

# FEDERAL RESERVE BANK OF NEW YORK



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## Monetary Policy and Credit Pressures\*

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### CURRENT ECONOMIC SETTING

The American people are enjoying an economic expansion of a length unprecedented except during World War II. This fine achievement has been accompanied in recent months by fast-moving developments in financial markets. The demand for credit has been pressing against the available supply. Interest rates have been rising, and capital markets are faced with heavy demands.

Our understanding and our judgment in economic and financial matters—as well as our willingness to act—are being subjected to a severe test. Will we cope with recent economic and financial developments in a way that will promote the continuation of our economic expansion at a sustainable rate and promote our other national economic goals? The stakes are high. Success is important.

### ECONOMIC GOALS

By way of background, I would review with you, in the light of our national economic goals, the developments of the last five years, i.e., since the February 1961 trough of the last recession. Our goals include: (1) maximum sustainable economic growth, (2) maximum practicable employment, (3) reasonable price stability, and (4) equilibrium in international payments. These goals are interdependent. Inflation would soon distort growth patterns and undermine growth itself. Nor could we have, over the long run, maximum practicable employment at

home, unless we have a strong dollar in international markets.

Most of the funds used by business for the expansion of plant and equipment, and by state and local governments for capital improvements, come from savings. A large part of the savings of the people is channeled through financial institutions, such as savings banks, insurance companies, and pension funds. The commercial banks are also depositories of savings, but in addition they create credit. The commercial banks thus provide credit beyond the savings of the people. This additional credit equals only a fraction of the amount of savings, but it provides an important further stimulus to economic activity and a necessary base for growth. Through controlling the reserves of the banking system, the Federal Reserve is able to influence the amount of credit created by the banking system. Broadly speaking, the Federal Reserve seeks to foster the creation of enough credit to promote the attainment of our economic goals while avoiding the creation of too much credit which would tend to defeat their attainment.

### RECORD OF LAST FIVE YEARS

**ECONOMIC ACHIEVEMENTS.** In the last five years gross national product rose by over 7 per cent per annum in money terms and by over 5½ per cent per annum in real terms. In 1965, the increase was over 8 per cent and 6 per cent, respectively.

In the last five years, there has been an even faster climb in expenditures by state and local governments on goods and services. Their spending on construction of all types rose by more than 10 per cent last year; the average rate of growth over the preceding four years was 8

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\* An address at a luncheon meeting of The Municipal Forum of New York, New York City, March 24, 1966.

per cent per annum. This type of spending tends to be financed through debt securities. Last year capital issues of state and local governments rose to record levels.

In the same five-year period nearly seven million new jobs have been created. Seasonally adjusted unemployment has dropped from about 7 per cent in early 1961 to 3.7 per cent in February 1966. Unemployment among married men has been less than 2 per cent for the last three months, the lowest since 1954 when these statistics were first collected. Our basic unemployment problem today is among teen-agers and among unskilled workers, many of whom are Negroes or members of other minority groups. We are hearing more and more reports of a shortage of skilled workers.

During most of the last five years we have had greater stability in prices than at any time in the last two decades. But within the last year prices have been moving upward, and are clearly threatening our good record of price stability.

For nearly a decade we have had a persistent and severe deficit in our international balance of payments. The yearly average deficit from 1961 through 1964 was \$2½ billion. In 1965, it was \$1.3 billion; the reduction was due in large part to the voluntary restraint program which reduced the flow of capital funds abroad.

In summary, over the last five years we have failed in our efforts to achieve equilibrium in international payments, although good progress was made in 1965. We have done much better with respect to the other three goals. Our achievement over the period was promoted by a beneficial mix of fiscal policy and monetary policy.

**FISCAL POLICY.** Fiscal policy in 1961-65 was deliberately expansionary. The Federal Government was a net contributor to the flow of income, thus increasing the overall demand for goods and services. The major policy measures included liberalized depreciation allowances, an investment tax credit, and a large tax cut. The objective was to boost consumer and business purchasing power; the action proved highly effective.

**MONETARY POLICY.** Monetary policy also was distinctly expansionary during most of the current economic advance. Ample credit was available at home, but for balance-of-payments reasons short-term interest rates were prevented from declining to the extremely low levels they had reached in periods of expansionary policy in the 1950's.

