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The Challenge of the Boom*

By WILLIAM F. TREIBER
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It is again a pleasure for us in the Federal Reserve System to meet with you, the members of the New Jersey Bankers Association, and to share our thoughts on matters of mutual concern. I propose to discuss with you today some current challenges to the attainment of our national economic goals of growth, employment, price stability, and equilibrium in international payments.

HALF DECADE OF ECONOMIC DEVELOPMENTS

We are now in the sixth year of continued economic expansion, and the tempo is strong. We have seen a growth in gross national product of over 5½ per cent per annum in real terms, a reduction in the rate of unemployment to below the 4 per cent interim unemployment target set by the Council of Economic Advisers in 1961,[1] and relatively stable prices during most of the period. This achievement was promoted by a mutually reinforcing combination of fiscal policy and monetary policy.

DISTURBING FACTORS. But there are also disturbing factors, such as the general increase in prices which has begun to erode our relatively good price record of recent years, and the severe deficit in our international balance of payments which has persisted over most of the last decade.

CURRENT ECONOMIC SCENE

Economic activity in the first four and a half months of 1966 has been booming. In the first quarter, gross national product rose at an exceptionally rapid pace. The gain in real terms was large, but more than one third of the dollar increase represented higher prices.

The newspapers remind us daily of the cost of the war in Vietnam and of other military needs. But spending at all levels of government for other purposes is also high—indeed at record levels; and the same is true for consumers and businessmen.

It appears that these high rates of spending by the various segments of our economy will continue. This conclusion is supported by recent surveys of consumers' buying intentions and of businessmen's plans for spending on capital and equipment, and by the outlook for large spending by government at all levels.

BANK CREDIT. As bankers, you know at firsthand that business loan demand continues very strong. Bank credit is expanding rapidly, after having slowed down somewhat in February. So far in 1966, bank credit has been growing at very nearly the exceptionally high rate of 1965; and this expansion is taking place despite the increased pressure of monetary policy and higher interest rates.

BALANCE OF PAYMENTS. With the aid of the voluntary restraint program, the flow of capital funds abroad was reduced substantially in 1965, with the result that the balance-of-payments deficit for 1965 was $1.3 billion, compared with an average annual deficit of $2½ billion during the preceding four years. Fortunately, our exports have exceeded our imports for many years; last year the excess was about $4.8 billion. Thus our favorable trade balance has offset part of the drains caused by military and

* An address at the sixty-third annual convention of the New Jersey Bankers Association, Atlantic City, New Jersey, May 19, 1966.

[1] "In 1961, the Council set as an 'interim target' a 4 per cent unemployment rate—as a level that could safely be achieved by measures of demand expansion alone. At that time the Council noted that effective measures to improve the training and mobility of the labor force might safely permit a lower target. It also noted that the degree of inflationary pressures that would be associated with any given unemployment rate depends as well on the extent of internal balance—among economic sectors, industries, and regions. . . ." Remarks of Council Chairman Gardner Ackley on *The Businessman's Role in Fighting Inflation* at the fifty-fourth annual meeting of the Chamber of Commerce of the United States, May 2, 1966.

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foreign aid payments, capital movements, and other payments.

Despite a welcome rise in exports so far in 1966, the growth in our imports has exceeded the gain in exports. And we have just learned that our balance-of-payments deficit in the first quarter of 1966 (expressed at a seasonally adjusted annual rate) has deteriorated from the year 1965. If we have further increases in costs and prices at home, it will be even harder for American products to compete in foreign markets. At the same time, with high demand for goods at home and increases in prices in the United States, Americans are likely to buy many more imported goods. Thus, it is easy to visualize the possibility of a worsening of our adverse balance-of-payments position.

INFLATION

In a setting of rapidly expanding business activity, increased demand for and use of credit, declining unemployment, shortages of skilled labor, and increased production bottlenecks, pressures on prices have been mounting. With an already high utilization of resources, a high aggregate demand for goods and services is pressing on a limited supply. Inflation is a clear and present danger. Relatively mild action, if taken in time, may suffice to bring inflationary pressures under control in their early stages. Delay may induce economic distortions that require stronger and more painful action later on.

Inflation adversely affects everyone. In combating it, there should be concerted effort by all—by Government, by labor, by businessmen, by bankers—to protect the value of the dollar.

GOVERNMENT INFLUENCE

The United States Government has two principal instruments of general and indirect application that influence the overall demand for goods and services; these instruments are fiscal policy and monetary policy. By the use of such instruments to prevent demand from increasing too rapidly, opportunity is afforded the market mechanism to assist in equating the demand for goods and services with the supply at reasonably stable prices. Over the last half decade fiscal policy and monetary policy worked together to promote our national goals of economic growth and employment.

MONETARY POLICY. In the earlier portion of the period an expansionary policy on the part of the Federal Reserve brought about the creation of substantial additional reserves for member banks, and thus allowed the banking system to expand deposits and credit greatly. For balance-of-payments reasons, however, short-term interest rates were prevented from declining to the extremely low levels they had reached in periods of expansionary policy in the 1950's.

In the latter part of the recent period, monetary policy, while still providing for growth, gradually shifted from ease to restraint. Through open market operations the Federal Reserve refrained from creating sufficient reserves to accommodate all the increased demands for credit at unchanged interest rates. The increase in the discount rate from 4 per cent to 4½ per cent in December was a further step in a policy to deal with the excessively rapid rate of credit expansion and with developing inflationary pressures.

In 1966 the Federal Reserve has been gradually increasing the degree of restraint in the creation of bank reserves. You may expect that in the present economic setting the Federal Reserve will not supply sufficient reserves to enable the banks to make all the loans requested of them by borrowers of good credit risk; if the Federal Reserve were to supply such reserves it would be adding fuel to the fires of inflation.

FISCAL POLICY. In 1961-65 fiscal policy was deliberately expansionary, boosting consumer and business purchasing power. Through liberalized depreciation allowances, an investment tax credit, and a large tax cut in a period of a budgetary deficit, fiscal policy demonstrated its usefulness in speeding a recovery. Fiscal policy can be a double-edged tool—one that is effective in checking a boom as well as in promoting expansion.

Through the Tax Adjustment Act[2] enacted two months ago, fiscal policy has already begun to contribute to the dampening of overall demand, by raising certain excise taxes, increasing the withholding on individual income taxes, and speeding up the payment of corporate income taxes. Nevertheless, the Federal Government is still providing a considerable fiscal stimulus in a setting marked by excess demand.

The Joint Economic Committee of Congress has expressed its concern about inflation and has urged fiscal action to combat it. The majority stresses increased taxes; the minority stresses reduced spending. A combination of both would seem helpful. It may not be realistic, however, to expect large cutbacks in spending. Many informed observers have expressed the view that the announcement of a proposal for an increase in Federal income taxes

[2] Tax Adjustment Act of 1966, Pub. L. 89-368 (March 15, 1966).

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would immediately dampen inflationary psychology, that the enactment of the increase would promptly reduce overall demand, and that the action could be reversed with minimum delay if developing events were to counsel a reversal.

No doubt, all of us have heard a variety of suggestions as to the appropriate characteristics of a tax increase. Perhaps the most important requirement would be simplicity, which would encourage consideration and enactment without undue delay. Recognizing that the Administration and the Congress have the responsibility for working out together the terms of any tax legislation, I would think that characteristics such as the following merit careful consideration:

(1) that the increase be temporary, designed to deal with a temporary situation and not to provide a permanent boost to Federal revenue;
(2) that the incidence of the increase on taxpayers be as neutral as possible; and
(3) that the increase be large enough to blunt inflationary pressures, but not so large as to jeopardize continuing expansion of economic activity within the capabilities of available resources.

It seems to me that the prompt announcement and enactment of a suitable tax program would help to maintain an orderly and balanced economy now, and would contribute over the long run to sustainable economic growth and the expansion of employment. More fiscal restraint would, of course, lessen the need to place too great an anti-inflationary burden on monetary policy, and would reduce the inevitable pressure on interest rates.

ROAD AHEAD FOR BANKS

In the present economic setting, bank credit cannot be permitted to expand at as rapid a rate as it has in recent years. As I indicated earlier, you may expect that the Federal Reserve will not supply sufficient reserves to enable the banks to make all the loans requested of them by borrowers of good credit risk. This does not mean that the Federal Reserve wants to bring bank credit expansion to a halt; it wants to moderate the pace of the expansion so that the overall economic advance can be sustained.

Even with the most appropriate Governmental policies and with self-restraint on the part of participants in the private sector of the economy, the road ahead for banks will not be easy. The individual bank will have at least two very important problems: (1) determination of the loans it will make, and (2) determination of how it will meet temporary or perhaps more lasting deposit losses.

POLICY ON LENDING. The individual bank will probably not be able to make all the loans it would like to make. In other words, a bank must be selective; and ability of a prospective borrower to repay the loan cannot be the only test of selectivity. Higher rates of interest charged on those loans that a bank is not anxious to make is a traditional method of discouraging borrowing. But rationing through rate alone cannot be the determining factor. In many cases, a bank will probably find it necessary to apply some order of priorities.

Yesterday the President of the American Bankers Association gave some advice on the banker's role in reinforcing monetary policy. At the Annual Convention of the Arkansas Bankers Association, he said:[3]

> All of us on the firing line in bank lending operations know that today there is simply not enough money available to meet all loan demands—that many of the requests which must be turned down are not marginal applications, but are from good customers who need to finance sound projects. The hard fact is that we must select; we must allocate—and we need to do so on the basis of logical and equitable principles that will serve both the needs of our customers and the economy.

Emphasizing that no set of rules can apply to all institutions, he asked bankers to consider carefully ten questions developed as general criteria by a subcommittee of the Association's Banking and Financial Research Committee. I commend the ABA for its constructive advice to the bankers of the country.

Of course, no set of questions and no statement of policy, priorities, or guidelines on lending can be a substitute for proper monetary policy. Nor could any domestic voluntary credit restraint program, whether formal or informal, be a substitute for adequate monetary and fiscal policies; moreover, such a program would eventually fail without support from a general restriction on credit creation by the Federal Reserve. But with adequate monetary and fiscal policies, in an environment in which the demand for credit is high, some order of priorities is an indispensable tool for an individual banker as he makes his day-to-day decisions in response to requests for credit by specific customers.

BANK LIQUIDITY AND TIME DEPOSITS. Now let's consider the bank's problem of meeting its liabilities. Loan-deposit

[3] Remarks of Archie K. Davis before Annual Convention of Arkansas Bankers Association, May 18, 1966, page 3.

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ratios of banks are higher than they have been in decades. In order to meet the loan demand of customers, individual banks have reduced their liquid assets and increased their short-term liabilities. They have been running off investments at maturity and selling other securities in advance of maturity; as a result many banks now have fewer securities that they can readily liquidate than they have had in over a quarter century.

As one means of enlarging their loanable funds, banks have been aggressively seeking time deposits in the form of negotiable certificates of deposit and savings certificates. More than $17 billion of negotiable C/D's are now outstanding; business corporations are important holders of C/D's. Savings certificates and similar types of nonnegotiable instruments total more than $12 billion; individuals are of course the most important holders of such instruments, but many are also held by smaller businesses and institutions. The holders of negotiable certificates are highly rate conscious, and rates are also an important consideration for many of the holders of nonnegotiable instruments. The relationship of the rates on certificates and similar instruments to the rates on other comparable investment media is closely watched by such investors.

Mindful of the rate consciousness of such holders and of the strong demand for loans, some banks that have issued large amounts of certificates have been inclined to raise the rates of interest on their certificates in order to assure themselves against a runoff of the certificates and to pick up some additional deposits. As competing banks have taken similar steps, the rates on certificates have ratcheted upward. The result has been an increased cost of money to the banks without materially affecting the volume of deposits in the banking system as a whole. This upward ratcheting of rates on certificates has in turn tended to push up the rates on other investment media. As the President of the American Bankers Association pointed out yesterday, "Even though sound competition for savings can benefit all involved, unsound and unbridled competition, coupled with an upward spiraling of interest rates, can result only in trouble for banks, for their competitors, and for the financial structure and the economy."[4]

[4] Remarks of Archie K. Davis before Annual Convention of Arkansas Bankers Association, May 18, 1966, pages 6 and 7.

What would happen if a significant number of holders of C/D's or similar instruments were to decide not to renew or replace maturing certificates and other persons did not buy new certificates? Perhaps a holder decides to use the proceeds for business purposes or for the acquisition of another investment. The fact that the banking system as a whole may not experience a reduction in overall deposits is likely to be small comfort to the individual banker who sees his certificates of deposit declining with a consequent reduction in his total deposits and a loss of reserves to other banks.

