

FEDERAL RESERVE BANK OF NEW YORK



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The International Monetary System: Retrospect and Prospect

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*An address before the Business Forum and the Money Marketeters,
New York University, New York, N.Y., on November 13, 1974*

Today I would like to share with you a look at the development of the international monetary system since World War II, together with a brief attempt to see what may lie ahead. Let me state at the outset, however, that visibility has rarely been lower than it is now. The whole world economy is being subjected to strains greater than would have been imaginable a few years ago. And, as you know, the International Monetary Fund (IMF) Committee of Twenty found it impossible to give the recent annual meeting of the Fund's governors a full blueprint of a new system. In the light of this very uncertain state of affairs, it is especially hard to distinguish those tendencies that are likely to be embodied in whatever new system will emerge some years in the future. However, I think the effort is worth making.

My vantage point for these observations is a favorable one. The Federal Reserve Bank of New York is the operating arm of the Federal Reserve System in the international area, and we participate in the Federal Open Market Committee's formulation of policies. The Bank also acts as agent for the Treasury in carrying out most of its foreign exchange and other international transactions. We enjoy close relations with virtually all the central banks and other monetary authorities in the world.

In our vaults are \$17 billion of gold (valued at the official price) held in custody for these monetary authorities—the largest concentration of gold in the world—as well as the bulk of their holdings of United States Treasury securities, \$60 billion, well over 10 percent of the total United States public debt. A very large proportion of their dollar payments pass through our books, and last year the securities transactions we carried out for them

came to almost \$300 billion, about three times the huge total effected for the System Open Market Account.

Since my coming to the Bank in 1956, our international transactions have expanded greatly in volume and our overall international activities have grown in importance. This is one area of our responsibilities that over recent years has involved much of the time and attention of the Bank's top executives. One aspect of this involvement that deserves particular attention is the development of the Federal Reserve swap network.

THE EARLY YEARS OF THE FEDERAL RESERVE SWAP NETWORK

This network has turned out to be a major contribution to the international monetary system. In general, it is fair to say that the Federal Reserve swap network has proved its worth under both fixed-rate and managed-float arrangements and will probably remain an indispensable feature of whatever may be the future international financial system.

I don't have time to go into the mechanics of the swap transactions, but the essence of the operation is a renewable short-term credit of, say, ninety days' duration from one central bank to another. Before the inception of the Federal Reserve swap network in 1962, such central bank swap transactions had been arranged from time to time on an *ad hoc* basis, notably during the run on sterling in 1961.

In early 1962, the Federal Reserve, with the strong support of the United States Treasury, concluded that there would be a continuing and probably increasing need

for central banks to help each other out by providing short-term credits to partner central banks whose currencies might come under selling pressure from time to time for a broad range of reasons, from seasonal weakness to unwarranted speculative attacks. It seemed to us in the Federal Reserve that the best way of dealing with this problem was to arrange well in advance for reciprocal lines of credit linking up the major central banks in the world with the Federal Reserve, whose currency—the dollar—was the intervention currency for our foreign central bank partners. We felt, and I think correctly, that by setting up these reciprocal lines of credit in a highly visible way, and in advance rather than waiting until they were actually needed, we could provide an assured reinforcement of the international financial system. I hasten to add that neither the Federal Reserve nor any of its central bank partners in this endeavor ever had any illusion that the swap network could do more than provide such a reinforcement. After all, the continued operation of any stable international financial system depends fundamentally upon the ability of the United States and other major trading nations to maintain reasonable equilibrium in their balance of payments.

From April 1962 until the closing of the gold window in August 1971, the Federal Reserve swap network grew from a single \$50 million swap arrangement with the Bank of France to an \$11.7 billion credit system embracing fourteen central banks and the Bank for International Settlements. During this decade, many countries saw their balance of payments swing from surplus into deficit and back. As various currencies came under temporary selling pressure, the swap network was called upon to make available an overall total of \$27.1 billion of swap credits. Of this total, \$11.8 billion were drawings by the Federal Reserve, and \$15.4 billion drawings by our partners. In general, the swap credits accomplished their purpose of enabling countries to ride through speculative squalls and other short-term difficulties, and the repayment record was generally excellent.

THE DEFENSE OF STERLING IN THE 1960's

Of the many financial events of the 1960's in which the swap network played a role, the defense of sterling merits special attention. From the restoration of convertibility in 1958 until Britain's devaluation of sterling in 1967, sterling was the currency that caused by far the greatest concern in financial circles. Sterling's malady was not a steady one, for it was punctuated by periods of strong recovery and restored faith—only to be followed by new difficulties. I shall not try to analyze the reasons for

sterling's recurrent weakness. But, since it had a reserve currency role second only to that of the dollar, its fate involved the whole monetary system and was a matter of keen interest to other countries. There was wide recognition of the danger that a devaluation of the pound would prove to be a prelude to speculative attacks against the dollar. As it turned out, these fears were borne out almost immediately after sterling was actually devalued. In recognition of this interdependence, the Federal Reserve participated with other major central banks in the defense of sterling. Naturally only the country whose currency is in question can make the basic political decision to devalue or revalue. But as long as the will to defend the sterling parity continued within the United Kingdom, I believe our concerted efforts in its behalf were thoroughly justified.

During this period, the drawings by the Bank of England on the Federal Reserve swap network and on other *ad hoc* central bank credit arrangements fluctuated quite widely as sterling moved up and down. The reliance on central bank credit did not obscure the question of exchange rate adjustment. In fact, six months before the devaluation of sterling in November 1967, the Bank of England had completely paid off all outstanding central bank debt. Incidentally, in the case of the dollar, the major buildup of swap indebtedness of the Federal Reserve, totaling more than \$3 billion at the time of the closing of the gold window, was incurred only during the very last weeks of dollar convertibility.

THE INCONVERTIBLE DOLLAR

The relative trade position of the United States had begun to deteriorate in the late 1950's and early 1960's, and vast sums were already moving abroad for investment to take advantage of faster growing markets and lower costs and to jump Common Market barriers. But it was the sharp acceleration of United States inflation after mid-1965, together with the sterling devaluation, that really brought dollar convertibility into serious doubt. Whether or not the decision of August 1971 could have been avoided or deferred through timely measures by all the major trading nations before the final speculative wave struck the dollar will be debated for a long time. In any event, cutting the tie between the dollar and gold had a traumatic effect on the international monetary system from which it has not yet recovered. Because of its primacy as a trading and investment currency, the dollar had become by far the principal medium for official intervention in the exchange markets and also by far the largest component of monetary reserves except for gold.

With all respect for the valiant and painstaking efforts to establish the special drawing right (SDR) as an acceptable substitute, it cannot take the dollar's place as the chief vehicle for official intervention. Moreover, it must be acknowledged that gold still represents the most cherished form of monetary reserves in a great many countries.

After the tie to gold was cut, it came to be quite widely held that we need feel no concern as to how low the dollar might sink in the exchange markets, even under periodic speculative attacks, because a cheaper dollar would assure a better competitive trade position for United States products. The philosophy of "benign neglect" overlooked the serious inflationary impact that a depreciation of the dollar could have, and indeed did have, on the domestic price level. It also neglected the fact that the bulk of the world's trade was denominated in dollars, the largest financial markets were dollar markets, and most countries of the world still looked to the dollar as their main monetary anchor. An anchor that bobbed about wildly in the heavy seas was not very helpful. Furthermore, this philosophy posed the danger of encouraging a spirit of competitive exchange rate adjustments and monetary controls which, if it had developed, could have destroyed much of the fabric of economic cooperation that had been woven so carefully in the years following World War II.

The Federal Reserve swap network lay dormant for slightly more than a year after the closure of the gold window, while the negotiation and launching of the Smithsonian agreement got under way. By July 1972, however, it had become clear that the United States could not leave the entire burden of supporting the Smithsonian dollar rate to foreign governments, and so the Federal Reserve resumed intervention in the exchange markets, again relying upon the swap network to meet its needs for foreign currencies.

