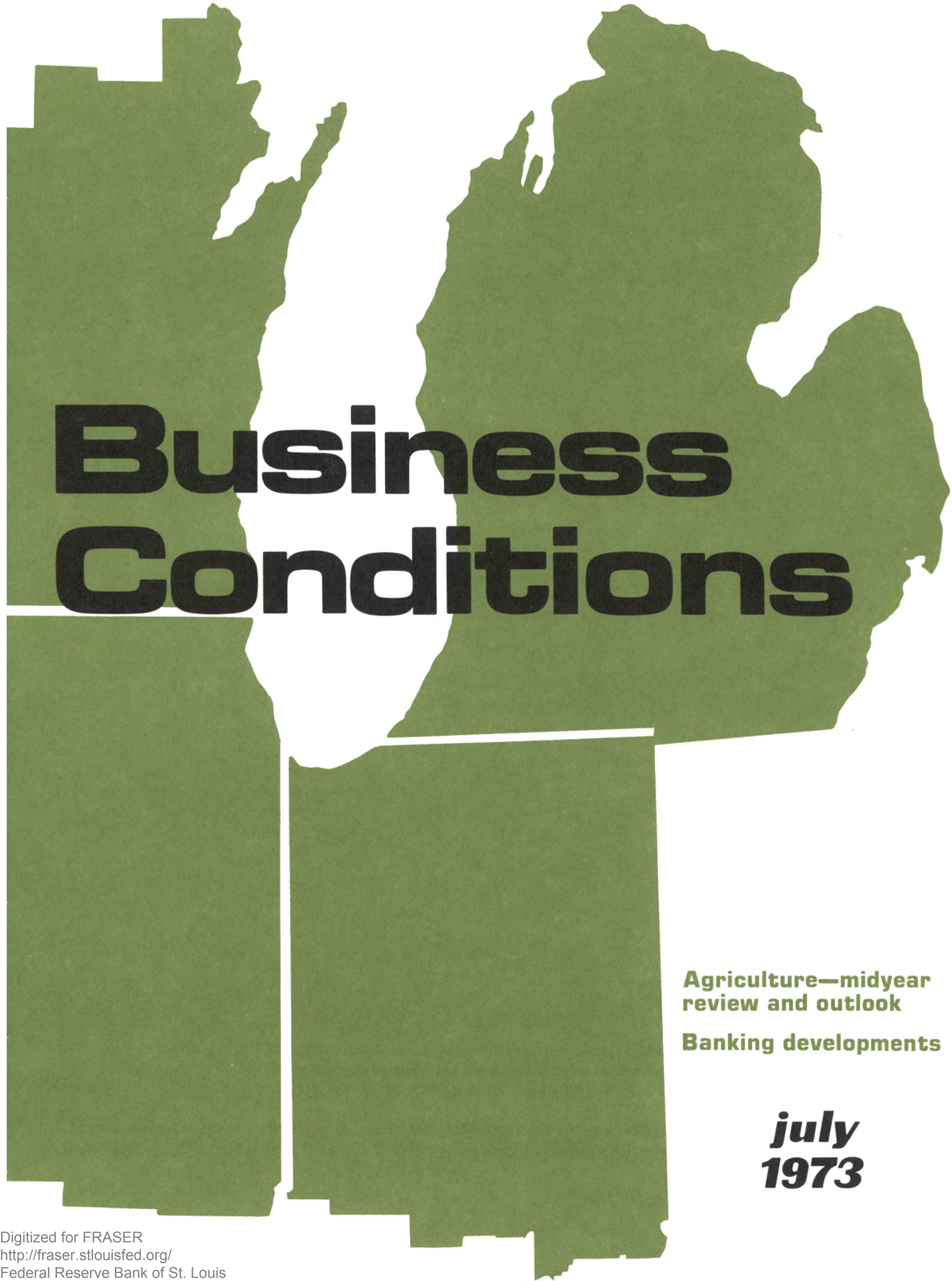
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

Agriculture—midyear review and outlook

Banking developments

july
1973

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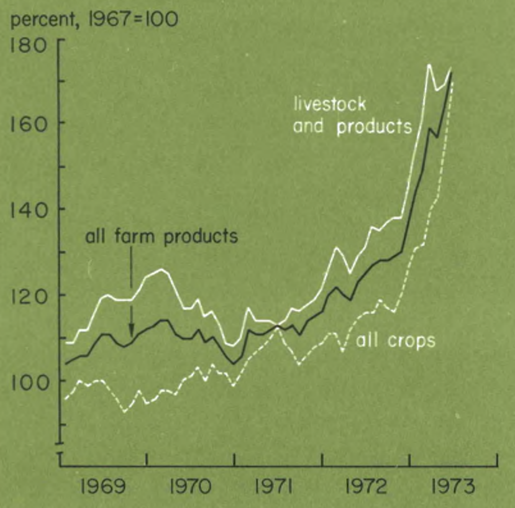
Agriculture—midyear review and outlook

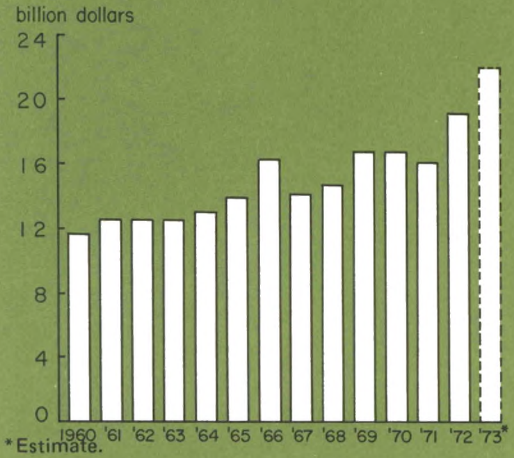
The agricultural sector of the economy experienced one of the most lucrative periods in history during the first half, but the situation changed abruptly for livestock producers late in the second quarter. Prices received by farmers for many major commodities rose sharply, with some reaching record levels. By midyear, the composite index of agricultural prices stood 26 percent above the ending 1972 level and nearly 38 percent above the year-earlier level. The surge in prices boosted cash receipts from farm marketings 23 percent over the first six months of 1972. Prices paid by farmers also rose steadily—particularly during the second quarter—but the gain in overall expenses fell short of the increased revenues.

