FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

OCTOBER 1969

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Volume 51 **No. 10**

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The Business Situation

Recent indicators of business activity have continued to show a mixed pattern. Signs of a slowing in the rate of expansion have apparently multiplied of late—although the possibility that some of these reflect little more than random movements must be kept in mind, especially in summer months when seasonal adjustments are particularly difficult to make. In August, industrial production recorded its first decline in a year, new orders for durable goods fell, and housing starts and permits dropped a bit further. Higher inventory-sales ratios among durables manufacturers and retail merchants may have contributed to the recent moderation of production. Retail sales showed little buoyancy over the summer, and while personal income gains have been sizable, this strength resulted largely from special and nonrecurring factors. Some easing of exceptionally tight labor market conditions became apparent, as nonfarm employment continued to show relatively little growth. The unemployment rate rose sharply in September, though the rise was probably swollen by special factors. On the other hand, recent surveys of business spending plans indicate that the current boom in capital outlays may well be sustained into 1970, though at a less hectic pace than early this year. Also, a phasing-out of the 10 percent income tax surcharge next year, together with a proposed sizable increase in social security benefits, is likely to provide considerable stimulus to the private economy. Meanwhile, the price situation remains very unsatisfactory. Consumers continue to be faced with sizable price increases on a wide array of goods and services, and industrial wholesale prices have resumed their climb.

PRODUCTION, ORDERS, INVENTORIES, AND RESIDENTIAL CONSTRUCTION

The volume of industrial production declined in August, as iron and steel output fell and activity in most other industries remained about unchanged. The Federal Reserve Board's index of industrial production edged down 0.3 percentage point to 174.3 percent of the 1957-59 average, the first drop since August 1968. At the same time, the July increase in production was revised down substantially from the preliminary estimate. Physical output in the iron and steel industry fell about 3½ percent in August, after leveling off in July. Moreover, the output of raw steel—which accounts for about half the iron and steel index—was up only slightly in September from the August level. This apparent flattening of activity in the iron and steel industry followed a very sharp uptrend in the first half of 1969 when production expanded rapidly in response to vigorous European demand and to the surge in business capital spending.

Business equipment output remained unchanged in August after many months of uninterrupted large gains. Although the absence of a further rise in equipment production may simply have been a random variation, there is supporting evidence that capital spending may be entering a period of slower growth. Recent surveys of business plans for plant and equipment suggest that capital spending outlays will rise more slowly in the current half year than in the first six months of 1969, though the same surveys also indicate that the uptrend will continue into next year. In view of record borrowing costs, the squeeze on profit margins, probable repeal of the investment tax credit, and relatively low capacity utilization rates in manufacturing, the planned further rise of plant and equipment spending apparently rests on expectations of sharply higher labor costs and robust product demand.

Consumer goods production continued to grow at a modest pace in August, although output of automotive products was about unchanged. On a seasonally adjusted basis, auto assemblies remained at the very strong July rate of 9 million units per year. That pace was maintained in September, but industry production schedules point to a cut in automobile assemblies in October to an 8½ million unit rate.

Recent movements in the volume of new orders received by manufacturers of durable goods have been dominated by wide swings in defense bookings, which are a particularly volatile component of the orders series. Perhaps reflecting timing factors related to the Federal Government's fiscal year, defense orders slackened toward the end of fiscal 1969 but were quite strong in July, the first month of the new fiscal year. Defense bookings fell back in August, giving rise to a $0.7 billion decline in total new durables orders, to a level of $29.9 billion. The backlog of unfilled orders for durable goods has also been affected by the erratic movements of de-

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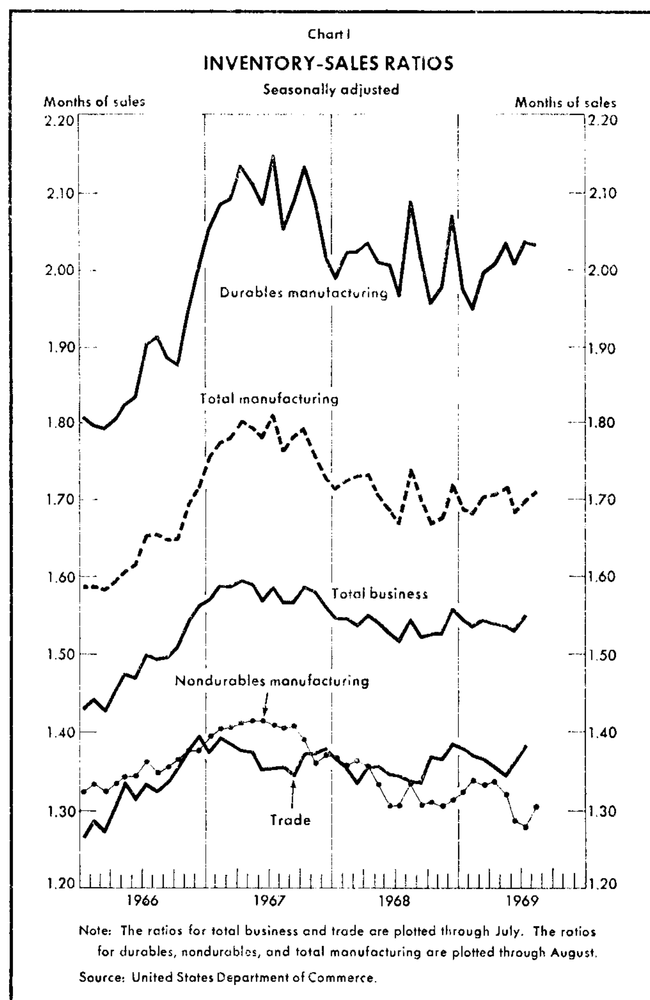
fense orders. Following a steady uptrend that lasted about a year, the backlog of unfilled orders at durables manufacturing establishments declined in June as orders fell and shipments rose. There was a partial rebuilding of the backlog in July, but it dropped again in August as shipments volume, though lower than July, again exceeded orders. Nevertheless, excluding the defense component, the flow of durables orders remained above shipments, and the backlog of nondefense orders expanded through August.

The inventory situation continued to appear relatively well balanced during the summer, though there may have been some involuntary accumulation (see Chart I). Total business inventories rose by a sizable $1.3 billion in July. While accumulation in the trade sector accounted for only $0.4 billion of the increase, both wholesalers and retailers experienced a decline in sales and a noticeable rise in their inventory-sales ratio. The ratio in manufacturing also advanced in July, as durables inventories surged by $1.0 billion and total shipments moved up by only $0.1 billion. In August, the ratio in manufacturing rose again as inventories climbed by $0.5 billion and shipments fell.



Note: The ratios for total business and trade are plotted through July. The ratios for durables, nondurables, and total manufacturing are plotted through August.
Source: United States Department of Commerce.

