FEDERAL RESERVE BANK OF NEW YORK

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The Business Situation

The economy moved up at a fast clip in the second quarter, and prices again rose very sharply. The increase in gross national product (GNP) was fully as large as in the first quarter, although real growth and the increase in final demand were both smaller. Most leading indicators point to the likelihood of further growth in the months ahead, but there are indications of easing in some areas of the economy. Housing starts, under pressure from tight mortgage market conditions, dropped in June for the fifth consecutive month. Also, retail sales at the end of the second quarter were apparently down to a level nearly 2 percent below that of April, though these statistics may tend to understate retail buying somewhat. The recent slump in the stock market possibly reflects a growing expectation in the business community that the pace of business activity will indeed moderate in the months ahead. However, other areas of the economy are continuing to show substantial strength. The upward thrust of state and local government spending shows little sign of slowing. Business capital outlays may continue to increase, in part because delivery and construction delays apparently held back planned spending in the first half of the year. Further, business inventory positions have apparently remained in good balance with sales. In sum, while there are suggestions of slowing in some sectors of the economy, there is little evidence that financial restraint has as yet sufficiently dampened the excessive pace of economic activity.

GROSS NATIONAL PRODUCT IN THE SECOND QUARTER

The market value of the nation's total output of goods and services continued to rise rapidly in the second quarter. However, an increasingly large share of the advance simply reflected higher prices, and real growth slowed further. According to the Department of Commerce's preliminary estimate, GNP rose $16.4 billion (see Chart I) to a seasonally adjusted annual rate of $925.1 billion. The rate of gain, which amounted to 7.2 percent on an annual basis, was about the same as in the first quarter.[1] Real growth in the April-June period eased to an annual rate of 2.3 percent, compared with 2.6 percent in the first quarter and 3.2 percent in the final quarter of last year. Prices in the GNP accounts rose at the first-quarter annual rate of 4.8 percent, compared with 4.2 percent in the last three months of 1968.

Although the total increase in GNP was about the same as that in the first quarter, the $13.5 billion growth of final spending—total GNP less inventory investment—was much more modest than in the earlier quarter when such spending surged by an unusually steep $20.1 billion. The slower growth of final purchases largely centered in consumer outlays, which rose by a fairly modest $8.7 billion to a seasonally adjusted annual rate of $570.7 billion. The moderation in consumer buying was almost entirely in nondurables, where spending climbed at less than half the first-quarter rate; expenditures on durable goods and services, however, also grew slightly less than in the January-March period. On a monthly basis, retail sales figures showed little buoyancy in the quarter. Following a large gain in April, retail sales fell in May and—according to the advance report—declined again in June. Although the advance estimate is frequently subject to major revision, it indicates that June sales ran at a seasonally adjusted level of $28.9 billion, virtually the same as in March. For the April-June period as a whole, retail sales were up from the first quarter, but only because of the strong volume in April.

Personal income advanced by a large $16.3 billion in the quarter, reaching a seasonally adjusted annual rate of $740.7 billion. The strength in personal income reflected

[1] The Commerce Department's annual midyear revisions of the national income and product accounts increased the first-quarter estimate of GNP by $5.3 billion to a level of $908.7 billion. The revisions also raised GNP by $2.3 billion in 1966, $3.8 billion in 1967, and $5.1 billion in 1968.

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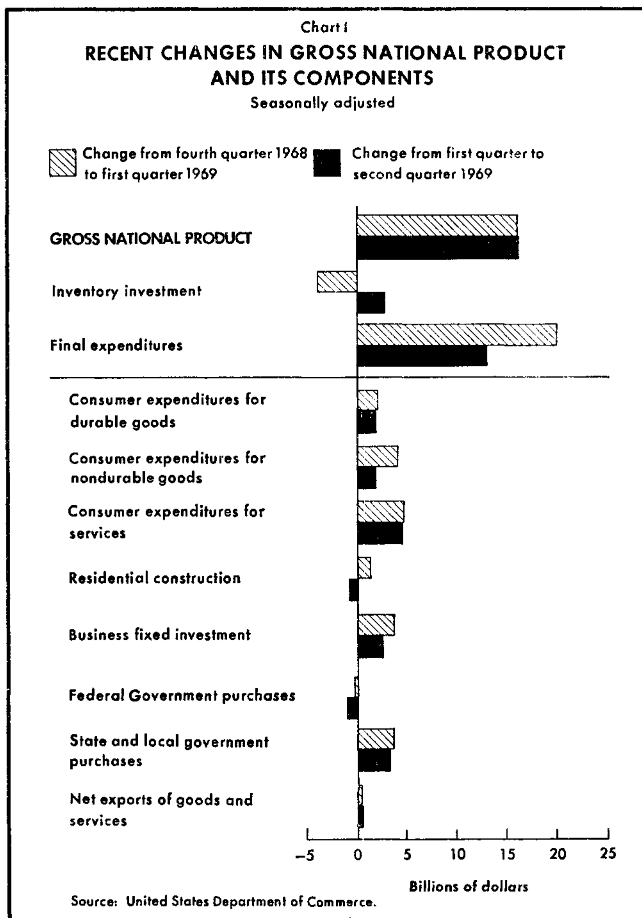

gains in total payroll employment and average hourly earnings, as well as some lengthening of the average work-week. Disposable income did not rise so rapidly as total personal income because of the extra April tax payments associated with the surcharge, which were roughly $3.0 billion at an annual rate. Nevertheless, the $12.3 billion increase was sizable, particularly compared with the first quarter when final tax payments on 1968 incomes were also substantial and when higher social security taxes went into effect. In that period, disposable income expanded by only $6.4 billion. Reflecting both moderation in the growth of consumer demand and the large increase in disposable income, the savings rate in the second quarter rose 0.4 percentage point from the relatively low first-quarter level, reaching a more normal 5.8 percent.

In the first quarter, a large rise in total final demand was associated with a marked slowdown in the rate of inventory spending. In the second quarter the reverse was true. A moderation in final expenditures was coupled with a $2.9 billion increase in inventory accumulation, bringing inventory growth to an annual rate of $9.5 billion. Because this estimate of inventories is based on only two months of data, Commerce Department spokesmen emphasized the preliminary nature of these estimates for the full quarter. The rise in business inventories through May was chiefly in the manufacturing industries—particularly in durables manufacturing. But according to the June data, which were not available when the GNP estimates were made, manufacturers' inventories were about unchanged in that month. The second-quarter's increase in manufacturers' shipments was about in line with the inventory rise, and the inventory-sales ratio in manufacturing was essentially unchanged. At the trade level, sales rose considerably faster in April and May than did inventories, and the inventory-sales ratio dipped to the lowest level in seven months.

The second quarter's $2.7 billion gain in business fixed investment was smaller than in the first quarter, because spending on structures declined by $0.7 billion. Expenditures for producers' durables climbed $3.3 billion—twice the first-quarter rate. Recent surveys of business plans for capital investment had indicated there would be a large increase in plant and equipment spending in the first half of the year, followed by little growth thereafter. However, according to the Commerce Department, the anticipated rise in the first half of the year was not fully realized, probably as a result of delivery bottlenecks and construction delays. Thus, spending in the second half of the year may run higher than the earlier surveys had indicated as the shortfall in the first half is made up.

Not unexpectedly, spending on residential construction dropped to an annual rate of $32.4 billion in the past quarter, down $0.9 billion from the January-March pace. According to seasonally adjusted monthly data, private nonfarm housing starts have fallen steadily since January when they reached the unusually high annual rate of 1.85 million units. Starts in June were down to an annual rate of 1.42 million units, 70,000 below the May pace. Building permits issued by local authorities in recent months have also shown a weakening housing picture. In June, the permits level was about unchanged, following a large decline in May.

Total spending by governments at all levels increased by a small $2.5 billion, contributing to the slower growth of final demand in the second quarter. Federal Government purchases actually declined $1.0 billion to $100.6 billion, as spending for both defense and nondefense purposes moved down. Because of the $2.8 billion July pay raise for Federal Government employees, Federal spending is expected to increase in the current quarter.

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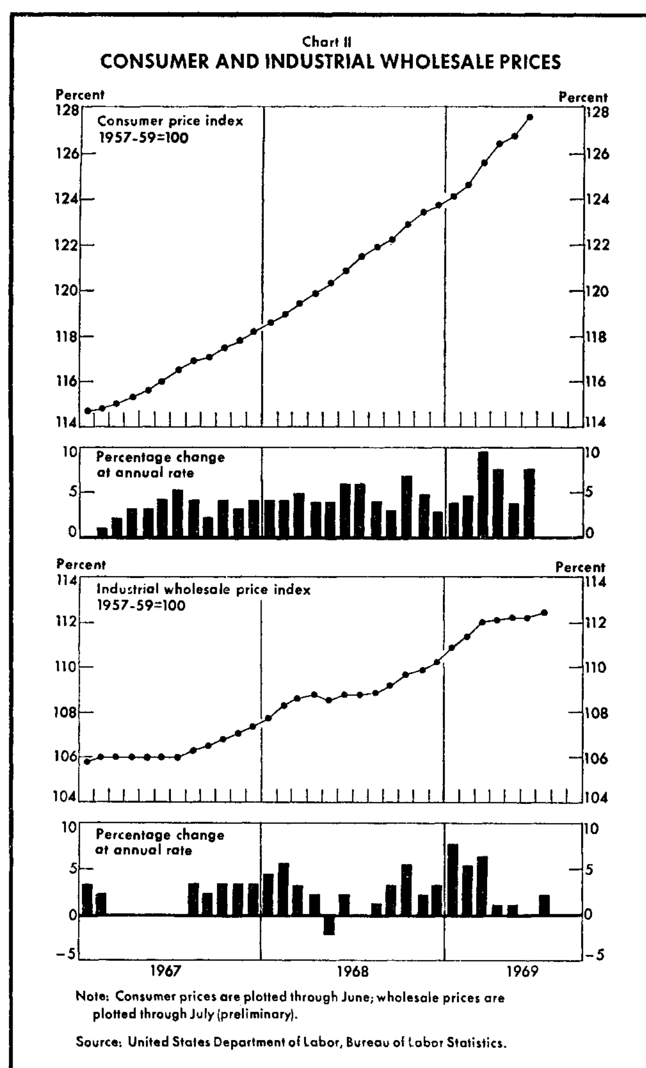
State and local expenditures in the April-June period continued to rise about in line with the sharp gains of recent quarters, and no significant change from this uptrend is in sight. In the past quarter, such spending amounted to an annual rate of $111.9 billion, fully $3.4 billion higher than in the previous period.