The problem of the aggregate reserve needs of the banking system is, of course, the primary responsibility of the Federal Reserve. The problem of the reserve and liquidity requirements of an individual bank, however, is the primary responsibility of the bank's management. Now is the time for each banker to scrutinize carefully his liquidity needs, his ability to maintain his deposits, and his reserve needs to support his deposits. He must guard against the temptation to sacrifice too much liquidity in order to increase earning power; in the long run, it may turn out that a relatively modest increase in earnings has been purchased at too high a cost—a cost incurred through adjustments later forced upon the bank because a low cushion of liquid assets turned out to be inadequate to meet losses of interest-sensitive deposits.

CONCLUSION

In summary, total demands on the economy are outrunning real resources. Inflationary pressures threaten the attainment of our economic goals. Monetary policy and fiscal policy are called upon to exert their complementary influences to dampen those pressures. Banks have already felt the effects of a monetary policy that has involved an increasing degree of restraint. Looking to the future, the best way to avoid the ills of inflation is to fight the inflation promptly, and the best way to fight a recession is to fight the inflation that customarily precedes and helps to bring about a recession.

Each individual banker must determine for himself, in the light of overall considerations, what loans he should make and what steps he should take in the conduct of his bank's affairs, to assure that there is never any question of the ability of his bank to serve the public interest, and to protect the interests of his customers, his depositors, and his stockholders.

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Bankers' Acceptances

By ROBERT L. COOPER*

The volume of short-term credit extended through bankers' dollar acceptances has grown very substantially since the end of World War II. This growth has reflected the unique character of the bankers' acceptance as an instrument for financing the expanding volume of international commerce, as well as the high quality attributed to bankers' acceptances by investors of short-term funds. This article describes the nature of bankers' acceptances and the market for them as it has existed in recent years.†

Bankers' dollar acceptances outstanding increased almost steadily from a level of $104 million at the end of May 1945 to a record high of $3,467 million at the end of May 1965; a total of $3,464 million was outstanding at the end of April 1966. The postwar revival in the use of acceptance credit followed a long period of virtual extinction during the depression and war years. After reaching a peak of $1,732 million at the end of 1929, the volume of acceptances outstanding declined steadily with the shrinkage of international and domestic trade in the 1930's. During the four years of United States involvement in World War II, the month-end volume outstanding ranged roughly between $100 million and $200 million. After the war, the renaissance of normal international commerce, the reestablishment of currency convertibility, the new role of the dollar as a free world reserve currency, and the vast capacity of the United States credit market all combined to generate a burgeoning worldwide demand for dollar acceptance financing. As a result, the market for bankers' acceptances has become significantly broader and more active, although it is by no means as important a segment of the total money market as it was in the 1920's, when the volume of other high-grade short-term paper outstanding was much smaller.

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† This article represents a thorough revision and updating of the article of the same title in the June 1961 issue of this *Review*.

BANKERS' ACCEPTANCES AS A FINANCING DEVICE

A bankers' acceptance usually comes into being in connection with a commercial transaction in which a buyer of goods is obligated to make payment to the seller. In most cases the buyers and sellers are importers and exporters who are located in different countries. Consequently, the credit standing of each may well be unknown to the other. Dollar acceptance financing provides a means whereby an internationally known American bank assumes the obligation to pay the amount involved at a given time in the future.

In order to establish the bank's obligation, the importer or the exporter, or an agent of either, draws a time draft on the American bank. The draft is a written order for the American bank to pay a certain amount of money in dollars (the amount involved in the commercial transaction) to a designated recipient (usually the party who draws the draft) on a specified date in the future, say ninety days after the date the draft is drawn or after the date it is presented to the paying bank. Upon presentation, if the draft has been authorized by the bank and is found to be in order as described below, it will be stamped "Accepted" and signed by an officer of the bank. By this action, the bank unconditionally assumes liability for payment of the obligation when it matures (in this case in ninety days) even if the party for whom it was created fails to reimburse the bank. A bankers' acceptance is therefore a time draft drawn on and accepted by a bank.

The process of acceptance financing may be traced through by means of a characteristic example, such as the importation of goods into the United States from abroad. One way of handling such a transaction would be for the United States importer to approach his bank with a re-

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quest for acceptance credit. If the bank agrees to finance the importer, it would send a letter to the foreign exporter (or to the exporter's bank) advising him that the credit has been established. The letter, generally known as a commercial letter of credit, would authorize the exporter to draw a time draft (described earlier) on the American bank. The bank would agree—for a fee—to accept the draft when it is presented, provided it is accompanied by certain documents related to the underlying commercial transaction, as specified by the importer. Documents most usually required are an invoice describing the goods shipped and the terms of sale, a bill of lading giving evidence of the shipment and conveying title to the goods, and evidence that the goods are insured. When arrangements for the shipment have been completed, the foreign exporter draws the time draft on the American bank and delivers it to his local bank, together with the required documents. At this point, the exporter may receive cash immediately by, in effect, selling the draft to his bank. However, the amount paid for the draft would be less than its face value, in order to compensate the bank for handling costs and risks and to allow a return to the bank on the money advanced on an obligation that does not become payable until sometime in the future. The difference between the face amount of the draft and the amount paid to the exporter by his bank is known as a discount, and the draft is then said to have been discounted.

The exporter's bank then forwards the draft to the American bank, which examines the accompanying documents. If it finds them to be in order, the bank accepts the draft as described above, thereby making it a bankers' acceptance. Once the draft is accepted, the obligation to pay it at maturity is irrevocably assumed by the bank, although the importer is, of course, obligated to reimburse the bank at, or prior to, the maturity of the acceptance.

The acceptance thus created is then ordinarily discounted for the foreign bank by the accepting bank, i.e., the accepting bank pays the face amount less its discount charge to the foreign bank. Even after the deduction of this amount, the foreign bank receives enough to reimburse it for the amount originally paid to the exporter since, as will be recalled, the exporter was paid less than the face amount of the acceptance.

The accepting bank may now retain the discounted instrument in its own portfolio, in which case it is similar to a loan by the bank, and the amount of the discount charged to the exporter's bank becomes an earning to the accepting bank. More commonly, the acceptance would be sold by the accepting bank to an acceptance dealer or directly to a customer of the bank at the prevailing rate of discount for prime bankers' acceptances. In the latter case, the bank would recoup the money paid to the foreign bank and would therefore have "lent" only its name and credit standing to the importer. The ultimate buyer of the acceptance, a domestic or foreign investor, would actually provide the funds to finance the importation of the goods.

There may be variations in this pattern. For example, the terms of the import transaction might call for immediate payment by the United States importer. Instead of drawing a time draft on the importer's bank as above, the exporter might draw a sight draft on the importer. This draft would be a written order for the importer to pay the amount involved as soon as the draft is presented to him. If the importer's bank agreed to extend acceptance credit to him, the importer would draw a time draft on the bank, ordering it to pay the importer the amount involved at a future date, say in ninety days. The bank would accept this draft upon presentation and would discount the resulting acceptance by paying the importer the face amount less the bank's discount charge. The funds would be used by the importer to pay the exporter's sight draft on him, while deferring any drain on the importer's cash until the maturity of the acceptance. By that time, the importer would presumably have received and sold the goods and would be in a position to reimburse the bank in time for it to pay the maturing acceptance.

Under still another variation, if the import transaction calls for payment by the United States importer at a future date, the foreign exporter rather than the importer might make arrangements for the acceptance credit. In this case, the exporter's local bank would request its American correspondent bank to accept a time draft drawn upon the American bank by either the exporter or his bank. The resulting draft would be accepted and discounted by the American bank, as above, and the funds would be paid to the exporter through his own bank. The eventual payment for the goods by the importer, under the terms of the commercial transaction, would enable the exporter to repay his bank, which in turn would repay the American bank in time for it to meet the acceptance at maturity.

A primary function of the acceptance is to enable the seller or exporter of goods to obtain cash as soon as possible (by discounting the acceptance) while permitting the buyer or importer to defer payment, at least until the goods have been received and sold. Acceptance credit may also finance the accumulation of goods by an exporter who has contracted to ship them abroad within a reasonable time (a pre-export acceptance). A foreign exporter, for example, having contracted to sell goods abroad, might arrange through his local bank to have an American bank extend acceptance credit. The proceeds of the credit would

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be used by the exporter to purchase and ship the goods. Acceptances may also be used to finance an importer until he can distribute the goods into the channels of trade (a post-import acceptance). In this case, an importer may arrange for a bank to finance the temporary carrying of imported goods which are expected to move within a relatively short time.

Dollar acceptances have been used to an increasing extent in recent years to refinance other credit arrangements previously made between buyers and sellers. For example, Japanese trading companies in the United States export goods to Japan and draw either sight or time drafts on the United States agency of a Japanese bank. The agency finances the shipment by discounting the draft for the trading company and then forwards the draft to its home office in Japan, together with the accompanying documents that will be needed by the Japanese importer. The home office of the Japanese bank refinances the shipment, or a number of shipments, by drawing a time draft on an American bank, which accepts and discounts the draft, thereby creating a dollar acceptance. The proceeds of the discounted acceptance reimburse the Japanese bank and/or its agency in the United States for the money it had paid to the Japanese trading company in the United States.

Only about 115 institutions in the United States—those that emphasize international transactions—currently engage in any significant volume of acceptance financing. These institutions include commercial banks and Edge Act Corporations,[1] two private banks, foreign banking corporations, and United States agencies and branches of foreign banks. The bulk of acceptances is created by institutions in New York City and in the San Francisco Federal Reserve District, reflecting the importance of these strategically located banks in the financing of international trade.

A prime bankers' acceptance, i.e., an acceptance of a bank whose name has gained recognition in the marketplace as one that is experienced and active in creating acceptances, is considered an investment of top quality by holders of short-term funds. This quality depends mainly upon the unconditional obligation of the acceptor, which is a widely known and respected, although not necessarily a large, financial institution. Virtually all acceptances trade at the prime rate—not to be confused with the prime rate on direct loans—and rates are not publicly quoted for paper that is not prime. In addition, the drawer of the bank draft and any unqualified endorsers are contingently liable to pay the instrument in the event that it is not paid by the acceptor. The sale of the goods involved in the underlying transaction is expected to generate funds that, directly or indirectly, will enable the borrower to liquidate his indebtedness to the accepting bank. Moreover, the liquidity and attractiveness of prime bankers' acceptances are enhanced by their eligibility for discount or purchase by Federal Reserve Banks if the paper conforms to certain conditions set forth in Regulations A, B, and C of the Board of Governors of the Federal Reserve System. Regulation C describes such commercial drafts or bills as those growing out of any of the following transactions:

(1) the importation or exportation of goods,
(2) the shipment of goods between foreign countries,
(3) the storage of readily marketable staples in the United States or in any foreign country, and
(4) the shipment of goods within the United States.

Acceptances, to be eligible, must mature within six months of the date of acceptance and should bear evidence of the nature of the underlying transaction in a form satisfactory to the Federal Reserve Bank.[2]

TYPES OF ACCEPTANCE FINANCING

INTERNATIONAL TRADE. The bankers' acceptance is especially adaptable to the financing of international trade, and such acceptances constitute the bulk of total acceptances outstanding (see table). Chief among United States imports typically financed by acceptances are coffee, sugar, iron and steel products, wool, and textile products. United States exports most frequently financed by acceptances are grains, machinery and parts, cotton, ores, oil, and iron and steel (including scrap). In connection with trade between foreign countries, acceptances drawn on banks in the United States most frequently finance transactions in oil, ores and metals (chiefly iron), wool, cotton,

[1] For a description of the organization and operations of Edge Act Corporations, see the article "Edge Act and Agreement Corporations in International Banking and Finance", this *Review*, May 1964, pages 88-92.

[2] A member bank may not extend acceptance credit of more than 10 per cent of its paid-up and unimpaired capital and surplus to any one borrower unless the bank is secured for that portion in excess of 10 per cent by documents or other security arising out of the transaction. In addition, the total amount of drafts accepted by a member bank may not amount to more than 50 per cent of its paid-up and unimpaired capital stock and surplus except with the special permission of the Board of Governors of the Federal Reserve System, which may allow a maximum of 100 per cent of capital stock and surplus; domestic acceptances, however, are limited to 50 per cent of capital and surplus in any event. There are no restrictions on the amount a member bank may invest in eligible acceptances of other banks.