Within this environment, net farm income rose to an annual rate of $22 billion during the first quarter, 15 percent above the record established for all of 1972, and 26 percent above the previous peak registered a quarter century ago. And although the second-quarter figure, when available, is likely to show some decline from the first-quarter results, net farm income for the first half is expected to reach a record high.

Surging farm prices...



...boosted net farm income to a record level



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The expected decline in net farm income for the second quarter reflects the losses incurred by many livestock producers. Sharply higher costs for feed and feeder stock coupled with indirect price ceilings on market animals substantially reduced margins of beef and pork producers. Profit margins of dairy and poultry farmers also were squeezed by rising feed costs throughout the second quarter and, as the first half ended, by the impact of the price freeze. These developments have curtailed the anticipated expansion in beef, pork, poultry, and dairy production and caused much concern over the adequacy of food supplies for the second half of this year.

The overall performance of the agricultural sector during the first half largely reflected exceptionally strong market demands and lower-than-anticipated supplies. But contributing to the overall demand/supply environment were a number of unusual developments in governmental actions, in market conditions, and in weather conditions.

Governmental actions

Concern over tight food supplies and rapidly rising food prices led to a number of governmental actions that directly, or indirectly, had an impact on the agricultural sector. Among these actions were the imposition of meat price ceilings at the wholesale and retail level, the freeze on all wholesale and retail food prices, and the imposition of export controls on certain agricultural commodities. Other actions included the relaxation of import quotas, the depletion of government-owned stocks of various agricultural commodities, and an unprecedented release in set-aside acreage under various farm commodity programs.

Market conditions

Several unusual developments surfaced in both the markets for agricultural products and the markets for production inputs. These included the consumer meat boycott, a record volume of export shipments, the transportation bottlenecks that hampered the movement of grain and soybeans from farm and country elevator storage to seaports and other distribution centers, and tight supplies of major inputs such as seed, fuel, fertilizer, and machinery.

Weather conditions

Adverse weather conditions materially reduced last year's crop harvest in many parts of the world, particularly in Asia and in the Soviet Union. Domestically, wet weather conditions last fall delayed completion of the 1972 corn and soybean harvest until the early part of this year and hampered the planting of many vegetables grown in the Southwest. Heavy rains this spring delayed 1973 crop plantings and vegetable harvests, while late spring frosts nipped budding fruit trees in many areas. Moreover, snowstorms in late winter and early spring resulted in abnormally high livestock death losses and a substantial reduction in livestock feeding efficiency.

Strong market demand

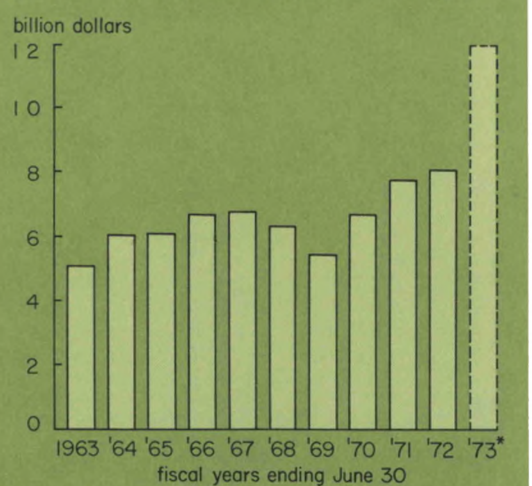
Demand for agricultural products rose sharply during the first half reflecting vigorous growth in the U. S. economy and strong foreign demand. Domestically, the U. S. economy grew at one of the fastest rates in recent history. Employment and personal income increased sharply during the first half and provided the base for a surge in consumer spending. Total employment in June reached 84.7 million, on a seasonally adjusted basis, up 2.9 million from the year-earlier level. With more employment at higher wages, total personal disposable income rose to a seasonally adjusted annual rate of $850 billion in the first quarter, up more than 10 percent from the comparable year-earlier level. Spending was further augmented by sharp gains in consumer credit, large income tax refunds, and a reduction in the savings rate.

Although much of the increase in consumer spending was for purchases of durable goods, a large portion was devoted to food purchases. The resulting increase in demand, in conjunction with comparatively tight supplies, led to substantially higher food prices. Nevertheless, expenditures for food, adjusted for the higher prices, rose 1 percent above the year-earlier level during the first quarter.

Food prices averaged nearly 12 percent above year-earlier levels during the first half of this year. Much of the early gain reflected the sharp 15 percent rise in retail meat prices during the first quarter. Concern over rising meat prices resulted in the imposition of ceilings on all wholesale and retail meat prices on March 29 and a consumer meat boycott during the first week in April. While these actions temporarily slowed the rise in meat prices, prices of other foods, particularly fruits and vegetables, began rising sharply in the second quarter. In light of these first-half pressures and despite the price freeze announced on June 13—controlling all food prices except meat, which remained under the earlier-imposed ceiling controls—it now appears that food prices for all of this year may average more than 12 percent above 1972, the largest gain in 26 years.

