consequence of this rise in employment, the unemployment rate in October dropped to 4.3 percent, an eight-year low.

As of now, the combination of more tanks and fewer taxes has already affected the pace of the business expansion. Moreover, these factors—and the investor and consumer reactions to them—will continue to have an important impact on business activity in coming months. —*William Burke*

Borrowing Still

FURTHER substantial demands upon the nation's credit markets accompanied the continued expansion in the output of goods and services during the third quarter. The business sector again generated the bulk of these credit demands; business firms expanded their borrowings substantially, even though at a slower pace than in the preceding quarter. Consumers added to their debt at about the same rate as they did earlier in the year, with more than two-fifths of the increase again reflecting their seemingly insatiable appetite for new automobiles. State and local governments—the fastest growing sector of the economy—continued to increase their new debt offerings. On the other hand, the Federal Government covered its cash deficit largely by drawing upon its operating balances; in fact, virtually all of the small net increase in Federal debt centered in special issues held by Government agencies and trust funds, as the marketable public debt remained virtually unchanged.

Monetary policy firm

For its part, monetary policy maintained the somewhat firmer tone initiated during the spring months in response to a sustained and vigorous demand for bank credit—and also in response to the nation's continuing need to remedy the imbalance in its external-payments position. Member-bank borrowings rose by about $50 million during the third quarter to an average level of $550 million, but this rise was offset by a comparable increase in excess reserves. Consequently, net borrowed reserves remained almost unchanged at an average level of about $155 million.

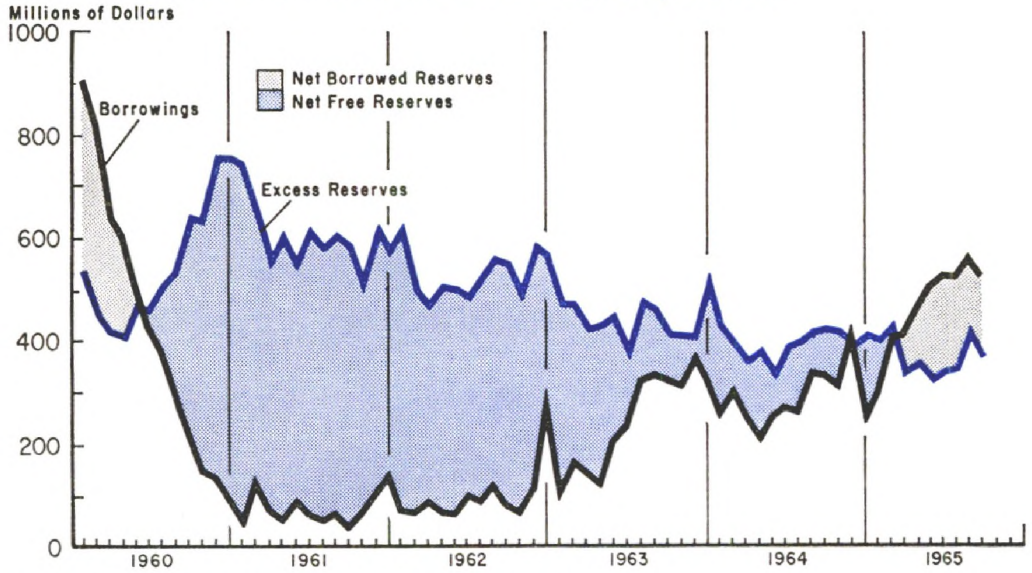
This stability was accompanied by a slower growth in total bank credit—about $4 billion (seasonally adjusted), or only about half of the average quarterly gain recorded earlier in the year. But this reduced rate of credit expansion was accompanied by a $2.5-billion rise in the money supply (seasonally adjusted) —a gain larger than that for the entire January-June period. This sharp increase partly reflected an appreciable decline in U. S. Government deposits from their exceptionally high mid-year level.