The creation of substantial additional reserves for member banks allowed the banking system to expand deposits and credit. Readily available credit helped consumers to finance additional purchases, helped business to invest in more plant and equipment, and helped state and local

governments to raise vast sums above current tax revenues.

As the economy moved closer to full utilization of resources last year, signs of inflation appeared. There was a distinct speedup in the rate of advance of consumer and wholesale prices. Monetary policy responded by gradually shifting from ease toward mild restraint. Reserve availability was reduced and the banking system was obliged to move into a net borrowed reserve position, i.e., all member banks as a group were borrowing more from the Federal Reserve Banks than the total excess reserves held by all member banks. The Federal Reserve thus refrained from creating sufficient reserves to permit banks to accommodate all the increased demands for credit at unchanged interest rates. In December the Federal Reserve expressed its concern about the changing economic environment by raising the discount rate from 4 per cent to 4½ per cent. Rising interest rates were not sought as an end in themselves. They reflected the booming demands for credit and a need to prevent an excessive and inflationary upsurge.

Indeed in 1965 the Federal Reserve provided a large amount of reserves—enough to support a substantial growth in bank credit and in the money supply. In 1965 more funds were raised by borrowing than in any other year. To put it another way, the Federal Reserve did not seek—and it does not seek—to bring the bank credit expansion to a halt; it seeks only to moderate the pace of the expansion so that the overall economic advance can be sustained. Even though there were net borrowed reserves, the Federal Reserve continued to create a substantial amount of additional reserves and to facilitate further growth in bank credit and in the money supply.

If the Federal Reserve had not exercised moderate restraint, even more bank credit would have been created and the resultant increased bidding for productive resources would have led to still greater total claims on these resources. Price pressures would have been much stronger than they were.

## INFLATION

For several years inflation was not a problem in the United States. But today prices are rising, and the risk of inflationary distortion is obviously greater than at any time in the last half decade. The difficulties of measuring the precise extent of inflation do not long obscure an inflationary trend once it is under way. Once under way, inflation is difficult to stop; and stopping it creates other problems.

Inflation seriously distorts the distribution of income. It affects most severely those persons least able to help themselves. It has quite properly been called "the cruelest

tax". Inflation is, in effect, a universal tax on savings and thus undermines the basic motivations for individuals to save. Inflation distorts business decisions and encourages speculative excesses; it creates uncertainty in business investment decisions, particularly those which extend over a long period. Inflation is a major threat to equilibrium in our international accounts; by raising the cost of goods we sell to foreigners, and by encouraging imports inflation would seriously and adversely affect our international trade surplus; thus it would quickly ruin the progress we have made in reducing our balance-of-payments deficit. Inflation has a detrimental effect on the long-run willingness of investors to acquire fixed yield securities, such as mortgages, corporate bonds, and of course the obligations of state and local governments. Inflation sows, and nurtures, the seed of an eventual economic downturn.

#### OUTLOOK FOR 1966

Although 1966 is young, it is apparent that claims this year on the nation's real resources are potentially excessive. Virtually all forecasts of gross national product indicate another rise equal to or larger than that of 1965. Despite all hopes for settlement of the Vietnam conflict, there is no reasonable expectation of an immediate substantial reduction in expenditures connected with Vietnam. Indeed, the conflict continues to require increased Federal spending.

Businessmen are highly optimistic; they are planning to spend this year a sixth more on plant and equipment than they did last year, and last year they spent a sixth more than they did in 1964. In past periods of expansion, actual capital expenditures by business have exceeded preliminary estimates. When the additional plant and equipment are in operation, they will no doubt contribute to enlarged output and the more efficient production of goods. But before this happens the expenditures to create them exert further pressures on the available supply of goods and services.

There are no strictly comparable data on the capital spending plans of state and local governments, but it is widely expected that such spending will increase. In addition, consumer buying intentions are strong.

From these reports and other data, it is apparent that our economy, and particularly the nation's credit markets, will be subject to continuing strain as the year progresses.

Naturally our military effort and general defense effort will continue to have first claim on our national resources. While we foresee another good gain in the labor force and plant capacity during the coming year, shortages of skilled labor and supply bottlenecks easily could become more

common. The possibility of further increased price pressures is evident.

#### APPROPRIATE ACTION

Everybody wants further genuine economic progress. But when growth is accompanied by a substantial increase in prices, the progress is not genuine. Modest restraint early in a period of inflationary pressures will pay large dividends later.

