

FEDERAL RESERVE BANK OF NEW YORK



MONTHLY REVIEW

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Volume 48

No. 1

The Business Situation

Economic activity continued to advance strongly across a wide front late in 1965. Business outlays for plant and equipment are running higher than previously expected, Federal expenditures for both military and domestic purposes have been increasing, state and local government spending is continuing to advance, and consumer demand is high and still rising even though acquisitions of durable goods have been sizable throughout the current expansion. Moreover, while aggregate inventory demand by business has declined in recent months as steel inventories have been worked down following the signing of labor contracts, this adjustment is apparently about completed.

Planned expenditures on plant and equipment, recently reported by the Department of Commerce and the Securities and Exchange Commission, indicate outlays in the first half of 1966 fully 16 per cent above the first half of 1965 and 7 per cent above the second half of 1965. Furthermore, a private survey taken since the commercial bank prime rate increase in December suggests that only a small proportion of the corporations questioned anticipated reducing their planned capital spending in 1966 as a result of higher interest charges, and all these cutbacks were expected to be less than 5 per cent. Consumer intentions to increase purchases in future months have moved up once again. Retail sales, which reached a record high in November, appear to have advanced further in December. Although it is too early to evaluate the effects of the January transit strike in New York City, it is clear that the strike depressed both sales and incomes in the immediate area, with consequent repercussions on the national economy as a whole.

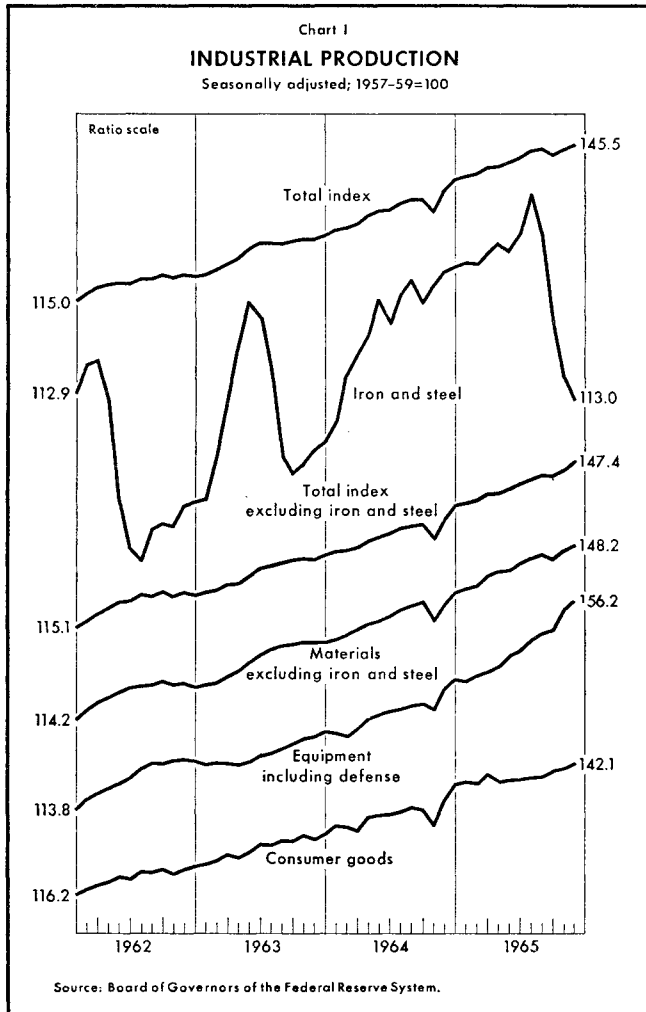
The continued momentum throughout the economy coupled with the many indications of strong future demand has heightened competition for the human and physical resources needed to meet current and expected future production schedules. As a result, price and wage restraints resulting from substantial margins of idle labor and capital have to a considerable extent been removed. The unemployment rate fell to 4.1 per cent in December, the lowest level in nine years. A substantial reduction in the unemploy-

ment rate is of course a most gratifying and important development, but it is also necessary to keep in mind that the current outlook for aggregate demand suggests a distinct danger of further intensified pressure on prices. Consumer prices moved up in November for the third consecutive month, but even larger increases were recorded at the wholesale level. The wholesale price index climbed 2.8 per cent for the year ended in November, with advances in almost every major category. The twelve-month increase in the industrial component of this index was the largest in a decade. Furthermore, the food component resumed its upward trend in November, and this was accompanied by accelerated increases in the prices of processed foods.

PRODUCTION, EMPLOYMENT, AND PERSONAL INCOME

Industrial output posted a broad gain in November, and the Federal Reserve Board's production index moved to a record level at 145.5 per cent of its 1957-59 average, despite a slight further decline in the iron and steel component (see Chart I). This moved the index 1.1 percentage points higher than the October figure, which had been revised upward, and slightly above the previous peak posted in August. Increases were widespread among final products and industrial materials (excluding iron and steel). Production of consumer goods, which had been sluggish during the first three quarters of the year, climbed for the second straight month. Gains for household appliances showed a substantial recovery from reduced summer levels, and auto assemblies through December continued strong at an annual rate of 9.3 million units. Output of equipment, advancing further after a large October increase, continued to reflect the sustained growth of business capital spending and the growing demand for defense equipment.

In December, steel output appears to have reversed the four-month downtrend that accompanied the liquidation of strike-hedge inventory built up in 1964 and early 1965. Preliminary figures indicate that last year's produc-



tion probably reached an all-time high of roughly 130 million tons, topping by some 3 million tons the previous record established in 1964. The consensus of the trade is that any excess of inventories has been just about eliminated, and that steel consumption can be expected to grow further. New orders booked by steel mills for January and February show increases for a wide range of users, particularly among automobile companies. Incoming orders in all other durable goods industries as a group remained near their record high in November, despite substantial reductions in the typically volatile bookings received by the aerospace industry. Moreover, the level of unfilled orders advanced further even though shipments rose to an all-time high.

Nonfarm employment in December rose 367,000 to a record peak of 61.8 million persons, following an even

larger gain in November. The latest figure, up 4.5 per cent from a year ago, is the biggest December-to-December advance in a decade. All major sectors except transportation and public utilities shared in the increase. Extensive use of overtime kept the average workweek clocked by manufacturing employees at the November figure of 41.4 hours, the highest level since October 1945. Despite increased overtime, economic momentum produced further tightening in the labor market. The number of labor market areas with "substantial labor surplus"—over 6 per cent—is down to 19, from 30 a year ago; the layoff rate is the lowest in twelve years; and the help wanted index in November advanced sharply once again. The need for additional skilled workers is reported to be particularly acute. The civilian labor force in December moved up to a new peak of 76.5 million, with the 4.1 per cent unemployment rate substantially below the 5.0 per cent registered only twelve months earlier. Unemployment rose slightly among teenagers, but significant declines were registered for both men and women over 20 years of age.

Total personal income in November posted one of the largest gains of the year, with higher wages and salaries accounting for two thirds of the advance. This upward movement brought the rate up to the record set in September, when income was swollen by a large retroactive social security payment. Reflecting both increased employment and a longer workweek, manufacturing payrolls showed a particularly sharp rise. All other forms of income including dividends, interest, and transfer payments also increased.

CONSTRUCTION ACTIVITY

Over the past several years, construction activity has been the one major sector in which real growth has lagged behind the pace of the over-all economic advance. This development actually may have aided the performance of other industries as relatively more resources have been available for expansion elsewhere. At the same time, price increases in this part of the economy have generally been more pronounced than elsewhere.