Foreign demand for U. S. agricultural products has also been unusually strong this year, reflecting the dollar devaluation and lower competitive supplies in other exporting countries. Shipments from the United States during the first half were at a record pace. The increased volume coupled with sharply higher commodity prices boosted the value of agricultural exports above $12 billion for fiscal 1973, compared to $8 billion in fiscal 1972. Wheat shipments during the first half more than doubled the year-earlier level, while feed grain exports rose by nearly two-thirds. Exports of soybeans and soybean products and meat and livestock products also rose markedly. The inordinately large volume of shipments resulted in transportation bottlenecks that delayed the movement of grain and soybeans from farms and elevators, and reduced domestic supplies.

Agricultural exports exceed prior record by wide margin



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Increased governmental actions

In the past few months, governmental actions to expand domestic food supplies and curb the rising pressures on food prices have become notably more pronounced. In January, government spokesmen announced that meat import quotas would remain suspended throughout 1973. (The quotas were originally suspended for the latter half of 1972.) This action was expected to boost imports of meat subject to quotas—which account for the bulk of imported meats—by 7 percent in 1973. While such imports during the first five months of this year rose 10 percent above year-earlier levels, total meat imports remained virtually unchanged as imports not subject to quotas fell sharply. Last year, meat imports equaled 7 percent of domestic production.

The government also relaxed import quotas on some dairy products in order to boost tightening domestic supplies. Quotas on nonfat dry milk were temporarily relaxed in January and again in May. Imports rose by 85 million pounds during the first half well above the 1.8 million pound annual limit established by the quotas, and equivalent to 9 percent of the nonfat dry milk sold in the United States in 1972. Cheese import quotas were temporarily relaxed in April to permit imports of cheese subject to quotas to rise 50 percent. In 1972, all cheese imports, of which over one-half were subject to quotas, equaled 7 percent of U. S. commercial cheese sales.

Governmental actions also were evident in efforts to expand domestic crop production. As a result of several revisions to various 1973 government farm commodity programs, over 40 million acres were released for potential plantings, as acreage diverted from production fell to 19 million acres. This represented the largest year-to-year release in diverted acreage in the history of government farm programs and left the amount of acreage idled from production at the lowest level since 1956. Government payments to farmers are expected to fall by $1 billion from the 1972 total of $4 billion due to the revisions.

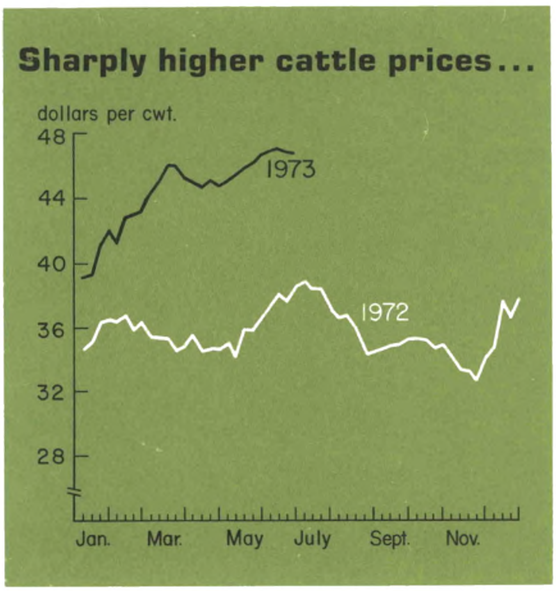
Other government actions

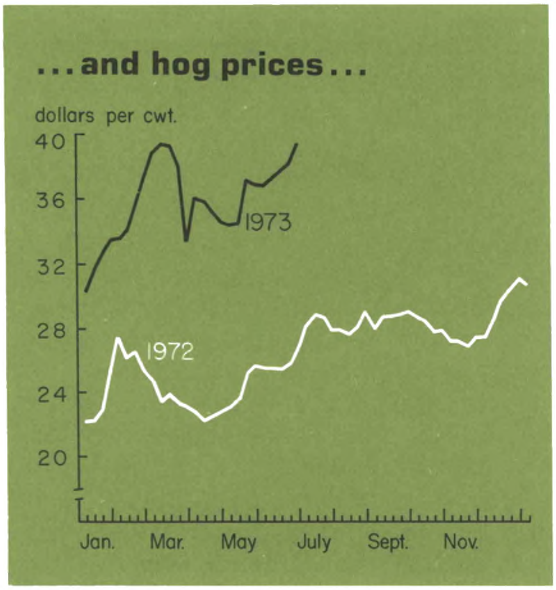
In an effort to augment free market supplies, the government sold virtually all of its inventories of major grains over the past few months. (Inventories of grain are acquired through unredeemed loans extended in price support activities.) Moreover, since outstanding loans will not be extended beyond existing contract maturities, and since market prices are well above loan redemption costs, commodities currently under price support loans are certain to move into market rather than government inventories. These developments mark the first time in several years that grain stocks controlled by the U. S. Government (either through loans or ownership) have fallen to such low levels.

The government also took steps to discourage the unprecedented movement of agricultural commodities into export channels. As world prices moved above domestic levels in late 1972, the controversial export subsidy to wheat exporters was discontinued. Subsequent actions terminated all other direct export subsidies on agricultural commodities. The strongest action taken against exports occurred around midyear. On June 13, President Nixon announced he was urgently seeking congressional approval of broader authority to implement export controls, and was instituting a mandatory reporting system to monitor exports of nine basic agricultural commodities. Preliminary evidence indicated pending exports would deplete supplies of soybeans and cottonseeds and their products before new crop supplies became available. Consequently, the Administration ordered an immediate embargo on these commodities on June 27, and five days later replaced the embargo with a licensing system limiting exports of soybeans and meal to 50 and 40 percent, respectively, of unfilled commitments outstanding on June 13.