Settlement of the first-quarter dock strikes brought a surge in both imports and exports. Net exports rose by $0.5 billion to a slim $2.0 billion annual rate, as the gain in exports only slightly exceeded the rise in imports.

THE CURRENT PRICE SITUATION

Reflecting both demand and cost factors, pressures on the price level have intensified in recent months. Although wage cost increases are increasingly a concern, excess demand still exists. As an indication of the strength of this demand, raw materials prices have climbed a steep 10 percent in the first half of 1969 alone. The rise in total industrial wholesale prices has been much slower, in good part because of rapidly declining lumber and wood prices. According to the preliminary estimate, industrial wholesale prices rose in July by a relatively small 0.2 percentage point to 112.4 percent of the 1957-59 average, after remaining stable in June. On the cost side, the recent trend in wage settlements suggests that wage increases are becoming progressively larger. Under collective bargaining contracts settled in the first half of the year, the median package increase for wages and benefits amounted to 7.1 percent a year. In 1968 the median was about 6.0 percent. The combination of demand and cost pressures and a precipitous rise in food prices—particularly of beef—has led to a rapid rise in consumer prices in recent months (see Chart II). In June, the total consumer price index advanced at an annual rate of 7.6 percent. Excluding food, prices at retail rose at an annual rate of 4.7 percent in June. In both the first and second quarters, total consumer prices advanced at an annual rate of almost 6½ percent.

Chart II
CONSUMER AND INDUSTRIAL WHOLESALE PRICES



Note: Consumer prices are plotted through June; wholesale prices are plotted through July (preliminary).

Source: United States Department of Labor, Bureau of Labor Statistics.

RECENT DEVELOPMENTS IN PRODUCTION AND EMPLOYMENT

Industrial production registered a large advance in June, as output was spurred by the post-strike recovery in the auto industry and by continuing gains in production of both business equipment and industrial materials. The Federal Reserve Board's index of industrial production rose 0.7 percent in June to a seasonally adjusted 173.9 percent of the 1957-59 average. Almost half of the June advance reflected the rebound in production of motor vehicles and parts from the depressed April and May levels, when the industry was affected by scattered strikes. Passenger car production rose 13 percent in June from the April-May rate to a seasonally adjusted annual rate of 8.6 million units. For the first six months of this year, automobile output has averaged an 8¼ million unit rate. Although actual production declined in July because of preparations for the model changeover, the seasonally adjusted rate advanced further to 8.8 million units.

The continued strong uptrend in business equipment output also contributed to the overall June rise in industrial production. Since last summer when business capital spending began to move up, production of business equipment has increased at a seasonally adjusted annual rate of over 10 percent. However, the growth of the total equip-

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ment index has been much less marked during this time because defense production has declined by over 10 percent, in part reflecting strikes in the aircraft industries. Defense output accounts for about 20 percent of the total equipment index.

Iron and steel production continued to increase rapidly in June. Reflecting healthy domestic demand—particularly in the capital goods industries—and vigorous European demand, iron and steel output has shown surprising strength this year. The increases in iron and steel production in the first half of 1969 boosted output to about the peak rate set during last year's inventory buildup, just prior to the midyear strike threat in the industry. Moreover, steel ingot production, which comprises about half of the iron and steel index, increased again in July.

In June, declines in orders for construction materials and aerospace equipment outweighed increases elsewhere. Thus, total new orders received by manufacturers of durable goods fell $1.1 billion to a level of $28.9 billion. Durables orders had also fallen in the previous month, following a surge in April which was associated with President Nixon's recommendation for repeal of the investment tax credit. At the same time, manufacturers' durables shipments rose $0.5 billion to a seasonally adjusted rate of $30.0 billion. As the flow of shipments exceeded orders, the backlog of unfilled orders on the books of durables manufacturers declined for the first time since last July.

For the second quarter as a whole, nonfarm payroll employment, seasonally adjusted, gained an average of 187,000 persons per month. This was quite a strong performance for employment, although not so buoyant as in the first quarter when nonagricultural payrolls rose at an unsustainable rate of 278,000 per month. In July, moreover, payroll employment continued to rise rapidly; total payrolls were up 192,000 in that month. The July gain in manufacturing employment exceeded the sizable June increase which accompanied that month's large advance in industrial production.

Turning to the household survey of employment, total civilian employment rose strongly in July despite a sizable decline in agricultural employment. However, the labor force expansion was greater than that of employment, and the unemployment rate rose to 3.6 percent from 3.4 percent in June. A large increase of adult men in the labor force resulted in a rise to 2.2 percent from 2.0 percent in the jobless rate for this group. On the other hand, a large increase of adult women seeking jobs was fully absorbed, and their unemployment rate was unchanged at 3.7 percent.

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The Money and Bond Markets in July

Continuing monetary restraint was the predominant influence on the money and bond markets in July. The average effective rate on Federal funds and member bank borrowings at the discount window were at essentially the same high levels as in June, while most monetary variables exhibited continuing weakness. A notable feature of the month was widespread interest by small investors in United States Treasury, Federal agency, corporate, and municipal obligations.

Attention in the Treasury bill market was largely focused on two $1.75 billion issues of tax anticipation bills, which were auctioned on July 9 and July 11, and the upward rate movements that occurred in this market (see Chart I) largely reflected the subsequent adjustment to this sizable supply of new issues. Concern over possible alterations which the Congress might make in the tax-exempt status of state and municipal bonds added to the continuing pressures in that market from restricted commercial bank demand. Prices eroded in the tax-exempt market following a proposal by the House Ways and Means Committee that could lead to Federal taxation of some income from municipal issues.

Prices of United States Government securities trended downward during July, with the exception of some bill and coupon issues in the very short- and longer term maturity areas. The Treasury bill market was not overly receptive to the new December 1969 and March 1970 tax anticipation bills, and an air of heaviness developed in the face of this $3.5 billion addition to its supply. The market for notes and bonds experienced a brief rally around midmonth, largely in response to some indications that counterinflationary policies might be having an effect and to encouraging reports concerning the Vietnam situation. The rally was short-lived, however, and prices for intermediate-term issues resumed their downtrend, partly reflecting the possibility that an offering in this maturity range would be included in the Treasury's August refunding. The terms and likely reception of the Treasury's impending refunding increasingly became the center of attention in the final weeks of July. On July 30 the Treasury announced that holders of the $3.4 billion 6 percent notes maturing on August 15, 1969 would be offered in exchange a 7¾ percent eighteen-month note due on February 15, 1971. The new notes are to be priced at 99.90 to yield 7.82 percent, reportedly the highest rate in over a century.

Corporate bond prices declined at the start of July but, as the month progressed, staged an upturn in response to considerable investor interest in several large new offerings by industrial corporations. Moreover, small investors particularly were attracted by the record 7.91 percent yield on the Bell System Aaa-rated telephone debenture brought to market on July 8. The corporate market did not benefit from the general enthusiasm surrounding the lunar landing on July 20, and prices trended downward for most of the remainder of the month. However, some improvement occurred on the final three days of the month, when another telephone issue was marketed and investors again responded quite favorably.

BANK RESERVES AND THE MONEY MARKET

The tone of the money market was generally firm during July, with the effective rate on Federal funds averaging approximately 8⅘ percent, slightly above the daily average in June. Member bank borrowings at the discount window amounted to $1,312 million on a daily average basis, down $44 million from the preceding month, while excess reserves averaged $4 million higher than in June. Net borrowed reserves of member banks averaged $1,078 million for July as a whole.

Banks borrowed heavily at the discount window and in the Federal funds market during the early part of the statement week ended on July 2, in preparation for the publishing of their midyear financial statements. Borrowings from the Federal Reserve Banks in that period averaged $1,634 million, the highest weekly average since December 1952. The basic reserve positions of the forty-six major money center banks showed a marked improvement during this week (see Chart II), largely because of a sizable inflow of private demand deposits and a decline in dealer loans at the eight New York City banks. The heavy borrowing associated with the midyear publication date, together with the shift in the distribution of

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reserves, combined to create a huge volume of excess reserves which reached the market on Wednesday, when the effective rate on Federal funds fell to 5½ percent—the lowest since late February—and some trading occurred at ¼ percent.

The banking system's recent pattern of accumulating reserves early in the settlement period and disposing of them toward the close was generally continued in the statement week ended on July 9. Thus, effective rates on Federal funds were at 9 percent and 9½ percent on the first three days of the holiday-shortened week and at 7½ percent on the final day. However, this pattern was reversed during the week ended on July 16. Having established deficit reserve positions on average over the first five days of the week, the money center banks became aggressive bidders for Federal funds as the period drew to a close, pushing their effective rate to 9⅞ percent by Wednesday, July 16, from a 9 percent level on Monday.

