FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

JUNE 1975

Contents

Volume 57 **No. 6**

International Banking

By RICHARD A. DEBS
First Vice President and Chief Administrative Officer
Federal Reserve Bank of New York

An address before the tenth annual banking law institute in New York City on May 8, 1975

It's a great pleasure to be here with you today, and a privilege to have such a distinguished audience of experts in banking law. The roster of participants in this conference is indeed impressive, and the theme of your conference—"Defensive Banking"—is most timely. The subject of my talk today may seem a bit inconsonant with that theme, with your focus on domestic banking, but it is not at all unrelated. In today's world, no one can talk for long about the United States banking system without looking at international banking. For better or for worse—defensive or offensive—international banking is an integral part of the United States banking system. And, without belaboring the theme, I think it's fair to say that international banking has certainly been on the defensive during the last year or so, at least in the sense that it has had to react and adapt to massive, pervasive, and rapid changes in environment that have shaken the roots of the system and challenged its viability. I must hasten to add—and am happy to report—that so far the system has met the test of these challenges. And I can also add that international banking seems to have emerged from this troublesome period with a stronger and healthier foundation.

To support that conclusion I would like to summarize briefly the experience of international banking over the past year or so, to review what it has been through, where it is now, and where it may be going.

DEFINITION AND LEGAL FRAMEWORK

Before that, however, it would be useful to outline a working definition of what I mean by international banking from the point of view of United States banks. Very simply stated, on the one hand it refers to the operations of United States banks in foreign countries, with foreign customers, or in foreign currencies; on the other, it refers to the operations of foreign banks in the United States. And it must also refer to the Euro-dollar market, to ensure that all overseas banking transactions in United States dollars are included.

I'd also like to note very briefly the legal framework for this kind of working definition of international banking. I know that in this forum I should start with the law—putting first things first—and I also know that with such an audience I need not do more than recall to mind briefly the overall legal framework.

UNITED STATES BANKS ABROAD. First, with respect to the activities of United States banks operating abroad, the basic laws applicable are the Federal Reserve Act, including those provisions known as the Edge Act, and the Bank Holding Company Act, pursuant to which the Federal Reserve has primary regulatory authority over such activities. Among other things, such authority covers the establishment of foreign branches, investments in foreign subsidiaries and affiliates, the chartering of Edge Act corporations, and the supervision of the activities of such banking facilities. State laws also apply to the foreign activities of state-chartered United States banks but, except for a very few states like New York, state regulation and supervision of foreign activities have been minimal.

On the whole, I think it is fair to say that the Federal Reserve's regulatory philosophy with respect to international banking has been rather liberal, in the sense that it has permitted United States banks to engage in a much broader range of operations overseas than are authorized in the United States. In the area of international banking, the Federal Reserve has more or less limited its concern to the basic soundness of the United States banks that may be operating abroad and with the range of activities that such banks may undertake abroad. Within the limits set by its regulations, the Federal Reserve Board has reviewed on a case-by-case basis applications by United States banks to engage in additional financial activities abroad through subsidiaries and affiliates. But it has not chosen to impose a restrictive regulatory structure on international banking. I think that it is clear that, without this attitude over the years, the remarkable growth of United States banks' operations overseas could not have taken place.

I also recognize that, apart from this general philosophy, many banks and bank counsels feel that several specific provisions of the Federal Reserve's regulations unnecessarily restrict the ability of United States banks to compete abroad. The Federal Reserve itself has many questions and reservations about its regulations in this area. It is an area in which there has not been much change for many years, certainly not enough to keep up with the rapid changes in international banking over those years. Accordingly, the Federal Reserve, through its System Steering Committee on International Banking Regulation, is reviewing the entire range of the regulatory framework in this area.

FOREIGN BANKS IN THE UNITED STATES. In sharp contrast to the System's broad authority over the overseas activities of United States banks, its regulatory authority (as well as that of any other Federal regulator) over the activity of foreign banks in this country is minimal. Its formal jurisdiction is limited to the activities of United States subsidiaries of foreign bank holding companies. But these subsidiaries account for no more than a fraction of the total foreign bank operations in the United States. Although the use of such subsidiaries has been increasing, the great bulk of these operations is conducted by agencies and branches of foreign banks established and operating under state laws. Most of these agencies and branches operate in New York, with a large number also in California and several in Illinois. Thus, this segment of international banking—the part conducted by foreign banks in the United States—is subject primarily to state law and is not subject to Federal supervision and regulation.

As you know, the Federal Reserve Steering Committee has studied this question and has concluded that it would be desirable to provide for a system of Federal regulation and supervision of foreign banking operations in the United States. Accordingly, the Federal Reserve Board has submitted to the Congress legislation, entitled the Foreign Bank Act of 1975, that would provide foreign banks with the same opportunities to conduct activities in this country that are available to domestic banking institutions, and that would subject them to the same rules and regulations. The proposed legislation is based on the principle of "nondiscrimination", or "national treatment", in that it attempts to treat all banks operating within the United States—both foreign and domestic banks—on the same basis. I should also mention that the proposed legislation would provide a grandfather clause for existing operations.

It should also be noted, of course, that all United States banks abroad, as well as all foreign banks in the United States, are subject to the laws of other countries—the laws of the host countries and the laws of the home countries, respectively. In some cases, the banking laws of foreign countries can be quite restrictive, and in other cases they can be quite liberal—as you well know, I'm sure. And, of course, the difference in banking law philosophies has had a significant effect on the direction of the growth of international banking in the world.

EURO-DOLLAR MARKET. Finally, for the sake of logic, I should mention the legal framework of the Euro-dollar market, since I included the Euro-dollar market in my working definition of international banking from the point of view of the United States. However, I'm afraid that I can't do much more than just mention it. The Euro-dollar market itself is not easily definable, and its legal framework, if any, is even less so. The market grew rapidly without the assistance, or burdens, of an integrated or even coordinated set of laws. It is an international—or multinational, or transnational—phenomenon, but it is regulated only to the extent that the Euro-dollar activities of the institutions operating in that market—the Euro-banks—are subject to regulation and supervision by the national jurisdictions in which they operate. In practice, supervision by national banking authorities has been minimal, and there has been no overall legal framework regulating the Euro-dollar market *per se*.

GROWTH OF INTERNATIONAL BANKING

Turning now to a brief review of recent developments, we might take as a starting point the beginning of last year, since 1974 was in many respects a watershed in the history of international banking. Until then, international banking had been growing steadily and rapidly for many years. There had been a sharp rise in the number of major United States banks that developed global branch and affiliate networks, offering an integrated banking service of worldwide scope. This internationalization of United States banking was closely associated with the rise to prominence in the world economy of multinational corporations, which require broadly diversified financial facilities in a large number of countries. Another important factor in this development was the program of capital controls that was introduced in the United States in 1963, and which had put pressure on United States banks to establish banking facilities abroad in order to serve the borrowing needs of their customers operating overseas.

The growth in international banking over the years is dramatically reflected in almost any set of statistics relating to international banking for the period. For example, in 1965 only thirteen United States banks had foreign branches, with total assets of about $9.1 billion. At the end of 1974, 125 United States banks had branches abroad, and their total assets were in excess of $150 billion.[1] As another indication, in 1965 foreign earnings were a negligible portion of total earnings even for the largest banks. In 1974, foreign earnings for some of the larger New York City banks were about one half their net income after tax.

During the same period, there had been a steady, although not quite as dramatic, growth in the operations of foreign banks in the United States. For example, from 1965 to 1974, the number of foreign branches and agencies in New York City increased from 49 to 92, with total assets increasing from $4.8 billion to $29.5 billion. At the end of 1974, the total assets of agencies, branches, and subsidiaries of foreign banks in the United States added up to $56 billion.

Together with the expansion of international banking both here and abroad, there had been a parallel development in the growth of the Euro-dollar market. From rather modest beginnings in the early 1960's, the market burgeoned until it had reached rather massive proportions in the early 1970's. For example, in 1965 the net size of the market was about $9.5 billion and it reached a volume of approximately $150 billion in 1974, not including sizable Euro-currency liabilities denominated in currencies other than dollars.[2]

[1] Almost half of these assets was held by branches of United States banks in the United Kingdom. Another 20 percent was held by branches in the Bahamas and Cayman Islands. The Nassau and Cayman branches are principally "shell" offices which perform only limited services and conduct no local business; however, they act as a major vehicle for the acquisition of Euro-dollars by United States banks; also they enabled the banks to extend loans to foreigners financed with offshore funds without exceeding the quota limits established under the foreign credit restraint program.

[2] These figures attempt to exclude the large volume of interbank deposits in order to approximate the size of Euro-bank liabilities to others. See Charles A. Coombs and Scott E. Pardee, "Treasury and Federal Reserve Foreign Exchange Operations", *Monthly Review* (Federal Reserve Bank of New York, March 1975), pages 55-56, for a discussion of recent developments in the Euro-dollar market.

PROBLEMS OF 1974

Focusing again on the beginning of 1974, we all recall that the year began with the removal of capital controls by the United States. There was some uncertainty as to what all of the ramifications of that action would be, particularly with respect to the structure of international banking. (For example, it was expected that the removal of controls would result in the strengthening of New York City's role as a world financial center.) In any event, however, one point seemed clear: the action was a move toward a more open and efficient international banking system in the long run.