Residential construction activity continues to be the one distinctly weak part of the business picture. Private nonfarm housing starts fell in August for the seventh month in a row, although the decline was small, and the number of building permits issued by local authorities also edged down further. The reduced availability of mortgage credit for new-home purchase has clearly exerted a restraining influence on home building this year. In August, the national average rate on conventional new-home mortgages was over 8 percent. At the same time, the prices of both new and existing homes have climbed steeply, increasing the amount of mortgage credit needed by the typical purchaser. The rise in mortgage rates has also resulted in problems with usury ceilings, which in twenty states are at or below 8 percent. A further complication in the housing industry has been the fact that builders may have encountered difficulty obtaining loans from commercial banks to finance construction operations.

EMPLOYMENT, PERSONAL INCOME, AND RETAIL SALES

In the past two months, the labor market indicators have shown signs of easing from the very tight conditions which have prevailed most of this year. However, the easing may have been overstated as a result of special factors. The timing of the automobile industry's model changeover brought an earlier return to full operating schedules than in past years, thus raising August employment and lowering September employment on a seasonally adjusted basis. Employment outside the transportation industry changed little in August and September. Difficulties with seasonal adjustment apparently also played a role in the household survey of employment. The September rise in the civilian labor force was mostly among persons aged 16 to 24, for whom seasonal adjustments are difficult to make as the school year begins. The sizable advance in the labor force, together with a small decline in total employment, resulted in a jump in the unemployment rate of 0.5 percentage point, the largest monthly change in nine years, to 4.0 percent. Although the most dramatic movement in the September data was in the younger age group, the unemployment rate for those 25 and over rose substantially, moving up 0.2 percentage point to 2.5 percent.

Personal income rose in August by $5.2 billion to a seasonally adjusted annual rate of $756.6 billion, following a similar advance of $5.3 billion in July. The expan-

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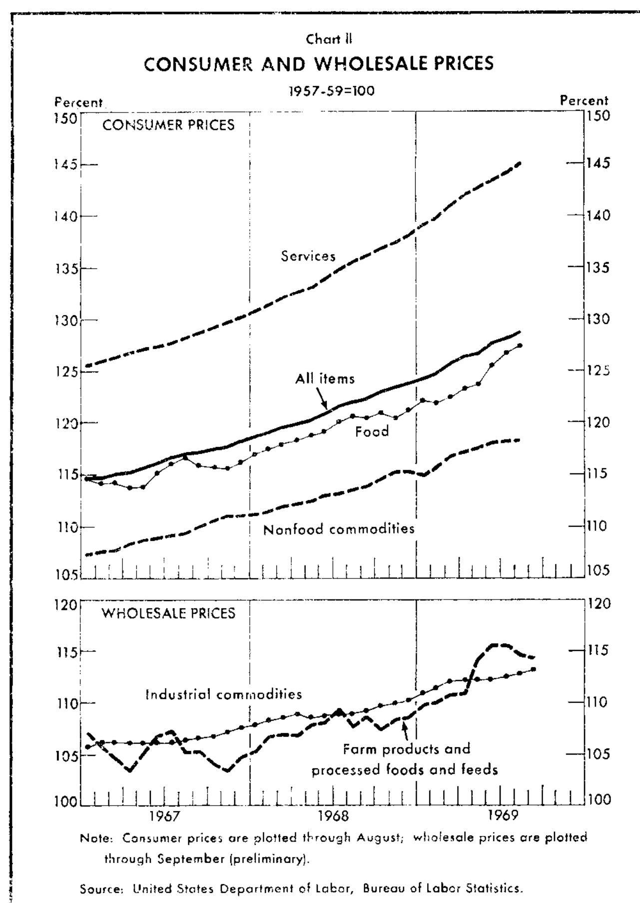
sion in July and August was in line with the roughly 8½ percent annual rate of gain recorded over the first six months of this year. However, income growth in both those summer months was buoyed by the pay raise for Federal Government employees, which first appeared in July salaries and became fully effective in August. Furthermore, the personal income estimate for August received an extra boost from the timing of this year's automobile model changeover. Excluding these nonrecurring factors, income growth in July and August was at a rate considerably less than in the first half of 1969.

Consumer demand showed no signs of strength in the summer months, as monthly retail sales continued little changed from the $29.4 billion level reached in April. Also, a recent survey of consumer attitudes has found a marked drop in optimism, suggesting that the current sluggishness may continue. Retail sales in August recovered a $0.3 billion dip in July, moving back to a seasonally adjusted rate of $29.4 billion. Automobile sales have shared in the general weakness. For the first nine months of 1969, sales of domestic cars averaged 8.4 million units at a seasonally adjusted annual rate, down from the 1968 total of 8.6 million units but still well above the 7.6 million units sold in 1967. While sales advanced in September, the introduction of the 1970 models came too late in the period for the month's figure to be a reliable indication of market acceptance of the new cars. The real test for the 1970 models will be in the weeks following introductory sales promotions and deliveries to fleet-buyers and auto-leasing organizations. Sales of imported cars have continued to rise this year, although the advance has been distinctly smaller than the large gains of the last few years. For the first eight months of 1969, sales of imports were 6 percent above the comparable period in 1968. Earlier, imported car sales had been growing at about 25 percent per year. This slowing may reflect fresh competition from new low-priced models produced in this country, or it may simply have stemmed from the absence of growth in the demand for new cars generally.



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

RECENT PRICE DEVELOPMENTS

The price situation remains a major concern. At both the retail and wholesale levels, rates of increase have continued to be very large, threatening not only our fragile balance-of-payments position but also the prospects for orderly economic growth. The average July-August gain in the consumer price index was at a 5 percent annual rate—only slightly less than the 6 percent rate averaged in the first six months of 1969 (see Chart II). To be sure, much of the recent increase in the consumer index can be attributed to a sharp run-up in food prices. Nevertheless, during the June-August period substantial increases were also recorded in the nonfood components—notably in housing and services—and the aggregate index for all items except food rose at a 4½ percent annual rate.

At wholesale, increases since June in the overall index have been small only because declining agricultural prices largely offset increases in prices of industrial commodities. The index of farm and food products is, nevertheless, still far above the levels of the first part of the year, despite the recent declines. Also, there has been a renewed upward trend in industrial prices since June. During the spring, the index of industrial wholesale prices had been relatively stable, as sharp declines in lumber and wood prices about offset other increases. The downtrend in lumber moderated in the summer, and price increases elsewhere—particularly in iron and steel—caused the industrial index to rise once again. The industrial commodities index rose a further 0.4 percent in September, reaching a level of 113.2 percent of the 1957-59 average.

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The Money and Bond Markets in September

The money and bond markets continued to feel the effects of monetary restraint during September, as new corporate issues provided record yields and rates on most commercial paper and bankers' acceptances also moved higher. The effective rate on Federal funds again averaged 9 percent, but member bank borrowings declined during the month as a result of an unusually large volume of reserves provided temporarily by Treasury operations.