In the second half of the month the eight New York City banks continued running deficits at the start of each statement week, but the thirty-eight money center banks outside the city reverted to the more cautious management pattern of accumulating needed reserves early in each period. Since the other reserve city and "country" banks were also managing their reserves in a conservative way, the range of rates in Federal funds resumed its more common recent weekly pattern of declining on the final days of the week.

Basic reserve positions at both the eight New York City and the thirty-eight other money center banks improved in

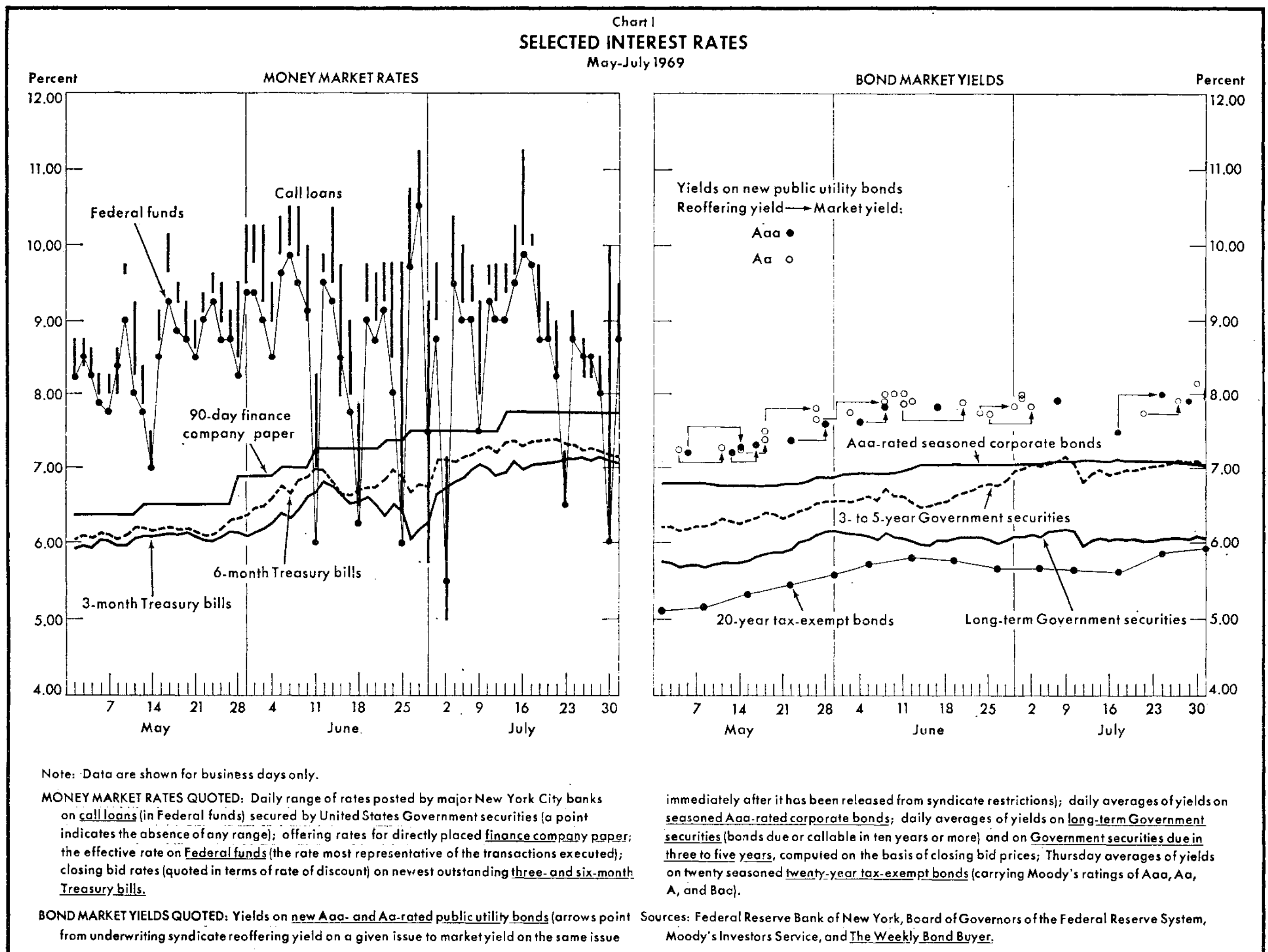

Chart I
SELECTED INTEREST RATES
May-July 1969

Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on 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 (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 seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on 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.

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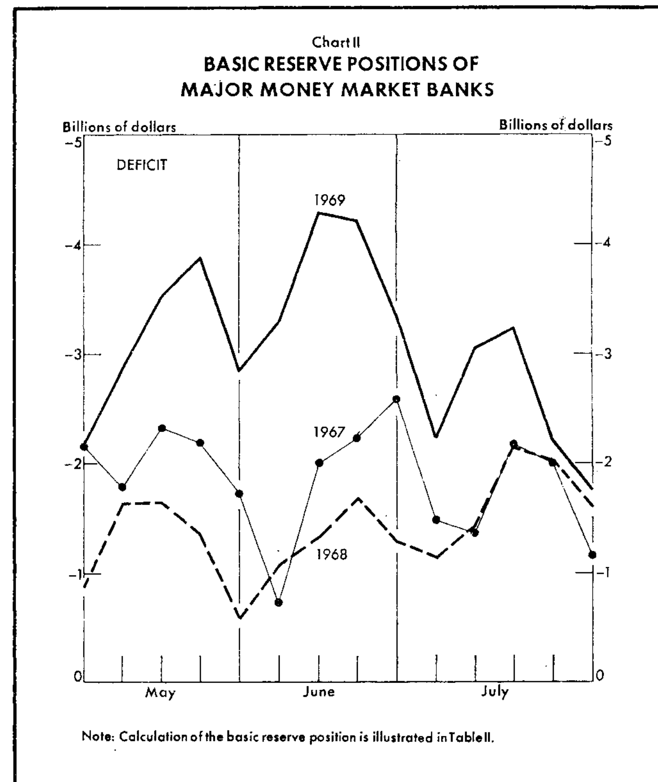
the July 23 statement week, aided to a considerable extent by the addition to their United States Government deposits of the proceeds from the two United States Treasury tax anticipation bill auctions. Moreover, there was a sizable inflow of private demand deposits to the New York City banks which also increased their borrowing from foreign branches by $200 million. Further improvement occurred in the basic positions of the forty-six money center banks during the week ended on July 30, primarily as a result of declines in their loans and investments and in their required reserves.

System open market operations during July offset the largely seasonal reserve influences of market factors. The System furnished reserves of $735 million on a daily average basis over the first two statement weeks (see Table 1), in large part to offset the drain on reserves customarily associated with the Fourth of July holiday weekend. Daily average reserves of $706 million were absorbed by the System through open market operations in the final three statement weeks. On balance, the System provided reserves of $29 million on a daily average basis during the five statement weeks of July.

Daily average deposits subject to reserve requirements (the bank credit proxy) declined in July at a seasonally adjusted annual rate of about 21.1 percent following declines of 13.1 percent in June and 2.5 percent in May. After adjustment to include the changes in liabilities to foreign branches, however, the July decline was reduced to 13.5 percent, compared with a 4.0 percent decline in June. (As yet there is no complete measure of liabilities such as direct sales and participations of loans to foreign branches and adjustment for such items is not included.) The major factors accounting for the decline in July were sizable runoffs in United States Government balances and private time deposits.



THE GOVERNMENT SECURITIES MARKET

Price trends were mixed in the market for Treasury securities during July. Notes and bonds displayed a mixed pattern, posting price gains in the very short and long maturities but declines in much of the intermediate area. Most maturities of bills registered a deterioration with the exception of the one-year bill and those due in less than a month.

All segments of the Treasury securities market declined in price following the Board of Governors' proposed regulation changes at the close of June, and prices moved lower through the July 2 statement week. Bids were accepted over a wide range in the regular weekly auction on Monday, June 30, and bill rates increased on the following day, as dealers attempted to work off an unexpectedly large volume of bills acquired in Monday's auction. In addition, with financing costs at a high level, dealers were also anxious to pare their inventories before the long July 4 holiday weekend. After the close of business on July 2, the Treasury announced plans to raise $3.5 billion of new money through the sale of $1.75 billion of December 1969 tax anticipation bills to be auctioned on Wednesday, July 9, and a like amount of March 1970 bills to be auctioned on Friday, July 11. Payment for both issues, which depository banks could make through credits to their Treasury Tax and Loan Accounts, was scheduled for July 18.

