

FEDERAL RESERVE BANK OF NEW YORK



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Treasury and Federal Reserve Foreign Exchange Operations *

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The foreign exchange markets had a lot to contend with during the past six months. The root difficulties were the continuation of serious imbalances in international trade and payments, notably the German and Japanese trade surpluses, the French deficit, and abnormally heavy short-term capital flows from Europe to the United States via the Euro-dollar market.

During most of the period, speculative activity was tempered by the high cost of borrowing in the Euro-dollar market. In focusing as it generally does on short-term risks, the exchange market was also inclined to the view that no parity changes in either the French franc or the German mark were politically feasible before the French and German elections. In early May, however, this speculative timetable was suddenly disrupted as reports spread like wild fire that the German government might be prepared to consider a revaluation of the mark in the context of a multilateral realignment of parities. Highly charged market expectations of eventual parity changes exploded in a burst of speculation in favor of the mark and against a broad range of other currencies. In ten days, the flow of funds into the German Federal Bank amounted to \$4.1 billion, with \$2.5 billion flooding into Germany on Thursday and Friday, May 8 and 9. A substantial share of this massive flow into Germany apparently resulted from hedging and related operations by United States corporations, with consequent gross exaggeration of the United States liquidity deficit in the second quarter of 1969. Various European countries were even more se-

verely affected: reserve losses approximating \$1.9 billion were suffered by ten different European countries during the speculative crisis. On May 9 a German government communiqué flatly rejecting revaluation broke the speculative wave, and the exchange markets settled back to orderly trading as money flowed out from Germany into foreign markets through midsummer. The reflux of funds from Germany was accentuated by the strong pull of high Euro-dollar rates.

During the spring and early summer of 1969, the Euro-dollar market was subject to unprecedented credit demands, generated in large part by the effects of increasing monetary restraint in the United States. As United States commercial banks borrowed heavily in the Euro-dollar market through their overseas branches, Euro-dollar rates moved steadily upward through mid-June, reaching historic highs and strongly attracting funds from foreign financial centers. In response to these developments, a number of European countries took steps to protect their domestic money markets and international reserves from Euro-dollar pressures, and in the summer months the Board of Governors of the Federal Reserve System issued amendments to its regulations in order to reduce the attractiveness of Euro-dollars to United States banks. Euro-dollar rates declined substantially throughout July and early August, as the supply of dollars continuously generated by the United States liquidity deficit was augmented by further dollar outflows from Germany.

On August 8, the long ordeal of the French franc since the events of May 1968 came to an end as the French government, in a cleanly executed maneuver, devalued the French franc by 11.1 percent. Although the Belgian franc and, to some extent, sterling experienced some backwash from the French move, other currencies were relatively unaffected as it became clear that the new franc rate could be readily accommodated within the international structure of currency parities.

* This report, covering the period March 1969 to September 1969, is the fifteenth in a series of reports by the Senior 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 Federal Reserve System in the conduct of foreign exchange operations.

During the six-month period under review, most of the pressures on central bank reserves generated by trade imbalances, capital flows in response to interest rate differentials, and speculative disturbances were more or less fully financed by the Federal Reserve swap network (see Table I), associated international short-term credit facilities, and large-scale recycling arrangements. Reflecting the continuation of a very substantial United States surplus on official settlements account, however, swap drawings by the Federal Reserve during the period were limited to \$40 million on the Netherlands Bank and \$100 million on the Swiss National Bank. Each of these drawings was fully repaid during the period under review and, in early September, no swap drawings by the Federal Reserve were outstanding (see Table II). In contrast, six European central banks plus the Bank for International Settlements (BIS) had occasion to draw on the Federal Reserve during the period. Such foreign drawings totaled \$1.3 billion as of the end of August (see Table III). Since the inception of the swap network in March 1962, total drawings on the

swap lines by the Federal Reserve and its partner foreign central banks have amounted to \$19.5 billion.

Bank of England drawings of \$1,150 million outstanding at the end of 1968 were reduced somewhat during the early months of the year, but rose to a peak of \$1,415 million during the crisis created by the speculative rush into German marks in early May. Subsequently, the Bank of England made additional repayments, and as of the end of August the swap debt outstanding was \$975 million.

Bank of France drawings on the swap line, which had risen to a peak of \$611 million in November 1968, were reduced to a balance of \$306 million in early March, but rose to \$461 million by the end of the month. Pressures on the French franc during the May crisis were financed by drawing on the \$200 million credit provided by the United States Treasury under the Bonn credit package of November 1968 and on other foreign central banks. Before the end of June the Bank of France repaid the entire \$461 million outstanding under the Federal Reserve swap line. No new drawings were made subsequently, and the entire \$1 billion swap line to the Bank of France with the Federal Reserve currently remains available to the Bank of France on a standby basis.

The National Bank of Denmark repaid in mid-March the \$25 million then outstanding under its Federal Reserve swap facility, but in April reactivated the line, drawing \$50 million to replenish reserves lost through Euro-dollar market pressures. During the mark crisis in May the National Bank had to draw another \$50 million. With the \$100 million Federal Reserve swap line thus exhausted, the United States Treasury reinforced the Danish defenses by providing a special credit facility of \$50 million. During June, an inflow of funds to Denmark enabled the National Bank to repay the \$100 million to the Federal Reserve, restoring the Federal Reserve credit line to a fully available standby basis, while the Treasury credit of \$50 million also remains entirely available.

The Austrian National Bank made its first drawing on the swap line in the amount of \$50 million to replenish reserves lost in the mark crisis early in May. This drawing was fully repaid in August.

The Netherlands Bank suffered reserve drains late in the second quarter as a result of the strong pull of the Euro-dollar market, and drew on the Federal Reserve swap line during June and July for a total of \$192 million. Defensive measures by the Netherlands Bank, including a discount rate increase, subsequently reversed the flow of funds and enabled the Netherlands Bank to reduce its swap debt outstanding to \$109.7 million by late August.

The National Bank of Belgium also experienced reserve pressures originating in the Euro-dollar market early in

Table I

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

September 10, 1969

In millions of dollars

Institution	Amount of facility
Austrian National Bank.....	100
National Bank of Belgium.....	500*
Bank of Canada.....	1,000
National Bank of Denmark.....	100
Bank of England.....	2,000
Bank of France.....	1,000
German Federal Bank.....	1,000
Bank of Italy.....	1,000
Bank of Japan.....	1,000
Bank of Mexico.....	130
Netherlands Bank.....	300†
Bank of Norway.....	100
Bank of Sweden.....	250
Swiss National Bank.....	600
Bank for International Settlements:	
Swiss francs-dollars.....	600
Other authorized European currencies-dollars.....	1,000
Total	10,680

* The facility with the National Bank of Belgium was increased by \$75 million effective May 15, 1969 and by \$200 million effective September 2, 1969.

† The facility with the Netherlands Bank was reduced by \$100 million effective May 15, 1969.

Table II
FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS
UNDER ITS RECIPROCAL CREDIT ARRANGEMENTS
 In millions of dollars equivalent

Transactions with	System swap drawings on January 1, 1969	Drawings (+) or repayments (—)			System swap drawings on September 10, 1969
		1969			
		I	II	July 1-September 10	
German Federal Bank	112.1	--112.1			
Netherlands Bank.....		+ 40.0	— 40.0		
Swiss National Bank....	320.0	—280.0	+100.0 — 45.0	—95.0	
Total.....	432.1	—352.1	+ 15.0	—95.0	-0-

the year, raising its outstanding drawings on the Federal Reserve swap line to \$40.5 million by the end of January. After effecting partial repayments during the rest of the first quarter, the National Bank found it necessary to increase its swap drawings to \$175.5 million during the mark crisis in May but was able to bring down the total of this debt to \$114 million as of the end of June. In July, Belgium used funds available from the International Monetary Fund (IMF) to finance a complete repayment of outstanding debt to the Federal Reserve, and the swap line reverted to a fully available standby basis. Sudden pressures on the Belgian franc developed in the wake of the French devaluation, however, and in mid-August the National Bank made new drawings totaling \$244 million. By the end of August, \$20 million had been repaid, leaving a debtor balance of \$224 million.

Finally, relatively minor drawings on its swap line were made by the BIS to finance brief imbalances in cash flows. In contrast to earlier years, the BIS did not draw on the swap line to finance intervention in the Euro-dollar market during the June window-dressing period, since it was judged that the pressures then impinging on the Euro-dollar market originated in fundamental economic policy matters rather than seasonal strains or speculation.

As shown in Table I, during the period under review the Federal Reserve swap line with the Netherlands Bank was reduced from \$400 million to \$300 million on May 15, 1969, while the swap line with the National Bank of Belgium was simultaneously increased from \$225 million to \$300 million. On September 2, the Belgian swap line was further increased to \$500 million, thereby enlarging the overall network to \$10,680 million.

No operations in forward markets were undertaken by

either the Federal Reserve or Treasury during the period under review.

Since the beginning of 1969, the outstanding total of United States Treasury securities denominated in foreign currencies has declined slightly, to \$2,220.1 million as of September 10 (see Table IV). In February and May the Treasury repaid at maturity a total of \$99.9 million equivalent of mark-denominated securities held by the German Federal Bank. In April, however, in connection with earlier agreements relating to United States military expenditures in Germany, the Treasury issued to the German Federal Bank a medium-term security for \$124.3 million equivalent of marks. This was the last of eight quarterly issues, and no further securities issues are contemplated under the new two-year offset agreement signed in July. In order to refinance Federal Reserve swap obligations to the Swiss National Bank, the Treasury issued a \$49.7 million Swiss franc-denominated security to the BIS and a total of \$94.9 million of such securities to the Swiss National Bank. In July, the Treasury repaid at maturity \$53.2 million of a \$152.6 million equivalent Swiss franc security held by the BIS while renewing the remainder. In addition, the Treasury redeemed a \$25.2 million note denominated in Austrian schillings in July, and in August redeemed a \$100.2 million note denominated in Italian lire; both repayments were in advance of maturity.

GERMAN MARK

Throughout 1968 there were recurrent rumors of imminent revaluation of the mark as Germany continued to show a very large surplus in its balance of payments on current account. Although the current account surplus was offset by an equally substantial capital outflow, the markets remained apprehensive that the outflow could not be sustained and that German competitive strength eventually would force a mark revaluation. These fears culminated in a huge rush of funds into Germany in November 1968, but speculation receded in the face of the determined refusal by the German government to revalue the mark. Reversal of the massive influx of funds took some time, but by early 1969 German monetary reserves were back to their pre-November level and the volume of outstanding market swap commitments of the German Federal Bank had been significantly reduced. Moreover, by late January the Federal Reserve had acquired sufficient marks to repay in full its \$112.1 million equivalent of swap drawings on the German Federal Bank.

During the first quarter of 1969 the flow of funds from Germany continued unabated, as the authorities pursued a policy of monetary ease at a time when Euro-dollar

rates were rising sharply. In addition to the substantial flow into the short-term Euro-dollar market, long-term capital exports rose to record levels as foreign borrowers flooded the German capital market with loan demands and securities issues in response to the relatively low borrowing costs in Germany. With the mark consequently trading below par (see Chart I), the Federal Reserve and Treasury purchased marks to add to balances throughout the quarter.

Such capital outflows from Germany more than offset the current account surplus and by mid-March had contributed to a tightening of the German money market and the first signs of indigestion in the capital market. At the same time, with domestic credit demand intensifying, German monetary policy shifted toward somewhat less ease. In order to prevent too rapid a tightening of domestic liquidity, however, the Federal Bank raised its market swap rate, thereby reducing the incentive for banks to make covered placements abroad.

By early April, congestion in the capital market was becoming severe and the West German Capital Committee acted to space out issuance of securities by foreign borrowers. With capital outflows dropping sharply, the steady decline in German reserves came to an end. Moreover, the gradual shift in official policy toward restraint aroused

concern that reliance on monetary means to curb inflationary pressures might result in reflows of funds to Germany and consequent renewed buying pressure on the mark. The 1 percentage point jump to 4 percent in the Federal Bank's discount rate on April 18 (see Chart II) pointed up this potential dilemma inherent in official efforts to avert domestic inflation while avoiding internationally disruptive shifts of funds into Germany.