Review of major commodities

Farm prices registered one of the most rapid gains in history during the first half of this year. Livestock prices paced the overall advance during the first quarter, but surging crop prices dominated in the second quarter. As the first half closed, livestock prices exceeded ending 1972 levels by 19 percent, while crop prices were up 34 percent.



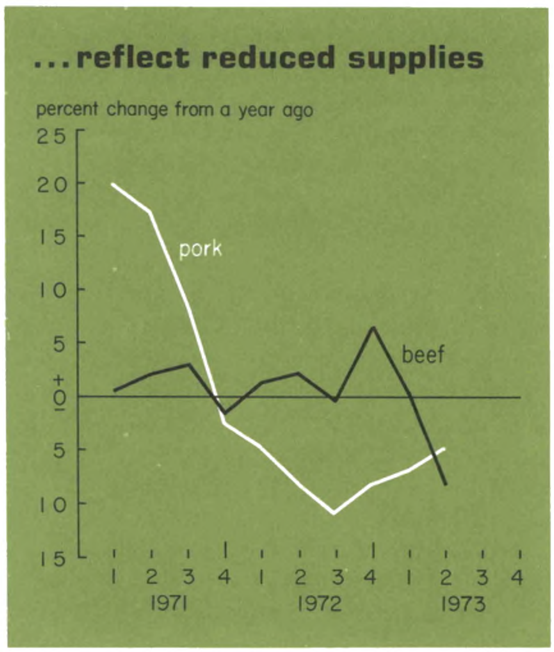


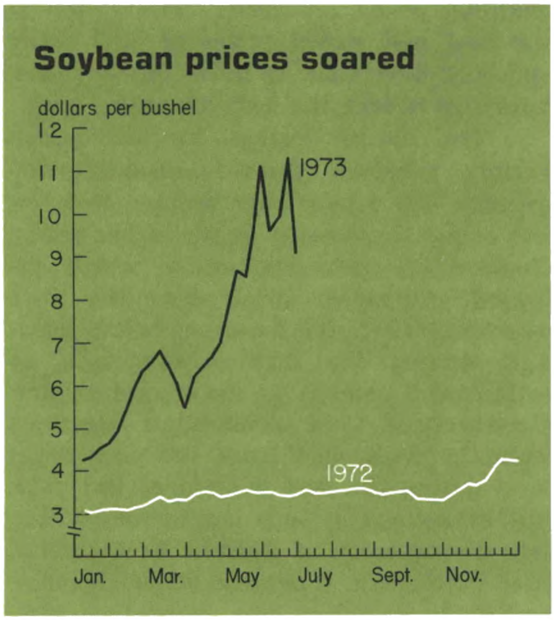
Livestock. The sharp uptrend in livestock prices began in December of last year and continued through the first half of March. At the peak, prices of barrows and gilts at Omaha averaged $39 per hundredweight, 66 percent over the year-earlier level and nearly 44 percent above the average price for November of last year. Similarly, the mid-March peak of over $46 per hundredweight for choice steers at Omaha represented a 39 percent gain from the November 1972 average and a 32 percent rise from the year-earlier level.

As the gains in livestock prices began to surface at the retail level, consumer resistance to high meat prices mounted. During the latter part of March, it became obvious that a consumer meat boycott, scheduled for the first week of April, would receive considerable popular support. This plus President Nixon's announcement of meat price ceilings on March 29 led to considerable disruptions in livestock markets, especially for hogs. As a result, steer prices were about $1 per hundredweight below the March peak through April, and hog prices declined to $34.50 per hundredweight through mid-May. But with the persistent lag in slaughter supplies, livestock prices recovered quickly, and as the first half ended prices of both cattle and hogs were back up to the March peaks, bumping against the indirect ceiling levels.

The sharply higher livestock prices largely reflected shorter-than-anticipated supplies and a consumer demand that was not easily discouraged by the higher prices. Commercial pork production, which has lagged year-earlier levels since the third quarter of 1971, fell 7 percent below a year ago during the first quarter, and an estimated 5 percent for the second quarter. Commercial beef production remained virtually unchanged from the year-earlier level during the first quarter of this year, but exceptionally large lags in the marketings during much of April held commercial beef production 8 percent below the year-earlier level during the second quarter. Overall, the developments in pork and beef slaughter during the first six months of this year led to an estimated 5 percent reduction in commercial red meat production as compared to a year earlier.