The Treasury's announcement contributed to a heavier atmosphere in much of the bill market, since the size of the issue was somewhat larger and the timing of it somewhat earlier than most market participants had anticipated. Bidding in the auctions for the tax anticipation bills was somewhat unenthusiastic, with the average issuing rate for the December bill set at 6.776 percent and for the March bill at 7.201 percent. After the auction results were known, the December bill initially traded at 7.30 percent bid and closed the month at 7.21 percent while the March bill moved from early trading at 7.49 percent to 7.36 percent

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JULY 1969

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

Factors	Changes in daily averages— week ended on					Net changes
	July 2	July 9	July 16	July 23	July 30	
"Market" factors						
Member bank required reserves	— 227	— 70	— 75	+ 351	+ 340	+ 319
Operating transactions (subtotal)	— 140	— 71	— 72	+ 146	— 239	— 376
Federal Reserve float	— 237	+ 386	— 118	+ 452	— 962	— 479
Treasury operations*	+ 221	+ 23	— 65	— 87	— 6	+ 86
Gold and foreign account	— 19	— 48	+ 48	— 9	+ 14	— 14
Currency outside banks	— 17	— 342	— 49	— 242	+ 713	+ 63
Other Federal Reserve accounts (net)†	— 90	— 89	+ 113	+ 31	+ 4	— 31
Total "market" factors	— 367	— 141	— 147	+ 497	+ 101	— 57
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 368	+ 367	+ 2	— 412	— 296	+ 29
Outright holdings:						
Government securities	+ 180	+ 399	+ 122	— 404	— 264	+ 33
Bankers' acceptances	— 1	—	— 2	—	+ 1	— 2
Repurchase agreements:						
Government securities	+ 117	+ 2	— 92	— 4	— 23	—
Bankers' acceptances	+ 19	— 5	— 11	—	— 3	—
Federal agency obligations	+ 53	— 29	— 15	— 4	— 5	—
Member bank borrowings	+ 309	— 615	+ 259	+ 77	— 82	— 52
Other loans, discounts, and advances	—	—	—	—	—	—
Total	+ 678	— 249	+ 262	— 336	— 376	— 21
Excess reserves	+ 311	— 390	+ 115	+ 161	— 275	— 78
	Daily average levels					
Member bank:						
Total reserves, including vault cash	27,472	27,152	27,342	27,152	26,537	27,131‡
Required reserves	27,004	27,074	27,149	26,798	26,458	26,897‡
Excess reserves	468	78	193	354	79	234‡
Borrowings	1,634	1,019	1,278	1,355	1,273	1,312‡
Free (+), or net borrowed (—), reserves	—1,166	— 941	—1,085	—1,001	—1,194	—1,078‡
Nonborrowed reserves	25,838	26,133	26,064	25,797	25,264	25,819‡
Net carry-over, excess or deficit (—)§	110	267	89	55	181	140‡
	Changes in Wednesday levels					
System account holdings of Government securities maturing in:						
Less than one year	+ 889	— 438	+1,106	—1,152	— 686	— 281
More than one year	—	+ 58	—	—	—	+ 58
Total	+ 889	— 380	+1,106	—1,152	— 686	— 223

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

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS JULY 1969

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on					Average of five weeks ended on July 30
	July 2	July 9	July 16	July 23	July 30	
Eight banks in New York City						
Reserve excess or deficiency (—)*	150	— 48	58	79	48	57
Less borrowing from Reserve Banks	125	—	88	86	146	89
Less net interbank Federal funds purchases or sales(—)	207	678	558	190	— 33	320
Gross purchases	*1,541*	*1,911*	*1,838*	*1,693*	*1,558*	*1,708*
Gross sales	*1,334*	*1,233*	*1,280*	*1,503*	*1,591*	*1,388*
Equals net basic reserve surplus or deficit(—)	— 182	— 726	— 588	— 197	— 65	— 352
Net loans to Government securities dealers	626	568	341	662	682	576
Net carry-over, excess or deficit(—)†	26	73	— 7	28	27	29
Thirty-eight banks outside New York City						
Reserve excess or deficiency(—)*	103	— 42	— 96	102	— 94	— 5
Less borrowings from Reserve Banks	416	165	302	213	148	249
Less net interbank Federal funds purchases or sales(—)	1,735	2,112	2,230	1,878	1,451	1,881
Gross purchases	*3,633*	*4,084*	*4,270*	*3,737*	*3,694*	*3,884*
Gross sales	*1,898*	*1,971*	*2,040*	*1,856*	*2,243*	*2,002*
Equals net basic reserve surplus or deficit(—)	—2,048	—2,319	—2,628	—1,989	—1,693	—2,135
Net loans to Government securities dealers	— 29	46	— 56	— 39	78	16
Net carry-over, excess or deficit(—)†	23	83	22	— 29	69	34

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.
† Not reflected in data above.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—July 1969			
	July 7	July 14	July 22	July 28
Three-month	7.069	7.105	7.220	7.172
Six-month	7.309	7.400	7.459	7.313
	Monthly auction dates—May-July 1969			
	May 27	June 24	July 24	
Nine-month	6.307	7.387	7.407	
One-year	6.270	7.342	7.313	

* 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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over the interval. Some commercial bank selling of the newly acquired tax anticipation bills occurred during the month, but the market was generally able to handle these sales partly as a result of demand from corporations and tax-exempt institutions. Dealer inventories became fairly sizable, however, and a cautious tone pervaded the market following the tax anticipation bill auctions. In the latter part of the month, a steadier tone emerged. Moderate investment demand developed, and dealer positions were reduced somewhat.

At the regular monthly auction on July 24, average issuing rates on the nine- and twelve-month bills were set at 7.407 percent and 7.313 percent, respectively, 2 basis points higher and 3 basis points lower than comparable rates at the auction a month earlier (see Table III). The rate on the nine-month bill set a new record, but the twelve-month bill rate declined from its historical high which was set last month. At the final weekly auction on July 28, average issuing rates for the new three- and six-month bills were set at 7.172 and 7.313 percent, respectively, 72 and 37 basis points above the average rates established at the last weekly auction in June. Interest from individuals was strong in all the weekly auctions in July.

The market for Treasury notes and bonds was largely dominated by professional activity during the early days of the month, and prices generally drifted lower in the absence of any significant investor demand. Prices rallied during the statement week ended on July 16, however, as long-term bonds rose by as much as 1½ points and intermediate issues by somewhat less. A better tone developed at the start of that week in response to demand from mutual funds and commercial banks. This atmosphere was strengthened further by the announcement that a major automobile company had made a sizable reduction in its capital expenditures plans, a move which many market participants interpreted as indicative of the effectiveness of monetary restraint. The market was also buoyed by the improved tone in the corporate bond sector and the possibility that interest rates might be peaking out. Enthusiasm waned somewhat after the weekend when some professional selling emerged, but prices edged higher on the final day of the statement week in response to reports that the North Vietnamese government believed negotiations could bring about peace within a year.

A more cautious tone was present in the Treasury coupon market during the July 23 statement week, when trading activity was generally quiet and attention was centered to a large extent on the Treasury's August refunding. Prices of most intermediate-term issues declined $\frac{1}{32}$ to $\frac{14}{32}$ over the period, but demand continued for the relatively thin supply of long-term bonds and these issues showed slight gains of $\frac{2}{32}$ to $\frac{8}{32}$.

As the July 30 date for the announcement by the Treasury of its refunding terms drew closer, speculation in the market as to the size and maturity of the refinancing increased and prices on most outstanding notes and bonds drifted lower. Some gains were posted following the announcement, however, as the market responded favorably to the fact that only $3.4 billion of a relatively short maturity would be offered.

OTHER SECURITIES MARKETS

The corporate bond market was in the doldrums during the early part of July but picked up interest and momentum during the second business week and continued the uptrend until the week following the Apollo 11 lunar expedition. Some hesitation then set in and continued until the last week when prices turned up. During the first three weeks of the month the market for state and municipal bonds also showed some improvement, but in an atmosphere subdued by continuing discussion of Congressional proposals related to the taxation of income from state and municipal bonds. Following the report by the House Ways and Means Committee of its tentative approval of a "minimum tax" on previously tax-free income, there was a sharp deterioration in the municipal bond market. *The Weekly Bond Buyer's* index of yields on twenty tax-exempt bonds jumped 24 basis points on July 24 to a new high of 5.86 percent, thereby eradicating the reductions which had been made since mid-June.

Reduced investor interest and an unexpectedly large buildup in the volume of offerings to the highest monthly total in 1969 resulted in lower corporate bond prices at the start of July. On July 8, however, investor interest was spurred by a new record-high yield of 7.91 percent set for a Bell System Aaa-rated debenture, and this $150 million issue was quite successful. Two days later the market again responded favorably to a $100 million A-rated issue yielding 7.75 percent, as new industrial offerings which earlier had been in short supply began to reappear. Small investor interest was a sizable factor in these sales. The improved reception to new corporate bonds continued through the next week or so, apparently aided by the transfer of funds from the declining stock market and the news of a sizable cutback in new capital expenditures planned by a major automobile corporation. Several large industrial issues were brought to market at successively higher prices during this period, and the public's response was such that the issues sold out quickly and their prices rose to premiums. Investor interest began

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to wane following the lunar expedition, and corporate prices trended irregularly downward partially in reaction to the minimum tax proposal of the House Ways and Means Committee. On July 29, however, another $100 million of Aaa-rated Bell System debentures was marketed to yield 7.90 percent, a rate virtually unchanged from that on the July 8 issue, and investor response was again enthusiastic. In this climate prices of some outstanding issues rose, and the market closed the month with a decidedly improved tone.