Against this background, the market grew increasingly apprehensive at the approach of the April 27 referendum in France, fearing that a defeat for President de Gaulle and his resignation from office might lead to new speculation on changes in currency parities. Demand for marks rose sharply, and on April 22 the Federal Bank began purchasing dollars. The bank immediately resumed swap operations, pushing the dollars back into the market. The news of the referendum defeat for President de Gaulle touched off substantially heavier demand for marks on April 28, but the authorities permitted the spot rate to rise steeply and this helped dissipate the buying pressure. Meanwhile, it soon became clear that the transfer of power in France following President de Gaulle's resignation would be orderly and that a franc devaluation by the interim government was unlikely. Consequently, demand for

Table III
DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS
AND THE BANK FOR INTERNATIONAL SETTLEMENTS
UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Banks drawing on Federal Reserve System	Drawings on Federal Reserve System on January 1, 1969	1969		Drawings on Federal Reserve System on June 30, 1969	Drawings on Federal Reserve System on August 31, 1969
		I	II		
Austrian National Bank			+50	50.0	
National Bank of Belgium	7.5	{+ 74.0 {- 58.5	{+195 {-104	114.0	224.0
National Bank of Denmark		{+ 25 {- 25	{+100 {-100	0	
Bank of England	1,150.0	- 50	{+465 {-540	1,025.0	975.0
Bank of France	430.0	{+225 {-194	-461	0	
Netherlands Bank			+ 82.2	82.2	109.7
Bank for International Settlements (against German marks) ..	80.0	{+ 51 {-131	{+ 25 {- 25	0	
Total	1,667.5	- 83.5	-312.8	1,271.2	1,308.7

marks began to taper off, and the Federal Bank succeeded in rechanneling to the international money markets most of the \$500 million taken in during this period.

The market atmosphere changed dramatically overnight, however, following reports that German official circles might be willing to consider a mark revaluation as part of a multilateral realignment of parities. Demand for marks soared as firms with commitments in marks rushed to hedge them, commercial payments leads and lags began to swing heavily in favor of the mark, and outright speculation began again. Between April 30 and Friday, May 2, the Federal Bank purchased over \$850 million.

Speculative pressures built up on an even more massive scale during the following week. On May 7 the Federal Bank suspended its swap operations as it became clear that the spot dollar proceeds of the swaps were being used to finance speculative purchases of marks rather than covered investments abroad, as requested by the authorities. Frenzied speculation induced huge shifts of funds to Germany, exerting strong pressure on the Euro-dollar market and dangerously straining the international reserves of some of Germany's trading partners. On May 8, in view of the unprecedented speculative excesses, the German Federal Bank decided to limit the amount of marks it would supply in markets outside Germany. Consequently, the Federal Bank placed a fixed amount on its support order through the Federal Reserve Bank of New York. When heavy demand for marks spilled over into the New York market, the United States Treasury made available \$114 million of marks for sale through the Federal Reserve Bank of New York. These marks, plus those provided by the German Federal Bank, made it possible to hold the rate at its ceiling through most of the trading day in New York; at about 3:30 p.m. the supply was exhausted, and in the closing hours of dealing the mark traded up to 26 cents.

The following day—Friday, May 9—was even more turbulent, with transactions in marks taking place outside Germany at rates as high as \$0.2550 even while the German Federal Bank continued to sell marks in its market at \$0.2517½. The speculation did not halt until the German government announced late on that day that it would not revalue the mark and that supporting measures would be announced in a few days. By then the exchange markets had witnessed the heaviest flow in international financial history. The speculative onslaught between the end of April and May 9 increased German monetary reserves by some \$4.1 billion—including \$2.5 billion on May 8 and 9 alone—to a record level of \$12.4 billion.

The exchange markets began returning to normal on the Monday following the German government's decision,

which was backed up by an official communiqué from Basle declaring that agreement had been reached among the central banks on steps to recycle the speculative flows. The unwinding of speculative positions brought a sharp fall in the mark rate and the Federal Bank began to sell dollars on a large scale.

On May 13 the German authorities announced new measures to be submitted to parliament, including: (1) authority for the German Federal Bank to impose higher minimum reserve requirements on all foreign-owned mark deposits in German banks and (2) extension beyond the March 31, 1970 expiration date of the tax adjustments introduced in late 1968 effectively to raise export prices and lower import costs.

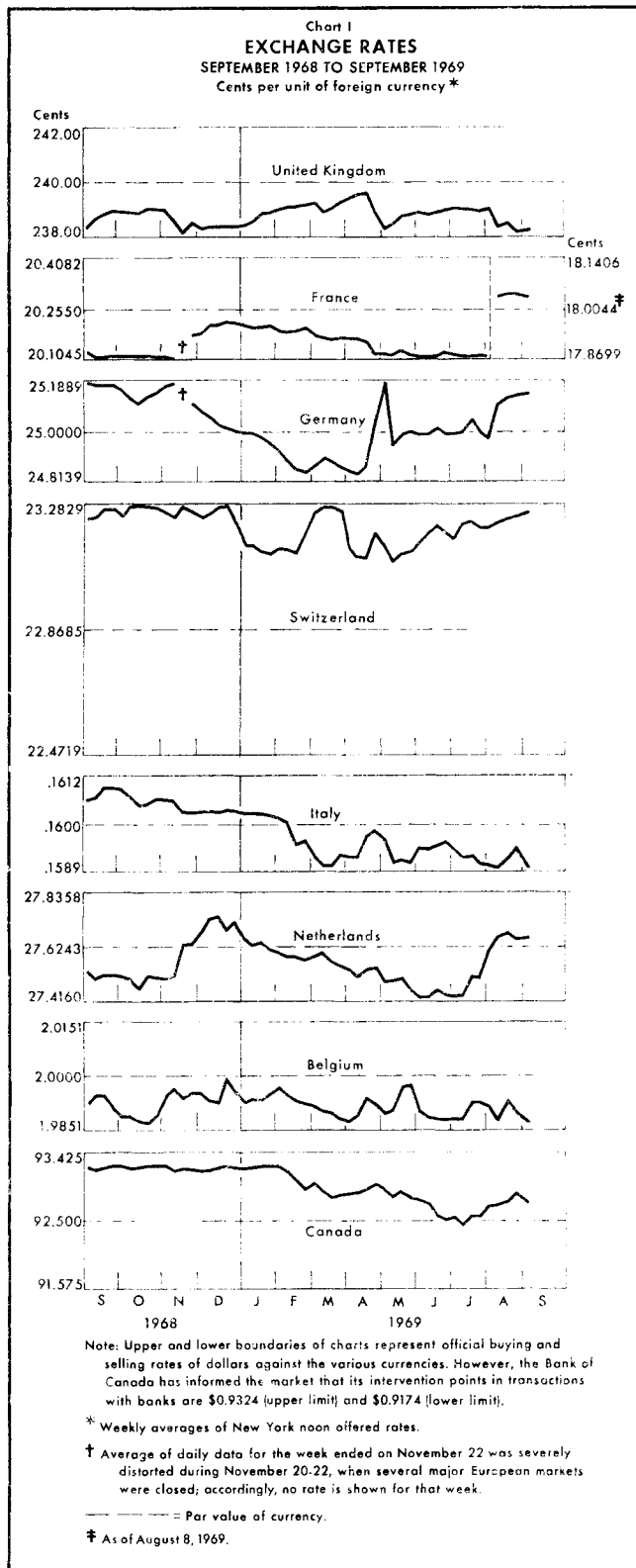
Thereafter, there was a large outflow of funds from Germany that continued through early June, as Euro-dollar rates moved higher and as the Federal Bank resumed swap operations. A tightening of liquidity conditions in Germany around the mid-June tax date brought a temporary hiatus in the outflow, but despite a further increase in the Federal Bank's discount rate to 5 percent the flow resumed toward the month end and continued into early July. By then nearly \$3 billion had returned to the international markets.

In subsequent weeks the market began to show signs of nervousness once again, with the growing pre-election debate among German political figures keeping the issue of revaluation of the mark in the foreground. Thus, when the German Federal Bank moved to tighten monetary policy further by raising the minimum reserve requirements of commercial banks toward the end of July, there was a brief flare-up of demand for marks. This scare passed quickly, however, and the outflow of funds resumed.

The devaluation of the French franc on August 8 introduced new uncertainties and triggered a fresh rush of demand for marks. The Federal Bank once again purchased dollars, but the buying pressures were not sustained and the authorities were able to swap back to the market a substantial part of the inflow. The mark remained firm into early September in relatively light trading, and there was no further official intervention in the spot market. With funds beginning to come into the reserves as a result of maturing market swaps, however, the Federal Bank progressively reduced its swap rate in order to encourage banks to renew these transactions.

STERLING

The unwinding of the speculative excesses of November 1968 brought an improvement in sterling rates, but the exchange markets continued to take a very cautious



view of the future. Progress in reducing the United Kingdom trade deficit was slow and uneven during the winter months, and sporadic labor difficulties, tensions in the Mideast, and rising interest rates abroad tended further to delay the return of confidence. The first quarter of the year, however, is generally favorable to sterling because of seasonal strength in the export trade of the overseas sterling area (OSA). Since most of the official sterling holdings of those countries are now guaranteed under the terms of the September 1968 arrangements, OSA countries were encouraged to retain rather than convert their sterling balances, thus strengthening the net demand for sterling in the markets. Moreover, with the London money market under tight official rein, foreigners tended to buy rather than borrow sterling. In these circumstances, sterling was firm and the Bank of England was able to make substantial dollar gains.

The British authorities used the dollar inflow to meet repayment obligations to the IMF and to begin repaying outstanding shorter term indebtedness. By the end of March, the Bank of England had reduced its drawings from the Federal Reserve by \$50 million to \$1,100 million. In addition, the bank liquidated part of the credits drawn under the 1968 sterling balances arrangement.

Sterling remained seasonally strong in early April, and the Bank of England was able to make a further repayment of \$150 million to the Federal Reserve. As the month wore on, however, the seasonal strength began to fade and in midmonth the latest United Kingdom trade figures showed a smaller improvement than the market had expected, with imports remaining high. In this setting, the United Kingdom government's new budget stirred little market enthusiasm, despite general satisfaction with the much tighter stance of fiscal policy in evidence. To bolster the austerity program, the United Kingdom authorities provided for substantially increased taxes and an overall surplus of more than £800 million for fiscal 1969-70.

Sterling was also adversely affected in late April by developments abroad. Euro-dollar rates had advanced to relatively high levels in March, and pressures in that market were intensified in April when the Federal Reserve Banks raised their discount rates and several continental European central banks followed suit. Moreover, in a number of countries, steps were taken to curtail capital outflows or to induce repatriations of funds. Throughout this period, there was no incentive to move covered funds into London and, indeed, there was little net incentive for users of sterling to build their balances above minimum levels.

In these circumstances, sterling was vulnerable to the uncertainties generated by President de Gaulle's decision

to stake his presidency on the outcome of the April 27 constitutional referendum. Sterling weakened as the voting date approached, but there was no large-scale selling and official support costs were modest. The rate dropped sharply following the referendum and President de Gaulle's resignation, but demands for sterling for month-end payments absorbed most of the immediate selling pressure.

Just as the market was beginning to regain its equilibrium, a new wave of speculation on possible parity realignments was unleashed by reports of German official willingness to consider revaluing the mark as part of a broader readjustment of parities. As funds flowed from virtually every major center into Germany, sterling was particularly hard hit, with the familiar buildup of selling pressure in advance of the weekends. Over the ten days that it took the speculation to run its course, Bank of England support costs in the spot market were very large, while forward sterling discounts widened sharply.

This episode, of course, interrupted the progress the United Kingdom authorities had been making in reducing their external indebtedness, as the Bank of England had to draw on the swap line with the Federal Reserve to help cover market losses. At their peak, swap drawings reached \$1,415 million, but sterling had been very heavily oversold and rebounded sharply following the German government's rejection of a revaluation of the mark on May 9. During the remainder of May and through June the Bank of England was able to make sizable reserve gains, despite the further upsurge of interest rates in the Euro-dollar market.

The reserve gains once again were used to make repayments of debt under various international credit lines. By the end of June the Bank of England had succeeded in reducing its outstanding drawings from the Federal Reserve to \$1,025 million, \$75 million below the end-of-March level. In addition, during May and June the United Kingdom made a large scheduled repayment to the IMF and liquidated the bulk of the credit still outstanding under the 1968 sterling balances arrangement. On the other hand, the Bank of England obtained new credit from the German Federal Bank under a recycling arrangement designed to neutralize part of the speculative flow from the United Kingdom into Germany, and drew \$500 million from the IMF under a new standby facility. On balance, the British authorities succeeded in making sizable net repayments of debts during the second quarter, and indeed recently released monetary data indicate that in the second quarter the underlying United Kingdom balance of payments was in substantial surplus.

A generally quieter atmosphere prevailed in July, and the Bank of England further reduced its drawings on the

Federal Reserve. The basic situation was still of concern to the market, however, as the trade figures failed to show the expected gains and hostilities in the Mideast intensified. Thus sterling was vulnerable to the uncertainties resulting from the devaluation of the French franc on August 8. The spot sterling rate dropped sharply, and pressures became substantial on August 13 with the release of figures showing an enlarged British trade deficit. But once again, more sterling had been sold than the market could deliver, and in subsequent days speculators paid high prices to cover short sales. At the end of August, Bank of England drawings on the Federal Reserve swap arrangement stood at \$975 million. By then the market had calmed, although the spot rate remained near its floor and forward discounts continued wide.