A large Treasury refinancing, which included the prerefunding of a December maturity, attracted a good deal of attention during the month. On September 17 the Treasury announced that holders of $6.4 billion of Treasury notes and bonds due on October 1 and almost $2.5 billion of bonds maturing on December 15 would be offered three issues in exchange. These were a 19½-month note offered at par to yield 8 percent, a 3-year 7½-month note with a 7¾ percent coupon also offered at par, and a 7½ percent note maturing in 6 years 10½ months and priced to yield about 7.59 percent. These rates were the highest on comparable Treasury issues in more than a century, and the public gave the offering a very good reception. The attrition rate on the publicly held portion of the maturing issues was 19.7 percent, considerably lower than expected in the light of current market conditions. Of the $8.9 billion being refunded, the public held $7.6 billion.

With the exception of some short-term bill and coupon issues, prices of United States Government securities declined during September. Some brief improvement occurred from time to time in response to such factors as a statement by Chairman Martin that interest rates might have reached their highest level and optimistic speculation associated with the cease-fire in Vietnam following the death of Ho Chi Minh. Such rallies were short-lived, however, and the overall trend was downward. Concern over the current and prospective volume of Federal agency securities weighed heavily on the market toward the end of the month.

Corporate bond prices also fell in September, and record offering yields were set on many of the issues that were marketed. The volume of new corporate issues was the largest September total on record, and investor resistance was at times quite pronounced. One prime-rated Bell System issue, for example, received only a fair initial reception despite a record yield of 8.25 percent. In the municipal bond market, on the other hand, an unusually light supply of new issues resulted in a decline in yields during the month (see Chart I). Several scheduled municipal offerings were postponed because of statutory interest ceilings and others withdrawn because of unfavorable market conditions. Growing optimism about the tax reforms that would eventually emerge from the Congress relating to income from municipal securities also contributed to the better tone in that market.

BANK RESERVES AND THE MONEY MARKET

Money market conditions continued firm during September despite a large volume of reserves provided in the week ended on September 10 by a rundown of Treasury balances and the sale of $1,102 million of special Treasury certificates to the Federal Reserve. The effective rate on Federal funds averaged 9.1 percent for the month, essentially unchanged from August, while rates on commercial paper and bankers' acceptances were increased during the month. Due primarily to the unexpectedly large provision of reserves by Treasury operations, member bank borrowings at the discount window in September—amounting to $1,026 million on a daily average basis—were down $185 million from the preceding month, while excess reserves averaged $88 million higher than in August. Net borrowed reserves of member banks averaged $766 million for September as a whole.

The basic reserve positions of both the eight major New York City banks and the thirty-eight money center banks outside New York showed a deterioration over the month though their intramonthly patterns differed. The New York City banks had a basic reserve surplus averaging $285 million at the close of August but moved to a deficit position in the week ended on September 3, primarily as a result of a sizable decline in their borrowings other than from their foreign branches. The thirty-eight

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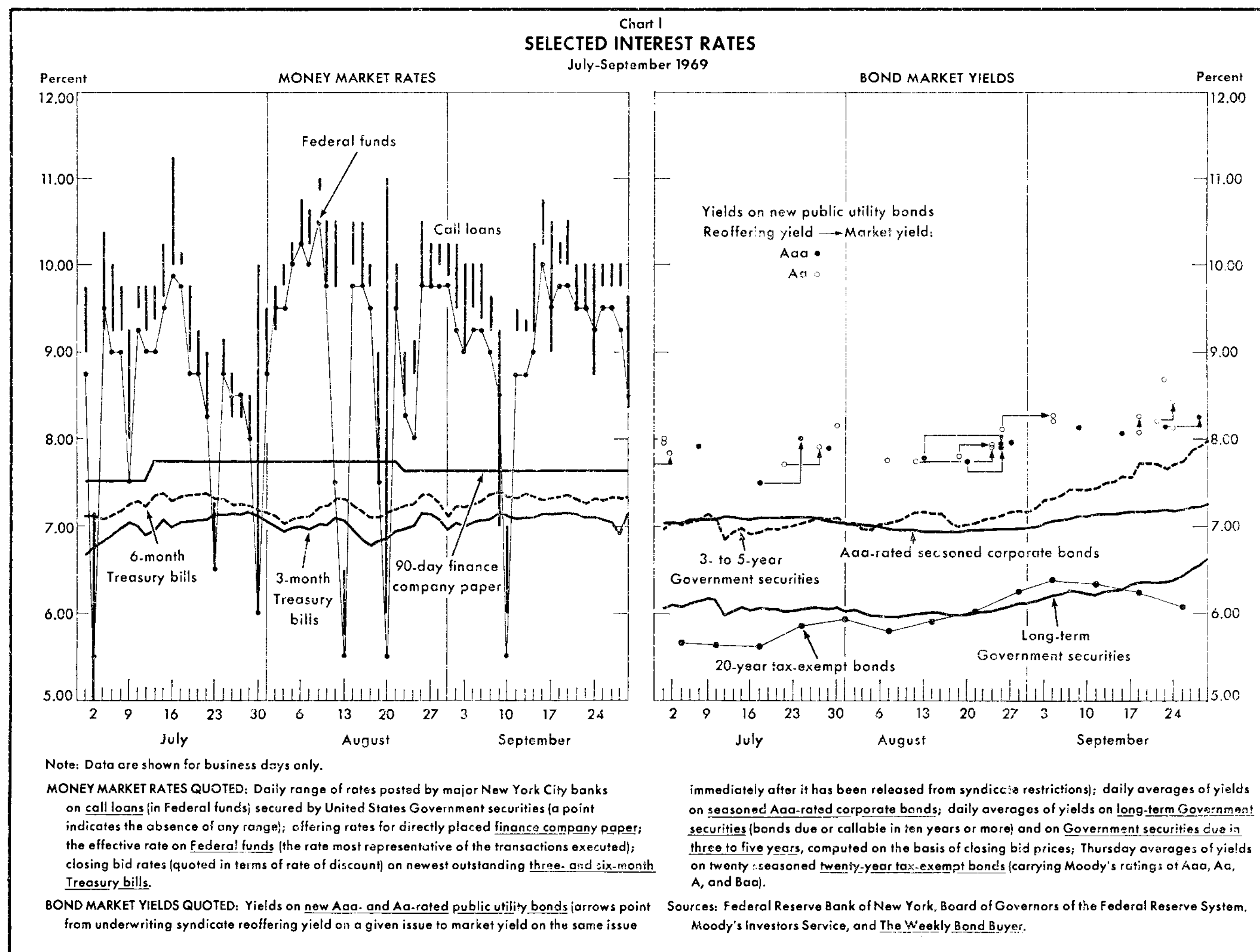

other money center banks, in contrast, showed a slight improvement in their position.

In the week ended on September 10 the basic deficit at the New York City banks increased by $1,085 million and that at the other money center banks by $433 million. A major factor contributing to the worsening in New York was a rise of $722 million in loans to Government securities dealers. That increase was to a large extent the counterpart of sizable matched sale-purchase transactions by the System to offset the effects of the large volume of reserves being supplied by Treasury operations. In addition, the Treasury made frequent calls on its accounts at money center banks. A loss of private deposits also contributed to the deterioration of the basic position at both groups of banks. Despite the fact that this was the week of quarterly corporate dividend payments as well as the sale of Alaskan oil leases, total loans and investments, other than loans to dealers, declined at the forty-six banks.