In early 1973, another tidal wave of speculation swept through the exchange markets, and in February 1973 it was decided to devalue the dollar for the second time. A modest amount of Federal Reserve swap debt incurred just prior to the devaluation was quickly repaid, but intervention was not resumed as both the United States and the major European countries agreed in March 1973 to let the dollar float. Unfortunately, the dollar did not float, but sank precipitously, as speculative pressures cumulated. By early July 1973, exchange trading in the dollar was grinding to a standstill. At this critical juncture, the Federal Reserve was again called upon by both the United States and European governments to resume exchange market intervention, backed up by a major enlargement of the swap network to nearly \$18 billion. (The

total now stands at almost \$20 billion.) The very announcement of this policy shift from a free to a managed float of the dollar brought about an immediate strong recovery of dollar rates. From then on, the tide began to turn.

Over the succeeding year, Federal Reserve intervention to support the dollar amounted to somewhat more than \$1 billion, mainly financed by drawings on the swap network, all of which were repaid in less than six months' time. Today, as the markets realize that the authorities are fully prepared to show their presence, violent speculation has subsided and exchange markets are orderly. The oil embargo and skyrocketing oil prices have, of course, contributed to sizable swings in the exchange rates over the past year.

THE FINANCIAL ASPECTS OF THE ENERGY CRISIS

The quadrupling of the price of oil has altered the whole international financial outlook more violently than any other event in many decades. I need not remind this audience that the magnitudes involved in the prospective shift of monetary reserves to the oil-producing countries really stagger the imagination. No wonder there is widespread pessimism about devising arrangements that can handle such flows. Even the most successful arrangements would still mean overwhelming burdens of debt service for many countries, both developing and developed, that could not be carried indefinitely. This prospect underlines the great need to bring about—through cooperative measures by oil producers and consumers alike—a reduction of this huge imbalance in international payments as rapidly as possible, with a view to its elimination in the foreseeable future.

This may seem a dreamer's objective, but I see it as the only way out and I would hope that the joint efforts necessary toward this end will get under way before too long. The aim should be a two-pronged reduction of the imbalance: to reduce the volume of oil payments and, in the longer run, to speed up the oil-exporting countries' purchases of goods and services.

Regarding the gross flow of oil payments, much has been said of the need to achieve a lower level of oil prices, and I endorse this aim. I would also like to see a greater emphasis on effective measures to conserve fuel, however unpopular they might be, and on the development of alternative energy sources.

The other side of the imbalance, the inability of the oil-exporting countries to spend their newly found wealth promptly on imports from abroad, is clearly even more difficult to tackle and has to be viewed in a longer con-

text. A great deal of skepticism prevails regarding the possibility of ever raising the level of the oil-exporting countries' imports anywhere near the value of their oil receipts. Their imports, however, are already rising at a surprisingly rapid rate. And for the future, massive international programs of economic development not just in individual countries but in entire regions, such as the Middle East, should make it possible for the oil-consuming countries to make the transfers of resources necessary to pay for the oil they require. At the same time, of course, such programs would help the oil-exporting countries speed their efforts to utilize their underground resources for the benefit of their coming generations.

In the meantime, while the large imbalances continue, the world must find better ways for financing them. So far private markets and institutions have taken care of most of the oil payments without undue difficulty. But it would be a bad mistake to assume that they can continue to do so much longer. For one thing, the oil payments are now running at a much higher rate than even in the first half of the year, apparently at least 50 percent higher. No doubt the commercial banking system will retain a role but, from now on, a variety of public channels will have to be relied upon to an increasing extent. This will be necessary if we are to avoid serious dislocations in the weaker—but not necessarily the smallest—nations and the consequences these would entail for the trading and investing world in general.

The term "recycling" has become very popular in recent months. To me it is a misnomer—or worse—for the problem at hand. It tends to conceal the basic question of who should assume the credit risk in lending to the countries beset with economic difficulties.

Notwithstanding the risks and difficulties involved, if the United States receives a large share of the investment flows from the oil producers, as a good many market observers think quite likely, careful thought will have to be given to means of channeling some portion of these flows to less fortunate countries experiencing big oil deficits—and this will call for political awareness as much as technical skill.

More fundamentally, the oil-exporting countries will have to take on themselves an increasing share of the risk of the financing of the oil deficits through bilateral credits and grants. There are already some encouraging signs to this effect. These countries will probably also wish to undertake a growing volume of the oil-deficit financing through international organizations. There would thus seem to be a major role in the financing of the oil deficits for these organizations, such as the IMF and the World Bank and their affiliates, or even for new bodies.

REFLECTIONS ON BRETTON WOODS

Before I attempt to look further ahead at the prospects for reshaping the international monetary system, I should like to reflect on Bretton Woods.

In the last few years, views as to the merits of greater "flexibility" in the international monetary system have exhibited substantial swings. The Bretton Woods system—based on mutually agreed and preestablished par values for all currencies, embodying a clear code of international monetary behavior, monitored and guided by the IMF, and shared in by all the principal countries of the non-Communist world—was widely disparaged after the closing of the gold window in August 1971. For a while it was the conventional wisdom to welcome a brave new world in which exchange rates would no longer be instruments of economic policy but would be left largely to seek their own levels in the market. This new world, it was thought, would no longer have to fear exchange "crises" in which the dams finally break after large-scale efforts of central banks to maintain untenable rates prove futile. Moreover, it was claimed, governments would no longer have to compromise domestic economic policies to protect exchange rates. Inflationary consequences of large payments imbalances could be avoided, as surplus countries would no longer face the need for huge support operations. At the same time, deficit countries could escape having to restrain domestic spending to stem vast losses of reserves.

However, it didn't work out that way. In the first place, during the brief periods since the end of Bretton Woods when exchange markets were on their own, it was not surprising that speculative pressures tended to cumulate and exchange rates were driven far from any likely equilibrium levels. Thus serious exchange troubles were not banished, but took the form of violent movements of exchange rates rather than violent movements of exchange reserves. To be sure, surplus countries did not have to face the inflation potential of unwanted reserve gains. But excessive exchange rate swings aggravated inflation in deficit countries, without bringing fully corresponding price moderation to the surplus countries whose exchange rates were appreciating. The experience also showed that the hope of freeing domestic policies from external constraint was largely illusory.

In any event, after the Bretton Woods system was abandoned, it became clear that exchange rates were still a matter of major political and economic importance in every country. Hardly any government or its monetary authority was willing for very long to let its own currency float entirely in response to market forces. In fact, since

March 1973 (when floating began) official intervention in the exchange markets to moderate exchange rate fluctuations has totaled some \$52 billion by the Group of Ten countries alone.

Thus, in my view, the recent experience has underlined some of the positive aspects of the Bretton Woods system. By providing an international framework for exchange rate changes, with the backing of substantial amounts of credit, both automatic and discretionary, that system made it possible for such changes to be made without international discord and with a minimum of restrictions on the international movement of goods, services, and capital. To be sure, as time went on, exchange rate stability sometimes turned out to be rigidity. It is, of course, a truism that no international system can either compensate for the inability of sovereign member states to manage their affairs properly or offset their unwillingness to pool some of their sovereignty for the benefit of a wider community. More fundamentally, what brought the Bretton Woods system to an end were the asymmetries in the adjustment process that increasingly came to the fore: on the one hand, the asymmetry between the strong pressures exerted on debtor countries and the weaker pressures felt by creditor countries and, on the other hand, the asymmetry in the meeting of deficits of reserve currency countries and countries without such currencies. But, as we look ahead, these shortcomings should not blind us to the old system's very considerable contributions to an unprecedented growth in world commerce.