The traditional method of dampening such pressures has been through general, indirect controls affecting overall demand. By preventing demand from increasing too rapidly, opportunity is afforded the market mechanism to assist in equating the demand for goods and services with the supply. The two principal general controls are fiscal policy and monetary policy.

The use of these general controls avoids having any governmental body decide who should get credit and how much, and who should not get credit at all. Judgments in this respect are exercised in the marketplace. And, of course, we want to avoid the direct control of wages and prices and other aspects of our economic life.

**FISCAL POLICY.** Fiscal policy involves what and how the Federal Government takes from the people in the form of taxes and otherwise, what it spends, and how it spends. The President has just signed into law legislation to rescind certain reductions in excise taxes that became effective January 1, 1966, to increase the withholding on individual income taxes, and to speed up the payment of corporate income taxes.<sup>1</sup> This fiscal policy action will help to restrain overall demand. Yet many informed observers question whether it will do enough. In their view, a further increase in taxes, some reduction in contemplated spending, or both, are needed.

Despite the speed with which the most recent tax bill was enacted, further fiscal action is likely to bring more discussion and debate in Congress, and the enactment of effective legislation could take much longer. A proposal for a tax increase is likely to produce debate not only on the nature of the increase and on whom it falls, but also on the question of what expenditures could properly be reduced. The Joint Economic Committee of Congress has expressed its concern about inflation and has urged fiscal action to combat it. The majority stresses increased taxes; the minority stresses reduced spending. In my view, it is not too soon right now for Congress through its appropri-

<sup>1</sup> Tax Adjustment Act of 1966, approved March 15, 1966.

ate legislative committees to consider what further fiscal policy steps would be appropriate.

**MONETARY POLICY.** Monetary policy has been used to moderate the growth of bank reserves, and thus dampen the rate of increase in the expansion of bank credit. In the current setting monetary policy will continue to be used to that end. Credit cannot be expected to grow at the extraordinarily rapid rate at which it grew last year. This does not mean that monetary policy will be used to bring economic growth to a jarring halt. Reserves should continue to be supplied to help banks provide credit needed for sustainable economic growth.

**BANK CREDIT.** In the last few weeks a number of commercial banks, recognizing that they will not be able to satisfy all credit-worthy borrowers, have taken steps to restrict lending to essential loans. In varying degrees banks have encouraged customers to reduce the amounts of requested loans, to postpone borrowing, and to go to the capital markets rather than the banks for credit; and in some cases loans to credit-worthy borrowers have been refused. The recent increase in the bank prime rate should complement these other steps being taken by the banks. The higher prime rate should discourage some credit demands, and should encourage business concerns in need of long-term funds to seek those funds in the long-term bond and equity markets. It should help to check a growth in total spending on goods and services that threatens to become excessive.

In times of tightness, banks view lending to their customers as more important than acquiring securities for investment. Under present circumstances, many banks may confine their purchases of municipal securities to those of municipalities with which they have direct customer relationships. It is clear that in the foreseeable future banks will not play the important role as buyers of municipal securities that they have in recent years.

**MUNICIPAL BORROWING.** From what I have said so far, it is apparent that, in my view, state and local governments in general should not at this time seek to continue the rapid expansion of the borrowing that they have undertaken in the last five years. As financial advisers to such governments and as underwriters of their securities, you will play a vital role in their financial plans in the coming year.

In the current situation of high credit demand, all state and local governments should ask themselves a variety of questions, such as: Is it necessary that spending for a particular purpose be undertaken at this time, or can it be postponed? If spending for a particular purpose must be undertaken now, would it not be advisable to seek to obtain all or part of the necessary funds through taxation rather than borrowing?

In 1951, at the time of the Korean conflict, certain criteria were established under a voluntary credit restraint program designed to curtail the total amount of credit while not interfering with essential credit.<sup>2</sup> I do not suggest the adoption of a similar program at this time, but I do suggest that it would be desirable for municipalities and municipal securities dealers to ask questions in a similar vein about issues now proposed. In 1951 it was suggested that careful scrutiny be given to issues of municipal securities involving: (1) the replacement of facilities that could continue to perform their function, (2) the construction of less essential facilities, such as war memorials and playgrounds, (3) the acquisition of rights of way not immediately needed, (4) the purchase of privately owned utilities by municipalities which involved borrowing to replace equity capital, and (5) excessive borrowing in anticipation of taxes or other revenue.