The major money center banks managed their reserve positions aggressively in the week ended on September 17, accumulating sizable reserve deficiencies over the first five days. As a result, the more usual pattern of tightness in the Federal funds market at the start of the week and some easing at the close was reversed. The effective rate on Federal funds was 8¾ percent on Thursday and Friday but then began to rise, reaching 10 percent by Tuesday as the money center banks attempted to settle their reserve positions. The volume of float was less than had been expected, and the System executed repurchase

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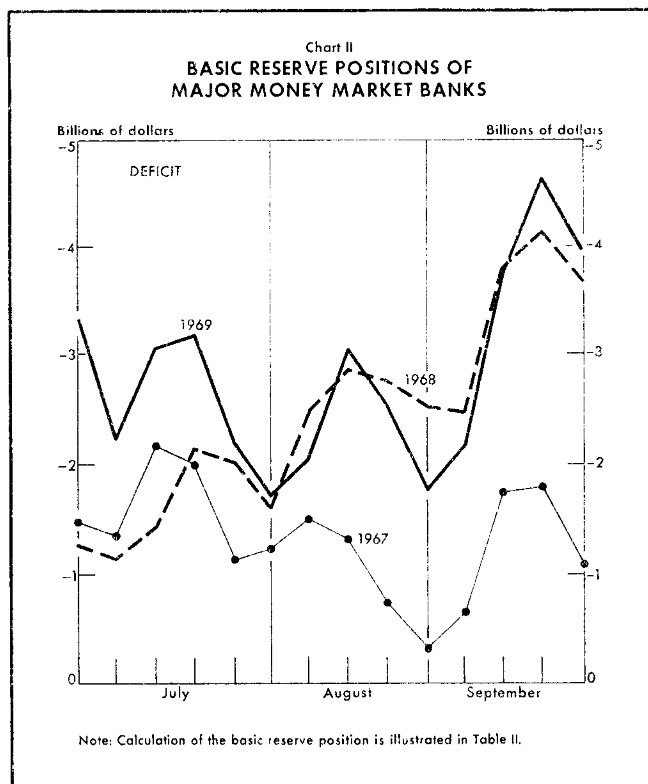
agreements which helped to reduce the effective rate to 9½ percent on the settlement date. Loans and investments at the major money center banks increased sharply during this corporate tax payment week, and the basic position of the thirty-eight banks outside New York City worsened by $773 million. The deterioration in the basic position of the eight New York City banks was considerably less, however, as sizable gains in deposits and Euro-dollar borrowings offset a large amount of the increase in loans and investments.

The tone of the money market was quite firm during the final statement week in September, and the effective rate on Federal funds was above 9 percent throughout the period. In a reversal of the pattern of two weeks earlier, Treasury operations absorbed $1,796 million of reserves on a daily average basis in the week ended on September 24, primarily in relation to tax collections. The redelivery to the System of securities from matched sale-purchase transactions executed in the previous week, and the purchase of additional securities under repurchase agreements, helped to alleviate the pressure on the banking system. The basic reserve position of the forty-six banks improved during the week (see Chart II), largely as a result of a decline in loans to Government securities dealers.



Note: Calculation of the basic reserve position is illustrated in Table II.

During the month of September, System open market operations absorbed $735 million of reserves on a daily average basis (see Table I). System operations during the first and last weeks of the month supplied reserves of $878 million on a daily average basis through repurchase agreements, but $1,613 million of reserves was absorbed during the second and third statement weeks, primarily through the use of matched sale-purchase agreements of varying maturities.

There was no change in the seasonally adjusted money supply during September following a decline of 1.8 percent (annual rate) in August. Over the third quarter as a whole the money supply grew at a rate of only 0.2 percent but at a rate of 2.9 percent for the first nine months of 1969. Total member bank deposits subject to reserve requirements (the bank credit proxy), plus banks' liabilities to their foreign branches, increased at a seasonally adjusted rate of 3 percent in September, compared with a decline of 2 percent over the first nine months as a whole. Because of the proliferation of nondeposit means of raising funds, 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 rate of 2 percent over the first nine months of the year. After adjustment for asset sales to affiliates and foreign branches, the rate of growth in bank credit increased to 3 percent.

THE GOVERNMENT SECURITIES MARKET

The market for United States Government securities was dominated in large part during September by the Treasury's October refunding, which included an issue coming due in December as well. Terms of the refunding were announced after the close of business on September 17, and subscription books were open September 22-24. Attention in the market, particularly early in the month, was also focused on the September 10 auction of North Slope oil leases by the state of Alaska, from which some reinvestment demand was anticipated.

The market also was affected by a sizable amount of Federal agency borrowing during September. The gross volume amounted to some $1,948 million, while net new money totaled $573 million. By far the largest single borrower was the Federal Home Loan Bank System, which sold $650 million of consolidated notes due in July 1970 and $250 million of consolidated bonds due in April 1971. Offered at par, the issues carried coupons of 8.40 percent and 8.375 percent, respectively.

Prices of most Treasury securities eroded persistently

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Table I

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

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

Factors	Changes in daily averages—week ended on				Net changes
	Sept. 3	Sept. 10	Sept. 17	Sept. 24	
"Market" factors					
Member bank required reserves	+ 148	— 7	— 142	— 25	— 26
Operating transactions (subtotal)	— 256	+1,395	+ 328	— 620	+ 847
Federal Reserve float	— 108	+ 365	+ 175	+ 195	+ 627
Treasury operations*	+ 39	+ 860	— 18	—1,125	— 244
Gold and foreign account	— 9	+ 27	— 2	— 11	+ 5
Currency outside banks	— 145	+ 35	— 72	+ 218	+ 36
Other Federal Reserve accounts (net)†	— 31	+ 106	+ 246	+ 104	+ 425
Total "market" factors	— 108	+1,388	+ 186	— 645	+ 821
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 237	— 935	— 678	+ 641	— 735
Outright holdings:					
Government securities	+ 155	—1,276	— 890	+1,254	— 757
Bankers' acceptances	— 1	—	— 3	—	— 4
Special certificates	—	+ 507	+ 154	— 661	—
Repurchase agreements:					
Government securities	+ 63	— 131	+ 50	+ 40	+ 22
Bankers' acceptances	+ 6	— 12	+ 7	—	+ 1
Federal agency obligations	+ 14	— 22	+ 4	+ 8	+ 4
Member bank borrowings	+ 38	— 499	+ 277	+ 89	— 95
Other loans, discounts, and advances	—	—	—	—	—
Total	+ 276	—1,433	— 401	+ 728	— 830
Excess reserves	+ 168	— 45	— 215	+ 83	— 9

