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Interest Rates and Monetary Policy in Perspective*

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It is very pleasant for all of us in the Federal Reserve Bank of New York to meet again with our good friends of the New York State Bankers Association. As I look back at some of our reunions of past years, the circumstances surrounding some of those earlier occasions seem comparatively uneventful. Certainly banking and central banking matters have been more in the limelight in the past two or three months than for a great many years. Our monetary actions and the reasons therefor represent ground that has been pretty well worked over. However, I would like to review with you some of the basic economic philosophy behind these recent dramatic events, and if I touch briefly on the events themselves it is merely to bring these underlying concepts into clearer focus.

I have been saddened to find so many glaring misconceptions of the role of monetary policy in much of the comment made in the past couple of months. And there seems to have been equal confusion on the part played by interest rates in general in the environment of a market economy. Much of what I have to say today may strike this financially sophisticated audience as obvious and elementary. Nevertheless, I think it may be worthwhile to go over with you a few of the fundamentals.

In the first place, let's look for a moment at the connection between monetary policy and our basic economic objectives such as maximum sustainable growth, a reasonably stable price level, maximum practicable employment, and near-equilibrium in our international payments. The linkage, of course, runs from specific monetary policy actions (open market operations, changes at the "discount

window" and in reserve requirements) to the cost and availability of credit (and especially bank credit), thence to changes in the amount of private and public spending, and from there to changes in real economic activity, use of resources, price relationships, and international payment flows.

Of course, the nature of this "linkage" is immensely complex and is the subject of continuing searching analysis by economists in the Federal Reserve System and in Government generally, and in our universities and research organizations. The chain of cause and effect is still far from being susceptible to exact scientific measurement, so that judgment remains an essential element in analyzing not only the probable direction and strength of various influences but also the probable time lags involved. The fact that monetary policy moves cannot be fitted into an exact scientific formula does not mean that they are not well worth making. On the contrary, the world has learned, through a long process of trial and error, that monetary policy is one of the best methods—and undoubtedly the most flexible method—for exerting a generalized impersonal influence on borrowing and spending and thereby on economic activity while still permitting market forces to control most individual economic decisions. Granted that monetary policy may, and often does, affect different parts of the economy somewhat differently, this is a far cry from a selective method of control where the national Government would undertake to judge the social value of each and every economic activity and to set policies accordingly.

Fiscal policy is of course another important way of exerting a generalized influence on the economy, although both taxes and Federal expenditures inevitably involve very significant differential effects on various parts of the economy. One of the great gains of the last couple of decades has been the growing recognition that fiscal policy is a very useful and potent tool for speeding a recovery,

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sustaining an expansion, or checking a boom.

Because changes in taxes and Government outlays directly affect the spending stream, fiscal policy is undoubtedly an even more powerful economic weapon than monetary policy. It suffers, however, from one exceedingly serious drawback—lack of flexibility. This reflects the long process of legislative and administrative actions that must take place before a given policy recommendation is adopted and produces its economic effects. If Congress were able to speed its own deliberations and decisions, or if it were willing to delegate to the Executive Branch some modest leeway in determining tax rates, or more than the existing limited discretion with respect to expenditures, the drawback might be overcome in some degree—and I would hope that continuing study will be devoted to these possibilities. But, as things stand now, fiscal policy is clearly a poor second to monetary policy with respect to the potential for quick adjustment to changing conditions. The Federal Reserve System has the technical capability of adjusting its policies on a week-to-week or even a day-to-day basis.

The discount rate increase in early December brought forth several critical comments to the effect that, if inflation was threatening, fiscal rather than monetary policy should have been looked to for remedial action. It was argued that monetary restraint might react primarily on investment activity and hence on future productivity growth, whereas fiscal restraint would be more likely to dampen consumption. Interpreting these comments broadly, I agree that monetary policy should not always be relied upon exclusively to bring about whatever restraint is needed. However, in the specific December 1965 situation, the critical comments conveniently overlooked two important elements: first, the fact that there was little prospect of a significantly tighter fiscal policy that would become effective in the next few months rather than a year or so from now; second, the existence of our international payments problem, which has certainly not yet been solved despite the past year's notable progress. Both of these points merit some elaboration.

While timing is of course always a significant factor in any "policy mix", there is no rule as to whether fiscal or monetary policy must move first. Each must move in the light of past, present, or contemplated moves of the other type of policy. Late last fall it was clear that the Federal budget was tending to become more of an expansionary force during the remainder of fiscal 1966 than had earlier been expected, so that some firming of credit conditions was consistent with the avoidance of more total stimulus from both types of policy than had been deemed right just a few months earlier. In these circumstances, pleas that

monetary moves be delayed until after the presentation in January 1966 of the budget for the 1967 fiscal year did not seem to me persuasive. The need of the moment was for action that would immediately work to counteract incipient and actual inflationary developments before they gathered further momentum. It is gratifying to note that the President's fiscal 1967 budget, as forecast in the State of the Union Message, gives clear recognition to the threat of inflation and offers fiscal proposals that will help to deal with it.

When there is a choice between checking an inflationary threat through stiffer credit terms and checking it through higher tax rates or restraint on Government outlays, there is little doubt that the former will be more useful from a balance of payments point of view. (This aspect deserved special emphasis in early December when the Government was about to announce a tightening of the President's balance of payments program.) There is, of course, plenty of room for argument as to just how much balance of payments influence a monetary policy action may have, but it would be very hard indeed to contend that it will not bring some benefits. Indeed, for the past four or five years we in the Federal Reserve Bank of New York have suggested in our annual reports that the determination of a desirable policy mix between monetary and fiscal policy must take full account of international factors. Thus, from the earliest days of the talk of tax reduction we supported a tax cut primarily because it would tend to put unused domestic resources to work without running the international risks inherent in too easy a monetary policy. The tax cut, both in anticipation and in realization, enabled the System to maintain a lesser degree of monetary ease than would otherwise have been called for by domestic considerations. The argument that international factors must be given full weight in determining the proper fiscal-monetary policy mix has as much validity today—with our payments problem still unsolved—as it had five years ago. Yet it receives, in my judgment, far too little recognition in most press and academic pronouncements. Naturally, this is not to deny that at times both monetary and fiscal policy should simultaneously move toward restraint or ease. In fact, right now is a time when both types of policy should jointly combat a resurgence of inflationary forces.

Now let's turn for a minute to the role played by interest rates in general in our economy. The level of interest rates has long been regarded as the balancing mechanism between credit demands on the one hand and credit supplies on the other. Besides providing a kind of thermometer to measure these respective pressures, interest rates also exercise an influence of their own on both demand

and supply. Demand is spread in roughly even proportions among consumers, private business, and Government entities (with the Federal Government representing only a modest share of total borrowing except in time of war). On the supply side, savings of course represent by far the largest source of credit, and it is well to bear in mind that to a very considerable extent the commercial banks operate in the same way as any other financial intermediary when they issue relatively liquid claims in return for savings which are then directed into long-term investment channels. At the same time, the commercial banks also of course retain the unique characteristic of their power to create money, in the form of demand deposits, as the counterpart to their extension of credit. This unique power plays a marginal but strategic role in balancing total credit demand and supply.

One important factor entering into our recent discount rate decision was the very rapid growth of bank credit in 1965—at about 10 per cent per annum, as against an already rapid rate of around 8 per cent in each of the four preceding years. We had in mind not only bank credit but also total credit creation, which had grown at a fast pace, too, although the banks had accounted recently for a somewhat larger share of the total than earlier. It was a source of concern to us that the fast and perhaps accelerating pace of credit expansion was occurring in an environment of growing scarcity of resources in the form of unemployed labor and unused plant capacity. With unemployment down sharply in the past year, there was a real question whether continued rapid credit creation would not do more to encourage borrowers to bid up prices rather than to help in bringing about further rapid gains in real economic activity.

Some critics have cited the rather modest growth (around 4 per cent per annum) of the money supply—demand deposits plus currency—in recent years as evidence of an excessively restrictive monetary policy. They might well reflect that the public, and especially business, has been eager to economize on cash balances in order to earn interest on other forms of liquid assets. The aggregate of these other assets has risen much faster than the money supply proper; and, in contrast with earlier periods of business expansion, total liquid assets of the non-bank public have grown more rapidly than the gross national product since early 1961. Whatever ailments our economy may have been subject to, it has certainly not been short of liquidity.

I have spoken of the December discount rate action as being motivated partly by a wish to check too rapid a growth of bank credit. It has been rightly pointed out on many occasions, however, that the rate action's effective-

ness will be largely determined by the extent to which it is supported by restrictive open market operations. Discount rate changes and open market operations are complementary instruments of policy, with the latter playing the dominant role on a day-to-day, week-to-week basis because of their influence on bank reserve positions and, at one step removed, on bank credit growth.

I might add, however, that neither the System's intent with respect to the rate of bank credit growth nor the likely actual result should be judged on the basis of the published free reserve figures alone. A given free reserve position or net borrowed reserve position may produce differing rates of credit growth, for the banking system's response can vary widely according to the force of credit demands. If credit demands were very strong, the maintenance of a net borrowed reserve position of "X" million dollars, for example, might result in very rapid credit expansion, whereas in a period of stagnant demand it could lead to little or no credit growth.

A discount rate change is always in some degree merely a mark of official recognition that market interest rates have been on the move. As Chairman Martin said in an address last month, it would be harmful to increase the discount rate if the natural forces of the market—which reflect the underlying strength or weakness of the economy—were moving in the opposite direction. Actually, market rates had been rising very strongly for several months before the December discount rate increase. There is always room for judgment as to how soon the discount rate should be moved to conform to, or even perhaps to anticipate, such a market trend. Last December a number of rather glaring distortions had occurred in the interest rate structure, and it was rightly felt that a discount rate rise would tend to ameliorate these rate distortions, thus promoting a more orderly flow of funds in the economy.