Prices of state and municipal bonds improved modestly over the first three weeks of July as the supply of new issues continued fairly light. However, investors were somewhat cautious in response to the uncertainty concerning possible Congressional reforms affecting the tax-exempt status of these bonds. Reflecting this caution, the largest new issue of the month, $146 million of New York City bonds, encountered some selling difficulty despite the fact that it was priced to yield as much as 6.05 percent. The *Bond Buyer's* index declined by 6 basis points between June 26 and July 17, continuing the moderate downtrend which began in mid-June. On July 24, however, the municipal market experienced a marked setback in reaction to the tentative proposals of the House Ways and Means Committee. Thus, the cost of a $60 million issue of Aaa-rated Connecticut bonds was set at 5.71 percent, some 22 basis points higher than an Aa-rated issue a week earlier, and several scheduled new issues received no acceptable bids. Prices of outstanding bonds also declined by a sizable amount. Following this initial response to the minimum tax proposal, the municipal bond market continued to deteriorate and several scheduled offerings either received no acceptable bids or were postponed. However, prices improved somewhat at the close of the month, largely in response to indications that interest on corporate holdings of municipal bonds might remain exempt from Federal taxation. Nonetheless, the *Bond Buyer's* index of tax-exempt bond yields (computed each Thursday) reached a new high of 5.93 percent on July 31.

OPEN MARKET OPERATIONS

The Federal Reserve Bank of New York has just published the second edition of *Open Market Operations* by Paul Meek, Assistant Vice President in the Bank's Open Market Operations and Treasury Issues function. The 48-page booklet describes for the interested layman and student how open market operations—the purchase and sale of United States Government securities—are used to meet the economy's short-run cash needs and to influence the economy by affecting the cost and availability of credit. A section called "Promoting a Healthy Economy" has been expanded to examine the monetary and fiscal measures taken in the 1960's against the background of the nation's economic objectives.

Up to 100 copies of the booklet are available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

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Banking and Monetary Developments in the Second Quarter

The nation's banking system was subjected to heavy pressure from continued monetary restraint in the second quarter of 1969. Although there was a moderate step up in the rate of growth of bank credit and the money supply, compared with the first three months of the year, a noticeable slowing in the rate of expansion of these aggregates developed as the quarter progressed. There was a deceleration in the growth of most major types of bank loans to rates well below those posted in the first quarter. On the other hand, while banks further reduced their holdings of all types of securities as a means of obtaining loanable funds, their total holdings of investments declined at a slower pace than in the first quarter. A major factor influencing bank lending and investment policies during the second quarter was the continued heavy losses of large certificates of deposit (CD's), in response to sharply rising market interest rates and unchanged Regulation Q ceilings on bank time deposit rates. Larger banks, in order to offset their heavy CD losses, made extensive use of the Euro-dollar market and also greatly expanded their efforts to develop other nondeposit sources of funds. With loanable funds becoming more difficult and costly to raise, and continued strong loan demand, commercial banks increased the prime rate on June 9 from 7½ percent to a record 8½ percent, the fifth increase in seven months.

INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

Market interest rates rose throughout the second quarter, as pressures on the money and bond markets intensified. The increase in rates was most pronounced during the last three weeks of June, in part because of pressures arising from the corporate tax and dividend payment dates in the middle of the month. The rate for three-month Treasury bills climbed 42 basis points over the quarter to an average of 6.43 percent in June. The rise in long-term rates, while substantial, was generally not so large; however, rates on high-grade tax-exempt securities issued by state and local governments rose 61 basis points, partly reflecting continued bank selling of these securities and, later in the period, investor concern about tax reform proposals that might restrict the tax-exempt status of these issues. While banks found it increasingly difficult to accommodate the strong loan demand, more borrowers turned to the commercial paper market. The increased pressure on this source of short-term funds was reflected in sharply higher interest rates. For example, the rate on prime four- to-six month commercial paper climbed from an average of 6.82 percent in March to 8.23 percent in June. Because of rising market interest rates, banks found it difficult to replace maturing large CD's even though they continued to offer the maximum rates established under Regulation Q, which range from 5½ percent on the shortest maturities to 6¼ percent on the longest.

At the beginning of the quarter, the Federal Reserve discount rate was increased to 6 percent from 5½ percent, and reserve requirements on member bank demand deposits were increased by approximately $650 million. With a relatively small increase in total reserve availability during a period when reserve drains ordinarily tend to be large, heavy pressure on member bank reserve positions developed. Net borrowed reserves increased from an average of $701 million in March to an average of $1.1 billion in June, and borrowings at the Federal Reserve Banks rose to $1.4 billion in both May and June from a March average of $918 million. These developments were associated with a sharp increase in the effective rate on Federal funds from an average of 6.8 percent in March to 8.9 percent in June.

BANK CREDIT

The growth of total commercial bank credit stepped up slightly to a seasonally adjusted annual rate of 3.7 percent during the second quarter (see Chart I). Bank credit expansion had decelerated sharply from a 10½ percent rate in the last quarter of 1968 to 2.3 percent during the first quarter of this year. Almost all the second-quarter increase in bank loans and investments occurred during April. As the quarter progressed, the pace of bank sales of loans—mainly to their own foreign branches and affiliated holding companies—stepped up, and partly for this reason total bank credit declined in June. These loan sales,

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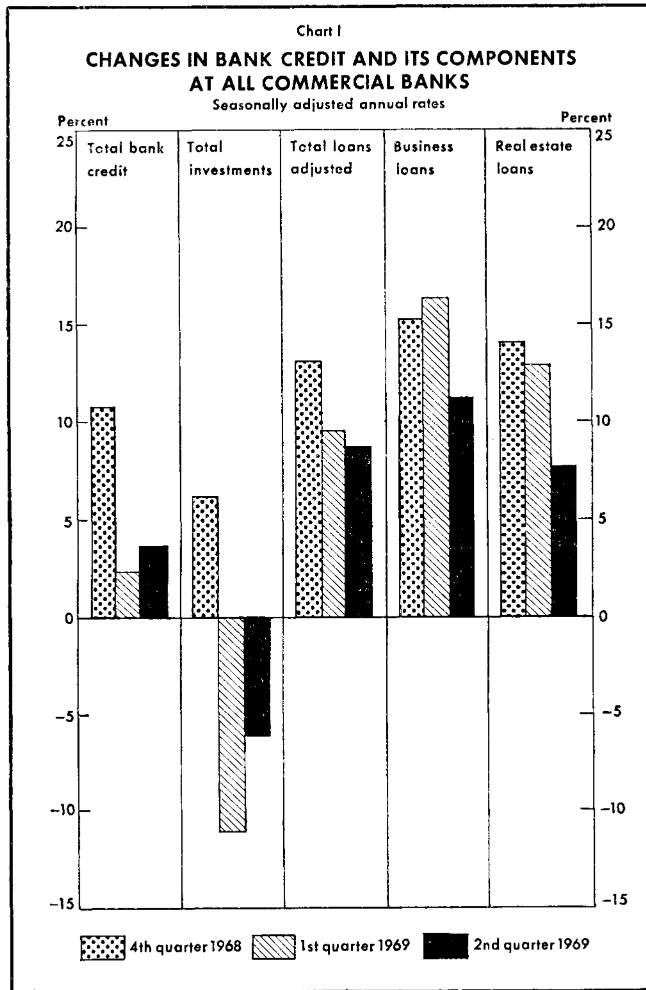

which reduce the level of loans appearing on a bank's balance sheet, lead to an understatement of the volume of credit originated through the banking system. Nonetheless, even after allowance for this possible distortion, bank credit growth during the first half of 1969 was still very much lower than in 1968.

Increased restraint on banks' loan portfolios began to develop in the April-June period. During the last quarter of 1968 and the first quarter of this year, banks made substantial increases in business, consumer, and real estate loans, which were financed in large part by sizable reductions in their holdings of Government securities and sharp declines in securities loans. In the second quarter, however, the seasonally adjusted $3.6 billion growth of bank credit reflected a slower increase in total loans less securities loans, together with a more moderate rate of decline in total bank investments. Moreover, while banks continued to reduce their holdings of Government securities during the second quarter, they also found it necessary to reduce their holdings of other securities—primarily state and local government obligations—in order to accommodate borrowers.

Commercial bank holdings of United States Government securities declined $1.5 billion on a seasonally adjusted basis during the second quarter. Virtually all the reduction occurred in May, and the total drop in holdings of Government securities in the second quarter was only about one third the size of the rundown in the first quarter of the year. However, bank holdings of other securities, principally tax-exempt notes and bonds issued by state and local governments, declined slightly on a seasonally adjusted basis in the second quarter after rising modestly in the first quarter. The reduced rate of decline of United States Government securities holdings in the second quarter, together with a turn to net liquidations of other securities, may indicate that banks were finding it difficult to reduce further their holdings of Government securities. A large proportion of these are pledged as collateral against Government demand deposits with banks.

Outstanding bank loans to securities dealers and nonbank financial institutions rose somewhat during the second quarter after declining in the first; however, the behavior of this component of bank credit ordinarily tends to be highly erratic over short time periods. Securities loans outstanding tend to vary with the levels of inventories held by securities dealers. In the first quarter, the heavy nonbank demand for Treasury obligations as well as a low level of Treasury borrowing encouraged dealers to reduce their inventories of Government securities, and inventories held by corporate and municipal bond dealers also fell. Thus, there was a substantial drop in securities loans over the first three months of the year. In the second quarter, although Treasury borrowing was not substantial, rising market rates and weak demands for securities led to small increases in dealers' inventories and, concomitantly, a moderate 4.5 percent increase in banks' securities loans. However, bank lending rates on securities loans were increased even before the prime rate went up, and securities loans declined substantially in June as borrowers economized on their credit.

In the face of rising market rates, nonbank financial institutions diverted a greater share of their borrowing to banks in April and May. However, after the prime rate increase in early June, borrowing by these institutions also fell rapidly. On balance, loans to nonbank financial institutions, which is a relatively small part of total bank credit, increased at a 13 percent rate in the second quarter.