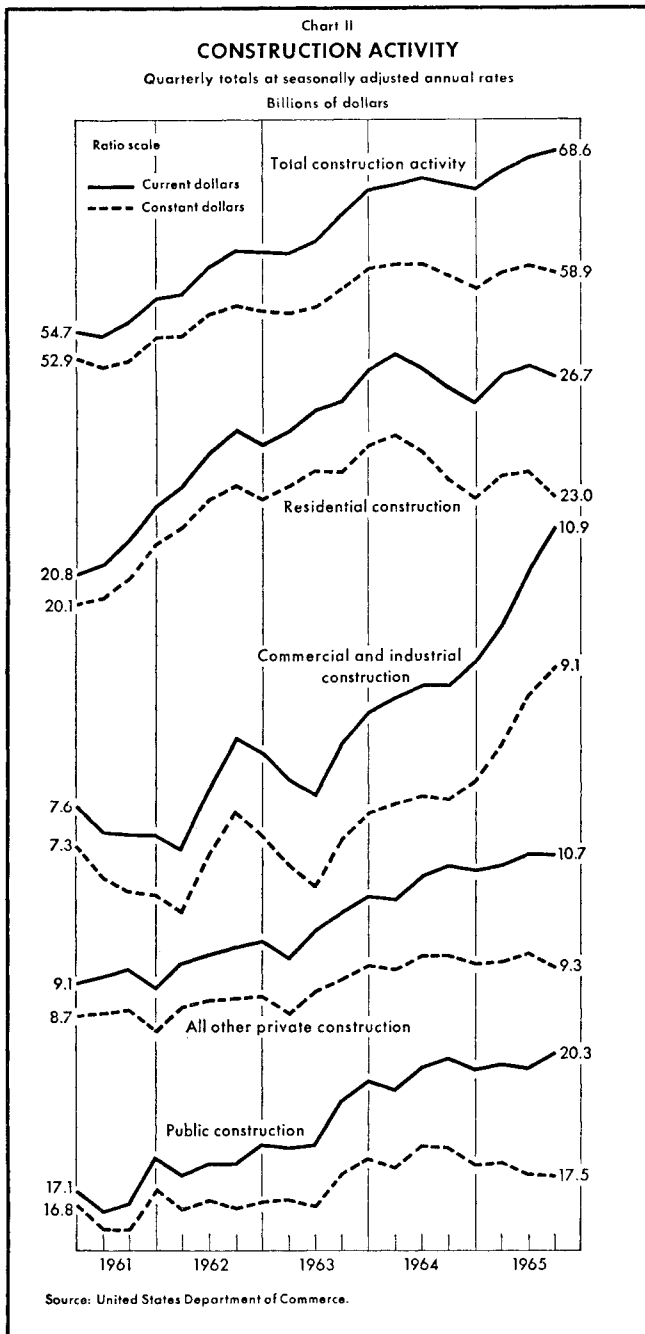
Total spending on new construction appears to have risen approximately 3 per cent during 1965 to a record of nearly \$68 billion. But in constant (1957-59) dollars, which may be viewed as a rough indicator of changes in physical volume, building activity remained virtually unchanged. These aggregates, however, hide the fact that there were substantially different movements in the four major components of the construction industry. Thus, residential construction, i.e., private homes, was sluggish while commercial and industrial activity rose sharply (see Chart II).

The category "all other private construction"—including schools, churches, hospitals, farm buildings, and some utilities—as well as public construction advanced modestly when measured in current dollars while declining slightly in real terms (these categories are also shown in Chart II). Thus, virtually all of the \$2 billion expansion in construc-

tion outlays in 1965, and about 45 per cent of the \$14 billion advance during the past five years, represent price increases. In the residential sector, the downward movement of 1964 and 1965 is more marked when measured in constant dollars.

The three most basic features characterizing the housing sector of the construction market since 1961 have been a comparatively stable demand for additional single-family homes, a generally growing demand for apartments, and a cycle in apartment construction resulting from considerable overbuilding in the early part of the period followed by many months of adjustment. The first two of these features largely reflect specific demographic forces, which may well continue to influence heavily the composition of residential construction activity in the near future. Although the total demand for housing is directly related to the rate of household formation and the demolition of existing structures, the type of housing that families seek is more closely associated with the age of the head of the household. According to patterns that have been indicated by a University of Michigan survey, less than one out of every six family heads under 24 years of age owned a home in 1964. This proportion rose to almost one half in the 25- to 34-year group, and to roughly three quarters in the 35- to 44-year category. (The percentage of homeownership remains virtually unchanged between 45 and 55 years and drops slightly for older groups.)

Thus, it appears that the largest additions to the demand for privately owned homes originate with the 25- to 44-year-old group, which is precisely the portion of the population that did not increase in size during the last five years. In fact, the number of people in the 30- to 39-year category actually declined. The largest population gains were among the 18- to 24-year-olds (reflecting the "baby boom" during and immediately following World War II) and among the aged—both groups in which rentals of apartments are the most typical way of making a home. It is not surprising, therefore, that the construction of apartments almost doubled as a percentage of housing starts from 1960 through 1964. Neither is it surprising that the suddenness of the surge in apartment demand led to overbuilding in some major metropolitan areas—especially in the Far West in the early 1960's—and to subsequent adjustments in 1964 and 1965. This pattern in apartment building was reinforced, in the case of New York City, by a construction speedup in 1962-63 in anticipation of the effective date of more stringent building codes, followed by two years of lower activity. It appears, however, that the excess in the supply of apartments has been reduced in at least a few major metropolitan areas and that, supported by the growing number of young adults and elderly people, some



renewed expansion in this area can be expected. Both apartment- and house-building activity has been aided by the abundant supply of mortgage financing that has been available throughout the current five-year expansion.

The present age composition of the population indicates that the number of people entering the home-buying group will probably not increase rapidly enough to lift near-term demand for one- and two-family homes much above the plateau of the past few years. From the end of 1965 through 1970, for instance, the size of the 30- to 39-year-old group is expected to continue declining. Moreover, demolitions of existing housing, which primarily removed rental units in 1965, have been relatively constant over the last few years.

Industrial and commercial construction, on the other hand, have been advancing strongly since mid-1963. With over three quarters of 1965 accounted for, it appears that outlays moved up last year by an exceptionally large 15 per cent. The expansion, modernization, and relocation of manufacturing plants has been the primary source of this advance, but the building of stores, warehouses, and offices also moved ahead strongly in 1965. Moreover, the high rate of capital spending planned by business for the first half of 1966 suggests that activity in industrial and commercial construction will remain strong over the months ahead.

The category "other private construction" has been moving up steadily since early 1963. With the sole exception of the farm component, which has been experiencing a downturn for at least the last decade, the country's growing and increasingly mobile population provides an underpinning for further moderate advances in this sector.

Public construction, measured in current dollars, advanced irregularly during the 1960's as a whole but

showed significant strength in the closing months of 1965. Most of the subsections of this group—such as street and highway construction and sewage and water works—involve long-term programs and thus are fairly predictable. The current level of commitments indicates that in the year ahead further growth may approximate the same 6 per cent rate that has prevailed in 1963 and 1964. In real terms, however, public construction has trended downward during the past year and a half, and no major reversal seems likely in the immediate future.

Thus, it appears that trends in construction activity have been mixed, with nonresidential construction providing the only major source of strength. Within the residential component, there is some evidence of a recovery in apartment building, but the next major expansion in the demand for single-family homes does not appear likely in the immediate future.

PERSPECTIVE ON 1965

The Federal Reserve Bank of New York has just published *Perspective*, its annual nine-page review of economic and financial developments during the preceding year. This booklet is a brief and simplified summary of the highlights treated more fully in the Bank's *Annual Report* which will be available in mid-March. Copies of *Perspective on 1965* are available without charge from the Publications Section, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045.

The Money and Bond Markets in December

The increase in the Federal Reserve discount rate from 4 per cent to 4½ per cent—made effective first at the Federal Reserve Banks of New York and Chicago on December 6¹ and shortly thereafter at the remaining ten Federal Reserve Banks—was the single most important factor shaping developments in the money and bond markets in December. In preceding weeks, market participants had already begun to doubt the tenability of prevailing interest rate levels, but the actual timing of the ½ percentage point rise in the discount rate came as a surprise. Subsequent rate and price adjustments in the money and securities markets proceeded in an orderly manner as yields rose to their highest levels since early 1960.