FRENCH FRANC

The French franc had come under heavy speculative attack during the massive rush for German marks in November 1968, and the Bank of France had sustained large reserve losses in support of the franc at its floor. In the aftermath of that assault, the French government had bolstered its defenses with anti-inflationary measures, \$2 billion in new international credits, and reimposition of exchange controls. Late in 1968 and early in 1969 the exchange controls were tightened to require French commercial and banking interests to surrender substantial amounts of foreign exchange to the Bank of France. The French authorities used these exchange inflows partly to cover the large current deficit in the French balance of payments, but also to reduce their outstanding indebtedness under short-term international credits. Thus, by early March the Bank of France had cut its swap drawings from the Federal Reserve to \$306 million from the November peak of \$611 million and had repaid credits drawn from other EEC (European Economic Community) countries and the BIS.

As these induced reserve inflows tapered off, however, the current account deficit again began to drain French official reserves. Apart from the weakening reserve position, a number of background factors were cause for continuing concern. Inflationary pressures were still in evidence, and large unresolved wage demands were a potential threat to the international competitive position of the franc. At the same time, recalling the November Bonn conference, the market remained fearful of a possible currency realignment involving both the German mark and the French franc. These uncertainties kept the franc market off balance and, in spite of tight exchange controls, the franc remained in an exposed position.

New fears of devaluation emerged on March 6 when

the French trade union leadership dramatized its wage claims by calling a general strike for March 11. The strike call triggered the heaviest burst of selling since November 1968. The devaluation scare receded almost as quickly as it had arisen, however, when the general strike was orderly and, as scheduled, lasted only one day. Although it appeared that the unions were not yet prepared to force the issue on wage claims that far exceeded the official guidelines, uncertainties persisted through the end of March and the official reserves were subject to further erosion. Accordingly, the Bank of France made new drawings on the Federal Reserve swap line, raising its swap obligations to \$461 million by the end of March, and sold \$50 million of gold to the United States Treasury.

Early April brought a brief respite from pressure and the Bank of France was able to repay \$25 million of its swap drawings from the Federal Reserve, but selling of francs soon resumed before the Easter holidays. Near the middle of April a new element of doubt suddenly was injected into the situation by President de Gaulle's decision to stake his political future on a favorable vote in a constitutional referendum on April 27. At the same time, news of a large trade deficit in March underscored the difficulties involved in restoring the franc to a position of strength. Market tensions increased with the approach of the referendum date. The Bank of France met the pressure in both the Paris and New York markets, at heavy cost to its reserves.

As was to be expected, the news of President de Gaulle's referendum defeat and immediate resignation from office generated still heavier selling pressure on April 28. The selling soon began to fade, however, as it became clear that France's calm response to President de Gaulle's withdrawal from office presaged an orderly transfer of governmental authority. Moreover, the market quickly concluded that no official decision on the franc parity was likely before the formation of a new government in June.

Just as the uncertainties in the franc market were receding, speculation on a possible revaluation of the German mark and adjustments in other currency parities burst upon the markets. Demand for German marks swept through exchange centers all over the world and the franc again came under heavy pressure, as the speculative wave rose to a crest on May 9. Forward franc rates declined precipitously, with three-month contracts quoted at discounts as wide as 32 percent per annum before the forward market temporarily dried up completely. The speculative fever showed no sign of abating until the German government announced late Friday, May 9, that it would not revalue the mark. That announcement relieved the immediate pressure in the exchange markets, and on the fol-

lowing Monday, as the spot franc moved up from its floor in response to market covering of speculative short sales of francs, the Bank of France began to recoup some of its losses.

Although the latter part of May was a quieter period for the franc, the impending Presidential elections, scheduled for June 1 and June 15, aroused renewed uneasiness. Mr. Georges Pompidou's impressive victory in the elections was seen by the market as assuring the continuity of stable government in France, but there remained an overriding concern for the viability of the parity. Sharply rising Euro-dollar rates also aggravated strain on the franc. On June 13 the Bank of France countered some of the pull from the Euro-dollar market and reinforced its anti-inflation program by raising its discount rate a full percentage point to 7 percent. Even so, during June the franc required further sizable official support.

In view of the heavy strain on the official reserves, the Bank of France made substantial drawings on its credit lines during the second quarter of 1969. The bank drew heavily on international assistance available under the November 1968 package, including the full \$200 million provided by the United States Treasury. France also sold \$275 million of gold to the United States Treasury in the second quarter. In order to avoid an undue prolongation of credits outstanding under the Federal Reserve swaps, the Bank of France used part of the proceeds of these gold sales, and some of the new drawings on the November 1968 credits, to liquidate its obligation to the System. During the second quarter the Bank of France repaid the total of \$461 million outstanding on the swap line, so that the \$1 billion facility was restored to a fully available standby basis.

The underlying situation remained unchanged as the summer progressed. Although the exchange market received favorably the new cabinet appointments of President Pompidou, and the vacation period contributed to quieter markets, the franc remained weak. Faced with a continuing attrition of official reserves, the French government announced on August 8 that it had decided to devalue the franc, rather than impose too severe a deflation on the French economy. The 11.1 percent devaluation, to a new parity of \$0.180044, had been discussed at the Group of Ten meeting of Finance Ministers in November 1968 at Bonn and was judged to be within the limits that could be accommodated by the existing framework of exchange rates.

Explaining the reasons for the devaluation, the French Minister of Finance and Economic Affairs, Giscard d'Estaing, noted that French reserve losses had averaged \$500 million a month in the second half of 1968 and

\$300 million a month in the first half of 1969. Thus, France was faced with the prospect of seeing its reserves dwindle to practically nothing by the end of the year. Moreover, he said, further defense of the former par value against international speculation would have left the franc overvalued, weakening French competitiveness in world markets. The Minister made clear that devaluation would be backed up by credit restrictions, continuation of exchange controls, and a tightening of France's economic policy to produce a balanced budget in 1970. For the rest of the month of August the franc held firmly above its new par and the Bank of France began to accumulate dollars as a steady reflow of funds to France developed.

At the end of August the French government announced that it had \$1.6 billion of international credits available and was applying to the IMF for a facility of \$985 million. As promised, in early September the authorities strengthened their austerity program with further curbs on consumer credit, measures to encourage savings, and substantial cuts in public spending. A temporary price freeze imposed immediately after devaluation will be replaced by strict official surveillance of domestic prices. Minister Giscard d'Estaing declared that the new measures were designed to bring the French trade balance into equilibrium by July 1, 1970.

BELGIAN FRANC

The Belgian franc was weak during the first quarter of 1969, largely as a result of capital outflows to the Euro-dollar market. Early in the year the Belgian National Bank provided occasional support to the market and drew a net of \$33 million on the swap facility with the Federal Reserve to help cover market losses, thereby raising its outstanding swap indebtedness to \$40.5 million. A temporary easing of market pressures in February enabled the Belgian authorities to repay \$27.5 million of these drawings, but by the end of March they again had to provide support to the franc as the outflow of funds accelerated. On March 31 the National Bank's drawings on the Federal Reserve stood at \$23 million.

With little prospect that the demand for funds in the Euro-dollar market would soon abate and with domestic credit expanding at an excessive rate, the Belgian National Bank raised its discount rate to 5½ percent on April 10, the second ½ percentage point increase in a month. To further relieve pressures on the franc rate, the authorities reinforced this measure by instructing the Belgian banks to repatriate a portion of their net foreign exchange assets in several stages by the end of June. These measures were followed by an immediate firming of the franc, and by

Table IV
OUTSTANDING UNITED STATES TREASURY SECURITIES
FOREIGN CURRENCY SERIES

In millions of dollars equivalent

Issued to	Amount outstanding on January 1, 1969	Issues or redemptions (—)			Amount outstanding on September 10, 1969
		1969			
		I	II	July 1-September 10	
Austrian National Bank.....	50.3			— 25.2	25.1
German Federal Bank.....	1,176.3	—50.0*	{ 124.3 —49.9		1,199.7
German banks.....	125.1				125.1
Bank of Italy.....	225.6			—100.2	125.4
Swiss National Bank.....	444.7	25.4	39.5	30.0	540.6
Bank for International Settlements†.....	207.7	49.7		— 53.2	204.1
Total.....	2,229.7	25.2	113.8	—148.6	2,220.1

Note: Discrepancies in totals are due to valuation adjustments and roundings.

* In addition, on January 16, 1969 the United States Treasury issued a medium-term security in place of a certificate of indebtedness purchased by the German Federal Bank on December 27, 1968.

† Denominated in Swiss francs.

late April the rate had advanced to par.

But the strength was short lived, as the worldwide rush for marks in early May generated heavy sales of francs along with other currencies. The spot rate declined sharply, and the Belgian National Bank sold large amounts of dollars to support the spot franc at its floor. The National Bank covered the heavy losses by further drawings on the Federal Reserve swap line. Although pressures eased after the German government rejected a mark revaluation, there was no important immediate reflux of funds, and at mid-May the Belgian National Bank's outstanding obligations under the swap line stood at \$175.5 million. (During the month the swap facility was increased by \$75 million to \$300 million in order to restore the earlier parity between that line and the facility with the Netherlands Bank.)

Subsequently, as the exchanges calmed further, the Belgian franc began to strengthen. Although there were occasional moderate outflows to the Euro-dollar market through shifts of nonbank funds, the franc was reasonably well insulated from the heavy pressures in that market in May and June by the directive regarding the commercial banks' foreign asset positions. Moreover, on May 29, the Belgian National Bank raised its discount rate by a further ½ percentage point, to 6 percent. The National Bank was able to purchase sufficient exchange to reduce its outstanding swap obligation to the Federal Reserve by a net of \$61.5 million to \$114 million by the end of June.

The franc generally stayed firm in July as Euro-dollar rates eased and there was also a modest commercial demand for francs, but market conditions did not permit significant reserve gains by the National Bank. At the end of the month the authorities moved further to reinforce both the curbs on domestic monetary expansion and the efforts to reduce capital outflows. The Belgian National Bank raised its discount rate by a full percentage point to 7 percent and abolished its preferential discount rates for export credits extended by Belgian banks to countries outside the EEC. These preferential rates had tended to shift financing of other countries' trade to Belgian financial markets rather than to stimulate Belgian exports and consequently had added to the strain on the franc.

By this time the Belgians had been making use of the Federal Reserve swap facility to some extent for a period of ten consecutive months. In keeping with the principle that wherever possible the use of central bank credit should not be unduly prolonged, the Belgian authorities decided to utilize some of the resources previously accumulated by them with the IMF to repay the swap drawings. Consequently, the Belgians drew \$116.5 million from the IMF, representing the credit available to Belgium as a result of IMF use of Belgian francs under the General Arrangements to Borrow plus part of the Belgian gold tranche. The Belgian National Bank used nearly all the proceeds to liquidate completely its \$114 million swap obligation outstanding to the Federal Reserve. The \$300 million facility then reverted to a standby basis.

In the wake of the uncertainties created by the devaluation of the French franc on August 8, the Belgian franc came under renewed pressure. The spot rate dropped to its floor and, in the first week following the French move, the Belgian National Bank suffered substantial reserve losses. To replenish its reserves, the National Bank reactivated its swap line with the System, drawing \$244 million. With the passing of another weekend a calmer atmosphere emerged, and as the franc strengthened markedly the authorities began recouping some of the reserve loss. In late August, Belgium repaid \$20 million of the outstanding drawings, reducing the total to \$224 million. Then at the month end it was announced that the reciprocal credit facility with the Federal Reserve was being increased by \$200 million to \$500 million and that, in addition, the Belgian National Bank had obtained a \$100 million equivalent credit facility from the German Federal Bank.

DUTCH GUILDER

The international payments position of the Netherlands was about in balance on current account during early

1969, but the spot guilder rate fell below par as short-term funds flowed to the relatively high-yielding Euro-dollar market. At the beginning of March the Dutch money market tightened, and on March 6 the flare-up of currency fears surrounding the French franc and German mark brought an upswing in the guilder rate in sympathy with the mark. As Dutch funds were repatriated, the Netherlands Bank purchased dollars to slow the advance. On March 12 the Federal Reserve drew \$40 million of guilders from the Netherlands Bank and used the guilders to purchase an equivalent amount of dollars from that bank. This was the first Federal Reserve use of the swap line since April 1968.

The flurry of demand for guilders soon ended and the market calmed; with Euro-dollar investments remaining attractive, the spot guilder eased once again. Outflows of funds from the Netherlands were small, however, since the domestic money market was still tight. In early April, liquidity conditions in Amsterdam eased and short-term capital outflows increased. The Netherlands Bank sold dollars in support of the spot guilder rate, and then replenished its dollar balances by selling \$20 million equivalent of guilders to the Federal Reserve. The System used the guilders to reduce its outstanding swap drawings from the Netherlands Bank to \$20 million equivalent.