Business loans grew at a seasonally adjusted annual

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rate of 11 percent during the second quarter, well below the 16½ percent rate of increase in the first three months of the year. The continued strength of spending on plant and equipment and the substantial increase in the rate of inventory accumulation contributed to heavy business demands for funds. In addition, the volume and timing of business credit demands were strongly affected by the corporate tax payments in April and June, and perhaps also by expectations of the higher cost and reduced availability of credit at banks. It is probable that many corporations borrowed two or three weeks before the corporate tax and dividend date on June 15, as they may have thought that the banking system would be hard pressed to provide funds when these payments were due. At the same time, the sale of business loans to foreign branches may have been a factor limiting the rise of business loan holdings in the second quarter.

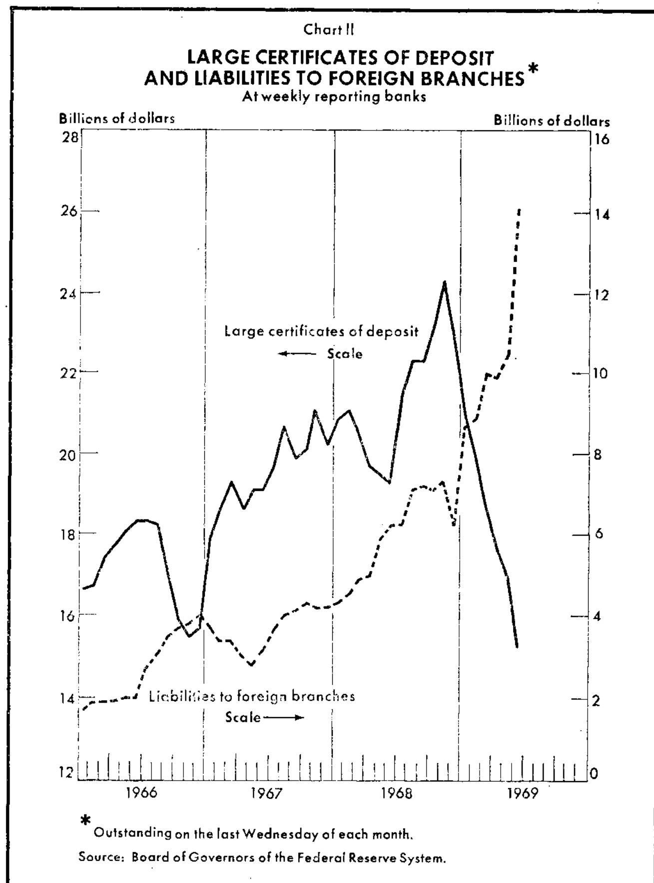
The rapid expansion of bank real estate and consumer lending which began last fall slowed in the second quarter. Real estate loans increased at a 7½ percent annual rate, compared with a 13 percent gain in the first quarter. Moreover, the $0.3 billion June advance in these loans was the smallest monthly increase in a year. Consumer loans outstanding rose at a 7 percent seasonally adjusted annual rate, down from the 8 percent first-quarter increase. The second-quarter strength in consumer loans occurred mainly in April, and the rate of expansion also showed signs of moderating as the quarter progressed.

MONEY SUPPLY AND TIME DEPOSITS

The daily average money supply—privately held demand deposits plus currency in circulation outside banks —grew at a 2.5 percent seasonally adjusted annual rate over the second quarter, as presently measured. The second-quarter money supply gain was comprised of annual rate increases of 1½ percent in private demand deposits and 6½ percent in the currency component.

The modest rise reported for the money supply in the second quarter brought the increase for the first half of the year down to an annual rate of 2.2 percent, sharply below the 6½ percent rate of gain averaged during 1968. However, cash items in the process of collection, which are subtracted from gross private demand deposits in the computation of the money supply, continued to rise rapidly throughout the first half of 1969. Many of these cash items are apparently attributable to domestic banks' Euro-dollar transactions, and corrections of the money supply statistics to eliminate their effect would undoubtedly increase both the current level of the money supply and its rate of growth over the first six months of the year. Nonetheless, money supply growth for the year to date would still be significantly lower than in 1968.

Time and savings deposits at commercial banks declined at a 3½ percent annual rate in the second quarter, following a 6½ percent rate of decline in the first three months of the year. Banks found it increasingly difficult to retain maturing large CD's (see Chart II) or to issue new ones in the face of sharply rising market rates on alternative short-term investments. Losses of CD's at the weekly reporting banks, which in any month tend to vary with the amount reaching maturity, were rather severe in June. These banks were able to retain only 64 percent of maturing CD's in that month, when there were large cash needs associated with corporate tax and dividend payments. In the second quarter as a whole, CD losses were 28 percent of maturing deposits, or $3.5 billion, whereas they had been 26 percent of maturing deposits, or $4.0 billion, in the previous quarter. For the first time since the CD runoff began last December, the weekly



* Outstanding on the last Wednesday of each month.
Source: Board of Governors of the Federal Reserve System.

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reporting banks outside New York City sustained relatively greater losses in June than those in New York City.

The second-quarter rate of growth of total bank time deposits was also restrained by weakness in passbook savings accounts. At weekly reporting banks, for example, such deposits fell by $1.1 billion from March through June. Not all the decline in savings accounts need result in an outflow of funds from commercial banks as a whole; many of these deposits in the past have remained in the banking system in the form of higher yielding consumer-type time deposits. However, consumer-type time deposits —total private time deposits less those in denominations of $100,000 or more—increased only $184 million in the second quarter, compared with a first-quarter gain of $1.4 billion. These data are not adjusted for seasonal variation, but nevertheless the behavior of time and savings deposits at the weekly reporting banks seemed weak.

In an effort to offset time deposit losses, the larger commercial banks continued to turn to the Euro-dollar market as a source of funds and, through bank holding companies and other affiliates, to the commercial paper market. Large commercial banks increased their borrowings from their foreign branches by about $4.1 billion during the quarter even though Euro-dollar rates rose steadily, reaching an average in June of about 11 percent in the case of three-month maturities. Most of the increase in Euro-dollars liabilities—$3.6 billion—occurred in June when the CD runoff at banks was most severe. Funds raised outside the United States currently are subject neither to the reserve requirements specified in Regulation D nor to the interest rate ceilings established under Regulation Q. However, in response to the rapid rise in Euro-dollar liabilities in recent months, the Board of Governors of the Federal Reserve System on June 26 invited comments on a proposal to amend its regulations governing member bank reserve requirements and the foreign activities of member banks. The proposed amendments would subject borrowings by member banks from their foreign branches, as well as assets acquired by such branches from their parent banks, and credit extended by the branches to United States residents—above the amounts of such borrowings and assets in a base period—to a 10 percent reserve requirement. The proposed changes are described on page 140 of the July 1969 issue of this *Review*.

THRIFT INSTITUTIONS

The rate of growth of savings accounts at thrift institutions slowed substantially in the April-June period, falling to 3½ percent from the previous quarter's 6 percent gain. The continued widening of the spread between rates on deposits at the thrift institutions and rates on alternative money market instruments most likely retarded flows to these institutions. Share capital at savings and loan associations grew at a 3 percent annual rate, only one half the rate of increase attained in the previous two quarters. Deposits at mutual savings banks accumulated at an annual rate of 4¼ percent, compared with the 6¼ percent gain in the first quarter.

Despite the relative decline in savings inflows during the second quarter, there was no reduction in the rate of acquisition of mortgages by thrift institutions. During the April-June period, mutual savings banks added mortgages to their portfolios at a 5.2 percent seasonally adjusted annual rate, while outstanding mortgages held by savings and loan associations rose at an 8.9 percent annual rate. The savings and loan associations were able to finance net mortgage acquisitions in excess of savings inflows largely by a considerable increase in borrowing at the Federal Home Loan Banks.

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Growth and Retrenchment in the Euro-Bond Market*

The Euro-bond market, while suffering some decline in activity in recent months, has continued to play an important role in international finance by providing facilities that are attractive to both borrowers and lenders.[1] The market's success can be explained by its ability to provide access to funds on a worldwide scale and to avoid many official regulations concerning foreign borrowings in local currencies. At the same time, it offers investment opportunities which are exceedingly attractive because of the outstanding quality of the borrowers, the public quotation of the securities, and the high and, in practice, frequently tax-free yields. The introduction in this country of the mandatory Department of Commerce foreign direct investment restraint program early in January 1968 induced an accelerated growth of this market, as United States corporations began to raise long-term Euro-dollars on a large scale. Under this program, transfers of United States funds for direct business investment in most Western European countries were severely restricted; American companies were thus compelled to rely even more extensively than before on foreign sources of funds to finance their investments abroad. Largely as a result, in the fifteen months from January 1968 to March 1969, total new Euro-bond borrowings soared to nearly $4½ billion equivalent, almost as much as had been issued over the entire preceding four years.

This surge in Euro-bond flotations was absorbed with a minimum of difficulty, as borrowers adjusted the terms of their offerings to meet changing investor preferences and market circumstances. In the first half of 1968, the finance affiliates of American corporations borrowed more extensively than before by issuing dollar-denominated Euro-bonds convertible into the common stock of the parent company; then in the second half many borrowers turned increasingly to straight Euro-bonds denominated in German marks. But success brought trouble. Governments in several of the capital-exporting countries became concerned about the effects of large-scale capital outflows on their own balance-of-payments positions and on the availability of funds for their domestic borrowers. Thus, beginning in April 1969, several countries started to take steps to restrict resident purchases of Euro-bonds. Market factors also led to a sharp decline in new borrowing during the second quarter.