Although the major market adjustment took place immediately after the discount rate increase, rates on Treasury bills continued to move higher through the midmonth tax and dividend dates and over much of the remainder of the month. Increases in rates on bankers' acceptances, commercial paper, and finance company paper also occurred during the month. Prices of intermediate- and long-term Government securities declined irregularly, raising yields on intermediate-term issues over the month by about ½ percentage point to almost 5 per cent (bid), while yields on long-term issues rose by about ⅛ percentage point. Initial declines in prices of corporate and tax-exempt issues paralleled those on long-term Governments, but after these adjustments most new corporate and tax-exempt bonds were accorded generally favorable receptions at the higher rate levels.

The upward adjustment in the maximum interest rate ceilings on time deposits under Regulation Q¹, which accompanied the discount rate change, also affected the money and bond markets in December. Posted rates on new negotiable time certificates of deposit moved upward by about 25 to 35 basis points.

Aided by a larger than seasonal provision of reserves by

the Federal Reserve System, the money market handled without difficulty the heavy flows of credit and deposits typical of December. The tone of the money market fluctuated between ease and firmness during the month, as banks experienced the usual amount of difficulty in anticipating the extent of their reserve needs. The banking system moved from a position of \$110 million daily average net borrowed reserves in the week ended December 1 to free reserves of \$73 million two weeks later. The System first accommodated the adjustment to the discount rate change and then sought to alleviate the buildup of pressure around the midmonth corporate tax and dividend dates. After midmonth, a firm tone reappeared in the money market as the banking system gradually returned to a net borrowed reserves position, and this firm tone generally prevailed through the remainder of the month with Federal funds trading largely at rates of 4½ per cent and 4⅝ per cent.

THE MONEY MARKET AND BANK RESERVES

Immediately after the discount rate increase, most commercial banks raised their prime loan rate from 4½ per cent to 5 per cent. By the end of the month, increases in rates on the various maturities of finance company paper amounted to ⅜ to ½ of a per cent, while commercial paper rates and rates on bankers' acceptances had been increased by ⅜ of a per cent and ½ of a per cent, respectively. Following the Regulation Q revision and similar revisions by the New York State Banking Board, major banks in New York City posted rates on new time certificates of deposit. Three-month certificates were offered in a 4.75-4.80 per cent range at the end of the month, and rates on six-month and over one-year certificates were quoted in a 4¾-4⅞ per cent range, as against the previous ceiling of 4½ per cent for all these maturities. Rates on prime certificates trading in the secondary market rose to as high as 5 per cent in some cases.

The money market was quite firm early in December, on the eve of the discount rate change. After the weekend announcement of the increase to 4½ per cent in the dis-

¹ For the details, see this *Review*, December 1965, pages 254-55.

Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, DECEMBER 1965

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

Factors	Changes in daily averages— week ended					Net changes
	Dec. 1	Dec. 8	Dec. 15	Dec. 22	Dec. 29	
"Market" factors						
Member bank required reserves*	- 249	- 114	- 22	- 666	- 49	- 1,100
Operating transactions (subtotal)	- 536	- 298	+ 267	+ 671	- 109	- 5
Federal Reserve float	- 462	+ 58	+ 193	+ 823	- 163	+ 449
Treasury operations†	+ 111	+ 99	+ 54	- 66	+ 31	+ 229
Gold and foreign account..	- 14	+ 5	- 4	+ 13	- 36	- 36
Currency outside banks*	- 63	- 421	- 25	- 144	+ 44	- 609
Other Federal Reserve accounts (net)‡	- 111	- 38	+ 50	+ 46	+ 14	- 39
Total "market" factors ..	- 785	- 412	+ 245	+ 5	- 158	- 1,105
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities ...	+ 747	+ 376	- 87	- 22	- 171	+ 843
Bankers' acceptances ...	+ 1	+ 7	+ 1	+ 5	+ 4	+ 18
Repurchase agreements:						
Government securities ...	-	+ 103	- 48	- 33	+ 199	+ 221
Bankers' acceptances ...	+ 58	+ 11	- 12	- 7	+ 9	+ 59
Member bank borrowings	+ 173	- 56	+ 8	- 268	+ 328	+ 185
Other loans, discounts, and advances	-	+ 3	- 4	- 3	+ 17	+ 13
Total	+ 979	+ 443	- 141	- 328	+ 386	+ 1,339
Excess reserves*	+ 194	+ 31	+ 104	- 323	+ 228	+ 234

Member bank:	Daily average levels					
	22,190	22,335	22,461	22,804	23,081	
Total reserves, including vault cash*	22,190	22,335	22,461	22,804	23,081	22,574‡
Required reserves*	21,766	21,880	21,902	22,568	22,617	22,147‡
Excess reserves*	424	455	559	236	464	428‡
Borrowings	534	478	486	218	546	452‡
Free reserves*	- 110	- 23	73	18	- 82	- 24‡
Nonborrowed reserves*	21,656	21,857	21,975	22,586	22,535	22,122‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					
	+ 696	+ 144	- 102	- 193	+ 258	
Less than one year	+ 696	+ 144	- 102	- 193	+ 258	+ 803
More than one year	-	-	-	-	-	-
Total	+ 696	+ 144	- 102	- 193	+ 258	+ 803

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

* These figures are estimated.

† Includes changes in Treasury currency and cash.

‡ Includes assets denominated in foreign currencies.

§ Average for five weeks ended December 29.

Table II
RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS
DECEMBER 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended					Average of five weeks ended Dec. 29
	Dec. 1	Dec. 8	Dec. 15	Dec. 22	Dec. 29	
Eight banks in New York City						
Reserve excess or deficiency(-)†	46	58	43	21	11	36
Less borrowings from Reserve Banks	107	39	124	66	138	95
Less net interbank Federal funds purchases or sales(-)	295	309	392	1,080	811	577
Gross purchases	733	770	1,133	1,629	1,435	1,140
Gross sales	438	461	741	548	625	563
Equals net basic reserve surplus or deficit(-)	- 355	- 290	- 472	- 1,125	- 937	- 636
Net loans to Government securities dealers	691	590	859	752	718	722

Thirty-eight banks outside New York City

Reserve excess or deficiency(-)†	25	62	40	19	34	36
Less borrowings from Reserve Banks	70	103	142	22	158	99
Less net interbank Federal funds purchases or sales(-)	256	399	499	671	371	439
Gross purchases	1,071	1,017	1,081	1,440	1,198	1,161
Gross sales	816	618	582	768	827	722
Equals net basic reserve surplus or deficit(-)	- 301	- 440	- 600	- 674	- 494	- 502
Net loans to Government securities dealers	189	116	168	192	96	152

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

† Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

Table III
AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—December 1965			
	Dec. 6	Dec. 13	Dec. 17	Dec. 27
Three-month	4.344	4.391	4.505	4.457
Six-month	4.468	4.553	4.692	4.655
Monthly auction dates—October-December 1965				
	Oct. 26	Nov. 24	Dec. 23	
One-year	4.192	4.276	4.731	

* 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.

count rates of the New York and Chicago² Reserve Banks, borrowings from the other Reserve Banks, which still quoted the 4 per cent rate, bulged sharply on Monday, December 6. When the market opened that day, the System purchased Treasury bills in volume to facilitate orderly rate adjustments in the Government securities market. The cumulative effects of excess reserves amassed by heavy borrowings at other Reserve Banks and as a result of System purchases in the open market led to an easier tone in the Federal funds market. Borrowings from the Federal Reserve dropped to nominal levels on the last two days of the December 8 statement period, averaging \$478 million for the week as a whole. The Federal funds rate, which rose briefly to 4½ per cent immediately after the discount rate change, declined to ½ per cent by Wednesday, December 8, as large unused reserve excesses piled up at money market banks. On a daily average basis, System open market operations provided \$497 million of reserves, and net borrowed reserves declined from \$110 million in the preceding week to \$23 million for the week ended December 8 (see Table I).