PROSPECTS FOR THE INTERNATIONAL MONETARY SYSTEM

As I said at the outset, the past year's events have made it even more difficult than before to foresee the shape of tomorrow's monetary system. I was always of the view that, once the key element of the postwar system no longer existed, i.e., the link between the dollar and gold, it would not prove possible to agree in advance to a complete new system. Rather it would be necessary to rebuild gradually on an *ad hoc*, experimental basis, with various blocks of the new system being put in place as they proved their worth. The oil problem merely strengthens my conviction in this regard. If asked to mention specifics of the system that will eventually develop, about all I can do is to cite a few principles that I think must be adhered to and to point out some areas that call for special attention and study.

We need agreed-upon rules of conduct and balanced pressures to help enforce them. The area of exchange rate policies is crucial to the well-being and growth of the

world economy, and fortunately it is one where we can begin promptly, building upon our recent experiences. A country's exchange rate is too vital an element of its economic welfare to be left in the hands of often capricious exchange markets. At the same time, it affects other countries as well, particularly among the major trading nations. As a result, exchange rate relationships bear the seed of conflicting national interests. Unless these are reconciled, no monetary system can function properly. A framework of greater exchange rate stability is one that lends itself best to such a reconciliation. But reasonable exchange rate stability should be a primary aim in its own right. With it, exchange markets can function better, world trade and payments have a more assured basis on which to grow, and national governments have the opportunity to carry out domestic policies in a climate of relative certainty. And it must not be forgotten that such stability is in the interest of the developing countries as well as of the major industrial powers. The developing countries have in recent years been seriously exposed to violent swings of exchange rates that were not of their making. No wonder they have been quite vocal in urging a return to a system in which there is some reasonably stable framework to which they can tie their own currencies.

As we move toward greater exchange rate stability, and I believe we are doing so, we must not overlook the need for orderly procedures for changes in rates. The balance-of-payments adjustments that are necessary as the world economy grows and develops, at times at a different pace in individual countries, cannot always be made through domestic policies alone. But to give such policies a chance to be effective requires international credit lines that can be utilized as and when needed. The IMF quota facilities, the Common Market's Fund, the Federal Reserve swaps, and other central bank credit lines are essential components of an orderly monetary system.

Thus, as I see it, exchange rate stability, orderly balance-of-payments adjustments, and a solid network of international credit arrangements are some of the building blocks for the new system. Beyond this, a multitude of problems such as the role of multinational corporations and banks, surveillance of the Euro-currency markets, better coordination of national monetary policies, and the plight of the poorest among the developing countries need thorough attention.

Progress on all these fronts is unlikely to be as rapid as we would like. Unfortunately, the oil problem and the worldwide disease of virulent inflation, and now the fears of recession, enhance the risk that shortsighted nationalistic tendencies might come to the fore.

Of one thing I am certain, however. The world we live

in is one where interdependence is a vital reality that we cannot afford to overlook. We must bend every effort to find cooperative and durable answers to our major economic problems. In the specialized area of financial and monetary cooperation, the world's monetary authorities have made a good start in the past few decades. In

particular, I can attest from personal experience that central bankers have learned to work together intimately and effectively in matters involving the exchange markets. I see every reason to believe that effective means of international cooperation will be found in this very difficult new world we face today.

New Publications

Public Policy Toward Mutual Savings Banks in New York State: Proposals for Change, a new study, recommends that savings banks be permitted to offer checking account services and loans to consumers, but also be made subject to reserve requirements, deposit rate ceilings, and taxes that apply to commercial banks.

Single copies of this 272-page study are available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. Additional free copies are available, in reasonable quantities, for educational purposes. In other cases, additional copies can be ordered prepaid at \$2.50 per copy. A 44-page booklet containing the first chapter and summaries of the six remaining chapters of the study is available, in reasonable quantities, without charge.

* * *

A revised version of *Key to the Gold Vault* is available. The twelve-page pamphlet unlocks some of the mysteries of gold, exposes some of its often glamorous past, and reveals the workaday operations of the New York Fed's gold vault—the depository for the world's largest gold treasure.

Key to the Gold Vault is available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

The Business Situation

Recent economic news indicates some further weakening in business activity.* In October, after months of comparative stability, industrial production posted a sharp, widely based decline, and the automobile industry made substantial layoffs in November and scheduled further cuts for December. New orders for durable manufactured goods fell somewhat further in October, and the backlog of unfilled durables orders dropped for the first time in over three years. Moreover, recent surveys of plant and equipment spending planned for 1975 suggest little or no increase, and quite possibly a decline, in real terms, from capital spending in 1974. Retail sales have continued to weaken, and home building remains depressed. Reflecting the slump in business activity, the unemployment rate jumped to 6.5 percent in November.

Despite the reduction of demand pressures, severe inflation persists. There are, however, some tentative signs that the slowdown in economic activity may be beginning to have an impact on prices at the wholesale and retail levels. While food prices have begun to climb again, the prices of commodities other than food have lately grown at significantly slower rates. Industrial wholesale prices increased at a 13.4 percent annual rate in October, about equal to the September rise but well below the almost 33 percent annual-rate increase averaged during the first eight months of the year. At the retail level, prices of nonfood commodities rose at a 6.8 percent annual rate in October, the smallest advance in a year.

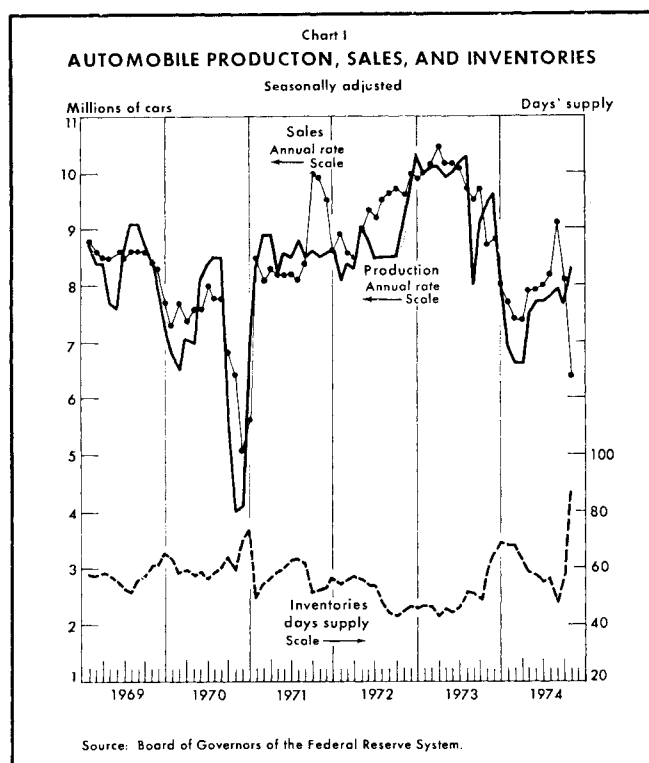
* The revised third-quarter estimates indicate that the gross national product (GNP) increased at a seasonally adjusted annual rate of 9.4 percent. The rate of growth of the implicit price deflator was revised upward to 11.8 percent per annum, and the rate of decline of real GNP was estimated to be 2.1 percent. According to the preliminary estimate released with the GNP revisions, pre-tax corporate profits were reported to have grown \$1.1 billion to a seasonally adjusted annual rate of \$106.7 billion.

INDUSTRIAL PRODUCTION

Industrial production declined at a 6.7 percent annual rate in October. In the previous eight months, the output of the nation's factories, utilities, and mines had been fairly stable, having even recovered somewhat from the sharp drop induced by the oil embargo last winter. However, the October decline put the level of production below the third-quarter average and 2 percent below the November 1973 peak. Decreases in output in October occurred in nonautomotive consumer durables, construction materials, and a wide range of other durable and non-durable materials. At the same time, however, business equipment output edged up and steel production remained high, possibly in anticipation of the coal workers' strike.

The strike by members of the United Mine Workers union, which began on November 12, undoubtedly had an adverse impact on industrial production in November. Within a week of the strike's onset, steel mill output had begun to slow down. Subsequently, layoffs were announced by the major steel companies, and total steel production fell 12.5 percent in the four weeks ended December 7. The effect of the four-week strike on other coal-dependent industries was probably minimized by stockpiling and the already slow rates of production.