The situation today is not strictly comparable to that of a decade and a half ago. Our military forces are much stronger today, and we do not need the massive buildup required at that time; there is more leeway in the economy now; a greater capacity for growth is in prospect; monetary policy is now being used to restrain excessive aggregate demand; and current priorities probably are not quite the same. Nevertheless, some self-restraint in lending and in borrowing is needed, and some tests must be applied to encourage borrowers to cut down their borrowing.

Today, there are at least two additional types of issues that should be scrutinized carefully. One type is a security issued by a municipality in advance of the need for funds in order to invest the proceeds of the security at a profit. The Comptroller of New York State recently stated that a municipality may not issue tax or bond anticipation notes where the dominant purpose is to borrow funds to invest at a profit.<sup>3</sup> The New York Comptroller's advice is good for any governmental body anywhere and for any kind of tax-exempt security. The second type is an industrial development bond—a security issued by a governmental body to finance the purchase or construction of a plant to be leased to a business enterprise. Regardless of the effect of these two types of securities on resource utilization, their issuance at this time would add to current pressures in the capital market. There is of course a more fundamental objection: the issuance of such securities at

<sup>2</sup> See Bulletin No. 3 of Voluntary Credit Restraint Committee, 37 *Federal Reserve Bulletin* 498 (May 1951).

<sup>3</sup> Statement of Arthur Levitt, Comptroller of the State of New York, dated February 14, 1966, entitled "Statement of Policy Relative to Municipal Borrowing for Investment Purposes".



any time appears to me to be contrary to the public interest.

Quite possibly we have seen already the first signs of a most desirable self-restraint on the part of local governments. Since the end of January several dozen municipal offerings have been postponed or withdrawn, or have not been awarded because of unacceptable bids. Despite this restraint, it appears that more municipal securities have been sold so far this year than in the corresponding period last year.

Would not local governments be well advised now to finance expenditures out of current taxation to the maximum extent possible? If spending must exceed current revenues and their likely short-run growth, financing a deficit through borrowing will throw an additional burden on the capital markets now and will mortgage future revenues with high interest charges. The only important, but quite dubious, virtue of such procedure may be to postpone unpleasant but inevitable additional taxes.

Some postponement of credit demands in general and an orderly scheduling of those demands would reduce current pressures in the capital market, and would reduce the pressure on resource utilization. Any municipality that issues bonds today commits itself to pay high interest

for a long period. An easing of the Vietnam conflict, or a decision to raise Federal taxes, could bring a change in market conditions.

#### CONCLUSION

The basic strength of the American economy, and the conviction that it can provide an abundant life for all, should not obscure the fact that we now face a problem of economic priorities. The real resources of the economy now and in the immediate future cannot satisfy all the immediate desires of everyone.

Each municipality must judge for itself the immediacy and the intensity of the need for borrowing. Each investor must judge for himself whether, in the light of the overall situation, he should invest in a particular security of a particular municipality. Each municipal securities dealer must judge whether the sale of a proposed issue of municipal securities would in the long run be a service to the municipality and promote the economic goals of the nation. As these judgments of many persons are made from day to day, I would trust that their overall effect would reduce the pressures on the money and capital markets and promote our national economic goals.

## The Applicability of the Federal Antitrust Laws to Bank Mergers

By EDWARD G. GUY\*

To what extent should the antitrust laws apply to bank mergers? After extended committee hearings, Congress has found it desirable to legislate for the second time in six years an answer to this question. Public Law 89-356, amending the Bank Merger Act of 1960, was signed by the President on February 21, 1966. This article reviews briefly some of the pertinent background and sets forth the principal provisions of the new legislation. For brevity, the term "merger" will be used to include consolidations, acquisitions of assets, and assumptions of deposit liabilities as well as mergers.

### PRE-1960 BACKGROUND

Prior to 1960, controls over bank mergers were incomplete, and ineffective with respect to the competitive aspects involved. There were gaps in the controls exercised under the banking statutes by the Federal banking agencies (the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation). Mergers in some cases could be effected without obtaining Federal approval, and even in those cases where approval was required the statutes prescribed no standards by which the appropriate Federal banking agency was to be guided in determining the significance to be attributed to the anticompetitive effects of a proposed merger.