In the following week the money market readily accommodated the large transfers of funds associated with the quarterly corporate tax and dividend dates, both of which fell within the period. The money market was generally quite firm. Federal funds were strongly bid at 4½ per cent, and some funds moved at 4⅝ per cent on several days as "country" banks accumulated excess reserves which averaged about \$440 million in the first week of their two-week reserve settlement period. As the major reserve city banks came under increased pressure, they purchased Federal funds in volume and borrowed rather heavily from the Reserve Banks (see Table II). On the final day of the week, however, the major New York City banks found that they had provided for more than their reserve needs. Therefore, they sought to sell reserves, and some Federal funds traded at 1½ per cent. Country banks were heavy purchasers of funds at the low rates, but the eight major New York City banks nevertheless ended the period with cumulative reserve excesses of over \$300 million.

During the December 15 statement period, the weekly reporting member banks increased their total loans³ and investments by approximately \$3.2 billion, with the rise in loans accounting for \$2.9 billion of the gain. Much of the expansion in bank credit during this period reflected

credit needs of businesses and nonbank financial intermediaries over the midmonth tax and dividend period. On the liabilities side of bank balance sheets, total demand deposits (including checks in process of collection) at weekly reporting member banks rose by \$8.4 billion as corporations built up the deposits with which to pay dividends and Federal taxes.

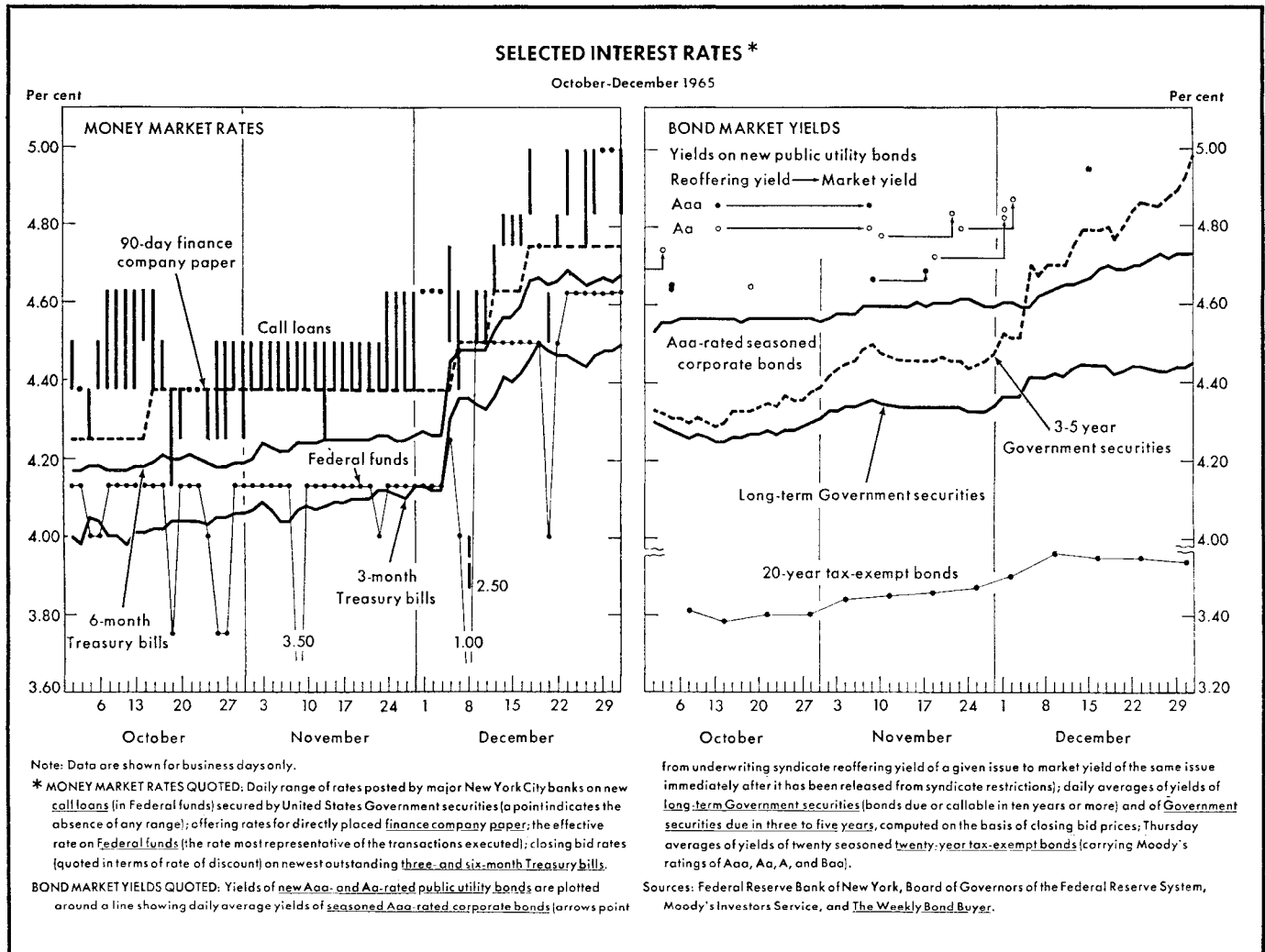
As the second half of the month began, the money market displayed a firm tone. Banks in New York and in other major money centers were under heavy reserve pressure as they continued to carry a large volume of the loans extended over the tax date and experienced deposit drains as dividend and tax checks cleared. However, Federal funds were in fairly good supply at rates of 4½ to 4⅝ per cent from banks outside the money centers, and member bank borrowings from the Federal Reserve declined to fairly low levels. In the final statement week of the month the money market was firm, with Federal funds trading predominantly at 4⅝ per cent. Some of the reserve pressure, which had lingered in the money market after the tax and dividend period, abated; however, country banks built up excess reserves during the week which was the first week of their new reserve settlement period. With nationwide reserve availability also declining, member bank borrowings from the Reserve Banks rose to the levels characteristic of earlier months.

THE GOVERNMENT SECURITIES MARKET

A cautious atmosphere characterized the Government securities market at the beginning of the month in the aftermath of a late November shift in market expectations toward anticipations of higher interest rate levels—a shift which followed news of an enlarged Federal deficit for the current fiscal year. Nevertheless, the Board of Governors' announcement of a rise in the discount rate and changes in Regulation Q caught the market by surprise, and sharp adjustments followed. Treasury bill rates initially moved about 15 to 25 basis points higher (see the left-hand panel of the chart), but comfortable money market conditions and System purchases contributed to orderly adjustments in the bill sector. Nevertheless, considerable uncertainty continued, as the market watched the rate adjustments on new negotiable time certificates of deposit which compete with Treasury bills for investment funds. The ultimate extent of their rise was considered a key element affecting the entire structure of short-term rates. Additional factors contributing to uncertainty—and thus caution—included expectations of new Treasury cash financings in the bill market during January, and the high costs of refinancing the sizable volume of

² After a short interval, the other ten Reserve Banks followed suit.

³ Exclusive of loans to domestic commercial banks and after deduction of valuation reserves.



bills returning to dealers in December from maturing repurchase agreements.

On December 22, the Treasury outlined a portion of its cash financing plans for the remainder of the fiscal year ending in June 1966. It announced that it would auction on December 29, for payment on January 5, an additional \$1 billion of tax anticipation bills maturing on June 22, 1966 and would permit commercial banks to make payment through credits to Treasury Tax and Loan Accounts. The Treasury also disclosed that—beginning with the January 3 regular bill auction—it would increase the weekly three-month bill issues by \$100 million each, probably until the full thirteen-week cycle of bill maturities has been rolled over. The Treasury also announced that it would make another short-term cash offering of approxi-

mately \$1.5 billion early in 1966. These borrowings will fill the bulk of the Treasury's \$5 billion cash needs for the rest of the fiscal year.