In the automotive industry, scheduled production cuts for November and December reflect the dramatic fall in new car sales and the existence of large stocks of unsold cars. Auto manufacturers misjudged demand for new 1975 models in October, producing at an annual rate of 8.3 million units while sales dropped off to an annual rate of 6.4 million units (see Chart I). As a result, inventories of auto dealers jumped from an average fifty-eight days' supply in September to eighty-seven days' supply in October. In response, all four United States automotive manufacturers drastically reduced production plans for November and December.



CAPITAL SPENDING, DURABLES ORDERS, AND INVENTORIES

Appropriations for new plant and equipment by the nation's 1,000 largest manufacturers advanced by 8.5 percent in the third quarter, according to preliminary estimates by The Conference Board, Inc. However, excluding the capacity-short petroleum industry, the third-quarter rise was only 4.6 percent, and the Conference Board estimates that inflation accounted for almost all of this increase. For the economy as a whole, the McGraw-Hill survey of anticipated outlays on plant and equipment projects a 12 percent rise in 1975, about the same as this year. However, if realized, the survey also reports that these plans amount to little, if any, change in real terms. Moreover, planned expenditures on plant and equipment in 1974 have already been pared, according to the latest survey conducted by the Department of Commerce. The projected increase in outlays in the fourth quarter is now placed at 0.4 percent, significantly lower than the August survey estimate of 2.8 percent.

Preliminary data indicate that new orders for durable

manufactured goods fell in October by \$1.1 billion, after dropping by \$3.1 billion in September. Most of the decline over the last two months occurred in the capital goods industry, but bookings in all sectors, including primary metals and transportation equipment, are significantly below their August levels. Unfilled orders of durables, which have probably cushioned the drop in production in recent months, fell in October for the first time in almost three and one-half years; the 1 percent decline was widespread. The latest survey conducted by the National Association of Purchasing Management, Inc., indicates a continued weakening in new orders in November. Declining orders were noted by 48 percent of those reporting in November, up from 39 percent in October and the largest percentage in twenty-six years.

In September, manufacturing and trade inventories rose by a sizable \$4.5 billion, little changed from the advances recorded in the last four months. Coupled with a slight fall in business sales, this resulted in a sharp jump in the ratio of the book value of manufacturing and trade inventories to sales. Although the level of the current inventory-sales ratio does not appear to be very high by historical standards, two factors suggest that stocks may be somewhat more excessive than indicated by this ratio. First, the ratio of book-value inventories to manufacturing and trade sales is an underestimate of the true inventory-sales ratio during inflationary periods, because much of the book value of inventories is valued in terms of past prices while sales are valued more nearly in terms of current market prices. Second, the composition of recent inventory gains tends to suggest some unintended inventory accumulation: the accumulation of finished goods inventories accounted for 41 percent of the total change in manufacturers' inventories in September, contrasting sharply with the 27 percent average over the previous three months. In October, the portion of finished goods to total manufacturers' inventory accumulation remained at 41 percent.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

Personal income rose by \$8.4 billion in October, about the same rate of total increase as over the past year. However, in the private sector, wage and salary gains slowed substantially, moving up by only \$2.8 billion at an annual rate in contrast to a \$5.7 billion advance in September. Manufacturing payrolls alone rose by \$1.7 billion, as increases in average hourly earnings offset declines in employment and the average workweek. At the same time that income growth in the private sector began to lag, the

implementation of a pay raise for Federal Government employees added \$2.1 billion to the increase in personal income.

Consumer spending continued at a sluggish pace. According to the advance report, retail sales fell by 0.4 percent in October, following a larger 2.1 percent drop in September. In real terms, sales have been weakening for some time. Indeed, as of October 1974, constant-dollar retail sales were 6 percent below what they had been a year earlier. Declines in real disposable income and general economic uncertainties have made the consumer wary. The index of consumer sentiment prepared by the University of Michigan fell to 64.5 percent in the third quarter. This was about the same level as in the first quarter of 1974, when fears associated with the oil embargo pushed the index to the lowest point in the twenty-eight-year history of the Michigan survey.

The slump in auto sales more than accounted for the October decline in retail sales. According to the Michigan survey, auto buying has been hurt by widespread awareness of record price increases. Moreover, the cost of financing purchases of autos has continued to rise: the finance rate charged consumers by major automotive finance companies, as published by the Board of Governors of the Federal Reserve System, averaged 14.03 percent in September, up from 13.82 percent in August and 13.45 percent in September 1973.

Residential construction remains at depressed levels. In October, housing starts edged down to a seasonally adjusted annual rate of 1.1 million units, little changed since August but 32.9 percent below a year ago. Total permits for new housing units fell 2.6 percent during October to a seasonally adjusted annual rate of 802,000 units, the seventh straight monthly decline. Rapid increases in the prices of homes, low levels of consumer confidence, high mortgage rates, and lack of mortgage money have all contributed to the weakness in the housing sector. Deposit growth at thrift institutions has picked up recently, with inflows to savings and loan associations and mutual savings banks rising by 5.3 percent in October or twice as much as the average for the previous three months. Thrift institutions may concentrate on rebuilding their liquidity over the near term, but continued deposit inflows should eventually lead to improvement in the availability of mortgage funds.

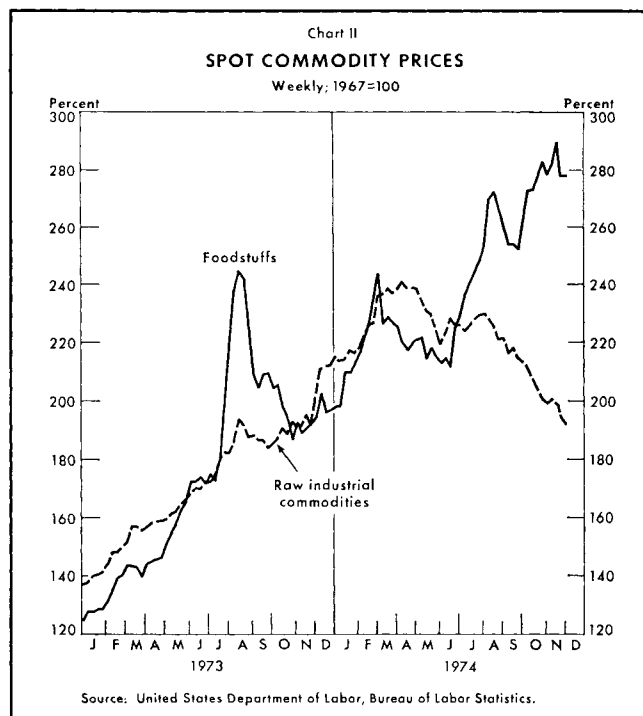
PRICES

Wholesale prices surged ahead in October, bringing the rise over the last twelve months to 22.6 percent, the largest yearly increase since 1947. After edging up at an annual

rate of only 1.1 percent in September, the seasonally adjusted index of wholesale prices jumped by 27.9 percent at an annual rate, as food prices resumed their climb. The index for farm products, processed foods, and feeds has moved irregularly upward over the past year to a level 10.6 percent above October 1973, and the trend is expected to continue. However, recent spot prices indicate a slight easing in farm prices in November (see Chart II). The spot price index rose only 0.3 percent from mid-October to mid-November, after rising 10 percent over the previous monthly period.

Industrial commodity prices rose at a 13.4 percent annual rate in October. While high by historical standards, the 13 percent advance in the index over the last two months is considerably less than the 32.9 percent average annual increase in the first eight months of 1974. Moreover, about one third of the October rise is attributable to higher 1975-model car prices. (About two thirds of the average \$386 increase in the price per car was included in the wholesale price index, because one third of it was attributed to improvements such as pollution control devices. To the extent that increases in prices of products are traceable to improved quality, that increase is not reflected in the index.)