Moreover, the antitrust laws had apparently provided no solution. There was little experience by which to judge the usefulness of the Sherman Act in dealing with bank mergers. Section 1 of that act prohibits unreasonable restraints of interstate trade or commerce,<sup>1</sup> and Section 2

prohibits monopolizing and attempts to monopolize any part of such trade or commerce.<sup>2</sup> No bank merger case under the Sherman Act had come before the United States Supreme Court, and the thrust of that act in the regulated field of banking had yet to be authoritatively determined. In addition to the apparent ineffectiveness of the Sherman Act, it was understood, by probably every responsible Government official who took a position on the question between 1950 and 1960, that Section 7 of the Clayton Act, as amended in 1950,<sup>3</sup> prohibiting specified corporate acquisitions where the effect "may be substantially to lessen competition, or to tend to create a monopoly", would not apply to the usual method of merging banks through asset acquisitions.<sup>4</sup>

The legislative history of the Bank Merger Act of 1960 leaves no doubt that the competitive effects or possible antitrust implications of bank mergers were the major reasons prompting adoption of that act. It was emphasized

<sup>2</sup> Section 2 of the Sherman Act, 15 U.S.C. §2, provides in part: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor. . . ."

<sup>3</sup> Section 7 of the Clayton Act, as amended in 1950, 15 U.S.C. §18, provides in part: "No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

<sup>4</sup> This understanding was due, in part, to the terms of Section 7. As amended in 1950, Section 7, by its literal terms, reached acquisitions of corporate stock or share capital by any corporation engaged in commerce and acquisitions of corporate assets but only by corporations "subject to the jurisdiction of the Federal Trade Commission". Since bank mergers were not considered as being accomplished through stock acquisitions and since banks were not subject to the jurisdiction of the Federal Trade Commission, it was understood that Section 7 did not apply to the usual method of merging banks.

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<sup>1</sup> Section 1 of the Sherman Act, 15 U.S.C. §1, provides in part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. . . ."

that competition is an indispensable element to a strong and progressive banking system. These considerations, as well as the important gaps that existed prior to 1960 in the Federal law governing bank mergers, were stressed as the reasons why legislation was necessary.

#### THE BANK MERGER ACT OF 1960

The Bank Merger Act, as enacted on May 13, 1960, required the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation—depending on whether the resulting, acquiring, or assuming bank was to be a national bank (or a District of Columbia bank), a state member bank, or a nonmember insured bank—to pass upon applications for mergers. In so doing, the following six so-called banking factors were to be considered: (1) the financial history and condition of the banks involved, (2) the adequacy of their capital structure, (3) their future earnings prospects, (4) the general character of their management, (5) the convenience and needs of the community to be served, and (6) whether the corporate powers of the banks were consistent with the purposes of the Federal Deposit Insurance Act. In addition, the responsible agency was required to take into consideration “the effect of the transaction on competition (including any tendency toward monopoly)”. The Bank Merger Act provided that the responsible agency “shall not approve the transaction unless, after considering all of such factors, it finds the transaction to be in the public interest”. The Bank Merger Act thus made the “public interest” the ultimate consideration with regard to bank mergers. Although the responsible agency “in the interests of uniform standards” was required, except in a case involving the probable failure of one of the banks, to request reports on the competitive factors from the other two banking agencies and from the Attorney General, these reports were merely advisory. The final decision as to whether the proposed merger was in the public interest was to be made by the responsible agency on the basis of a balancing of the competitive factors and the so-called banking factors. The Senate defeated a proposed amendment which would have made the competitive factors controlling.

Although the Bank Merger Act was silent as to the applicability of the antitrust laws to a merger approved by the responsible banking agency, it was generally understood that Congress intended that the banking agency’s decision on a proposed bank merger would be determinative. A recent report of the Senate Banking and Currency Committee states that at the time the Bank

Merger Act was passed “it was clearly expected that the decision of the responsible Federal banking authority . . . would be final and conclusive”.

Accordingly, it seemed with the passage of the Bank Merger Act in 1960 that that act was to be the paramount statutory provision governing bank mergers. But then came the *Philadelphia* and *Lexington* cases.