PETRO-DOLLAR SURPLUSES. However, other things happened in 1974 that began to cast grave doubts on the future of international banking. To begin with, the price of oil quadrupled and the world began to compile and wonder at the astronomical figures being projected as surpluses for the oil-producing countries. For example, in July 1974, the World Bank projected that OPEC (Organization of Petroleum Exporting Countries) would accumulate a cumulative surplus of $650 billion by 1980 and that this surplus would rise to $1.2 trillion by the end of 1985.[3]

And so the problem that came to be known as "recycling" was born. Because of the huge amounts of surplus funds that would be accumulating in the hands of the oil producers, the prospects for deeper deficits by many of the consuming countries, and the massive flows of funds that would be involved in the payment, receipt, lending, investment, and transfer of these "petro-dollars", there were serious doubts that the private international banking system could cope with the process of "recycling" these petro-dollars. The concern grew as larger and larger amounts of petro-dollars were accumulated in overnight Euro-dollar deposits. The position of the Euro-banks seemed to become more and more vulnerable as they used these overnight deposits to fund credits carrying much longer maturities, and in being exposed to the danger of sudden withdrawals of major portions of their deposit liabilities by a relatively limited number of depositors.

[3] See Robert McNamara's 1974 Annual Address to the World Bank, reprinted in the *Summary Proceedings of the 1974 Annual Meetings of the Board of Governors*, page 31. These estimates are in current dollars and assume an increase in prices over time. This 1980 estimate is equivalent to about $400 billion in constant 1974 dollars.

THE FRANKLIN CASE. These doubts were not eased by the emergence of another problem on the United States domestic banking scene—the Franklin National Bank case. Franklin was the twentieth largest bank in the United States, and it was also heavily engaged in the foreign exchange market. By May 1974, its situation had deteriorated badly, and it seemed clear that, unless a permanent solution could be found, the bank would soon be forced to close its doors. Such a closing would have caused serious harm to the bank's depositors and customers, would have shaken confidence in the entire United States financial system, and would have had major adverse repercussions for both the domestic and the international banking systems. In the circumstances, the Federal Reserve took up its responsibilities as lender of last resort and extended emergency credit to Franklin in an effort to permit the development of a permanent solution to the problem that would be in the best interests of all concerned. As you may recall, the loans extended by the Federal Reserve Bank of New York amounted to $1.7 billion by the time the solution was finally worked out in October of last year.

The Franklin case was particularly troublesome from the point of view of international banking because one of the major causes of Franklin's problems was its foreign exchange operations. Franklin, like many other banks, had expanded its international banking activities at a very rapid pace. In doing so, however, management control was not effectively maintained, and it was in this area that some of the more serious problems of the Franklin case came to light. As a result, there was deepened concern in the markets regarding the foreign exchange activities of all commercial banks, in addition to the general malaise caused by the tottering of one of the largest banks in the world.

HERSTATT AND OTHER CASES. This uneasiness was intensified by some substantial losses related to foreign exchange operations incurred by several banks in the spring and summer of last year. The most dramatic case, of course, was that of Bankhaus Herstatt, which was forced to close its doors in June. The very fact of a bank failure was, in itself, sufficient to create problems for the international banking community, but beyond that the circumstances in which Herstatt failed resulted in further problems for banks involved in foreign exchange. Confidence in the international payments mechanism was severely shaken. For a while, the mechanism hardly functioned at all, while participants in the international banking community retrenched and attempted to protect themselves from any possible exposure to credit risks. Since the international payments mechanism, by its nature, relies on confidence and credit, the result was that the mechanism ground down to a very slow and cumbersome pace.[4]

MARKET REACTIONS. The response of Euro-banks to these unhappy developments was to cut their credit lines rather ruthlessly for all but the very best names. Quality became the watchword for investors throughout the world, and rate structures in virtually all money and loan markets reflected this preference for quality. In the Euro-market, even banks with good names, but less well known than the prime banks, were forced to pay a premium over the rates offered to the bigger institutions. In order to obtain funds, banks in countries that in the view of the market had overborrowed, as well as fringe banks, had to pay rates substantially above the London interbank deposit rate. One consequence of this tiered rate pattern was that many banks at rollover dates for syndicated term loans were forced to refinance their commitments at rates close to or above the rates payable by the borrowers, which were based on the London interbank deposit rate for prime banks plus a small margin. As a result, a number of banks were no longer able to participate in syndicated loan operations. Fears were then widespread in the London financial community that some of the smaller banks participating in the Euro-currency market would be unable to secure sufficient funds to refinance their medium-term loans. Some of these banks, including branches and affiliates of regional banks in the United States, began last year to pull in their horns and to scale down their Euro-currency activities in London and elsewhere.[5]

All of these developments took place against the background of general disquiet and anxiety throughout the financial world. Worldwide inflation was rampant. Interest rates were at record high levels. Stock markets were plummeting. Confidence in the dollar remained precarious, and exchange markets continued to show wide rate fluctuations. No one had a good fix on the dimensions of the petro-dollar problem. Projected balance-of-payments deficits for some countries seemed to suggest that they were

---

[4] Perhaps the most vivid example was the practice by members of CHIPS (Clearing House Interbank Payments System, including about forty banks) during the latter part of June to meet each morning to state whether or not they intended to "recall" any payments of the preceding day before the settlement sheet was given to the Federal Reserve Bank of New York.

[5] For a detailed review of these developments, see Fred H. Klopstock, "Oil Payments and Financial Markets", *Record* (The Conference Board, Inc., May 1975).

on the brink of bankruptcy. The credit of major industrial countries was put into question. And questions were also raised about the soundness of banks and the banking system. All in all, 1974 was not a year of great promise for international banking.

RESPONSES TO THE PROBLEMS OF 1974

Yet, at the same time there were other developments, many of which were generated from these doubts and concerns, that assisted in bringing international banking through this period of uncertainty and that laid the groundwork for the emergence of an even healthier and stronger system.

COMMERCIAL BANK RESPONSES. In the first place, the banks themselves recognized their problems and took measures to deal with them. In a sense, the foreign exchange problem of the Franklin case dramatized to all banks the dangers of losing management control over foreign exchange operations. It brought home the need for internal controls and surveillance procedures, the need for management involvement, and the need for qualified staffs. In the past, there were too many cases in which foreign operations were launched by bank management as part of a fashionable trend, as a "growth industry" in which quick profits could easily be turned. Traders were too often left to their own devices, with management's interest limited to counting the earnings coming in. Those banks soon learned that this is an area of enormous risk that must be brought under more effective management control.

The Herstatt case, as well as other similar cases, also demonstrated the exposures involved in foreign exchange dealings, and underlined the fact that participants in the business that followed aggressive, speculative strategies could expose all their business partners to excessively high risks. Unfortunately, the Herstatt case also made the point that the rules of the game of the international payments mechanism were far from perfect and that innocent parties could be rather badly hurt by a malfunctioning of the mechanism. The lesson caused all parties concerned to undergo a searching reappraisal of those rules and to make changes in procedures to reduce the risks of exposure.

CENTRAL BANK RESPONSES. In addition to the steps taken by the commercial banks, there also has been much greater involvement by central banks, both individually and in cooperative efforts, in the problems of international banking and in measures to strengthen its soundness and integrity. One of the first moves in this direction was the action by the Federal Reserve to take over Franklin's foreign exchange position in order to avoid adverse repercussions in the international banking system, as well as to protect the domestic financial structure. In October 1974, as part of the package worked out by the authorities for the solution of the Franklin situation, the Federal Reserve Bank of New York, in an unprecedented step, took over Franklin's foreign exchange book with a view to liquidating it in an orderly fashion. The alternative—to permit the outstanding contracts to be dishonored—would certainly have led to serious disruptions in the markets.

In addition, the Federal Reserve and the other bank regulatory authorities in the United States, as well as their counterpart authorities in Europe, took measures to tighten their supervision of the foreign exchange operations of their commercial banks. Programs were undertaken to strengthen bank examination procedures and to provide for stricter surveillance and reporting requirements.[6]

The central banking fraternity also undertook to review the need for coordination among central banks in their supervision and examination of commercial banks involved in international banking, and they also reviewed their respective roles as lenders of last resort. The issues posed are complicated ones; they become more complicated as banks operate in foreign countries through subsidiaries, and even more complicated as they operate through affiliates or consortium banks in which their investments may be relatively limited. For example, which central bank should be (a) the supervisory authority or (b) the lender of last resort, with respect to (1) a foreign branch, (2) a wholly owned foreign subsidiary bank, or (3) a consortium bank with, say, five foreign minority shareholder banks as parents? And what are the responsibilities of the parent banks in any of these situations? As you know, the Bank of England has expressed a viewpoint on these questions in requesting "letters of support" from such parent banks.

In this connection, I should make the general point that all central banks have the responsibility for maintaining orderly exchange markets and do intervene in the markets from time to time to that end. Working together, the major central banks have developed more extensive procedures for consultation and coordination of exchange intervention

[6] In this country, the Federal Reserve has conducted a survey of selected banks' foreign exchange position limits and controls. The Federal Reserve is also monitoring United States banks' positions with the aid of Treasury foreign currency reporting forms recently instituted under the Par Value Modification Act.

than ever before. As you know, the Federal Reserve swap network has played a key role in these operations. In this area of conflicting philosophies over the functioning of exchange markets and the role of central banks, it has now been generally recognized that a floating system managed by open market intervention by cooperating central banks has a much greater chance of functioning well than a system in which order is imposed by extensive and detailed exchange controls.