Yields stiffen

The money and capital markets showed definite signs of tightening, even though the reserve measures of monetary policy indicated just about the same degree of restraint as before. Most yields throughout the maturity range firmed substantially during the third quarter, somewhat in contrast to their behavior during the preceding quarter.

The market yield on 91-day Treasury bills,

Monetary policy maintains firmer tone
as banks remain in net borrowed-reserve position



Source: Board of Governors of the Federal Reserve System

after ranging between 3.81-3.86 percent from the end of June through late August, later moved up strongly. In late September it topped 4.00 percent — a five-year high — after the Treasury announced the tender of $4 billion of tax-anticipation bills. This third-quarter development, with dealers cutting prices to reduce inventories in the face of high financing costs, contrasted markedly with the second-quarter pattern, where a strong investment demand for bills tended to put downward pressure on yields.

The trend toward higher yields was not confined to short-term securities. Psychological and expectational considerations, stemming in part from developments in the Mekong, the Kutch, Sikkim and Threadneedle Street, combined with market factors to push up yields throughout the maturity spectrum. The Vietnam situation, for one thing, bred considerable uncertainty with regard to future increases in defense expenditures and the possibility of larger Federal deficits. Then too, the possibility of a crisis in pound sterling was not alleviated until almost the middle of September. Most important of all, a growing belief that economic activity would continue booming into 1966 re-enforced market expectations of higher interest rates.