The slowdown in industrial commodities price increases



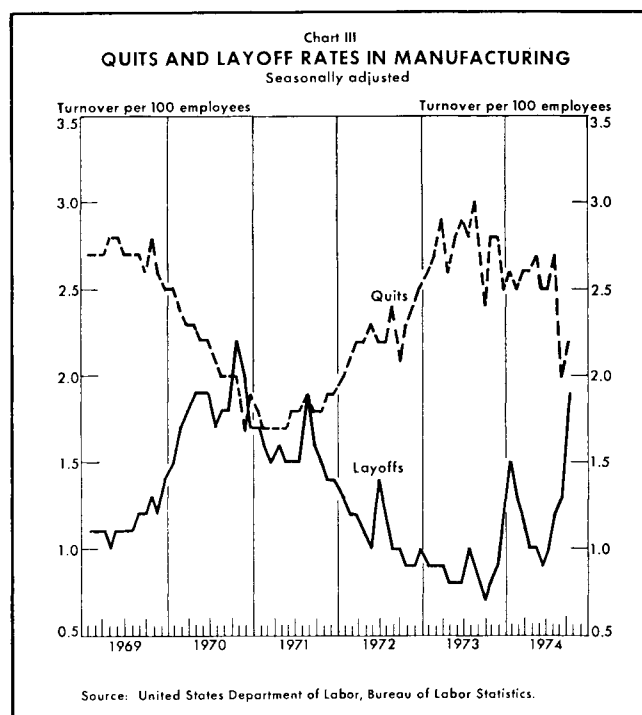
reflects, in part, the recent slackening in basic raw materials prices. Over the last three months, the index of crude materials excluding food and feed has risen only 0.2 percent at an annual rate. This compares with an increase in the previous seven months of 1974 of 47.1 percent at an annual rate. However, while raw materials have stabilized in price, the cost of finished goods continues to surge at rates somewhat more than 20 percent on an annual basis. These prices probably reflect previous increases in raw materials prices as well as accelerating wage costs.

Total consumer prices climbed at an annual rate of 10.3 percent in October, down from 15 percent in September and 16 percent in August. While food prices have continued to surge—the food component of the consumer price index rose 16 percent at an annual rate in October as higher prices for sugar, cereal, and bakery products offset declines in meat and poultry prices—the rate of increase in the prices of nonfood commodities has slowed significantly in the last two months. In October, the index of all commodities less food rose 6.8 percent at an annual rate, down substantially from 12 percent in September and an 18.2 percent annual-rate increase in August. Attempts to liquidate finished goods inventories in the face of softening demand may be contributing to the slowing in the rate of price increases. The latest price rise reflected increases in new and used car prices.

LABOR MARKET DEVELOPMENTS

The nation's civilian unemployment rate soared to 6.5 percent in November, the highest level since October 1961. The 0.5 percentage point rise, which was widespread among major age and sex groupings, reflected the continued economic slump. Total civilian employment fell by 785,000 workers in November to the lowest level since December 1973. Over the first ten months of this year, employment had been advancing at a slow but irregular pace.

In the November payroll survey of nonfarm establishments, seasonally adjusted employment fell by 443,000 workers. Since this survey was taken early in the month, the drop did not reflect the strike by 120,000 members of the United Mine Workers union. The recent decline was pervasive, with employment down substantially in, among other sectors, machinery, electrical equipment, transportation equipment, furniture, and primary metals. Move-



ments in the labor turnover rates underscore the deteriorating situation in the manufacturing sector (see Chart III). The layoff rate has jumped sharply from a rate of 1.3 per 100 employees in September to 1.9 percent in October, and the November and December figures, when available, will probably show that further increases occurred during those months because of shutdowns in the auto industry. Meanwhile, indicative of the reduced job opportunities, the number of people voluntarily leaving their present jobs has declined from an average rate of 2.6 workers per 100 employees in the first eight months of the year to 2.1 percent in September and October combined.

The employment picture was further clouded by the sharp drop in the average workweek. Production workers' average weekly hours dropped by 0.4 hour to 36.2 hours in November, the lowest level in the fourteen-year history of the survey. In manufacturing, the average workweek fell 0.6 hour in November to 39.5 hours. Overtime also dropped sharply, from 3.2 hours in the previous month to 2.7 hours in November.

The Money and Bond Markets in November

Following two months of decline, interest rates were mixed in November. Short-term rates, which had fallen substantially in previous months, fell somewhat further at the start of November but held steady or increased later on. For the month as a whole, most short-term rates changed little, although commercial banks' prime lending rates were lowered further in November in lagged response to previous declines in other money market rates. After the close of the month the Board of Governors of the Federal Reserve System approved reductions in the discount rates at six Federal Reserve Banks, including New York, from 8 percent to $7\frac{3}{4}$ percent. The Board announced that it had taken these actions, effective December 9 and 10, in view of lower money market rates and the slackening in the demand for credit.

In the markets for corporate and longer term Government securities, the rally continued through most of November. The halt in the decline in short-term rates and growing supplies of issues in dealer positions, however, caused bond prices to lose some of their gains as the month drew to a close. Moody's Aaa bond-yield average declined 38 basis points over the month. The long-term markets were faced with a heavy volume of new issue activity in November. The Federal Government was in the market often, refinancing maturing obligations and raising new cash. Substantial quantities of corporate issues also came into the market during the month at generally lower yields. However, the absence of investor demand for tax-exempt issues and large current and upcoming supplies kept these securities from joining the bond market rally.

During the month, the Board of Governors of the Federal Reserve System announced several regulation changes. The Board announced on November 13, and later modified slightly on November 18, a restructuring of reserve requirements on member bank demand and time deposits. The new reserve requirements apply to deposits in the week beginning November 28 and affect required reserves in the week beginning December 12. The timing of the change, which was expected to free about \$750 million (net) of reserves, was set to coincide with the seasonal need for reserves in December. (Details of the restructuring are discussed below.) On November 22, the Board an-

nounced that the limit on outright holdings of bankers' acceptances by the Federal Reserve System had been increased from \$500 million to \$1 billion. The increase was initially authorized by the Federal Open Market Committee on November 11 to insure a smooth market adjustment following the suspension of the System's guarantee of acceptances purchased by the Federal Reserve Bank of New York for foreign official accounts. Finally on November 26, the Board amended its Regulation Q to permit governmental units to hold savings deposits at member commercial banks. The action was taken in conjunction with new legislation, effective November 27, providing deposit insurance for public time and savings deposits up to \$100,000. The Board set the interest rate ceilings for public deposits at member banks at 5 percent on passbook savings deposits and 7.5 percent on other time deposits under \$100,000.

The Board also released revised measures of the monetary aggregates, which incorporated new bench-mark data for nonmember banks from the June 30 call report and revised seasonal adjustment factors. The revisions began in 1968 for M_1 , in 1964 for M_2 , and in 1969 for the adjusted bank credit proxy. Growth rates for these measures computed over periods as short as a quarter are about the same as those derived from the old series. Monthly growth rates in 1974 for the revised series, however, fluctuate over a somewhat narrower range than previously indicated. The growth of seasonally adjusted M_1 in October was revised downward from an annual rate of 5.1 percent to 3.8 percent, while third-quarter growth remained unchanged at a sluggish 1.6 percent. According to preliminary estimates, however, the growth of the monetary aggregates strengthened in November.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