"RECYCLING" PETRO-DOLLARS. Another development that helped to ease the concerns and worries of last year has been the ability of the private banking system to handle the petro-dollar flows. Despite the earlier dire predictions, the system has not only survived but has contributed in a significant way to coping with the problems of "recycling". The private banking system did not do it alone; it was aided in large part by official programs for the channeling of funds through multilateral institutions and arrangements —such as the International Monetary Fund (IMF) Oil Facility—and by the rather substantial direct lending and aid programs of the surplus countries. It was also aided by responsible and conservative investment policies followed by the central banks and governments of the surplus countries. Even with this assistance, however, a large measure of the burden of the recycling problem fell on the private international banking system; for example, it is estimated that in 1974 OPEC deposited over $20 billion in the Euro-currency market, and most of that was very short term.[7]

Another factor that contributed to a calming of concern about the future was the development of a better understanding of the dimensions of the petro-dollar surplus problem. It now appears that those dimensions are not as unmanageable as some had thought earlier. Total revenues of OPEC last year was over $100 billion, and the net investable surplus—the amount left over after expenditures for imports and after loans and grants to the less developed countries (LDCs)—was about $50 billion. But rather than increase over the years ahead, as originally predicted, the surplus will probably decrease gradually and shrink to much smaller proportions within a few years. Rather than the cumulative surplus of $1.2 trillion in 1985 and $650 billion by 1980—as originally predicted —the World Bank reportedly now estimates a peak in the cumulative surplus in current dollars of $460 billion by 1980. Other sources have estimated the 1980 surplus (in current dollars) to be in a range of $180 billion to $350 billion.[8]

The reasons for these changes in estimates are many, but one of them is simply a better understanding of the problem as it has evolved. Last year, there were very few experts indeed who were able to predict the level of imports reached by OPEC; nor were there many experts who were able to predict the level of loans and aid by the oil producers to LDCs. OPEC imports added up to more than $40 billion in 1974, and OPEC grants and loans to LDCs were about $7 billion.[9] Projections early in 1974 were substantially below these aggregates. This experience, of course, led to upward revisions in estimates of OPEC expenditures for future years. At the same time, the softening of demand for oil, reflecting the worldwide recession as well as the impact of higher oil prices, dampened the predicted rise in actual foreign exchange revenues by the oil-producing countries. This in turn caused a scaling-down in the forecasts of future revenues. Based on these revised forecasts, it now appears that the funds left over as "surplus"—the funds that are at the core of the "recycling" problem—are more manageable than previously predicted and should become more so in the years ahead.

In commenting on the dimensions of the recycling problem, I am referring primarily to the workings of a financial mechanism. I would not want to minimize the seriousness of the underlying problems. The potential pressures and strains arising from the oil-import-induced balance-of-payments deficits continue to involve risks to international financial stability. But experience to date indicates that, as a technical matter, the various channels used for coping with the recycling question have been dealing with that immediate problem.

[7] The Bank of England has estimated that oil exporters in 1974 placed Euro-currency deposits of $13.8 billion in the United Kingdom and $9.0 billion elsewhere. See the *Bank of England Quarterly Bulletin* (Vol. 15, No. 1, March 1975). The United States Treasury has estimated that OPEC placed $21 billion in Euro-currency deposits during 1974. See Treasury Secretary William E. Simon's statement before the Subcommittee on Financial Markets of the Senate Finance Committee (Washington, D.C., January 30, 1975), page 1.

[8] The World Bank estimate of $460 billion in current dollars is roughly equivalent to $250 billion in 1974 dollars. The United States Treasury has estimated the 1980 surplus between $200 billion and $250 billion in 1974 dollars. See Deputy Assistant Secretary of the Treasury, Thomas D. Willet, "The Oil Transfer Problem" (January 30, 1975).

[9] This includes bilateral and multilateral assistance. OPEC commitments—as opposed to disbursements—for developmental grants and loans made to LDCs in the last year were considerably larger, and are estimated to have been around $17 billion.

CONSOLIDATION AND RECOVERY

All of these developments I've referred to have contributed to a restoration of confidence that seems to be reflected in the overall tone of the Euro-dollar market. For example, differentials between the rate charged the different classes of banks—which were quite substantial last year reflecting the confidence crisis—are now only a fraction of those seen last summer. After some contraction in the summer and early fall, the market again resumed its growth, although at a much slower, and perhaps more reasonable, pace than in years past.

At the same time, there has been a retrenching, a consolidation, a sorting out, among the institutions involved in international banking, all of which should lay a solid basis for the future. After the experience of last year, many banks have withdrawn from or limited their participation in the field. Others have plans for gradual future expansion. All of them, however, are much more careful about the management of their international operations and want to avoid growth at a pace that could expose them to risks of weakened management control. As in domestic banking, there is a heightened emphasis on the quality of credit and on returns commensurate with risks. And, with the friendly interest of their banking supervisors, they are also aware of the desirability to proceed cautiously in the light of their need for adequate capital to support future growth.[10]

In any event, while the resumption of growth in international banking may be, and should be, gradual, it seems clear that a stronger foundation for the future has been laid. One of the growing edges of international banking is, as should be expected, in the Middle East, oriented to the petro-dollar. At the end of 1973, United States banks had interests in about thirty-four branches, subsidiaries, affiliates, and representative offices in the Middle East. Since then, they have opened, or have plans to open, about thirty additional facilities.

Future growth in international banking can also be expected from foreign banks operating in the United States. One of the incidental by-products of the Franklin case, of course, was the emergence of a foreign-owned consortium bank, European-American Bank & Trust Company, as a major banking institution in the United States. In addition, there is likely to be a continuing gradual growth of foreign banking offices in the United States. One of the more interesting areas of potential growth is the possibility of the development of banking interests in the United States on the part of the oil-exporting countries. There are several examples of such banking interests in Europe, and they may well find it convenient, much like the United States banks in the Middle East, to establish facilities within the United States.

ISSUES FOR STUDY

Having reviewed the experience of the last year and having concluded that, contrary to the expectations of some, international banking is still alive and well, I would like to take a brief look, not at the future (I wouldn't be so bold), but at the issues that may well influence the future. In doing so, I draw very heavily on the lessons of the recent past. And if I may, I would like to look at these issues from the point of view of a central banker.[11]

(1) To begin with, one of the immediate issues is the extent to which the international banking system is able to maintain adequate management control over foreign operations. This question relates not only to the commercial banks—domestic and foreign—involved in international banking but also to the regulatory authorities, both United States and foreign. The issue also encompasses all participants in international banking; it is not enough to say that most of the international banks observe stringent standards and have their operations in good order. As we have learned, weak links in the chain of the many partners involved in international transactions can cause problems for all.

(2) Another important issue relates to the regulatory framework for foreign banks operating in the United States. As I mentioned, the Federal Reserve has sponsored legislation that would provide for a new legal framework, under Federal law, based on the principle of nondiscrimination. The issue is now in the hands of the Congress, and its resolution will have significant implications for the future course of international banking.

[10] During the summer, the Federal Reserve Board expressed its general concern with the tendency of many United States banking organizations to pursue a policy of rapid expansion in domestic and foreign markets. The Board noted that such expansion can expose these organizations to substantial risks, and, therefore, such expansion should be supported by a strong capital base.

[11] Most of these issues are discussed in more detail in a speech by Governor Robert C. Holland of the Federal Reserve Board, entitled "Public Policy Issues in U.S. Banking Abroad", delivered at the fifty-third annual meeting of the Bankers Association for Foreign Trade on April 8, 1975.

(3) There is also the question of the regulatory and supervisory framework governing United States banks operating abroad. As I noted, the approach of the Federal Reserve, which is the primary United States regulatory authority in this area, has been developed over the years, within a statutory framework that itself evolved by the gradual accretion of statutory requirements over the years on an *ad hoc* basis. In view of the importance of international banking, as witnessed by its rapid growth in recent years and particularly by the events of the last year or so, it is timely to review the entire regulatory framework to see where changes are needed to keep up with changing times. As I noted, the Federal Reserve is undertaking such a comprehensive review.

(4) Another issue relates to the capital needs of United States banks engaged in international banking. As you in this audience well know, the issue of capital adequacy on the domestic scene is complicated enough, and has not yet been settled with any precision, but it's even more complicated with respect to international activities. In view of the risks that United States banks are exposed to in international banking, again as witnessed by the events of last year, it is important to focus specific attention on the question of capital adequacy in the light of the particular needs and requirements of international banking.

(5) Apart from the role of the United States regulatory and supervisory authorities, there is also the question of cooperation among the world's central banks with respect to the supervision of banks engaged in international banking, and the role of central banks as lenders of last resort for such banks. There is also the related question of the extent to which the Euro-dollar market, as a market, should or could be subject to greater regulation. In the light of recent developments, it seems clear that these are important issues for the future development of international banking. As I've indicated, they are under active study by a committee of central bankers.

(6) A final issue worth noting, and worth studying, is the extent to which international banking has implications for our domestic financial and economic conditions. International banking has grown so rapidly, and the Euro-dollar market has grown so large, that they cannot be dealt with in isolation. They have important ramifications for domestic policy and must be taken into account in the formulation of that policy.

In conclusion, let me emphasize that we in the Federal Reserve have no illusions that we have all the answers to the difficult issues raised by recent developments in international banking. We believe that we have learned many lessons from what has happened in the last year or two and, as I mentioned, are now undertaking a broad review of regulatory and supervisory policies with respect to the foreign operations of United States banks. We need the benefit of your experience and views, and would welcome a continuing dialogue with you in this challenging undertaking.

The Business Situation

While the latest readings of business statistics point to further slippage in economic activity, they also suggest that the low point of the recession may be reasonably near at hand.* Industrial production declined again in April, but the drop was the smallest since August 1974. No doubt this cutback in production reflects the ongoing inventory correction. The book value of manufacturers' inventories fell in April for the second consecutive month, with the decrease probably fairly substantial in physical terms. Although inventories still appear to be high in relation to sales, and it is thus difficult to determine how much further inventory liquidation will be carried, the recent rate of liquidation seems unlikely to be intensified further.