Whether or not a discount rate change must be mildly or strongly reinforced through open market operations will depend on factors that cannot be accurately measured at the time of the rate move. To some extent the rate move itself, and related changes in market rates, can be counted on to affect the strength of credit demands and the supply of savings. Our disposition in December, given all the special seasonal pressures that are characteristic of that month, was to ease the transition to a new rate level by making reserves somewhat more abundant than they had been a month or two earlier while still avoiding any flooding of the banks with reserves that might have seriously misled the market as to our underlying policy. We are watching developments closely. Our open market operations will be guided by cumulative evidence of the effect of the discount rate move on the pace of money and credit

expansion and related economic and financial developments, and by the extent to which bankers themselves exercise good judgment and are selective in meeting credit requests.

By this time it should be reasonably clear, if my exposition has not been grievously obscure, that interest rates are not just another price, like that of any commodity, a rise in which may be a signal of inflation to be combated by right-thinking public servants. Yet it was startling how often I heard just such comments at the time of our discount rate increase. Several friends in the business community asked me how the System could, in good conscience, make this contribution to an upward trend of prices in general; and remarks in the same vein even came surprisingly enough from the mouths of a few trained economists. Now it would be wrong to assert that interest rates do not play a significant role as an element of cost. In some economic sectors this aspect is especially important, as in housing or in investment projects undertaken by state and local governments. In political circles it is popular to stress also the large Federal bill for interest charges, with a consequent higher level of tax rates or budget deficit than would otherwise be necessary. All this is no doubt true. Yet it is frequently overlooked that the inflation-checking influence of higher interest rates is vastly more important than this cost aspect for the economy as a whole. Since interest represents the cost of borrowing money to be injected into the spending stream, higher interest rates will tend to slow this process and thereby to minimize the upward pressure on prices and costs that reflect excessive spending. In a very important way, then, interest is not only not just another price but is the exact opposite of a commodity price. In his testimony before the Joint Economic Committee last month, Governor Balderston showed how much more serious for a municipal government a general commodity price rise could be than an increase in the same government's interest cost on borrowed funds.

Another fallacy worth mentioning is the tendency to attribute higher interest rates simply to the insatiable greed of the bankers. This strand of thought is a holdover from the ancient Populist theories which have long since lost whatever validity they might once have had in a rather primitive and largely agricultural economy. In our present highly developed economy, all income groups participate importantly in saving and benefit directly or indirectly from the flow of interest payments. Under these conditions, it is pretty hard to tell whether the greater social benefit will follow from lower or higher interest rates *per se*. What is not at all hard to tell, however, is that a great number of people are badly hurt by general price increases.

As for the argument that higher rates benefit only the bankers, I hardly need to remind this audience that interest is one of the banker's largest items of cost besides being a major item of income. Perhaps it is worth pointing out that some of the loudest protests against the recent lifting of ceilings for rates on certificates of deposit came from bankers who feared their inability to cover this important increase in cost that was resulting from deposit rate increases at competing institutions. In any case, as I have said before, the really important question is not whether the interest rate level is high or low but whether it is "right" for the economic circumstances.

Let me add a word here on the significance of the changes made last month in Regulation Q. At that time it had been increasingly clear for many weeks that the existing ceilings were inconsistent with rising market interest rates resulting from strong and growing credit demands. Actual rates for certificates of deposit were right up against the ceilings. Unless the ceilings had been raised, any further rise in market rates could have caused a major loss of deposits to many banks, and the resulting effort to liquidate assets could have had serious consequences for the municipal bond and mortgage markets. Furthermore, the law behind Regulation Q was enacted—rightly or wrongly—not as a means of regulating interest rates by fiat for their own sake but as a supplementary means of protecting the banking structure against unsound lending and investing policies that could result from pressure to cover excessive outlays for the payment of competitive deposit rates.

In this setting it was surprising that some of the System's critics last month suggested that it would have been better for the monetary authorities to combat any inflationary threat through further moderate pressures on bank reserve positions rather than by overt moves involving the discount rate and Regulation Q ceilings. Further pressure through open market operations would merely have accentuated the fact that both the discount rate and the Regulation Q ceilings were increasingly out of line with market realities with the consequences I have already enumerated. Moreover, the alternative of a "revalidation" of existing certificate of deposit rates through easing the pressure on bank reserve positions would have been equally inappropriate because it would have encouraged a further speedup in credit growth. Thus, the need for relief on the ceilings was a significant reason behind the timing of the policy moves. And it would have been most unwise to raise the ceilings without touching the discount rate, for in that case there would have been even greater uncertainty in the money and capital markets, in the belief that a discount rate rise would have to come at some time in the fairly near future. This was an occasion when the discount rate and Regula-

tion Q moves had to occur simultaneously.

Their simultaneity, however, has had one unfortunate result, i.e., that commentators have tended to disregard the basically different nature of a discount rate increase and a lifting of Regulation Q ceilings. The latter action involves setting a permissible maximum, with the determination of the actual rate left entirely to a free market. There was a lamentable tendency to speak of the System's having increased "the rate paid on time deposits" to 5½ per cent. A major reason for setting the new ceiling at this historically high level was in fact to make crystal clear that the System was *not* trying to designate a desirable rate—which had tended to be the interpretation of earlier more modest increases in the rate ceilings.

The establishment of the 5½ per cent ceiling implies a philosophy which I have long shared, i.e., that to the greatest extent possible we should leave the establishment of both deposit and loan rates to the best judgment of the banks themselves—and the competitive markets within which they operate—with interference by the System only if abuse of this freedom is evident. In the first instance this interference might consist mainly of suggestions from the bank examiners. The freedom of action of which I speak should, of course, apply to the prime rate as well as any other lending or deposit rate. It does obviously imply the need for a high degree of responsibility and prudence on the part of the bankers themselves. For a good many years, Regulation Q ceilings provided a sort of "umbrella"—or perhaps a "crutch" would be a better

term—that relieved the banks of some of this responsibility; and there have been, surprisingly enough, outcries against the lifting of the ceilings by individuals who in nearly every other field are staunch supporters of free enterprise. In any case, I trust that the bankers will live up to their greater responsibilities and will exercise prudence in preventing runaway competition from causing sharper rate increases than are consistent with the real forces of supply and demand. The System must remain vigilant in this area, but I am optimistic that our faith in the maturity and prudence of the nation's bankers will be justified.

I have tried to cover a good deal of ground today by touching a few highlights rather than by exploring our actions in considerable depth. As I said at the outset, our December policy moves seemed to provide a useful background against which to review some of the fundamentals of interest rates and monetary policy. Ours is an art rather than a science, but one which is gradually becoming more susceptible to scientific analysis. We make no claim to omniscience, and our judgments may prove faulty from time to time. But the great beauty of monetary policy is the fact that it need never stand still but can be and is indeed being adjusted constantly to developing events. I hope you agree that a vigorous Federal Reserve System, maintaining the closest contacts with other arms of Government but exercising independent judgment within the Government, can play a useful role in fostering the balanced economic progress we all seek.

Recent Trends in Commercial Bank Lending and Borrowing*

By WILLIAM F. TREIBER

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ECONOMIC PERFORMANCE IN 1965

1965 was a year of economic achievement on a broad front. At the year-end, the nation was in its 58th consecutive month of economic expansion, the longest period of continuous growth in peacetime history. Spurred by buoyant consumer demand and record business capital outlays, total output over the year rose by about 7½ per cent in money terms and 5½ per cent in real terms. Total employment reached a new peak, and the unemployment rate fell to its lowest level in eight years. Productive capacity expanded sharply. Yet many businesses were using their plant and equipment at close to—and in some cases above—their preferred operating levels.

And so the year ended with mounting pressure on resources. These pressures are being accentuated by the expectations of businessmen that additional military demands will be superimposed on an already high general demand.

COSTS AND PRICES. As the margin of unused resources contracted, pressures on costs and prices mounted. After several years of gratifying stability, 1965 witnessed a pickup in the rate of advance in the over-all price level—threatening not only the continuation of steady economic expansion but also further improvement in the international position of the dollar.

BALANCE OF PAYMENTS. While the deficit in our international balance of payments was cut sharply in 1965, it was still well over \$1 billion, however calculated. Most of the improvement occurred in the second quarter of the year, reflecting the initial impact of the voluntary credit re-

straint program. The initial large return of funds from abroad and the cutback in foreign loans outstanding were “one-shot” propositions temporarily producing capital flows to the United States. Although the program continued to be effective throughout the year, it contemplated moderate outward capital flows. Another factor affecting our balance of payments in 1965 was a decline in the size of our trade surplus; imports rose more rapidly than exports.

INCREASED DOMESTIC CREDIT DEMAND

As the year progressed, the demand for credit rose rapidly, and interest rates came under pressure. Late in the year, it became clear that the existing level of rates could be maintained only if the Federal Reserve increased the already swift pace at which it was providing reserves to the banks. But such a policy would have been inappropriate in view of actual and threatening inflationary pressures as well as the continuing international payments problem. In these circumstances, two related steps were taken early in December. The discount rates of the Federal Reserve Banks were increased; and the maximum rates commercial banks might pay on time deposits under the Federal Reserve Board's Regulation Q were raised. These actions were not intended to choke off the flow of credit. The discount rate increase was intended to dampen mounting demands on banks for still further credit extensions that, in our judgment, would have added considerably to inflationary pressures. The increase in permissible rates under Regulation Q was intended to enable banks to attract and retain deposits of businesses and individuals and thus make more effective use of funds already available in the economy to finance their loan expansion. These Federal Reserve actions should help to protect the value of the dollar at home and abroad, and should promote the attainment of still another year of sustainable economic growth in 1966.

* An address before the eighteenth national credit conference sponsored by the Credit Policy Committee of the American Bankers Association, New York City, January 31, 1966.