Dairy products. Demand for dairy products continued strong this year (in part

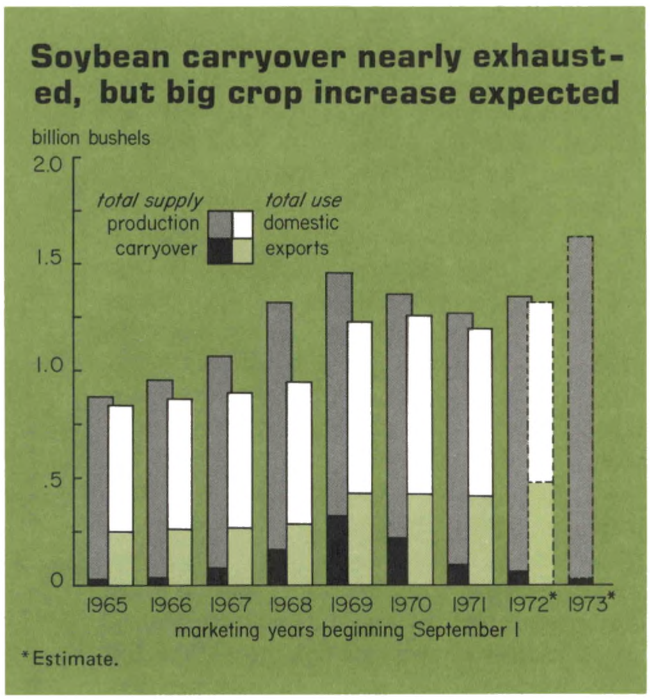


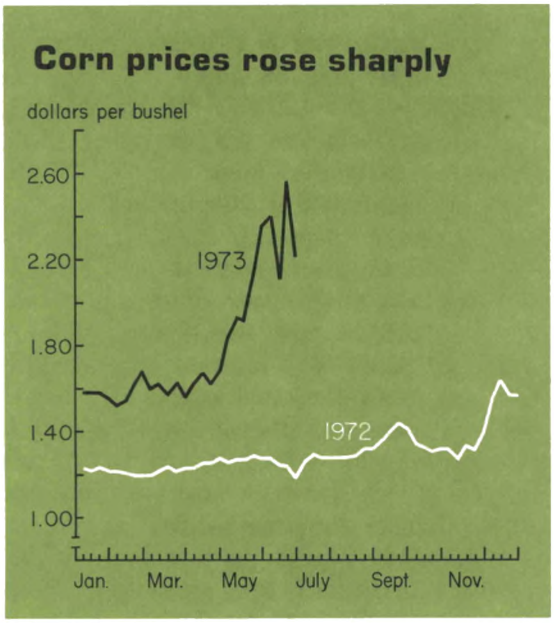


reflecting consumers' tendency to substitute dairy products for higher-priced meats), while production fell 2 percent. As a result, milk prices averaged 9 percent above year-earlier levels during the first half. The cutbacks in production represented the response of dairy farmers to both the profit squeeze—resulting from sharply higher feed prices—and higher cattle prices—encouraging heavier-than-normal culling of dairy herds. Despite higher milk prices, the milk-feed price ratio (pounds of concentrate feed ration equal in value to one pound of milk) averaged 1.45 during the first half, the lowest level for that time period since 1965.

Corn and soybeans. Higher feed costs during the first half largely mirrored the price developments in feed grains, primarily corn, and soybeans. Although prices of nearly all agricultural commodities registered sharp increases during the first half, soybean prices exhibited the most dramatic gains. During October 1972, soybean prices at Chicago averaged $3.35 per bushel, well above normal harvest season levels. Weather-plagued harvesting conditions, however, sent prices skyrocketing to near the $7 level in early March. Although the upward pressures abated in the latter half of March, a surge throughout most of the second quarter pushed soybean prices at Chicago to over $12 per bushel before uncertainties over export controls pushed the June-ending price down to $9 per bushel, nearly triple the year-earlier level.

Corn prices also experienced substantial gains, particularly since April. Last fall, corn prices averaged $1.33 per bushel at Chicago despite the pending near-record harvest. But as adverse weather conditions delayed the harvest, prices rose to $1.60 per bushel in December and maintained that level with only temporary fluctuations until late April. As excessive moisture and flooding conditions began to develop, concern over the ability of farmers to complete 1973 corn plantings began to mount. The resulting upward pressure on prices was





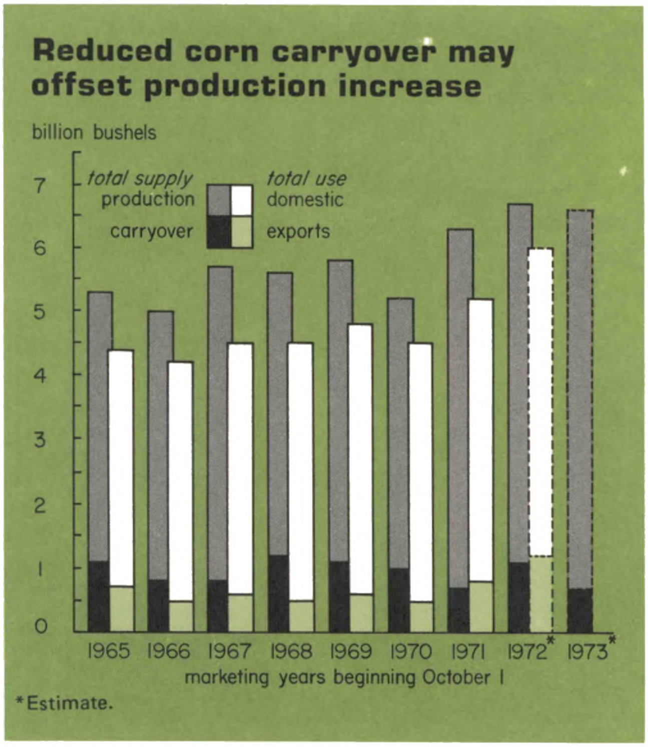
augmented by heavier-than-expected utilization of corn stocks. As a result, corn prices at Chicago reached $2.50 per bushel in late June, double the year-earlier level.

The combination of strong domestic and foreign demands more than offset the increase in corn and soybean supplies—both of which were up about 6 percent from the previous year. Domestic demand for corn was bolstered by reduced livestock feeding efficiency (reflecting the lower quality of the 1972 corn crop as well as weather-related factors during the winter and early spring), and a ban on DES, a growth-stimulate administered to cattle. Moreover, the high price of soybean meal—a high protein livestock feed supplement—led to a reduction in domestic utilization of soybean meal, and necessitated greater utilization of corn in feeding rations.

Foreign demand for U. S. corn and soybeans was bolstered by a reduction in competitive supplies available in other exporting countries and by larger livestock inventories worldwide. And despite sharply higher prices—which, in part, were offset by the dollar devaluation and floating currency exchange rates—corn exports during the first half rose 71 percent above the year-earlier level, while soybean and soybean meal shipments rose 32 and 40 percent, respectively.