Meanwhile, other signs of a possible improvement in the economic weather have begun to accumulate. Manufactured durable goods orders rose in April for the second time in three months. This increase was the largest in more than seven years and was broadly based as well. Personal income also advanced in April, and retail sales increased despite a relapse in auto sales. Looking ahead, as the tax cut takes effect and rebate checks are distributed, sales should receive additional stimulus. While residential construction has not yet pulled out of its slump, housing starts did manage a mild increase in April and building permits climbed to the highest level since last August. Labor market conditions weakened further in May, as a sharp rise in the civilian labor force helped push the unemployment rate up to 9.2 percent. Nevertheless, total employment did manage to increase for the second consecutive month.

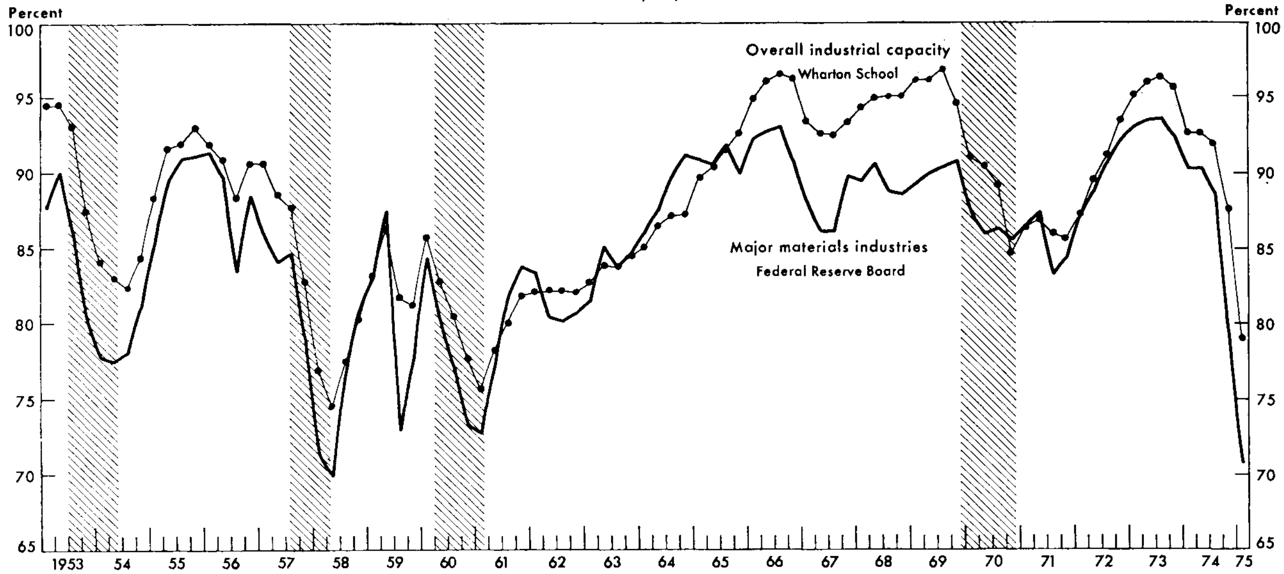
*Revised estimates indicate that current-dollar gross national product (GNP) fell $13.8 billion, instead of $11.7 billion, at a seasonally adjusted annual rate in the first quarter of 1975. Inventory liquidation was revised from $18 billion to $19.2 billion, and consumer spending was less robust than initially estimated, rising $17.4 billion instead of $20.5 billion. In real terms, GNP declined 11.3 percent instead of 10.4 percent as initially reported, while the annual rate of change in the implicit price deflator for GNP was revised slightly from 8 percent to 8.5 percent.

The price news was mixed in April and May, but on balance the recent pattern of more moderate overall inflation continues to prevail. Consumer prices rose faster in April than in the two previous months, as food prices increased after two months of decline. While the advance of nonfood commodity prices also accelerated somewhat in April, the overall increase in these retail prices in the February-April period was slower than in any other three-month interval in more than two years. At the wholesale level, prices rose for the second consecutive month in May, as prices for farm products and related items moved higher. On the other hand, increases in industrial commodity prices continued to be encouragingly mild. In May, wholesale industrial prices edged up at a 2.1 percent annual rate. Increases in prices of fuel and power accounted for most of this rise, so that if energy is excluded industrial wholesale prices barely changed.

INDUSTRIAL PRODUCTION AND CAPACITY

As measured by the Board of Governors of the Federal Reserve System, industrial production fell 0.4 percent in April, thereby dropping 14.2 percent below its peak of November 1973. The most recent decline in this measure of the nation's output of factories, mines, and utilities was the smallest since last August. As in previous months, the production of business equipment and industrial materials posted sizable reductions. However, the output of consumer goods rose modestly in April, the first such increase since last June. Although the production of nondurable consumer goods rose somewhat, the overall increase chiefly reflected a rise in the output of durable consumer goods, especially automobiles. Encouraged by the success of the price-rebate program and anticipating the traditional spring upturn in automotive sales, manufacturers in April boosted production 26 percent above the average first-quarter rate. In May, automotive production rose even higher. Unfortunately, however, domestic auto sales have been sluggish in recent months, and the increased production has been added to the stock of unsold cars.

Chart I
MEASURES OF CAPACITY UTILIZATION
Seasonally adjusted



Sources: University of Pennsylvania, Wharton School of Finance and Commerce; Board of Governors of the Federal Reserve System.

Quite unlike the situation that prevailed at the end of 1973, the economy is now operating well below its productive potential. Indeed, some observers have suggested that there is now more slack and unused resources in the economy than at any time since the end of the Great Depression. This seems to be an overstatement, however. Rather, the evidence would appear to justify the view that the current level of excess capacity is more like that experienced during the 1957-58 and 1960-61 recessions than that experienced just prior to World War II.

The Federal Reserve Board compiles two indexes which measure the utilization of the physical stock of plant and equipment in the manufacturing sector and in the major materials industries, respectively. While the index for manufacturing reached its lowest level in twenty-two years in the first quarter, there is reason to believe that this measure has tended to overstate capacity in recent years and hence this reading should be discounted to some degree. The major materials capacity utilization series appears to be a more accurate measure. Unlike the index for total manufacturing, utilization rates among the twelve major materials producers are based on estimates of maximum output. Although its coverage is limited, this indicator does succeed in measuring the extent of aggregate demand pressures at the initial stage of the production process. Indeed, output in the primary processing industries was severely strained during the 1973 boom, causing serious bottleneck problems throughout the entire economy. The major materials utilization rate reflected these pressures, as it climbed to a peak of 93.5 percent in the third quarter of 1973 (see Chart I), with some basic industries producing at nearly 100 percent of capacity. Since then, of course, the utilization rate has fallen. In the first quarter of 1975, the extent of used plant and equipment in this subsector equaled 70.7 percent. At this level, the index stood midway between the lows attained in the 1957-58 and 1960-61 recessions.

In addition, there is the Wharton School comprehensive index of capacity utilization which reached an exceptionally high rate of capacity utilization in the third quarter of 1973 of 96.2 percent. As of the first quarter of this year, this index had dipped to 78.5 percent. At this level, it was still above the lows of 73.3 percent and 74.2 percent, respectively, reached in the 1957-58 and 1960-61 recessions. Overall, judged in terms of unused plant and equipment capacity, the current level of excess capacity is substantial but not more so than in the two earlier major postwar recessions.

The most popular single measure of slack in the labor market is the overall unemployment rate (see Chart II). In May the jobless rate reached 9.2 percent of the civilian labor force, the highest level since 1941. However, this may exaggerate the current degree of labor-market slack to some extent, since any historical comparison is affected by the dramatic changes in the composition of the labor force that have occurred during the postwar period. For example, women and young men have higher average unemployment rates than adult men, in part because their attachment to the labor force is weaker. The proportion of women and young men in the labor force has increased substantially in recent years, and this has tended to raise the overall unemployment rate irrespective of the demand for labor. In comparing the current jobless rate with that of earlier years, it may be more meaningful to adjust the recent data for this shift in labor-force composition by restoring the relative importance of the major age-sex groups to, say, 1956 levels. On this basis, the current unemployment rate equals 8.1 percent, which is just slightly higher than the peak rates of 1958 and 1961. Moreover, at 5.8 percent in May, the jobless rate for men aged twenty-five and above is about equal to the peak rate in 1961 but below the 1958 rate. At least in some respects then, current labor-market slack is roughly comparable to the 1958 and 1961 situations.

APPROPRIATIONS, MANUFACTURERS' ORDERS, AND INVENTORIES

According to the Conference Board's survey of the 1,000 largest manufacturing firms, appropriations for new plant and equipment dropped 9.4 percent in the first quarter of this year. And over the six-month period ended in March, newly approved appropriations fell 33.2 percent, the largest two-quarter decline since 1957. Reduced spending plans by durable goods manufacturers were entirely responsible for the latest slide, as appropriations by nondurable goods producers picked up somewhat. Cancellations of previously approved projects have also stepped up markedly in these two quarters, primarily because of postponements in the spending plans of the petroleum industry. As a result, net new appropriations are currently at the lowest level in two years.