COMMERCIAL BANKS AS SUPPLIERS OF CREDIT

In 1965 the commercial banks demonstrated their flexibility in meeting the credit demands associated with substantial economic growth and their ability to attract large flows of savings.

FOREIGN LOANS. At the same time the commercial banks played an important part in holding down our 1965 international payments deficit. The guidelines under the voluntary credit restraint program permitted a 5 per cent increase in extensions of credit by banks to foreigners in 1965. The actual increase was less than 1 per cent. This moderate increase contrasted sharply with a 30 per cent advance in 1964, prior to the program. This self-restraint in foreign lending in 1965, of course, enabled the banks to extend more credit to domestic borrowers.

DOMESTIC LOANS. On the domestic side, commercial banks once again played a major role in providing the funds necessary to finance record levels of business and personal spending. During the year, total bank credit to domestic borrowers rose more than 10 per cent—the highest rate of expansion in many years. Virtually all this increase was accounted for by a growth in loans; bank lending to nearly every domestic sector advanced at a fast rate.

CONSUMER LOANS. Bank credit provided strong support to personal expenditures in 1965. Commercial banks increased their direct loans to consumers by more than 15 per cent last year, as against a gain that averaged about 9½ per cent per annum over the preceding four years. At the same time, there was a sizable advance in the type of bank credit that goes to consumers indirectly. For example, bank loans to nonbank financial institutions, such as sales finance companies, rose by 26 per cent—more than double the average annual rate of increase in the preceding four years.

REAL ESTATE LOANS. Although residential construction was sluggish in 1965, bank real estate loans registered a record dollar gain. Many of these loans apparently represented new mortgages in connection with the purchase of older houses having lower mortgages; many other loans represented the refunding or enlargement of existing mortgages with the proceeds used for major home improvements, the purchase of durable goods, and a variety of other purposes, such as educational expenses of the homeowners' children.

BUSINESS LOANS. While the banks were expanding their loans to consumers last year, they were also increasing their loans to business concerns by almost \$11 billion, or 19 per cent; this was more than double the average annual rate of expansion in the preceding four years.

The 1965 experience was actually a continuation of an acceleration in bank borrowing by business concerns that started in the second half of 1963. Over the two and one-half years ended last month, business loans have increased by almost 40 per cent. In retrospect, the reasons are fairly clear. Prior to mid-1963, business concerns had been able to meet the bulk of their financial needs out of cash flows generated by undistributed profits and by depreciation allowances. But as over-all economic activity accelerated, the growth of internally generated funds failed to keep pace with the rapid expansion in capital outlays and in working capital required to support higher sales volume. Accordingly, business firms in the last two and one-half years have turned increasingly to banks and other lenders for additional funds. If the Internal Revenue Code is amended, as recommended by the President, to speed up the payment of corporate income taxes, demands by business firms for credit will rise even more.

Not only have the commercial banks provided business concerns with an unprecedented amount of credit, but the banks have also been gaining in relation to other suppliers of credit. Since mid-1963, banks have supplied over a quarter of all outside funds borrowed by business—in the credit markets as well as through other means, including trade financing. In the 1955-57 period, when business capital spending was also high, the banks provided one fifth. Furthermore, the banks' rising share in business financing has been accompanied by a similar performance in satisfying credit needs elsewhere in the economy. Thus, in the last four years, commercial banks have supplied about 40 per cent of the total funds raised in the credit markets by all private domestic nonfinancial borrowers. In earlier years, by contrast, banks rarely filled more than a quarter of such credit needs. This expansion in bank credit has been facilitated, of course, by the generous provision of bank reserves by the Federal Reserve.

In competing for loans, banks have aggressively sought out and then met the changing needs of business as they emerged in a dynamic economy. More banks are engaging now in financing on the basis of commercial receivables. A number of banks have developed or expanded departments for each of many industries—from such old-line industries as mining, petroleum, and real estate to such new industries as electronics, aerospace, and atomic energy. As a result, there is now more flexibility than ever among commercial banks in adjusting to shifts in the relative rates of growth among industries.

Banks have been making more loans based on the earning power of a firm rather than on its readily salable assets. Essentially, this has meant that banks are becoming more important suppliers of intermediate and longer term

capital to business. The weekly reporting banks in New York City, for example, increased their term loans to business by well over \$2 billion in 1965; these loans accounted for two thirds of the over-all gain in their business loans. At the year-end, over 60 per cent of the business loans at these banks had maturities of one year or more, compared with about 55 per cent three years earlier.

Another development has been equipment leasing. While still relatively small, direct leasing by national banks rose to nearly \$200 million at mid-1965 from only \$50 million a year earlier. Here in New York State the Superintendent of Banks, on the advice of an advisory committee of banking experts, has recommended that the State Banking Law be amended to authorize state banks to enter the field of leasing.¹ This and other recommendations proposed by the committee, and endorsed by the Superintendent, are designed to eliminate competitive inequalities in the position of state chartered banks vis-à-vis national banks whenever consistent with sound banking principles. Similar efforts may be expected of other state supervisory authorities as they strive to improve and modernize their banking laws and regulatory procedures.

SOURCES OF STRENGTH OF BANKS

BANKS AS COMPETITORS FOR LIQUID FUNDS. The growing role of commercial banks in the credit markets is due in large part to the aggressiveness of banks in competing for the liquid balances of the nonbanking sector of the economy. Their ability to compete has been facilitated by the flexible approach of the Federal Reserve toward interest rates on time and savings deposits. In order to keep permissible rates on such deposits in line with other domestic and foreign money market rates, the Federal Reserve Board has raised the maximum rates payable on member bank time and/or savings deposits under Regulation Q four times in the last four years.² Federal Reserve action in raising the rate ceilings was taken with the expectation that banks would exercise prudence in availing themselves of the

enhanced flexibility in competing for funds. The last three revisions of Regulation Q have focused particularly on the liberalization of rates for deposits of short maturities; now the maximum rate on all time deposits is 5½ per cent. Accordingly, banks have been able to compete vigorously even for relatively short-term funds.

MARKETABLE CERTIFICATES OF DEPOSIT. Accompanying this greater rate flexibility, banks also developed new deposit instruments to attract funds which might otherwise have moved into other short-term investments. The most prominent such instrument is, of course, the negotiable time certificate of deposit; it has been the fastest growing component of time and savings deposits since it was first used nationally in 1961. Large business concerns have found the certificates highly attractive. At present, negotiable certificates of deposit account for well over 10 per cent of all interest-bearing deposits at all commercial banks, and for considerably higher percentages at money market banks. For some New York City banks the percentage is over 50; for most New York City banks the percentage is over 35.

SAVINGS CERTIFICATES. Another type of certificate of deposit that has been growing in popularity is the savings or investment certificate. This instrument is designed to appeal to individuals, eleemosynary institutions, and small business concerns; it enables banks to attract and retain deposits of their more interest-sensitive savings depositors.

Reflecting in part these developments with respect to certificates of various kinds, commercial bank time and savings deposits advanced at a 15 per cent annual rate in the first three years following the January 1962 increase in Regulation Q ceilings; the rate of advance was even more rapid in 1965.

OTHER INSTRUMENTS. Banks also sought additional short-term funds by issuing promissory notes and nonnegotiable "acknowledgments of advances" to corporate customers and others. These instruments brought over \$0.5 billion net to weekly reporting member banks in 1965. I shall comment later on these instruments.

Banks in New York City have obtained additional funds on short term by entering into repurchase agreements on Government securities with corporations. Such repurchase agreements rose from \$200 million to \$500 million in 1965.

CHANGING STRUCTURE OF BANK ASSETS AND LIABILITIES

The broadening role of commercial bank lending operations in recent years makes it more likely that the widest possible spectrum of credit demands can be satisfied at a

¹ For the committee's recommendations, see *Report of the Advisory Committee on Commercial Bank Supervision* submitted to the Superintendent of Banks of the State of New York, December 1965.

² In October 1962, Congress amended the Federal Reserve Act to remove the interest rate ceiling on time deposits of foreign governments and monetary authorities and international financial institutions; the amendment was initially effective for a three-year period, was subsequently renewed, and is presently due to expire in October 1968.

commercial bank. Yet, this broadening role and the surge in bank loans in recent years do raise some questions.

LOAN-DEPOSIT RATIOS. One such question relates to the sharp run-up in bank loan-deposit ratios. The average loan-deposit ratio of all commercial banks reached a post-war high of about 63 per cent at the end of 1965, nearly 20 percentage points above the figure of a decade ago; about 5 percentage points of the rise occurred in 1965 alone. Even recognizing the significant change in the composition of their assets and liabilities, many banks may now be operating at or above their preferred loan-deposit ratios, somewhat as a number of manufacturing concerns appear to be operating above their preferred capacity utilization ratios. Consequently, the present high level of loans relative to deposits could soon become a constraining factor in bank lending.

I would hasten to add, however, that the upward trend in loan-deposit ratios over the last several years does not necessarily mean that banks in general are now over-extended. One should look at more than the bare statistical ratio. One should examine the items involved in the ratio—the composition of loans and investments, and the nature of the deposits—and the ability of the banks to provide for the additional needs of their customers. The steady and balanced nature of the current economic expansion has probably contributed to the avoidance of some of the excesses of previous expansions. For example, there may be far less financing of possibly excessive and speculative inventories among total bank loans now than in earlier expansions.

The changing composition of commercial bank liabilities since 1960 has also contributed to the acceptability of higher loan-deposit ratios. Time and savings deposits, and also bank capital accounts, have grown far more rapidly than demand liabilities. In fact, between 1961 and 1965, the rate of gain in time and savings deposits has been nearly seven times as fast as the increase in demand deposits. Savings deposits generally have good stability. And so do many time deposits; but the stability of the marketable certificate of deposit is related to available rates on other money market instruments.