BACKGROUND: THE EURO-BOND MARKET'S WIDENING HORIZONS

By the time the 1968 foreign direct investment restraint program was introduced in the United States, the Euro-bond market had already proved it could accommodate borrowers from an increasing number of countries with the funds of investors from many parts of the world. When the Euro-bond market first emerged in 1963, it was used primarily by a few European institutions and by private and public borrowers in the small group of industrialized countries—members of the European Free Trade Association, Japan, and Italy—which, prior to the imposition of the United States interest equalization tax, had relied on the New York market for funds. By the end of 1965, the market had provided funds for borrowers in a wide variety of countries, including all members of the European Economic Community, and for today's most important borrowers, the finance subsidiaries of American corporations.

The ultimate investors in this market reside all over the globe, although funds are channeled almost entirely through those European countries which do not impede the flow of funds by way of exchange controls or tax laws. Switzerland has been the most important single supplier of funds,

* Margaret L. Greene, Economist, Foreign Research Division, had primary responsibility for the preparation of this article.

[1] For the purpose of this article, Euro-bonds are defined to be those issues sold simultaneously in several financial centers by multinational underwriting syndicates. For further discussion of this market, see "Recent Innovations in European Capital Markets", this *Review* (January 1965), pages 9-15; "Recent Developments in International Capital Markets", this *Review* (October 1966), pages 225-29; and "Euro-bonds: An Emerging Capital Market", this *Review* (August 1968), pages 169-74.

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but more than half of the Euro-bonds taken up on the Swiss market have been purchased on behalf of the Swiss banks' foreign depositors. London, as well, has been a major center through which foreign-owned funds are transmitted to Euro-bond borrowers. More recently, Euro-bonds have been purchased in the Netherlands and Belgium for the account of foreign depositors and, when interest rates in the Euro-bond market were higher than those in domestic markets, also for the account of their own residents. Italian residents, too, have been consistent purchasers of Euro-bonds.

The Euro-bond market has been able to attract funds from a wide variety of sources through a complex network of multinational underwriting syndicates. London, with its long tradition in the issuance of overseas bonds, was the first center for Euro-bond borrowing. But the rapid growth of the Euro-bond market has attracted issuers in several other countries as well, and has drawn an increasing number of bankers and securities dealers into the international selling or "subunderwriting" groups that place the issues with investors. Luxembourg early became a major center largely because of favorable securities legislation and stock exchange regulations. New York underwriters became active sponsors, especially as United States corporations expanded their European borrowing. German banks have participated in multinational issuing syndicates on a large scale ever since the abolition of a new issue tax in 1965.[2] In the Netherlands, and after 1966 in Italy, banks were given general license to act as underwriters and to participate in selling groups for issues to be listed on foreign stock exchanges; consequently, they became increasingly active as members of issuing syndicates. Although from the beginning the Swiss banks took up by far the largest share of the Euro-bonds issued, they were unable to join issuing syndicates on a competitive basis, except as subunderwriters, until the abolition of a coupon tax on interest payments at the end of 1966. In order to maintain an adequate supply of capital for the domestic economy and to ensure that higher Euro-bond rates would not exert upward pressure on Swiss interest rates, two conditions were imposed. The first requires Swiss National Bank approval for any issue exceeding a prescribed amount. The second requires the banks to place at least half of the bonds assigned to them by the consortium with foreign customers and prohibits them from publicly advertising such issues in Switzerland.

RECENT DEVELOPMENTS

The outstanding feature in the Euro-bond market, from early 1968 through the first quarter of 1969, was the abrupt rise in borrowing by United States corporations. The bulk of the funds raised was for employment abroad; but, to a much less extent, some American firms secured funds for use in the United States. In some cases where funds were raised for use in this country, credit may not have been so readily available elsewhere, and in other cases a company intending to make a domestic corporate acquisition some time in the future obtained the necessary funds in the Euro-bond market in order to avoid disclosure of its plans at an early stage.[3] The borrowing of American firms was effected not only through domestic finance subsidiaries, as in the past, but also through finance subsidiaries incorporated in the Netherlands Antilles. In part, this latter approach was developed to obtain funds that could be employed for acquisitions in the United States or to facilitate the transmission of funds to the United States in accordance with Commerce Department regulations. ("Delaware" corporations are handicapped in repatriating funds held abroad because they lose certain tax benefits if as much as 20 percent of their total income is earned in the United States.)[4] In addition, these subsidiaries benefit from favorable local taxation and incorporation regulations and various other tax advantages.

The biggest rush of American new issues was in the first half of 1968, especially in January immediately after the announcement of the 1968 foreign direct investment restraint program and in May and June after the uncertainties of the March gold crisis were largely dispelled. For the year as a whole, new issues of American corporations and their affiliates nearly quadrupled; they rose to over $2

[2] After the German government imposed in March 1964 a withholding tax on interest payments to nonresidents holding domestic bonds, foreign bonds denominated in marks began to be offered in Germany, which were bought by nonresidents at interest rates lower than on the domestic market.

[3] The Securities Act of 1933 requires a borrower who wishes to raise funds publicly in the United States to file a registration statement; this may require disclosure of either the name of the company the borrower proposes to acquire or sufficient information to permit the company's identification.

[4] The term "Delaware" corporation is generally used to denote any international finance subsidiary incorporated in this country. As long as more than 80 percent of the income of such a qualified international finance subsidiary is derived from sources outside the United States, interest paid to nonresidents on its outstanding obligations is not income according to United States Internal Revenue Code, §861, and therefore is not subject to United States withholding tax.

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EURO-BOND ISSUES, 1963 THROUGH FIRST HALF 1969

In millions of dollars

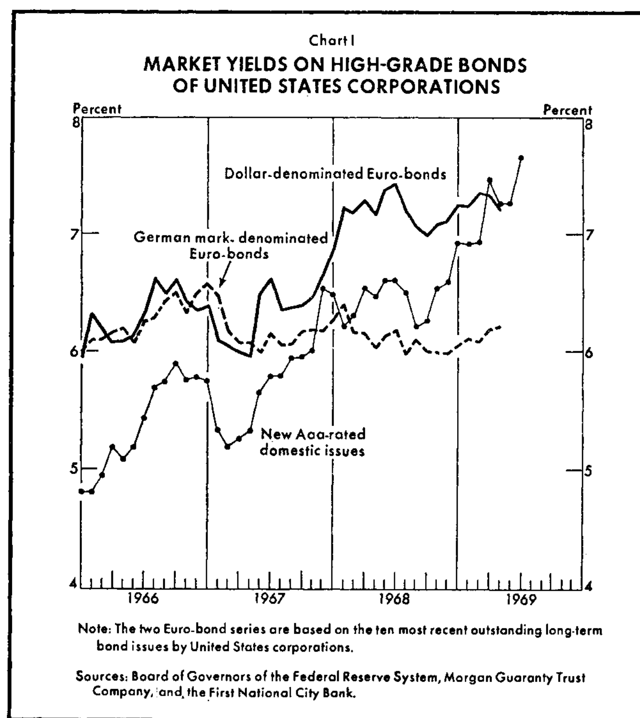
Country of borrower	1963	1964	1965	1966	1967	1968	First half 1969*
United States	—	—	331	439	527	2,059	546
Continental Europe	88	408	456	426	886	658	477
United Kingdom	—	—	25	40	51	134	189
Japan	20	162	25	—	—	180	120
Canada	—	—	—	—	—	38	138
Rest of world	25	5	83	101	305	259	176
International institutions	5	121	128	101	120	40	—
Total	137	696	1,046	1,107	1,889	3,368	1,646

Note: Because of rounding, figures do not necessarily add to totals.
* Preliminary.
Source: Annual data from 1963 through 1968 from the Bank for International Settlements *Annual Report,* June 1968 and June 1969.

billion, or more than 60 percent of all new issues floated in the Euro-bond market, from only $527 million, or just over 25 percent of total new issues, in 1967 (see table). American borrowing was particularly heavy in January of this year but has tapered off considerably since the first quarter.

The access of other borrowers to the Euro-bond market does not seem to have been seriously impaired by the emergence of this large-scale borrowing by American corporations. To be sure, some placements may have been postponed, particularly in those months when United States corporate borrowing was heaviest, and as a result new issues of all borrowers other than United States corporations were at about the same level as in 1967. However, by midyear, borrowers in some European countries—Finland, the United Kingdom, and especially the Netherlands — increased their flotations substantially. These countries continued to borrow heavily during the first half of 1969; in addition, German and Swiss firms returned to the market for the first time in two years. The appearance of borrowers from countries with relatively free access to the United States market—Japan and Canada—is evidence that throughout 1968 and the first six months of this year the Euro-bond market continued to provide funds at relatively attractive rates.

Faced with rising interest rates (see Chart I), borrowers found ways to adjust the terms of their issues so as to satisfy investors' preferences and reduce borrowing costs. During the first half of 1968, the heavy volume of new issues contributed to sharply rising yields on straight dollar issues. Under these circumstances, and with a buoyant New York stock market, American corporate borrowers shifted dramatically from straight debt issues to convertible dollar bonds. Later, Dutch and British companies also issued convertible securities. Indeed, outstanding convertible dollar issues rose more than $1.9 billion during 1968, compared with only $250 million during the previous year, whereas straight dollar issues rose by only $535 million, compared with more than $1.4 billion in 1967 (see Chart II). While terms vary, these convertible bonds typically permit the holder to exchange his bonds for shares at a conversion price about 10 to 15 percent above the stock price prevailing at the time of issue, any time between a period of six to eighteen months after issue and the bond's final redemption date. As a result, the investor can benefit from a rise in the price of the common stock of the parent company and, at the same time, receive an interest income yield which is generally greater than the dividend yield provided by that common stock. Because these features make convertible bonds relatively more attractive to investors, the direct interest expense to the borrower of a convertible issue is generally less than that for a straight bond. The yield spread between the two has been about 1½ percentage points, but in mid-May 1968, when the demand for con-



Note: The two Euro-bond series are based on the ten most recent outstanding long-term bond issues by United States corporations.