	Daily average levels				
Member bank:					
Total reserves, including vault cash	26,929	26,891	26,818	26,926	26,891‡
Required reserves	26,549	26,556	26,698	26,723	26,632‡
Excess reserves	380	335	120	203	260‡
Borrowings	1,239	740	1,017	1,106	1,026‡
Free, or net borrowed (—), reserves	— 859	— 405	— 897	— 903	— 766‡
Nonborrowed reserves	25,690	26,151	25,801	25,820	25,865‡
Net carry-over, excess or deficit (—)§	80	169	166	70	121‡

	Changes in Wednesday levels				
System account holdings of Government securities maturing in:					
Less than one year	— 468	—1,703	+ 48	+1,164	— 959
More than one year	—	—	—	—	—
Total	— 468	—1,703	+ 48	+1,164	— 959

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 September 24.
§ Not reflected in data above.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS SEPTEMBER 1969

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on Sept. 24
	Sept. 3	Sept. 10	Sept. 17	Sept. 24	
Eight banks in New York City					
Reserve excess or deficiency(—)*	19	151	— 52	27	36
Less borrowings from Reserve Banks	57	64	129	84	84
Less net interbank Federal funds purchases or sales(—)	95	1,305	1,198	1,251	962
Gross purchases	*1,803*	*2,203*	*2,089*	*2,124*	*2,055*
Gross sales	*1,708*	*898*	*891*	*873*	*1,093*
Equals net basic reserve surplus or deficit(—)	— 133	—1,218	—1,379	—1,308	—1,010
Net loans to Government securities dealers	505	1,054	1,083	466	777
Net carry-over, excess or deficit(—)†	28	7	55	— 2	22
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	135	2	— 8	8	34
Less borrowings from Reserve Banks	289	39	329	306	241
Less net interbank Federal funds purchases or sales(—)	1,892	2,442	2,915	2,377	2,407
Gross purchases	*4,025*	*4,599*	*4,447*	*4,320*	*4,348*
Gross sales	*2,133*	*2,157*	*1,532*	*1,943*	*1,941*
Equals net basic reserve surplus or deficit(—)	—2,046	—2,479	—3,252	—2,675	—2,613
Net loans to Government securities dealers	— 203	26	422	— 53	48
Net carry-over, excess or deficit(—)†	— 4	81	26	2	26

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—September 1969			
	Sept. 8	Sept. 15	Sept. 22	Sept. 29
Three-month	7.184	7.156	7.161	7.106
Six-month	7.408	7.329	7.362	7.340

Maturities	Monthly auction dates—July-September 1969		
	July 24	August 26	Sept. 23
Nine-month	7.407	7.387	7.357
One-year	7.313	7.340	7.350

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

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during the month of September. The largest declines were in longer term bonds which were off by $3\frac{10}{16}$ to $4\frac{15}{16}$ points, while intermediate-term issues due in three to seven years for the most part fell by $2\frac{5}{16}$ to $3\frac{15}{16}$ points. Treasury bills due within two months experienced some improvement in September, but rates on all bills maturing beyond November rose from 1 to 27 basis points.

There was a weak tone in the market for notes and bonds during most of the first half of September. This resulted from several factors. Investment demand was quite light, and the growing congestion in the markets for Federal agency securities and corporate bonds provided further competition for available investor funds. Moreover, there was some concern over the approaching Treasury refunding, and dealers attempted to lighten their positions in the intermediate maturity area. A brief improvement occurred in response to the aforementioned speculation concerning an extension of the Vietnam cease-fire and to the remarks by Chairman Martin. Following this, however, dealers began to mark down prices of outstanding issues in anticipation of the terms of the Treasury's refunding. It also became gradually apparent that no further investment demand was likely to stem from the Alaska oil rights sale.

On September 18, the day following the announcement of the refunding terms, prices of outstanding Government notes and bonds moved sharply lower in adjustment to the yields set on the new issues. Market response to the terms was generally favorable, and the "when-issued" notes of 1971 and 1973 gained $\frac{2}{32}$ on the day, while those of 1976 rose by $\frac{1}{32}$. Heaviness developed as the month progressed, however, and the three notes were down $\frac{10}{32}$ to $\frac{19}{32}$ at the close of the period.

With the exception of the shorter maturities which were in thin supply, bill rates adjusted higher at the beginning of September and then fluctuated in a narrow range. Early in the month, activity was moderate and selling by foreign investors as well as dealers led to an increase in bill rates. This was tempered somewhat by the optimistic speculation about a Vietnam cease-fire.

In the week ended on September 19, bill rates fluctuated narrowly in fairly active trading, and the September 15 tax date presented no unusual pressures. Sizable investment demand from foreign central banks and considerable interest in the bills sold at the regular weekly auction contributed to a decline in rates at the start of the week. The trend was reversed on Wednesday afternoon, however, in the face of professional and investor selling, and rates moved higher over the remainder of the week.

Foreign demand was again a factor in the bill market in the week ended on September 26 and contributed to a better tone at the start of the period. Demand emanating from the refunding was less than participants had expected, however, and rates moved irregularly during the next several days. On balance most rates increased over the week, but some improvement occurred at the close of the month.

At the regular monthly auction on September 23, average issuing rates on the new nine- and twelve-month bills were set at 7.357 percent and 7.350 percent, respectively, down 3 and up 1 basis points from the comparable rates set at the auction a month earlier (see Table III). At the final weekly auction on September 29, average issuing rates for the new three- and six-month bills were set at 7.106 and 7.340 percent, respectively, 9 and 17 basis points above the average rates established at the last weekly auction in August.

OTHER SECURITIES MARKETS

Corporate bond prices moved steadily downward during most of the month as the volume of new offerings reached the highest total on record for September. The market rallied briefly on September 10 in response to Chairman Martin's comments and to hope for an extension of a cease-fire in Vietnam. Another short-lived rally occurred around midmonth, when the first prime-rated electric utility issue ever to offer investors more than 8 percent was marketed and a sizable scheduled issue of industrial bonds was withdrawn from the calendar. With the exception of these two periods, the trend in the corporate bond market was one of rising yields and successively higher records set on new issues. In the municipal bond market, the start of September saw a continuation of the previous month's deterioration, and on September 4 *The Weekly Bond Buyer's* Thursday index of yields on twenty municipal bonds jumped an additional 11 basis points to a record 6.37 percent. The calendar of new issues scheduled for the month was light, however, and further postponements, voluntary and involuntary, were continually occurring. In this situation of a relatively scarce supply of new issues, coupled with a more hopeful outlook on the part of participants regarding the future tax status of municipal bonds, yields on state and local government securities moved down. By September 25 the *Bond Buyer's* index stood at 6.08, a drop of 29 basis points from September 4. Thereafter, yields again rose, reflecting weakness in other markets.

The response of investors to new corporate bond offerings during the early part of the month was somewhat mixed despite the high level of returns. An Aa-rated issue of power company bonds yielding a record 8.20 per-

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cent was a quick sellout, but an Aaa-rated $150 million issue of Southwestern Bell Telephone Company debentures received only a fair reception on its offering date, despite a record return for a Bell System issue of 8.14 percent. (On August 20 a similar offering provided investors with only a 7.75 percent return and was an immediate success.) The Southwestern Bell debentures did sell out on the day following their initial marketing, as the market reacted favorably to optimism about a cease-fire and to Chairman Martin's remarks.