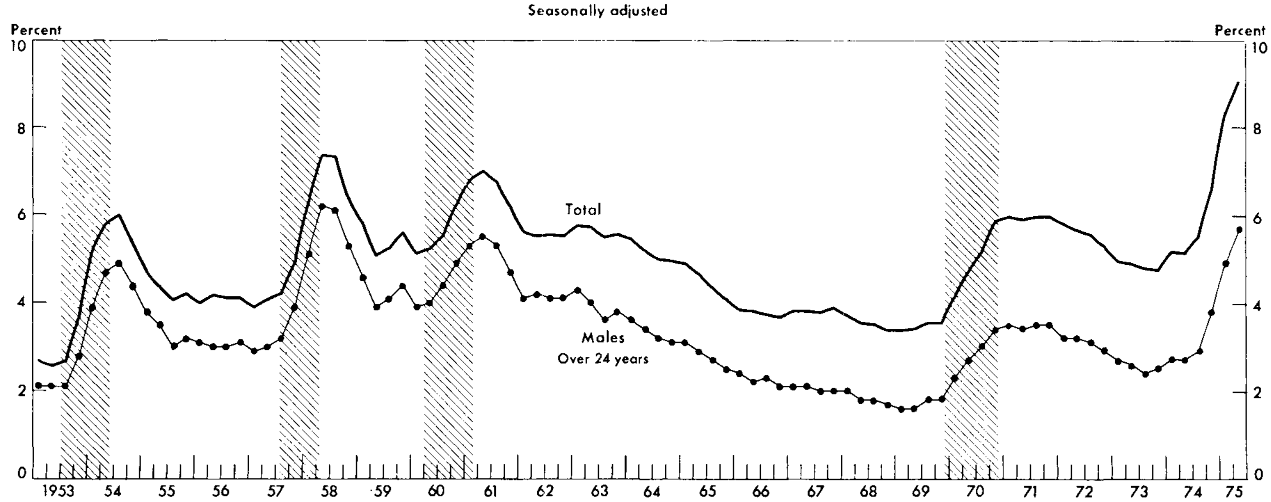
The flow of new orders received by durable goods manufacturers surged upward by 9.7 percent in April. Although new bookings were still 21 percent below the peak reached last August, the most recent increase was the largest in more than seven years, and it raised durables bookings to the highest level since last November. Despite this jump, shipments rose even faster and the backlog of unfilled orders fell to the lowest level in one year.

Historically, a sustained increase in durables orders has

Chart II

UNEMPLOYMENT RATES

Seasonally adjusted



Note: Unemployment rates for the second quarter of 1975 are an average of April and May.

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

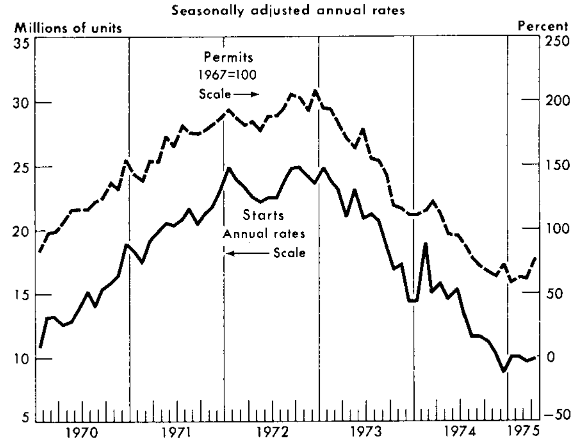
typically been a forerunner of increases in production. While the April advance could of course be reversed in subsequent months, orders have now increased in two of the last three months, thus providing some support for the view that the economy appears poised for recovery. This conclusion seems more likely, since the April jump in orders was widespread among all industrial sectors. Bookings for transportation equipment registered the largest advance, but the increase in bookings for machinery and primary metals was also sizable. Orders for nondefense capital goods also jumped for the first time since last September. However, while the increase was rather large, orders for nondefense capital goods just barely managed to climb above the level recorded four months ago.

Manufacturers succeeded in reducing inventories of both durable and nondurable goods in April for the second consecutive month. With stocks falling by $1.15 billion, this latest round of inventory liquidation exceeded the previous month's drop and was the largest in percentage terms since May 1958. Declining inventories of nondurable goods accounted for most of the drop, as stocks of both finished goods and materials fell by a sizable margin in this sector. While the ratio of nondurable inventories to sales is now at its lowest level since last November, stocks of durable manufactured goods still seem to be high in relation to current sales. In April, manufacturers' inventories of durable goods declined only modestly, as a reduction in materials and supplies offset increases in work in progress and in finished goods inventories.

Chart III

PRIVATE RESIDENTIAL CONSTRUCTION

Seasonally adjusted annual rates



Source: United States Department of Commerce, Bureau of the Census.

PERSONAL INCOME, RESIDENTIAL CONSTRUCTION, AND RETAIL SALES

Personal income rose $6.7 billion in April, the largest increase thus far this year and just slightly below the $7 billion monthly rise averaged during 1974. Income in the private sector remained unchanged in the month, however, as a small increase in the payrolls of service industries was offset by a decline in income in the distributive industries. Manufacturing payrolls stabilized in April, after posting a small increase in March. Prior to this, manufacturing payrolls had been reduced considerably so that in April they were 7.4 percent below the peak of last October. Government payrolls, meanwhile, rose slightly as a result of expanded employment under public service job programs. Among nonwage earners, small gains were posted by all groups, with the rise in transfer payments especially modest in comparison with previous months. Finally, reflecting an increase in farm prices, income of farmers grew $1.7 billion in April but the advance still left farm income 38 percent lower than it was a year ago.

Weakness in residential construction persisted in April, as housing starts rose only modestly above the sluggish pace of the previous month (see Chart III). At 990,000 units in April, starts were 37 percent below the level of a year earlier. However, there are signs that a modest upturn in housing construction may soon begin. Thus far this year, housing starts have consistently been above last December's depressed level. Moreover, in April, newly issued building permits jumped 27 percent above those of March and were higher than at any time since last August. Also, there is some evidence that the recently passed tax credit for purchases of new homes built or under construction before the end of March is cutting into the inventory of unsold homes. The combination of an increase in sales and a reduction in the number of homes available for sale lowered the backlog to 10.6 months in March, well below the 11.7 months averaged over the previous six months. On the other hand, mortgage interest rates are still very high and, despite the large volume of funds flowing into thrift institutions, the cost of financing a new home is only slightly below what it was one year ago. In coming months the behavior of mortgage interest rates as well as the growth in real income and changes in housing prices will be important in determining the strength of the housing recovery.

Retail sales advanced $647 million in April, after slumping rather sharply in March. Of course, the dollar volume of sales has been quite volatile in the past months, and consumer spending in April was only a little above the level of last July. Expenditures on durable goods rose slightly during the month, but they were nevertheless well below the average of the initial quarter of 1975. The reason for this is that in January and February widespread clearance sales and the automobile industry's cash rebate program boosted sales substantially. Over the entire first quarter, domestic auto sales averaged 6.6 million units but, upon the termination of the rebate program, sales slumped to 5.7 million units in April. Although an improvement was evident in May, auto sales were still running well below the industry's expectations. Spending on nondurables increased by nearly $300 million in April to a level 8.5 percent above that of a year earlier.

PRICE DEVELOPMENTS

Prices moved up irregularly in the past few months, but further indications of an abatement in underlying inflationary pressures were evident. At the retail level, inflation accelerated in April largely because of a spurt in food prices. Wholesale prices rose more slowly in May than they had in the previous month, however, with the advance in industrial commodity prices being about in line with the moderate increases registered in previous months.

Consumer prices jumped at a 7.1 percent seasonally adjusted annual rate in April, nearly double the advance of the previous month. Nevertheless, retail prices have increased only 5.7 percent over the three-month period ended in April, the mildest three-month advance since the beginning of 1973. Food prices, which declined in each of the two preceding months, reversed course in April and rose at a 4.2 percent annual rate. At the same time, higher prices for used cars and power and fuel paced a 9 percent annual-rate advance in consumer nonfood commodity prices. Although this was a bit higher than the advance experienced over the first quarter of this year, it was less than the 13.4 percent rise recorded in 1974. Finally, prices of consumer services rose at a 6.6 percent annual rate in April. This increase was about equal to the rise in the last three months, and it was mainly attributable to higher prices for transportation and medical care.

After jumping sharply in April, wholesale prices rose at a 4.2 percent annual rate in May. These increases, which reversed a decline that began last December, were precipitated by large boosts in prices of farm products and processed foods and feeds. The 7.3 percent annual-rate advance in farm and food prices in May was led by an increase in prices for livestock and poultry. Although prices of meat and poultry are expected to continue rising through the summer months, further large increases in food prices may be tempered by the expectation of record feed grain crops. While adverse weather conditions initially delayed corn plantings, prospects still appear good for a record crop. Furthermore, according to the latest Department of Agriculture forecast, this year's wheat crop is expected to be even larger than last year's record.

Meanwhile, wholesale prices of industrial commodities, which are generally considered to be a more accurate barometer of inflationary pressures, continued to climb only modestly. In May, industrial wholesale prices edged up at a 2.1 percent annual rate and, excluding power and fuel, industrial commodity prices remained unchanged over the last three months. To a large extent, this moderation reflects the large decreases in prices of raw materials that occurred earlier in the year. More recently, spot prices of raw industrial commodities have started to fall again so that there may well be a further abatement in inflation. At later stages of fabrication, prices of intermediate materials declined in May for the first time in nearly two years, while the increase in consumer finished goods prices remained below the advance of the last six months.

The Money and Bond Markets in May

The money and bond markets rallied for most of May in the wake of the Treasury's May 1 announcement that higher than expected revenues in April had reduced its borrowing needs through the end of June. Furthermore, the view of market participants that the decline in the Federal funds rate early in the month reflected Federal Reserve desires bolstered the rally. Market sentiment was also aided by the approval by the Board of Governors of the Federal Reserve System of a reduction in the discount rate from 6¼ percent to 6 percent at all Federal Reserve Banks. Short-term rates declined in response to these developments as well as in response to continued weakness in business demand for short-term credit and a diminution in Treasury borrowing in the bill market. Late in the month, however, the rally stalled in the absence of further declines in the Federal funds rate.