Sources: Board of Governors of the Federal Reserve System, Morgan Guaranty Trust Company, and the First National City Bank.

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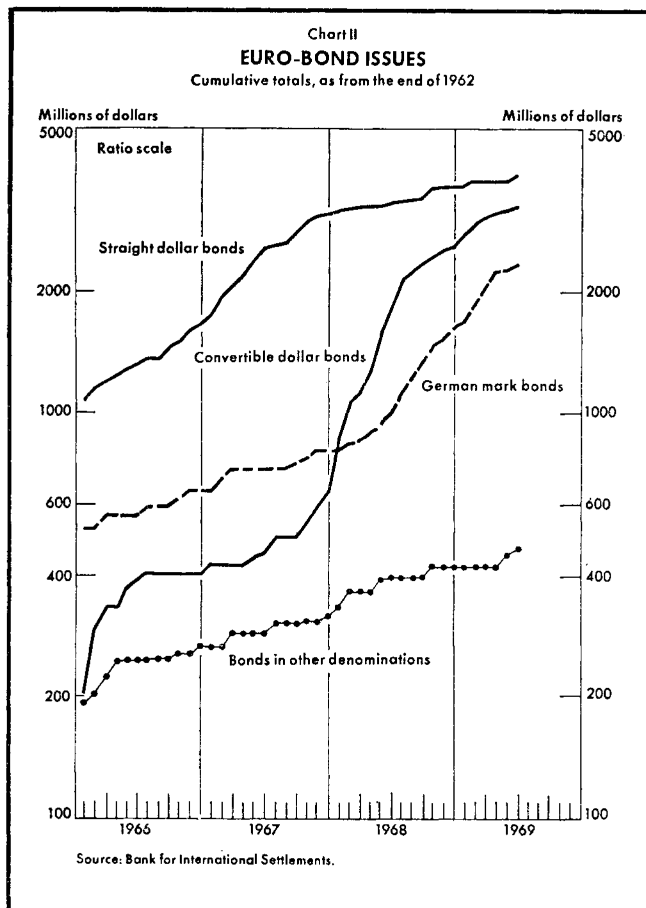

Source: Bank for International Settlements.

vertible Euro-bonds was quite heavy, it widened to between 2 and 3 percentage points.

By fall, when interest rates in the United States were rising rapidly, issue conditions for dollar-denominated securities became less attractive. At the same time, a high level of liquidity in the German capital market kept German interest rates low. As the differential between dollar and German mark-denominated Euro-bonds widened, many borrowers—particularly governments and international institutions—were induced to switch to German mark issues despite any risk of revaluation of the German mark. In fact, new mark-denominated issues rose from $200 million equivalent during the first half of 1968 to $600 million in the second half and, during the first quarter of 1969, reached $460 million. For investors, the possibility of a mark revaluation made these issues attractive, despite their relatively low yield. In addition, German residents, particularly German banks, bought substantial amounts as yields on mark-denominated Euro-bonds became more favorable relative to yields in the domestic market. Before last year, German investment in the Euro-bond market had been relatively small, representing mostly unsold portions of new issues left with German underwriters.

During the fifteen months through March 1969, new financial techniques were developed in the Euro-bond market, which led to a further broadening of its scope. In the United Kingdom, subsidiaries of overseas (especially American) companies began issuing sterling securities convertible into the common stock of the parent company. These sterling-dollar convertible issues differ somewhat from convertible Euro-bonds; they are regarded as domestic securities by British authorities and they can therefore be purchased by British residents, but the proceeds must be used within the United Kingdom. In addition, the secondary market for outstanding Euro-bonds developed substantially during this period. Most issues are listed on at least one of the major stock exchanges as a formality necessary to make a security "eligible" for purchase under the exchange-control regulations of a number of countries. But, in fact, the secondary market is largely an over-the-counter market in which dealers make their quotes on the basis of their own positions and the prevailing Euro-dollar rates. The secondary market now comprises a number of dealers and banks in the United Kingdom, on the Continent, and in the United States. A further development was the handling by international syndicates of secondary stock offerings. In some cases, the securities sold were those issued in connection with a company take-over, which the shareholders of the acquired company did not want to keep.

From the point of view of European countries, the Euro-bond market has tended to make management of domestic capital markets more difficult. Since Euro-bond issues are often substitutes for long-term local investments, the Euro-bond market tends to bring long-term interest rates in the European national markets more in line with each other. In the early months of this year, as the hectic pace of Euro-bond borrowing continued, some European countries decided they could not permit a repetition of last year's sizable capital outflows. In order to prevent undue congestion in the German capital market, the semiofficial Capital Market Committee decided, early in April, to bring the volume of foreign German mark issues in which German banks participate below the average for the first three months of this year. The Bank of Italy, in an attempt to protect the relatively low domestic long-term interest rates, has been requiring since the beginning of April special authorization for banks who wish to participate in Euro-

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bond issues. Authorization is now granted only when the borrower has business interests in Italy. For similar reasons, in Belgium, a bill is pending that would authorize the government to restrict resident purchases of foreign securities.

Not all the decline of more than $530 million in new-issue activity in the Euro-bond market during the second quarter of 1969 was a direct result of these countries' measures to restrict resident purchases of foreign securities. Many borrowers may have been discouraged by the continuing high interest rates. The high interest rates obtainable on Euro-dollar deposits, together with the stock market decline in New York, substantially reduced the attractiveness of long-term investment generally and of convertible bonds in particular. Furthermore, many American corporations probably still have sufficient proceeds from previous borrowings available to wait for more favorable terms.

The emergence and development of this international capital market has been a consequence of various countries' attempts to curb the outflow of domestic capital: it was initiated in order to avoid controls on foreign borrowing in domestic currency, and it expanded at a hectic pace with the adoption of successive balance-of-payments programs in the United States. Last year, the Euro-bond market proved its capacity to attract an ever-widening clientele of borrowers and lenders and to accommodate transactions in various types of debt and equity securities. Attempts by some of the Continental countries to curtail resident participation in the Euro-bond market are unlikely to do more than slow this growth. However, such policies may constitute the first attempts to brake the increase in the number of local financial institutions participating in syndicates issuing Euro-bonds. As a result, these policies may also hamper the strengthening of international financial intermediaries in those countries that adopt these measures and thus make more difficult the path to eventual integration of the European capital markets.

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Publications of the Federal Reserve Bank of New York

The following is a selected list of publications available from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. Copies of charge publications are available at half price to educational institutions, unless otherwise noted.

1. **CENTRAL BANK COOPERATION: 1924-31** (1967) by Stephen V. O. Clarke. 234 pages. Discusses the efforts of American, British, French, and German central bankers to reestablish and maintain international financial stability between 1924 and 1931. ($2 per copy)

2. **ESSAYS IN MONEY AND CREDIT** (1964) 76 pages. Contains articles on select subjects in banking and the money market. (40 cents per copy)

3. **KEEPING OUR MONEY HEALTHY** (1966) 16 pages. An illustrated primer on how the Federal Reserve works to promote price stability, full employment, and economic growth. Designed mainly for secondary schools, but useful as an elementary introduction to the Federal Reserve. (First 100 copies free; 7 cents for each additional copy*)

4. **MONEY AND ECONOMIC BALANCE** (1968) 27 pages. A teacher's supplement to *Keeping Our Money Healthy*. Written for secondary school teachers and students of economics and banking. (First 100 copies free; 8 cents for each additional copy*)

5. **MONEY, BANKING, AND CREDIT IN EASTERN EUROPE** (1966) by George Garvy. 167 pages. Reviews recent changes in the monetary systems of the seven communist countries in Eastern Europe and the steps taken toward greater reliance on financial incentives. ($1.25 per copy; 65 cents per copy to educational institutions)

6. **MONEY: MASTER OR SERVANT?** (1966) by Thomas O. Waage. 48 pages. Explains the role of money and the Federal Reserve in the economy. Intended for students of economics and banking. (First 100 copies free; 13 cents for each additional copy*)

7. **OPEN MARKET OPERATIONS** (1969) by Paul Meek. 48 pages. A basic explanation of how the Federal Reserve uses purchases and sales of Government securities to influence the cost and availability of money and credit. Recent monetary actions are discussed. Intended for college students. (First 100 copies free; 10 cents for each additional copy*)

8. **THE NEW YORK FOREIGN EXCHANGE MARKET** (1965) by Alan R. Holmes and Francis H. Schott. 64 pages. Describes the organization and instruments of the foreign exchange market, the techniques of exchange trading, and the relationship between spot and forward rates. (50 cents per copy)

9. **THE STORY OF CHECKS** (1966) 20 pages. An illustrated description of the origin and development of checks and the growth and automation of check collection. Primarily for secondary schools but useful as a primer on check collection. (First 100 copies free; 4 cents for each additional copy*)

10. **THE BALANCE OF PAYMENTS** (1968) 6 pages. Discusses the dominant role of the dollar in world trade and investments and the ABC's of the United States balance of payments in nontechnical language. ($3 per 100 copies in excess of 100*)

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