The improved tone in the corporate bond market was only temporary, however, and prices soon resumed their downtrend. Then, on September 15, it was announced that a $150 million issue scheduled for marketing on September 17 was being withdrawn because of unfavorable market conditions. Market participants responded positively to this sizable reduction in supply and to the sale on the next day of a prime electric utility issue whose yield marked the first offering of more than 8 percent on such an issue. Again, the improvement was brief and an Aa-rated offering of utility bonds which was aggressively priced a few days later met with a poor reception from investors. When the syndicate managing this issue was terminated, the yield on the bonds adjusted up to 8.21 percent from the initial offering of 8.08 percent. Those new issues which were attractively priced over the remainder of the month were generally well received, but successively higher record yields were required to achieve this. Moreover, investor response was not enthusiastic even at these levels.

Prices of state and local bonds fell sharply at the start of September, and a mounting backlog of older issues prompted underwriters to release several issues from price restrictions. The resulting upward yield adjustments ranged as high as 45 basis points. Postponements due to market conditions and failures to receive bids because of interest rate ceilings continued, thereby reducing the already light calendar even further. The "Blue List" of municipal dealers' inventories declined by $56 million from $406 million on August 29 to $350 million on September 30. Although there was still concern about the longer term outlook for the municipal markets, the immediate situation of relatively few new issues provided a respite, however temporary, and municipal bond yields began a retreat. Despite the sharp drop in the *Bond Buyer's* index of 29 basis points over the last three weeks of the month, the level of yields remains historically high. This was underscored by the fact that on September 24 the Federal Housing Assistance Administration was unable to sell $142 million of a $191 million offering of tax-exempt local housing authority bonds because of a 6 percent statutory ceiling. Earlier in the month the same restriction had resulted in less than half of two offerings of temporary housing and urban renewal notes being sold.

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The Clearing Mechanism of the Latin American Free Trade Association*

At a September 1965 meeting in Mexico City, central bank governors of the nine nations then belonging to the Latin American Free Trade Association (LAFTA)[1] agreed to establish a limited clearing mechanism for facilitating intraregional payments. The basic agreement provides for the negotiation of bilateral (and reciprocal) credit agreements between each pair of participating central banks and for the multilateral clearing of balances which arise from each individual bilateral credit agreement clearing. The mechanism went into operation in mid-1966 among only six countries, but since then more countries have joined and actively participated, while the number and size of underlying bilateral credit arrangements have been expanded. By reducing the magnitude and frequency of cash transactions among countries, the clearing facility has helped economize on their convertible foreign exchange and has made payments easier and less costly. LAFTA's clearing arrangement has become an important step toward financial integration among LAFTA countries. This article describes the evolution of this mechanism and the ways in which it serves the participating countries.

BACKGROUND

For decades, Latin American governments, central bankers, and regional organizations have been discussing possible means for achieving a greater degree of financial integration within the region and have considered numerous proposals for intraregional credit and clearing of balances. Establishment of intraregional clearing came slowly, however, because clearing proposals were combined with automatic credit, and some countries were reluctant to extend such credit to intraregional deficit countries. Under some proposals, creditor countries within the region would not have been able to use their regional surpluses to settle extra-regional deficits, and this appeared to them as a backward step, away from free convertibility. Furthermore, smaller and poorer surplus countries felt it unreasonable that they be forced to extend credit to larger and wealthier deficit countries, and surplus countries did not always approve of the economic policies of debtor countries.

The problem of Latin American payments was discussed at the first meeting of the United Nations Economic Commission for Latin America in 1948. At that time, bilateral agreements covered about half the area's intraregional trade as well as some extra-Latin American trade. It was hoped that multilateral arrangements could be developed to improve and eventually replace the network of bilateral agreements. Discussions continued, and in 1958 a working group of central banks proposed an agreement to create a multilateral clearing system for bilateral balances. Although the draft scheme was rather similar to the system now in force, it was not implemented at the time.

By 1960 the Latin American integration movements were becoming institutionalized, as evidenced by the establishment of the Inter-American Development Bank, LAFTA, and the Central American Common Market. Other regional organizations, such as the Center for Latin American Monetary Studies (CEMLA) and various committees of the Organization of American States and the Alliance for Progress, actively studied the financial aspects of integration. These aspects of clearing arrangements received new emphasis, as ways were sought to smooth out possible balance-of-payments difficulties arising from the lowering of intraregional trade barriers. While discussion proceeded, emphasis shifted again from this objective to that of providing incentives to facilitate the growth of intraregional trade. The example of the Central American Clearing House, which began operations in 1961 as part of Central American integration efforts, contributed to this shift. The Clearing House made intra-

* M. Alberto Alvarez, Economist, Foreign Research Division, had primary responsibility for the preparation of this article.

[1] The original signatories were the central banks of Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, and Uruguay. Bolivia and Venezuela joined later.

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regional payments easier and reduced the use of scarce foreign currency for such purposes without large mutual credit facilities. It became evident that a payments or credit system need not involve extension of sizable and long-term credits, and support developed for an arrangement whereby the maximum amount of such credit would be specified in advance and its term would be held to a very short period.

The decisive impetus to establish the present mechanism was given at the first meeting of commercial bankers of LAFTA. In their report of March 1965 to their central banks, the commercial bankers suggested the signing of a complementary agreement to the LAFTA treaty, establishing guarantees of free convertibility and the transferability of exchange used in transactions among LAFTA countries. The bankers also recommended the creation of correspondent relations among the commercial banks, whose clearing payments would be expressed in United States dollars and settled through arrangements made by the central banks. In June the Advisory Commission on Monetary Affairs of LAFTA drafted the documents, and on September 22, 1965 the governors of the LAFTA central banks signed a general agreement establishing the clearing mechanism.

THE AGREEMENT

The preamble to the general agreement makes clear that the system was conceived as the first step toward the long-run goal of financial and monetary integration. The more immediate aims, however, were to provide a stimulus to financial and trade relations within the region and to foster systematic consultations on monetary, exchange, and payments matters.

The agreement calls for the establishment of bilateral (and reciprocal) lines of credit, expressed in United States dollars, among all participating central banks. The channeling of payments through the system is entirely voluntary, thus allowing each country to maintain its trade and exchange practices. (In reality most central banks have made it compulsory for payments among addressees of signatory countries to go through the mechanism.) Article 7, however, requires the central banks to guarantee the convertibility of the currencies used in the final settlements with each other, a feature reinforced by Article 8 which specifies that settlements must be made in United States dollars.