The Treasury's announcement triggered some further upward adjustments in yields of Treasury bills, and rates edged irregularly upward over the remainder of the month. At the higher emerging rate levels, investment interest expanded both for outstanding bills and for the new bills auctioned during the period. The Treasury's sale of June tax bills attracted considerable interest from commercial banks anxious to obtain the accompanying Tax and Loan Account deposits, and a 4.281 per cent average issuing rate was set. Demand for outstanding bills favored short maturities which were sought for seasonal year-end statement purposes. The newest outstanding three- and six-month

Treasury bills closed the month at 4.49 per cent and 4.67 per cent bid, respectively.

After the initial price markdowns of from ½ point to almost a full point following the discount rate change, an atmosphere of caution continued to dominate the market for intermediate- and long-term Government issues. The vigorous performance of the economy, renewed concern over the mounting defense spending caused by the Vietnamese conflict, and the prospects of increased Treasury financing needs during the first half of 1966 were the primary factors contributing to market uncertainty. The downward pressure on prices was especially pronounced in the case of intermediate Government issues. The market expected the 4¼ per cent interest rate ceiling applying to coupons on Government bonds to restrict Treasury financing to the under-five-year area. Pressure developed initially from the efforts of dealers to reduce positions rather than from an expansion in outright investor selling. Late in the month, market sentiment was temporarily buoyed by discussion of possible peace overtures in Vietnam. As the year drew to a close, a large volume of tax-swapping operations dominated market activity, but some outright investment and professional offerings also developed.

OTHER SECURITIES MARKETS

Prices of corporate and tax-exempt bonds drifted lower during early December in light trading. After December 6, activity expanded and prices of corporate and tax-exempt bonds went down sharply, paralleling the price declines recorded by long-term Government securities. Subsequently, demand for corporate and tax-exempt issues expanded at the lower price levels, and new issues marketed after the Federal Reserve action were accorded fair to excellent receptions. One of the largest issues of the period, a \$100 million Aa-rated utility company issue, reached the market at midmonth. The issue, which consisted of 5 per cent first

and refunding mortgage bonds maturing in 1996 and non-refundable for five years, was reoffered to yield 4.95 per cent and received an excellent investor response. By the end of the month the issue had risen in price to the point that the yield to the investor was 4.84 per cent. As the year drew to a close, activity contracted in both the corporate and tax-exempt sectors and prices fluctuated narrowly.

Over the month as a whole, the average yields on Moody's seasoned Aaa-rated corporate bonds rose by 13 basis points to 4.73 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose by 7 basis points to 3.54 per cent (see the right-hand panel of the chart).

MONEY AND ECONOMIC BALANCE

An updated version of *Money and Economic Balance* has been published by the Federal Reserve Bank of New York. The 32-page booklet, which first appeared in August 1962, is primarily a teacher's supplement to the 16-page picture pamphlet, *Keeping Your Money Healthy*.

Money and Economic Balance is also of interest to the layman seeking a simplified explanation of the role of money in our economy. It describes how the Federal Reserve analyzes the business situation and uses its powers over bank reserves and money creation. Free copies are available from the Publications Section, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045.

The Financial Position of Consumers*

The strength or weakness in the financial balance-sheet positions of the various sectors of the economy is generally assumed to play a significant role in the over-all course of economic activity, credit flows, and interest rates. Even though it is true that spending and financial transactions are most closely related to the flow of money income to each individual, business, and governmental unit in the economy, there is a strong presumption that balance-sheet considerations also exert a separate influence that should not be overlooked. A family or business with large stocks of financial assets and only small debts is likely to be more willing to spend out of current income, or to borrow against future income, than a similar family or business with only small financial assets and large outstanding debts. Consequently, when balance-sheet positions are strong on average, spending propensities are likely to be higher than when balance sheets are weak.

This article deals with the financial balance-sheet position of one sector of the economy—the consumer sector. The primary purpose of the article is to present in a systematic way the available data on financial assets and liabilities, with particular focus on the broad trends of the past twelve years. Since no attempt is made here to go beyond the financial items on the balance sheet, this article leaves aside consideration of consumer wealth held in the form of physical property—such as houses and durable and semidurable goods—which also are presumably important factors in consumer behavior.

The discussion that follows first presents the assets side of consumers' balance sheets—with reference to four particular types of financial assets—and then discusses the liabilities side. Two traditional methods of combining the effects of trends on both sides of the balance sheet into over-all measures of financial strength are also evaluated. The article closes with some tentative conclusions about the recent financial position of consumers relative to earlier years.

* A. Marshall Puckett, Chief, and Joel I. Brest, Economist, Domestic Research Division, had primary responsibility for the preparation of this article.

PRECAUTIONARY NOTES

Before turning to the data, some notes of caution are in order. First, the balance-sheet data are taken from the flow-of-funds accounts compiled by the Board of Governors of the Federal Reserve System and, while they represent a major conceptual and statistical effort of many years, these data do have some limitations for the purpose of the present analysis. For example, the "household" sector, as defined in the flow-of-funds accounts, includes, besides consumers, private nonprofit institutions directly serving households. While it is possible partially to eliminate such institutions from the liabilities side of "consumers' " balance sheets, presently available data do not permit their exclusion from the assets side. Furthermore, except for corporate stocks, flow-of-funds data on assets and liabilities are measured at face value whereas market valuation would be preferable for this study. In addition to these definitional difficulties, there are uncertainties regarding measurement: it is quite likely that the flow-of-funds data on the household sector are the least reliable ones among all the major sectors covered, since no direct information is available on certain types of consumer assets. It should be stressed, however, that these data limitations are in all likelihood not so serious as to invalidate a broad analysis of general trends, especially if the time period examined is reasonably long and the over-all changes are fairly large.

A second note of caution relates to the fact that, in attempting to characterize the financial position of consumers, one should examine not only the total value of all assets and liabilities, as is done here, but also the distribution of these claims and obligations among consumers. Any balance-sheet strength derived from the ownership of corporate stocks and bonds, for example, cannot be attributed to consumers as a whole, for these instruments are not widely held. Consumer debt is also unevenly distributed, and any increase in its outstanding volume should be evaluated in terms of the effects on only a limited portion of the over-all consumer population.

A final cautionary note relates to the need to take some account of the effects on assets and liabilities that stem

purely from the changing scale of economic activity over time. As the economy grows and the country's population increases, it is to be expected that total assets and liabilities of consumers will grow as well. In order, then, to make a meaningful comparison of balance-sheet positions at two separate points of time, it is necessary to "deflate" by some measure of the level of over-all economic activity. In this article, balance-sheet figures have been expressed as a ratio to the over-all total of personal outlays¹ as defined in the gross national income and product accounts. Any number of other deflators might have been used—the most obvious alternative being personal disposable income—but experiments with alternative measures revealed no significant differences from the results reported in this article.

TRENDS IN CONSUMER FINANCIAL ASSETS

During most of 1952-64—the time period of this analysis—the various categories of consumer financial assets have shown highly diverse trends. Because of this it is worthwhile to distinguish four main categories of assets: namely, liquid assets, bonds and mortgages, life insurance and pension fund claims, and corporate stocks.² Each of these types of assets tends to reflect, and be affected by, a different set of economic forces.

Consumers' "liquid" assets are usually defined as including holdings of demand deposits and currency, savings deposits and other depositary accounts, United States savings bonds (which are redeemable on demand), and short-term Government securities. The over-all size of such holdings at any one point in time is often used as "the one" measure of an individual's or all individuals' balance-sheet strength. Comprising money and close money substitutes, these assets are a source of immediately available purchasing power and can provide a means of increasing consumption or long-term investment at the expense of short-term liquidity.

During the greater part of the 1952-64 period, the ratio of consumer liquid assets to consumer spending moved within a narrow range of 85-88 per cent. Since 1960, however, the ratio has edged upward, and by late 1964 stood at about 95 per cent (see Chart I). At the 1964 level of

personal outlays, this increase of approximately 8 percentage points in the liquid assets-spending ratio represents more than \$78 billion in additional liquid assets.