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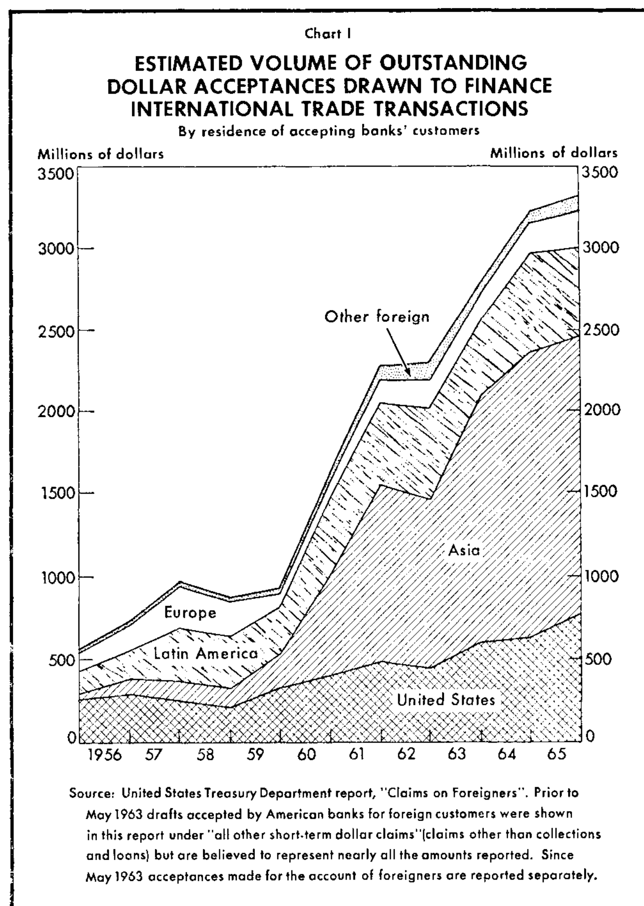
grains, sugar, and rubber. The volume of dollar acceptances financing international trade has more than doubled since the end of 1960. A major portion of the growth has been in acceptances covering trade between foreign countries (known as third-country trade), which about tripled during the same period. Acceptances against United States imports have also grown steadily, although at a much slower pace, while the year-end volume of export acceptances has been relatively stable since 1961.

As indicated in Chart I, borrowing by foreigners has been primarily responsible for the growth of dollar acceptances during the 1960's, while acceptance borrowing by firms domiciled in the United States has increased much more slowly. The rise in foreign borrowing has been mainly by the Japanese, who have accounted for most of the Asian borrowing shown on the chart. As already indicated, acceptance credit is especially tailored to the financing of international trade, and such trade is of vital importance to the Japanese economy. Moreover, with interest rates in Japan generally at a very high level, Japanese merchants and bankers have intensively utilized the comparatively cheaper credit available in the United States to finance their expanding world trade. To a lesser extent, there has been an increase in the extension of acceptance credit to Latin American borrowers, mainly to finance exports to the United States and a growing volume of trade among Latin American countries. In contrast, the volume of dollar acceptances used by Europeans has been relatively small and reflects the more active utilization by Europeans of financing alternatives, including the Euro-dollar market. European credit has been more readily available and somewhat more competitive with United States credit than Japanese and Latin American credit facilities.



Source: United States Treasury Department report, "Claims on Foreigners". Prior to May 1963 drafts accepted by American banks for foreign customers were shown in this report under "all other short-term dollar claims" (claims other than collections and loans) but are believed to represent nearly all the amounts reported. Since May 1963 acceptances made for the account of foreigners are reported separately.

DOMESTIC TRADE. Bankers' acceptances have long ceased to be used in significant volume to finance domestic trade. At the close of April 1966, there were only $20 million of acceptances outstanding for this purpose, of which $11 million were created to finance the shipment of goods within the United States and $9 million were to finance the storage of certain types of goods pending their further movement into trade. Business practice in the United States has never encouraged the use of bankers' acceptances to finance domestic shipments of goods since most such transactions customarily involve the direct extension of credit by the seller to the buyer, without any formal written obligation. Furthermore, in order for domestic shipment acceptances to be eligible for Federal Reserve discount or purchase, they must bear a certification that, at the time of acceptance, shipping documents conveying or securing title were attached or were in the physical possession of the accepting bank or its agent. Because of inconveniences related to this requirement and the availability of other means of financing, banks have not encouraged the use of acceptances for the financing of domestic shipments.

In the past, most domestic acceptances financed the storage of readily marketable staples such as cotton, grain, rice, wool, or tobacco. To be eligible for Federal Reserve discount or purchase, storage acceptances must be secured by a warehouse receipt or other such document conveying or securing title to the stored goods. Control of the warehouse involved must be completely independent of the borrower, and the goods should be stored pending a reasonably prompt sale, shipment, or distribution into the process of manufacture. Domestic storage acceptances have not been created in any significant volume in recent years (see table), partly because direct bank loans, even after allowing for compensating balances, have been cheaper to the borrowers involved, many of whom are able to borrow at the "prime rate". At no time since late 1961

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DOLLAR ACCEPTANCES OUTSTANDING, CLASSIFIED BY TYPE OF TRANSACTION

In millions of dollars

Type of transaction	1929	1939	1945	1950	1955	1960	1961	1962	1963	1964	1965	April 1966
International trade	1,348	163	128	364	562	1,596	2,273	2,293	2,792	3,231	3,330	3,410
Imports into the United States	*383*	*102*	*103*	*245*	*252*	*403*	*485*	*541*	*567*	*667*	*792*	*829*
Exports from the United States	*524*	*39*	*18*	*87*	*210*	*669*	*969*	*778*	*908*	*999*	*974*	*875*
Goods stored in or shipped between foreign countries	*441*	*22*	*7*	*32*	*100*	*524*	*819*	*974*	*1,317*	*1,565*	*1,564*	*1,706*
Domestic trade	308	54	26	28	63	308	293	171	41	43	35	20
Shipments	*23*	*10*	*12*	*10*	*9*	*13*	*18*	*12*	*9*	*12*	*11*	*11*
Storage	*285*	*44*	*15*	*18*	*54*	*295*	*275*	*159*	*32*	*31*	*24*	*9*
Dollar exchange	76	16	*	2	17	122	117	186	56	111	27	34
Total	1,732	233	154	394	642	2,027	2,683	2,650	2,890	3,385	3,392	3,464

Note: Data refer to end of period. Because of rounding, figures do not necessarily add to totals.
* Less than $500,000.

has the cost of acceptance financing (including both the accepting bank's commission and the cost of discounting) been lower than the commercial bank prime lending rate on direct loans. Also, since 1958, the Commodity Credit Corporation has been financing most domestic storage of cotton, thereby minimizing the need for private financing for this purpose. Prior to that time, the seasonal financing needs of cotton merchants generated a large volume of storage acceptances whenever relative costs favored acceptance financing over other sources of credit.

DOLLAR EXCHANGE ACCEPTANCES. Dollar exchange acceptances are time drafts drawn by banks (usually the central bank) in certain foreign countries and accepted by banks in the United States, for the purpose of creating dollar exchange.[3] Thus, dollar exchange acceptances do not arise from specific merchandise transactions but are designed to alleviate seasonal shortages of dollar exchange for certain countries, when it can be reasonably expected that the credit will be subsequently liquidated from funds acquired in the normal course of trade. Most frequently, dollar exchange acceptances have been drawn by Latin American banks. To be eligible for Federal Reserve discount or purchase, dollar exchange acceptances may not have an initial maturity exceeding three months and may only originate in a limited number of countries designated by the Board of Governors.

The volume of dollar exchange acceptances has fluctuated widely (see table), and a total of only $34 million was outstanding at the end of April 1966. Political and economic unsettlement in some Latin American countries has limited the use of dollar exchange acceptances. However, the expanded use of pre-export acceptances in some countries tends to furnish dollar exchange in a less direct manner. In contrast to dollar exchange acceptances, the eligibility of pre-export acceptances for Federal Reserve discount or purchase depends on the existence at the time the acceptance is created of an actual contract to ship specific merchandise. Such a contract gives pre-export acceptances a larger element of self-liquidity.

THE COST OF ACCEPTANCE FINANCING

The cost of acceptance financing consists of a commission charged by the accepting bank plus all charges involved in the handling and discounting of the accepted draft. For prime customers, a much broader group than in the case of direct loans, the commission charge of United States banks is usually 1½ per cent, but higher rates may be charged for others. The rate of discount charged is normally the current market bid rate of acceptance dealers for the appropriate maturity. At the end of April 1966 this rate was 5⅛ per cent for three-month acceptances. The combined commission and discount charge for three-month acceptance financing for a prime

[3] The total amount of dollar exchange acceptances that a member bank has outstanding may not exceed 50 per cent of its paid-up and unimpaired capital and surplus, with a maximum of 10 per cent for any one drawer (unless fully secured). This limitation is separate and distinct from, and in addition to, the limitations prescribed with respect to the acceptance of commercial drafts (see footnote 2, page 129).

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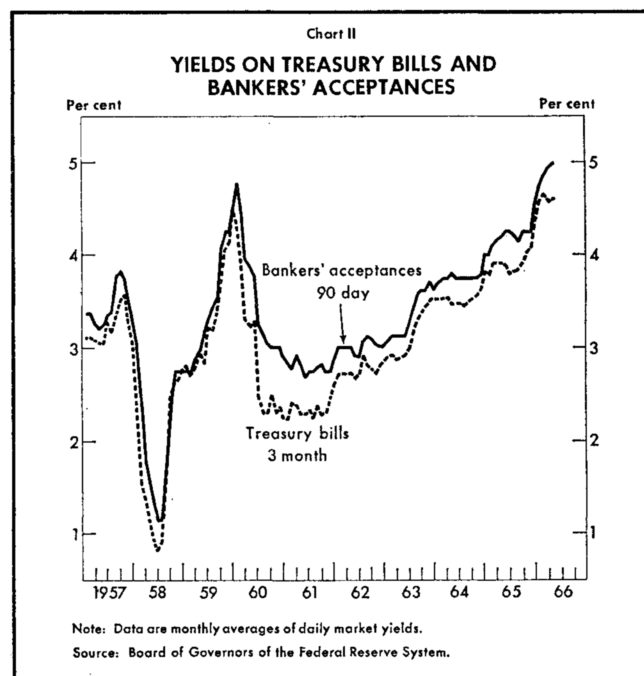
borrower was, therefore, 6⅝ per cent. Whether the acceptance commission, the cost of discounting, and charges of intermediary banks are to be paid by the exporter or importer depends upon which party arranged for the credit and on the terms agreed upon in the underlying commercial transaction. In the case of pre-export and post-import financing, however, the exporter or importer, respectively, being in each case both the borrower and drawer of the related drafts, would normally pay the entire cost of financing.

The cost of alternative financing opportunities, particularly direct bank loans, exerts a significant influence on a borrower's willingness to finance his transactions by acceptance credit. Thus, the volume of acceptances would be expected to increase if their cost is low relative to direct loans and to contract when acceptance financing is relatively costly. However, when banks are under reserve pressure, they may actively encourage borrowers to use acceptances rather than direct loans, since the banks can then sell the acceptances in the open market and conserve their cash resources. A comparison of the relative costs of borrowing on acceptances versus direct loans must take into account the indirect cost of maintaining compensating balances in the case of direct loans (where these balances exceed the borrower's normal transactions balance needs). Also, as noted above, the minimum acceptance commission of 1½ per cent applies to many borrowers that would not be able to obtain direct loans at the prime rate.

The cost of borrowing in foreign countries may exert some influence on the volume of dollar acceptances. For example, large active borrowers might shift their demand for credit to London if the cost of sterling acceptances dropped significantly below that on dollar acceptances, assuming there were no British governmental restrictions on the financing of foreigners. The borrower would have to repay in sterling and would normally hedge the exchange risk by buying sterling for future delivery. He would therefore have to consider the premium or discount on forward sterling in arriving at the net cost of sterling acceptance financing.



BANKERS' ACCEPTANCES AS AN INVESTMENT

The tested safety and high degree of liquidity of prime bankers' acceptances make them a useful vehicle for the investment of short-term funds. Over the years, market rates for bankers' acceptances have usually been only slightly higher than those for United States Treasury bills (see Chart II), and at times the Government's bills have actually sold at the higher of the two rates. It should be noted that the prime character of an accepting bank's name does not necessarily depend on the size or location of the bank but rather upon the bank's reputation for knowledge and skill in the field of international lending. Thus the acceptances of well-known smaller banks with proven experience in the financing of international commerce are traded in the market at the same rate of discount as those of the largest accepting banks. This is quite different from the situation in the market for negotiable time certificates of deposit, where a substantial concession may be required to induce investors to buy the paper of a smaller bank despite a long history of prudent and successful management. As noted above, the liability of endorsers and drawers, the presumption (except in the case of dollar exchange acceptances) of the existence of a self-liquidating commercial transaction underlying each credit, and eligibility for Federal Reserve discount and purchase all contribute to the quality of prime bankers' acceptances, although the importance attached to each of these considerations varies among different types of investors. Corporate buyers of acceptances, for example, reportedly rely almost solely on the obligation of the accepting bank.

THE MARKET FOR BANKERS' ACCEPTANCES

Bankers' acceptances are negotiable and marketable short-term obligations. As such, they may be bought or

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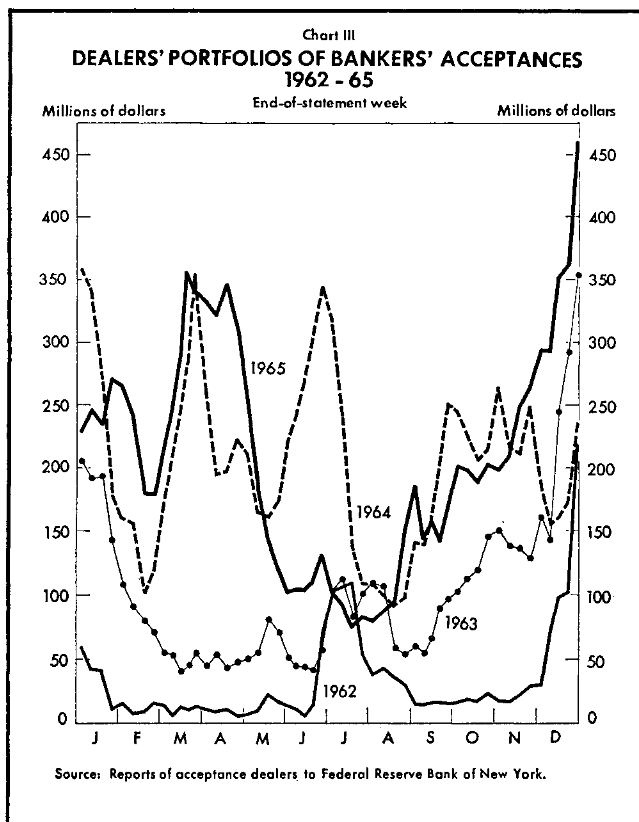
sold in the market, competing with other short-term obligations such as Treasury bills, commercial paper, and negotiable certificates of deposit for the attention of investors. Participants in the market are acceptance dealers, accepting banks, foreign and domestic investors, and the Federal Reserve System.

DEALERS. Six dealers regularly conduct operations in bankers' acceptances. All are located in New York City and all but one actively deal in other money market obligations. These dealers stand ready to buy and sell various maturities of prime bankers' acceptances at publicly posted prices which are quoted in terms of a rate of discount from the face value of an acceptance. Rates of discount are higher for longer than for shorter maturities because of the increased risk of a rise in interest rates over the longer period and because of the need to provide increased compensation to the ultimate investor for committing his funds for a longer period of time. The rate of discount at which dealers will sell acceptances is normally ⅛ per cent lower than the rate at which they will buy acceptances of the same maturity. This spread is the principal source of the dealers' income. Although the spread is currently larger than dealers' spreads for some other short-term obligations, acceptances are relatively costly to handle because of the number of individual acceptances usually involved in a single transaction and because of the need for careful examination to establish the eligibility and negotiability of the instruments. For example, a dealer buying $1 million of acceptances might have to process thirty or forty individual instruments while a similar transaction in Treasury bills might involve only one piece of paper.



Dealers' bid quotations also provide the basis for the discounting of acceptances by accepting banks, as described above, and any changes in dealers' posted rates are immediately communicated by the banks to their customers and correspondents around the world. Dealers' quotations are usually not subject to very frequent changes since the cost of discounting acceptances is an important consideration in the negotiations constantly under way between international buyers and sellers of goods. Subject in varying degree to these considerations, dealers' rates for bankers' acceptances fluctuate in response to persistent movements in other short-term money rates and to marked changes in the level of dealers' portfolios. During 1965, there were only nine occasions when a majority of the dealers changed their rates.

Prior to November 1963, dealers conducted their operations in bankers' acceptances with very small portfolios in relation to turnover. During the years 1955 through 1962, the annual average position of all dealers combined ranged from about $5 million to $35 million and dealers frequently found it impossible to satisfy the demand of investors. More recently, however, dealers have been carrying much larger portfolios, averaging around $210 million in 1964 and 1965 (see Chart III). Portfolios have been particularly heavy over most quarterly statement dates, reaching a record level of $461 million on December 31, 1965, as banks relied heavily on sales of acceptances to help meet seasonal reserve needs. Dealer portfolios are usually financed by call loans from commercial banks in New York City. The Federal Reserve Bank of New York also makes funds available to dealers under repurchase agreements at times when the reserve effect of such accommodation is consistent with the System's general monetary objectives.

ACCEPTING BANKS. Investors who buy acceptances do not normally resell them but hold them until maturity so that, once placed with investors, relatively few acceptances find their way back into the market. Therefore, dealers are dependent upon sales by accepting banks as the major source of supply. The willingness of banks to sell their acceptances varies significantly with changes in general money

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market conditions. Accepting banks tend to hold a large proportion of their own acceptances in their portfolios in the absence of pressure on bank reserves. On the other hand, when banks are under pressure they may sell newly created acceptances or those that they had been holding. This enables them to recoup the funds paid out when they discounted the paper and to transfer the extension of credit from themselves to the ultimate buyers of the acceptances. Thus, between the end of 1964 and the end of 1965, when banks came under gradually increasing pressure, the percentage of outstanding acceptances held by accepting banks (including acceptances of other banks) dropped from 49.4 per cent to 36.1 per cent. This meant that acceptances were more readily available to other investors than in 1964. Many banks sell some portion of their acceptances directly to their customers, bypassing the dealer market, although the banks depend upon the dealers to absorb their bills at times of money market strain and lagging investor demand. Both accepting and nonaccepting banks are also important buyers of other banks' acceptances as an investment when rates on acceptances are relatively attractive vis-à-vis other short-term obligations.

FOREIGN INVESTORS. Investors abroad have long recognized the highly safe and liquid character of bankers' acceptances and consider them attractive assets for the placement of short-term funds. Consequently, foreign central and commercial banks and, to some extent, nonbank foreign investors, are important holders of bankers' dollar acceptances. Accepting banks have among their foreign bank customers many who require acceptances with two bank names. These acceptances are obtained predominantly through swapping operations with the dealers. The accepting bank sells its own acceptances to the dealer at his buying rate, say 5¼ per cent, and buys back the acceptances of other banks at the dealer's selling rate (5⅛ per cent). When selling these acceptances to a foreign bank, the selling bank generally adds its own endorsement, charging ⅛ of 1 per cent commission for assuming the related risk. The net rate of discount to the foreign bank, based on the above example, would be 5 per cent. Foreign demand for endorsed bills has reportedly been declining somewhat in recent years as nonbank investors, and even some banks, have been satisfied with only one bank name, so that swapping operations presently constitute a smaller proportion of total dealer activity than they did in the late 1950's.

DOMESTIC INVESTORS. Domestic investors in acceptances, other than commercial banks, include savings banks, insurance companies, and a variety of nonfinancial corporations. Corporations have shown increasing interest in acceptances in recent years whenever acceptance rates become sufficiently attractive relative to rates on Treasury bills, commercial paper, and negotiable time certificates of deposit. Some disadvantages of acceptances as an investment, such as their comparatively small and oddly denominated amounts, lack of convenient maturities, and uncertainty of adequate supply, are being overcome to some extent. The large-scale refinancing of Japanese trade through dollar acceptances, for example, has produced larger acceptances in round amounts (most frequently $100,000) and with attractive maturity dates, covering not one but many individual shipments of goods. These multiple-type acceptances are purchased by the Federal Reserve Bank of New York, provided the underlying transactions are adequately described on each acceptance or on an attachment thereto. Also, the larger positions regularly carried by dealers since late 1963 have increased the possibility that an investor can obtain sufficient bills of a desired maturity at a given time to satisfy his requirements. Domestic investors buy unendorsed acceptances almost exclusively, depending upon the obligation of the accepting bank to provide sufficient safety.

FEDERAL RESERVE BANK OPERATIONS. The Federal Reserve Bank of New York purchases a substantial volume of acceptances in the dealer market for its foreign correspondents and for its own account. Acceptance holdings for foreign accounts amounted to $144 million as of December 31, 1965. The Federal Reserve Bank (whether for its own account or for foreign accounts) buys only endorsed bills, i.e., acceptances bearing three names—those of the acceptor, of the drawer, and in most instances, of an endorsing dealer. The rate of discount to the buyer of endorsed bills is $\frac{1}{16}$ per cent less than that for two-name paper (unendorsed bills). In addition, the Federal Reserve Banks guarantee payment of acceptances purchased for the account of foreign correspondents, charging ⅛ of 1 per cent for the guarantee. Therefore, if endorsed bills were offered by dealers at $5\frac{1}{16}$ per cent discount, the net return to foreign correspondents on acceptances purchased for them by the Federal Reserve Bank of New York would be $4\frac{15}{16}$ per cent. The contingent liability arising from the guarantees is participated among the twelve Reserve Banks—as are the proceeds of the guarantee fees.

In 1955, the Federal Open Market Committee authorized the Federal Reserve Bank of New York to purchase acceptances from the dealers for its own account and to make repurchase agreements with nonbank dealers against bankers' acceptances, as part of its open market operations for the Federal Reserve System. The purpose was to encourage the postwar redevelopment of the bankers' acceptance market and to demonstrate official recognition

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of the high quality and usefulness of these instruments in international finance. This participation in the market also affords the Reserve Bank added opportunities to examine the quality of the paper flowing through the market as an aid to the fulfillment of the System's traditional supervisory function in this area. In recognition of the increasing importance of bankers' acceptances, a separate Acceptance Department was created at this Bank in January 1964.

Outright holdings of acceptances by this Reserve Bank for its own account have been deliberately limited to marginal amounts. At the close of 1965, the peak of year-end seasonal pressures on the money market, these holdings amounted to $75 million, only 2 per cent of total acceptances outstanding.

CONCLUSION

Bankers' dollar acceptances have become increasingly important in the financing of international trade during the postwar era, and particularly since the mid-1950's, as acceptances have proved their usefulness to borrowers, banks, and investors. The market for these instruments has also grown and acceptances have been competing with other short-term investment media. Much of the growth has reflected the intensive use of the instrument by the Japanese. The prospects for further growth in the use of acceptances seem good, particularly if they should come to be utilized more intensively by the developing countries of South America, Africa, and Southeast Asia.

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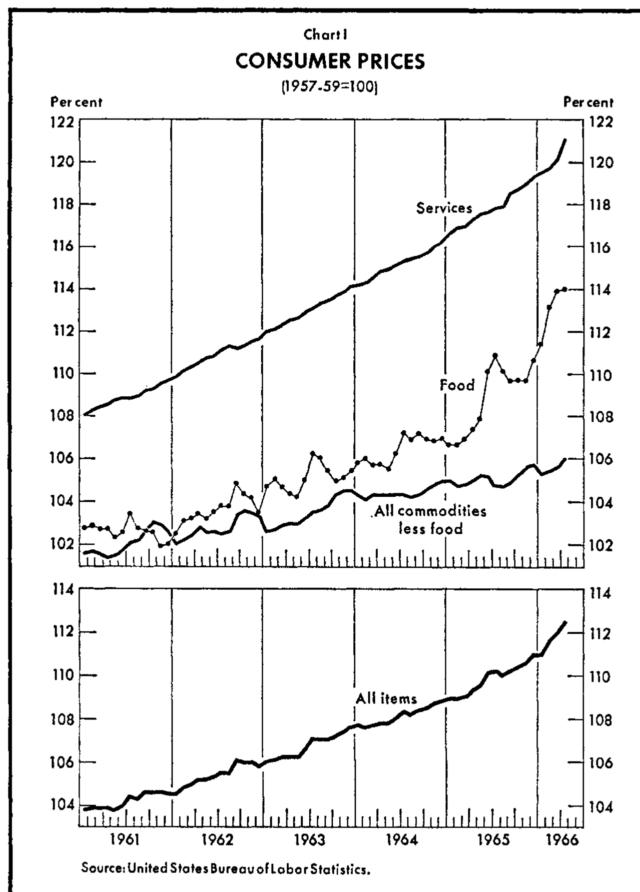
The Business Situation

The rate of growth of domestic business activity has moderated somewhat, following an extraordinary surge of activity in the first three months of the year. In view of the fact that the first-quarter rate of economic growth had inflationary implications and was quite clearly unsustainable, the slower pace of recent weeks is an encouraging development both for the near-term and the longer term outlook. Indicators of prospective demand in the months ahead continue to point to further advances in output and spending. Despite the recent slackening of economic growth—and the May rise in unemployment, mainly among teen-agers—the likelihood of continued pressure on industrial capacity, the supply of skilled labor, and prices remains.

The slower pace of the business expansion in April showed up in a reduced rate of advance in overall industrial production and personal income. In addition, retail sales and new orders received by manufacturers of durable goods backed off a bit from their high March levels. Strikes and poor weather conditions appear to have been a factor in some of these developments, but reduced rates of production and sales in the automobile industry were clearly an important dampening influence. To what extent consumer demand for new cars may have been affected by recent public discussion of vehicle safety and by higher excise taxes on autos is not clear. In any case, a survey of consumer buying intentions taken in April found that plans to purchase automobiles remained at about the high level of the previous April. Moreover, intentions to purchase other consumer durables moved up strongly, indicating that any slack in automobile sales may be offset by spending on other durables. Indeed the outlook for further strength of overall consumer demand and of other broad areas of demand, such as capital spending, point up the danger of reading too much into the slowdowns apparent in some recent data—especially in view of the normally erratic course of short-term movements in many sectors of the economy.

Prices of goods and services have continued to move up (see Chart I). In April, the consumer price index advanced by 0.5 percentage point, exceeding the average monthly increase of 0.3 percentage point experienced in the first quarter and bringing the annual rate of increase so far this year to a very high 4.1 per cent. One special factor pushing up consumer prices in April was the restoration of excise taxes on new automobiles and telephone services effective March 15 and April 1, respectively, thereby offsetting the excise reductions made on these items at the beginning of the year. Price increases were reported in all major classifications of consumer purchases, however, with services replacing foods as the primary cause of the advance in the overall index. At the whole-



sale level, prices were about unchanged on average in April as declines in farm and food prices largely offset a substantial 3.5 per cent annual rate increase for industrial commodities. So far this year, industrial wholesale prices have risen at an annual rate of 3.2 per cent as against 1.4 per cent in all of 1965.

OUTPUT, ORDERS, AND INVENTORIES

Total industrial output rose to a record level in April, but the gain was much reduced from the average advance for the preceding three months. The Federal Reserve Board's seasonally adjusted index of industrial production increased by just under 0.3 per cent for the month, compared with the large average monthly gains of 0.9 per cent in the first quarter of the year. The brief railroad strike in early April and the coal mining strike that month had a substantial dampening impact. The reduction in automobile output was also a minor factor.

The recent weaker tone in the automobile industry followed an extraordinary performance earlier in the year. In 1965, sales of domestic cars amounted to 8.8 million, and most observers foresaw little likelihood of significantly higher sales in 1966. Nevertheless, in the first quarter of the year, sales were running at a seasonally adjusted annual rate of 9.3 million. In April, sales began to back off from this high level, amounting to a seasonally adjusted annual rate of about 7.9 million for the month, and with inventories rising, cutbacks in production schedules soon followed. Auto sales in May decreased further to a seasonally adjusted annual rate of 7.3 million units, and production also continued to move down. That there has been some decline from a first-quarter sales rate which many observers regarded as unsustainable is perhaps not surprising. Industry spokesmen have stated their belief that public airing of the safety issue was a factor in the timing of the slowdown. The repeal on March 15 of the portion of the excise tax cut on automobiles that had become effective at the beginning of the year may also have played a role. While the actual dollar impact of the increase in the tax was small—perhaps amounting to little more than $20 on the average new car—dealer promotions apparently made much of this imminent increase in costs. Moreover, price-conscious business and Government purchasers may also have bunched some purchases in the January through mid-March period that would otherwise have been delayed until spring.

Despite the dampening influence of reduced steel orders from automobile manufacturers, iron and steel output advanced to a record annual rate of roughly 140 million tons in April, and it appears that steel production remained at roughly the same high level in May. The demand for some steel products is advancing quite rapidly, and industry spokesmen have stated that it will be difficult to maintain current prices in the months ahead.

There was another notable expansion in the output of defense goods in April, and new orders in that sector remained strong. Reflecting the strength of capital spending, production of business equipment moved further ahead as sizable gains were reported throughout the machinery and transportation equipment industries except for the motor vehicles and parts category. With delivery times lengthening in many industrial areas, purchasers have turned increasingly to foreign producers, and imports, particularly of business equipment, rose substantially during April. Output of consumer goods also continued to advance beyond the high first-quarter level despite the dampening influence of slower automobile production. Solid gains were posted in the production of color TV sets and other home appliances, furniture, and a wide range of nondurable goods.

Prospects for further production gains in the months ahead appear good. New orders received by manufacturers of durable goods have increased by progressively larger amounts in each of the past five quarterly periods. And although new durables orders in April moderated somewhat from the March level, they remained at the high monthly average of the first quarter. As new orders continued to exceed shipments, unfilled orders climbed to new highs. Including nondurables orders, backlogs have now topped $70 billion, a solid $12 billion advance in the past year. Rising backlogs are being experienced by manufacturers of primary metals, fabricated metal products, machinery and business equipment, transportation equipment, and other durable goods. The present backlog of unfilled orders is equivalent to about three months of shipments at the current rate.

Advancing levels of unfilled orders combined with the high rates of capacity utilization place increased pressure on producers to continue adding to their equipment and facilities. In most instances, these pressures seem to be outweighing the restraining effects of higher interest costs and reduced availability of credit as well as higher capital goods prices and slower deliveries. Indeed, according to a Commerce Department and Securities and Exchange Commission survey taken in May, businessmen's plans to expand capital expenditures in 1966 appear to have increased a moderate 1 percentage point from the 16 per cent rise indicated in the February survey. Some announced cutbacks in planned projects have been offset by upward revisions, and in addition higher than previously anticipated costs for construction and equipment are likely

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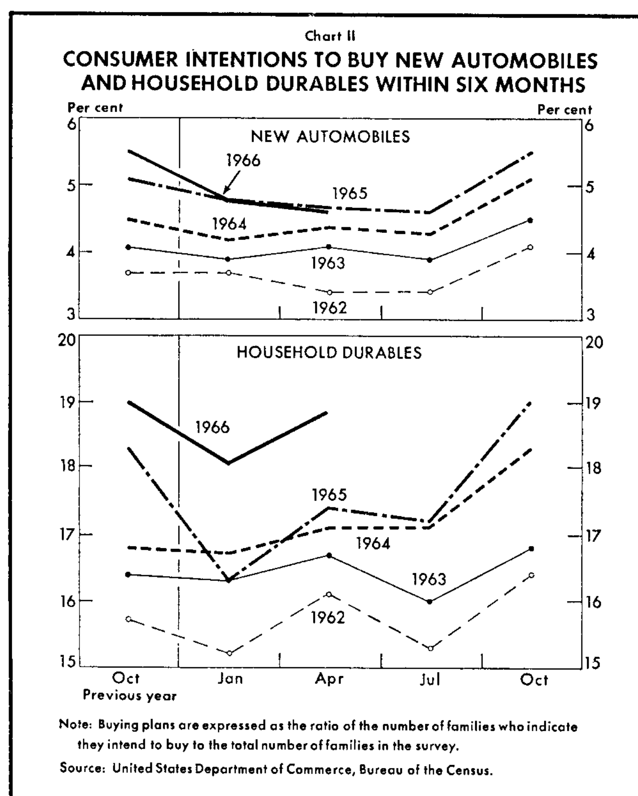
to offset the cutbacks in terms of total dollar spending.

Conservative inventory-sales ratios, and recent reports that inventory buildups in many industries are falling short of plans, also support the outlook for further production increases. Inventory-to-shipment ratios among manufacturers are now significantly below the high of the current business expansion, while inventory-to-sales ratios among retailers of both durable and nondurable goods are averaging moderately less than levels for a year ago.



EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Partly reflecting the more moderate pace of economic activity, nonagricultural employment remained stable in April though it moved up moderately in May. In April, strikes and unfavorable weather conditions resulted in employment decreases in the mining and construction industries, while declines were also reported in the retail trades, perhaps because of the fact that the monthly employment survey followed the Easter holiday this year. These reductions offset job gains in manufacturing, government, and other nonagricultural jobs. In May, advances in nonagricultural employment were recorded in all major industrial categories except construction and finance. The seasonally adjusted rate of unemployment moved up to 4.0 per cent in mid-May, however, from 3.7 per cent the month before. The Bureau of Labor Statistics, which collects and processes the data, attributed the May increase to a larger than usual number of students looking for work while still in school and a slightly larger than usual number of women entering the labor force. Normally, many women are needed to work on farms in May but, due to poor weather conditions, employment in agriculture was lower than usual for the month. Attesting to the continued underlying firmness in the labor market, the unemployment rate for married men—the hard core of the civilian labor force—remained at its low April level of 1.8 per cent.

Stability in nonagricultural employment in April and the reduced rate of income expansion in the same month may well have been among the factors contributing to the moderate decline in retail sales. After climbing to three consecutive all-time highs during the first quarter of this year, sales volume at retail outlets was down about 1 per cent for the month. The level, however, remained fully 10 per cent above the year-ago figure. The April decrease was more than accounted for by lower automobile sales. In addition, unfavorable weather in many areas of the country adversely influenced sales of lumber, building materials, and hardware. It is striking, however, that retail sales excluding automobiles rose to $20.7 billion, roughly 2 per cent above the exceptionally strong monthly average in the first quarter of the year. Gains among a wide range of nondurable goods continued strong.

Prospects for consumer demand over the months ahead are bright, according to the Census Bureau's latest quarterly survey of consumers' buying intentions taken during the third full week of April. This survey indicated a marked increase in the proportion of families reporting that their incomes had advanced during the previous twelve months, and the percentage expecting still higher incomes in the year ahead also showed a gain. Consumers' intentions to buy new automobiles during the next six months moved down moderately to a level roughly in line with the figure reported for the corresponding period a year ago (see Chart II). The proportion of families planning to buy at least one of the seven household durable goods included in the survey was 18.8 per cent, significantly above the year-earlier reading of 17.4 per cent (also shown on Chart II).

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The Money and Bond Markets in May

The money market was generally quite firm in May, although there was some variation in the intensity of market pressures within individual statement weeks. Member bank reserve positions remained under considerable pressure during the month, as the credit demands of the economy continued to push against shrinking nationwide reserve availability. Member bank borrowings from the Federal Reserve Banks were substantial, and most trading in Federal funds took place in a 4⅞ to 5⅛ per cent range, marking the first time the effective rate on Federal funds has been as much as ⅝ of a per cent above the discount rate. Indeed some trading occurred at a record high of 5¼ per cent, ¾ per cent above the discount rate.

In the Treasury bill market, a fairly good overall demand emerged during the first half of the month. However, investor interest in bills concentrated in the short maturity area where rates declined, while rates for longer bills edged higher. Subsequently, demand for bills persisted, but firmer conditions in the money market made dealers quite cautious and bill rates fluctuated narrowly over the remainder of the month.

Prices of Treasury notes and bonds moved irregularly through mid-May with prices of most issues showing a net increase. Crosscurrents in market sentiment were evident as traders reacted to the continuing public debate over the likelihood of an anti-inflationary tax increase and to various other developments. In particular, the coupon sector was affected by news of a contraction in automobile production, which had a depressing effect on stock prices. Against this background, investment demand for coupon issues remained rather light and trading was dominated by professional participants. In the second half of the month, prices of coupon issues drifted lower in reaction to the widespread view that prospects for a tax increase were dimming, to uncertainties over the future posture of monetary policy, and to indications that pressures were mounting in other sectors of the bond market.

In the corporate and tax-exempt sectors, traders focused their attention in May upon the heavy flow of current and scheduled flotations. Offering yields on new issues climbed to record levels, while the termination of syndicate price restrictions also led to a series of subsequent dealer price concessions, particularly in the corporate area. Nevertheless investor demand remained restrained and selective throughout the month.

THE MONEY MARKET AND BANK RESERVES

The firmer tone which had developed in the money market during April intensified in May. Rates on a variety of short-term money market instruments—including bankers' acceptances, commercial paper placed by dealers, and directly placed finance company paper—were increased from ⅛ to ⅜ of a per cent, while rates posted by commercial banks on call loans to Government securities dealers generally were about ¼ of a per cent higher than in April. At the same time, Federal funds traded mainly in a 4⅞ to 5⅛ per cent range.

Several money market banks posted higher offering rates during May on time certificates of deposit maturing in three months or more. Toward the end of the month, a few banks reportedly were paying the maximum permissible rate of 5½ per cent on certificates maturing in three months, while the ceiling rate was quite commonly applied to longer maturities. To some extent, the higher rates were aimed at attracting funds to replace the approximately $1.1 billion of certificates reaching maturity at the weekly reporting member banks during the month, as well as the additional $3.9 billion maturing in June when corporate dividend and tax payments come due. Partly as a result of the more attractive yields, the weekly reporting member banks were able to increase their time certificates outstanding by about $295 million in May.

As the credit needs of the economy pressed against a contracting availability of bank reserves, member banks were under reserve pressure. They responded to this pressure by making purchases of Federal funds at rising rates, and by recourse to the Federal Reserve "discount window" where borrowings averaged $653 million (see Table I).

Intraweekly patterns of variation in market pressures, which had also been evident in April, were superimposed on the underlying May trend toward more stringent money market conditions. During the statement week ended May

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1966

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

Factors	Changes in daily averages—week ended				Net changes
	May 4	May 11	May 18	May 25	
"Market" factors					
Member bank required reserves*	− 214	+ 196	+ 101	+ 223	+ 306
Operating transactions (subtotal)	− 246	− 564	+ 178	− 323	− 955
Federal Reserve float	− 60	− 151	+ 248	− 42	− 5
Treasury operations†	− 18	+ 13	− 85	− 259	− 349
Gold and foreign account	− 23	+ 11	− 92	+ 7	− 97
Currency outside banks*	− 184	− 454	+ 124	+ 168	− 346
Other Federal Reserve accounts (net)‡	+ 41	+ 15	− 18	− 195	− 157
Total "market" factors	− 460	− 368	+ 279	− 100	− 649
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 309	+ 185	− 128	+ 203	+ 569
Bankers' acceptances	+ 3	—	—	+ 1	+ 4
Repurchase agreements:					
Government securities	+ 82	+ 217	− 164	− 135	—
Bankers' acceptances	—	− 43	—	+ 40	− 3
Member bank borrowings	− 25	+ 63	− 17	− 10	+ 11
Other loans, discounts, and advances	− 4	+ 2	—	− 1	− 3
Total	+ 366	+ 422	− 308	+ 98	+ 578
Excess reserves*	− 94	+ 54	− 29	− 2	− 71

	Daily average levels				
Member bank:					
Total reserves, including vault cash*	22,735	22,593	22,463	22,238	22,507§
Required reserves*	22,449	22,253	22,152	21,929	22,196§
Excess reserves*	286	340	311	309	311§
Borrowings	617	680	663	653	653§
Free reserves*	− 331	− 340	− 352	− 344	− 342§
Nonborrowed reserves*	22,118	21,913	21,800	21,585	21,854§

	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 559	− 270	− 483	+ 250	+ 56
More than one year	—	—	+ 282	—	+ 282
Total	+ 559	− 270	− 201	+ 250	+ 338

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 May 25.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS MAY 1966

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended				Average of four weeks ended May 25
	May 4	May 11	May 18	May 25	
Eight banks in New York City					
Reserve excess or deficiency(—)*	7	29	7	7	13
Less borrowings from Reserve Banks	115	82	69	13	70
Less net interbank Federal funds purchases or sales(—)	179	565	348	− 19	268
Gross purchases	*985*	*1,029*	*927*	*834*	*944*
Gross sales	*806*	*463*	*578*	*853*	*675*
Equals net basic reserve surplus or deficit(—)	− 287	− 619	− 410	13	− 326
Net loans to Government securities dealers	980	699	629	520	707
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	38	23	19	37	29
Less borrowings from Reserve Banks	67	126	135	18	87
Less net interbank Federal funds purchases or sales(—)	174	290	357	280	275
Gross purchases	*1,231*	*1,131*	*1,160*	*1,194*	*1,179*
Gross sales	*1,057*	*842*	*803*	*914*	*904*
Equals net basic reserve surplus or deficit(—)	− 203	− 393	− 473	− 261	− 333
Net loans to Government securities dealers	478	387	324	276	366

Note: Because of rounding, figures do not necessarily add to totals.
* 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—May 1966				
	May 2	May 9	May 16	May 23	May 27
Three-month	4.674	4.630	4.626	4.638	4.641
Six-month	4.782	4.818	4.823	4.835	4.826

Maturities	Monthly auction dates—March-May 1966		
	March 24	April 26	May 25
One-year	4.739	4.773	4.966

* 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.

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4 and to a lesser extent during the May 18 period—in both cases the first half of a biweekly reserve averaging period for "country" banks—net nationwide reserve availability was relatively abundant before the weekend when, in addition, reserves tended to be concentrated in the money center banks. Consequently, as some city banks built up basic reserve surpluses and others were able to fill a good portion of their reserve needs in the Federal funds market, member bank borrowings from the Federal Reserve were relatively moderate over the weekend. Following the April 30-May 1 and May 14-15 weekends, nationwide reserve availability contracted while the distribution of reserves shifted in favor of the country banks. City banks moved into deep basic reserve deficits and, with Federal funds in less abundant supply, borrowings from the Federal Reserve Banks rose sharply. Such borrowings amounted to $889 million on Wednesday, May 4, and $901 million on Wednesday, May 18.

A contrasting intraweekly pattern was evident in the money market during the statement periods ended May 11 and May 25, each of which represented the concluding half of a country bank reserve averaging period. As these weeks began, reserves were lodged outside the money centers, while the city banks cautiously managed their reserve positions in the wake of the taut money market conditions which they had encountered on May 4 and May 18. Thus banks with basic reserve surpluses held on to their reserves rather than place them in the Federal funds market over the weekend, while deficit banks bid strongly for funds at rates as high as 5¼ per cent, and then turned to the Federal Reserve discount window to fill their residual reserve needs. Accordingly, borrowings from the Federal Reserve were substantial over both the May 7-8 and May 21-22 weekends. Following these weekends, the excess reserves which had been accumulated earlier, partly as a result of the heavy pre-weekend borrowings, spilled into the money market. Consequently, some of the tension faded from the money market toward the end of the May 11 and May 25 statement periods, Federal funds traded occasionally below the discount rate, and member bank borrowings from the Federal Reserve tapered off.

THE GOVERNMENT SECURITIES MARKET

In the market for Treasury coupon issues, prices edged irregularly higher through mid-May. Investors generally remained on the sidelines assessing a number of unfolding events, and activity was largely of a professional nature. During much of this period, the bond market was alternately strengthened and depressed by conflicting opinions on the likelihood of a Federal tax increase. Moreover, when the early May news of cutbacks in automobile production triggered a prolonged downward spiral in stock prices, the price behavior of Treasury coupon-bearing obligations became quite sensitive to the daily trend of stock prices. In broad terms, setbacks in the equities market generally buoyed bond prices during the first half of May, as dealers in Government coupon issues covered short positions when stock prices fell.

With their attention occupied by other matters, bond market participants showed little reaction when the Treasury reported on May 6 that investor response to its May refinancing had been quite restrained.[1] Approximately 43 per cent of the eligible maturing securities held by the public were not exchanged, the largest attrition percentage in any modern refunding.[2] While market observers had generally anticipated that the attrition would be much greater than usual, the actual net redemption exceeded most expectations. The Treasury announced, however, that the results would not cause any alteration in its financing plans.

After midmonth, several factors began to have a restraining effect on the market for Treasury notes and bonds. The coupon sector reacted with caution to a growing consensus that a near-term increase in tax rates was not likely, as well as to news that nationwide reserve availability had contracted further. In addition, traders focused their attention upon the sizable current and prospective demands for funds converging upon the corporate and tax-exempt bond markets and upon the market for Government agency issues. The coupon sector also was affected by the steadier tone emerging in the stock market, and by the Treasury Secretary's suggestion that Congress might consider some modification in the current 4¼ per cent coupon interest rate ceiling on Government bonds. Against this background, prices of intermediate- and long-term Treasury issues moved lower from May 18 until the final day of the month when prices edged higher in response to some professional short covering. (The right-hand panel of the chart on page 142 illustrates the irregular rise in yields which accompanied this decline in prices.)

The Treasury bill market displayed a fairly strong tone in May. As was the case in April, a steady demand for

[1] For details of the offering, see this *Review* (May 1966), page 112.

[2] A total of $8.1 billion of the $9.3 billion of notes and bonds maturing on May 15 was converted into the new 4⅞ per cent notes of November 1967 offered in the refunding. However, $6.7 billion of this amount was exchanged by Federal Reserve Banks and Government accounts.

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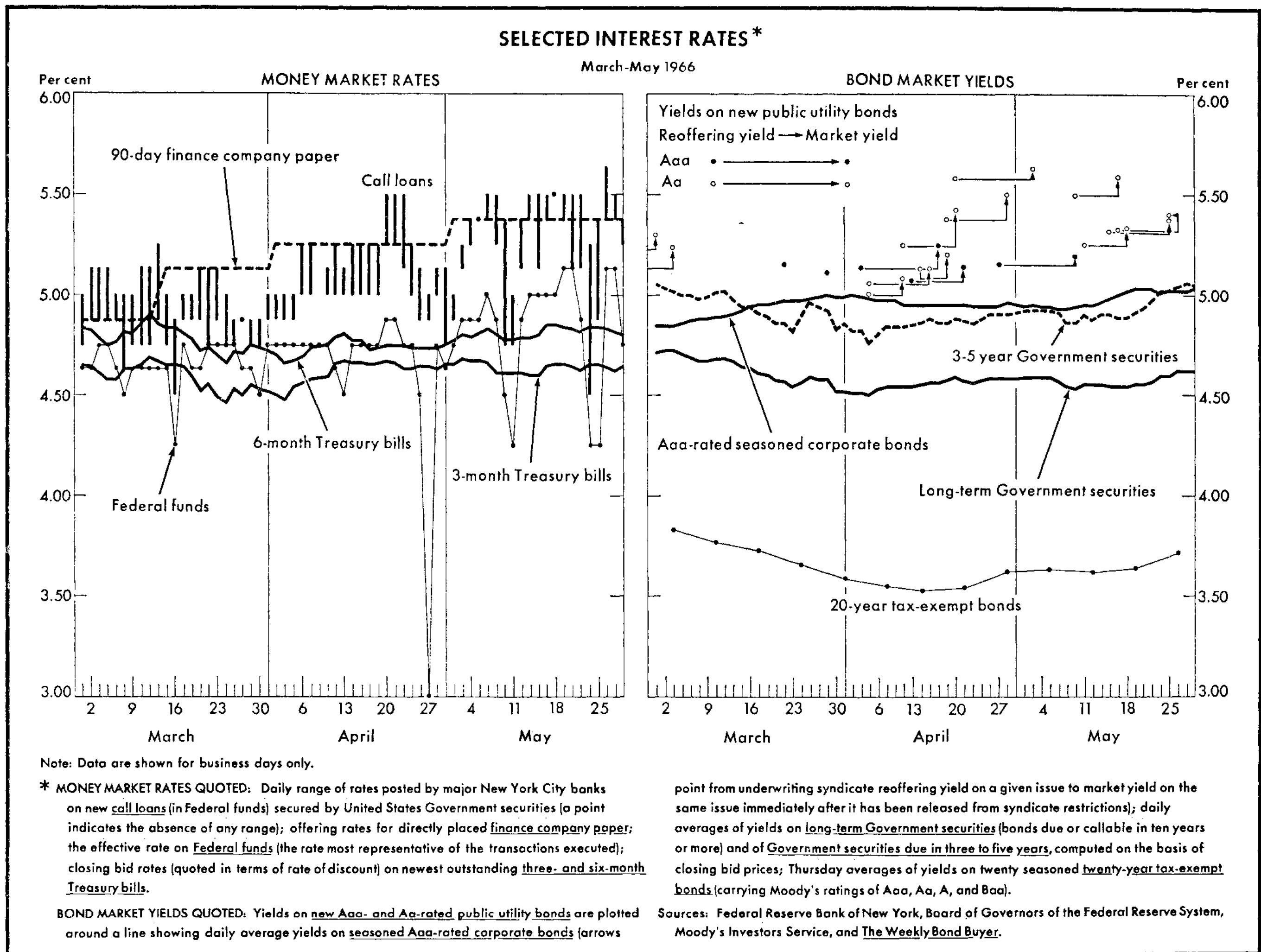

Note: Data are shown for business days only.

* 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 on new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields on seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on 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 on 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.

bills from public funds and other sources prevailed during the first half of the month. In addition, a portion of the proceeds of a sizable secondary offering of common stock was reinvested in bills during the period, and bills were also in demand from owners of maturing notes and bonds who had decided not to exchange their holdings for the Treasury's refunding offering. Demand focused on short-dated bills, and rates for issues maturing within three months declined through midmonth. At the same time, rates for longer bill maturities, which were somewhat neglected by investors, generally edged higher (see the left-hand panel of the chart). As a result of the diverse rate movements recorded by bills at different points in the maturity scale, the rate spread between three- and six-month bills widened from 10 basis points in late April to 20 basis points in mid-May. Subsequently, investment demand remained fairly strong, but with money market conditions rather firm, dealers became more aggressive sellers and rates for bills of all maturities fluctuated narrowly.

The market for securities issued by agencies of the United States Government remained quite active in May. A flood of agency flotations reached the market during the month, including offerings by the Federal National Mortgage Association, the Export-Import Bank, the Federal Home Loan Banks, and the Federal Intermediate Credit Banks. Such offerings totaled approximately $2.4 billion in May, of which a substantial $1.4 billion represented new money. During most of the month, investors continued to be quite selective in their response to agency issues as they awaited the heavy calendar of scheduled

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offerings in this sector. On May 18, an offering by the Federal Home Loan Banks of $656 million of 5.55 per cent eleven-month notes encountered considerable investor resistance. Two days later, however, investors responded enthusiastically to a $312 million par offering by the Federal Intermediate Credit Banks of nine-month debentures carrying a 5.60 per cent coupon rate. Toward the end of May, another large addition to the calendar of scheduled agency issues was made when the Federal National Mortgage Association announced a June offering of $530 million of participation certificates in its pooled loans. The sale will take place under provisions of enabling legislation recently passed by Congress.

OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices moved steadily lower over most of the month. Demand was quite restrained, as investors evaluated both the performance of new flotations reaching the market and the continuing buildup in the calendar of scheduled offerings. Although new corporate bond offerings totaled a relatively light $385 million in May (estimated), the volume of scheduled flotations grew steadily larger during the month. By the end of May, the four-week calendar of scheduled corporate bond offerings had swollen to approximately $695 million. In the tax-exempt sector, new bonds marketed in May totaled a substantial $845 million (estimated), while a comparable volume awaited flotation in June. With customers rather reluctant to invest their funds in new issues even at record high reoffering yields, underwriters removed syndicate price restrictions on several recent corporate and tax-exempt flotations during the month and adjusted their yields still higher, with the largest concessions occurring in the corporate sector. (As is apparent in the right-hand panel of the chart, yields on new public utility bonds were adjusted higher throughout the month.) Even at the more attractive emerging yield levels, however, investor demand remained quite selective throughout the period both for new and recent issues.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 9 basis points to 5.04 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose by 10 basis points to 3.72 per cent (see the right-hand panel of the chart). These indexes are, however, based on only a limited number of seasoned issues and do not necessarily reflect market movements fully, particularly in the case of new and recent issues.

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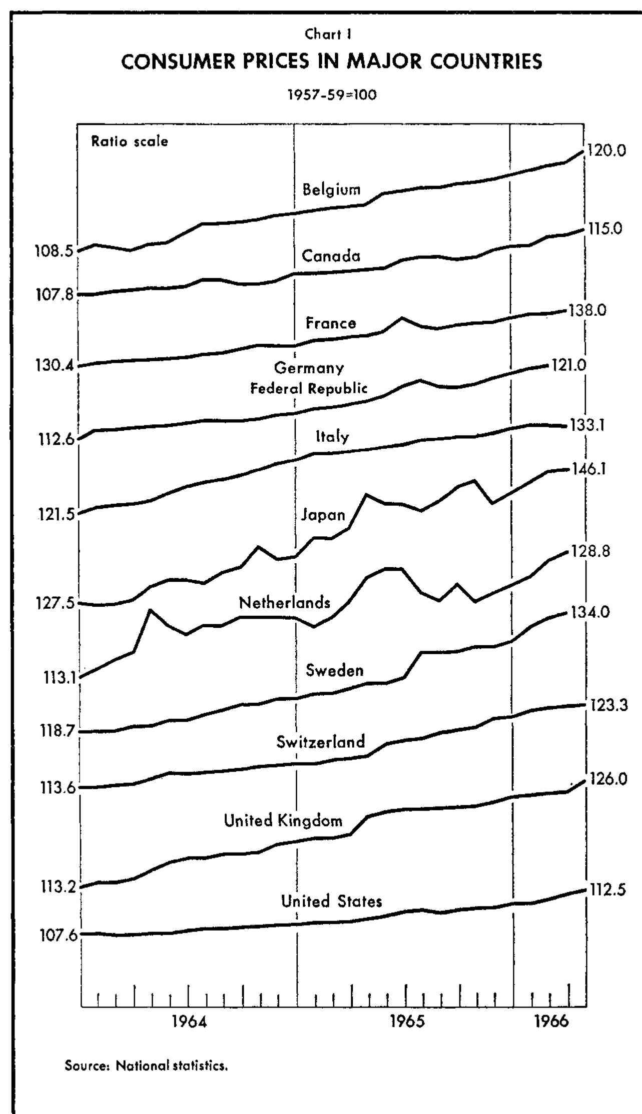
Recent Economic Policy Measures In Industrial Countries Abroad

Most of the major industrial countries abroad maintained or tightened restrictive policies during the November 1965-May 1966 period, either in response to mounting inflationary pressures or to unsatisfactory balance-of-payments positions.[1] The United Kingdom has introduced additional measures to reduce aggregate demand as wage pressures and the external deficit have yielded more slowly than anticipated to earlier restraints. At the same time, the authorities have taken a number of steps designed to effect longer term structural improvements in the British economy. Concern with price increases (see Chart I) has led Canada and Belgium to adopt monetary restraints in an effort to curb excess demand. The Canadian authorities have supplemented monetary restrictions with tax increases and reduced public expenditures, while the Belgians have exercised price controls. The Netherlands too has imposed monetary and fiscal restraints, but its actions were in part prompted by a deterioration in its external trade balance. Germany has tightened its monetary policy to limit wage and price increases even though industrial production has leveled off (see Chart II). While economic policy in Switzerland and Sweden has not changed markedly, the authorities have generally maintained an attitude of restraint in both countries. In contrast, France, Italy, and Japan, which all have strong payments positions and some margin of unused capacity, continued to pursue expansionary policies.

UNITED KINGDOM

The United Kingdom made substantial progress during 1965 in overcoming the difficulties that had produced a series of speculative assaults on sterling between November 1964 and September 1965. Most notably, the balance-of-payments deficit was reduced by more than one half:



[1] For a discussion of foreign economic policy measures earlier in 1965 and late in 1964, see "Recent Monetary and Financial Policies Abroad", this *Review* (November 1965), pages 239-45 and "Recent Economic Policy Measures in Industrial Countries Abroad", this *Review* (April 1965), pages 74-78.

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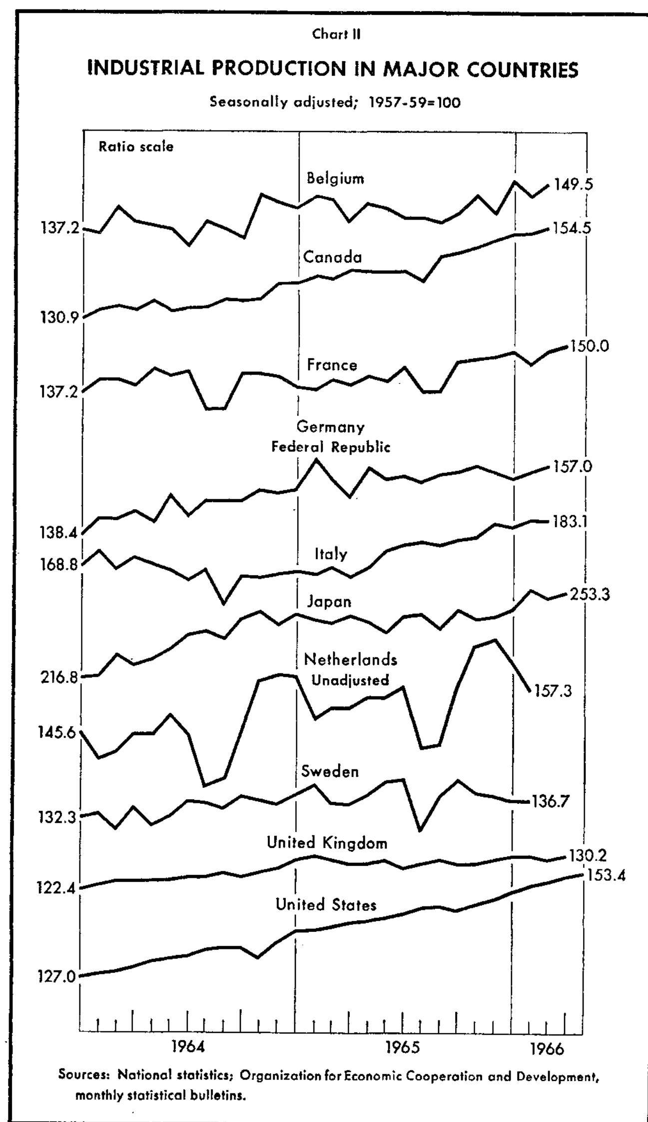

exports rose nearly 7 per cent, the growth of imports was held to less than 1 per cent, and the long-term capital outflow was reduced substantially. While real national output increased only 2 per cent last year, gross fixed investment (at constant prices) grew more than 3.5 per cent, and the growth of real consumption was held to 1.5 per cent. Nevertheless, retail prices rose by 4.5 per cent during 1965, and wholesale prices of manufactured goods increased by 3.9 per cent.

During the first four months of 1966, both exports and imports were up 5 per cent at seasonally adjusted annual rates. The current seamen's strike can hardly help Britain's external trading position. Domestically, industrial production does not seem to have risen above the December 1965 level so far this year, and yet the labor shortage has not eased significantly. Indeed, the number of unemployed hit a ten-year low in March, and during 1966 hourly wages have been increasing at a rate in excess of the 6.8 per cent rise in 1965.

Thus in the months from November through May, the British authorities have had to combine measures aimed at promptly curbing demand pressures and improving the balance of payments with policies designed for a longer term recovery. Their basic approach—reflected in a program of investment incentives, the government's incomes policy, and the recent budget—is to bring about a structural shift in the economy that will speed the growth of productivity while holding down prices and wages and avoiding large-scale unemployment. In this way the authorities hope to bolster the pound, strengthen Britain's international competitive position, and enhance the possibility of uninterrupted economic growth.

To provide short-term assistance to the balance of payments, the government in November 1965 requested (and subsequently obtained) Parliamentary authorization to retain the 10 per cent import surcharge until November 1966. In his recent budget message, the Chancellor of the Exchequer announced that the surcharge will be abolished when this authorization expires in November. On the export side, the authorities have moved to stimulate sales abroad by liberalizing the terms of export credit guarantees. In March of this year, the minimum size limitation was abolished for government guarantees on export credits of two years and longer. Moreover, negotiations with the banks led to the implementation of an arrangement under which thirty-day to two-year export financing will receive an unconditional guarantee at a reduced rate of interest.

To aid Britain's capital-account position, a voluntary program to curb long-term capital outflows to Australia, New Zealand, South Africa, and Ireland was also introduced with the budget. This measure will be administered by the Bank of England. Under it, British residents are requested to refrain from investing in these four countries unless the capital expenditure will be returned within two or three years or unless the outlay can be financed from funds obtained abroad.

In order further to assist the balance of payments by retarding the advance of prices and costs, the Bank of England has continued to limit the growth of credit, and the government intends to present a bill in Parliament establishing a statutory basis for the incomes policy. Although the discount rate remained unchanged at 6 per cent throughout the period under consideration (see accompanying table), on February 1 the Governor of the Bank

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CHANGES IN SELECTED FOREIGN CENTRAL BANK DISCOUNT RATES, 1965-66

In per cent

Country	Date	New rate	Change
Belgium	1966: June 2	5¼	+½
Canada	1965: December 6	4¾	+½
	1966: March 14	5¼	+½
France	1965: April 8	3½	−½
Germany	1965: January 22	3½	+½
	August 13	4	+½
	1966: May 27	5	+1
Japan	1965: January 9	6.205	−0.365
	April 3	5.84	−0.365
	June 26	5.475	−0.365
Netherlands	1966: May 2	5	+½
South Africa	1965: March 5	5	+½
Sweden	1965: April 9	5½	+½
United Kingdom	1965: June 3	6	−1

of England requested that the banks and other financial institutions extend no additional credit once the existing allowance—a 5 per cent expansion over the level outstanding in mid-March 1965—had been utilized. With most institutions at or near their credit ceilings by April 1966, there is virtually no room for further credit expansion. Also during February, the terms of instalment credit purchases were tightened to reinforce the restrictions imposed in June and July of last year.

Under the government's bill establishing a statutory basis for its incomes policy, the National Board for Prices and Incomes would gain authority to collect evidence on expected price and wage increases. The bill would also enable the authorities to delay such increases for up to four months, but not to prohibit them. A provision is included that would compel employers and unions to notify the Board of wage claims and settlements and of proposed price increases. Notification is now voluntary, and this section would be implemented, at the government's discretion, only if the voluntary arrangements were found unsatisfactory.

In a special effort to raise the long-run productivity of industries believed likely to produce exports or import substitutes, the government announced in January a revision and expansion of its investment incentives; in May it bolstered this move by introducing a bill for the creation of an Industrial Reorganization Corporation (IRC). The new incentives replace special depreciation allowances with cash grants in "development areas", where labor and other resources are available, and in the manufacturing and mining industries. Firms not eligible for the new incentives, such as those in the service and construction industries, will continue to qualify for benefits under the former program. With funds obtained from the Exchequer, the IRC will purchase an interest in and combine firms too small to compete successfully in international markets; its interest in these firms will be sold when the continuation of profits is assured and their international competitive ability is established.

Although consistent with the Labor government's previous policies, the budget presented in May for fiscal 1966-67 constitutes a novel departure in British fiscal planning. The outstanding feature is a Selective Employment Tax (SET), designed both to achieve a short-run reduction in domestic purchasing power and in the long run to encourage the transfer of labor from the service and construction industries into manufacturing. This measure will not substantially alter the costs of manufacturers, but employers in most other private industries will be taxed for each individual on their payrolls. The SET, like the investment incentive program described above, favors manufacturing in order to encourage production of exports and import substitutes.

While the SET will contribute to the anticipated $3 billion expansion in the central government's revenues, current spending is scheduled to rise by about $2 billion, with the largest increases representing social service expenditures and grants to nationalized industries. At the same time, government lending for capital expenditures will expand by about $200 million. The net outcome of all changes in revenues and expenditures is expected to reduce the government's budget deficit to $804 million, or half the deficit in the last fiscal year.

As for the United Kingdom's external obligations, the government recently confirmed its intention to pay the first $1 billion instalment on Britain's debt to the International Monetary Fund when due in November 1967 rather than attempt to refinance or reschedule this payment; moreover, repayments may be initiated ahead of schedule.

OTHER COUNTRIES INTENSIFYING RESTRAINTS

Rising inflationary pressures have prompted Canadian efforts to restrain demand. The discount rate has been raised twice during the period under review, on December 6 and on March 14. The first increase, from 4¼ per cent to 4¾ per cent, followed a ½ per cent rise in the Federal Reserve discount rate, but the Canadian decision was also a response to changing credit conditions and market yields in that country. The second increase lifted the rate to 5¼ per cent and primarily re-

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flected the view of the authorities that some moderation of the growth of aggregate demand was desirable.

Canada's monetary restraint has been reinforced by fiscal measures to restrain both private and public spending. In addition to a cut in public construction projects, government revenues will be supplemented by the withdrawal of most of last year's 10 per cent personal income tax reduction and by a sharp cut in depreciation allowances for various types of capital goods purchased during the next eighteen months. Two further measures have been introduced to encourage the temporary deferral of private investment expenditures. First, the sales tax on production machinery and equipment will be reduced in April 1967 and then abolished a year later. Secondly, under an interesting fiscal innovation, a refundable 5 per cent levy is to be placed on retained corporate profits and depreciation allowances. The amounts collected under this measure will earn interest at 5 per cent and will be refunded at the government's initiative after eighteen to thirty-six months, depending upon business conditions.

Belgian industrial production turned upward in the second half of 1965, apparently reversing the downswing that had persisted through the first six months of the year, but unemployment remains a problem in areas affected by coal-mine closings and lagging steel output. In recent months, bank credit has expanded rapidly and the upward movement of prices has accelerated. The planned government budget deficit for 1966 is substantial, although smaller than in 1965. In view of these developments, the National Bank of Belgium reinstituted quantitative limits on bank credit expansion in May; credits to private borrowers are to increase by no more than 12 per cent over the next year. If the rise in the first six months is more than 6 per cent, reserve requirements—removed last July —may be reimposed.[2] The Belgian authorities followed these measures with the imposition of direct price controls. Certain consumer prices will be reduced through negotiations with businessmen and through cuts in domestic taxes (requiring equivalent domestic price reductions). Prices of all goods not included under these arrangements are to be frozen for at least three months. On June 2, the National Bank reinforced these restraints by increasing its discount rate ½ of a percentage point to 5¼ per cent. This move undoubtedly reflected the desire to place an additional limitation on domestic credit expansion, but in view of the short-term capital outflow that occurred in the first quarter of this year, the Belgian decision was in part a response to rising interest rates abroad. The government has indicated that other general measures may be expected: these reportedly include a slowdown of government spending, strict application of the capital gains tax to curb speculation in real estate, and incentives to promote saving.

In the Netherlands, monetary and fiscal policy has been tightened following a deterioration of the external trade balance and continued increases in wages and prices. Although industrial production expanded by 7 per cent in 1965, wages and real consumption increased even more rapidly; the cost of living consequently rose 5 per cent. The impact of these developments on external transactions produced a rise in the seasonally adjusted trade deficit of more than 50 per cent from the first to the second half of 1965, and this trend has apparently continued. 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. The permissible expansion of bank credit during January through April was the same as that established for the last four months of 1965. To supplement these measures, the discount rate was raised on May 2 from 4½ per cent to 5 per cent. Even more recently the government intensified price and wage restraints: all firms will now be required to report each price increase, the guideline on annual wage raises specifying a 7 per cent maximum will be enforced by invalidating contracts awarding larger increases, a ban on government hiring has been imposed, and all new central government investment projects will be postponed for at least four months.

Continued upward pressure on wages and prices in Germany has induced additional moves toward restraint. A moderate slowdown in the growth of aggregate demand has recently occurred, largely as the result of a reduced rate of industrial investment. Private consumption, on the other hand, has continued its rise and demand for labor has remained high. In a series of three steps between January 7 and March 4 the German Federal Bank raised its selling rates on open market paper by a total of ⅛ of a percentage point for maturities of three months or less and by ¾ of a percentage point for maturities of over three months to two years. To limit credit availability further, commercial bank rediscount quotas with the central bank were reduced by 12½ per cent as of May 1.[3]

[2] Reserve requirements are a comparatively recent innovation in Belgium and were first applied in mid-1964.

[3] This was the second half of the 25 per cent quota reduction originally scheduled for last October but then postponed.

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A ceiling was also imposed on rediscounts of certain bank acceptances that had previously been eligible for discounting without limitation. Even more recently, the German central bank on May 27 raised its discount rate from 4 per cent to 5 per cent. At the same time, the official rate for advances on securities was increased by 1¼ percentage points, the selling rates on Treasury bills and stockpile financing paper were raised by 1 percentage point, and selling rates on other open market paper were increased by ½ of a percentage point. In an effort to prevent an excessive rise in already high long-term interest rates, however, which might induce unwanted capital inflows, discussions on the scheduling of loans have continued among all public borrowers. The federal government recently announced its intention not to borrow on the capital market this year, and the state governments and municipalities resolved early in May to float no new issues before June 30. As for wages, an important compromise was reached in February with workers in the metallurgical industry. While providing for wage increases of 6 per cent and 5 per cent in 1966 and 1967, respectively, a reduction in the workweek that had been previously agreed upon was postponed. It is hoped that this settlement will become a model for other industries.

COUNTRIES MAINTAINING RESTRAINTS

The rise in consumer prices in Switzerland accelerated toward the end of 1965, and the growth of industrial output, which slowed early in 1965, had speeded up somewhat by the year-end. Short-term interest rates have been moving upward since early 1965 in response to both domestic demand for funds and higher rates abroad. The Swiss federal budget for this year is expected to show a marginal surplus after a much larger surplus in 1965. In order to keep domestic credit expansion under rein, the Swiss parliament in March renewed for another year the 1964 temporary controls over inflows of foreign capital, securities flotations, and the expansion of bank credit. The permissible increase in bank advances to domestic borrowers during 1966 is equivalent to the total rise allowed last year. Thus most restraints have continued in force. However, because the construction industry is lagging, controls over its activity have been removed.

The government has recently proposed a bill, which will be submitted to parliament later this year, to expand the powers of the Swiss National Bank and, it is hoped, provide a substitute for the temporary controls which are scheduled to expire in 1967. Under this bill the Swiss National Bank would be able to issue its own interest-bearing notes (as the medium for expanded open market operations), to fix minimum reserve requirements for commercial banks, and to establish ceilings for the expansion of bank credit.

Monetary policy in Sweden has remained restrictive during the period under review, mainly as a response to inflationary pressures and an adverse trade balance. Recently, however, industrial production has turned down and unemployment has risen. In addition to maintaining the discount rate at a historically high level, the central bank has requested the banks and insurance companies to observe specified priorities in making new loans. The government budget for the 1966-67 fiscal year, in addition to an increased general turnover tax and a greater capital gains tax on the sale of stocks, includes higher taxes on wines and liquors, gasoline, and automobiles. While some public expenditures will be deferred, other scheduled increases in government spending and higher salaries for public employees are expected to produce a deficit substantially larger than the small deficit anticipated for the current fiscal year.

NATIONS CONTINUING EXPANSIONARY POLICIES

French policy has remained oriented toward economic growth at a measured pace. The industrial expansion has become more firmly established, and the annual increase in consumer prices has remained below 3 per cent. But monthly balance-of-payments surpluses, which were particularly large earlier in 1965, have on average been smaller during the period under review. The government has continued its efforts to modernize French industry and to strengthen the French capital market. As a means of stimulating domestic investment, corporations will be allowed to deduct from their tax liabilities 10 per cent of the cost, after the permitted allowance for depreciation, of most large capital equipment orders placed between February 15 and the end of this year. The government in May embarked on a major effort to develop a national market for home mortgage loans, which have been negotiated locally at high rates and with maturities of only two or three years. Through a program to create a secondary market, the government hopes to bring about lower rates and terms possibly as long as twenty years. Several measures have been taken recently to increase the efficiency of the banking system: the distinction between commercial and investment banks has been reduced,[4] two of the four largest commercial banks, both nationalized, are being

[4] See the November 1965 issue of this *Review*, page 245.

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merged, and minimum lending rates have been abolished. In a move to offer greater flexibility under the 1963 price freeze, still in effect, industrywide stability agreements have been supplemented by a system of agreements between individual firms and the government. Both types of agreement have the objective of allowing price changes while avoiding a general increase in price levels. The earlier program balanced price increases and declines in the same industry; in contrast, the newer plan offers the opportunity for price changes in exchange for submission to a comprehensive government review of business plans.

Italy's 1963-64 recession is now clearly in the past, and total production is continuing to expand beyond its former peak. However, the construction and investment goods sectors of the economy are still lagging. Recently prices have been stable, and unemployment is still declining but has not yet reached the pre-recession low. In 1965, the balance-of-payments surplus more than doubled and the growth of exports provided most of the stimulus for the domestic economy.

Policy in Italy has remained expansionary; the government cash budget showed a large deficit during 1965 in contrast to the previous year's virtual balance. The monetary authorities permitted the large external surplus and Treasury borrowing at the central bank to swell bank reserves. As the result of these actions and slack demand for credit, the banking system has recently attained the highest level of liquidity in years. To aid the construction sector, the terms of household mortgages have been eased, and commercial and savings banks have been permitted to hold a portion of their reserves in the form of mortgage certificates. Limitations on consumption have also been relaxed by abolishing restrictions on instalment purchases of certain durables.

In Japan, efforts to stimulate domestic economic recovery have continued. Although 1965 saw the first substantial external trade surplus of the postwar years, the domestic economy remained weak. To bolster activity the government decided that, instead of curtailing expenditures to achieve a balanced position, it would finance a shortfall in tax revenues during the second half of the fiscal year ended in March 1966 through a flotation of long-term bonds. Primarily to finance an expected budget deficit in the current financial year, the government plans to issue in 1966 domestic bonds worth the equivalent of about $2 billion. In addition, the government's extra-budgetary loan and investment program is being expanded by nearly 25 per cent. Since mid-1965 the Bank of Japan's discount rate has remained at 5.475 per cent, the lowest level since 1951. As a result of both policy measures and slack domestic demand for credit, interest rates have declined to levels more closely in line with those in the rest of the world. A consequent shift in trade financing from foreign sources to Japanese institutions contributed to a reversal in the direction of capital movements leading to net outflows. A number of measures have been taken to reduce these net outflows: the Bank of Japan has suspended its practice of granting low-cost import credits, a 40 per cent reduction has been permitted in the external assets that Japanese banks are required to hold as reserves against their short-term foreign exchange debts, the limit on banks' net long position in foreign exchange has been cut 10 per cent, and quantitative restrictions on the acceptance of Euro-currency and free-yen deposits have been relaxed.

CONCLUSION

Most of the major industrial countries abroad have responded to inflationary pressures with monetary restraints and, in several cases, with fiscal measures or direct controls as well. Interest rates have tended to rise in many of these countries, and to some extent national efforts to apply monetary restraint have been assisted by United States efforts to curtail capital outflows. Nevertheless, industrial production and aggregate output have generally continued to increase at satisfactory rates. The main problem has been, in fact, that aggregate demand has in most cases responded slowly to monetary restraints, suggesting the possibility that somewhat more emphasis on fiscal policy may be required. During the same period there has been some reduction in the major payments imbalances, the French surplus has diminished, while the United Kingdom has substantially curtailed its deficit.

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