Reflecting these various factors, most Treasury issues of beyond one-year maturity were yielding at least 4.25 percent by the end of September, and a number of maturities beyond five years were priced to return around 4.35 percent. Indeed, the average yield on long-term bonds, which had remained stable at about 4.14 percent during the March-June period, reached 4.29 percent by the first of October.

Corporates, municipals, mortgages

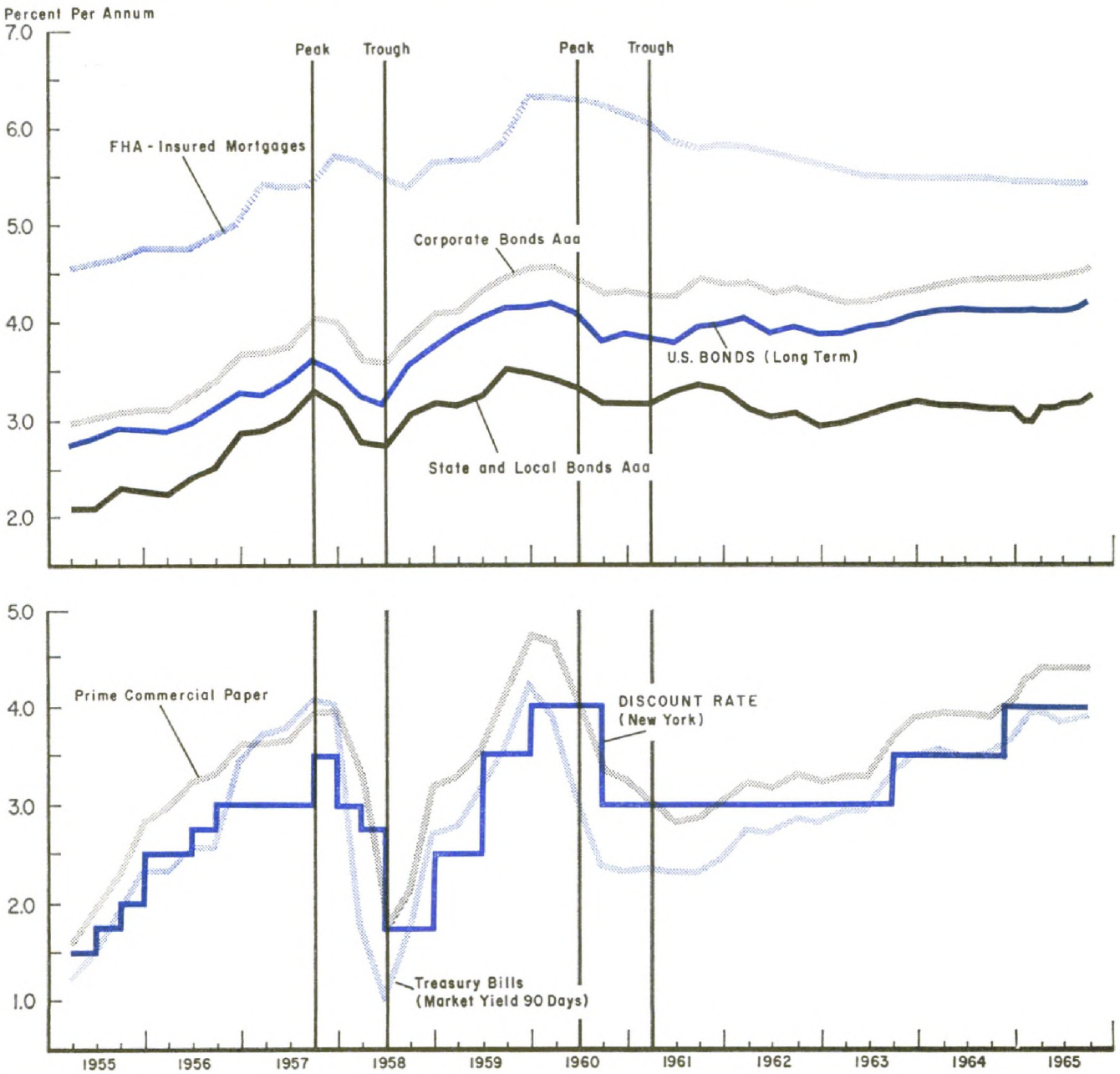
In addition, market factors strongly affected yields in the corporate and municipal bond markets, and indirectly, in the Government bond market. The volume of new offerings of both corporate and tax-exempt issues was exceptionally large for this normally quiet summer period. The $3.3-billion expansion of new corporate issues, plus the continued vigor in business borrowing from banks, suggested that corporate liquidity might henceforth be squeezed as internally generated funds become less adequate to finance rising outlays for inventories and plant and equipment. Thus, yields on seasoned bonds rose by about seven basis points during the third quarter (to 4.53 percent late in September), and by an additional 4 basis points during the first week of October. The increase since mid-September also was accompanied by a widening in the yield spread relative to