Many banks may be willing to live with higher loan-deposit ratios in good part because they have an understandable faith in the quality of their earning assets and a confidence in their ability to maintain deposit levels. But such confidence may not be sustainable, particularly in the case of banks that have a sizable volume of certificates of deposit and find that conditions are not conducive to renewing or replacing the certificates.

RESERVES AGAINST DEPOSITS. We all know that time and savings deposits carry lower required reserve ratios than

do demand deposits and that there are no reserve requirements for capital accounts. Consequently, in building up time and savings deposits and adding to capital, banks have reduced the proportion of their assets held as required reserves. In addition, on several occasions in recent years, the Federal Reserve has acted to reduce the amount of reserves needed by the banks; it has reduced the percentage of required reserves in respect of demand and time deposits and it has permitted vault cash to be counted as reserves. Since the end of 1960 the reduction in effective reserve requirements on deposits, combined with the increase in capital accounts, has made possible about one third of the total advance in the average loan-deposit ratio. Thus, total bank earning assets—loans and investments—have increased relative to deposits.

SELECTIVITY IN MANAGEMENT OF ASSETS. Although the current levels of loan-deposit ratios may well be equivalent to considerably lower ratios than in the past, banks in the period ahead will have to be particularly selective in managing their assets. Happily, the business expansion to date has apparently been characterized by few destabilizing excesses. Fiscal and monetary policy have contributed to the continued viability of the expansion; and current economic prospects are good, provided we deal appropriately with price and cost pressures and we keep pressing for solutions of our balance of payments difficulties. There is a real danger, however, that long continued prosperity and the increasing need for larger income to pay for the higher cost deposits may lull bank management into a complacent acceptance of lower credit standards and the relaxation of procedures that should continue to be strict.

Even if the steady pace of the economic expansion is maintained, bankers will have to think about the capacity of bank portfolios to adjust to the flows of interest-sensitive liquid balances. The realities of the marketplace suggest that banks cannot expect their competitors to stand still in the face of the large absolute and relative gains of banks in the money and credit markets. Thus, although time and savings deposits are more stable than demand deposits on a day-to-day or month-to-month basis, such deposits may still prove quite variable over time as investors respond to changing rate differentials among competing short-term earning assets. Even if corporate time deposits remain at a high level they can and do move from one bank to another in response to small rate differentials. Thus, these deposits may simultaneously be stable for the banking system as a whole, yet volatile for individual banks. That volatility implies that management should preserve its ability to adjust to a failure, however temporary, to renew or replace maturing time deposits.

EQUIPMENT LEASING. I would also raise a word of caution about equipment leasing. As the advisory committee to the New York Superintendent of Banks has pointed out,³ equipment leasing has the same underlying purpose and practical effect as other commonly accepted financing devices such as a term loan secured by a chattel mortgage. Therefore a leasing proposal should be approached with similar considerations and caution. For example, the term of a lease of equipment, or of a loan secured by a chattel mortgage on equipment, should be related to the useful life of the equipment being financed. It would be a departure from sound banking practice for a bank to rent equipment to a succession of lessees under circumstances in which the bank would have full risk of ownership.

TERM LOANS. Commercial banks are uniquely qualified to meet the short-term credit needs of business, and such lending is their primary responsibility. But, if banks commit larger and larger portions of their available funds to credits maturing in several years or more, will they be able to satisfy the shorter term requirements of business, especially if the Federal Reserve reduces the pace at which it supplies reserves to the banking system? Another way of looking at this matter is to raise the question whether bankers should not advise borrowers to turn more frequently to the capital markets and sell shares or bonds in order to meet their long-run needs for funds.

BANK BORROWING. While the success of commercial banks in attracting and holding short-term funds has helped to create the gratifying record of meeting credit needs, it has also raised questions about the appropriateness of the various forms of short-term bank indebtedness. There is not much difference in substance between a demand deposit and a loan to a bank by a customer for a day or two. Nor is there much difference between a thirty-day certificate of deposit and a thirty-day promissory note. Yet, only deposits, because of their legal form, have been subject to statutory restrictions on the payment of interest, to reserve requirements, and to FDIC assessments. Since the effect is the same, whatever the form, the Federal Reserve Board has proposed that short-term promissory notes be treated the same way as certificates of deposit. The Board has published its proposal in the Federal Register and has asked for comments by February 25.⁴

BANK CAPITAL. Of course, a bank should also maintain a sound capital structure as its business expands. Bank

capital accounts increased in 1965 by about \$2.5 billion, or by roughly 9 per cent, compared with less than 7½ per cent on average in the four preceding years. We should note, however, that a substantial portion of the increase in the last two years took the form of capital notes and debentures. Indeed, the rise in borrowed capital from \$150 million at the end of 1963 to \$1.6 billion at the end of 1965 has accounted for more than 30 per cent of the rise in capital accounts over the period. The increased use of borrowed capital apparently reflects the belief among a number of bankers that capital notes and debentures are a relatively inexpensive way to raise capital; not only do they bring tax advantages, but they provide through greater leverage the possibility of increased earnings for stockholders.

While this leverage is favorable to stockholders when bank earnings are rising, the effect may be adverse when earnings are falling. And it is important not only for stockholders but also for depositors and the general public that borrowed capital not be excessive. It seems to me that debt capital should not exceed a reasonable percentage of a bank's total capital funds; that the debentures should be amortized over a reasonable period; that the bank should be able, on some reasonable basis, to call the debentures for payment before their stated maturity; and that upon the retirement of the debentures there should be a corresponding increase in the bank's permanent capital, e.g., by a transfer from undivided profits to surplus. As a starter, I would suggest that the debentures not exceed 25 per cent of the bank's total capital funds and that there should be provision for complete retirement out of earnings over a reasonable period, say, twenty-five years.

SELF-RESTRAINT IN MAKING LOANS

As bankers see the likelihood of strong loan demand continuing or perhaps intensifying, there is a natural inclination to raise the rate of interest they pay on time deposits in order to assure themselves against a runoff of such deposits and to pick up some additional deposits. As competing banks take similar steps, the rates can ratchet upward without producing a substantial amount of additional deposits to satisfy the strong loan demand.

In the present situation in which the economy is operating close to capacity ceilings and credit cannot be expected to grow at the extraordinarily rapid rate of last year, the individual banker will have to be more selective in meeting loan requests. He will have to exert ingenuity in paring down loan demands. And in making loans he will have to consider more criteria than merely the creditworthiness of the borrower. He will have to apply some order of priorities. For example, in a period of inflationary pres-

³ *Report of Advisory Committee*, page 4.

⁴ 31 Federal Register 1010 (January 26, 1966).

sure a so-called nonproductive loan, such as a loan to purchase an additional plant or company where no over-all increase of production would result, or a loan for speculative investments or purchases, would generally have a much lower priority than a loan for the production or distribution of goods.

JUDGMENT OF INDIVIDUAL BANK

The proper structuring of loans and investments and of their maturities is, of course, a problem for the individual

bank. Each bank must judge for itself the degree of vulnerability to sizable deposit drains and whether its portfolio is appropriate to the risks. The need for this self-appraisal does not imply that a bank should stop seeking new ways to accommodate loan demands or the needs of its depositors. But the employment of these new techniques should be consistent with the time-honored necessity of serving the public interest and of balancing the interests of the bank's customers, its depositors, and its stockholders. The primary responsibility for this balancing rests on the management of the bank.

The Business Situation

As the current business expansion rounds out its fifth full year, domestic economic activity continues to move ahead with undiminished vigor; and indeed there has been some acceleration in the pace of the advance in recent months. Despite a reduction of excess steel inventories, the fourth-quarter gain in gross national product (GNP) exceeded that recorded in the third quarter, and the expansion in both employment and industrial production speeded up. All current indications point to further strong advances in economic activity in 1966. The push that is expected from further gains in consumption and in business capital spending will be strongly reinforced by Government spending for goods and services as projected in the Administration's budget. Expanding military requirements, which are the major factor in the projected rise in Federal purchases, are already having a discernible impact on the economy. The difficulty of forecasting precisely the future trend of such requirements constitutes a source of uncertainty in any current assessment of the balance between likely demand conditions and resource availability during the months ahead. Although present estimates point to only a small deficit in the administrative budget in fiscal year 1967—and to a small surplus in the more comprehensive cash budget—these finely balanced calculations could be upset by developments at home or abroad.

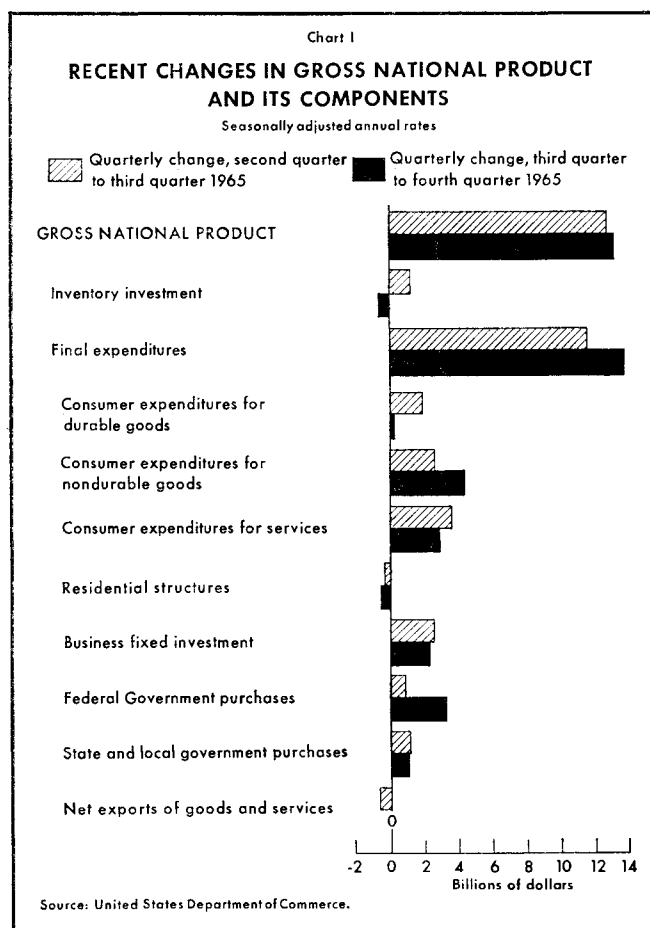
Recognizing the potential risk of excessive demand pressures, the President has asked Congress to repeal temporarily the automobile and telephone excise tax cuts that became effective on January 1, to bring personal withholding tax payments more in line with actual tax liabilities, and to accelerate the shift of corporate tax payments to a pay-as-you-go basis. While the two latter measures would leave actual tax rates unchanged, they would increase tax collections this year and thus might result in some postponement of business and consumer spending, although the magnitude of such an effect is extremely hard to predict. Even after allowing for the possible effects of the measures proposed by the President, the Council of Economic Ad-

visers has projected that the increase in GNP for 1966 as a whole will nearly match, and may possibly exceed, the \$47 billion gain recorded last year. The Council's projection puts GNP this year in the \$717-727 billion range with a midpoint of \$722 billion which, if realized, would represent a rise of nearly 7 per cent.