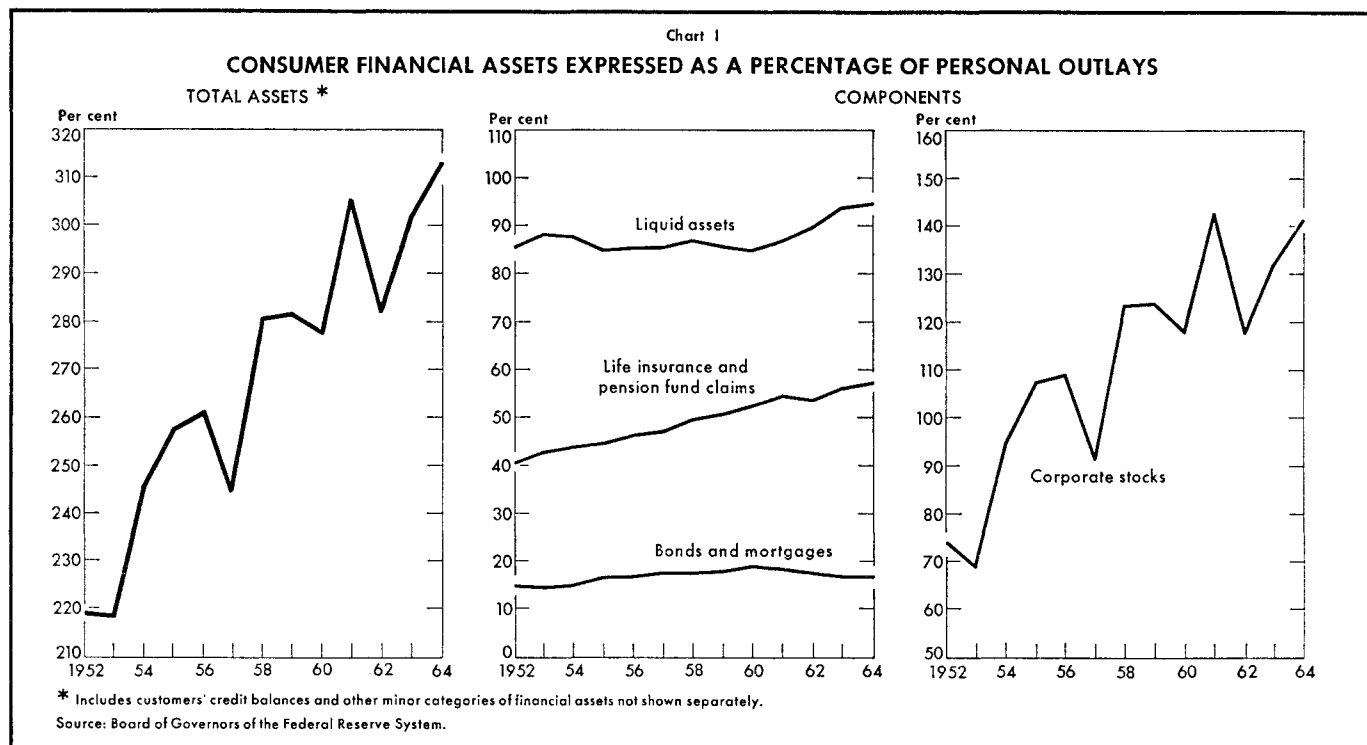
Among the various components of the liquid assets total, consumers' holdings of demand deposits and currency (i.e., of money, narrowly defined) rose in absolute amount over the past twelve years, but their growth rate was quite low compared with the increase in consumer spending. As a result, the assets-spending ratio for this particular component moved downward rather steadily over the period. Moreover, an even stronger downward trend is evident in the ratio of savings bonds to spending, for the stock of savings bonds held by consumers actually declined slightly over the period. Holdings of marketable, short-term Government securities grew at a more rapid rate than did holdings of money, but nevertheless only just enough to keep pace with the upward trend in spending. Consumers' savings deposits, on the other hand, grew quite rapidly over the early part of the period and their growth accelerated after 1960, with the pace of the advance substantially exceeding the rise in consumer spending throughout. In the 1950's, the surge in savings deposits roughly compensated for the sluggish growth in the other liquid assets components, and the over-all liquid assets-spending ratio remained stable. In more recent years, however, the sharper rise in savings deposits was sufficient to bring about an actual increase in the over-all liquid assets-spending ratio. Since savings deposits have been the only strong growth element in the liquid assets category, they have understandably attracted much attention in recent financial analysis.

The differences in growth rates between the various types of liquid assets, and the resulting changes that occurred in the composition of consumer liquid assets holdings, have to some extent been influenced by changes in the structure of interest rates since 1952. Because rates paid on savings deposits moved upward virtually throughout the period, both absolutely and relative to rates on other liquid assets, it became progressively more advantageous to hold savings deposits rather than savings bonds, and at the same time it became more costly—in terms of interest foregone—to hold cash and demand deposits. The growing yield advantage of savings deposits was, of course, widely and successfully advertised by savings institutions.

In contrast to the accelerated growth in liquid assets held by consumers during recent years, consumer holdings of bonds and mortgages—the second of the assets categories enumerated above—have shown a somewhat slower rate of growth since 1960 than in earlier years. The ratio of holdings of bonds and mortgages to total personal outlays rose from 14.9 per cent at the end of 1952 to 18.8

¹ Personal consumption expenditures plus consumers' interest payments.

² A few minor items on the assets side of the consumers' balance sheet—such as customers' credit balances at securities brokers and dealers—are included in the discussion of total assets but are not analyzed separately.



per cent by the end of 1960, but the next four years witnessed a net downward movement in this ratio, to 16.6 per cent at the end of 1964 (see Chart I). Bonds and mortgages have accounted for a steadily declining share of total consumer assets over the past four years.

Once again, interest rate developments may account for at least part of this relative shift in the composition of consumer assets. The rise in interest rates on time and savings deposits undoubtedly led some individuals to hold in such accounts funds that might otherwise have entered the bond and mortgage markets directly. However, some part—possibly a substantial part—of total personal holdings of bonds and mortgages is administered institutionally (through trust funds) and hence is not subject to the direct discretion of individuals.

A third component of consumer financial assets singled out in this article is the paid-in value of claims against insurance and pension plans. This category has become one of the most important outlets for savings (see Chart I), and accounted for nearly one sixth of the estimated value of all financial assets held by consumers at the end of 1964. Moreover, in recent years the increases in such claims have absorbed 30 to 50 per cent of the annual net additions to total financial assets. Because these con-

tractual claims are in most cases not readily convertible into cash at the option of the holder, they provide little immediate or short-term financial flexibility. On the other hand, insurance and pension claims do provide basic safeguards against future adversities and thus permit consumers to take more risks in investing their other financial assets.

The primary reasons underlying this rapid rise in consumer holdings of insurance and pension reserves are fairly clear. These two forms of accumulating financial assets have become widely used only during the years covered by this study.³ While consumer incomes have steadily grown, the demand for these assets has grown even faster, demonstrating an increased preference for financial security. It is well-known, for example, that in

³ A recent study of the effects of pension fund growth on savings patterns found that, when households come under a pension plan, they do not merely substitute pension contributions for other forms of saving but that "the net addition to aggregate personal saving apparently equals the full amount of employees' and employers' contributions". See Phillip Cagan, *The Effect of Pension Plans on Aggregate Saving: Evidence from a Sample Survey*, Occasional Paper 95 (National Bureau of Economic Research, 1965), page 82.

labor contract settlements of recent years great emphasis has been placed on employee pension arrangements.

The fourth and final component of consumer financial assets here reviewed—holdings of corporate stock—has been the greatest single source of increased consumer wealth since 1952. Corporate stocks, valued at market prices,⁴ at the end of 1964 amounted to 141 per cent of consumer spending, compared with only 74 per cent at the end of 1952 (see Chart I). By far the greatest source of the increased value of corporate stock holdings has been the appreciation of market prices: in the past twelve years, consumers have spent a net total of only \$3 billion for stocks, but stock values have been marked up an additional \$414 billion.