The outlook

The agricultural outlook for the latter half of this year is clouded by several uncertainties. The duration of present export controls, the possibility of additional controls on exports of other commodities, the extent of curtailed production caused by recent price controls, and the effective relaxation of controls under Phase IV all will have an impact. Moreover, uncertainties surrounding the level of worldwide demands for and the supplies of agricultural commodities in the months ahead further cloud the picture.



The U. S. Department of Agriculture recently estimated 1973 planted corn and soybean acreage at 72.5 million and 56.7 million acres, respectively. Assuming normal harvesting patterns and trend-adjusted yields (which many observers feel are too high due to late plantings), this level of plantings would produce a 5.9 billion bushel corn harvest—up 6 percent from last year—and a 1.6 billion bushel soybean harvest, up 24 percent. In light of sharply lower carryover stocks, however, total corn supplies for the 1973-74 marketing year (October 1-September 30) may fall short of the year-earlier level, while total soybean supplies would be up 18 percent.

Foreign demand for U. S. grains and soybeans is expected to remain strong for the next several months. Indeed, barring extended export controls, many observers anticipate a larger volume of shipments during fiscal 1974 than the record established in fiscal 1973. Early reports from the mandatory export-reporting system indicate that as of late June unfilled corn export commitments scheduled for delivery during the remainder of the current marketing year totaled 418 million bushels. This suggests that corn exports through the third quarter, barring export controls, will exceed the record-setting pace of the first half. Unfilled corn export commitments requiring delivery during the 1973-74 marketing year already total 709 million bushels, surprisingly high for this time of year and equal to over one-half of the corn exports anticipated for the entire 1972-73 marketing year. Soybean export commitments outstanding in late June and calling for delivery in the 1972-73 and the 1973-74 marketing years (September 1-August 31) totaled 78 and 458 million bushels, respectively. While export controls will limit the former to 50 percent, some of the remainder may be added to shipments scheduled for the 1973-74 marketing year. Soybean exports for the entire 1972-73 marketing year that ends August 31 are currently estimated at 490 million bushels.

Domestic demand for grains, soybeans, and soybean products may ease in the latter half of this year. Evidence to date clearly indicates that the combination of high feed prices and indirect ceilings have thwarted the anticipated expansion in livestock supplies and altered traditional feeding practices. Nevertheless, any significant widening in livestock feeding margins would increase domestic needs.

A recent report on hog and pig inventories indicated the spring pig crop (December 1972-May 1973) fell 2 percent short of the year-earlier level. This was in sharp contrast to the 5 percent gain anticipated earlier. Since the spring pig crop provides the bulk of hogs marketed during the second half, pork supplies during the next six months are likely to fall short of year-earlier levels by a similar 2 percent. Beef supplies during the second half also are likely to remain below year-earlier levels. Although the July 1 inventory of cattle on feed was up 2 percent from a year ago, the continuing decline in nonfed slaughter is likely to offset any increase in fed slaughter during the second half. In light of the tight supplies, the continuing strong consumer demand, and the dollar passthroughs permitted in Phase IV, prices of hogs and cattle are likely to rise above midyear levels in the second half.

Gary L. Benjamin

Banking developments

Money, credit, and Treasury balances

The money stock of the United States, defined as currency and demand deposits held by the public, rose at an annual rate of about 10 percent in the second quarter. This compares with a growth rate of less than 2 percent in the first quarter and about 8½ percent in the fourth quarter of 1972, an average of a little more than 5 percent for the six months ended in March.

In view of the pressures being exerted on the nation's economic resources and prices due to accelerating business activity, second-quarter money growth appears excessive. However, the extent to which the Federal Reserve System was able to check this rate of growth was affected to a greater-than-usual degree by a significant reduction in U. S. Treasury balances that took place at the same time.

Views differ as to whether the impact on the economy of a given change in the money supply may be modified by the behavior of Treasury balances, but the effects of that behavior should not be ignored. It is clear, for instance, that a given growth rate in money is likely to be associated with greater pressures on the ability of banks to make loans and on money market interest rates when the Treasury's deposits in commercial banks are declining than when they are stable. Moreover, because the Federal Reserve affects the money supply indirectly—by influencing the availability of bank reserves and money market conditions—significant unanticipated changes in Treasury deposits may thwart the achievement of money targets by upsetting projected relationships between the System's reserve-supplying action, money market conditions, and money growth.

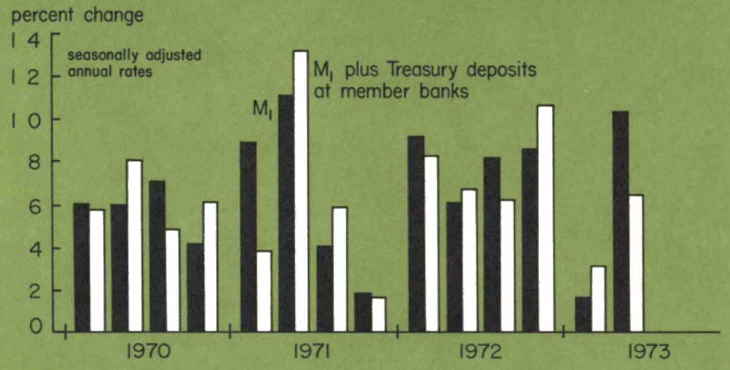
Defining "money"

There has been considerable debate among economists over the appropriate definition of money, and the Federal Reserve publishes three monetary aggregate series. The narrow money stock, M_1, consists of currency outside the Treasury and the banks and demand deposits (checking accounts) at commercial banks. For inclusion in the money stock, the latter are adjusted to eliminate the deposits of other banks and the U. S. Treasury, and checks in process of collection. M_1 represents an estimate of funds held by the public in a form immediately available for spending. A broader measure, M_2, includes M_1 plus commercial bank time and savings deposits other than large certificates of deposit (CDs). A still broader concept, M_3, extends the M_2 measure by embracing deposits at mutual savings banks and savings and loan associations.