Although the pressure on the guilder mainly reflected the high interest rates in the Euro-dollar market, inflationary price increases in the Netherlands also began to threaten the guilder's underlying position. Accordingly, on April 8 the Dutch government imposed a price freeze, and the Netherlands Bank announced a $\frac{1}{2}$ percentage point increase in its discount rate to $5\frac{1}{2}$ percent, both to reinforce domestic anti-inflationary policies and to reduce the incentive to move Dutch funds abroad. Following these measures, the guilder market generally remained in equilibrium in the latter part of April, and the Netherlands Bank discouraged covered outflows through modest swap purchases of dollars against forward sales, thus widening the forward premium on the guilder. Near the end of April and in early May, however, the initial shock waves emanating from a new eruption of mark revaluation fears began to hit the guilder. On May 8 the spot rate dropped to its floor, and the Netherlands Bank provided support that day as the rush for marks reached major proportions. Following the German government's announcement on May 9 that the mark would not be revalued, speculative pressures lifted throughout the exchanges and the spot guilder moved up from its floor.

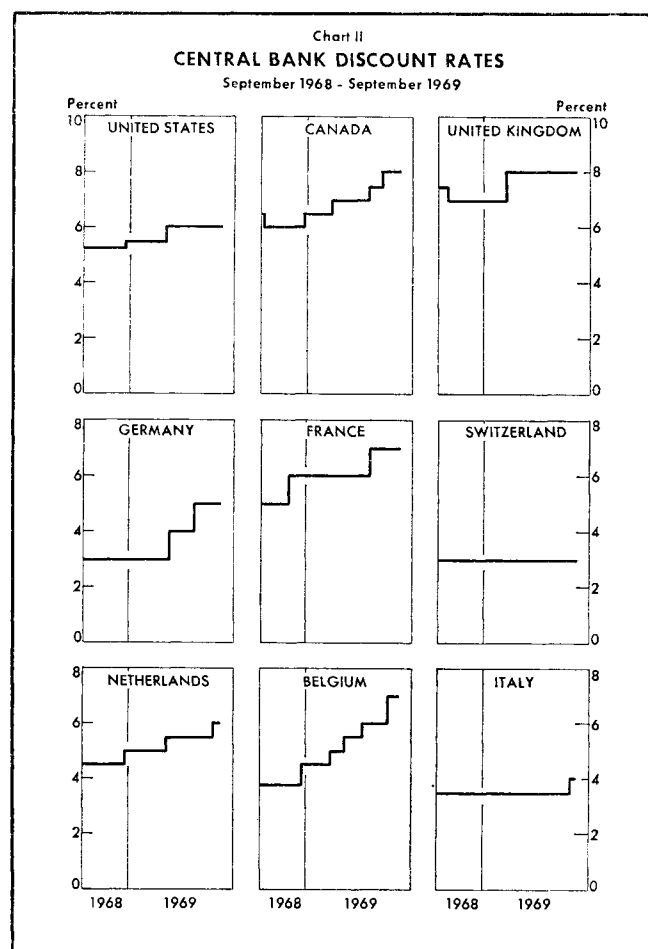
The support operation had reduced the dollar position of the Netherlands Bank which then replenished its holdings by selling the System \$20 million equivalent of

guilders. The System used the guilders to liquidate completely its outstanding swap drawing from the Netherlands Bank, and on May 12 the entire facility reverted to a standby basis. Meanwhile, consultations had been taking place among the Federal Reserve, the Netherlands Bank, and the National Bank of Belgium with a view to restoring the previous equality of the Federal Reserve swap lines with those two banks. On May 15, the System's swap facility with the Netherlands Bank was lowered by \$100 million to \$300 million while, as previously noted, the line with the National Bank of Belgium was increased from \$225 million to \$300 million.

Later in May the Netherlands Bank was able to purchase in the market a moderate amount of dollars on a swap basis. These transactions not only reduced the incentive to move funds abroad by increasing the premium on the forward guilder, but also relieved liquidity stringencies in the Amsterdam market.

Higher Euro-dollar rates brought renewed selling of guilders starting at the end of May. With Euro-guilder rates at relatively low levels, there was an incentive to borrow in guilders; as funds flowed out of the Netherlands through such transactions, the spot rate again declined to its floor during the early part of June. As a result, the Netherlands Bank was obliged to provide a substantial amount of support and by June 12 found it necessary to reactivate its swap facility with the System. Selling pressure on the guilder continued through June, and the Netherlands Bank drew further on the swap line to ease the drain on its reserves. At the end of June the bank's outstanding swap drawings on the Federal Reserve totaled \$82.2 million.

Accordingly, in early July the Dutch authorities took measures to prevent the pull of interest rates abroad from imposing a prolonged strain on local interest rates, domestic liquidity, and official reserves. After discussions with the Dutch commercial banks, the Netherlands Bank requested that they reduce their net foreign exchange positions by 10 percent during the last half of 1969. Nevertheless, the pressures continued and, with the guilder requiring further official support, the Netherlands Bank drew again on the swap facility. In the latter part of July the pressure on the spot guilder began to ease, as Euro-dollar rates dropped and Euro-guilder rates rose to levels that discouraged further shifts of liquidity into dollars. At the same time Dutch commercial banks began to repatriate funds in compliance with the earlier official request, thus adding to the demand for guilders. Consequently, the spot rate was firmer and the Netherlands Bank's support operations tapered off. The Netherlands Bank, however, delivered a sizable amount of dollars to the market



in connection with maturing forward contracts, and the bank drew further on the swap facility with the System to replenish its reserves. By the end of July, outstanding drawings by the Netherlands Bank on the Federal Reserve swap line had reached a total of \$192 million.

On August 1 the Netherlands Bank announced an increase in its discount rate by $\frac{1}{2}$ percentage point (to 6 percent) and in its other rates by 1 percentage point as an adjustment to the rise of domestic and foreign interest rates. Following these increases the spot guilder moved up sharply, as the higher interest rates in the Netherlands further discouraged outflows of funds. The spot guilder soon moved above par, and the Netherlands Bank began adding to its reserves. Later in the month the Netherlands Bank repaid \$82.2 million of drawings outstanding on the swap facility, thereby reducing the amount outstanding to \$109.7 million. During the remainder of August the market was quiet and the guilder was firm.

SWISS FRANC

In early 1969 the seasonal reflux of funds from Switzerland was accentuated by the pull of high interest rates in the Euro-dollar market. The Swiss franc rate declined and the Swiss National Bank sold a large amount of dollars, providing the Federal Reserve with the opportunity to purchase \$190 million of francs from the National Bank. The System used these francs, together with some in balances and additional francs obtained in nonmarket transactions (see this *Report*, March 1969, pages 52-53) to reduce its outstanding swap debt to the Swiss National Bank by \$280 million to \$40 million equivalent as of the end of February.

The flow of excess liquidity from Switzerland tapered off by early March, however, and the Swiss franc strengthened in response to a brief flare-up of currency uncertainties surrounding the French franc and German mark. The franc rate did not reach its official ceiling until late in the month, when the Swiss commercial banks began to repatriate funds to cover their usual quarter-end needs; with the rate at the ceiling the Swiss National Bank took in \$244 million. Despite the strong pull of Euro-dollar rates, there was little reflow of funds after the quarter end. In these circumstances a special transaction was required to liquidate the residual \$40 million obligation outstanding under the swap line. On April 29 the United States Treasury issued to the Swiss National Bank a fifteen-month Swiss franc-denominated note equivalent to \$39.5 million. The Treasury sold the francs to the System which used them, along with a small amount of francs in balances, to liquidate the obligation. On April 30, however, in view of the eruption of new uncertainties regarding currency parities, the Swiss National Bank requested the System to reactivate the swap line to provide cover for \$100 million of the funds that had come into its reserves at the end of the first quarter.

In early May, the rush for German marks began pulling funds from Switzerland and, as the franc rate declined, the Swiss National Bank sold a small amount of dollars. These pressures subsided when the German government rejected a revaluation of the mark, but the pull of the Euro-dollar market on Swiss franc funds grew stronger during the remainder of May. As the Swiss franc weakened, the Federal Reserve was able to accumulate a small amount of francs in market transactions and reduced its outstanding swap obligation by \$5 million equivalent to \$95 million on May 28.

Swiss banks added substantially to their Euro-dollar assets during June, offsetting the large Swiss balance-of-payments surplus on current account. At midyear, in par-

ticular, the heavy pull from the Euro-dollar market had a strong effect on Swiss banks' portfolio decisions, as the banks preferred to reduce their seasonal repatriation of funds rather than forego the high yields on Euro-dollar placements. Moreover, the Swiss National Bank, while again offering market swap facilities to bridge the quarter end, limited such facilities to no more than \$250 million. For the balance of their liquidity needs the Swiss banks rediscounted an unusually large volume of eligible paper with the central bank. Following past practice, the Swiss National Bank rechanneled to the Euro-dollar market the dollar proceeds of its market swap purchases of dollars, so that overall there was no drain on the Euro-dollar market from the midyear positioning of the Swiss banks.

Through July the Swiss franc market was quiet, and during the month the Federal Reserve liquidated completely its outstanding \$95 million swap drawing on the Swiss National Bank. The System acquired \$5 million of Swiss francs in the market and, against the background of generally calm exchange markets and some Swiss government need for dollars, purchased a total of \$60 million equivalent of francs directly from the Swiss National Bank. The remaining \$30 million of francs needed to repay the swap drawing was obtained from the United States Treasury, which had issued to the Swiss National Bank a Swiss franc-denominated certificate of indebtedness for the same amount. By July 17 the \$600 million facility reverted to a fully available standby basis.

On July 24 the Treasury purchased from the Swiss National Bank sufficient Swiss francs to liquidate \$53.2 million equivalent of a maturing \$152.6 million certificate of indebtedness held by the BIS; the balance of the certificate was rolled over.

Trading in Swiss francs remained quiet in August, with only a minimal reaction to the devaluation of the French franc. The spot rate continued very strong but held below the ceiling, and there was no need for official intervention.

ITALIAN LIRA

During the early months of 1969, the upward surge of interest rates in the Euro-dollar and Euro-bond markets resulted in heavy outflows of funds from Italy. Moreover, domestic political uncertainties spurred withdrawals of foreign and domestic funds, both through normal channels and through the export of Italian bank notes. Italian lire consequently were heavily offered in the foreign exchange markets, and the Bank of Italy provided substantial support for the lira while allowing the rate to drop sharply below par.

In view of the continued outflow from Italy during the

early spring, the Italian authorities took several steps to protect the official reserves and to alleviate the growing strain on Italian capital markets. Italian banks were asked to repatriate by midyear an amount of foreign exchange equivalent to their net foreign assets (then about \$800 million). Long-term investment flows abroad were restricted: (1) by temporarily suspending official permission for Italian banks to participate in underwriting consortia for foreign securities, except for those issued by institutions with large financial interests in Italy and (2) by subjecting Italian residents to strict regulations on purchases of investment fund shares and on other transactions involving capital transfers abroad. Along with these measures, the authorities moved to reduce excess domestic liquidity and to align Italian interest rates more closely with those abroad.

The cumulative impact of these measures brought the lira rate above par by late April, and the Bank of Italy purchased some dollars. The recovery ended, however, with the new eruption of mark revaluation fears. Italian residents joined the speculative rush for marks and also sold lire in order to cover the commitments in German marks, and to some extent in Swiss francs, that they had undertaken because of relatively low interest rates in Germany and Switzerland. The spot rate dropped to its official floor and the Bank of Italy provided substantial support through May 9.

Once the speculation in marks subsided, the lira market improved and during late spring and early summer there was some reflow from German marks. This reflow, combined with repatriations of funds by Italian banks acting under the official request to eliminate their net foreign asset positions, more than offset the further outflow of Italian capital via export of Italian currency. Effective July 1, the Bank of Italy reinforced its defensive measures by imposing a penalty rate of $1\frac{1}{2}$ points above its discount rate of $3\frac{1}{2}$ percent for banks making excessive use of central bank borrowing.

New uncertainties unsettled the lira market with the fall of the Italian government in early July. Despite the subsequent formation of a new government, a strong undercurrent of apprehension persisted. When the French franc was devalued, the spot rate dropped to its floor, and during the next few days of exchange market uncertainties lire were offered in heavy volume, with the Bank of Italy extending sizable support. On August 14 the Bank of Italy raised its discount rate to 4 percent, and as the speculative pressures subsided the lira firmed. It held well above the floor through the end of August.

In August the Italian authorities replenished their dollar balances by encashing prior to maturity a \$100.2 million

equivalent lira note issued by the United States Treasury to the Italian Exchange Office in late 1968 in conjunction with its understanding with Italy on the neutralization of United States military expenditures. During the period under review the United States Treasury reduced moderately its technical forward lira commitments which have arisen in connection with dollar-lira swaps extended by the Italian Exchange Office to its commercial banks. The remaining commitments have been rolled over periodically as they came due.

CANADIAN DOLLAR

Canada's trade position remained relatively strong in the first half of 1969—though the surplus was much lower than in 1968—and Canadian residents continued to borrow heavily in the United States capital market. As the year progressed, however, the Canadian dollar, like other major currencies, was increasingly affected by short-term capital outflows in response to the high and rising level of interest rates in the United States and in the Euro-dollar market.

One of the principal channels for these outflows was the growth of so-called "swapped deposits" with Canadian banks. In these transactions, deposits in Canadian funds are converted into United States dollars on a covered basis. Using the dollars thus obtained, Canadian banks acquired a substantial amount of short-term assets directly from United States banks in forms not subject to Regulation Q. Some of the United States dollar proceeds also were invested in the Euro-dollar market, although placements were limited by Canadian official directives issued in 1968 (in conjunction with Canada's exemption from all United States balance-of-payments programs) to prevent Canadian financial institutions from acting as a "pass-through" channel.

The pull of abnormally high yields on United States dollar instruments not subject to Regulation Q contributed to a sharp rise in outstanding swapped deposits during the spring and summer months. The large short-term outflows from Canada resulting from these transactions and other Canadian investments abroad was largely offset by a surplus on current and long-term capital accounts combined, and by a compensating short-term capital inflow from the United States. American investors, seeking outlets not subject to Regulation Q and discouraged by the United States balance-of-payments program from taking advantage of the high rates available in the Euro-dollar market, moved short-term funds to Canada. Such investments were attractive because the covered outflows from Canada generated equally heavy demand for Canadian dol-

lars in the forward market and, as a result, the forward rate moved out to a substantial premium. This premium increased the attraction of covered investments in Canada, where interest rates were rising, not only in line with the increase in rates abroad, but also as a result of the tightening in Canada's anti-inflation program. This tightening included a $\frac{1}{2}$ percentage point increase in the Bank of Canada's discount rate to $7\frac{1}{2}$ percent on June 11.

By early July, however, the spot Canadian dollar had dropped below par as a result of the overriding effect of short-term capital outflows. To restrain such short-term outflows, the Bank of Canada asked the Canadian banks to regard the existing level of their swapped deposits as a temporary ceiling and, effective July 16, announced a further $\frac{1}{2}$ percentage point increase in its discount rate to 8 percent. These measures curtailed the short-term capital outflow, and the spot rate quickly moved up above par where it held through August.

OPERATIONS IN OTHER CURRENCIES: DANISH KRONE AND AUSTRIAN SCHILLING

In January the Danish National Bank had drawn \$25 million on the swap facility with the Federal Reserve; this drawing was repaid in March. Subsequently, the Danish krone was brought under pressure by sharply higher interest rates abroad, as Danish commercial firms shifted part of their borrowings from international to domestic markets. The Danish National Bank suffered a sizable reserve drain in supporting the krone rate and, in the latter part of April, drew \$50 million under the \$100 million Federal Reserve swap arrangement. Even greater outflows from Denmark occurred as speculation on the mark developed in late April and early May. To bolster its reserves, the National Bank drew the remaining \$50 million under the Federal Reserve swap facility and drew \$45 million under the Danish gold tranche with the IMF. With the regular swap line with the Federal Reserve fully utilized, the United States Treasury provided a supplementary standby facility for \$50 million. Danish authorities also took several measures to stem the outflow, including a 2 percentage point increase in the discount rate to 9 percent. Thus reinforced, the krone firmed after the German government rejected revaluation, and in June the Danish National Bank was able to repay the full \$100 million of swap drawings on the Federal Reserve. During the summer the market was calm and, although the krone remained somewhat below par, it was not adversely affected by the devaluation of the French franc. At the end of August, the \$100 million Federal Reserve swap facility and that for \$50 million from the United States Treasury remained

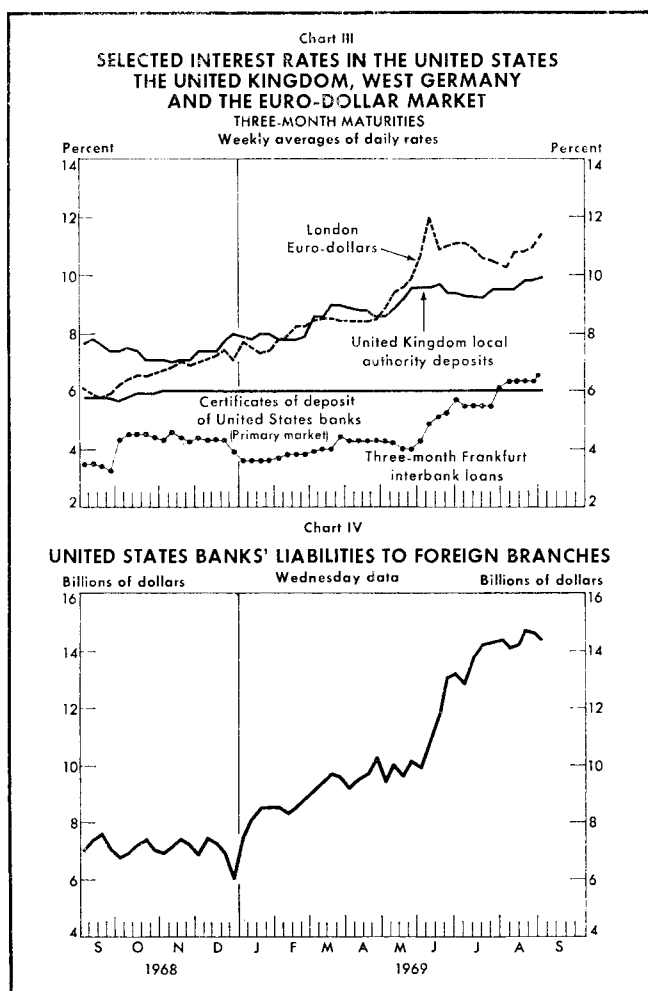
fully available.

The Austrian National Bank also lost reserves during the international rush into marks and in late May drew \$50 million under the Federal Reserve swap facility—its first drawing since the arrangement was established in 1962. During the summer tourist season the National Bank began to accumulate reserves, and in August it fully liquidated its \$50 million swap drawing. In early summer it was agreed that the Austrian National Bank would encash prior to maturity a \$25.2 million equivalent outstanding United States Treasury security denominated in Austrian schillings.

EURO-DOLLAR MARKET

During the spring and early summer of 1969, the Euro-dollar market was subject to unprecedented credit demands, generated in large part by the effects of increasing monetary restraint in the United States. Throughout this period, the large United States banks experienced sizable and sustained losses of time certificates of deposit (CD's), as the ceiling on bank time deposit rates under Regulation Q remained well below market rates on alternative short-term investments. At the same time United States banks faced a continued expansion of business loan demand. In an effort to offset the deposit losses and meet the loan demand, many of the larger commercial banks resorted to the Euro-dollar market, borrowing heavily through their overseas branches. In the process, Euro-dollar rates rose steadily through mid-June (see Chart III), reaching historic highs and attracting funds from foreign financial centers and from the United States. In response to these developments, several countries moved to protect their domestic money markets and their international reserves from the Euro-dollar pressure, and in the summer months the Board of Governors of the Federal Reserve System issued amendments to its regulations in order to reduce the attractiveness of Euro-dollars to United States banks.

In February, United States banks increased their borrowings through their foreign branches in the Euro-dollar market only marginally from the \$8.5 billion level at the end of January (see Chart IV). Nevertheless, with the heavy outflow of short-term funds from Germany tapering off and French commercial banks withdrawing funds from the market, Euro-dollar rates moved sharply higher, with the rate on three-month deposits rising almost 1 percentage point to just under $8\frac{1}{2}$ percent by the end of February. Then early in March, in anticipation of higher demands for loans in connection with the March 15 corporate tax date, United States banks began to bid more aggressively for Euro-dollars and by midmonth their aggregate dollar bor-



rowings through foreign branches reached a new peak of \$9.7 billion. Interest rates, however, were not substantially affected; with the three-month rate around 8½ percent, funds were attracted from a great many money markets. Indeed, several European central banks increased their discount rates late in February and in March, as pressures on their reserves mounted and domestic short-term rates rose.

Meanwhile, the growing stringency in United States financial markets caused commercial banks in this country to raise their prime rate, on March 17, to 7½ percent, from 7 percent. Moreover, in early April, Federal Reserve discount rates were increased by ½ percentage point to 6 percent and reserve requirements against demand deposits were raised. The impact of these measures was quickly transmitted to European money market centers,

and three central banks followed the Federal Reserve move by raising their discount rates in April. Furthermore, in March the Italian authorities, and in early April the Belgian authorities, imposed restrictions on their commercial banks' net foreign asset positions, in effect requiring the banks to repatriate funds from the Euro-dollar market.

The fresh outbreak of speculative activity in the foreign exchange markets in late April and early May—especially the expectation of a revaluation of the German mark—put very strong pressures on the Euro-dollar market. As huge amounts of funds moved into marks and United States banks attempted to maintain the level of their Euro-dollar borrowing, Euro-dollar rates jumped sharply, with the call rate bid up to 10 percent per annum by May 8. Following the German government's rejection of a mark revaluation, rates declined briefly.

In June, there was a heavy surge of United States banks' borrowings in the Euro-dollar market. During the first three weeks of the month, when the runoff of CD's was particularly severe, the liabilities of banks to their foreign branches rose more than \$3 billion, to \$13 billion, and generated extreme pressures on Euro-dollar rates. On June 10—the day after United States banks had raised their prime loan rates by a full percentage point to 8½ percent—the Euro-dollar call rate rose to 11½ percent and the three-month rate was bid up to 13 percent. The market withstood the high rates without serious dislocation, and rates actually eased somewhat once preparations for the mid-June United States corporate tax date were completed. Throughout this period there was evidence that United States funds were being drawn into the Euro-dollar market. Yet, toward the end of the month, there were indications that United States corporations pulled substantial amounts of dollar balances and other foreign currency deposits out of Europe, only to redeposit these funds early in July following the month-end reporting date under regulations issued by the Commerce Department's Office of Foreign Direct Investments. At the same time, midyear window-dressing by continental European commercial banks was on a much smaller scale than in past years.

In July United States banks' demand for Euro-dollars continued at a high level, though the increase in the banks' liabilities to their branches, which reached \$14.3 billion on July 30, proceeded at a much slower pace than in June. Euro-dollar rates declined substantially throughout July and by the end of the month, call money was bid at 9 percent and three-month deposits at 10⅞ percent. The market continued to attract substantial amounts from several European financial centers, and additional central

banks took steps to protect their domestic money markets and monetary reserves from the pull of high Euro-dollar rates.

The devaluation of the French franc on August 8 triggered new pressures in the Euro-dollar market. The three-month Euro-dollar rate jumped to 11 percent by August 12 and moved irregularly around that level through the rest of the month. At the end of August the liabilities of United States banks to their foreign branches had risen to \$14.6 billion, a \$7.4 billion increase over the November 27, 1968 level, offsetting 64 percent of the \$11.6 billion decline of outstanding negotiable CD's during the same period.

In the light of the heavy reliance of some United States

banks on Euro-dollar borrowings and the repercussions on foreign monetary reserves and financial markets, the Board of Governors of the Federal Reserve System took a series of measures in order to moderate the flow of Euro-dollars to United States banks. First, the Board amended Regulation D (which governs reserves of member banks) so as to eliminate a technical loophole which had led banks to increase their use of overnight borrowings of Euro-dollars. Subsequently, the Board amended Regulation D and Regulation M (which governs the foreign activities of member banks) by placing a marginal reserve requirement of 10 percent on Euro-dollar takings by member banks and on United States assets acquired by foreign branches from their home offices.

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The Business Situation

The level of business activity continues to expand, though the pace varies rather widely among the key sectors of the economy. New survey evidence suggests that business capital spending may continue rising into 1970, in part because of delays in project completions experienced this year. At the same time, the balance between inventories and sales remains relatively conservative by recent past standards, and further inventory building could supply economic thrust in the months ahead if business sales expectations remain strong. Modest consumer spending and declining residential construction are currently helping most to slow the rise of aggregate demand and to limit inflationary pressures from the demand side. However, the recent large Federal pay increase may tend to lift consumption spending over the near term.

Meanwhile, industrial production continues to increase, new orders received by durable goods manufacturers have about recovered earlier declines, and the labor markets remain tight. On balance, the inflationary situation seems to have changed little over the course of this year, though this is not surprising in view of the usual delay with which restrictive monetary and fiscal actions influence economic activity and price behavior. Indeed, because the current period of inflation has continued for so long—about four years—considerable time may be required to restore price stability.

PRODUCTION, ORDERS, AND INVENTORIES

Industrial output rose strongly again in July when production of iron and steel, business equipment, and automotive goods all advanced. The Federal Reserve Board's seasonally adjusted index of total industrial production increased 1.3 percentage points to 175.2 percent of the 1957-59 average (see Chart I). The production index has climbed without interruption this year, and from December through July the annual rate of increase was a vigorous 6.6 percent. An important factor in this strength has been the rapid climb in iron and steel production, which by July had reached a level 20 percent above that prevailing at the end of last year. In the last few months the steel firms have been operating at close to full capacity,

and the industry continues to forecast a high level of activity through the fourth quarter. The relatively ready—if unhappy—acceptance of the recent steel price increases underscored the strength of steel demand as well as the ability of steel consumers to pass along higher costs in today's firm markets.

Much of the gain this year in iron and steel output has stemmed from the high and rising level of activity in the capital goods industries. Production of business equipment continued to expand rapidly in July, growing by almost 1 percent in that month alone. From the end of 1968 through July, output of business equipment rose at an annual rate of 8 percent. Production of defense-related goods also increased sharply in July, mainly reflecting the settlement of two major labor disputes that had earlier limited output in this sector.

Paralleling the rather mild uptrend in total consumer demand, output of consumer goods has grown much less rapidly in recent months than that of either materials or equipment. Excluding the automotive sector, production of consumer goods has been virtually unchanged since early this year. In the first seven months of 1969, the production index for automotive products—which accounts for one tenth of the consumer goods portion of the index and includes production of parts as well as cars—actually averaged less than the figure for the full year 1968. In the January-July period auto assemblies by domestic producers averaged a seasonally adjusted annual rate of 8.3 million units, compared with a total 1968 output of 8.8 million units. Labor problems have played a part in this year's lower production rates, but dealer sales of domestic cars have also fallen from the 1968 level. The month-to-month movement of auto production has been somewhat erratic of late; scattered strikes significantly reduced assemblies in April and May but output surged in June, when the labor situation calmed. The industry initiated its annual model changeover in July—somewhat earlier than usual—and actual production slumped. However, after allowing for the earlier timing of the changeover, the seasonally adjusted assembly rate rose further in July from the June level. To some extent, this increase may reflect the fact that changes in the 1970 models were

unusually minor and involved little downtime for retooling. Because of the spring strikes and the earlier changeover date, the auto producers had expected to have relatively small carry-over stocks of old models, providing a tighter market for the introduction of the 1970 models. However, sales of domestic-model cars dropped in July and August to a seasonally adjusted annual rate of 8.1 million units, after averaging close to 8½ million units in the first half of the year. This July-August decline in sales left the industry at the start of the new-model year with about the same number of old-model cars as in 1968.

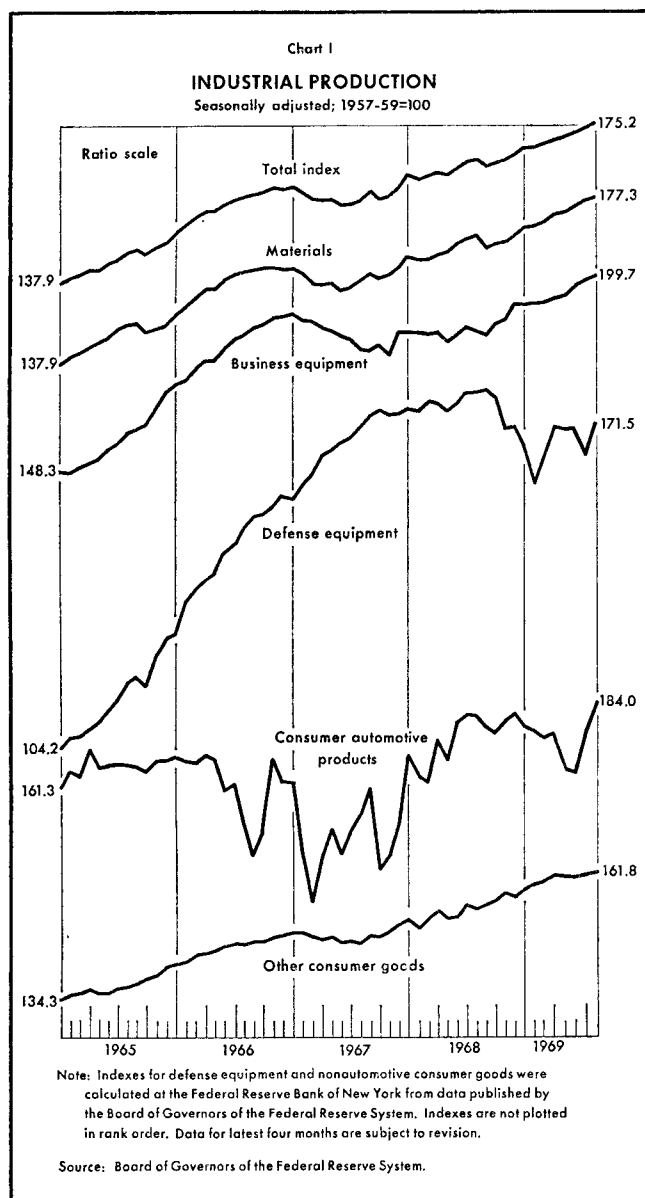
The often volatile series on new orders received by manufacturers of durable goods climbed to \$30.5 billion in July, up \$1.3 billion from June. A sharp recovery in defense-related orders accounted for almost all the latest rise. In the previous two months the total volume of new orders had fallen substantially, but the declines were mostly in the defense area. Orders for machinery and equipment eased \$0.1 billion in July to \$6.4 billion. This series peaked at \$7.1 billion in April, around the time of President Nixon's recommendation for repeal of the investment tax credit, but aside from that month's spurt machinery and equipment orders have been running at about \$6½ billion per month throughout this year.

Manufacturers' inventories were little changed in June after increasing strongly for several months, while trade inventories—chiefly at retail stores—turned in a sizable increase.¹ Shipments in June also showed a mixed pattern, as sales at retail and wholesale edged off whereas manufacturers' shipments rose sharply. Thus, the inventory-sales ratio for trade firms edged up and the ratio in manufacturing dropped significantly. On balance, however, for all businesses combined the inventory-sales ratio in June was at its low for the year. In July, manufacturers' shipments were about unchanged while total inventories rose by \$1 billion, with durables manufacturing accounting for all the increase. As a result, the inventory-sales ratio for all manufacturing firms moved back up to about the average level of the past year and a half. The ratio for durables manufacturers increased to a level on the high side of the range prevailing since late 1967, but that for nondurables manufacturers dropped to a sixteen-year low.

CAPITAL SPENDING AND RESIDENTIAL CONSTRUCTION

The capital spending boom appears to be losing some of its earlier strength, but new evidence also suggests that it may prove longer lived than earlier studies had indicated. A very recent survey by the Department of Commerce and the Securities and Exchange Commission found that businesses have revised downward their plant and equipment spending plans for this year. Businessmen now plan, according to this survey, expenditures of \$70.9 billion

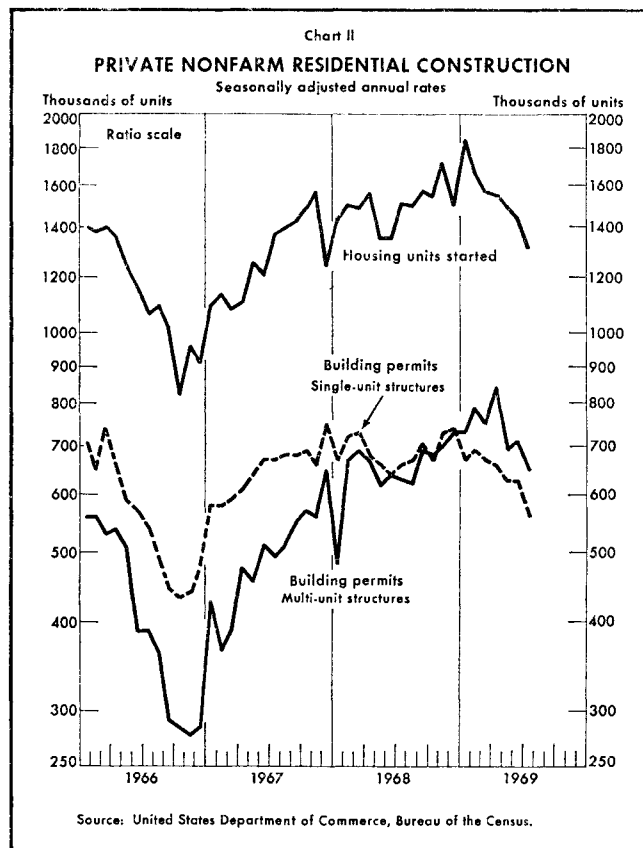
¹ The Department of Commerce has revised its estimate of the gross national product (GNP) for the second quarter of 1969. The estimate of inventory accumulation was revised downward by \$2.6 billion to \$6.9 billion at a seasonally adjusted annual rate. Consumption was revised up by \$2.1 billion to \$572.8 billion, and total GNP was revised down by \$0.3 billion to \$924.8 billion.



for new plant and equipment, or 10.6 percent more than was spent in 1968. An earlier Commerce-SEC survey taken last spring had indicated that outlays in 1969 would be about \$1.3 billion higher than the latest reading. A recent McGraw-Hill study found much the same lowering of sights on 1969 spending plans, but concluded that the downgrading reflected some stretching-out of spending into 1970. Thus, the McGraw-Hill survey, which also queried businesses about their 1970 plans, found that they expect outlays to continue rising next year to a level 5 percent above this year. If realized, these results would imply some continued stimulus from business capital spending, though less than in the past year or so.

In contrast to the strength in business spending for plant and equipment, activity in residential housing has weakened substantially in the last few months (see Chart II). Private nonfarm housing starts began the year on a strong note, averaging a seasonally adjusted annual rate of 1.7 million units in the first quarter, up 0.1 million from the average of the final quarter of last year. Following their January peak, however, starts fell steadily to an average annual rate of 1.5 million in the second quarter. The July decline amounted to a particularly large 127,000 units, bringing the starts rate down to 1.3 million units. The number of housing permits issued by local authorities also dropped in July. Housing permits have declined for multi- as well as for single-unit buildings in the last few months. Earlier in the year, multi-unit construction showed considerable strength, running counter to the downward trend in single units.

The data on housing starts and permits encompass only those housekeeping units that are in conventional homes or apartment buildings. That is, these series measure output of the construction sector. Data on mobile home production are excluded from the starts and permits series, since they are classified as output of the manufacturing sector. Nevertheless, mobile homes are becoming an increasingly significant part of the supply of new housing. This market is an especially important source of low cost housing: in 1968 mobile homes accounted for 90 percent of all new housing units which sold for under \$15,000. Perhaps reflecting their growing price advantage, the demand for mobile homes has increased very rapidly in recent years. Production rose from a level of 150,000 units in 1963 to over 300,000 in 1968, and industry spokesmen believe output will reach 400,000 units this year. Purchase of mobile homes has traditionally been financed through consumer instalment loans, but the Federal Home Loan Bank Board has recently proposed a regulation that would allow Federally chartered savings and loan associations to extend mortgage loans on mobile homes.



EMPLOYMENT, PERSONAL INCOME, AND RETAIL SALES

The employment situation generally remains very tight. According to the household survey, total civilian employment rose by over 300,000 in August, the third consecutive month of strong increase. The civilian labor force also expanded sharply but not so much as employment, and the unemployment rate edged down by 0.1 percentage point to 3.5 percent. The payroll survey also showed a large employment increase at nonagricultural establishments in August, following a slight decline the month before. About two thirds of the latest advance in payrolls occurred in manufacturing, but the average workweek in manufacturing moved down a bit.

Personal income recorded a large \$6.2 billion advance in July, when the pay raise for Federal Government employees went into effect. Total wage and salary disbursements rose by \$5.0 billion, but half of that increase was due to the larger paychecks of Federal workers. Outside

the Government, the July gain in income was relatively small, in part reflecting the fairly weak performance of payroll employment in that month.

Consumer demand still shows little buoyancy. Retail sales declined in May and June, and in July are estimated to have fallen by another \$200 million to a seasonally adjusted level of \$29.2 billion. These recent movements were in line with the weak trend in sales that has prevailed for nearly a year. Retail sales averaged \$28.8 billion monthly in the third quarter of 1968, eased to an average of \$28.6 billion in the fourth quarter, and then climbed by about \$0.4 billion in both the first and second quarters of this year. A good part of this sluggish showing can be attributed to the auto sector. Sales of new domestic-model cars ran at a seasonally adjusted annual rate of 9.0 million units in the third quarter of 1968, but then edged down to 8.8 million units in the final three months of last year and dropped further to 8.4 million units in the first quarter. Sales steadied at an annual rate of 8.5 million units in the April-June period, but declined during July and August to a seasonally adjusted rate of 8.1 million units.

THE PRICE SITUATION

It appears that since last fall the dollar value of total consumer purchases at retail stores has not kept pace with the rising level of prices. The dollar volume of retail sales has risen since last September at an annual rate of less than 2 percent, but the retail price level—as estimated by the consumer price index excluding service costs—has advanced at an annual rate of over 5 percent. During the same period the total consumer price index rose at an annual rate of just under 6 percent. In July, the consumer price index increased further at a 5½ percent annual rate, with the major part of this gain resulting from higher food costs. Excluding food, prices rose at an annual rate of over 3½ percent.

At the wholesale level, the sharp run-up of prices of farm and food products has moderated. According to preliminary figures, the index of farm and food products dropped by almost 1 percent in August after remaining unchanged in July. Apparently because of a rapid increase in demand in the face of a somewhat reduced supply, agricultural prices had climbed at an annual rate of over 17 percent in the second quarter. The August decline apparently largely reflected a seasonal increase in supplies. There is some doubt that these price reductions will be passed on to consumers because the earlier increases in retail food prices had not kept pace with those at wholesale. The preliminary estimate of wholesale prices for industrial commodities indicates a sizable rise in August,

resulting in good part from price increases for steel and several other metals.

NEW PUBLICATIONS

The Federal Reserve Bank of New York has published a second collection of essays, entitled *Essays in Domestic and International Finance*. The volume consists of nine articles, all but one of which were originally published in this *Monthly Review*; minor revisions have been made to bring them up to date. The first two essays deal with important episodes in the history of United States central banking; the second two articles examine some facets of the relationship between financial variables and business activity; and the remaining five deal with various aspects of the domestic and international financial markets. Copies are available from the Public Information Department at a full charge of 70 cents and an educational charge of 35 cents.

The Federal Reserve Bank of New York is also publishing a book, entitled *The Velocity of Money*, by George Garvy, Economic Adviser, and Martin R. Blyn of the California State College, Dominguez Hills, and formerly with the Federal Reserve Bank of Cleveland. It is a completely revised and expanded edition of *Deposit Velocity and Its Significance*, published a decade ago, and embodies some of the research in monetary economics being conducted at the Bank. The chapter headings in the new edition of 116 pages are: "The Demand for Money", "The Flow of Payments", "The Measurement of Velocity", "The Statistical Record", "Factors Affecting Velocity", and "Implications of Recent Changes in Velocity". Copies will be available in October from the Public Information Department at a full charge of \$1.50 and an educational charge of 75 cents.

Single copies of either of the two volumes mentioned above will be sent free to domestic teachers, commercial bankers, and libraries (public, school, and other nonprofit institutions) and to domestic and foreign government officials, central bankers, and newsmen. Classroom or training copies will be available to these groups (including school bookstores) at the educational charge. Free and educational-charge copies will be sent only to school, business, or government addresses.

The Money and Bond Markets in August

Conditions in the money market during August were little changed on average from those prevailing during July. Member bank borrowings from the Federal Reserve and net borrowed reserves averaged about the same as their July levels, and Federal funds rates averaged somewhat higher. Effective July 31, the Federal Reserve Regulation D was amended to eliminate a reduction in demand deposits subject to reserve requirements, which had formerly resulted from some banks' transactions with their foreign branches. Adjusted for the estimated effects of these transactions prior to the revision of Regulation D, the money supply grew at an annual rate of about 4 percent during the first seven months of the year, compared with about 2½ percent before that adjustment. During August, however, the money supply on the new basis declined at an estimated annual rate of more than 5 percent, bringing the growth for the year down to 3 percent. Total bank credit, as estimated from data for the final Wednesday of each month and adjusted to allow for bank sales of assets to affiliates and foreign branches, increased at an annual rate of about 3½ percent in the first eight months of the year.

Most short-term interest rates edged downward during August. Offering rates on commercial paper—both dealer placed and directly placed—and bankers' acceptances were reduced, and Treasury bill rates also declined for much of the month in the face of strong demand from a wide variety of investors. The Treasury raised \$2.1 billion in new cash during August through the sale of a "strip" of short-term bills, the maturities for which demand had been most persistent. In the face of the augmented supply, rates on bills maturing within two months rose sharply, more than retracing their earlier declines.

Prices of most intermediate- and long-term Treasury notes and bonds declined over the month, while prices of several short-term issues increased slightly. The Treasury's August refunding in the early part of the month was conducted in a favorable atmosphere which was encouraged by Congressional extension to the end of the year of the 10 percent income tax surcharge. All but 13.8 percent of the privately held notes maturing August 15 were exchanged into a new eighteen-month 7¾ percent note which

was priced to yield 7.82 percent, the highest yield offered by the Treasury on a direct coupon obligation in more than a century. Prices of outstanding Treasury notes and bonds rose early in the month, but declined in reaction to the devaluation of the French franc on August 8 and the ensuing uncertainty over international monetary developments. Prices subsequently revived on expectations of heavy reinvestment demand from the proceeds of the sale of oil leases by the state of Alaska. Toward the end of the month, however, prices were tending downward in sympathy with other areas of the capital market.

Prices of seasoned corporate bonds rose during the first half of the month but, after a series of poor receptions on aggressively priced new issues, prices gave way during the latter half of the month. In the municipal bond market, prices declined sharply and steadily, after a short-lived rally at the beginning of the month, in part because of concern that proposed tax legislation would reduce the attractiveness of these securities to individual investors.

BANK RESERVES AND THE MONEY MARKET

On average, conditions in the money market during August were little changed from those of July. Member bank borrowings from the Federal Reserve Banks averaged \$1,211 million during August (see Table I), compared with \$1,312 million in July. Net borrowed reserves averaged \$1,054 million in August, compared with \$1,045 million in July. Federal funds traded at rates averaging about 9.2 percent during August, compared with 8.6 percent in July. Day-to-day conditions in the money market fluctuated widely, however, in large measure reflecting shifting strategies of reserve management by the member banks.

The money market was quite firm during the first statement week of August, as banks tended to concentrate their demands for reserves in the Federal funds market. In order to temper the developing tautness, the Federal Reserve injected reserves steadily in early August through the purchase of Treasury and Federal agency securities and bankers' acceptances under repurchase agreements. In spite of these substantial reserve injections, Federal

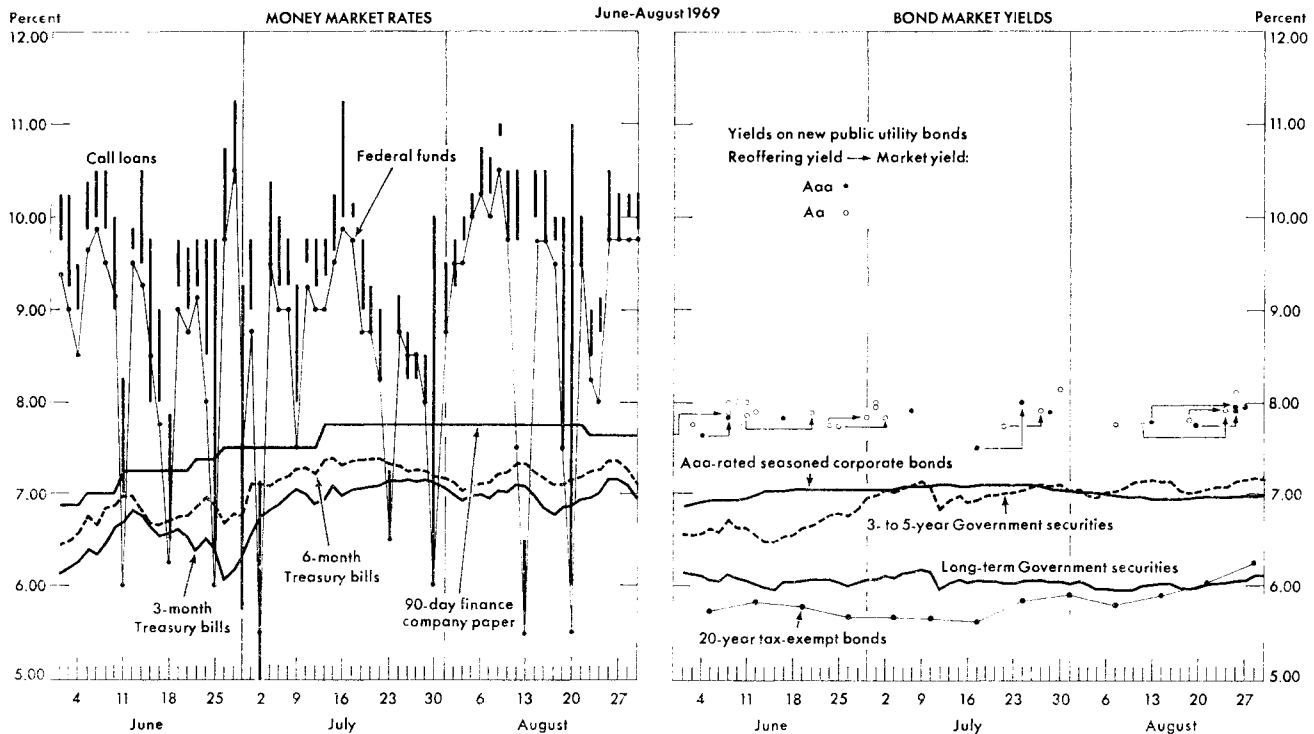
funds traded predominantly at rates ranging from $9\frac{1}{2}$ percent to $10\frac{1}{4}$ percent from August 1 to 6 (see Chart I). On the weekly settlement day for all member banks, Wednesday, August 6, some Federal funds traded at rates as high as 11 percent, matching the record established three weeks earlier.

There were some striking similarities between the money market conditions that prevailed during the two ensuing statement weeks. Conditions were very firm before each weekend, with Federal funds trading in a $9\frac{1}{2}$ to $10\frac{3}{4}$ percent range on the first two days of the statement week ended on August 13 and in a $9\frac{1}{4}$ to $10\frac{1}{4}$ percent range a week later. In both weeks the Federal funds market began to ease on Monday and the effective rate declined to $7\frac{1}{2}$ percent on Tuesday and finally

to $5\frac{1}{2}$ percent on Wednesday. Also in both weeks, the Federal Reserve injected reserves in order to temper the tautness before the weekend, and later absorbed reserves through matched sale-purchase transactions in order to counter the easing tendencies on the last two days of each statement week.

Despite the broad similarities in the tone of the money market during the weeks that ended on August 13 and August 20, there were some important differences in reserve management practices. In the earlier week, member banks borrowed heavily from the Federal Reserve over the weekend, thereby building up excess reserves that subsequently cascaded into the money market. In the following week, however, early borrowing from the Reserve Banks was more restrained and the resulting accumulation

Chart I
SELECTED INTEREST RATES



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-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

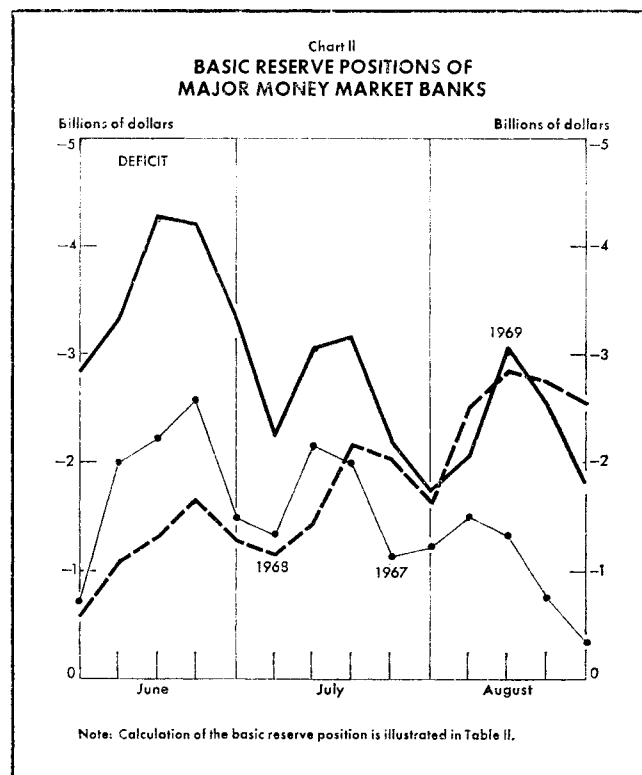
Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

of excess reserves much more modest. The easing of pressures in the money market after the weekend apparently reflected the decision of a number of major banks to sell Federal funds in large volume rather than risk being left with sizable reserve excesses at the end of the statement week, as had occurred a week earlier.

As a whole, the member banks succeeded in sharply reducing their excess reserves to \$29 million in the week ended on August 20 from \$216 million in the previous week. Related to this, a relatively large amount of reserve deficiencies was carried over into the following statement week, and conditions in the money market were firm on the first day of the latter period when Federal funds traded predominantly at $9\frac{1}{2}$ percent. The basic reserve position of the major money market banks quickly began improving, however (see Chart II), and the Federal funds rate eased to $8\frac{1}{4}$ percent on Friday, August 22, and to 8 percent on Monday. Subsequently, as a number of banks which were required to cover reserve deficiencies carried over from the previous week bid aggressively for Federal funds, the rate was driven up to $10\frac{1}{4}$ percent before the settlement on Wednesday, August 27.

The Board of Governors of the Federal Reserve System has closed a loophole in its Regulation D which had formerly permitted member banks with foreign branches to reduce their net demand deposits subject to reserve requirements. In the past, the so-called "bills payable checks" and "London drafts" used in settling transactions involving foreign branches (primarily in Euro-dollars) were not required to be included in the deposits of the remitting bank, even though they could be deducted as cash items in process of collection from the demand deposits of the receiving bank. Effective July 31, Regulation D was amended to include such checks in demand deposits subject to reserve requirements. The immediate consequence was an increase of approximately \$3 billion in net demand deposits subject to reserve requirements. This increase occurred largely at the major New York City banks, which are the biggest borrowers in the Euro-dollar market.

Adjusted for the estimated magnitude of the former understatement of demand deposits, the money supply (privately held demand deposits plus currency outside banks) grew at a seasonally adjusted annual rate of 4 percent during the first seven months of 1969, compared with the $2\frac{1}{2}$ percent rate of growth previously indicated. The money supply is estimated to have declined during August at an annual rate of over 5 percent. Total member bank deposits subject to reserve requirements (the so-called "bank credit proxy"), plus banks' liabilities to their foreign branches, declined at a seasonally adjusted annual rate of 10 percent in August, compared with 2 percent



over the previous seven months. Because of the proliferation of nondeposit means of raising funds by banks, this measure has become an increasingly poor indicator of trends in bank credit. The latter, on the basis of last-Wednesday-of-the-month figures, rose at a seasonally adjusted annual rate of $2\frac{1}{4}$ percent on average over the first eight months of the year. After adjustment for asset sales to affiliates and foreign branches, the rate of growth in bank credit increased to $3\frac{1}{2}$ percent.

THE GOVERNMENT SECURITIES MARKET

Along with other short-term rates, most Treasury bill rates declined during the month of August. Bills were in strong demand for most of the month from a wide variety of investors—banks, corporations, public funds, foreign central banks, and dealers. After declining steadily for the first week of August, rates edged higher amid exceptionally tight money market conditions for a few days prior to midmonth, but then resumed their decline on August 13.

Responding to the especially heavy demand for short-term bills, the Treasury announced on August 14 that it

was planning to fill its current cash needs by offering a "strip" of \$2.1 billion of bills with an average maturity of forty-five days. The offering consisted of a \$300 million addition to each of the seven outstanding weekly bill issues maturing from September 18 to October 30. Tenders for multiples of \$7,000, to be divided equally among the seven issues, were due August 20. Payment was made on August 25, and commercial banks were permitted to pay for subscriptions for their own accounts and for their customers by crediting Treasury Tax and Loan Accounts. The announcement of the "strip" offering was favorably received in the market and provoked only a slight reaction on the rates of some of the affected issues. Rates generally continued to decline up to the time of the auction on August 20. Bidding for the "strip" proved less aggressive than anticipated, however, and the average issuing rate was established at 5.544 percent, with tenders accepted over an unusually wide range of nearly 50 basis points. The "strip" opened trading at about 6.85 percent, the discount from the issuing price representing the estimated value to banks of the privilege of payment by crediting Tax and Loan Accounts.

When trading resumed the following day, rates on the seven reopened issues shot up about 25 to 50 basis points and rates on most other bills rose about 1 to 7 basis points. Rates continued to creep higher until the final two days of the month, when they again declined substantially in the face of strong demand for bills. For the month as a whole, rates on most bills were 2 to 25 basis points lower, except in the area of augmented supply where rates closed generally 30 to 60 basis points higher.

There was active interest in each of the regular Treasury bill auctions held during August. In the final auction of the month, held on Friday, August 29 (advanced from Monday in observance of the Labor Day holiday), the average issuing rates on the three- and six-month bills were 7.014 percent and 7.166 percent, respectively (see Table III), 16 and 15 basis points below the rates established in the auction held a month earlier. In the monthly auction of nine- and twelve-month bills on August 26, average issuing rates of 7.387 percent and 7.340 percent, respectively, were little changed from the rates set in June and July.

The Treasury's August refunding occupied the center of attention in the market for Treasury coupon issues during the early part of the month. On July 30, the Treasury announced that holders of the \$3.4 billion 6 percent note maturing August 15, 1969 would be offered in exchange a $7\frac{3}{4}$ percent eighteen-month note priced to yield about 7.82 percent. These terms were received enthusiastically, and prices of intermediate-term issues rose

as much as $\frac{1}{2}$ point on the following day, reflecting the absence of a longer term note offering and the decision not to prerefund \$6.2 billion of bonds maturing October 1, 1969. The new $7\frac{3}{4}$ percent note immediately moved to a premium in "when-issued" trading, which went as high as $2\frac{1}{4}$ above the issue price before the subscription books closed on August 6. All but 13.8 percent of the \$3.2 billion of the maturing issue held by the public was tendered for the new $7\frac{3}{4}$ percent note. This "attrition", although somewhat higher than predicted by many market participants, was considerably below the 20 percent figure which, it appeared, the Treasury had been prepared to accept.

Prices of outstanding Treasury notes and bonds also rose in early August amid the favorable atmosphere surrounding the refunding and the Congressional passage of an extension of the 10 percent income tax surcharge through the remainder of the year. Prices then slipped a bit over the next few days in a largely technical reaction to the earlier gains. Following the announcement on Friday, August 8, of the 11.1 percent devaluation of the French franc, additional mild losses occurred and the downward drift continued over the next few days amidst uncertainty over international monetary developments. Prices subsequently rose again in response to expectations of reinvestment demand from the proceeds of the sale by the state of Alaska of North Slope oil leases on September 10. Toward the end of the month, however, prices declined, partly in reaction to the relatively weak bidding in the "strip" bill auction, the deterioration of the corporate and municipal bond markets, and the anticipation of the Treasury's forthcoming refunding. Intermediate-term issues came under selling pressure as dealers prepared for a possible long note offering in exchange for the October 1, 1969 bonds. Over the month as a whole, prices of most issues maturing beyond two years were $\frac{1}{4}$ to $1\frac{1}{4}$ lower, while prices of shorter term issues were mostly $\frac{1}{8}$ to $\frac{1}{2}$ higher.

OTHER SECURITIES MARKETS

Prices of corporate bonds rose during the first week of August in a constructive atmosphere fostered by the Congressional passage of the tax surcharge extension. Prices declined in the wake of the devaluation of the French franc on August 8, later recovered partially, and resumed their decline in the latter half of the month. Aggressively priced new issues were well received early in the month but ran into increasingly stiff investor resistance thereafter. The generally deteriorating atmosphere in the new-issue sector of the market is illustrated

Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, AUGUST 1969

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

Factors	Changes in daily averages— week ended on				Net changes
	Aug. 6	Aug. 13	Aug. 20	Aug. 27	
"Market" factors					
Member bank required reserves	— 338	+ 173	— 486	+ 309	— 252
Operating transactions (subtotal)	— 122	— 314	+ 495	— 335	— 276
Federal Reserve float	+ 5	+ 38	+ 391	— 458	— 24
Treasury operations*	+ 318	— 147	+ 259	— 153	+ 277
Gold and foreign account	— 30	+ 10	+ 8	— 4	— 16
Currency outside banks	— 210	— 278	— 315	+ 288	— 515
Other Federal Reserve accounts (net)†..	— 207	+ 63	+ 153	— 9	—
Total "market" factors	— 460	— 141	+ 9	+ 64	— 523
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 741	— 86	— 90	+ 103	+ 658
Outright holdings:					
Government securities	+ 241	— 71	+ 355	+ 61	+ 586
Bankers' acceptances	— 1	—	+ 1	—	—
Repurchase agreements:					
Government securities	+ 431	+ 2	— 400	+ 35	+ 68
Bankers' acceptances	+ 22	—	— 19	+ 3	+ 6
Federal agency obligations	+ 48	— 17	— 27	+ 4	+ 8
Member bank borrowings	— 180	+ 235	— 107	— 20	— 72
Other loans, discounts, and advances.....	—	—	—	—	—
Total	+ 561	+ 149	— 196	+ 82	+ 596
Excess reserves	+ 101	+ 8	— 187	+ 146	+ 68

Member bank:	Daily average levels				
	Aug. 6	Aug. 13	Aug. 20	Aug. 27	Aug. 27†
Total reserves, including vault cash	27,004	26,839	27,138	26,885	26,967†
Required reserves	26,796	26,623	27,109	26,710	26,810†
Excess reserves	208	216	29	175	157†
Borrowings	1,093	1,328	1,221	1,201	1,211†
Free, or not borrowed (-), reserves	- 885	- 1,112	- 1,192	- 1,026	- 1,054†
Nonborrowed reserves	25,911	25,511	25,917	25,684	25,756†
Net carry-over, excess or deficit (-)§....	91	133	188	43	114†

System account holdings of Government securities maturing in:	Changes in Wednesday levels				
	Aug. 6	Aug. 13	Aug. 20	Aug. 27	Aug. 27
Less than one year	+1,898	- 934	+ 858	+ 530	+2,352
More than one year	-	-	- 408	-	- 408
Total	+1,898	- 934	+ 450	+ 530	+1,944

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 four weeks ended on August 27.

§ Not reflected in data above.

Table II
RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS
AUGUST 1969

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on Aug. 27
	Aug. 6	Aug. 13	Aug. 20	Aug. 27	

Eight banks in New York City					
Reserve excess or deficiency (—) *.....	6	65	— 61	46	14
Less borrowings from					
Reserve Banks	18	118	136	53	81
Less net interbank Federal funds					
purchases or sales (—)	— 11	446	— 152	— 292	— 2
<i>Gross purchases</i>	1,766	1,750	1,571	1,397	1,621
<i>Gross sales</i>	1,777	1,304	1,723	1,688	1,623
Equals net basic reserve surplus					
or deficit (—)	— 1	— 499	— 45	285	— 65
Net loans to Government					
securities dealers	617	386	335	358	424
Net carry-over, excess or deficit (—) †..	44	22	50	— 19	24

Thirty-eight banks outside New York City

Reserve excess or deficiency (-)*	44	18	- 26	- 52	- 4
Less borrowings from					
Reserve Banks	183	366	267	196	253
Less net interbank Federal funds purchases or sales (-)	1,913	2,192	2,224	1,846	2,044
Gross purchases	3,854	3,928	4,023	3,749	3,889
Gross sales	1,942	1,738	1,799	1,904	1,846
Equals net basic reserve surplus or deficit (-)	-2,051	-2,540	-2,517	-2,093	-2,300
Net loans to Government securities dealers	- 123	- 49	- 72	- 130	- 93
Net carry-over, excess or deficit (-)† ..	- 24	25	41	17	15

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—August 1969				
	Aug. 4	Aug. 11	Aug. 18	Aug. 25	Aug. 29
Three-month	6.994	7.081	6.856	7.098	7.014
Six-month	7.085	7.277	7.121	7.293	7.166
	Monthly auction dates—June-August 1969				
	June 24	July 24	August 26		
Nine-month	7.387	7.407	7.387		
One-year	7.342	7.313	7.340		

* 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.

by the experience of four Aa-rated utility issues, with five years of call protection, which came to market at approximately one-week intervals during the month. The first sold out quickly at a yield of 7.75 percent, 25 basis points below the record yield placed on comparable issues in mid-June. The second, which was marketed shortly after the franc devaluation, encountered a lackluster response from investors at the same yield. The third, offered a week later, was even more poorly received at a yield of 7.80 percent. When the substantial unsold balances of these issues were released from syndicate price restrictions on August 25, their prices declined enough to raise the yields about 15 basis points. The next day a similarly rated issue was marketed at a record yield of 8.10 percent and encountered only a fair investor reception.

After a sharp rally in municipal bond prices during the first week of the month, yields on tax-exempt securities rose to record levels. The early rally was sparked by the

modification of Congressional plans that had earlier threatened to diminish the attractiveness of investment in municipal securities by commercial banks, by far the biggest buyers of these issues. It became apparent, however, that the market's response had been overly exuberant and a reaction set in. Thereafter, the atmosphere in the municipal bond market steadily deteriorated amid continuing concern about proposals in the Congress to restrict the tax-exempt status of these securities. *The Weekly Bond Buyer's* twenty-bond index of yields on municipal securities, after dropping 13 basis points during the first week of August, rose 46 basis points over the next three weeks to a record 6.26 percent. The volume of new tax-exempt bond flotations during the month was relatively light, \$750 million as compared with the average of \$1 billion during the previous seven months and \$1.7 billion in August 1968. A heavy volume of short-term issues was sold, however.

Fifty Years of the Monthly Review

This issue marks the fiftieth year of publication of the *Monthly Review*. The first issue, dated September 20, 1919, was an eight-page summary of the "financial record of the last thirty days" entitled *Report on Business Conditions*. It stated to its readers that "copies are issued for the information of member banks and for those who have participated in its preparation".

The publication grew out of a report of the Federal Reserve Agent at New York to the Federal Reserve Board. In the earliest days of the System, a monthly report on business conditions had been required of each Federal Reserve Agent for publication in the *Federal Reserve Bulletin*, first issued in May 1915. Individual reports in the *Bulletin* were discontinued after December 1918, but the Federal Reserve Agents were permitted to release to the local press their own reports of business conditions.

The name of the organ evolved through several stages to *Business Conditions*, *Second Federal Reserve District* to *Monthly Review of Credit and Business Conditions* (August 28, 1920). With the December 1, 1936 issue, the *Review* ceased to be identified as a report of the Federal Reserve Agent and became a publication of the Federal Reserve Bank of New York. The last title change occurred in May 1958 when it became simply the *Monthly Review*.

At the time of the *Review's* inception, Pierre Jay was Chairman of the Board of Directors and Federal Reserve Agent and Benjamin Strong was Governor (a title which was changed in 1936 to President).