The ratio of the total of all components of consumer financial assets⁵ to personal outlays rose from 219 per cent in 1952 to 313 per cent in 1964, turning down only temporarily in three periods of stock market decline—in 1957, 1960, and 1962. This is a picture of considerably increased strength on the assets side of the consumers' balance sheets. The significance of this improvement in aggregate balance-sheet strength is open to some question, however. In spite of the increase in the proportion of consumer holdings of bonds, mortgages, and corporate stock over the past decade, none of these assets are as yet widely held. According to a recent survey, less than one family in five owns corporate stock and only one in fifty owns marketable bonds.⁶ Also, in the case of corporate stock the vulnerability of market prices to large-scale fluctuations in either direction leaves open the question to what extent consumers can view market appreciation as a permanent source of increased financial strength.⁷

In view of these factors, trends in the financial position of the average consumer may possibly be more closely

represented by movements in the two broadly distributed classes of assets—liquid assets and private life insurance and pension claims. But even when the analysis is restricted to these assets, the period since 1952 is still characterized by an improving financial assets position, though the trend is, of course, far less strong than when stocks, bonds, and mortgages are included.

TRENDS IN CONSUMER LIABILITIES

Any assessment of consumer financial positions must also take into account the liabilities side of the balance sheet. The two main types of individual indebtedness are consumer credit and home mortgage debt, both of which have grown sharply throughout the postwar period.⁸

At the end of 1952, the total amount of consumer credit outstanding equaled about 12 per cent of personal outlays. With more widespread use of this type of debt over recent years, the total had grown to fully 18 per cent of spending at the end of 1964 (see Chart II). Both instalment and noninstalment forms of consumer credit shared in this growth. During the past three years of high automobile sales, instalment loans for car purchases have grown especially rapidly.

The increase in outstanding mortgage debt of consumers, from 22.4 per cent of consumer spending in late 1952 to 45.1 per cent at the end of 1964 was even sharper than the growth of consumer credit (see Chart II). The major factor in this expansion has been the steady shift in living habits over the postwar years away from apartment rental and toward individual homeownership. In 1950, only about 55 per cent of all families owned their homes, but by 1960 almost 62 per cent were homeowners, and the proportion is probably even higher today. A second important factor in the growth of home mortgage debt—particularly in the past few years—is the liberalization of mortgage terms, which has allowed larger mortgage loans on homes of any given value as well as more frequent inclusion of major household appliances in mortgages.

Along with the growth in the outstanding amount of consumer credit and home mortgage debt, there has been

⁴ As previously noted, all data published in the flow-of-funds accounts are recorded on a face value basis, except for corporate stocks which are valued at market prices.

⁵ The four components discussed above, plus customers' credit balances and all other categories of financial assets.

⁶ See Board of Governors of the Federal Reserve System, "Survey of Financial Characteristics of Consumers", *Federal Reserve Bulletin* (March 1964), pp. 285-93.

⁷ As a first approximation in answering the question, it might be suggested that stock owners distinguish between a gradually increasing "basic" value of their holdings, as the economy and corporate earnings expand over the years, and more transitory fluctuations of the stock market around this basic trend. Only the former would be included as a permanent source of increased financial strength. Needless to say, it would not be easy to quantify and verify this suggestion.

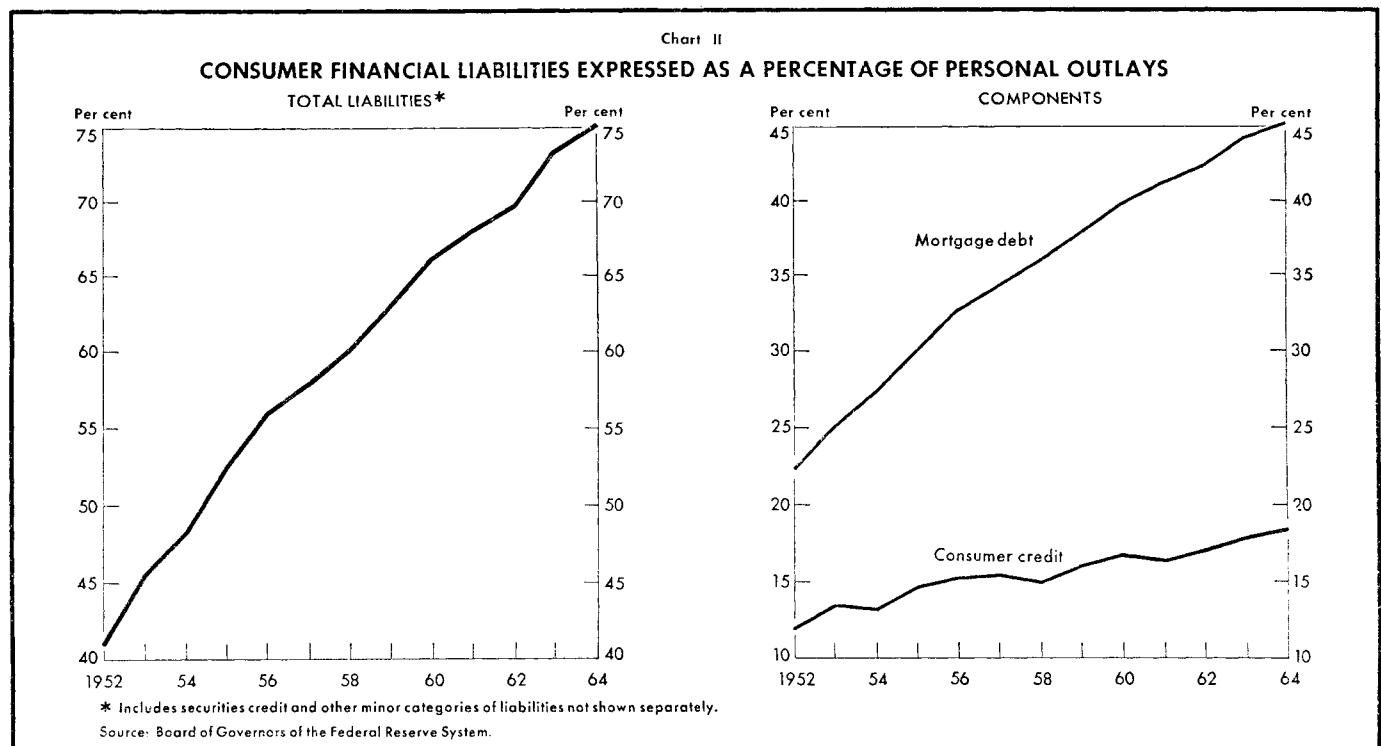
⁸ Three other categories of consumer indebtedness may be mentioned briefly. Consumers borrow relatively small amounts using nonresidential mortgage debt. They also borrow from insurance companies against life insurance policies and from securities brokers and dealers against holdings of marketable securities. It should be noted that these types of debt have also risen. They amounted to 3.6 per cent of personal outlays in 1952 and to 6.7 per cent at the end of 1964.