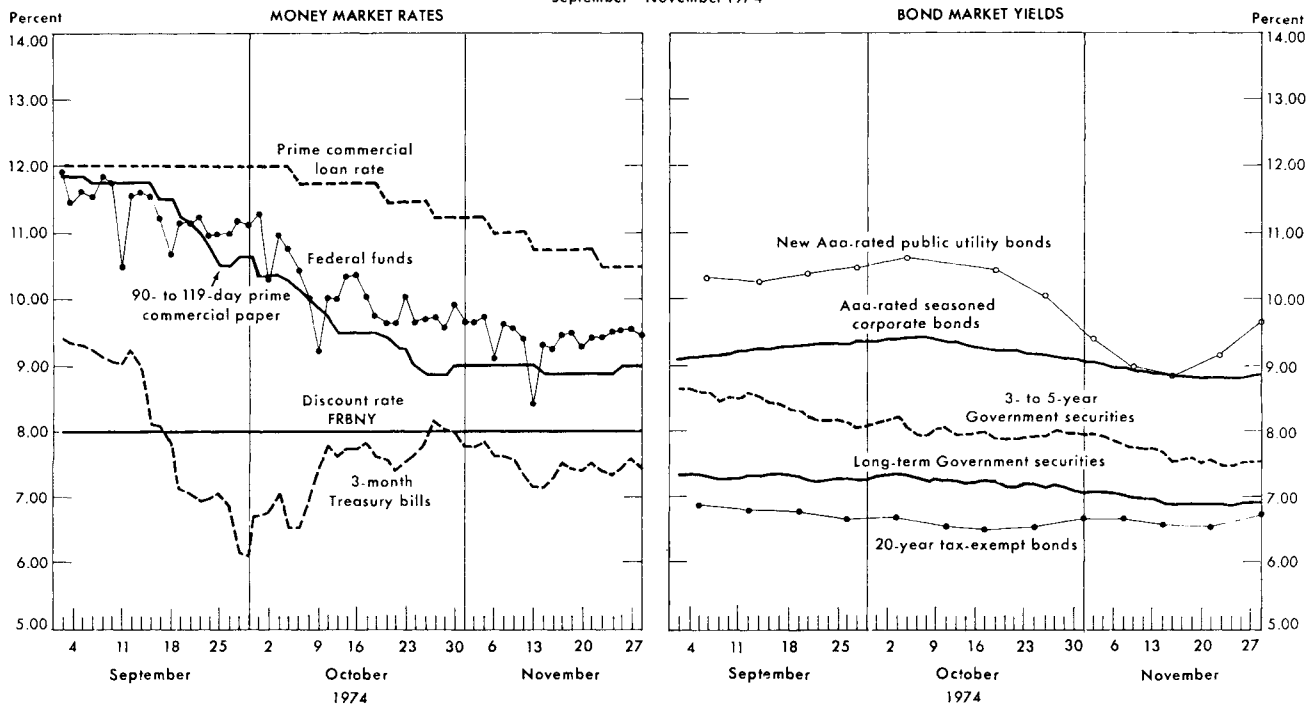
After falling sharply in the two preceding months, most money market rates changed little in November (see Chart I). While some further declines in rates were registered by midmonth, these movements were largely retraced by the close of the period. For the month as a whole,

the effective rate on Federal funds averaged 9.45 percent, 61 basis points below October's average and the lowest monthly level since March. The Federal funds rate actually changed little from the end of October to the end of November, but it resumed declining in early December. The rate on 90- to 119-day dealer-placed commercial paper dipped $\frac{1}{8}$ percentage point in mid-November to $8\frac{7}{8}$ percent but increased to $9\frac{1}{8}$ percent by the month end. Similarly, rates on other maturities of commercial paper were virtually flat over the period. The bankers' acceptance market sustained moderate rate increases over the month. In the early part of November the New York Federal Reserve Bank announced a suspension of the System's practice of guaranteeing acceptance purchases

on behalf of foreign official accounts. In announcing the change, the Bank noted that the volume of bankers' acceptances held for foreign official accounts and carrying the Federal Reserve's guarantee had risen sharply in recent years to over \$2 billion and that there was a good possibility of further large increases. Partly as a result of the suspension, small banks found they had to pay more in comparison with the large banks than previously.

Banks using floating-rate formulas continued to reduce their prime rates in several steps, in response to previous declines in other money market rates, but other banks generally lowered theirs at a slower pace. By the close of the month, a majority of banks were quoting a rate of $10\frac{1}{2}$ percent, down from $11\frac{1}{4}$ percent at the end of

Chart I
SELECTED INTEREST RATES
September - November 1974



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Prime commercial loan rate at most major banks; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the five dealers that report their rates, or the midpoint of the range quoted if no consensus is available; 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-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a

standard Aaa-rated bond of at least twenty years' maturity; daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

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

Table 1
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, NOVEMBER 1974

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

Factors	Changes in daily averages— week ended				Net changes
	Nov. 6	Nov. 13	Nov. 20	Nov. 27	
"Market" factors					
Member bank required reserves	— 109	+ 355	— 448	+ 306	+ 104
Operating transactions (subtotal)	+ 392	+ 892	—1,099	—1,182	— 997
Federal Reserve float	+ 102	+ 457	+ 521	— 952	+ 128
Treasury operations*	+ 328	+ 912	— 471	— 690	+ 79
Gold and foreign account	+ 10	—	— 210	+ 209	+ 9
Currency outside banks	— 131	— 856	— 856	+ 375	—1,468
Other Federal Reserve liabilities and capital	+ 83	+ 379	— 83	— 124	+ 255
Total "market" factors	+ 283	+1,247	—1,547	— 876	— 893
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 135	—1,342	+1,675	+1,389	+1,857
Outright holdings:					
Treasury securities	— 20	— 777	+ 775	+ 549	+ 527
Bankers' acceptances	+ 8	— 4	+ 39	+ 82	+ 125
Special certificates	+ 19	— 19	—	—	—
Federal agency obligations	—	—	+ 284	+ 47	+ 331
Repurchase agreements:					
Treasury securities	+ 65	— 274	+ 367	+ 458	+ 616
Bankers' acceptances	+ 46	— 97	+ 98	+ 54	+ 101
Federal agency obligations	+ 17	— 171	+ 112	+ 199	+ 157
Member bank borrowings	— 511	— 29	+ 269	+ 114	— 157
Seasonal borrowings†	— 25	— 9	— 7	+ 2	— 39
Other Federal Reserve assets‡	+ 80	+ 21	— 530	— 50	— 479
Total	— 296	—1,350	+1,414	+1,453	+1,221
Excess reserves‡	— 13	— 103	— 133	+ 577	+ 328
	Daily average levels				Monthly averages§
Member bank:					
Total reserves, including vault cash†	36,990	36,532	36,847	37,118	36,872
Required reserves	36,688	36,333	36,781	36,475	36,569
Excess reserves	302	199	66	643	303
Total borrowings	1,127	1,098	1,367	1,483	1,269
Seasonal borrowings†	79	70	63	65	69
Nonborrowed reserves	35,863	35,434	35,480	35,635	35,603
Net carry-over, excess or deficit (—) ..	127	198	114	25	116

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Included in total member bank borrowings.

‡ Includes assets denominated in foreign currencies.

§ Average for four weeks ended November 27, 1974.

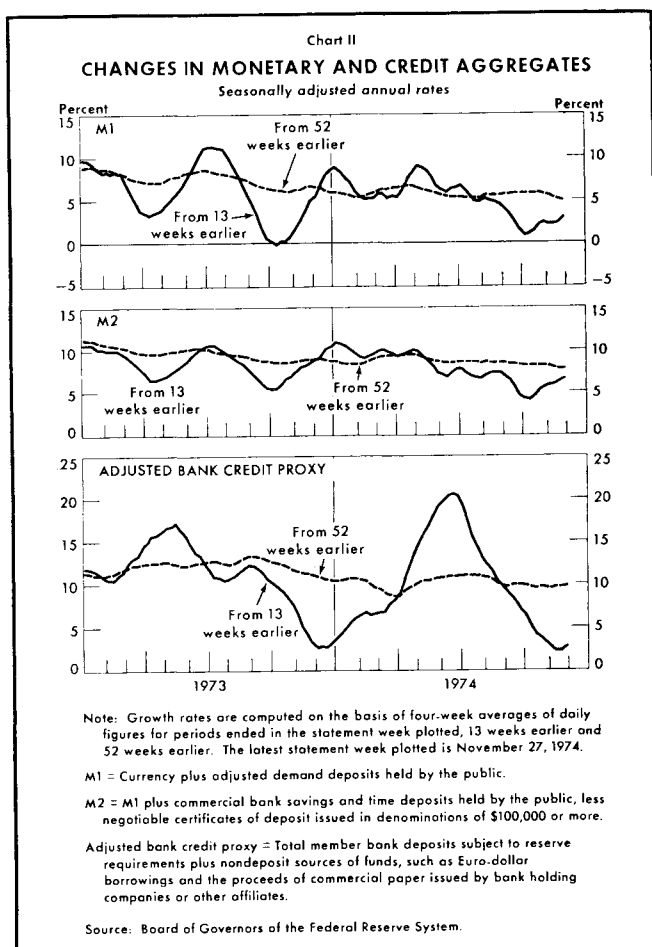
|| Not reflected in data above.