Treasury issues.

Upward pressures were also evident in the state-local government market, where yields continued along the uptrend initiated early in the year, rising by 14 basis points between end-June and end-September to an average of 3.31 percent on top-rated issues. Rising yields reflected both the massive amounts of new municipal offerings coming to market and the large inventories left in the hands of dealers. Both the $2.6 billion of new offerings in the third quarter and the $700 million of issues left unsold in mid-October were close to the record figures recorded this past spring.

Mortgage markets also gave evidence of increasing firmness in August and September as secondary market yields on long-term FHA-insured mortgages edged upward to

Yields move up throughout maturity spectrum,
as money and capital markets show definite signs of tightening



Source: Board of Governors of the Federal Reserve System

5.46 percent. But the long-delayed firming of mortgage yields was perhaps due more to a moderation in the flow of savings into mortgage institutions than to increased pressure from the demand side.

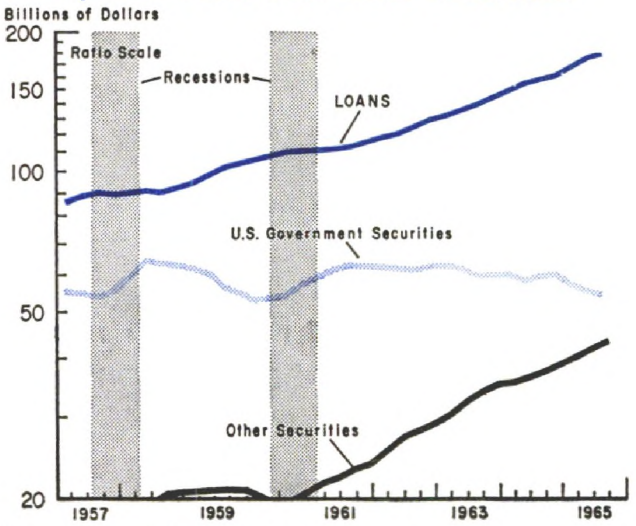
Banks and businesses

In their capacity as the department stores of finance, commercial banks continued to play a key role in the nation's credit markets during the third quarter. Total bank credit—total loans less interbank loans plus investments—rose by almost $4.0 billion (seasonally adjusted). This increase, although less than those recorded in the two preceding quarters, represented a substantial 5.5-percent annual rate of gain. And business loans again accounted for a significant portion of total credit demands, rising at a 14-percent annual rate during the quarter.

Following June's exceptionally strong performance, business loans declined by almost $700 million in July, but then recovered strongly in August and September. (Data not seasonally adjusted.) Significantly, business borrowings over the mid-September tax date surpassed last year's increase by a fair margin, even though corporations had to pay only 19.3 percent of their annual Federal-tax liabilities during the quarter, as against 28.3 percent in the year-ago period. This development, in conjunction with a sharp tax-date decline in corporate holdings of certificates of deposit, again suggests that businesses generally may be experiencing a squeeze on liquidity.

The latest increase in business borrowings, moreover, was accompanied by somewhat greater firmness in non-price terms of borrowing, and also by a somewhat higher average rate of interest. However, on short-term loans, the interest cost was still only slightly higher during the September survey period than in the year-ago period (5.00 percent, and 4.98 percent, respectively). And, while the proportion of loan volume made at the prime rate (56 percent) was less than in June, it too, was still higher than in September 1964.

Banks liquidate Governments
to expand loans and other securities



Source: Federal Reserve Board

Rising credit, rising deposits

Demands for bank credit by non-business borrowers also remained strong during the third quarter. The banks continued active in the mortgage field, as real-estate portfolios increased by $1.7 billion, the largest quarterly gain in well over a year. Similarly, consumer loans, on the heels of the auto boom, posted a near-record increase of $1.2 billion—and this gain accounted for over three-fifths of the combined increase in consumer debt at all types of lending institutions.

The banks also remained active in the state-local government field, expanding their portfolios of "other securities" by a substantial $1.7 billion. However, the rate of expansion slackened appreciably late in the quarter, as banks found themselves in an increasingly less liquid position from which to accommodate the widespread and vigorous demands for credit accommodation. And, just as earlier in the year, the banks financed the expansion of loans and "other securities" with a further ($1.4 billion) liquidation of U. S. Govern-

ment securities, along with a $2.1-billion net repayment of borrowings by security dealers.

The other side of the ledger also witnessed some significant developments during the quarter. Private demand deposits rose by about $3.6 billion (seasonally adjusted)—about double the average quarterly gain of the year to date—but this increase was roughly matched by the net decline in U. S. Government deposits. Time and savings deposits rose by $5.7 billion; this gain far surpassed the second-quarter increase, and it almost matched the exceptionally strong first-quarter increase, which reflected the initial impact of the higher rates paid on such deposits. With their impressive recent performance, the commercial banks continued to dominate this category by accounting for three-fifths of the total growth of depository-type savings.

This growth was not without its price. Money-market banks in particular, under the pressure of rising market rates of interest, acted during this period to retain funds by increasing the rates offered on their certificates of deposit. Late in the quarter New York City banks posted a 4½-percent rate—the maximum rate payable on time certificates with maturities of 90 days or more—while banks in widely scattered parts of the country began to offer instruments which would not be subject to interest-rate ceilings (for example, savings certificates and non-negotiable promissory notes). Nor was this all. For the prestige-conscious, a major New York bank announced a soon-to-be opened branch, bearing a French name and "patterned after an exclusive private club," whose privileges and services will be extended only to 800 "properly sponsored and approved members" who promise to maintain a minimum demand-deposit balance of $25,000.

—Verle Johnston and Herbert Runyon

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