The high rate of growth in aggregate demand now in prospect strongly suggests that this year will witness a further reduction in the margin of unutilized resources and continued upward pressure on prices and costs. Meanwhile, prices continue to rise. The wholesale price index advanced sharply in December, and some further increase apparently occurred in January. Although the rise in the over-all index in recent months was largely attributable to continuing increases in agricultural prices, the prices of a number of industrial products have also risen. Supply shortages are causing persistent upward pressure on some prices, and the daily price index for a group of important raw industrial commodities has advanced steadily for several months. In January, this index reached its highest level in more than a decade. Prices moved markedly higher in December at the consumer level as well, in large part because of a renewed advance in food costs. Prices of other consumer goods and of services also continued to rise, however.

RECENT PATTERNS OF DEMAND

Aggregate spending for goods and services increased by \$13.1 billion (seasonally adjusted annual rate) in the fourth quarter of 1965, according to the Commerce Department's preliminary estimate (see Chart I). This increase was somewhat larger than that recorded in the preceding three months, and was in fact one of the largest quarterly gains of the entire current business expansion—exceeded only by a slightly larger gain very early in the upswing and by the rise of \$16.5 billion in the first quarter of 1965 when economic activity rebounded sharply



from the effects of the auto strikes late in 1964.

Federal Government spending for goods and services provided an important boost to the expansion of aggregate demand in the fourth quarter of 1965. In contrast with the very mild uptrend of recent years, Federal outlays advanced sharply to register their largest quarterly gain in more than a decade. While the unusually large size of the advance was partly attributable to the fact that a Federal pay increase took effect during the quarter, a significant share of the gain reflected the current program of expansion in the armed forces and in military procurement. State and local government spending once again provided a modest contribution to demand expansion in the October-December period.

The pace of business inventory accumulation appears to have moderated slightly in the fourth quarter, with investment in additions to stocks running at an annual rate \$0.6 billion below that of the preceding three months.

There was a sharp decline in steel inventories in the fourth quarter, following the strike-hedge buildup earlier in 1965, and this special influence was responsible for the slowdown in over-all inventory accumulation. There continued to be a sizable expansion in nonsteel inventory holdings. In contrast with inventory investment, the volume of business fixed investment increased once again in the fourth quarter. The vigorous growth of capital spending was a very important factor contributing to the expansion of over-all GNP throughout 1965, and present indications point to yet another large gain this year.

Residential construction spending, the one major demand component that has failed in the past two years to share in the over-all expansion of economic activity, slowed once again in the fourth quarter. Some developments in the final months of 1965, however, suggested that a limited improvement may be seen at least over the near term. Private nonfarm housing starts moved up sharply in November and December, with the rate in the latter month reaching the highest level in nearly two years. Also, the number of units authorized by newly issued building permits increased in December for the third consecutive month, and likewise reached the highest level in nearly two years.

Buoyed by the steady rise in employment and incomes and by a sustained high degree of confidence, consumer demand for goods and services continues to provide an important thrust to the over-all expansion of output. There was a slowdown in the pace of spending on automobiles in the fourth quarter, following an exceptionally strong third quarter, and the growth of total outlays for durable goods was thus held to a moderate pace. However, demand for nondurables surged ahead—although the size of the gain partly reflected the trend to higher prices for food and apparel—and spending on services continued to expand at a rate in line with the average during the past two years.

The new car sales picture has been somewhat distorted recently by the impact of actual and proposed changes in the automobile excise tax. In January, when the excise tax was cut from 7 per cent to 6 per cent, the sales pace surged to a seasonally adjusted annual rate of nearly 9½ million units, after having fallen off from a very high 9 million in November to 8½ million in December. Of course, the large January gain may have reflected not only some purchases postponed from December but also some speedup in buying in anticipation of the proposed return of the tax rate to 7 per cent. Sales performance over the near term will probably continue to be affected by consumer reactions to developments with regard to the tax.

The brisk advance of aggregate demand late in 1965 was reflected in an acceleration in the uptrend of the Federal Reserve's seasonally adjusted production index. In

December, the index rose by a full 2 percentage points to 148.3 per cent of the 1957-59 average, following a gain of 1.5 points in November. By contrast, the monthly advance had averaged 0.8 percentage point in the eight months of 1965 preceding the early-September steel labor settlement. The sharp December rise in the index reflected widespread output gains. Although the new car assembly rate did not increase further from the advanced November level, output of other consumer goods and of equipment continued to expand. Materials production rose sharply, buoyed by an upturn in steel output following four months of decline from the peak reached last July.

Steel industry analysts are increasingly optimistic over the prospects for significant production gains during the current quarter. It appears that the decumulation of excess steel inventories is virtually completed, and steel users—particularly capital equipment and motor vehicle manufacturers as well as certain defense industries—are entering a growing volume of new orders. Indeed, lead times for some types of steel are reported to be lengthening, and seasonally adjusted steel ingot production rose by a further 8 per cent in January to reach the highest level since last August. The momentum of recent months has been maintained in other industries as well, with expanding defense procurement providing—in an increasingly broad range of industries—additional strength in an already bright demand picture. New orders received by manufacturers of durable goods rose substantially in December to reach a record volume, and the already large backlog of unfilled orders recorded yet another large increase.

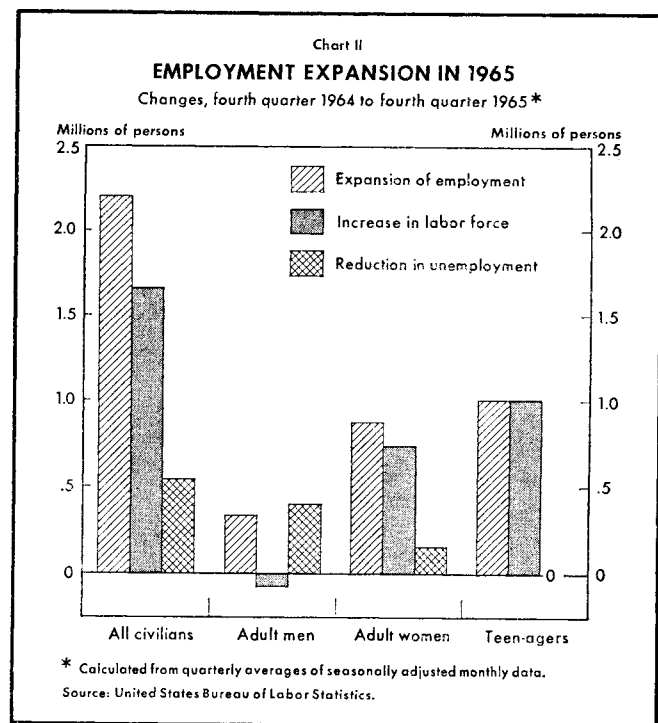
LABOR MARKET DEVELOPMENTS

In response to the pervasive strength in the economy, employment expansion also speeded up in the final months of 1965. The number of persons at work in nonagricultural establishments rose in December by almost 370,000 to reach 61.8 million (seasonally adjusted), following an even larger increase in November. The average monthly gain in the fourth quarter amounted to nearly 350,000 persons, in contrast with a monthly average of about 200,000 in the first three quarters of 1965. The step-up in employment growth late in the year was particularly noticeable in construction—where unseasonably warm weather in some areas was a contributing factor—and in manufacturing. Moreover, the average workweek of manufacturing production workers has lengthened further. Indeed, in both November and December these workers averaged a longer week than at any time since World War II.

Civilian employment as a whole has also been growing at a substantial pace. In January, the over-all unemploy-

ment rate edged down slightly further to reach 4.0 per cent, the lowest reading in nearly nine years. During 1965, the growth in the number of jobholders outpaced the expansion of the labor force by a substantial margin, and as a result the unemployment rate declined from an average of 5.0 per cent in the fourth quarter of 1964 to 4.2 per cent in the fourth quarter last year. Altogether, civilian employment expanded by 2.2 million persons over that one-year period, while the civilian labor force grew by just short of 1.7 million persons. Thus, the ranks of the unemployed shrank by about a half million (see Chart II).

It is noteworthy that the net increase in the civilian labor force was comprised entirely of women and teenagers, whereas the reduction in unemployment consisted very largely of adult men. The total population of adult men (aged 20 and over) expanded only moderately in 1965, and the rise was especially small in the 25- to 55-year-old range, where the proportion of the male population participating in the labor force is highest. Moreover, the number of adult men in the armed forces rose significantly. As a result of these factors, the number of adult men in the civilian labor force actually declined by almost 70,000 between the fourth quarter of 1964 and the fourth quarter of 1965. The net demand for additional adult male employees therefore had to be met by drawing on the un-



employed men already in the labor force. Thus, the number of unemployed men dropped by 25 per cent—from 1.6 million to 1.2 million.