October. Despite the decline, the spread between the prime rate and commercial paper rates remained unusually wide by historical standards. This encouraged businesses to continue meeting part of their financing needs by selling their own commercial paper, although many continued to use bank lines. Business loans at New York City weekly reporting banks increased by \$950 million over the four-week period ended November 27, and the volume of non-financial commercial paper outstanding rose over the same period by \$574 million.

Banks continued to reduce their outstanding large certificates of deposit (CDs) over much of the month, but this trend was reversed in the final week. After declining by \$715 million over the first three weeks, CDs at the twelve weekly reporting banks rose by \$876 million over the November 27 statement period.

According to preliminary data, the growth in most of the widely followed monetary aggregates increased in November. M_1 —demand deposits adjusted plus currency outside banks—advanced at a 6 percent seasonally adjusted annual rate in the four-week period ended November 27 over the average of the four weeks ended October 30. At the same time, the adjusted bank credit proxy—which includes deposits of member banks plus certain nondeposit liabilities—rebounded, growing at a 6.1 percent annual rate after showing virtually no change in October. Time deposits other than large CDs continued to rise rapidly, thus boosting the growth of M_2 —which consists of these time deposits plus M_1 —to a 9.4 percent rate over the same period. Taking a somewhat longer perspective, however, growth of M_1 , M_2 , and the proxy in the four weeks ended November 27 from the corresponding period thirteen weeks earlier remained well below the pace experienced over comparable periods earlier this year (see Chart II).

The restructuring of reserve requirements, as announced by the Board on November 13 and later amended slightly on November 18, incorporated the following changes. The reserve requirement on all time deposits with an initial maturity of six months or longer was reduced from 5 percent to 3 percent. The reserve requirement on all time deposits with an initial maturity of less than six months was increased from 5 percent to 6 percent. (The first \$5 million of such deposits at each member bank is subject to a 3 percent reserve requirement.) The marginal reserve requirement of 3 percent on large-denomination CDs with a maturity of less than four months was removed. (The 3 percent marginal reserve requirement on longer term large CDs had been removed earlier this year.) Finally, the reserve requirement on net demand deposits over \$400 million was reduced from 18 percent to 17½ percent.



THE GOVERNMENT SECURITIES MARKET

Heavy financing activity by the United States Government dominated attention in the Government securities market throughout November. In addition to its quarterly refinancing during the first part of the month, the Treasury auctioned several short-term issues to obtain new cash. Evidence of further weakening in the economic situation encouraged market participants to expect moderation in credit demands and some easing in monetary policy in the months ahead. In this atmosphere, the interest in longer term securities strengthened. Yields on coupon issues continued recent declines, with returns on intermediate-term issues generally about 25 to 50 basis points lower and returns on long-term issues 4 to 27 basis points lower than in October.

In its refinancing, the Treasury sold \$4.85 billion of notes and bonds to replace \$4.3 billion of obligations maturing November 15 and to obtain \$550 million of new cash. Investors were offered \$2.5 billion of three-year notes, \$1.75 billion of seven-year notes, and \$600 million of additional 8½ percent bonds due in 1999. Market participants bid strongly in the auctions of these issues, which took place November 6, 7, and 8, resulting in average yields of 7.85 percent for the three-year notes, 7.82 percent for the seven-year notes, and 8.21 percent for the bonds.

In addition to offering at each regular auction \$200 million more of Treasury bills than the volume maturing, the Treasury added to bill supplies on three occasions during the month. On November 20, \$2.25 billion of April 16, 1975 tax anticipation bills (TABs) was auctioned at a 7.43 percent yield; on November 21, additions to outstanding short-term bill series totaling \$1 billion were auctioned; and on November 26, \$1.25 billion of June 17, 1975 TABs was auctioned at a 7.52 percent rate. The terms for these TAB sales were somewhat unusual in that banks were not permitted to pay for bill purchases by crediting their Treasury Tax and Loan Accounts.

Treasury bill rates moved lower over the month, even though supplies were substantially enlarged. Investor demand for issues was generally good, and expectations of further declines in rates buoyed the market over a good part of the month. The average issuing rate for three-month bills fell about 56 basis points from 7.89 percent at October's last auction to 7.33 percent at the November 25 auction (see Table II). Bill rates in the secondary market generally declined 25 to 30 basis points over the month.

The market for Federal agency securities benefited from a fairly light calendar and from the favorable interest rate expectations that prevailed over most of the month. As strong demands for new corporate issues pushed rates down toward those on agencies, demand for the latter picked up. A net redemption of \$216 million in Federal Home Loan Bank debt obligations contributed to the good reception to the sale on November 8 of \$500 million of 2¼-year bonds yielding 8.05 percent and \$500 million of five-year bonds yielding 8.15 percent. The farm credit agencies again came to the market at midmonth with about \$1.5 billion of securities, raising about \$200 million of new cash. Yields were 40 to 50 basis points below similar offerings the previous month. On November 26, the Federal National Mortgage Association sold \$1.2 billion of debentures in a three-part package; yields on the issues which raised \$500 million in new cash were 7½ percent for \$200 million due to mature on September 10, 1976, 7.80 percent for \$700 million due in 4¾ years, and 7.95 percent for \$300 million due in 9¾ years.

Table II
AVERAGE ISSUING RATES
AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—November 1974			
	Nov. 1	Nov. 8	Nov. 18	Nov. 25
Three-month	7.880	7.604	7.528	7.328
Six-month	7.857	7.552	7.427	7.369
Fifty-two weeks	Monthly auction dates—September-November 1974			
	Sept. 18	Oct. 16	Nov. 13	
	8.341	7.629	7.362	

* 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.

THE OTHER SECURITIES MARKETS

Emerging investor demand for long-term corporate bonds allowed underwriters to place some large issues at reduced yields and supported a rally in prices of seasoned issues over a good part of the month. Concern over the effects of a weak economy on the financial condition of business, however, continued to temper market enthusiasm for lower rated debt. The calendar of new corporate issues remained very heavy and was highlighted by several high-quality offerings often combining notes and bonds. Utilities also benefited from the firmer tone, and some were able to obtain funds at lower cost and with less call protection than in recent months. However, the rates paid remained well above those paid by industrial borrowers, and the differential probably increased. Scant investor interest appeared in the tax-exempt market. New issues were not placed readily, and prices of seasoned bonds fell over most of the period.

Most new issue activity in the corporate sector remained on a negotiated basis. Underwriting syndicates easily placed large debenture offerings of two high-quality indus-

trial firms long absent from the bond market. But investors responded selectively to other financings, with utility and lower quality issues less favored. For example, in two twenty-five-year industrial offerings, \$100 million of debentures from an Aa-rated firm was priced to yield 8.73 percent, while underwriters were distributing \$100 million of A-rated debentures that came to market on the final day of the preceding month at a 9.35 percent return. A typical Aa-rated utility offered 9.15 percent on \$60 million of thirty-year first-mortgage bonds, and the yield on \$25 million of similar securities sold by an A-rated utility was 10.25 percent. American Telephone & Telegraph Company canceled the largest financing ever undertaken by a utility, after the Department of Justice entered a major antitrust suit against the company. The offering, which was withdrawn for technical reasons, was very well received by investors and will be returned to the market late in January.