One objective in defining money is to select that aggregate of financial assets which induces a predictable acceleration or slowing in the rate of spending when that aggregate exceeds or falls short of the amount businesses and individuals desire to hold. In short, the concept of money should embrace those liquid assets that can influence expenditures, and thus income, in the economy.

Treasury deposits are not "money"

All of the money concepts described above exclude deposit balances of the U. S. Treasury on grounds that they tend to remain fairly constant, that the amount of cash the government has on hand does not influence the volume of its expenditures, Second-quarter money growth would be reduced by including Treasury deposits



and that they do not meet the desired balance needs of the public. Nevertheless, Treasury checks do go to businesses and individuals, and changes that do occur in government balances typically are reflected in opposite changes in private balances.

Shifts between government and private deposits occur continuously but probably have little effect on the economy so long as they do not alter private balances on the average over a month's time. Moreover, regular intra-yearly patterns are countered by Federal Reserve action in supplying funds to meet seasonal needs. Seasonally adjusted measures of money, therefore, do not reflect these recurrent swings.

Only rarely in recent years have special conditions led to sustained shifts from Treasury deposits to private accounts. The second quarter of 1973 was one of these periods. Government deposits at member banks, after seasonal adjustment, declined about $2½ billion as the Treasury met expenditures and paid down debt from its abnormally high first-quarter cash balance. This was the largest such decline since the first quarter of 1971. The absolute rise in M_1 during the second quarter of 1973 was $6.7 billion, or a 10.4 percent annual rate of gain. The combined growth of Treasury deposits and M_1 was $4.3 billion, a 6.5 percent growth rate.

This comparison would give little comfort to those who feel M_1 is the financial variable most closely linked to economic activity. But to the "non-monetarist," M_1 is but one indicator of the thrust of policy and the probable economic impact of that policy. Another important indicator is the pace at which bank credit expands. Growth in bank credit may differ significantly from money growth for various reasons—one of which is changes in the Treasury's balance.

Bank credit and Treasury deposits

As the rate of growth of M_1 accelerated in the second quarter, bank credit expansion slowed, though the rate of gain was still high by historical standards. The ability of banks to increase loans and investments—expand credit—depends on their source of funds, and all deposits, including Treasury deposits, are sources of loanable funds to commercial banks. While Treasury deposits usually total less than $10 billion, compared with private demand balances of about $200 billion, short-run changes in Treasury balances are sometimes as large, or larger than, changes in the private component. A shift in the ownership of demand deposits from the Treasury to households and businesses does not change the loanable funds of banks but does result in a rise in M_1.

Changes in the loanable funds of banks and bank credit may result from such a shift, however, depending on the form in which the nonbanking public decides to keep its liquid assets. If increased M_1 balances generated by a reduction in Treasury balances are transferred to time deposits, M_2 will grow and this could accelerate bank credit expansion because of the lower reserve requirements applicable to these liabilities. A shift from Treasury deposits into currency held by the nonbank public—a less likely event—will increase M_1 initially but also reduce the ability of banks to expand credit because of the reserve losses to currency holdings.

Treasury deposits and control

Assuming that policymakers were concerned with a too-rapid expansion of M_1 in the last quarter, could it have been avoided? The Federal Reserve System does not have direct control over bank deposits or over the distribution of money between deposits and currency. The System does control the supply of bank reserves but, in the short run, under existing institutional arrangements, must provide the reserves necessary to support the existing amount of deposits. The smaller the proportion of these reserves the System supplies through its open market operations, the more the banks must borrow from their Federal Reserve banks. To avoid borrowing, they bid for funds in the money market, exerting greater upward pressure on money market interest rates. This higher cost of funds will influence the volume of loans—and thus aggregate deposit expansion—that banks will generate in the future. Because monetary growth rates and money market interest rates are interrelated, the Federal Reserve must determine in advance what combinations of interest rates and of money growth rates will be consistent in the existing environment. Then, on the basis of a policy choice among these combinations, the necessary reserves must be supplied to achieve that target.

A change in the level of Treasury deposits is one of a number of variables that affects the relationship between money growth rates and interest rates. As indicated earlier, a significant reduction in Treasury deposits results in an increase in private demand deposits, but there is no initial change in total bank deposits or reserves. However, a sharp increase in M_1 from a shift in balance ownership would be expected to cause actual balances held by the public to exceed desired balances at given levels of income, prices, and interest rates. Under these circumstances, interest rates would tend to fall as households and businesses attempt to restore their desired level of money balances by acquiring interest-bearing financial assets and increasing their expenditures for goods and services. Federal Reserve action designed to restrict the Treasury-induced growth in M_1 balances by reducing the growth of total reserves would, with no change in credit demand, tend to push interest rates in the opposite direction; that is, to raise them. Thus, the interest rate effects could be offset.

Under these circumstances, the change in reserves required to obtain the appropriate combination of money growth rates and money market interest rates consistent with the existing environment depends, in part, on the expected speed with which the banks and the nonbank public adjust their portfolios. The rapid rate of growth in money stock in the second quarter was at least partially a reflection of the fact that these adjustments do not occur instantaneously and they can be very difficult to predict. In the first quarter, M_1 showed little growth, but interest rates and bank credit rose rapidly. At the higher yields available on market instruments, such as Treasury bills and corporate notes, it was reasonable to expect a reduction in the willingness of the public to hold liquidity in the form of non-earning demand deposits and currency, even after allowing for growth in income and lags in adjustment to higher interest rates. Given the performance of interest rates, this apparently did not occur as rapidly as expected. Individuals receiving unusually large tax refunds were slow to spend these funds or shift them into earning assets.