The sizable growth in the number of adult women and teen-agers in the labor force during 1965 was due to the combined effects of population increase and a heavy demand for additional workers. There was a larger rise in the total population of adult women than was the case for adult men, while the teen-age population registered an exceptionally large gain. At the same time, the labor force participation rates of women and teen-agers increased. The rates of these two groups, in contrast with those of adult men, tend to be responsive to over-all demand conditions—rising in good times when the employment situation is favorable and declining somewhat in

periods of slack demand. The growth in the number of adult women and teen-agers in the labor force during 1965 was just about in line with the expansion of job opportunities for these two groups, and there was thus only a relatively small reduction in the number of unemployed women and none at all for teen-agers.

The outlook for 1966 is one of further tightening in the labor market, with only a modest increase expected in the adult male labor force. Moreover, a sizable expansion in the armed forces is planned for this year, which will tend to reduce the availability of additional adult men for civilian employment. Thus, sustained expansion of the economy will in all likelihood result in additional reductions in the number of the unemployed and increasing utilization of women and teen-age workers.

Recent Banking and Monetary Developments

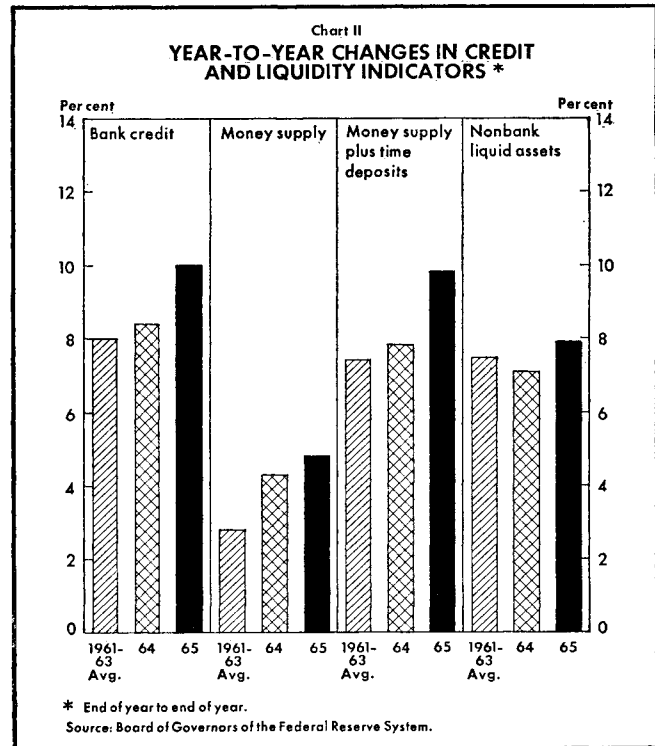
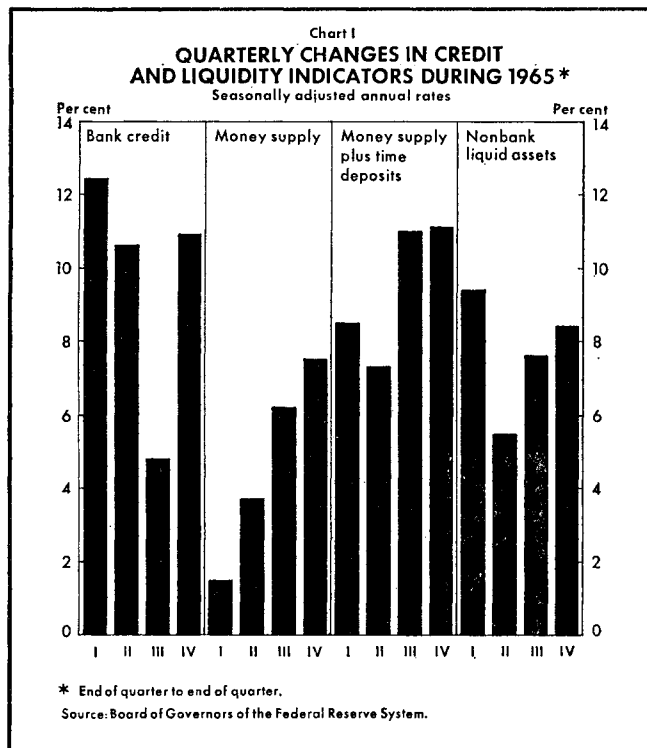
The growth of bank credit accelerated in the fourth quarter, expanding at more than twice the rate of the preceding quarter. Although the Federal Reserve discount rate was increased in early December from 4 per cent to 4½ per cent, bank credit continued to expand at the high rate set in November as the System supplied reserves in volume to ease money market adjustment to higher rate levels.¹

Special demand factors affecting bank credit in the final three months of 1965 included sizable Treasury financings in October and November as well as unusually large borrowing needs associated with the regular December corporate dividend and tax dates. The ample supply of reserves made available by the System in December

enabled banks to meet heavy year-end loan demands without a substantial liquidation of the short-term Government securities acquired during the earlier Treasury financings. Indeed, bank holdings of United States Government securities grew substantially during the October-December period as a whole. By the year-end, interest rates in the money and capital markets had moved markedly upward, but the new rate levels were still being tested as market participants attempted to evaluate the many uncertainties in the economic and financial outlook.

The fourth-quarter performance of the deposit liability counterparts of bank credit featured a sharp rise in private demand deposits, associated with the December corporate dividend payment date, and also a drop in the rate of time deposit growth. Government deposits, which had declined steadily since midyear, were lifted by tax receipts in December. Reflecting primarily the expansion in commercial bank deposits, total liquid asset holdings of the nonbank public grew more rapidly than gross national product (GNP) in the fourth quarter.

¹ For details on the discount rate increase and subsequent money and bond market developments see this *Review*, December 1965, pages 254-55, and January 1966, pages 7-11.



BANK CREDIT AND LIQUIDITY

Total bank credit expanded at a 10.9 per cent seasonally adjusted annual rate over the fourth quarter of 1965, exceeding the pace in the two preceding quarters but falling short of the unusually rapid 12.4 per cent advance in the first quarter of the year. Although sharply varying monthly and quarterly rates of growth in total loans and investments during 1965 did, at times, obscure the underlying trend, the 10 per cent pace for the year as a whole was significantly higher than the roughly 8 per cent per year average over the preceding four years of economic expansion. (See Charts I and II.)

A sizable fourth-quarter rise of 12 per cent in total bank loans was led by a December surge in business borrowing stemming from vigorous capital spending by business in addition to large year-end dividend and tax requirements. The reduction of strike-hedge steel inventories, which had been a factor tending to moderate business borrowing during most of the fourth quarter, was less of a restraining factor by the end of the year. Consumer and real estate loans by banks continued their persistent climb characteristic of most of the current expansion. After a substantial decline in the third quarter, the more volatile

securities loans rose sharply in October and November, primarily in response to enlarged Treasury financing activities.

Bank investments rose at a substantial 8.8 per cent seasonally adjusted annual rate during the fourth quarter of 1965. The dollar increase was divided about equally between bank holdings of United States Government securities and holdings of "other securities". This was in marked contrast with the pattern of the first three quarters of the year when substantial reductions in holdings of United States Government securities virtually offset bank net purchases of municipals and other securities. The strength in bank investment in Governments was partly attributable to the concentration of Treasury financings in October and November, but the ability of banks to meet very strong year-end loan demands without a large-scale liquidation of these securities reflected to a large extent the willingness of the Federal Reserve System to supply large amounts of additional reserves during the weeks following the rise in the discount rate.

Although investments accounted for a larger share of the bank credit advance in the fourth quarter than earlier in the year, the loan-deposit ratio at all commercial banks continued to move upward. Excluding borrowings by

brokers and dealers from the loan total, the loan-deposit ratio for the commercial banking system rose to 63.1 per cent at the end of 1965, up from 62.6 per cent at the end of the third quarter and 58.6 per cent at the end of 1964. At weekly reporting member banks, the loan-deposit ratio stood at 67.9 per cent by the year-end, up only slightly from 67.8 per cent at the end of the third quarter but appreciably higher than the 63.6 per cent at the end of 1964.

The substantial growth of bank credit during the final three months of 1965, coupled with a shift of the deposit mix from time deposits toward the demand deposit category with its relatively higher reserve requirement, involved large open market purchases by the Federal Reserve System to provide for the associated expansion of bank reserves. Federal Reserve bank credit outstanding rose by about \$2.2 billion during the fourth quarter. Member bank net borrowed reserves declined from an average of \$149 million in October to an average of only \$11 million in December—with banks showing positive free reserve positions in the two weeks following the rise in the discount rate. On a seasonally adjusted basis, total nonborrowed reserves grew at an annual rate of 9.7 per cent over the fourth quarter, compared with a 4.2 per cent rate for the year as a whole.

BANK DEPOSITS AND TOTAL LIQUID ASSETS

The rapid growth in total private bank deposits during the fourth quarter was, as noted earlier, highlighted by an extremely large December surge in private demand deposits. Consequently, the seasonally adjusted daily average money supply (which includes currency outside banks as well as private demand deposits) rose at a 7.5 per cent annual rate over the fourth quarter, higher than the rapid 6.2 per cent third-quarter pace and well above the 4.8 per cent increase for 1965 as a whole. (See Charts I and II.) In part, the uneven growth of the privately held money supply during 1965 may have reflected the behavior of

Treasury demand deposits. During the first five months of the year, the Treasury accumulated deposits at an unusually fast rate and the private money supply showed little change on a seasonally adjusted basis. Over the remainder of the year, however, Treasury deposits declined by \$4.8 billion—much more than is ordinarily the case. With these deposits flowing back into private hands, the private money supply received a substantial boost.