In 1963, the United States Supreme Court held in *United States v. Philadelphia National Bank et al.*<sup>5</sup> that the proposed merger of The Philadelphia National Bank and the Girard Trust Corn Exchange Bank of Philadelphia, which had been approved by the Comptroller of the Currency under the Bank Merger Act, would violate Section 7 of the Clayton Act, as that section was amended in 1950. The understanding that such section did not apply to bank mergers accomplished through asset acquisitions was thereby laid to rest.<sup>6</sup> In the following year, the United States Supreme Court in *United States v. First National Bank & Trust Co. of Lexington et al.*<sup>7</sup> held that the consummated merger of First National Bank and Trust Company of Lexington, Kentucky, and Security Trust Company of Lexington, which had been approved by the Comptroller of the Currency under the Bank Merger Act, constituted a violation of Section 1 of the Sherman Act. In effect, these decisions meant that bank mergers approved by the appropriate Federal banking agencies under the Bank Merger Act were not rendered immune from challenge under the antitrust laws, and that in antitrust suits bank mergers would be measured solely by the standards of the antitrust laws unencumbered by the standards of the Bank Merger Act. In his *Philadelphia* dissent, Mr. Justice Harlan said, “The result is, of course, that the Bank Merger Act is almost completely nullified; its enactment turns out to have been an exorbitant waste of congressional time and energy”. Many Congressmen agreed with this position.

Thus, the Federal law applicable to bank mergers had turned out to be quite different from the law as it was generally thought to be upon the enactment of the Bank

<sup>5</sup> 374 U.S. 321 (1963).

<sup>6</sup> In his majority opinion, Mr. Justice Brennan concluded that Congress intended the 1950 amendment to give Section 7 of the Clayton Act a reach which would bring mergers within its scope. Although the literal terms of the section would appear to limit its coverage, as noted in n. 4, *supra*, the stock-acquisition and asset-acquisition provisions, *read together*, were viewed as reaching mergers which, Mr. Justice Brennan said, fit neither category perfectly but lie somewhere between the two ends of the spectrum. So construed, Section 7 was held to embrace bank mergers.

<sup>7</sup> 376 U.S. 665 (1964).



Merger Act. Moreover, since there was no applicable statute of limitations, mergers approved under the Bank Merger Act, and mergers consummated prior to its enactment, were potentially vulnerable to antitrust attack.

The *Lexington* case not only demonstrated the potential thrust of the Sherman Act in the merger area, but also involved the difficult problem of divestiture since in that case, unlike *Philadelphia*, the merger had been consummated prior to the United States Supreme Court decision. Following the *Lexington* decision, the United States District Court for the Eastern District of Kentucky ordered the consolidated bank to create a separate institution that would be the competitive equal of the former Security Trust Company. The divestiture problem gained wide recognition when the District Court for the Southern District of New York held in *United States v. Manufacturers Hanover Trust Company*<sup>8</sup> that the consummated merger of Manufacturers Trust Company and The Hanover Bank, approved by the Board of Governors of the Federal Reserve System under the Bank Merger Act, violated Section 1 of the Sherman Act and Section 7 of the Clayton Act.

#### THE NEW LEGISLATION

In an effort to clarify the applicability of the antitrust laws to bank mergers, the Senate, in the first session of the current Congress, passed S. 1698. This bill would have exempted past approved and consummated bank mergers from antitrust attack, including those as to which antitrust suits were then pending. The bill would have required that future bank mergers not be consummated until thirty days after the date of approval by the appropriate banking agency under the Bank Merger Act. If the Attorney General did not institute an antitrust suit during the thirty-day period, the merger could be consummated and thereafter would be exempt from attack under the antitrust laws. If an antitrust suit were instituted during the thirty-day period, however, the bill would not have changed the apparent rule of the *Philadelphia* case to the effect that, in an antitrust suit involving a merger approved under the Bank Merger Act, the merger would be measured solely by the standards of the antitrust laws.

In contrast, the legislation, as modified by the House Banking and Currency Committee and enacted this year, establishes identical standards to be applied by the Federal banking agencies in approving merger applications and by

the courts in judging such proposed mergers in antitrust suits brought by the Attorney General (other than under Section 2 of the Sherman Act). This new legislation, in amending the Bank Merger Act of 1960, is designed to accomplish the following:

1. A proposed merger "which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States"<sup>9</sup> may not be approved by the responsible Federal banking agency. The responsible agency, however, may approve a proposed merger "whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly,<sup>10</sup> or which in any other manner would be in restraint of trade",<sup>11</sup> but only where it finds that the "anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served". In making its determination, the responsible agency is, "in every case", to consider "the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served"—this language revises the language of the six so-called banking factors of the Bank Merger Act of 1960.