Given an economic environment with increasing credit demands, attempts to offset the shift in Treasury balances to achieve an appreciably slower rate of growth of M_1 in the second quarter would have required a significantly sharper rise in interest rates than actually occurred. Even so, money market rates did rise sharply with, for example, the federal funds rate increasing from about 7 percent in late March to 8½ percent in late June, and the three-month Treasury bill rate advancing from about 6¼ to 7¼ percent over the same period.

Curbing bank credit

Federal Reserve System authorities have taken a number of actions in recent months aimed at reducing the inflationary pressures in the economy through a slowing in the rate of expansion in bank credit and the money supply. Reserve requirements on deposits of member banks were increased, the discount rate was raised, interest rate ceilings on $100,000 denomination time deposits were suspended, and ceiling rates on savings and smaller time deposits were raised. These actions increase the cost of loanable funds, thus tending either to reduce the incentive of banks to lend or, to the extent higher costs can be passed on to borrowers, to reduce the amount of credit demanded by customers.

The new rulings will permit banks to meet essential credit demands by allowing them to better compete for funds. Permitted increases in interest paid on consumer deposits will assure more equitable treatment for savers in a situation where market rates of interest are rising, and coupled with suspension of ceilings on large CDs, they can be expected to prevent a severe reduction in credit availability, especially for borrowers that are heavily dependent on commercial banks to serve their credit needs.

Changes affecting large banks

On May 16, the Board of Governors announced an increase in reserve requirements against certain types of financial instruments commonly employed by the nation's large banks. The instruments include deposits of $100,000 or more (mainly certificates of deposit, or CDs), commercial paper sold by bank holding companies for subsidiary bank use, and funds acquired through the sale of finance bills (these funds, sometimes called ineligible acceptances, were defined as deposits for reserve requirement purposes effective June 28). For CDs and reservable commercial paper, requirements were increased from 5 to 8 percent applicable to outstandings, beginning June 7, in excess of a bank's combined outstandings of these instruments in the week ended May 16, 1973. A 5 percent requirement continues to apply to amounts up to the base-period level or to $10 million, whichever is larger. When funds acquired through the sale of finance bills were defined as deposits for purposes of computing reserve requirements they became subject to the same provisions as large CDs and commercial paper. The 20 percent requirement on Eurodollars above a bank's reserve-free base was reduced to 8 percent also along with provisions for phasing out that base.

These major money market sources of funds are available mainly to very large banks. At the end of May, only 260 U. S. commercial banks reported large CDs outstanding, about 50 banks reported commercial paper issued by an affiliate, and less than 15 banks reported outstanding finance bills. As of the mid-May base period, large CDs totaled $58.5 billion, bank-related commercial paper was $3.9 billion, Eurodollar use by large banks was around $1.7 billion, and outstanding finance bills were

$1.1 billion. However, much of the growth in bank credit has been financed by the sale of large CDs by very large banks.

In addition to the reserve changes, the Board in a related action suspended interest rate ceilings on large CDs with maturities of 90 days or more. Ceilings on CDs with maturities of 30 to 89 days were suspended in June 1970. While both the reserve changes and removal of interest ceilings effectively increase the cost of funds for banks, they also provide more uniform treatment of the major sources of funds available to large banks in the nation's money market, and allow more flexibility in liability management.

Suspension of the rate ceilings on CDs over 89 days permits banks to achieve a more balanced maturity structure. When rates on competing instruments, such as commercial paper, rose above the old ceilings last March, banks were forced to confine new CD issues to the ceiling-free 30-89 day maturity range. Between the last Wednesdays of March and April, large commercial banks issued $19.7 billion in new CDs, rolling over $18.7 billion maturing CDs and adding $1 billion to outstandings. Of the $19.7 billion of new issues, $17.6 billion had maturities in May, June, and July, raising the proportion of CDs maturing in three months to almost 79 percent of total outstandings on April 25. So far, however, there has been no noticeable lengthening in maturities beyond 90 days.

The other shoe

The Board followed its May 16 announcement with another on June 29 that inaugurated a one-half percentage point increase in member bank reserve requirements on net demand deposits over $2 million (gross demand deposits minus cash items in process of collection and demand balances due from domestic banks). This move coincided with an increase in the discount rate from 6½ to 7 percent—a level two and one-half points above that which prevailed throughout 1972. The necessity of a move to a tighter stance was supported by statistical evidence that the money supply had grown roughly 10 percent and bank credit about 12 percent in the second quarter (seasonally adjusted annual rate).

The new requirements will certainly increase the cost of lending at all except the very smallest member banks. An increase of $800 million in reserves was required to support the July deposit level, and potential loan and deposit expansion per dollar of new reserves supplied by the Federal Reserve will be reduced. The higher requirements apply to average deposits on and after July 5, affecting reserves held in the week beginning July 19. Demand deposit requirements now range from 8 percent on the first $2 million (unchanged) to 18 percent above $400 million.

On July 5, in concert with similar actions by the Federal Deposit Insurance Corporation affecting insured nonmember banks and by the Federal Home Loan Bank Board for its member savings and loan associations, the Federal Reserve Board increased the maximum rates of interest member banks may pay on consumer deposits and eliminated ceilings on deposits of $1,000 or more maturing in not less than four years. This action had a twofold aim—to extend to savers the benefits of higher market interest rates, and to prevent an outflow of funds from financial intermediaries that would curtail credit available for mortgages and small businesses.

The new member bank ceilings schedule on savings and time deposits under $100,000 increases maximum rates by one-fourth to three-fourths of a percentage point, enabling banks and other financial institutions to compete more effectively with market securities for consumer funds. The Board also announced a new rule permitting a bank to pay a time deposit at any time before maturity but only at a reduced rate of interest. ■