The long-term markets benefited early in the month from the reductions in short-term rates, the modest amount of new cash raised in the Treasury refunding operation, and an announcement that a large amount of maturing debt would not be refinanced by the Federal Home Loan Bank (FHLB). Although rates rose somewhat in the second half of the period, they remained below the levels reached at the end of April in the Government and corporate sectors. The municipal market also displayed a firmer tone initially. However, with investor demand at a low ebb and New York City's financial problems weighing on the market, yields moved up sharply late in the month and closed above their end-of-April levels.

According to preliminary estimates, the growth of both M_1—private demand deposits adjusted plus currency outside commercial banks—and M_2—which adds time deposits other than large-denomination negotiable certificates of deposit (CDs) to M_1—picked up substantially in May, owing in part to the distribution of income tax rebates by the Treasury. In contrast, the volume of CDs outstanding continued to fall, resulting in sluggish growth in the credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds. The money stock series were revised in May to include the most recent call report data. The revision, which reduced M_1 in April by about $1 billion, covers the last half of 1974 and the first four months of this year. Growth rates for most monetary aggregates over the first months of this year were reduced slightly as a result of the revision.

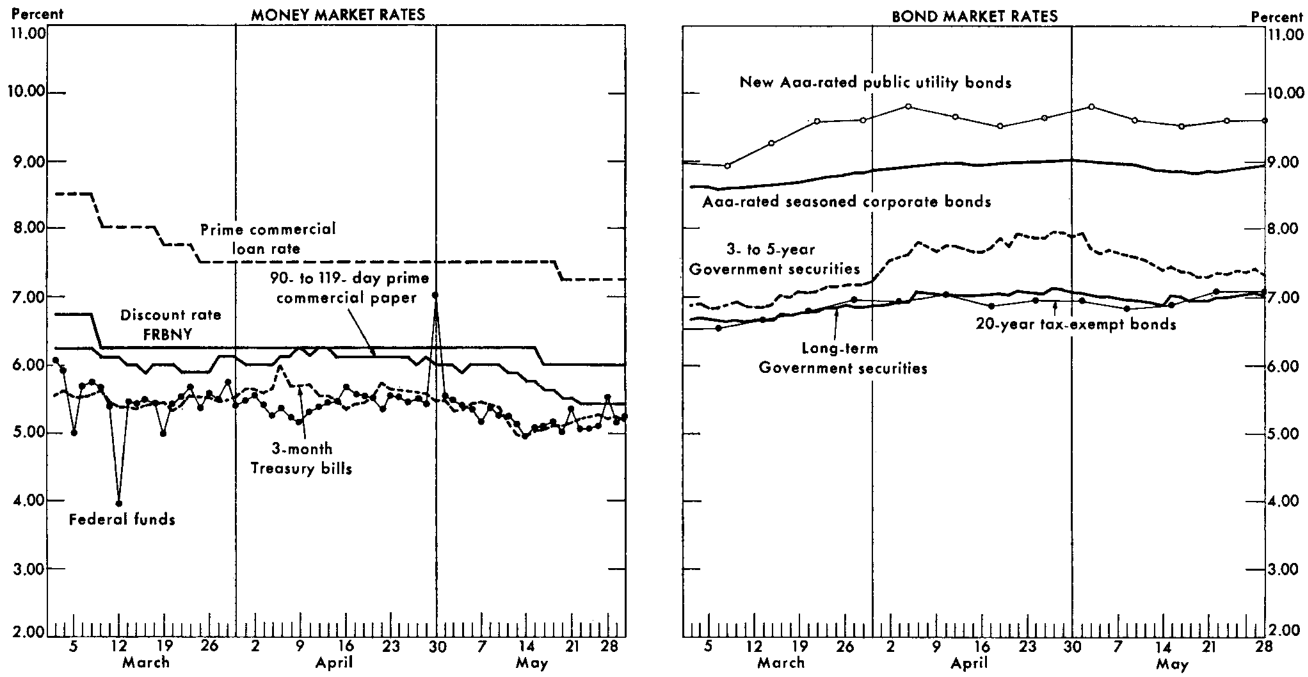
THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

After leveling off for over a month, money market interest rates declined in May, with particularly pronounced declines in the first half of the month (see Chart I). The effective rate on Federal funds averaged 5.22 percent in May, 27 basis points below April's average. Rates on 90- to 119-day dealer-placed commercial paper fell by ⅝ percentage point to the 5⅜ percent level at the month end. Comparable declines occurred in other short-term rates, as rates on three-month CDs in the secondary market ended May at 5.40 to 5.60 percent and rates on bankers' acceptances were in the 5.05 to 5.75 percent range at the end of May. After remaining constant for about six weeks, the commercial bank prime lending rate declined by ¼ percentage point late in the month, with most major banks quoting 7¼ percent and one bank posting 7 percent. Early in June, the prime rate was lowered again to the 6¾ to 7 percent range.

Business demand for short-term credit, which is generally sluggish in May, displayed considerable weakness during the month. Business loans at all weekly reporting banks declined about $2.5 billion in the four statement weeks in May, and the amount of nonfinancial commercial paper outstanding fell by about $900 million over the same period. The overall decline in the first five months of this year in the combined total of business loans and nonfinancial commercial paper was $8.1 billion, in contrast to increases of $10.8 billion and $12.5 billion in the comparable periods of 1973 and 1974, respectively.

After slowing sharply in April, most monetary aggre-

Chart I
SELECTED INTEREST RATES
March-May 1975



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.

gates grew at rapid rates in May, according to preliminary data. M_1 advanced at a 13.1 percent seasonally adjusted annual rate from the average level in the four statement weeks ended April 30 to its average over the four weeks ended May 28. This rapid expansion raised the growth rate of M_1 in the four weeks ended May 28 from its average level over the corresponding period thirteen weeks earlier to 9.2 percent, the most rapid such advance in almost two years (see Chart II). In contrast, growth in M_1 over the latest 52-week span was only 4.4 percent. Time deposits other than large CDs grew at a 14.8 percent rate from the average level in the four weeks ended April 30 to the average level in the four weeks ended May 28, and thus the rate of growth of M_2 over this period was 14.4 percent. Large banks continued to let their CDs run off at a substantial pace in May, and consequently the credit proxy grew only sluggishly over the same period. There was little pressure on bank reserve positions in May, and member bank borrowings from Federal Reserve Banks averaged \$64 million in the four weeks ended May 28 (see Table I), down \$38 million from the average of the five statement weeks in April.

In May, the Federal Reserve Board revised its estimates of the monetary aggregates for the period July 1974 to April 1975 to incorporate the data on nonmember bank deposits obtained in the December 1974 call reports. Demand deposits adjusted were revised downward, reducing the growth of M_1 in the first four months of 1975 to a 2.8 percent seasonally adjusted annual rate (the rate had been 4.1 percent before the revision). The other time deposit component of M_2 was raised somewhat, however, resulting in only slightly slower growth of M_2 than previously reported.

THE GOVERNMENT SECURITIES MARKET

The United States Government securities market was buoyant early in May after the Treasury's announcement that its borrowing needs over the May-June period would be less than expected. With investor demand picking up, yields on Government securities moved lower even though the Treasury raised only slightly less new cash in May (about $8.5 billion) than it had in April. Steady price gains were registered through midmonth, buttressed by both investor and professional demand. However, some of these gains were retraced late in the month, when participants concluded that Federal Reserve operations might not provide much further stimulus to the downward movement in rates. Participants noted the statement by Arthur F. Burns, Chairman of the Federal Reserve Board, that sufficient stimulation may have already been applied to the economy.

Treasury bill rates generally declined in May. The Treasury raised approximately $3.8 billion of new cash in the bill market during the month, about $2 billion less than in April. With bill rates falling in a favorable market climate, the first weekly bill auction attracted good interest. The average issuing rates were set at 5.36 percent for the three-month bill and 5.72 percent for the six-month bill (see Table II), about 36 and 43 basis points lower, respectively, than the rates established at the last auction in April. Bill rates continued to decline in response to investor demand (including Federal Reserve purchases for foreign customer accounts), and the average issuing rates for the bills at the second weekly auction moved slightly lower in aggressive bidding. Although demand for bills was reasonably strong late in the month, rates leveled off as professional participants attempted to trim rather large inventories. The average issuing rates at the last two weekly auctions were about unchanged. For the month as a whole, Treasury bill rates declined by 15 to 70 basis points.