The growth in daily average time deposits over the final three months of 1965 was at a 15.3 per cent annual rate, somewhat below the 16.8 per cent pace for the third quarter. For money supply and time deposits combined, the fourth-quarter rise was at a seasonally adjusted annual rate of 11.1 per cent, slightly higher than in the third quarter.

Nonbank liquid assets, which include commercial bank time and demand deposits and other forms of liquid assets owned by the nonbank public,² increased at an annual rate of 8.4 per cent over the fourth quarter of 1965, exceeding the corresponding growth rate of just under 8 per cent in GNP. As a result mainly of the especially rapid growth of privately held commercial bank deposits, the fourth-quarter advance in nonbank liquid assets was also faster than the growth rates in these assets of 7.9 per cent and 7.1 per cent during all of 1965 and 1964, respectively. The other deposit components of liquid assets—including savings and loan shares, deposits at mutual savings banks, and postal savings deposits—grew in total at a 7.3 per cent annual rate over the fourth quarter, down from a 7.9 per cent pace for 1965, and substantially below the 10.8 per cent rate for 1964.

² Total liquid assets include demand deposits and time deposits (adjusted) at all commercial banks and currency outside banks—all measured on a last-Wednesday-of-the-month basis; also, deposits at mutual savings banks, savings and loan shares, postal savings deposits, United States Government savings bonds, and the public's holdings of United States Government securities maturing within one year—all measured on an end-of-the-month basis.

The Money and Bond Markets in January

Activity in the financial markets was considerably impeded during the early part of January by the effects of a mass transit strike in New York City which brought a halt to public subway and bus service from January 1 to January 13. The strike hampered the processing of securities transactions, slowed check-clearing operations, and handicapped the estimation and satisfaction of reserve needs. In order to alleviate some of these problems, the Federal Reserve Bank of New York requested participants in the Government securities market to avoid trading on a same-day delivery basis for the duration of the strike. On January 13, a strike settlement was reached and the financial markets quickly returned to a more normal operating basis.

The money market was generally quite firm during the early part of January when reserve distribution favored the "country" banks. This development reflected in part the usual seasonal pattern, but was accentuated by the New York City transit strike. During this period, the major reserve city banks experienced large deposit drains, amassed substantial basic reserve deficits, and bid strongly for Federal funds. In the latter part of January, however, the reserve position of the New York City banks improved and the tone of the money market eased somewhat. Treasury bill rates edged upward through midmonth, as an expanding supply of bills in the market encountered a rather modest investor demand. In the second half of the month, demand generally was strong and rates receded irregularly until late in the period when offerings expanded and bill rates rose.

Prices of Treasury notes and bonds moved higher in the first third of January in active trading which included a heavy volume of switching operations. Subsequently, activity tapered off and prices of most issues drifted irregularly lower as participants awaited the terms of the Treasury's February refunding. Late in the month, the market initially reacted favorably to the refinancing terms (see details below). Prices of outstanding intermediate-term issues moved moderately lower, however, in adjustment to the

approaching increase in the supply of such issues, while prices of longer term issues also declined. Further price weakness developed as the month closed, following the resumption of United States bombing of North Vietnam. In the markets for corporate and tax-exempt bonds, prices were unchanged to slightly lower through much of the month as investors accorded lukewarm receptions to many of the period's new issues.

THE MONEY MARKET AND BANK RESERVES

During the first two statement periods of the month, the money market functioned in the shadow of the New York City transit strike, which disrupted operations throughout the financial community. During this time, a very firm tone emerged in the money market as banks in New York City and in other reserve centers experienced fairly sizable deposit drains and mounting reserve pressures. In the statement week ended January 12, the eight principal money market banks in New York City amassed a record average basic reserve deficit of \$1,358 million, while the basic reserve deficit of the thirty-eight major money market banks outside New York City was also substantial (see Table II on page 40).

To cover these deficits, the money market banks bid strongly for Federal funds and raised residual funds through borrowings from the Federal Reserve. While a good availability of Federal funds did emerge at the generally prevailing rate of 4½ per cent, country banks held on to a sizable volume of reserves—building up average excess reserves of more than \$600 million in the week ended January 12. Average nationwide net reserve availability expanded by \$349 million, as net borrowed reserves of \$249 million in the statement week ended January 5 gave way to free reserves of \$100 million in the week ended January 12. This sharp swing in aggregate reserve availability within the context of a generally firm money market provides another striking illustration of the inadequacy of any single statistic—such as free (or net

Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, JANUARY 1966

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

Factors	Changes in daily averages— week ended				Net changes
	Jan. 5	Jan. 12	Jan. 19	Jan. 26	
"Market" factors					
Member bank required reserves*.....	— 337	+ 413	+ 278	+ 106	+ 460
Operating transactions (subtotal)	— 55	— 140	+ 461	— 49	+ 217
Federal Reserve float	— 347	+ 24	+ 51	— 356	— 628
Treasury operations†	+ 87	— 56	— 38	— 44	— 51
Gold and foreign account	— 60	— 11	+ 41	— 8	— 38
Currency outside banks*	+ 330	— 14	+ 406	+ 350	+ 1,072
Other Federal Reserve accounts (net)‡	— 66	— 81	+ 1	+ 9	— 137
Total "market" factors	— 392	+ 273	+ 739	+ 57	+ 677
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	— 24	+ 316	— 490	— 123	— 421
Bankers' acceptances	+ 8	—	+ 1	— 1	+ 8
Repurchase agreements:					
Government securities	+ 202	— 101	— 322	—	— 221
Bankers' acceptances	+ 45	— 25	— 49	+ 35	+ 6
Member bank borrowings	+ 16	+ 28	— 372	+ 134	— 194
Other loans, discounts, and advances...	— 8	— 15	+ 1	— 2	— 24
Total	+ 239	+ 104	— 1,232	+ 44	— 845
Excess reserves*	— 153	+ 377	— 493	+ 101	— 168

	Daily average levels				
Member bank:					
Total reserves, including vault cash*.....	23,267	23,231	22,460	22,455	22,853½
Required reserves*	22,954	22,541	22,263	22,157	22,479½
Excess reserves*	313	690	197	298	375½
Borrowings	562	590	218	352	431½
Free reserves*	— 249	100	— 21	— 54	— 56½
Nonborrowed reserves*	22,705	22,041	22,242	22,103	22,423½

	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 601	- 721	- 849	+ 116	- 853
More than one year	-	-	-	-	-
Total	+ 601	- 721	- 849	+ 116	- 853

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 four weeks ended January 26.

Table II
RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS
JANUARY 1966

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended				Average of four weeks ended Jan. 26
	Jan. 5	Jan. 12	Jan. 19	Jan. 26	
Eight banks in New York City					
Reserve excess or deficiency(—)*.....	24	17	36	— 2	19
Less borrowings from Reserve Banks.....	170	289	66	61	147
Less net interbank Federal funds purchases or sales(—).....	639	1,086	902	— 171	614
<i>Gross purchases</i>	1,147	1,587	1,621	1,029	1,346
<i>Gross sales</i>	507	501	719	1,200	732
Equals net basic reserve surplus or deficit(—).....	— 786	— 1,358	— 932	108	— 742
Net loans to Government securities dealers.....	717	666	644	516	636

Thirty-eight banks outside New York City

Reserve excess or deficiency(—)*	25	28	23	17	23
Less borrowings from Reserve Banks...	143	135	26	99	101
Less net interbank Federal funds purchases or sales(—)	507	696	956	938	774
Gross purchases	1,108	1,356	1,599	1,586	1,412
Gross sales	602	661	643	648	639
Equals net basic reserve surplus or deficit(—)	- 627	- 803	- 959	- 1,020	- 852
Net loans to Government securities dealers	113	253	346	212	231

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—Jan. 1966				
	Jan. 3	Jan. 10	Jan. 17	Jan. 24	Jan. 31
Three-month	4.532	4.585	4.673	4.596	4.628
Six-month	4.718	4.737	4.770	4.699	4.740
	Monthly auction dates—Nov. 1965-Jan. 1966				
	Nov. 23	Dec. 23	Jan. 25		
One-year	4.276	4.731	4.699		

* 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.

borrowed) reserves—as a gauge of monetary policy. A sharply contrasting picture is given by another statistic, member bank borrowings from the Reserve Banks, which changed little during the two weeks (see Table I).

With the redistribution of available reserves to the money center banks, the money market became progressively more comfortable over the week ended January 19—despite a contraction of \$121 million in average nationwide net reserve availability. The basic reserve position of the major New York City banks improved markedly, though these banks remained in a deep deficit, as did the leading banks in other money centers (see Table II). However, the money market banks were able to satisfy their reserve needs readily in the Federal funds market at rates ranging from $4\frac{5}{8}$ per cent at the beginning of the week to as low as 1 per cent at the end, and average member bank borrowings from the Federal Reserve Banks fell by \$372 million to \$218 million. Having built up a huge volume of excess reserves the week before, country banks reduced their average excess reserves by more than half a billion dollars to \$95 million.

The money market became firmer during the final statement week of January but was less taut than it had been early in the month. The leading money market banks outside New York remained under heavy reserve pressure. They were able, however, to cover the bulk of their reserve needs in the Federal funds market where funds traded mainly in a $4\frac{1}{4}$ to $4\frac{5}{8}$ per cent range. During this period, nationwide reserve availability held fairly steady but reserves were concentrated at country banks and in New York City. In fact, the eight major New York City banks moved into an average basic reserve surplus position of \$108 million, after having run a basic reserve deficit averaging more than a billion dollars over the preceding five-week period. The comfortable reserve positions of the New York banks permitted these banks to be net suppliers of Federal funds and thus had a moderating effect on money market pressures.