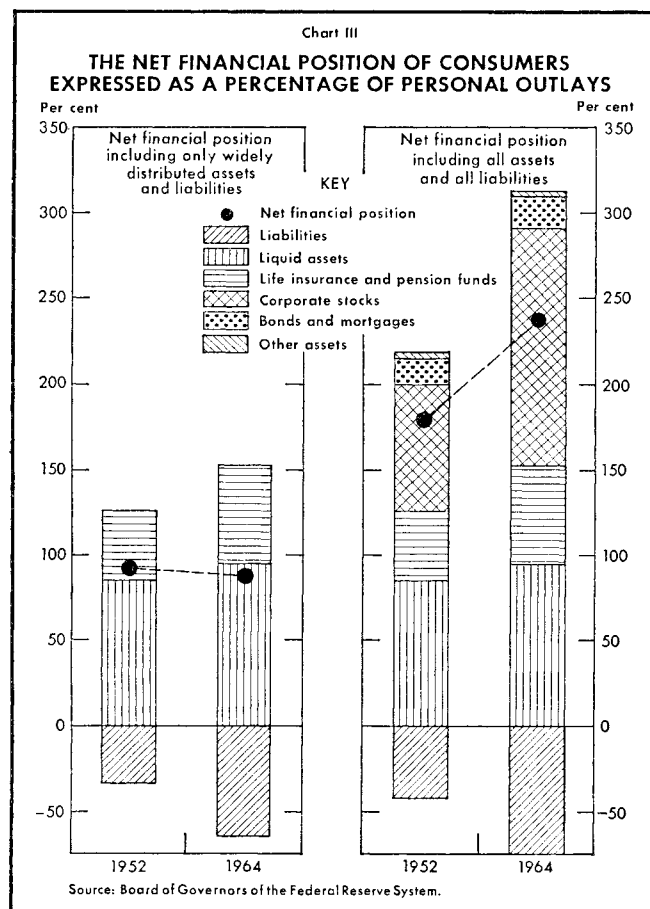
a rise in the ratio of monthly or annual repayments on such debt to after-tax personal income. This ratio, representing the proportion of current disposable income pre-committed to contractual debt obligations and therefore presumably unavailable for other purposes, is often used as a rough gauge of the financial "burden" of consumer debt. With respect to instalment debt, repayments (including refinancings) grew from 10 per cent of total disposable personal income in 1952 to almost 14 per cent in 1964. Recent studies conducted by the University of Michigan's Survey Research Center indicate, however, that much of this growth in aggregate consumer borrowing can be accounted for by a rise in the proportion of households using instalment debt rather than by a rise in the average indebtedness of households that already had some debt outstanding. This may reflect a broader acceptance of consumer credit among various income groups as a means of financing major expenditures, and a widening in the types of purchases for which consumer credit is considered appropriate. Thus, according to these studies, the average indebtedness of debtor households is not at present appreciably higher relative to the current incomes of these households than it was a few years ago, compared with the incomes prevailing at that time.

The volume of mortgage repayments undoubtedly has also risen sharply in relation to consumer incomes, perhaps partly because of an increased rate of repayments, but adequate information on the extent of the rise is not readily available. One factor tending to hold down the increase in the mortgage repayment-income ratio has been the gradual lengthening in maturities on mortgages, which of course reduces the size of the average monthly payment. Moreover, as families move from apartments to homes, to the extent that the increased mortgage payments are merely a substitute for what had previously been rental payments, a rise in the mortgage repayment-income ratio implies no increased financial burden on the individuals involved.

THE NET BALANCE-SHEET POSITION

It is apparent that the balance-sheet position of consumers has been subject to two opposing trends. On the one hand, consumer holdings of financial assets have grown, which might have contributed to the willingness as well as the ability to spend for current consumption. On the other hand, consumer debts have also risen, which implies an increase in the volume of contractual claims





consumers—the total of all assets less all liabilities—increased markedly over this period (see the right-hand panel of Chart III). The ratio of net assets so defined to personal outlays amounted to 238 per cent by the end of 1964, compared with only 178 per cent at the end of 1952. The alternative net assets measure—liquid assets and life insurance and pension claims, less consumer credit and household mortgage debt—actually declined slightly over the period, from 92 per cent of consumer spending in 1952 to 88 per cent at the end of 1964 (see the left-hand panel of Chart III).

The question inevitably arises as to which of these two measures offers the truer picture of trends in the underlying strength of consumer balance sheets over the past twelve years. Unfortunately, the safest statement is that neither measure is wholly adequate. While it may not be proper to give full weight to bonds, mortgages, and stocks in computing net assets, it also is not proper to exclude them entirely, especially since corresponding liabilities of the owners of these securities have not been eliminated in the computation. In a sense, then, the two measures presented might be considered to be extremes, with the true measure lying somewhere in between. Limited as this conclusion is, it is useful. Given the fact that net worth, excluding the narrowly distributed assets, fell only very slightly relative to consumer spending over the period while the over-all measure rose substantially, a middle position would lead to the conclusion that the net balance-sheet position of consumers has at the very least held its own over the past twelve years, and in all likelihood has actually strengthened to a significant degree.

CONCLUDING REMARKS

The main value of the preceding analysis may well be that it suggests the difficulty of making firm statements about recent trends in the over-all balance-sheet condition of consumers. Nevertheless, it may also serve as a basis for comment on two issues in the area of consumer financial strength which have been widely discussed. One is the increase in consumer liquidity as represented by the rapid accumulation of savings deposits since 1960, and the other is the continued expansion in consumer debt.

As mentioned earlier, savings deposits provide consumers with the ability to increase spending on goods and services independently of current incomes or availability of consumer credit, and without the risk of capital losses. The unleashing of this potential source of purchasing power in a period of high-level economic activity could have inflationary consequences. However, the recent

against both assets and incomes and therefore perhaps leads to some restraint on spending. One simple way of netting these divergent trends is to subtract the liabilities from the assets, and thus to obtain a rough measure of the movement in consumers' financial net worth. This procedure, of course, ignores many difficulties, such as the changes in the character of both assets and liabilities as well as the distributional shifts of these claims among the consumer population. These are problems which cannot easily be solved, but they can perhaps be eased by presenting two measures of net worth. The first is simply the difference between total assets and total liabilities. The alternative measure is an attempt to focus on the net worth position of only the "typical" consumer and thus includes only those assets and liabilities which are probably common to a majority of the population (see Chart III).

Perhaps the most significant point about these two net worth measures is that they have not moved together over the past twelve years. The over-all net assets position of

uptrend in savings deposits should be viewed in the context of the relative decline in other liquid assets and the simultaneous rise in debts. Total liquid assets have increased considerably less than either nonliquid assets or debts, and balance-sheet liquidity has actually declined relative to total assets and total liabilities. Moreover, there are some indications that consumers themselves do not view savings deposits merely as a temporary store of purchasing power. Despite the fact that the massive growth in savings deposits in recent years has been associated with considerable economizing on demand deposits, the turnover rate on savings accounts at mutual savings banks and on share accounts at savings and loan associations appears to have remained stable. This would imply that consumers have not usually considered savings deposits as substitutes for demand deposits as a means of accumulating funds intended for spending, even in the face of recent high rates of spending on items such as automobiles which have at times led to heavy drains on accumulated financial assets.

Nevertheless, it would be wrong to ignore completely the inflationary or speculative potential of the currently substantial liquid assets holdings of consumers. While the assets may not themselves spark inflation, they might be mobilized in reinforcing such a trend once it got under way for other reasons. In such a period, consumers would have a strong incentive to accelerate planned future expenditures on goods and services or to shift into assets such as common stocks or real estate at the expense of their liquidity holdings, especially since inflation reduces the

real yield on fixed-income assets.

At the opposite pole, some observers have become increasingly worried by the mounting burden of debt incurred by families, and by the deflationary potential of these obligations. The sharp rise in these debts, it is said, may limit further borrowing capacity and therefore restrain future spending on consumption goods and homes. Moreover, if the current level of indebtedness is already pressing against the ability to meet scheduled repayments, an economic decline of even modest proportions could result in widespread defaults, thereby weakening the solvency of creditors and adding to the downward pressures on the economy generally. This is a one-sided view. The rise in aggregate indebtedness must be viewed against the fact of the widening use of consumer and mortgage credit as living patterns change. Furthermore, one may once more note that at least on an aggregate basis the net balance-sheet position of consumers has most likely improved over time despite the growth in debt. Thus, to whatever extent the assets shown on consumer balance sheets (and such provisions as insurance on borrowers' lives) serve as a protection against consumer defaults on loans, the ratio of protection of creditors seems to have been maintained or strengthened. Naturally, this observation does not answer the argument that in a massive deflation the value even of fixed-price assets and hence the protection of creditors might be impaired. The answer to this argument must be found in our national commitment to economic growth and in the constant quest for fiscal and monetary policies appropriate to that commitment.