The market for Treasury coupon securities rallied sharply early in May in response to the smaller than anticipated size of the May refunding operation and the manageable size of each of the individual offerings. Yields declined prior to the refunding operation, as investor

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1975

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

Factors	Changes in daily averages—week ended				Net changes
	May 7	May 14	May 21	May 28	
"Market" factors					
Member bank required reserves	+ 370	+ 401	— 114	+ 596	+1,253
Operating transactions (subtotal)	—1,095	+ 189	— 383	— 66	—1,355
Federal Reserve float	— 26	— 14	+ 421	— 397	— 16
Treasury operations*	—1,045	+ 562	+ 478	+ 480	+ 475
Gold and foreign account	+ 47	— 45	+ 19	+ 78	+ 99
Currency outside banks	— 160	— 545	— 923	+ 21	—1,607
Other Federal Reserve liabilities and capital	+ 89	+ 230	— 378	— 249	— 308
Total "market" factors	— 725	+ 590	— 497	+ 530	— 102
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 967	— 905	+1,155	— 522	+ 695
Outright holdings:					
Treasury securities	+ 483	+ 526	+ 45	+ 250	+1,304
Bankers' acceptances	+ 19	+ 24	+ 27	— 2	+ 68
Federal agency obligations	— 27	—	—	— 20	— 47
Repurchase agreements:					
Treasury securities	— 8	— 972	+1,015	— 436	— 401
Bankers' acceptances	+ 234	— 162	— 43	— 147	— 118
Federal agency obligations	+ 266	— 321	+ 111	— 167	— 111
Member bank borrowings	— 208	— 15	+ 104	— 38	— 157
Seasonal borrowings†	+ 4	— 2	—	+ 2	+ 4
Other Federal Reserve assets‡	+ 143	— 77	— 654	+ 106	— 482
Total	+ 902	— 997	+ 604	— 454	+ 55
Excess reserves‡	+ 177	— 407	+ 107	+ 76	— 47

	Daily average levels				Monthly averages§
Member bank:					
Total reserves, including vault cash‡	35,319	34,511	34,732	34,212	34,693
Required reserves	34,934	34,533	34,647	34,051	34,541
Excess reserves	385	— 22	85	161	152
Total borrowings	33	18	122	84	64
Seasonal borrowings†	10	8	8	10	9
Nonborrowed reserves	35,286	34,493	34,610	34,128	34,629
Net carry-over, excess or deficit (—)‖	94	240	81	11	107

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 May 28, 1975.
‖ Not reflected in data above.

demand strengthened and Government securities dealers bought Treasury securities rather aggressively, in some cases to cover short positions in maturities of over five years. While a cautious view emerged as the bidding for the $5 billion of refunding issues began, the three auctions, which raised $1.2 billion in new cash, drew a good response. In the refunding, $2.75 billion of 3¼-year notes was auctioned on Tuesday, May 6, at an average yield of 7.70 percent, and a coupon of 7⅝ percent subsequently was placed on the issue. The next day, $1.5 billion of seven-year notes was sold with an average yield of 8 percent. At the final sale, $750 million of thirty-year bonds was auctioned at an average yield of 8.30 percent, and an 8¼ percent coupon was established on the issue. These issues moved to a premium in trading on a "when-issued" basis, and an auction of $2 billion of two-year notes attracted strong interest the next week. The two-year notes were sold at an average yield of 6.86 percent. Late in the month, however, the market developed a cautious stance in reaction to the potential for strengthening credit demands implied by the sharp rise in new orders for durable goods in April. Also, some participants began to revise expectations of further Federal Reserve easing. The auction of $1.5 billion of seventeen-month notes on May 22 did not attract as much interest as expected, and the average issuing yield was 6.54 percent. For the month as a whole, yields on intermediate-term issues moved 30 to 70 basis points lower, while yields on longer term issues dropped by about 15 to 45 basis points.

Yields on Federal agency issues declined in May, reflecting the generally light new cash needs of the agencies as well as the improvement in the Government securities market. Sentiment was bolstered early in the month by the announcement that the FHLB planned to redeem nearly $1.3 billion of debt maturing late in May. Overall, demands in this market during May were relatively light. At midmonth, two Farm Credit Administration agencies sold $1.3 billion of short-term securities which raised only $12 million in new cash. In particular, the Banks for Cooperatives sold $428.3 million of six-month bonds priced to yield 5.80 percent, and the Federal Intermediate Credit Banks sold nine-month bonds priced to yield 6.15 percent. These rates were 35 and 45 basis points lower, respectively, than on comparable issues marketed in April. On May 20, the Government National Mortgage Association auctioned $275.7 million of modified pass-through securities which were priced to yield 8.55 percent on a corporate-bond-equivalent basis. Two days later the Federal National Mortgage Association priced three issues to refund $750 million of securities and raise $600 million of new money: $400 million of three-year debentures priced to yield 7.45 percent, $650 million of 4½-year debentures priced to yield 7¾ percent, and $300 million of 8½-year debentures priced to yield 8 percent. These issues sold quickly.

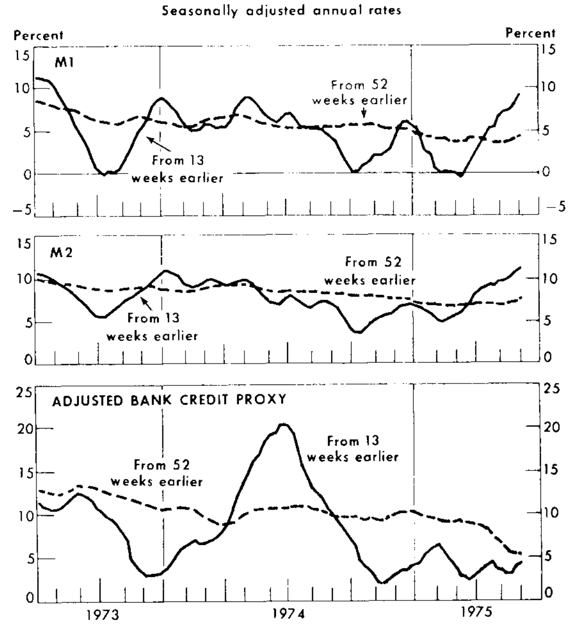
THE OTHER SECURITIES MARKETS

The corporate bond market, which had been marked by a cautious and uncertain climate as April drew to a close, rebounded sharply during the first half of May, and yields on new issues declined from the highs reached in April. Subsequently, the calendar became heavy and the market sagged under the weight of the new offerings, resulting in the postponement of at least one large offering at the month end. The municipal market also improved modestly early in May but the improvement was

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier and 52 weeks earlier. The latest statement week plotted is May 28, 1975.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

restrained, in part because banks continued to find tax-exempt income relatively unattractive. The Bond Buyer index of twenty municipal bond yields declined early in May and then rose to 7.09 percent on May 29, the highest rate since last December.

The degree of improvement in the corporate bond market was highlighted by the yields attached to several industrial offerings. Early in May, Texaco Incorporated brought to market a $300 million issue of thirty-year Aaa-rated debentures which were priced to yield 8.95 percent. Texaco had postponed this issue in early April, when the issue had been expected to be sold with a yield of about 9¼ percent. The rally extended to the middle of the month, and an offering of $250 million of thirty-year Aaa-rated debentures by Shell Oil Company was priced to yield 8.82 percent. These gains were shared by lower rated and shorter maturity issues as well. Also at midmonth, Aluminum Company of America sold a $150 million issue of 25-year A-rated debentures priced to yield 9.45 percent; early in April, comparable securities were sold with yields in the 10 to 10¼ percent range. In addition, Revlon, Incorporated, marketed $100 million of A-rated ten-year notes which were priced to yield 8.45 percent, down from the highs of about 9 percent reached in early April.

The new issue market for common and preferred stocks received some renewed attention in May, especially from utilities. The rebound in the stock market in general and the improved financial outlook for some of these companies have prompted them to reduce their dependence on debt capital and to improve their equity positions. According to preliminary estimates, new common and preferred stock financing amounted to roughly $900 million in May, in contrast to the monthly average of about $500 million in 1974. In other equity market activity, American Telephone & Telegraph Company received over $160 million when approximately 3.1 million warrants were exercised before their expiration on May 15.

The municipal bond market was buffeted by New York City's need to raise a total of about $1 billion in the May-June period. At midmonth the city announced and then subsequently canceled a planned sale of $280 million of short- and long-term securities after consulting with prospective underwriters. During the last week of the month, New York State made an advance payment of $200 million to the city to help meet payments that were due at the end of May.

The largest municipal offering of May, a $140 million issue of Commonwealth of Pennsylvania bonds, sold well early in the month. The securities, rated A-1 by Moody's and Aa by Standard & Poor's, were reoffered to yield from 4 percent in 1975 to 7.15 percent in 1992-94. In an improving atmosphere, the State of Michigan successfully sold a $100 million issue rated Aa by Moody's and Aaa by Standard & Poor's. The bonds were reoffered to yield from 4.5 percent in 1978 to 5.85 percent in 1987, rates that were slightly below those on an Aaa-rated issue sold late in April and 25 to 35 basis points below an Aa-rated issue sold at the end of April. The May calendar became heavier as the month progressed, and several issues sold slowly late in the month. The State of Maryland sold $89.2 million of Aaa-rated bonds originally priced to yield between 4.4 percent in 1978 and 5.9 percent in 1990, but price concessions were necessary to move the bonds out of dealers' inventories. During the month the Blue List of dealers' advertised inventories rose by $152 million to finish May at $614 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—May 1975			
	May 5	May 12	May 19	May 23
Three-month	5.356	5.182	5.115	5.206
Six-month	5.724	5.481	5.412	5.469
	Monthly auction dates—March-May 1975			
	March 5	April 2	April 30	May 28
Fifty-two weeks	5.637	6.475	6.400	5.803

* 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.

Treasury and Federal Reserve Foreign Exchange Operations Interim Report

By ALAN R. HOLMES AND SCOTT E. PARDEE*

As previously reported, in late 1974-early 1975, the exchange markets had been subject to an almost unremitting diet of bearish news for the dollar, and market forces drove dollar rates persistently lower. The economic downturn and the slide of interest rates in the United States had reinforced expectations of a further widening of interest differentials already adverse to the dollar. Gloomy forecasts emerging in the debates over economic and energy policies in Washington had further depressed the market. With individual oil-producing countries reportedly growing restive over the dollar's depreciation, market fears of an accelerated diversification of oil proceeds to other currencies had intensified. In addition, reports that the market might be left short of some continental European currencies as a result of the failure of several financial institutions last year had triggered further bidding for foreign currencies. In this atmosphere, the market had ignored favorable news for the dollar, such as the underlying improvement in the United States trade balance and the slackening in our rate of inflation.