A large supply of unsold state and local government bonds weighed on the tax-exempt market throughout the month, and additions to this supply were foreseen from a sizable calendar of new issues. On the demand side of the market, interest on the part of major commercial banks failed to materialize, and casualty and insurance companies also remained on the sidelines. With traditional purchasers of these securities largely absent from the market, the municipal sector generally failed to participate in the rally. Distribution of three state issues provided a reading on the market for Aaa-rated tax-exempt issues during the month. Investors accorded a good reception to \$95 million of state of Maryland bonds, yielding 4.85 percent in 1977 to 6.00 percent in 1989. However, two subsequent issues met resistance when priced more aggressively. The issues were a total of \$100 million of state of California bonds reoffered at yields of 4.30 percent in 1975 to 6.10 percent in 1995 and \$40 million of state of Ohio bonds returning 4.50 percent in 1975 to 6.60 percent in 1999. On November 29, The Bond Buyer index of twenty municipal bond yields stood at 6.71 percent, 6 basis points above its level at the end of October. The Blue List of dealers' advertised inventories rose over the month by \$212 million to a level of \$1,036 million on November 29.

Treasury and Federal Reserve Foreign Exchange Operations Interim Report*

By CHARLES A. COOMBS

As previously reported, the Federal Reserve had repaid by the end of July 1974 all but \$64.6 million of swap debt to the Bundesbank incurred during the first half of the year. The dollar remained generally buoyant in August during the transition of presidential authority from the Nixon to the Ford administration, rising against the mark to a level 10 percent above the lows reached in early May. In this favorable market situation, the Federal Reserve was able to acquire through a series of market purchases sufficient marks to liquidate the remainder of its swap debt to the Bundesbank and accumulate working balances as well. In two instances, however, the Federal Reserve found it desirable to intervene to restrain sudden selling pressure on the dollar. On August 8-9, when market uneasiness over the political uncertainties was compounded by release of discouraging United States wholesale price figures for July, the Federal Reserve sold \$20.8 million of marks from balances, \$5.3 million of Dutch guilders drawn on the swap line with the Netherlands Bank, and \$2.5 million of Belgian francs, of which \$0.8 million was financed from balances and \$1.7 million drawn under the swap line with the National Bank of Belgium. These swap drawings of guilders and Belgian francs were quickly repaid through market purchases as the dollar recovered. Again, on September 3, after the German authorities announced the proposed lifting of their reserve requirement on German residents' borrowings abroad (the "bardepot"), a sharp decline in the dollar was checked

by Federal Reserve sales of \$16.2 million of marks from balances.

The buoyancy of the dollar during the summer months reflected primarily the pull of unusually high interest rates in New York and the Euro-dollar market, reinforced by a revival of expectations that surplus oil revenues would accumulate in United States financial markets after saturating investment outlets elsewhere. By September, however, New York and Euro-dollar interest rates were slipping back from their peaks. Disappointing trade figures for both July and August and news of further rapid inflation of United States prices also tended to weaken the dollar rate.

By early October, the exchange markets were showing signs of nervousness as the decline of dollar interest rates continued amid mounting evidence of a slackening pace

Table I
FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS
UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, July 31, 1974	Drawings (+) or repayments (—) August 1 through October 31, 1974	System swap commitments, October 31, 1974
National Bank of Belgium.....	261.8	{+ 1.7 — 1.7	261.8
German Federal Bank	64.6	{+103.6 — 64.6	103.6
Netherlands Bank	-0-	{+ 5.3 — 5.3	-0-
Swiss National Bank.....	371.2	-0-	371.2
Bank for International Settlements (Swiss francs).....	600.0	-0-	600.0
Total	1,297.5	{+110.6 — 71.6	1,336.5

Note: Discrepancies in totals are due to rounding.

* This interim report, covering the period August through October 1974, is the fourth of a series providing information on Treasury and System foreign exchange operations to supplement the regular series of semiannual reports appearing in this *Review*. Mr. Coombs is 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 the Federal Reserve System in the conduct of foreign exchange operations.

of United States business activity. Reported diversification of surplus oil revenues from dollars and sterling into continental European currencies, and the pessimistic mood at the International Monetary Fund annual meeting, heightened market fears of renewed exchange rate volatility. Moderately heavy selling of dollars developed in early October, and the Federal Reserve resisted an excessive slippage in the rate by selling a total of \$36.1 million equivalent of marks from balances on October 3-4. The dollar briefly steadied, but on October 9, as the market assessed President Ford's anti-inflation proposals, a large buy order for marks pushed the dollar down sharply, setting off more generalized speculative selling of dollars. To maintain orderly market conditions, the Federal Reserve sold \$104.4 million of marks; of these, \$26 million was financed from balances and \$78.4 million was drawn on the swap line with the Bundesbank, which followed up by buying an even larger amount of dollars the next day. This coordinated operation helped the market to settle down and, to consolidate the improvement, the Federal Reserve sold later that day an additional \$15.5 million of marks drawn on the swap line.

The dollar then steadied against the mark and other major European currencies about 3 percent below early-September levels, and the Federal Reserve intervened on only two other occasions in October. On October 15, the continued easing of dollar interest rates and rumors of further diversification of surplus oil revenues provoked some selling of dollars, and the Federal Reserve sold \$5.8 million of marks to cushion the dollar's decline. On October 23, market expectations of a still bigger German trade surplus for September sparked a renewed flurry of dollar sales, and \$3.9 million of marks was sold to help stabilize the market. Both of these Federal Reserve intervention operations were financed by further drawings on the swap line with the Bundesbank. Late in the month, when the dollar firmed somewhat following discount rate cuts in Germany and the Netherlands, the Federal Reserve System began to acquire in the market moderate amounts of marks against outstanding swap indebtedness.

In summary, Federal Reserve sales of foreign currencies totaled \$210.5 million equivalent over the three-month period. Sales of German marks amounted to \$202.7 million, of which \$99.1 million was financed from System balances. The remaining \$103.6 million represented drawings under the swap line with the Bundesbank and remained outstanding as of October 31, 1974. In addition, the Federal Reserve sold \$5.3 million of Dutch guilders drawn on the swap line with the Netherlands

Table II
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 outstanding July 31, 1974	Drawings (+) or repayments (—) August 1 through October 31, 1974	Drawings on Federal Reserve System outstanding October 31, 1974
Bank of Mexico	-0-	+180.0	180.0
Bank for International Settlements (against German marks)	-0-	{ +128.0 { -128.0	-0-
Total	-0-	{ +308.0 { -128.0	180.0

Bank and \$2.5 million of Belgian francs, of which \$1.7 million was financed by a drawing on the swap line with the National Bank of Belgium; both of these drawings were quickly liquidated.

Also during the period, on August 21, the Bank of Mexico drew the full \$180 million available under the swap arrangement with the Federal Reserve to cover a temporary shortfall in reserves. This drawing was repaid in November, prior to maturity.

On September 26, the Federal Reserve Bank of New York, after consultations with the Board of Governors of the Federal Reserve System, the United States Treasury, and other Government agencies, acquired the foreign exchange commitments of the Franklin National Bank. Since disclosure in May of substantial foreign exchange losses, Franklin had found it increasingly difficult to fulfill its maturing contracts as other banks limited exchange dealings with it. By late September, the situation had worsened and there was a significant risk that Franklin might be unable to meet all its remaining commitments. To avoid a serious weakening of confidence in the exchange markets and in the dollar that could have resulted from a failure to honor such exchange commitments, this Bank acquired Franklin's foreign exchange book, which at the time included approximately 300 forward contracts for purchases and sales of several foreign currencies totaling about \$725 million. This action was greeted with relief by market participants in this country and abroad, and the subsequent news of Franklin's insolvency was taken in stride by the market with no adverse impact on dollar rates.