The balances resulting from the utilization of the bilateral lines of credit are to be cleared periodically and multilaterally. (Originally the period between settlements was two months, now it is quarterly.) The agreement calls for the immediate settlement of any balance exceeding the set credit limit, but the central banks are allowed to negotiate additional extraordinary credits. Furthermore, the agreement requests the central banks to encourage intraregional correspondent relationships among their commercial banks, so that the latter may clear their net balances through the system. The clearing operations, including the computation of the net balances at the end of the period, are carried out by an agent bank, a task which has been given to the Central Reserve Bank of Peru.

The procedures are simple: on the bases of accounting information cabled by each of the central banks within forty-eight hours after the end of the last working day of the settlement period, the agent determines the balances between each pair of central banks and also the net balance of each central bank in relation to all the other banks together. By the following day the agent must notify every central bank of its net position, and this information is also sent to the designated common correspondent bank —the Federal Reserve Bank of New York. Within the next twenty-four hours the debtor countries must make their payments, in dollars, to the special LAFTA account of the correspondent bank, which then proceeds to pay the creditor banks. If a bank does not provide the required information within the stipulated forty-eight hours, the agent will compute the net balances among the other banks, with which the tardy bank will have to settle its accounts directly. Furthermore, if a debtor bank does not pay the correspondent bank within twenty-four hours of being notified, the agent will annul the clearing by ordering the correspondent bank to return the amounts received and will proceed to settle the accounts again, excluding the delinquent bank.

DEVELOPMENT OF THE SYSTEM

Immediately after the system started operating, problems became evident. The central banks authorized every payment, cabled payment orders were confirmed by airmail, and in some cases payment data were cabled daily. There were serious questions as to how to treat expenses and commissions regarding payments and how to resolve conflicts of national holidays falling on settlement dates. Credit limits in many cases were insufficient, frequently making extraordinary settlements necessary—a problem which plagued the system in its first years. In addition, as any pair of participating banks could establish their own operating techniques by setting them forth in a bilateral agreement, until recently no two bilateral credit agreements were completely alike. For example, there were significant differences regarding the amount of documen-

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Table I

BILATERAL CREDITS
UNDER AGREEMENTS NEGOTIATED BY THE END OF MARCH 1969

In millions of dollars

Country	Argentina	Bolivia	Brazil*	Chile	Colombia	Ecuador	Mexico	Paraguay	Peru	Uruguay*	Venezuela	Total
Argentina	—	2.0	†	15.0	3.0	†	1.5	1.0	17.0	†		39.50
Bolivia	2.0	—	†	.5	.1		.2		.45			3.25
Brazil*	†	†	—	5.0	†		3.0	†	3.0			11.00
Chile	15.0	.5	5.0	—	.75	†	5.0	.2	4.5	.5	1.8	33.25
Colombia	3.0	.1	†	.75	—	.8	3.0		1.0			8.65
Ecuador	†			†	.8	—			.5			1.30
Mexico	1.5	.2	3.0	5.0	3.0		—	.2	1.0		1.5	15.40
Paraguay	1.0		†	.2			.2	—	.2			1.60
Peru	17.0	.45	3.0	4.5	1.0	.5	1.0	.2	—		†	27.65
Uruguay*	†			.5						—		.50
Venezuela				1.8			1.5		†		—	3.30

* The agreements have been signed but are not in operation.
† Agreements being negotiated.
Source: Boletín Mensual (CEMLA, February 1968), page 102, (July 1969), page 318, and *Síntesis Mensual* (LAFTA, May 1969), page 188.

tary credits to be authorized, the limit at which excess balances would require immediate settlement, the extent of the guarantee to be given on currency convertibility and transferability, and the option of channeling some or all payments through the system.[2] The general agreement, however, sets forth simple provisions for revising the system, and amendments soon solved many problems.

Last year most improvements were incorporated in a uniform text for bilateral credit agreements and a technical procedures annex, drafted by LAFTA's Advisory Commission on Monetary Affairs, to which all countries adhere today.[3] The uniform text provides that all payments between addressees of the two signatory countries are allowed to go through the mechanism. Payments are to be expressed in dollars, are subject to the foreign exchange regulations of the countries, are to be effected under most-favored-nation terms, and are to be made by the central banks or their authorized institutions. Those payments arising from trade in merchandise originating outside the two countries, as well as services and capital transactions with nonresidents, are excluded from the bilateral agreements.

A major improvement in the system, which had been discussed since 1966, is formalized in the uniform text by a "payments guarantee" clause. Each central bank guarantees the settlement of payments going through the agreement. Most of these payments arise from the letters of credit, documentary credits, certified drafts, and payment orders drawn or issued by its own commercial banks, and the guarantee provides that each commercial bank of the other country must declare "in writing and under its absolute responsibility" that it has made the payment according to the instructions of the drawer bank. Prior to this guarantee, commercial and financial transactions between commercial banks were routed through the central banks; now such transactions can be made directly between commercial banks.

Two other major improvements, which were introduced in May 1968 by the Council on Financial and Monetary Policies of LAFTA, are incorporated in the uniform text. First, interest is charged on debit balances at a rate 1½ percentage points below the discount rate of the Federal Reserve Bank of New York in effect at the beginning of the settlement period. This makes the mechanism more attractive to net creditor countries. Second, the central banks are authorized to use multilaterally, with the permission of all the parties concerned, the unused credits

[2] For a more comprehensive description, see Appendix 1, "Características Comunes y Aspectos Divergentes de los Convenios de Crédito Recíproco en ALALC", in "Ampliación y perfeccionamiento de los mecanismos de compensación en América Latina", *Boletín Mensual* (CEMLA, April 1968), pages 195-99.

[3] See *Boletín Mensual* (CEMLA, September 1968), pages 478-82 for text of the bilateral agreements and technical procedures.

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that are available to them bilaterally. This enhances the usefulness of the system as a multilateral instrument. Until recently, the credits were compartmentalized by the bilateral agreements: a country could exhaust its credit with one central bank and not be able to make use of the credits available under the remaining individual bilateral agreements. In August 1968 the new option was used for the first time by Chile, which settled $1.5 million with Mexico by utilizing its credit balances with Colombia, Peru, and Venezuela.

The uniform text provides for variations in the size of the basic credit that can be extended under each agreement (see Table I) as well as in the percentage of the basic credit to which balances may expand before immediate settlement of the excess is required. (These percentages presently run from as low as 5 percent to as high as 333.33 percent of the basic credits.) This provision regarding excess balances acts as a secondary line of credit and was introduced with the objective of eliminating, as far as possible, settlements before the end of the settlement period. It also gives the central banks time to adopt measures to reduce excess balances and takes into account legal restrictions on the granting of unlimited credit by some central banks.

Increasing participation of signatory countries in the system has been an important development. To be sure, the central banks are far from having concluded all the bilateral agreements possible, but it should be recalled that they are not compelled to do so and, what is more important, that some countries have virtually no trade

Table II

LAFTA CLEARINGS

In millions of dollars

Settlement date (end of period)	Argentina	Bolivia	Chile	Colombia	Ecuador	Mexico	Paraguay	Peru	Venezuela	Total*
1966										
June	1.8		— .5	— †		— 1.1	— .1	— †		1.8
August	.6		.2	— †		— 1.1	— .8	1.1		1.9
October	8.5		— 7.1	— .9	— .1	3.4	1.2	— 5.2		13.2
December	9.4		— 10.2	— 1.9	— †	4.0	1.2	— 2.6		14.7
1967										
February	12.5		— 10.7	.6	— .5	3.8	.4	— 6.0		17.3
April	16.0		— 10.1	.3	— .7	2.9	— †	— 8.3		19.2
June	11.2		— 7.5	— .5	†	3.0	— .6	— 5.6		14.3
August	13.2		— 8.7	— .1	— .2	.9	.2	— 5.3		14.3
October	10.8		— 9.8	— 3.6	.1	3.4	.2	— 1.1		14.5
December	10.6		— 6.8	— 1.9	— .2	3.7	— .1	— 5.3		14.3
1968										
February	22.1		— 11.0	— 3.1	.2	2.6	— .3	— 10.4		24.9
April	21.2	— .4	— 12.0	— 2.8	— .5	4.4	— 1.3	— 8.7		25.7
June	16.8	— .8	— 14.7	— 2.8	.9	5.8	1.1	— 6.2	— .2	24.7
September‡	25.4	.2	— 22.3	— 4.0	— .5	9.6	.5	— 8.9	— .1	35.7
December	13.3	— .5	— 8.9	— 4.0	— .4	4.3	.9	— 4.7	— †	18.5
1969										
March	14.0	— .9	— 8.2	— 1.7	— 2.1	7.6	— .1	— 8.5	— †	21.6
June	21.8	— 2.3	— 17.7	— .3	— 1.4	7.3	— .2	— 7.1	— .1	29.1

Note: Minus figures represent net payments; other figures are receipts. Because of rounding, figures do not necessarily add to totals.
* Total receipts and total payments.
† Less than $50,000.
‡ Since July 1, the clearings have taken place quarterly.
Source: Síntesis Mensual, LAFTA.

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relations with certain other LAFTA members. All things considered, the growth in the number of agreements signed and in the volume of final settlements has been extremely rapid. In May 1966 the clearing mechanism started operations with six central banks—out of nine original signatories to the general agreement—and nine bilateral agreements, totaling $17.8 million. At that time, five other bilateral agreements totaling $5.6 million had been signed, but balances were not cleared through the mechanism. By December 1967, ten banks had signed the general agreement, with seven taking part in the clearing through sixteen bilateral agreements totaling $25.7 million. Venezuela, the new member, settled balances under its two bilateral agreements outside the mechanism. By the first quarter of 1969, eleven banks had signed the general agreement, and nine of these were actively participating in the system through twenty-three bilateral credit agreements amounting to $61.2 million.[4] Brazil and Uruguay, original signatories of the general agreement, have signed four bilateral agreements totaling $11.5 million, but they have yet to start operations. Thus, out of a possible total of fifty-five bilateral agreements within LAFTA, twenty-seven have been signed, eight are being negotiated, and another twenty remain to be negotiated. As a result of one early revision of the agreement allowing the central banks of Latin American countries outside LAFTA to participate in the clearing mechanism, the Dominican Republic concluded a bilateral credit agreement with Venezuela and apparently intends to negotiate others in order to participate in the system.

Progress toward attaining other goals of the system has been mixed. "Triangulation"—the utilization of the services of a common correspondent commercial bank outside the region, usually in the United States, to make payments among commercial banks in the LAFTA countries—has been almost totally eliminated. Some banks, however, find lines of credit in hard currencies with banks outside the region, especially in the United States, to be useful in the financing of intraregional transactions. The development of correspondent relationships among commercial banks has been uneven. While the more aggressive LAFTA banking systems have been quite successful in establishing correspondent relationships among themselves, others are required to transact all foreign exchange operations through their central banks.

A major immediate objective of the clearing system —the saving of foreign exchange—has been successfully achieved. Foreign exchange transactions going through the system have been curtailed by almost three fourths: 65 percent to 75 percent of the transactions are cleared internally by the netting of claims against liabilities, and only the remaining 25 percent to 35 percent are settled in United States dollars. Thus, in June 1966, the first clearing, covering balances totaling $6.3 million, was settled by payments of only $1.8 million (see Table II). Recent figures indicate that between $70 million and $100 million in balances is now being cleared quarterly, with final settlements averaging $26 million. Savings have also resulted for the commercial banks. They can keep smaller balances outside the region and do not have to pay the commissions and cabling expenses entailed in the clearing of transactions through third countries.

While the system cannot claim to have increased LAFTA's trade, it has clearly expedited payments and lowered their costs.[5] Formerly, payments delays of over six months were not rare. Today, it is claimed that these delays have been reduced substantially, while the costs of bank commissions and fees have been considerably reduced in most cases. Moreover, it is reported that total payments going through the system exceed commodity trade payments, indicating the increased utilization of the mechanism for nonmerchandise purposes. For example, Argentina and Peru channel all payments through the system; on the other hand, Chile and Venezuela do not allow the payment of their main exports, copper and petroleum, to go through the system.

While problems have not disappeared, the central banks are gradually solving them. For example, some central banks are having difficulties in receiving data on payments from others, there are no uniform criteria as to the effective date for applying interest rates on the central

[4] Part of the $61.2 million resulted from the extension of the settlement period to three months and the subsequent increase in the amounts of the reciprocal credit agreements.

[5] Several studies have analyzed and evaluated the operations and achievements of the clearing system. Enrique Angulo, "Los acuerdos de créditos y compensación en Centroamérica y en la ALALC", *Boletín Mensual* (CEMLA, August 1966), pages 369-83, and "Integración financiera Latinoamericana en 1968", *Boletín Mensual* (CEMLA, July 1969), pages 311-23. Comité Técnico Especial sobre Mecanismos de Compensación, "Informe", *Boletín Mensual* (CEMLA, February 1968), pages 95-103. CEMLA, "Ampliación y perfeccionamiento de los mecanismos de compensación en América Latina", *Boletín Mensual* (April 1968), pages 188-200, (May 1968), pages 263-79, and (June 1968), pages 342-53. Felipe Pazos, "Mecanismos multilaterales de pagos en América Latina", *Temas del BID* (Inter-American Development Bank, September 1968), pages 1-18.

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bank debits, and commercial banks still occasionally forget some of the routine formalities embodied in the technical procedures.

Despite these problems, the system's immediate goals have been, for the most part, achieved. Through their close cooperation, the central banks have developed more understanding of each others' difficulties, a stronger mutual confidence, and a greater willingness to work together in solving common financial problems. This new attitude has been quite evident in the system's rapid shift from very restricted operations under detailed instructions to a more relaxed, decentralized, and multilateral method of operating under the bilateral credit agreements. It has also been evident in the continuous efforts to strengthen the institutions of financial integration. This strengthening was evident in September, when the Council on Financial and Monetary Policies of LAFTA reportedly approved the establishment of credits to cover balance-of-payments difficulties—a further step toward the common utilization of the area's financial resources.

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