As the dollar rates fell, the Federal Reserve had intervened in modest amounts on a day-to-day basis to cushion the decline, while other major central banks also intervened to buy dollars in their markets. But, with markets becoming increasingly nervous and unsettled, a more forceful intervention approach was clearly needed to avoid disorderly conditions, and during the last week of January the Federal Reserve and the Bundesbank stiffened their resistance to the further decline in dollar rates. By January 31, the Federal Reserve's swap debt incurred in market operations since October 1974 had accumulated to $412.5 million equivalent, of which $382.7 million was in German marks, $26.6 million in Swiss francs, and $3.2 million in Dutch guilders.

Over the weekend of February 1-2, senior officials of the Federal Reserve, the Bundesbank, and the Swiss National Bank met in London to conclude details of a coordinated, more forceful intervention approach. On Monday, February 3, the Bundesbank and the Swiss National Bank countered renewed selling pressure on the dollar through sizable dollar purchases while several other central banks joined in as buyers of dollars. The Federal Reserve followed up in New York with large offerings of marks, Swiss francs, Dutch guilders, and Belgian francs. Drawing on the respective swap lines, the Federal Reserve sold in two days a total of $139.4 million equivalent of currencies: $74.4 million of marks, $28 million of Swiss francs, $26.9 million of Dutch guilders, and $10 million of Belgian francs. This concerted operation, and its confirmation by Chairman Burns and by officials of the Bundesbank and the Swiss National Bank, prompted a recovery for the dollar of some 4 percent against the mark and Swiss franc.

Subsequent events, however, served to reinforce the bearish sentiment toward the dollar. During the first weeks of February, the cut in Federal Reserve discount rates, subsequent reductions in prime rates, and release of sharply higher unemployment figures seemed to reconfirm market expectations that the decline in United States interest rates would continue to outpace those of other countries. In fact, the easing of most money market rates in the United States was more gradual in February than before and in line with the downturn of rates already emerging in most European centers. Nevertheless, in the absence of

---

* This interim report, covering the period February through April 1975, is the fifth 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. Holmes is the Executive Vice President in charge of the Foreign Function of the Federal Reserve Bank of New York and Manager, System Open Market Account. Mr. Pardee is Vice President in the Foreign Function and Deputy Manager for Foreign Operations of the 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.

strong domestic credit demand, United States banks continued substantially to increase their loans and reduce their liabilities to foreigners. Moreover, market concern over the possibility of large-scale diversification into continental European currencies was heightened by repeated statements from OPEC (Organization of Petroleum Exporting Countries) officials that they were seeking ways to protect the value of their oil receipts from a further decline in dollar rates.

Against this background, the dollar came under renewed and occasionally heavy selling pressure which persisted through most of February and drove dollar rates back to the late January lows and beyond. The Federal Reserve, the Bundesbank, and the Swiss National Bank remained prepared to intervene forcefully, as necessary, to avoid the outbreak of disorderly conditions but without holding exchange rates at any particular level. The Federal Reserve intervened on ten of the fourteen business days between February 5 and February 26, selling a total of $278.2 million of German marks and $74.4 million of Swiss francs, all drawn on the swap lines with the respective central banks. Market pessimism was nevertheless so entrenched that, when on February 27 the United States released clearly improved trade figures for January, the dollar failed to rise and the New York market was soon flooded with speculative selling out of Europe. The Federal Reserve quickly countered with offerings of foreign currencies, selling $56.7 million equivalent of marks, $20.9 million equivalent of Swiss francs, $20 million equivalent of guilders, and $6.6 million of Belgian francs, all financed by drawings on the respective swap lines. This operation was followed up with sustaining intervention the next day, amounting to $23.7 million of German marks drawn on the Bundesbank, and helped set the stage for an improved market atmosphere beginning early in March.

By then, interest rate differentials were shifting in favor of the dollar, as the decline in United States interest rates slackened further while interest rates elsewhere continued to fall. In addition, reports of disagreements within OPEC eased some of the immediate concerns in the market that the group would collectively cut production or boost prices further. Moreover, a number of statements by United States officials emphasizing the fundamental strengths in this country's trade and payments position and rejecting a "benign neglect" policy toward the dollar helped to harden the market's view that dollar exchange rates were about to bottom out. The market's pessimism began to lift and dollar rates staged a tentative recovery. Meanwhile, the Federal Reserve had acquired $102.3 million of German marks from the Bank of Italy in connection with an Italian drawing on the International Monetary Fund and repaid $25 million of swap debt with the Bundesbank. Using the remainder of these marks, the Federal Reserve continued to intervene to resist a backsliding in rates that threatened to undermine a more solid recovery, selling in the first four days of March $63.3 million of marks from balances and $9.5 million of Swiss francs financed by further swap drawings.

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, January 31, 1975	Drawings (+) or repayments (—) February 1 through April 30, 1975	System swap commitments, April 30, 1975
National Bank of Belgium	261.8	+ 16.7 — 16.7	261.8
German Federal Bank	382.7	+491.7 —269.6	604.7
Netherlands Bank	3.2	+ 49.0 -0-	52.2
Swiss National Bank	397.8	+132.8 —159.4	371.2
Bank for International Settlements (Swiss francs)	600.0	-0-	600.0
Total	1,645.4	+690.2 —445.7	1,889.9

Note: Discrepancies in totals are due to rounding.

Thereafter, Federal Reserve intervention tapered off sharply and was limited to resisting sudden sharp drops in dollar rates that might rekindle more generalized selling pressure. The System operated on only five of the twelve business days between March 7 and March 24 to sell $55.8 million of marks, of which $47.1 million was financed by new swap drawings and the rest by balances. The Federal Reserve discount rate cut announced on March 7 had little exchange market impact, as it followed official lending rate cuts in several European centers. As time passed, the market became more resistant to unexpectedly adverse developments. The news on March 25 of King Faisal's assassination, for example, only temporarily unsettled the markets; although the Federal Reserve offered several currencies that day to avoid an abrupt decline in dollar rates, it sold only $2.1 million of Dutch guilders before the dollar steadied.

By this time, the Federal Reserve had increased its swap drawings by a net of $653.6 million to finance intervention in February and March, bringing total market-related indebtedness to a peak of $1,066.2 million. Of this, $837.8 million was in marks, $159.4 million in Swiss francs, $52.2 million in Dutch guilders, and $16.7 million in Belgian francs. Nevertheless, with market conditions becoming generally more settled, the Federal Reserve had begun to make modest daily purchases of currencies needed to repay that debt.

The dollar's tentative recovery gradually gave way to a more generalized advance that continued through most of April, as market sentiment improved further and outstanding short positions were covered. Underpinning the dollar's rise was mounting evidence of a basic improvement in United States trade and price performance, highlighted by news of successive record monthly trade surpluses in February and March. Moreover, United States interest rates leveled off, in anticipation of the United States Treasury's large borrowing needs in 1975, and the outflow of bank funds slowed.

As the dollar strengthened, the Federal Reserve was able to make progress in repaying swap debt. In late March and April, the System acquired sufficient marks both in the market here and abroad and directly from correspondents to repay $244.6 million of swap drawings. Moreover, the Federal Reserve purchased from the Swiss National Bank the francs needed to repay $159.4 million of swap drawings incurred since December 1974. The System also purchased in the market the Belgian francs needed to liquidate the $16.7 million of swap drawings with the National Bank of Belgium incurred in February. With the Dutch guilder at or near the upper limit of the European "snake" arrangement, however, the Federal Reserve refrained from purchasing guilders in the market.

Despite the dollar's greater buoyancy, the markets remained sensitive to potential diversification of OPEC funds into continental European currencies not only out of dollars but also out of sterling, which came under heavy selling pressure on several occasions during the month. When these concerns surfaced, the dollar occasionally came on offer, but the Federal Reserve intervened only four times—on April 8 and on three days between April 23 and April 29—to cushion sharp declines in dollar rates. These sales, in marks only, amounted to $42.6 million equivalent, of which $31 million was from balances and the remainder drawn on the swap line with the Bundesbank. In each instance, however, the dollar soon resumed its recovery. By the end of April, the dollar had advanced by 4 to 6 percent from its lows against the German mark and Swiss franc and by similar amounts against most major European currencies. On balance, the Federal Reserve reduced its outstanding swap debt incurred since October 1974 by $409.2 million to $657 million on April 30.

In summary, in exchange market intervention during the three-month period, the Federal Reserve sold a total of $793.2 million equivalent of foreign currencies. Of these, $594.7 million equivalent was in German marks, $491.7 million financed by drawings under the swap arrangement with the Bundesbank and the rest from balances. The System acquired in the market and from central bank correspondents sufficient mark balances to repay $269.6 million of swap drawings, leaving $604.7 million equivalent of mark debt outstanding on April 30. Intervention in Swiss francs amounted to $132.8 million equivalent all drawn on the swap line with the National Bank and fully repaid, along with $26.6 million carried over from December-January, by means of direct purchases of francs from the National Bank. In guilders, the System sold a further $49 million equivalent during the period, raising its swap drawings to $52.2 million equivalent. Finally, in Belgian francs, the $16.7 million equivalent of swap drawings on the National Bank of Belgium to finance exchange market intervention during the period was fully repaid through acquisitions in the market. On April 30, in addition to the $657 million equivalent of swap debt remaining from exchange market operations since October 1974, the Federal Reserve had $971.2 million equivalent of Swiss franc and $261.8 million equivalent of Belgian franc swap commitments outstanding since August 1971.

As described in the December 1974 and March 1975 reports, on September 26 of last year the Federal Reserve Bank of New York acquired the $725 million equivalent of forward exchange commitments of the Franklin National Bank. During the three-month period under review, the aggregate of outstanding forward contracts was further reduced by somewhat over $300 million to only $10.5 million on April 30.