national and international money market rates, they also permitted a demonstration of competitive strength on the part of money market banks, which may be especially well situated to capture short-term corporate funds. Additionally, the exemption from interest rate ceilings on time deposits of foreign official institutions since October 1962 was primarily designed to make dollar deposits attractive to such foreign authorities. Nevertheless, it may also have had the effect of enlarging the New York banks' share of total deposits, since these banks in fact hold the bulk of the official foreign deposits in United States banks.[7]

[7] More generally, it is likely that large New York banks—well-known outside the country—would be the deposit institutions favored by all categories of foreigners. Both official and private foreigners were substantial gainers of dollar deposits over the course of the major United States balance of payments deficits of the years 1958-64.

ADDITIONAL FACTORS STRENGTHENING THE NEW YORK BANKS' POSITION

It has already been pointed out that the relative improvement in the position of New York City banks over the past few years cannot be attributed to strength in attracting demand deposits, for the share of New York City weekly reporting banks in total demand deposits of the banking system has still generally declined. Nevertheless, it should be noted that this decline might have been worse (and the over-all gain of the New York banks less) without the reductions in reserve requirements on demand deposits of "central reserve city" banks from 18 per cent to 16.5 per cent in 1960 (made effective in two steps in September and December of that year).[8] A reduction of a bank's reserve requirement tends to result in a substitution of loans and investments for cash reserves at that

[8] The "central reserve city" category of banks, which was terminated and merged with the "reserve city" category in July 1962, included the largest banks in New York and Chicago. The reductions of the central reserve city bank reserve requirements were accompanied by an increase in the reserve requirement on demand deposits of "country" member banks—from 11 per cent to 12 per cent—in November 1960. Also during 1960 and the preceding year, however, all vault cash was gradually made eligible for inclusion in legal reserves. (This action by the Federal Reserve's Board of Governors was permitted under the same law of Congress that required an end to the central reserve city category of banks.) The inclusion of vault cash in legal reserves most benefited country banks, which as a group hold much higher ratios of vault cash to deposits than do money market banks. The reserve requirement on time deposits has long been uniform for all member banks, and has been 4 per cent since late 1962 when it was lowered from 5 per cent.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

bank, and a higher ratio of earning assets to liabilities in turn will make deposits potentially more profitable, thus encouraging the bank to intensify its competition for deposits.[9] Therefore, the reduction in the reserve requirement for central reserve city banks has perhaps tended to retard the relative decline of demand deposits at New York banks.

The long duration of the current expansion is, in itself, a factor that has recently tended to halt the decline in the relative position of large banks as the smaller banks have gradually drawn down and utilized the excess reserves with which they typically enter a period of economic expansion.[10] During the first three years of the current expansion, country banks again increased their earning assets by reducing their cash reserves in relation to deposits, but since early 1964 the excess cash ratio of country member banks has remained virtually unchanged. New York City banks, however, have reduced their excess reserve-deposit ratio only negligibly during the entire expansion.

It should also be noted that the development of the Federal funds market over the past few years has provided a means of mitigating the cyclical pattern of relative credit and deposit gains of country banks in an economic expansion. The possibility of rapid redistribution of reserve balances through that market has enabled the New York City banks to buy and use excess reserves previously held idle at country banks. The New York City banks have, in fact, generally been net purchasers of Federal funds.

Liberalized laws with respect to branch banking may also have been responsible for some of the improvement in the relative position of New York City banks. Prior to the passage of the New York State Omnibus Banking Act in 1960, banks with headquarters in New York City were not allowed the privilege of branching outside the city. Since 1960, New York City banks have been allowed to open branches in two adjacent counties as well as in the five counties in the city. Even today, however, the major New York City banks have relatively few branches outside the city, and it is possible that the deposits of these branches may partly represent only funds transferred from city offices rather than net additions to total deposits of these banks. Nevertheless, it is well to keep in mind that the share of the New York banks in the national totals currently represents a somewhat larger geographic area than, say, ten years ago.

CONCLUDING COMMENT

The recent competitive gain of the New York City banks represents the reversal of a long-term trend. For this reason, it is a noteworthy development that deserves close observation and further study. Yet, the previous trend lasted so long and was so consistent that a few years' change cannot be accepted as a definitive turn.

It can be argued, for example, that the shift from a local to a national deposit market implicit in the development of time certificates of deposit is a once-and-for-all change that may already have spent its main force in affecting the relative shares of various groups of banks in the banking business. There could well be some truth in this reasoning. Although the total volume of C/D's was still generally advancing through the first nine months of this year, their rate of growth has leveled off somewhat in 1964-65, compared with 1961-63. Meanwhile, large banks in New York and elsewhere have again found novel ways of attracting resources, such as nonnegotiable "acknowledgments of advance" and negotiable unsecured promissory notes. Provided the New York banks can compete in a nationwide market for loanable funds, they may well be able at least to maintain the gains already made.

[9] As noted previously, there is also the more general possibility that compensating balance requirements on loans will tend to keep somewhat higher deposits at the banks originating the loans than these banks would obtain from credit and deposit creation throughout the banking system. Cash reserves released by a reduction in reserve requirements are of course initially available for credit expansion at the particular banks for which the regulations have been changed.

[10] There are of course other important differences between the current and earlier expansions besides the greater duration of the present one. One such difference is that monetary policy has generally been easier. For example, total member bank reserves increased at an annual rate of 4.0 per cent from the cyclical trough of February 1961 through September 1965, compared with 0.6 per cent in the April 1958-May 1960 expansion and 1.0 per cent in the August 1954-July 1957 advance. However, the significance of this difference for relative shares in banking of various groups of banks is by no means clear.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis