FEDERAL RESERVE BANK
OF NEW YORK

MONTHLY REVIEW

SEPTEMBER 1967

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Volume 49 No. 9

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Treasury and Federal Reserve Foreign Exchange Operations*

By CHARLES A. COOMBS

During the first four months of 1967, sterling staged a strong recovery while international financial markets generally moved into better balance as inflationary pressures receded and credit conditions eased. Toward the end of May, unfortunately, the sudden eruption of the Middle East crisis jolted confidence in both the gold and foreign exchange markets. Money immediately flowed in heavy volume to the traditional haven of Switzerland, thereby imposing further strain on the Euro-dollar market from which funds were already being withdrawn in anticipation of midyear liquidity requirements. Sterling also came under pressure, reflecting concern that Britain might prove particularly vulnerable to adverse developments in the Middle East. In the gold market, fears that the Middle East hostilities might develop into a broader conflict briefly, but strongly, intensified speculative buying, already influenced by public discussions of United States gold policy, the Treasury's suspension of silver sales, alternating reports of imminent success or failure of negotiations to increase international liquidity, and tensions in the Far East.

These severe pressures in the gold and exchange markets in early June brought an immediate central bank response. To relieve the stringency in the Euro-dollar market, the Bank for International Settlements (BIS) drew $143 million on its swap line with the System and placed these funds in the market. This BIS operation, which was reversed in July, helped to settle the market and ease the pressures on sterling resulting from the pull of higher Euro-dollar rates. At the same time, the United States authorities, in cooperation with the Bank of England, acted to absorb sterling from the market by purchasing spot against forward resale a total of $112.8 million equivalent of sterling. In addition, the Bank of England strengthened its own resources by reactivating its swap line with the Federal Reserve through a drawing of $225 million in June. The Federal Reserve made even heavier drawings on its Swiss franc swap lines to absorb the flow of

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

August 31, 1967

Institution	Amount of facility (in millions of dollars)
Austrian National Bank	100
National Bank of Belgium	150
Bank of Canada	500
National Bank of Denmark	100
Bank of England	1,350
Bank of France	100
German Federal Bank	400
Bank of Italy	600
Bank of Japan	450
Bank of Mexico	130
Netherlands Bank	150
Bank of Norway	100
Bank of Sweden	100
Swiss National Bank	250
Bank for International Settlements	
Swiss francs/dollars	250
Other European currencies/dollars	300
Total	5,030

* This report, covering the period March to September 1967, is the eleventh in a series of reports by the Vice President in charge of the Foreign function of the Federal Reserve Bank of New York and Special Manager, System Open Market Account. The Bank acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

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Table II

DRAWINGS AND REPAYMENTS BY FEDERAL RESERVE SYSTEM UNDER RECIPROCAL CURRENCY ARRANGEMENTS

March 1962-August 1967

In millions of dollars

Institution	1962		1963		1964		1965		1966		1967		Total	Drawings outstanding on August 31, 1967
	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half	July-August		
Austrian National Bank														
Drawings		50.0											50.0	
Repayments			50.0										50.0	
National Bank of Belgium														
Drawings		30.5	10.0	15.0		145.0	65.0	85.0		30.0	37.5	92.5	510.5	120.0
Repayments		15.5	25.0		15.0	100.0	50.0	110.0	35.0	30.0	10.0		390.5	
Bank of Canada														
Drawings				20.0									20.0	
Repayments				20.0									20.0	
Bank of England														
Drawings	50.0		25.0	10.0									85.0	
Repayments		50.0	25.0	10.0									85.0	
Bank of France														
Drawings	50.0			21.5									71.5	
Repayments		50.0		12.5	9.0								71.5	
German Federal Bank														
Drawings			150.0	136.0	55.0	50.0	15.0			140.0			546.0	
Repayments				226.0	115.0		65.0				140.0		546.0	
Bank of Italy														
Drawings		50.0					250.0	100.0		325.0			725.0	
Repayments			50.0				82.0	168.0	100.0	310.0	15.0		725.0	
Netherlands Bank														
Drawings	10.0	50.0	50.0	100.0		100.0		25.0		65.0		20.0	420.0	20.0
Repayments		50.0	10.0	70.0	80.0		100.0	25.0		30.0	35.0		400.0	
Swiss National Bank														
Drawings		50.0		80.0	25.0		150.0			75.0	185.0	33.0	598.0	173.0
Repayments			50.0	5.0	100.0		90.0	60.0		60.0	43.0	17.0	425.0	
Bank for International Settlements														
Drawings		80.0		150.0		100.0				75.0	185.0	15.0	605.0	200.0
Repayments		25.0	55.0	5.0	145.0		60.0	40.0			75.0		405.0	
All banks														
Drawings	110.0	310.5	235.0	532.5	80.0	395.0	480.0	210.0		710.0	407.5	160.5	3,631.0	513.0
Repayments		190.5	265.0	348.5	464.0	100.0	447.0	403.0	135.0	430.0	318.0	17.0	3,118.0	

dollars to Switzerland, while the Gold Pool kept the London gold market price under firm control.

Although the immediate disturbances in the gold and exchange markets associated with the Middle East crisis were thus quickly dealt with, international financial markets remained uneasy during succeeding months while short-term funds continued to move across the exchanges in response to differentials in interest rates and credit conditions. Recurrent pressures on sterling, for example, seemed to reflect interest rate differentials marginally unfavorable to London, as well as hedging. At the close of August, the successful conclusion of the Group of Ten discussions on international liquidity brought about some covering of short positions in sterling while also relieving speculative buying pressure on the London gold market.

As in the past, dollar rates in the exchange markets were influenced both by the United States balance-of-payments deficit and the backwash from large shifts of funds among third countries. The Federal Reserve swap lines, after having reverted fully to a standby basis last February, were once again activated in May when the System began a series of drawings on its swap line with the Belgian National Bank in order to absorb a continuing influx of dollars into Belgium. Such drawings of Belgian francs rose to $120 million equivalent by the end of August, while drawings of $20 million equivalent of Dutch guilders were also required to absorb dollar acquisitions by the Netherlands Bank. By far the largest operation, however, was undertaken in Swiss francs in order to absorb $390 million that poured into the Swiss National Bank during May and June. There were only very limited opportunities to reverse these operations during the sum-

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Table III

OUTSTANDING UNITED STATES TREASURY SECURITIES FOREIGN CURRENCY SERIES

In millions of dollars equivalent

Issued to	Amount outstanding on January 1, 1966	Net changes 1966	1967 Issues or redemptions (—)			Amount outstanding on August 31, 1967
			I	II	July-August	
Austrian National Bank	100.7	— 50.3				50.3
National Bank of Belgium	30.2			—30.2		
German Federal Bank	602.1	—251.5			125.5	477.0
Bank of Italy	124.8					124.8
Swiss National Bank	257.3	— 46.2				210.8
Bank for International Settlements*	92.6			60.2		152.7
Total	1,207.8	—348.0		30.0	125.5	1,015.5

Note: Discrepancies in amounts are due to valuation adjustments, refundings, and rounding.
* Denominated in Swiss francs.

mer months, and at the end of August System swap drawings outstanding totaled $513 million (see Table II). Subsequently, in early September the Federal Reserve drew an additional $5 million under its arrangement with the National Bank of Belgium and $10 million from the Netherlands Bank.

During the period under review, the Federal Reserve swap network was expanded and further strengthened. In May, new swap facilities were negotiated with the central banks of Denmark and Norway in the amount of $100 million each and with the Bank of Mexico for $130 million. Then in July, against the background of the Middle East problem, the System negotiated increases in: (1) its Swiss franc swap lines with the Swiss National Bank and the BIS (each facility being increased by $50 million to $250 million), and (2) its swap line with the BIS providing for swaps of dollars against other European currencies (this facility rising from $200 million to $300 million). Thus, the Federal Reserve swap network now comprises bilateral agreements with fourteen central banks plus the BIS which provide mutual credit facilities totaling $5,030 million.

In April and May, the United States Treasury issued to the BIS certificates of indebtedness denominated in Swiss francs, the proceeds of which ($60.2 million equivalent) were used to reduce third-currency swaps negotiated with the BIS last February to liquidate previous Swiss franc drawings by the System. In July the Treasury issued the first of four scheduled 4½-year $125 million notes, denominated in German marks. These latest security issues, partly offset by redemption at maturity of Belgian franc-denominated bonds totaling $30.2 million, brought to $1,015.5 million total outstanding issues of United States Treasury foreign currency obligations (see Table III).

STERLING

During the first quarter of 1967, funds that had fled from sterling during the summer of 1966 began moving back at an accelerated pace. By early March, these inflows had enabled the Bank of England to liquidate completely the swap drawings from the Federal Reserve and to repay fully other sizable special credits from the Federal Reserve and the United States Treasury. (At their peak in August of last year, credits from the United States had reached $750 million. By the end of September they had been reduced to $575 million through substitution of other credit facilities.) Announcement of these repayments confirmed to the market the degree of recovery that had already taken place and triggered a spurt of buying that gained momentum as the month progressed.

Other developments during March contributed to a surge of covering of short positions. These included announcements of (1) renewal of the credit lines from nine central banks and the BIS, (2) unexpectedly good fourth-quarter balance-of-payments figures, (3) a cut in bank rate from 6½ per cent to 6 per cent, which was taken as a sign of confidence, and (4) the Government's decision to continue strict control over price and wage increases through July 1968. In addition to having repaid early in March its swap with the Federal Reserve, the Bank of England later in the month used most of its record reserve gains to repay other short-term central bank debts. Thus, within a six-month period, the Bank of England had repaid $575 million to the United States authorities and $720 million to other parties. Remaining central bank credits linked specifically to changes in overseas sterling balances were liquidated early in the second quarter.

The influx of short-term capital continued in April and early May, though at a diminishing rate. The British authorities were able to announce a reserve increase of $145 million in April, as foreign short-term interest rates continued to fall and the United Kingdom budget message met with a generally favorable reception. As early as April, however, some market concern was beginning to be expressed about the trend in the trade figures, and by early May covered interest rate comparisons that had tended to favor London earlier in the year started to turn adverse. Shortly after the announcement on May 4 of the third cut in bank rate this year, from 6 per cent to 5½ per cent, Euro-dollar rates began to firm, despite subse-

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quent steps toward further monetary ease by several Continental countries. Moreover, announcement on May 11 that the British trade deficit had jumped from $36 million in March to $115 million in April was followed a few days later by President deGaulle's sharply negative comments at a press conference on Britain's application to join the Common Market. By mid-May the combination of these adverse factors had led to the first net selling of sterling this year. Nevertheless, the British authorities proceeded with their plans to prepay $405 million on May 25 to the International Monetary Fund (IMF)—more than half of the amount due this December under the 1964 drawing—together with the whole amount ($80 million) borrowed in 1964 from Switzerland, thus further reestablishing available credit facilities.

On June 1, market expectations of an imminent outbreak of hostilities in the Middle East sparked a burst of selling of sterling. Such apprehension of war affected sterling not only directly but also indirectly through the Euro-dollar market, where precautionary withdrawals of funds combined with the usual pressures associated with midyear window dressing to create a sudden squeeze and a sharp hike in rates. These dual pressures were immediately met by a coordinated central bank response in both the exchange and Euro-currency markets. On June 1 the United States authorities, in consultation with the Bank of England, purchased a total of $92.9 million of sterling in the New York market on a swap basis, buying spot against forward sales. That same day the BIS began placing in the Euro-dollar market new dollar funds drawn under its swap arrangement with the Federal Reserve. By June 7, when a cease-fire resolution by the United Nations served to reduce tensions somewhat, the BIS had drawn a total of $143 million from the System and had placed these dollars, together with funds received from other central banks, in the Euro-dollar market. Meanwhile, the United States authorities had temporarily taken another $20 million of sterling out of private hands through additional swap purchases in New York. With the cessation of actual hostilities, covering by the market of short positions in sterling boosted the spot rate from a low of $2.7900 on June 6 to $2.7932 on June 7 while permitting the Bank of England to recoup much of the exchange that had been used during the preceding few days.

As the month progressed, however, rumors that Arab countries might withdraw sterling balances revived market anxieties while the announcement at midmonth of disappointing trade figures for May had a further disturbing effect. Finally, the pull of foreign interest rates, particularly during a brief squeeze in the Euro-dollar market at the end of June, exerted further pressure. To cushion the reserve impact of these adverse developments, the Bank of England drew $225 million during June under its $1,350 million swap arrangement with the Federal Reserve.

SWISS FRANC

During the first half of 1967, Swiss interest rates declined less rapidly than rates outside Switzerland. Indeed, during much of this period, the Swiss credit market remained relatively tight, and there was on the whole more incentive for foreigners to pay off previous Swiss franc borrowings than there was for Swiss residents to place new funds abroad. Even in the early months of the year, the reflux to foreign markets of funds repatriated by Swiss residents at the year-end was less than might have been expected on the usual seasonal pattern. As a result, the Federal Reserve was unable to acquire through the market sufficient francs to pay down completely earlier drawings under its swap lines with the Swiss National Bank and the BIS. To liquidate the residual balance of $75 million in Swiss francs due to the BIS, the United States authorities in February used $75 million equivalent of sterling balances to acquire Swiss francs from the BIS on a temporary swap basis. Subsequently, when the Swiss National Bank released to the Swiss commercial banks part of their deposits that had been blocked since 1961 the banks bought BIS Swiss franc promissory notes in the amount of $60.2 million equivalent. The BIS placed these francs at the disposal of the United States Treasury, which in exchange issued certificates of indebtedness denominated in Swiss francs. The Swiss franc proceeds of these issues were used to reduce the commitment under the sterling/Swiss franc swap to $14.3 million equivalent.

In order to forestall a rapid rise in the Swiss franc rate during March when Swiss banks repatriated funds for liquidity requirements, the Swiss National Bank announced early in the month that it would provide Swiss francs against dollars for end-of-quarter needs through short-term swaps with the Swiss commercial banks. This was the first time that the Swiss authorities had offered this facility other than at midyear and at the year-end. During the final weeks of March, the central bank took in $221 million on this basis and immediately reinvested the money in the Euro-dollar market to assist in moderating pressures in that market.

Following the end of the quarter, interest rates on sterling and dollar investments continued to decline, while the unwinding of the Swiss National Bank swaps with its commercial banks tended to tighten the Swiss market once again. Foreigners, particularly Italians, began to bid for

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Table IV

DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

March 1962-June 1967

In millions of dollars

Institution	1962		1963		1964		1965		1966		1967	Total	Drawings outstanding on June 30, 1967
	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half	Second half	First half		
National Bank of Belgium													
Drawings			35.0	10.0								45.0	
Repayments			25.0	20.0								45.0	
Bank of Canada													
Drawings	250.0									17.6		267.6	
Repayments		250.0								17.6		267.6	
Bank of England													
Drawings			25.0		15.0	1,355.0	1,215.0	550.0	175.0	450.0	225.0	4,010.0	225.0
Repayments				25.0		1,170.0	1,055.0	435.0	475.0	275.0	350.0	3,785.0	
Bank of Italy													
Drawings				50.0	100.0							150.0	
Repayments					150.0							150.0	
Bank of Japan													
Drawings					50.0	30.0						80.0	
Repayments						80.0						80.0	
Bank for International Settlements*													
Drawings										285.0	225.0	510.0	143.0
Repayments										85.0	282.0	367.0	
All banks													
Drawings	250.0		60.0	60.0	165.0	1,385.0	1,215.0	550.0	175.0	752.6	450.0	5,062.6	368.0
Repayments		250.0	25.0	45.0	150.0	1,250.0	1,055.0	435.0	475.0	377.6	632.0	4,694.6	

* Includes, in addition to drawings in connection with Euro-dollar operations, BIS drawings of dollars against European currencies other than Swiss francs to meet temporary cash requirements. During the first six months of 1967, such drawings totaled $82 million.

Swiss francs to repay indebtedness previously incurred and started shifting their borrowings to currencies that were being lent more cheaply, notably German marks, while in addition there may have been some net repatriation of funds by Swiss banks. As a result, the spot rate moved up from $0.2307½ at the beginning of April to the effective ceiling of $0.2317½ by April 26, at which point the Swiss National Bank became a buyer of dollars for the first time in 1967. With credit conditions remaining tight and some nervousness developing about sterling and the prospects of a Middle East clash, the rate held at or close to the effective ceiling through most of May, and the Swiss National Bank added some $180 million to its reserves. The prepayment by the Bank of England in May of the $80 million credit extended to it in December 1964 resulted in equivalent dollar acquisitions by the Swiss National Bank.

During the first days of June the rumor, and then actual outbreak, of hostilities in the Middle East precipitated a heavy flow of funds to Switzerland. The dollar holdings of the Swiss National Bank, already swollen by the inflows in May, jumped by $212 million in the first week of June. In order to absorb these dollar flows, the Federal Reserve on June 2 and June 8 drew a total of $370 million equivalent of Swiss francs in equal amounts under its swap arrangements with the Swiss National Bank and the BIS; in addition, the Swiss National Bank purchased $30 million of gold from the United States Treasury. Although only a part of the shift of funds to Switzerland during this period represented transfers directly out of sterling, the Swiss authorities were prepared to cooperate with the Bank of England in countering the effects of such shifts. One by-product of this cooperation was the acquisition by the Federal Reserve of $28 million equivalent of Swiss francs which were used on June 16 to repay an equivalent amount of its drawings on the Swiss National Bank.

Following the cease fire in the Middle East, the demand for francs abated, only to pick up again on a moderate scale just before midyear. Once again, the Federal Reserve drew on its swap arrangements to absorb these inflows; it added $33 million to its drawings on the Swiss central bank and $15 million to its drawings on the BIS, bringing the total of Swiss franc drawings outstanding on July 3 to the equivalent of $390 million, out of credit lines then totaling $400 million. The drawing on the Swiss National

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Bank was reduced on July 28 to $180 million, when the Swiss National Bank purchased $10 million from the System against Swiss francs to meet Swiss official requirements. In view of continuing uncertainties in financial markets and unsettled conditions in the Middle East during the summer, it was agreed in mid-July that the Federal Reserve swap lines in Swiss francs with the Swiss National Bank and the BIS should be expanded by $50 million each to a new combined total of $500 million. (At the same time, the $200 million swap facility with the BIS in European currencies other than Swiss francs was increased by $100 million equivalent to $300 million.)

The capital inflows in May and especially in June led to increased liquidity in Switzerland and eliminated the need for any special measures, such as short-term swaps, to meet midyear needs. Indeed, there was some easing in Swiss interest rates. In order to reinforce this trend, the Swiss central bank on July 10 reduced its discount rate from 3½ per cent to 3 per cent, explaining that the move was "likely to facilitate the reestablishment of interest rate differences existing normally between Switzerland and foreign countries and thus also the reflux abroad of the excess liquidity registered in the past two months". Following this move, and as Euro-dollar rates became relatively more attractive, some movement of funds out of Switzerland began to develop, and by late August the franc had eased considerably. When the rate reached $0.2304⅛, the Swiss National Bank began selling dollars to the market. The Bank subsequently purchased $7 million from the System which used the Swiss franc counterpart to reduce its outstanding drawings in Swiss francs. Such Federal Reserve drawings thus amounted to $373 million as of the end of August.

GERMAN MARK

The German economy has been operating at less than capacity this year, and the slack in domestic activity has been reflected in a substantial drop in imports and buoyant exports. As a result, the German trade surplus nearly quadrupled from $555 million in the first half of 1966 to $2.2 billion in the first half of this year. Had it not been for the very large outflows of short-term funds stimulated by the significant easing in German monetary policy, this trade surplus could have created severe strains in international credit markets and the foreign exchange market. Thus, the series of reductions in the discount rate and in reserve requirements during the first eight months of this year, while designed primarily to stimulate the flagging domestic economy, were very helpful from an international standpoint as well.

Following the usual seasonal pattern, there was a substantial reflow of funds from Germany just after the year-end, and the Federal Reserve was able to acquire in the market and through special transactions sufficient marks to liquidate by mid-February the $140 million drawn on the swap line with the German Federal Bank in December 1966. During March and April, the spot rate generally held close to its upper limit but the central bank did not add significantly to its reserves. By mid-May, however, the mark began to ease as the cumulative influence of easy money policy induced heavy outflows of commercial bank funds. At the same time, German firms that had taken up sizable amounts of funds abroad began making repayments as credit became more readily available in Germany.

The easing trend in spot marks became more pronounced toward the end of June, when the German Federal Bank announced the fourth reduction in reserve requirements this year. To encourage retention in Germany of this newly released bank liquidity, the German Federal Bank at the same time altered its pattern of exchange market activity. For several months, the central bank had been concerned that its policy of active ease had been more successful in stimulating outflows of funds than in reducing domestic interest rates. By widening its announced buying and selling rates and permitting a rapid fall in the spot rate, the central bank sought to increase the degree of uncertainty about future rate movements, particularly for those who were investing abroad at very short term on an uncovered basis. As the spot rate dropped sharply in early July to just below par, investors immediately began to purchase forward cover to avoid the risk of a future rise in the rate and the cost of such cover back into marks jumped from about ¾ per cent for three-month maturity, for example, to over 1¾ per cent and remained close to 1½ per cent through August.

During the period under review, there were discussions between Germany and the United States, together with the United Kingdom, concerning military forces in NATO and the balance-of-payments consequences of United States and United Kingdom troop deployments in Germany. In early May, the United States authorities released an exchange of letters growing out of these discussions between the President of the German Federal Bank, Karl Blessing, and the Chairman of the Federal Reserve Board, William McChesney Martin, Jr., in which the former indicated that the Federal Bank intended to continue its practice of not converting dollars into gold as part of a policy of international monetary cooperation. This statement was made with the agreement of the German Federal Government, which at the same time took note of the

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Federal Bank's intention to purchase $500 million of United States Government medium-term securities in four equal quarterly instalments beginning in July. The first $125 million equivalent German mark security was issued on July 3.

DUTCH GUILDER

During the early part of 1967, the guilder came on offer as the Dutch trade balance moved into deficit, primarily due to slackening demand by some of its major trading partners. At the same time, the recovery of sterling attracted additional outflows of guilder funds. Under the circumstances, the Netherlands Bank released dollars to the market and further reduced its dollar reserves by converting into dollars the guilder tranche of a multicurrency drawing from the IMF by Spain. The Netherlands Bank then replenished its dollar reserves by buying $35 million from the Federal Reserve against guilders. The Federal Reserve used the guilders to repay by the end of January the remaining commitment under a $65 million swap drawing made during the summer of 1966.

The Dutch economy continued to ease, and in mid-March the Netherlands Bank reduced its discount rate from 5 per cent to 4½ per cent. (The rate had been raised to 5 per cent in May 1966 in order to damp down the then overheated economy.) The move also brought interest rates in the Netherlands more nearly into line with those in other centers. At the same time, the Netherlands Bank removed the penalty deposit requirement for banks exceeding credit ceilings. Despite these moves, money market conditions in the Netherlands remained tighter than abroad and Dutch banks withdrew funds from other markets. Under the circumstances, the Dutch authorities began to rely increasingly on swap transactions in the exchange market—that is the purchase of dollars spot against forward delivery—as a regular method of relieving money market pressures. Dollars taken in by the central bank on a swap basis reached fairly substantial levels beginning in May and rose to a peak of $150 million in early June.

In the early summer, the backwash of the hostilities in the Middle East and renewed pressures on sterling dominated the foreign exchange markets. As additional funds moved into Amsterdam, the guilder rose sharply and the Netherlands Bank took in dollars both outright and on a swap basis. Accordingly, at the end of July the Federal Reserve drew $20 million of guilders under its $150 million swap line with the Netherlands Bank and used the proceeds to absorb an equivalent amount of dollars on the books of the Dutch central bank. Following a further flow of funds into the Netherlands, in early September the Federal Reserve made an additional drawing of $10 million equivalent.

CANADIAN DOLLAR

During the early part of 1967, movements in the Canadian dollar rate were influenced by fluctuations in the volume of new Canadian bond flotations in the New York market and by short-term capital flows. A flurry of new issues in January, together with the take-down of proceeds of previous issues and the repatriation of funds from the United States, more than offset adverse seasonal factors and the Canadian dollar moved above par ($0.9250) where it held through mid-February. At the end of February, as the rate of new external issues abated and adverse seasonal factors asserted themselves, the rate moved below par and remained there during the rest of winter and early spring.

The Canadian dollar began moving into a period of seasonal strength late in the spring as grain shipments started up again. Then in June an increase in the level of bond issues lent further strength to the Canadian dollar, pushing it above par. An additional—although quite temporary—boost was given to the spot rate when unfounded rumors of an increase in the Canadian-Russian wheat agreement were prompted by the arrival in Canada of a Russian trade delegation. During the summer, tourist receipts were unusually large as the success of EXPO 67 drew an exceptional number of visitors to Canada. Consequently, the Canadian dollar remained quite strong during July and August, fluctuating in a narrow range around $0.9300. Official gold and foreign exchange reserves nevertheless declined moderately during the first seven months of the year (by $53.3 million), with the decline in large part ($31.8 million) the result of purchases by the Canadian authorities of Canadian Government debt held by United States residents.

BELGIAN FRANC

The Belgian franc moved above par in January as lightly slackening activity in the Belgian economy contributed to a more than seasonal drop in imports, and the current account shifted from deficit to surplus during the winter. There was no real pressure in the exchange market, however, and official holdings of gold and foreign exchange were little changed through the first quarter.

In April the franc began to strengthen further as the current account continued in surplus and from May onward the franc held at or near its upper intervention point.

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In part, this strength reflected an inflow of short-term capital despite steps by the central bank to ease monetary policy somewhat, including three discount rate cuts during the first half of the year. During the rest of the period, the National Bank of Belgium was compelled to take in substantial amounts of dollars. Inflows in late April and early May led the Federal Reserve to absorb $30 million that had been acquired by the National Bank by utilizing its $150 million swap line with that Bank. In an unrelated transaction, the United States Treasury during May repaid two maturing Belgian franc denominated bonds totaling $30.2 million originally issued in 1963 using francs it had acquired in late 1966 when the dollar was in demand in Belgium.

The Federal Reserve used an additional $7.5 million of the swap line in June but shortly thereafter repaid $10 million by selling dollars to the National Bank to meet Belgian Government needs. In July and August demand for francs was intensified as commercial banks increased their inflow of short-term capital. (The scope for the banks to employ in Belgium the proceeds of foreign borrowings increased with the removal in late June of the credit ceilings that had been previously applied on a voluntary basis.) The renewed pressures on sterling also contributed to the substantial inflow as commercial interests and banks reduced their holdings of sterling. In order to absorb dollars purchased by the National Bank during this period, the Federal Reserve used a further $92.5 million under the swap arrangement plus $3 million of Belgian franc balances. Thus at the end of August, total swap drawings by the Federal Reserve stood at $120 million. Following a further flow of funds into Belgium, in early September the Federal Reserve made an additional drawing of $5 million equivalent.

ITALIAN LIRA

The deficit that had emerged in late 1966 in Italy's balance of payments continued during the first two months of 1967, reflecting seasonal factors and intensified import demand associated with an expanding economy. In addition, there were sizable exports of capital, partly in anticipation of changes in the Italian tax laws. Under the circumstances, United States monetary authorities were able to acquire sufficient lire to repay short-term lira commitments totaling $114 million, of which the final $15 million portion was liquidated at the beginning of 1967.

In March, Italy's balance of payments began to strengthen, although the reemerging surplus was considerably less than during the comparable period a year earlier as import demand expanded further and capital exports continued. As economic expansion generated mounting financial requirements on the part of Italian residents for both foreign exchange and local currency, Italian banks reduced their net claims on foreigners by nearly $275 million during the first six months of the year. During the same period, Italian official reserves, including Italy's position in the IMF, increased by $55 million.

About midyear the Italian payments position moved into the period of seasonal strength and the demand for lire intensified. The Italian authorities began to acquire substantial amounts of dollars, though on a lesser scale than the previous year. The Federal Reserve did not draw upon its $600 million swap line with the Bank of Italy during the period, but outstanding Federal Reserve and Treasury technical commitments in forward lire were rolled over periodically during 1967.

OTHER CURRENCIES

During the period under review, there were no System transactions in Austrian schillings, French francs, Japanese yen, Danish kroner, Norwegian kroner, Swedish kronor or Mexican pesos. Nor were there any drawings by the United States Treasury on the IMF. As of the end of August, net United States indebtedness to the Fund was $922.2 million.

EURO-DOLLAR MARKET

The Euro-dollar market eased considerably during the first four months of 1967, after having been subjected to considerable strain last year. Excessive reliance on monetary policy in a number of countries had pushed domestic interest rates to historically high levels which affected the international money market as well. United States banks in particular turned to the Euro-dollar market in an effort to recoup deposits being lost as certificate of deposit rates reached ceiling levels under Regulation Q and became uncompetitive with commercial paper. Thus, between late June and the peak in mid-December, United States banks added some $2.4 billion to their borrowings through foreign branches. Later, year-end liquidity requirements placed additional demands on the market. In the final weeks of 1966, concerted action was taken by the BIS and a number of central banks to counter these year-end pressures, and the constellation of Euro-dollar rates began to ease. (For a description of these operations, see this *Review*, March 1967, pages 43-51.)

The decline in rates was even more pronounced after the turn of the year. By late April, three-month deposits

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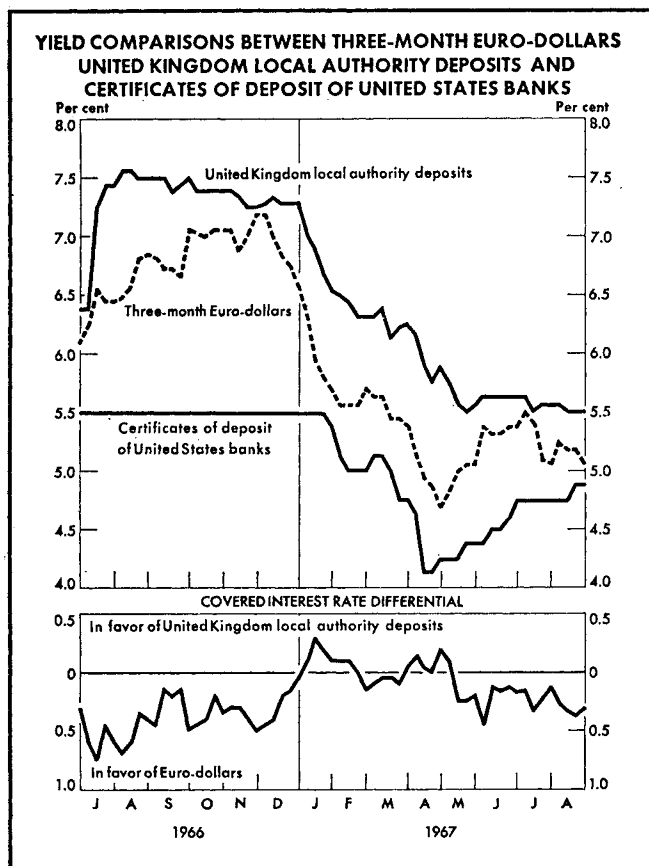

were quoted at $4^{11}/_{16}$ per cent, lower than at any time in 1966 and 2½ percentage points below their peak of late November (see chart). This sharp decline in rates reflected, in addition to the usual seasonal pattern, decidedly easier monetary conditions in the United States and Germany and to a lesser extent in other countries as well. By the end of the first quarter, United States banks had reduced their liabilities to foreign branches mainly in London by some $1.25 billion from the mid-December peak, while German and Swiss institutions added substantially to their net foreign currency assets abroad. A large part of the foreign funds shifted to London during the early months of the year were converted into sterling, reflecting both the relative attractiveness of sterling-denominated short-term assets and the return of confidence in that currency. As indicated on the accompanying chart, British local authority deposits commanded a modest edge over Euro-dollars early in the year and again in April, even allowing for exchange cover. On an uncovered basis, of course, there had been a substantial interest margin in favor of sterling assets right along, but this incentive became of practical significance in terms of shifts of funds only with the return of confidence.

The trend in interest rate relationships shifted during the second quarter as conditions in the Euro-dollar market began to tighten, partly reflecting a similar movement in United States short-term rates. Banks in some countries began to withdraw funds from the Euro-dollar market while those in other countries accelerated the pace of their previous borrowing. At the same time, placement of German funds tapered off and United States banks on balance were no longer repaying previous borrowings. Rates in the Euro-dollar market began to rise in May, and with the outbreak of hostilities in the Middle East in June, precautionary withdrawals of funds combined with preparations for mid-year to cause a sharp jump in rates. The increased interest incentive to shift funds from sterling to the Euro-dollar market added a further element of pressure on sterling. Accordingly, as indicated in the section on sterling, the BIS immediately began to place sizable amounts of dollars in the Euro-dollar market, financing $143 million of such placements by drawing on the swap line with the Federal Reserve. These operations quickly calmed the market, and, with the cessation of fighting, the rapid rise in rates came to a halt.

Apart from a brief period of stringency at midyear and in early July, Euro-dollar rates have generally tended downward in recent weeks despite renewed borrowings by United States banks through their branches that have brought these liabilities back to a level approaching last December's peak. Some new funds have come into the market as a result of the United States payments deficit as well as from short-term outflows from Germany and Switzerland. In addition, there has been a shift of funds out of sterling, partly because the covered incentive between sterling and Euro-dollar investments has favored the latter for several months now.

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Some Current Banking and Economic Problems*

By WILLIAM F. TREIBER

First Vice President, Federal Reserve Bank of New York

It is a great pleasure to be with you today. You, as state bank supervisors, and we in the Federal Reserve System have many common interests. Both are interested in promoting a sound banking system that will continue to develop and to serve effectively the nation and its people. You have the responsibility of chartering and supervising banks organized under state law. We in the Federal Reserve have a secondary responsibility of supervising some of those banks. We are also concerned with the preservation of the value of our nation's money, for we have been delegated responsibilities in this respect by the Congress which under the United States Constitution has the power to coin money and regulate the value thereof. Today I propose to discuss with you, as we see them, some recent developments and current problems in promoting an efficient and sound banking system, in preserving the value of the dollar, and in promoting our other national economic goals. Most of these problems involve Federal legislation in one way or another.

REGULATION OF INTEREST RATES PAID BY FINANCIAL INSTITUTIONS

Public Law 89-597, which was enacted September 21, 1966, broadened and placed on a discretionary basis the authority of the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) to limit interest rates paid by banks on time and savings deposits. It granted similar authority to the Federal Home Loan Bank Board to limit interest rates paid by savings and loan associations, and required prior consultation among all three agencies before any one agency could prescribe new rate limits.[1] The law is temporary. On September 21, 1967, the prior provisions of law will be restored unless the Congress enacts new legislation. On July 17, 1967, the Senate voted to extend for two years the provisions of Public Law 89-597. The Senate bill is now before the Committee on Banking and Currency of the House of Representatives.

I would like to comment on two aspects of this temporary legislation: (1) the discretionary nature of the authority to limit the rate of interest paid by commercial banks, and (2) the authority to limit interest rates paid by mutual savings banks and savings and loan associations. I think that these provisions, as well as other provisions upon which I will not take the time to comment, should be made permanent.

COMMERCIAL BANKS. Prior to the enactment of the temporary legislation last year, the Federal Reserve Board was required by law to establish maximum rates on time and savings deposits in member banks, and the FDIC was required to establish maximum rates on similar deposits in insured nonmember banks.[2] The objective of the requirement, enacted more than three decades ago, was to help assure sound banking. Improved bank examination and supervision in recent decades make continuous regula-

* An address at the sixty-sixth annual convention of the National Association of Supervisors of State Banks, Louisville, Kentucky, August 16, 1967.

[1] The law also expanded the range within which the Federal Reserve Board may vary reserve requirements on time and savings deposits, and it authorized the Federal Reserve Banks to conduct open market operations in United States Government agency obligations.

[2] Since 1938, insured nonmember mutual savings banks had been expressly exempted by the FDIC from the maximum rates established by it for insured nonmember banks.

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tion of interest rates unnecessary as a means of preventing destructive competition and the resultant acquisition of unsound assets.

In general, the public interest is best served when the forces of supply and demand are permitted to reflect themselves in prices, including interest rates. The relationship between buyers and sellers, or borrowers and lenders, is likely to be more equitable, and the allocation of resources is likely to be more satisfactory, when prices and interest rates are free to reflect market forces. Yet there may be times, and 1966 was such a time, when the establishment of maximum interest rates is necessary either to prevent institutional practices in the payment of interest that would be inconsistent with the safety and liquidity of a significant number of institutions or to supplement other governmental policies to promote our national economic goals. These factors counsel continuation of the authority on a discretionary basis. The exercise of such discretionary authority, it seems to me, should be limited to such special situations.

MUTUAL SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS. Although prior to 1966 the Federal Reserve and the FDIC were required to establish maximum interest rates for banks, no Federal supervisory authority was directed or even authorized to fix maximum rates of interest payable by savings and loan associations.

The absence of a maximum interest rate for thrift institutions gave them, at times in the past, a competitive edge over commercial banks in attracting funds. However, as interest rates rose rapidly in 1966, the thrift institutions were faced with very strong competition on the part of not only banks but also marketable securities including those of the United States Government. Because most of the investments of thrift institutions had been made for long terms when interest rates were lower, their earnings did not rise as rapidly as did current interest rates.

The temporary legislation specifically authorized the FDIC to limit the rate of interest paid by insured mutual savings banks, and it authorized the Federal Home Loan Bank Board to limit the rate paid by insured savings and loan associations. The authority was granted to restrain some thrift institutions from trying to match or to better competitive rates available to savers. Although the rates paid by insured commercial banks were already subject to Federal Reserve or FDIC control, it was not feasible to restrict further the rates paid by commercial banks while the rates paid by competing thrift institutions were subject to no supervisory control. The experience of 1966 demonstrated the desirability of vesting in the FDIC and the Federal Home Loan Bank Board, on a permanent basis, discretionary authority to limit the rates of interest paid by insured thrift institutions.

DISCOUNT WINDOW ADMINISTRATION

Another problem on which I would like to comment is the administration of the Federal Reserve "discount window". In recent years the Federal Reserve has sponsored legislation that would eliminate the outmoded technical requirements regarding the "eligibility" of customers' paper presented at the discount window to secure advances by the Reserve Banks to member banks. The System has also been engaged in a basic reappraisal of the functioning of the discount window in the light of the changes in the banking system and the financial markets over the past decade.

ELIGIBILITY LEGISLATION. In April 1967, the Senate passed S.966, streamlining discount window operations. The bill is now before the House Committee on Banking and Currency. Enactment of the bill would not cause a dramatic or abrupt change in the type of collateral offered by member banks to secure their borrowings at the Federal Reserve Banks. It would still be more convenient most of the time for member banks to pledge U.S. Government obligations and simple notes of customers as collateral for their borrowings. But this is important legislation for member banks that have limited holdings of unpledged Government obligations or that have small amounts of "eligible paper" in their loan portfolios. For these banks, access to the discount window under the circumstances specified in the Reserve Board's Regulation A would be facilitated. The legislation should also prove helpful to any member bank encountering an emergency or any other situation requiring substantial assistance from a Federal Reserve Bank.

The Federal Reserve System is already engaged in forward planning to process the wide variety of collateral that may be tendered at the discount window to support borrowings. The System has organized and has commenced to operate a school to train Federal Reserve discount personnel in collateral appraisal. As we in the Federal Reserve prepare for enactment of this legislation, member banks, too, would be well advised to consider how they may take advantage of the new possibilities when they materialize.

STUDY OF DISCOUNT MECHANISM. It is too early to report the conclusions of the fundamental study of the discount mechanism. It is not unlikely, however, that there will be recommendations leading to a greater use of the discount

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window to the advantage of both member banks and the Federal Reserve.

STUDY OF BANK LIQUIDITY AND CAPITAL

The Federal Reserve System is also engaged in another study which is even more closely associated with your interests and responsibilities as bank supervisors. The events of 1966 highlighted the importance of reexamining our approach to member bank liquidity and capital.

BANK LIQUIDITY. Traditionally, a bank's need for liquidity has been thought of in terms of a possible drop in deposits. The events of last year brought into sharp focus the necessity of considering also a bank's ability to meet potential credit demands, especially unexpected demands representing legitimate needs in the community. Many banks found it difficult to shift assets to meet such needs in a period of rapidly rising interest rates. Liquidity analysis should take into account not only potential deposit losses but also potential credit demands.

Changing banking practices have highlighted the importance of liability management. Banks have found that sometimes an increase in liabilities may be a more feasible way to obtain loanable funds than a sale or other disposition of assets. Banks and bank supervisors need to know more about the potential impact on a bank of an increase in various types of liabilities.

BANK CAPITAL. During the past decade, bank assets and deposits have grown more rapidly than retained earnings. The growth in time and savings deposits, coupled with the steady rise in interest rates paid on such deposits, has brought a sharp increase in total bank expenses in relation to total assets. In addition, the shift in the composition of bank assets from securities to loans, while yielding greater income to offset higher costs, has increased the relative amount of risk assets. Consequently, for most banks the ratio of capital funds to total resources has declined, while the ratio of risk assets to total resources has risen.

A number of banks have increased their capital by selling securities. Many more need to do so. All bank supervisors are interested in the continued soundness of the banks they supervise, including the maintenance of a capital position adequate to enable the banks to serve their communities and remain strong and competitive.

STUDY OBJECTIVES. The study being undertaken by the Federal Reserve has two objectives: (1) developing improved standards for measuring a bank's liquidity, and (2) formulating a guide for measuring the capital needs of a bank and for determining appropriate ways to meet such needs. We expect to share the results of the study with you, and we trust that they will be helpful.

PROTECTION OF PUBLIC DEPOSITS

The laws of many states require that banks receiving deposits of the state or its political subdivisions secure those deposits by the pledge of U.S. Government obligations or other specified types of securities. Similarly, banks must pledge collateral to secure United States Treasury Tax and Loan Accounts and other U.S. Government deposits. A decade or more ago, when most banks held large quantities of eligible securities, there was not much of a problem in making the pledge; but in recent years as loan demands have been heavy and banks have reduced their securities holdings, many banks have experienced some difficulty in meeting the pledge requirements and at the same time maintaining desirable flexibility with respect to their investment portfolios. It has been estimated that over $45 billion of collateral are tied up in such pledges.

Most state laws that require the pledge of assets to secure public deposits exempt the FDIC-insured portion of such deposits from the pledging requirements. There is a similar exemption with respect to U.S. Government deposits. Last year an advisory committee of banking experts appointed by the New York Superintendent of Banks to assist him in a comprehensive reappraisal of banking laws and regulations recommended to the Superintendent that appropriate statutes be amended to provide for full FDIC insurance of public deposits as a substitute for the pledging of assets.[3] Presumably upon the enactment of Federal leg-

[3] *Second Report of the Advisory Committee on Commercial Bank Supervision* submitted to the Superintendent of Banks of the State of New York, September 19, 1966. In summarizing its recommendations, the Committee said on page 9:

Security for Public Deposits. In order to provide security for the repayment of public deposits and at the same time to eliminate the onerous restrictions on the management of bank assets and the costs associated with the pledging of assets as security for such deposits, this Committee recommends that appropriate statutes be amended to provide for full FDIC insurance of public deposits as a substitute for the pledging of assets.

In a study prepared in 1967 for the Trustees of the Banking Research Fund of the Association of Reserve City Bankers, entitled *The Pledging of Bank Assets, A Study of the Problem of Security for Public Deposits,* Charles F. Haywood, Dean and Professor of Economics of the College of Business and Economics, University of Kentucky, said (page 8):

The final conclusion of this study is that the answer to the pledged-assets problem should be sought within the context of Federal deposit insurance and that an early effort in this direction would be most timely.

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islation providing for such FDIC insurance, the legislatures of those states that do not exempt insured deposits from pledging requirements would adopt legislation eliminating the pledge requirements. I think the proposal provides a constructive solution of the problem.

The proposal would protect public funds and simplify the operations of public officers responsible for the funds. The proposal would benefit practically every bank. It would give the bank greater flexibility in the management of its investment portfolio; it would increase the bank's effective liquidity because securities now immobilized as collateral for public deposits would become available for sale or for pledge as collateral for borrowing at the Reserve Bank; it would simplify a bank's internal operations in handling public deposits; and it would simplify operating relationships between the bank and the Federal Reserve Bank in its custodial, discount, and fiscal agency functions.

RESERVE REQUIREMENTS AND DISCOUNTING PRIVILEGES

Another important problem involves the role of commercial bank reserves. On March 15, 1967, Senator Sparkman, Chairman of the Senate Committee on Banking and Currency, introduced S.1298 at the request of the Federal Reserve Board. The bill has three principal provisions:

(1) it would make reserve requirements applicable to all insured commercial banks;
(2) it would eliminate the present classification of all member banks as reserve city banks or as "country" banks, and establish a system of graduated reserve requirements under which the reserves required on a bank's demand deposits would depend primarily upon the amount of its deposits rather than its location; and
(3) it would afford all insured commercial banks access to Federal Reserve discount facilities.

UNIVERSAL RESERVE REQUIREMENTS. Historically, bank reserves were that part of the assets of a bank specially kept in cash, or in assets readily convertible into cash, as a reasonable provision for meeting demands upon the bank. The basic purpose of bank reserves is now quite different from what it used to be. Today the primary purpose of bank reserves is to serve as a fulcrum for the implementation of monetary policy. The monetary policy of the Federal Reserve is directed to the promotion of our national economic goals of maximum sustainable economic growth, reasonable price stability, maximum practicable employment, and equilibrium in international payments. The Federal Reserve promotes these goals by influencing the availability and cost of credit. Additions to bank credit generally bring additions to bank deposits, and the banks then need additional reserves to support the additional deposits.

Under the Federal Reserve Act, the deposits of a member bank may not exceed a given multiple of its reserves, and its reserves must consist of currency and coin or deposits in the Reserve Banks. The basic source of such reserves is the Federal Reserve Banks which, through open market and discount operations, create reserves. By making reserves readily available, or by making them less readily available, the Federal Reserve System influences the ability and willingness of member banks to make loans and investments. This activity of the Federal Reserve involves the performance of a national function delegated to the Federal Reserve by the Congress. It is a function similar to that performed by central banks in other countries throughout the world.

Deposits in nonmember banks are no less a part of the money supply of the country than those in member banks. Yet reserve requirements applicable to nonmember banks do not play a direct role in the implementation of monetary policy, and in general they are less onerous than those applicable to members of the Federal Reserve System. In one state there are no reserve requirements for nonmember banks. In many states, the form in which reserves may be held is more favorable to nonmember banks. For instance, in a number of states, reserves may be held partly in the form of securities. Furthermore, correspondent balances, which nonmembers would maintain in some amount even in the absence of reserve requirements, and from which they derive benefits, serve to satisfy part or all of state reserve requirements. The difference in reserve treatment of member banks and nonmember banks tends to confer a competitive advantage on nonmember banks.

It is generally recognized that an effective national monetary policy is essential to a sound banking system and the economic well-being of the country. Nonmember banks enjoy the general benefits of such policy as well as the specific benefit of Federal deposit insurance, but they avoid the cost of the reserve requirements established to effectuate national monetary policy. Monetary policy cannot have its maximum impact when it fails to have a direct effect upon a substantial number of banks.

In my view, the proposal for universal reserve requirements would contribute to the more effective implementation of national monetary policy, and would not adversely

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affect the dual banking system. There would be no impairment of the right of a state to charter a bank, to determine the extent to which it should be permitted to have branches, to determine its lending and investment powers, and to regulate, examine, and supervise it. But in an area of national concern, in promoting our nation's economic goals, the proposal would put all banks on an equal footing.

GRADUATED RESERVE REQUIREMENTS. With graduated reserve requirements, the reserves required of a bank in respect of its demand deposits would depend on the size of its deposits rather than its location. A smoothly graduated system would permit each bank to maintain a relatively low reserve against the first few million dollars of its demand deposits, a higher reserve against its demand deposits above this minimum and up to a substantial figure, and a still higher reserve against its demand deposits, if any, above the latter amount.

As you know, smaller banks find it necessary, in order to obtain certain services from their city correspondents, to hold a substantial portion of their assets in the form of noninterest-bearing balances at other banks. In addition, the smaller banks are less able than the larger banks to take advantage of the economies of scale. Thus, many bankers and students of banking have concluded that, as a matter of equity, the smaller banks should have a lower level of reserve requirements in order to offset to some extent the disadvantages of smallness.

With graduated reserve requirements, all banks of the same size in terms of demand deposits would carry equal reserves. As a bank grew in size and passed into a higher reserve bracket, its overall reserve requirement percentage would rise smoothly and gradually, because the higher requirement would apply only to its additional deposits. There would, no doubt, be less change in total required reserves resulting from shifts in deposits among banks in different cities, and there would be no need to struggle with the elusive problem of determining whether or not a particular city is to be classified as a reserve city.

Many people consider it desirable to work toward a goal of uniform reserve requirements under which, for example, the same percentage requirement would apply to all demand deposits in large and small banks wherever located. The proposal in S.1298 would provide flexibility. Graduated reserve requirements would be facilitated but would not be required. By permitting the Federal Reserve to move first to graduated reserve requirements, the proposal would make possible a transition to greater uniformity, or to full uniformity, should that prove desirable.

The inauguration of graduated reserve requirements or any other basic change in reserve requirements will require substantial adjustments. Federal Reserve open market operations are customarily used to facilitate the adjustment of the banking system to any change in reserve requirements. No doubt, every banker would prefer that there be no increase in the required reserves of his bank. It is obvious that, if there were no increase in the required reserves of any bank, and if the requirements of thousands of banks were reduced in varying amounts, there would be a large reduction in the general level of required reserves in the banking system; large excess reserves would be created overnight. Whether such a result would be justified and whether open market operations could adequately provide the necessary adjustment would depend on economic and credit conditions at the time of the adoption of the new reserve requirements, and such conditions cannot be predicted now. If, at such time, economic conditions called for monetary ease, the creation of the additional bank reserves would not create as great a problem as if economic conditions then called for restraint. Today, it seems to me that it would be fruitless to discuss further the details of any possible change and the problem of adjustment in the light of future economic conditions about which we know nothing.

ACCESS TO FEDERAL RESERVE DISCOUNT WINDOW. At the same time that S.1298 would establish universal reserve requirements, it would grant all nonmember insured commercial banks access to Federal Reserve advances. Through its power to create reserves, the Federal Reserve is the ultimate source of funds to the banking system as a whole. Any insured commercial bank would have the same privilege that member banks now have of borrowing from the Reserve Bank. Every insured commercial bank would know it could go directly to the Federal Reserve in case of need.

ECONOMIC OUTLOOK AND FISCAL MEASURES

A few minutes ago I referred to our national economic goals and the responsibility of the Federal Reserve to promote these goals. What is the present economic situation? What is the economic outlook?

Business activity has continued to gain momentum. As the President reported in his message to the Congress on August 3, Federal Government expenditures, particularly for defense, have continued to rise at a fast rate—much faster than indicated in the January budgetary estimates. At the same time, private spending is once more rising across a broad range. The rise in consumer prices has accelerated. Many wage settlements this year have provided

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increases much greater than the increase in general productivity, and wage demands in current bargaining sessions are large. Thus, pressures of increased demand on an economy with little slack, coupled with upward cost pressures, threaten an even more rapid increase in prices.

Corporations and state and local governments have borrowed record amounts in the capital markets so far this year, and in recent weeks yields on some types of long-term obligations have exceeded last summer's peaks. The prospect of large United States Treasury borrowing in the second half of 1967 and a growing belief that the rate of economic advance will accelerate sharply have weighed more and more heavily on the markets.

The United States continues to be plagued by a critical international balance-of-payments problem. Inflation at home would reduce our ability to compete in international markets; it would be detrimental to our exports and would, no doubt, increase our imports. At the same time, inflation would diminish the faith of foreign holders of dollars in the value of our currency. It would weaken the position of the dollar internationally at the very time our world-wide efforts require that confidence be sustained and strengthened.

These developments make imperative prompt action to reduce the Federal budget deficit significantly. Expenditures should be rigidly controlled and reduced as much as possible, but it is not realistic to expect large cutbacks in spending. The President has recommended a comprehensive program to increase Government revenues; the key recommendation is a temporary surcharge of 10 per cent on individual and corporate income taxes. Prompt and decisive fiscal action by the Congress would go far to help assure that the renewed growth in the economy is held to a sustainable pace with a reduction in the pressure on prices and in the tensions in the money and capital markets. It would, of course, lessen the need for monetary policy to carry an excessive share of the overall anti-inflationary effort, as was the case in 1966.

* * *

In closing, I am sure that all of us—not only bank supervisors but also all our fellow citizens—want a sound banking system and a sound dollar. The studies and proposals I have discussed today are aimed at strengthening our financial institutions and the procedures through which our economic goals are promoted. Monetary policy and fiscal policy have a coordinated responsibility in promoting those goals. To assure a sound dollar, we need a more effective monetary machine and wise monetary and fiscal policies.

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The Business Situation

The business expansion gained increasing strength during the summer months. Housing starts rose strongly in July, industrial production advanced for the first time this year, and the backlog of unfilled orders in durables manufacturing reached a new record high. At the same time, personal income increased substantially, and preliminary data indicate that retail sales turned in another strong advance. In August the unemployment rate dropped for the second month in a row as employment—notably in manufacturing—recorded a large rise. Along with the quickening pace of business activity, price increases on both the wholesale and retail levels are accelerating and again pose a threat to the orderly growth of the economy. Although it is difficult to assess at this time the impact on the economy of the automobile strike, which began as this *Review* went to press, it seems likely that the strike will only temporarily moderate the business expansion.

PRODUCTION, INVENTORIES, AND ORDERS

Industrial activity increased in July, following six months of virtually uninterrupted declines. The Federal Reserve Board's seasonally adjusted production index rose by a full percentage point—to 156.3 per cent of the 1957-59 average—recouping one fourth of the overall decline in the index from its December peak of 159.0 per cent. While the July upturn reflected improvement in the general pace of industrial activity, a good part of the increase was due to the settlement of strikes in the rubber and electrical machinery industries and the surge in domestic crude oil output following the curtailment of supplies from the Middle East. In terms of broad market groupings, production of materials, equipment, and consumer goods all rose from the June levels.

In the consumer sector, output of automotive products increased once again in July, continuing the advance from the low mark reached in February. On a seasonally adjusted basis, the production of new cars rose by about 1½ per cent to an annual rate of just over 8 million units. While output slipped a bit in August, preliminary schedules for September had indicated an unusually large rise in automobile assemblies. However, the strike against the Ford Motor Company—which manufactures about 25 per cent of the nation's cars—will hold production below scheduled levels.

Output of consumer goods other than automobiles was about unchanged in July from the May-June pace. Declines in the apparel and furniture indexes were offset by gains stemming from the settlement of a strike against a major television set producer, as well as by increases in output of other appliances. As a result of the January-May sluggishness in retail demand and of the sizable inventories that existed earlier in the year, production of nonautomotive consumer goods has shown little buoyancy in the past few months. However, the recent pickup in retail sales, coupled with an improved inventory situation, points to a likely strengthening of activity in industries producing for the consumer market.

In the equipment category, defense-related production increased once again in a continuation of the rapid growth that began two years ago. The rise in the output of defense equipment over the first seven months of 1967 was at an annual rate of 18½ per cent, only moderately below the 22½ per cent increase registered over the full course of last year. At the same time, July saw this year's first increase in the production of business equipment. The slowdown in capital spending in the first half of 1967 had been reflected in a steady decline, dating from last December, in the pace of activity in the business equipment industries. The July rise in output of business equipment was not unexpected. Surveys of capital spending plans taken throughout this year, including the most recent one taken in August, have all pointed to increased outlays for plant and equipment in the second half.

The July rise in industrial production, while due in part to special factors, also provided some evidence that the inventory adjustment is nearing an end (see Chart I). This adjustment has, of course, been the major factor dampening industrial activity this year. Following the fourth quarter of 1966, when inventory additions averaged

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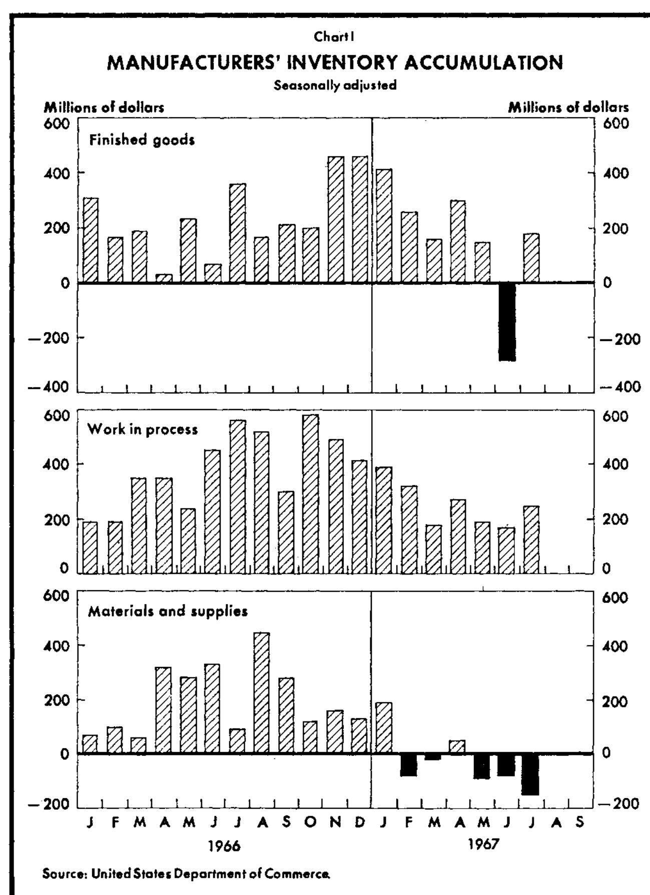

about $1½ billion a month, the rate of business inventory accumulation declined sharply.[1] In June, manufacturers actually reduced their inventories, the first decumulation in three years. In the following month, however, such stocks rose once again. The July accumulation was centered in inventories of work in process, and finished goods. Inventories of raw materials and supplies were cut back further.

Although the overhang of excessive inventories at the beginning of the year was most noticeable in the manufacturing sector, trade inventories early in 1967 were also high relative to sales. As a result of rising sales and of inventory reductions during the first half, however, inventory-sales ratios in the trade sector by midyear had moved back down to levels prevailing before the inventory surge in the later months of 1966. Indeed, the trade sector accounted for almost half the December-June cutback in total inventory accumulation. The June inventory-sales ratio for retail trade was the lowest in many years.

The continued rise in the backlog of orders on the books of durables manufacturers is another element of strength in the outlook for production and employment. Though new orders for durables declined in July from the high June level, largely as a result of a sharp drop in the volatile defense component, the backlog of unfilled orders expanded once again. The July increase put the backlog at a new record, surpassing the previous high set last December. At the same time, shipments by durables manufacturers rose for the third month in a row.

Residential construction activity is apparently continuing its vigorous recovery from the depressed 1966 pace. In July, housing starts rose strongly to an annual rate of 1.35 million units, closely approaching the average level that prevailed before last year's slump. Although the number of units authorized by building permits eased off slightly in July, prospects for further improvement in residential construction continue to be favorable. Statistics on vacancy rates and sales of new homes indicate strong demand. At the same time, mortgage credit availability currently appears adequate for additional expansion in new home and apartment construction.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Payroll employment rose sharply further in August. Most significant among the widespread gains was the upturn in manufacturing employment which resulted primarily from a large rise in the number of production workers employed. At the same time, the average week worked by manufacturing production workers increased again.

The civilian labor force expanded further in August for the third consecutive rise. In most of the earlier months of this year the labor force had declined on a seasonally adjusted basis, and the recent turnaround suggests that the quickening pace of economic activity has encouraged more individuals to enter the labor force. Reflecting the strength of demand in the labor markets, the growth of employment in both July and August exceeded the rise in the labor force, with the result that unemployment edged off to 3.9 per cent in July and 3.8 per cent in August.

[1] Revised figures for second-quarter gross national product (GNP) show a cutback in inventory accumulation larger than that previously estimated. However, upward revisions in other components—notably consumer spending—offset the reduced figure for inventory accumulation, and total GNP was therefore virtually unchanged from the preliminary estimate discussed in this *Review*, August 1967, pages 139-41.

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Increases in personal income through most of the first half of 1967, though quite sizable, were nevertheless dampened by the sluggish behavior of employment during the period, and particularly by the reduction in the number of workers and the length of the workweek in manufacturing. In June and July, however, the expansion of personal income showed renewed strength as employment gains gave rise to rapid growth in wage and salary payments.

The stepped-up rate of income growth has undoubtedly been a factor in the recent strengthening of consumer demand. But, at the same time, consumers also seem to be showing a willingness to spend a larger share of their incomes. Indeed, recent revisions in the GNP accounts for the second quarter indicate that the advance in consumer spending was stronger than had been shown in the preliminary estimates. The revised figures put the second-quarter savings ratio at an estimated 6.7 per cent, down appreciably from the unusually high rate of 7.3 per cent in the first quarter. The second-quarter savings figure was nevertheless relatively high by historical standards, and it is altogether possible that future consumer spending may benefit from still further decreases in the savings ratio as well as from income gains.

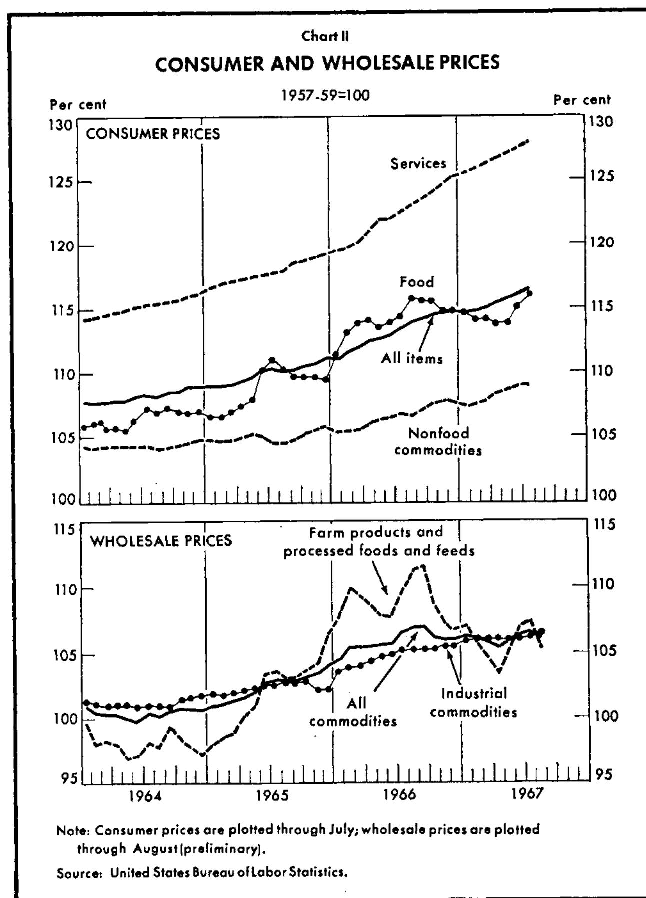
In any case, the available data do indicate rising consumer demand. According to preliminary estimates, retail sales volume recorded a sizable increase in July, following a strong rise in the preceding month. During the first five months of the year, sales at retail stores had followed a generally upward course but at a very modest pace. Thus, in the five-month period ended with May, retail sales rose only 2 per cent; the June-July expansion, in contrast, amounted to fully 3 per cent. In July, the increase was centered entirely at durables outlets, where gains were reported both for the automotive group and for other hard goods lines. Sales of new automobiles in July were at a seasonally adjusted annual rate of almost 8½ million units, well above the low point of 7 million reached last February. In August, however, automobile sales dropped off, reportedly because of a short supply of cars in the popular lines. At the month end, the inventory of 1967 models was more than 25 per cent below carry-over in 1966 of prior-year models (the timing of the changeover to the new models was the same in both years).

WAGES, PRODUCTIVITY, AND PRICES

Wage costs continue to mount and the rate of increase has accelerated. According to the Bureau of Labor Statistics, collective bargaining settlements concluded in the first half of 1967 involved wage and fringe benefit increases totaling 4.6 per cent a year, compared with increases of 4.1 per cent for all of 1966 and 3.3 per cent for 1965. The rapid advance in labor compensation this year has been accompanied by a leveling off in productivity growth. The combination of rising labor costs and virtual stability in output per man-hour resulted in a sharp increase in labor costs per unit of output. To be sure, the index of unit labor costs in manufacturing fell a bit in July, as the result of a jump in productivity associated with the upturn in output. Nevertheless, the July level of the index represented an advance over the first seven months of this year at a seasonally adjusted annual rate of about 5½ per cent, compared with a rate of 3½ per cent for all of 1966. While productivity can reasonably be expected to move upward once again as the economy expands more vigorously, it is unlikely that the growth in output per man-hour will be adequate to offset mounting labor costs.

In conjunction with the strengthening of demand, the rising trend in unit labor costs has been a major

Chart II
CONSUMER AND WHOLESALE PRICES



Note: Consumer prices are plotted through July; wholesale prices are plotted through August (preliminary).
Source: United States Bureau of Labor Statistics.

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source of upward pressure on prices. The midsummer was marked by a rash of announced price increases for a broad range of commodities, including trucks, rubber goods, household appliances, textiles, construction materials, aluminum and steel for can-making, a variety of other steels, and goods containing silver. Moreover, railroad freight rates—which affect costs throughout the economy—were also raised.

Some of these increases have already had an effect on the broad index of industrial wholesale prices. Preliminary figures indicate that this index rose sharply in August after five months of stability (see Chart II). Wholesale prices of agricultural commodities, however, dropped in August after a steep three-month run-up, and this decline more than outweighed the increase in industrial commodities. As a result, the total wholesale index moved lower. In the consumer area, prices rose by a sharp 0.4 per cent in July as costs of food and services increased again. Prices of nonfood commodities also rose substantially. The overall advance was the largest in nine months and followed four months of sizable gains. From February to July, the total consumer price index advanced at an annual rate of 3.6 per cent, compared with 1.5 per cent in the preceding five-month period.

The Money and Bond Markets in August

Money market conditions remained comfortable during August. Federal funds generally traded in a narrow band around the 4 per cent discount rate, while nationwide net reserve availability continued to fluctuate within the range of recent variation. As the month progressed, there was a significant improvement in the basic reserve positions of major banks in the money centers, reflecting in part a substantial contraction in business loans and increased acquisitions of Euro-dollars. Major banks also acquired a large volume of funds through sales of negotiable certificates of deposit (C/D's) during the month.

As was the case in July, even with the comfortable tone in the money market, yields on short-term and capital market instruments rose further in August. The President's request on August 3 for a 10 per cent surcharge on individual and corporate income taxes was welcomed by market participants, but the optimistic reaction was soon dampened by consideration of the accompanying projections of a large budget deficit and Treasury financing needs in fiscal 1968. Two Treasury cash offerings during the month—one to refund the August maturities and the other to raise new money—attracted only routine interest on the part of investors and trading activity in the Treasury market was generally light. Meanwhile, large current and anticipated corporate borrowing and the fair to poor receptions accorded several new corporate issues—in spite of mounting yields—contributed to a hesitant atmosphere throughout the capital markets. By the end of the month, yields on intermediate-term Treasury issues had risen by about 24 basis points, while long-term yields were up about 6 basis points. The yield on a new Aa-rated utility bond issue with five years' special call protection reached 6.20 per cent at the end of the month, 15 basis points more than the highest yielding comparable offering in July. The tax-exempt market was under somewhat less pressure than the corporate market, against a background of a comparatively light calendar and talk of an added relative yield advantage for tax-exempt securities in the event of a tax increase.

The cautious mood of the capital markets during August also pervaded the market for Treasury bills. Although there was a significant investment demand for bills at times during the month, rates on outstanding issues rose almost steadily until late in the month, when they receded slightly. The market yields on three- and six-month maturities rose by 26 and 23 basis points, respectively, to 4.38 per cent and 4.83 per cent at the close of the month.

BANK RESERVES AND THE MONEY MARKET

The money market remained comfortable throughout August. The effective rate for Federal funds generally was close to the 4 per cent discount rate, with some trading at 4⅛ per cent in the first half of the month and generally in a 3 to 4 per cent range later on. Free reserves averaged

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, AUGUST 1967

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

Factors	Changes in daily averages—week ended on					Net changes
	Aug. 2	Aug. 9	Aug. 16	Aug. 23	Aug. 30	
"Market" factors						
Member bank required reserves*	— 82	+ 82	+ 214	+ 63	+ 94	+ 371
Operating transactions (subtotal)	— 235	— 107	— 8	+ 330	— 48	— 68
Federal Reserve float	— 193	— 54	— 18	+ 247	— 324	— 342
Treasury operations†	— 178	+ 477	— 79	— 7	— 34	+ 179
Gold and foreign account	— 14	— 50	+ 2	— 6	— 2	— 70
Currency outside banks*	+ 29	— 510	+ 71	+ 125	+ 242	— 43
Other Federal Reserve accounts (net)‡	+ 122	+ 31	+ 14	— 30	+ 73	+ 210
Total "market" factors	— 317	— 25	+ 206	+ 393	+ 46	+ 303
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities	+ 118	— 29	— 200	— 100	— 255	— 466
Bankers' acceptances	+ 1	—	—	— 6	— 7	— 12
Repurchase agreements:						
Government securities	—	+ 127	— 17	— 110	—	—
Bankers' acceptances	—	+ 49	— 49	—	—	—
Federal agency obligations	—	—	+ 2	— 2	—	—
Member bank borrowings	+ 62	— 25	+ 38	— 82	— 1	— 8
Other loans, discounts, and advances	+ 3	— 3	—	—	—	—
Total	+ 184	+ 120	— 226	— 301	— 263	— 486
Excess reserves*	— 133	+ 95	— 20	+ 92	— 217	— 183

	Daily average levels					
Member bank:						
Total reserves, including vault cash*	23,967	23,980	23,746	23,775	23,464	23,786§
Required reserves*	23,676	23,594	23,380	23,317	23,223	23,438§
Excess reserves*	291	386	366	458	241	348§
Borrowings	116	91	129	47	46	86§
Free reserves*	175	295	237	411	195	262§
Nonborrowed reserves*	23,851	23,889	23,617	23,728	23,418	23,700§

	Changes in Wednesday levels					
System Account holdings of Government securities maturing in:						
Less than one year	— 50	—	—1,424	— 100	—335	—1,909
More than one year	—	—	+1,224	—	—	+1,224
Total	— 50	—	— 200	— 100	—335	— 685

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for five weeks ended on August 30.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS AUGUST 1967

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on					Averages of five weeks ended on August 30*
	Aug. 2	Aug. 9	Aug. 16	Aug. 23	Aug. 30*	
Eight banks in New York City						
Reserve excess or deficiency(—)†	19	12	10	14	25	16
Less borrowings from Reserve Banks	26	—	6	—	—	6
Less net interbank Federal funds purchases or sales(—)	392	486	508	169	— 19	307
Gross purchases	*1,255*	*1,186*	*1,198*	*1,120*	*991*	*1,150*
Gross sales	*862*	*700*	*690*	*951*	*1,010*	*843*
Equals net basic reserve surplus or deficit(—)	— 399	— 474	— 505	— 155	44	— 298
Net loans to Government securities dealers	963	1,048	943	928	907	958
Thirty-eight banks outside New York City						
Reserve excess or deficiency(—)†	18	28	30	24	6	21
Less borrowings from Reserve Banks	28	17	13	—	—	12
Less net interbank Federal funds purchases or sales(—)	813	1,038	835	633	370	738
Gross purchases	*1,845*	*1,936*	*1,901*	*1,698*	*1,666*	*1,809*
Gross sales	*1,032*	*898*	*1,066*	*1,065*	*1,296*	*1,071*
Equals net basic reserve surplus or deficit(—)	— 823	—1,029	— 818	— 609	— 364	— 729
Net loans to Government securities dealers	537	669	571	560	505	568

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

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—August 1967			
	August 7	August 14	August 21	August 28
Three-month	4.174	4.193	4.336	4.490
Six-month	4.757	4.791	4.922	4.995

Maturities	Monthly auction dates—June-August 1967		
	June 27	July 25	August 24
Nine-month	4.723	5.164	5.098
One-year	4.732	5.150	5.100

* 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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about the same as in July, with continued fairly wide fluctuations from week to week in line with varying demands for excess reserves (see Table I). Nationwide borrowings from the Federal Reserve Banks also averaged about the same as in July but declined sharply in the last two statement weeks of August. In the week ended on August 23, the banking system benefited substantially from large declines in required reserves and currency outside banks. In that week, the major reserve city banks were entirely free of Reserve Bank indebtedness, and borrowings of other reserve city and "country" banks fell to negligible levels (see Table II). In the final week, only country banks borrowed at the Reserve Banks. Throughout the month, banks in New York City having branches abroad continued to borrow substantial amounts of Euro-dollars, as they had in July. The sharply increased use of Euro-dollars since June has resulted from a considerable narrowing of the differential between Euro-dollar rates and domestic C/D rates. The attractiveness of Euro-dollars as a source of funds for banks is enhanced by the fact that such borrowings are not subject to reserve requirements or deposit insurance assessments.

The financing needs of Government securities dealers increased during August but were satisfied without difficulty by borrowing from either the New York City banks or out-of-town institutions or through repurchase agreements with corporations. Borrowing was particularly heavy at the start of the period when the dealers made payment for their awards of the new nine- and twelve-month Treasury bills sold in the regular monthly auction. Rates posted by the large New York City banks on new call loans to Government securities dealers were generally quoted within a 4⅛ to 4⅜ per cent range during most of August, but declined rather sharply toward the month end. Most other short-term money rates were little changed on balance during August.

The New York City money market banks continued to attract time deposits in volume during August through the issuance of negotiable C/D's; over the five statement weeks ended on August 30, the net increase in C/D liabilities amounted to $298 million. Large commercial banks outside New York City also benefited from a rapid inflow of funds from this source, and their aggregate C/D liabilities expanded by $643 million over the same five weeks. The most often posted offering rate on new C/D's of the large New York City banks at the end of August was 4.125 per cent for the shortest maturities, down from 4.50 per cent earlier in the month. On the other hand, the city banks seemed to be having difficulty in selling longer term C/D's, though the generally posted rate remained at 5¼ per cent.

THE GOVERNMENT SECURITIES MARKET

An atmosphere of renewed caution appeared in the Treasury coupon market in August, following a temporary improvement in the market tone during July. Prices moved irregularly lower to register declines for the month as a whole of as much as 1 point in the intermediate area and almost 1½ points in longer maturities. Exceptionally large Treasury financing needs in the second half of this calendar year, together with the prospect of a sustained heavy corporate demand for funds, were again the major market influence during August. The President's request for a 10 per cent surcharge on corporate and individual income taxes buoyed the market briefly at the beginning of the month, but participants quickly came to the realization that the deficit would be very large even after allowance for the additional revenues this tax measure would produce. Moreover, it was felt in the market that the timing and magnitude of the tax surcharge or, indeed, its very adoption by the Congress were far from certain.

Two Treasury financing operations executed in August dominated trading during the month. After the close of the market on August 2, the Treasury announced the results of its refunding of three issues maturing on August 15, for which subscription books had been open on July 31.[1] Awards of the new fifteen-month 5¼ per cent notes offered for cash or in exchange for the maturing securities amounted to $9.9 billion against total subscriptions of $15.6 billion. Larger public subscriptions were subject to a 35 per cent allotment. This allotment percentage was somewhat higher than initially estimated by most market participants.

After the close of the market on August 17, the Treasury announced the terms of a $2.5 billion of new cash borrowing. Investors were offered a new 5⅜ per cent note due February 15, 1971, priced at 99.92 to yield 5.40 per cent. Subscription books were open on August 22, and payment was made on August 30. Commercial banks were permitted to make payment for the issue by credits to Treasury Tax and Loan Accounts. Many market participants had hoped that the Treasury would offer a somewhat longer note, perhaps in the five- to seven-year area, as a means of extending the average maturity of its outstanding debt. The Treasury's choice of a 3½-year maturity was widely interpreted as an attempt to avoid a higher coupon rate which might have had adverse effects on the thrift institutions and on other securities markets. Sub-

[1] For details, see this *Review*, August 1967, page 143.

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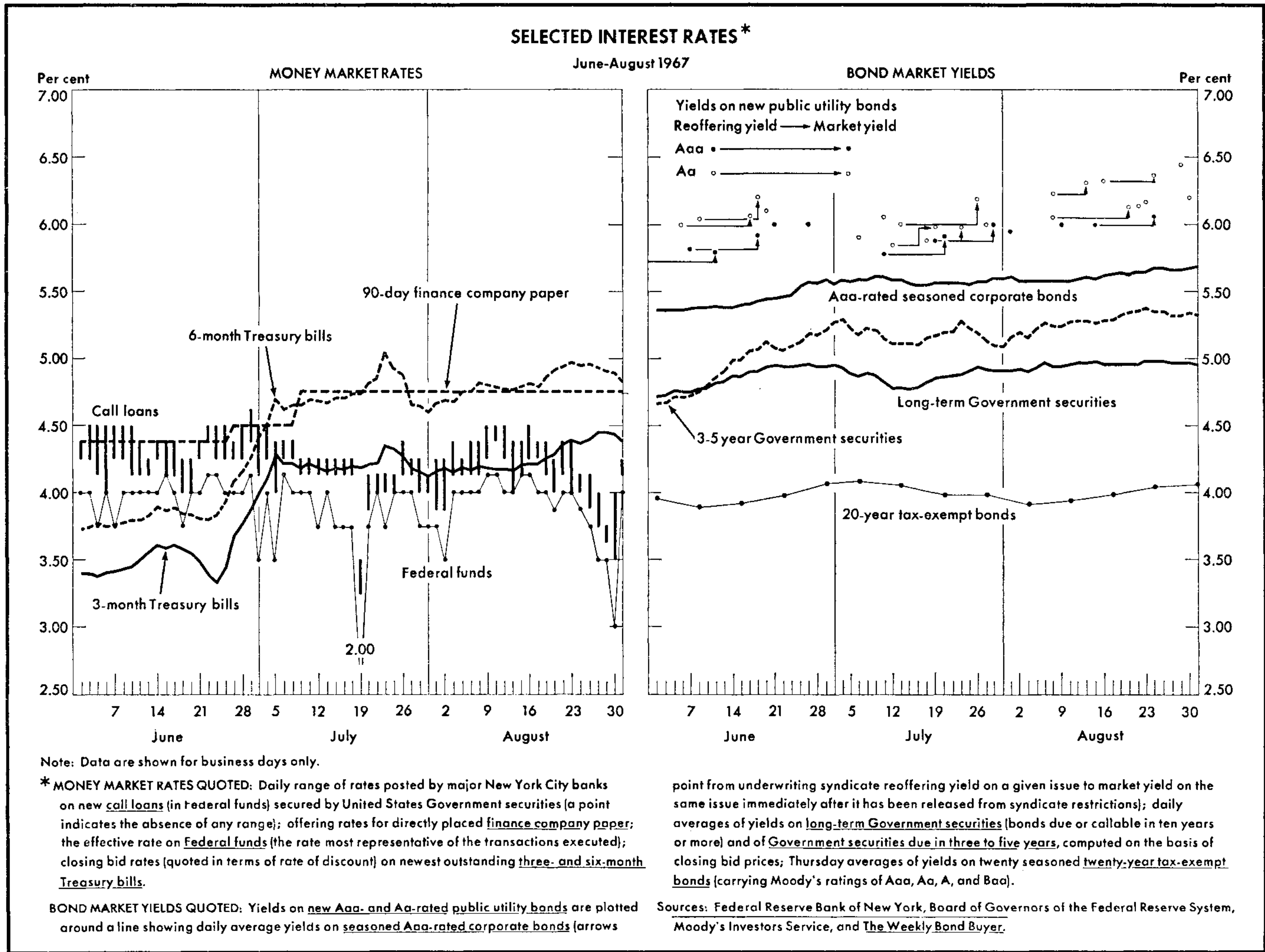

Note: Data are shown for business days only.

* 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.

scriptions totaled $6 billion and late on August 24, the Treasury announced that larger ones would be subject to a 38 per cent allotment. This allotment percentage was above initial estimates by most market participants, but generally in line with the consensus that emerged after the books had closed.

Price fluctuations on Treasury coupon issues were fairly wide early in August, but considerably narrower over the remainder of the month. In the first three days of the period, prices of intermediate issues declined in reaction to speculation that the response of investors to the offering of the new 5¼ per cent note in the August refunding would prove less favorable than had originally been thought. Prices rebounded immediately thereafter in a highly favorable market reaction to the President's request for a tax surcharge, since the suggested 10 per cent was higher than most market participants had expected. Once the new Federal budget statistics were fully digested, however, prices began an irregular downward drift which continued through the month end. The pessimism prevalent in the market was reinforced by the rising yield trend in the corporate and tax-exempt bond markets. The reports of a light volume of subscriptions for the new 5⅜ per cent notes had little effect on the market. Market activity during the month was mainly confined to professional liquidation of holdings of intermediate issues, investment switching into the new 5¼ per cent notes, and outright sales of long-term issues by investors moving into corporate securities.

The Treasury bill market was moderately firm over the

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first part of August, and rates for short-term bills continued to decline from the high levels attained in July after the Treasury announced that it would increase the size of each of the regular weekly and monthly bill auctions by $100 million. The early strength of the market resulted partly from the favorable yield on longer term bills relative to that offered on the closely competitive new 5¼ per cent Treasury notes of November 1968. Moreover, a fairly good investment demand from public funds and commercial banks was in evidence. After midmonth, the declining rate trend was reversed as the bill market was affected by the caution apparent in the coupon sector. With investor demand contracting and the possibility of some selling of bills around the mid-September dividend and tax dates, dealers were cautious in bidding for bills in the final auctions held during the month, and bill rates rose somewhat. In the monthly auction of nine- and twelve-month bills held on August 24, average issuing rates were set at 5.098 per cent and 5.100 per cent, respectively, slightly lower than in the July monthly auction. Average issuing rates established on the regular three- and six-month Treasury bills moved progressively higher over the month, and in the last weekly auction these rates reached 4.490 per cent and 4.995 per cent, respectively (see Table III), compared with 4.182 per cent and 4.638 per cent in the last July auction. In the wake of the auction, an active demand for bills by investors and dealers developed, and rates declined over the final three days of the month.

OTHER SECURITIES MARKETS

Developments in the markets for corporate and tax-exempt securities closely paralleled those in the Government securities market during August. The President's proposal of an income tax surcharge injected some temporary optimism into the market at the beginning of the month and, in fact, aided underwriters in completing a lagging distribution of the month's largest single corporate bond offering. Subsequently, however, market sentiment deteriorated with the growing concern over the huge demands likely to be made on the capital markets by the Treasury and corporate borrowers in coming months. The tax-exempt sector was slower than the corporate area to succumb to the general weakening tendencies, however, because of the somewhat lighter calendar of new offerings than in other recent weeks and perhaps also because of the yield advantage tax-exempt securities will gain by any income tax increase. Nevertheless, *The Weekly Bond Buyer's* average yield series for twenty seasoned tax-exempt bonds, carrying ratings ranging from Aaa to Baa, rose to 4.06 per cent at the month end from 3.98 per cent at the close of July (see chart). The average yield on Moody's Aaa-rated seasoned corporate bonds rose to 5.69 per cent from 5.60 per cent a month earlier.

In the corporate sector, a total of $1.8 billion of securities was publicly offered during August, the same amount as in July. The largest single offering was a $250 million Aaa-rated issue of 6 per cent 33-year debentures of the American Telephone and Telegraph Company, reoffered to yield 5.95 per cent and nonredeemable for five years. The issue was awarded to underwriters at a net interest cost of 6.006 per cent, a record for this borrower and considerably higher than the net interest cost of 5.46 per cent on a similar flotation by the same company in January of this year. The offering drew only a modest investor response prior to the President's tax message, but subsequently sold out quickly. In the heavier market atmosphere that developed later in the month, only negotiated industrial issues sold well, while public utility offerings awarded in competitive bidding were received unenthusiastically by investors. One $200 million offering by an oil company of Aaa-rated 5¾ per cent sinking fund debentures, carrying ten-year call protection, sold well at a reoffering yield of 5.85 per cent, 10 basis points higher than the yield on a comparable offering only three weeks earlier. During the month there were a number of syndicate terminations resulting in upward yield adjustments of about 10 basis points.

Total new publicly-offered tax-exempt securities amounted to $0.7 billion in August, down from $0.8 billion in July. In contrast to the corporate market, the municipal market retained a firm tone through midmonth, enabling dealers to reduce their inventories to the lowest level in seven months. Encouraged by the improved technical position of the market and rather light volume of offerings, dealers bid aggressively for new issues around midmonth. Investors showed considerable resistance to the lower yield levels, however, and reoffering yields tended to rise subsequently. Even at the higher yields available over the latter part of the month, there was a marked lack of enthusiasm for new issues being marketed, and most offerings moved very slowly.

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