Rates charged by the major New York City banks on their call loans to Government securities dealers were generally quoted in a $4\frac{3}{4}$ to $5\frac{1}{8}$ per cent range except briefly around midmonth when rates as low as 3 per cent were posted. Rates for several types of short-term money market instruments moved upward during the period. Many of the major banks in New York City raised their offering rates on new three- and six-month negotiable time certificates of deposit by about 15 and 25 basis points, respectively. Rates on prime certificates of deposit trading in the secondary market rose by approximately 5 to 25 basis points. Offering rates on the various maturities of directly placed finance company paper and those on commercial

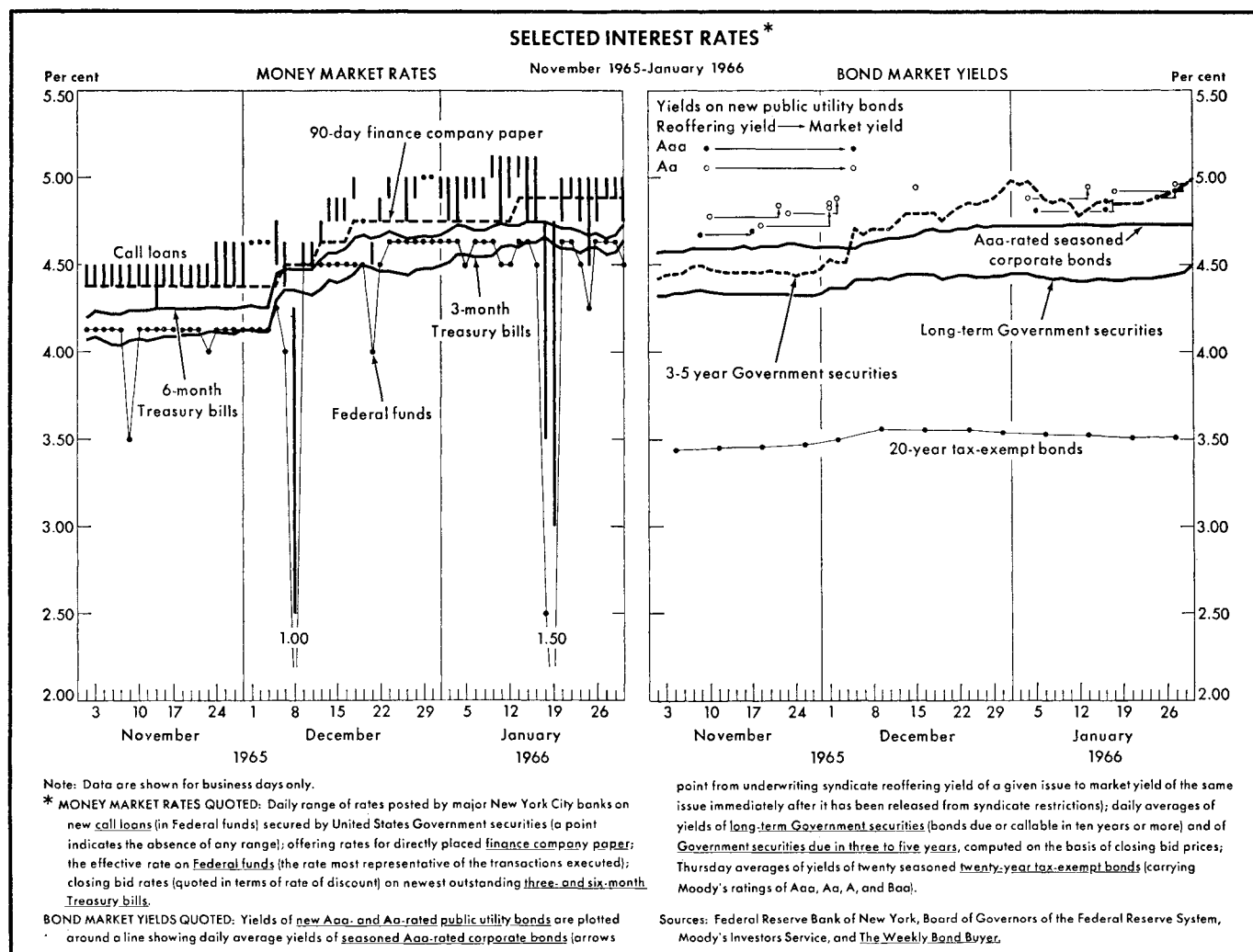
paper rose by $\frac{1}{8}$ of a per cent. At the end of the month, rates on commercial and finance company paper and on bankers' acceptances were generally $\frac{1}{2}$ of a per cent above the rates prevailing just prior to the December increase in the Federal Reserve discount rate.

THE GOVERNMENT SECURITIES MARKET

The effects of the early January transit crisis were particularly apparent in the market for Treasury bills, where a large proportion of transactions are normally conducted on a same-day delivery basis. Uncertainty over deliveries hampered activity and gave rise to considerable caution on the part of dealers. In addition, the supply of bills available in the market increased as commercial banks sold bills which they had held for year-end statement purposes. Moreover, the Treasury began adding \$100 million to its weekly offering of three-month bills starting with the January 3 auction and also offered approximately \$1.5 billion of new ten-month certificates of indebtedness on January 10 (see details below). While supplies were increasing, the demand for bills was rather limited and confined mainly to longer maturities. Some investment selling also developed, prompting professional offerings of bills. Dealer offerings were aggressively pressed upon the market, as rates on several competing money market instruments—especially new time certificates of deposit—moved upward and as higher rates on dealer borrowings tended to raise their inventory carrying costs. Against this background, Treasury bill rates edged irregularly higher through midmonth. At the regular weekly auction held on January 17, the three-month bill was sold at a record high average issuing rate of 4.673 per cent.

Subsequently, bill demand expanded—particularly for shorter maturities—partly in reflection of more comfortable conditions in the money market. Declining dealer financing costs also made professional participants less anxious sellers. As a result, bill rates edged irregularly lower from January 18 almost until the close of the month. Late in the period, some reinvestment demand for bills developed as holders of coupon issues eligible for exchange in the Treasury's February refunding switched out of "rights" into bills and other securities. Reinvestment demand proved disappointing, however, professional offerings expanded, and rates moved higher at the end of the month.

In contrast to the cautious atmosphere which was evident in the bill market early in January, a better tone developed in the coupon sector of the Government securities market during the first half of the month. Although the New York transit strike interfered with operations, fairly



active trading in Treasury notes and bonds was reported. Large-scale investment switching dominated activity, while outright demand for issues maturing in over one year also triggered professional short covering. The more confident atmosphere was reinforced when market participants reacted quite favorably to the Treasury's January 5 announcement that it would receive subscriptions on January 10 for approximately \$1.5 billion of 4¾ per cent certificates of indebtedness dated January 19, and would permit commercial banks to pay for their allotments by crediting Treasury Tax and Loan Accounts. The new certificates, which will mature on November 15, 1966, were priced at a discount to yield 4.85 per cent. Subscriptions totaled about \$10.1 billion, of which \$1.65 billion was accepted by the Treasury. Subscriptions for

\$50,000 or less were allotted in full, while larger subscriptions were subject to a 14.5 per cent allotment but assured of a minimum award of \$50,000. As the moderate amount of investment demand met limited supplies, prices of notes and bonds rose during the first third of January, with gains on most issues maturing in over one year ranging from about ⅛ to ½ a point. (The right-hand panel of the chart illustrates the decline in yields which resulted from this rise in bond prices.)

Around midmonth, investment demand contracted, there was some outright selling of short- and intermediate-term issues, and prices drifted lower. The market was little affected by the Administration's forecast of a reduced Federal deficit for the fiscal year beginning on July 1, while predictions of continued buoyancy in the economy

rekindled market apprehensions that future credit demands might apply upward pressures on interest rate levels. Subsequently, market activity subsided and prices of most intermediate- and long-term issues declined irregularly as investors awaited news of the Treasury's February refunding plans.

After the close of business on January 26, the Treasury announced that it would offer holders of \$28.8 billion of notes and bonds maturing from February through August 1966 the opportunity to exchange their holdings for two new note issues. Holders of the outstanding 3 $\frac{5}{8}$ per cent and 3 $\frac{7}{8}$ per cent notes maturing on February 15 and 1 $\frac{1}{2}$ per cent notes maturing on April 1 were permitted to convert these securities into 4 $\frac{7}{8}$ per cent notes of August 15, 1967 and/or into 5 per cent notes of November 15, 1970. In addition, holders of the 4 per cent notes and 3 $\frac{3}{4}$ per cent bonds coming due on May 15, as well as holders of the 4 per cent notes and 3 per cent bonds of August 15, were allowed to exchange their holdings for the new 5 per cent notes of November 1970. Of the maturing securities eligible for exchange, \$13.7 billion was held by the public at the time of the announcement and \$15.1 billion was held by the Federal Reserve and Government Investment Accounts. Subscription books were open from January 31 through February 2, with settlement scheduled for February 15. The terms of the refinancing were initially favorably received by market participants. Prices of outstanding intermediate- and long-term issues moved lower, however, partly in response to the forthcoming additions to market supplies. A further

sharp decline in prices occurred on the final day of the month in reaction to developments in Vietnam.

OTHER SECURITIES MARKETS

Prices of corporate and tax-exempt bonds were generally steady to moderately lower over most of the month. Investor interest in new issues was restrained by the expanding volume of scheduled flotations and expectations that yields might edge higher in the expansive economic environment. In the tax-exempt sector, where a seasonally moderate volume of new issues had been marketed in December, new offerings encountered a good reception early in the month but were less well received later. New corporate bonds, many of which were aggressively bid for by underwriters and carried somewhat higher prices than had recently prevailed, were accorded a rather selective investor response. During the month, several corporate bond syndicates terminated price restrictions, and yields adjusted upward by 4 to 6 basis points on the sizable unsold balances.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 1 basis point to 4.74 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) declined by 3 basis points to 3.51 per cent (see the right-hand panel of the chart). These indexes are, however, based on only a limited number of issues and do not necessarily reflect market movements fully.