2. The responsible banking agency, before acting upon a proposed merger, is required to request reports on the competitive factors from the other two agencies and the Attorney General, except that reports may be dispensed with where immediate action is necessary to prevent the probable failure of one of the banks involved. The reports must be furnished within thirty days of the request but, where an emergency exists requiring expeditious action, the reports must be furnished to the responsible agency within ten days. As under the Bank Merger Act of 1960, these reports are not binding upon the agency responsible for approving the merger.

3. An approved merger may not be consummated before the thirtieth day following the date of approval by the responsible banking agency, except that this period would be shortened to five days in those cases found by the responsible agency to be emergencies requiring expeditious action, and an approved merger could be consum-

<sup>9</sup> Compare Section 2 of the Sherman Act, *supra* n. 2.

<sup>10</sup> Compare Section 7 of the Clayton Act, as amended, *supra* n. 3.

<sup>11</sup> Compare Section 1 of the Sherman Act, *supra* n. 1.

<sup>8</sup> 240 F. Supp. 867 (S.D.N.Y. 1965).

mated immediately in order to prevent the probable failure of one of the banks involved. The Attorney General, who is to be immediately notified of approval by the responsible agency, can institute an action under the antitrust laws arising out of the merger, but only if he commences the action prior to the expiration of the prescribed waiting period. The House Banking and Currency Committee Report indicates that these prescribed time limitations do not relate to antitrust actions brought under Section 2 of the Sherman Act, and such actions may be brought at any time. In an antitrust action brought by the Attorney General within the prescribed period, the court would "review *de novo*" the issues presented, but would be required to apply standards "identical" with those to be applied under the new law by the responsible banking agency in approving the merger. The merger could not be consummated after such suit is commenced unless the court otherwise specifically orders. In such suit, the Federal banking agency concerned and the state bank supervisory agency having jurisdiction within the state involved may appear as a party and be represented by counsel. The House report indicates that this provision would even permit the appropriate state bank supervisory agency to present its views in a case involving the merger of two national banks.

4. The following bank mergers are, in effect, exempt from any attack under the provisions of the antitrust laws, other than under Section 2 of the Sherman Act:

- (a) Future mergers approved under the new law as to which the Attorney General does not institute suit prior to the expiration of the prescribed waiting period.
- (b) Past mergers consummated before June 17, 1963, the date of the *Philadelphia* decision, and not as yet unscrambled pursuant to final court order.
- (c) Past mergers consummated on or after the date of the *Philadelphia* decision and before enactment of the new law, except those as to which suits have been brought before enactment.

These provisions exempt, except as to Section 2 of the Sherman Act, some 2,200 bank mergers consummated since 1950 (including over 700 approved under the Bank Merger Act of 1960) which might otherwise continue to be, at least potentially, vulnerable to antitrust attack. Among those so exempted are the three pre-*Philadelphia* mergers as to which antitrust suits were then pending in the courts, involving Continental Illinois National Bank and Trust Company of Chicago (Illinois), First Security National Bank and Trust Company of Lexington (Kentucky), and Manufacturers Hanover Trust Company (New York). The *Manufacturers Hanover* action was terminated on March 7, 1966, and the *Continental Illinois* action was terminated on March 11, 1966. With respect to the *Lexington* case, it has been reported that the Justice Department is considering pressing for a favorable decision under Section 2 of the Sherman Act. (The Government had alleged violations in that case under both Section 1 and Section 2 of the Sherman Act, but the United States Supreme Court decision was based solely on Section 1.) These provisions do not exempt the three post-*Philadelphia* cases pending in the courts, involving Crocker-Citizens National Bank (California), Mercantile Trust Company National Association (Missouri), and Third National Bank in Nashville (Tennessee); and, in these suits, the new bank merger standards are to be applied.

5. Pre-enactment merger applications, which were withdrawn or abandoned as a result of objection or suit brought by the Attorney General, may be reinstituted and are to be acted upon in accordance with the new law.

The standards imposed by the new law have been praised, on the one hand, as providing certainty, uniformity, and promptness in the resolution of antitrust questions involved in bank mergers, and condemned, on the other hand, as vague and uncertain.

It would seem that the new law is intended to modify the application by both the courts and the Federal banking agencies of the antitrust laws to future bank mergers. Ultimately, of course, it will be up to the courts to resolve the extent of this modification; some clarification should be forthcoming in the cases now pending in the Federal courts.

## **The Banking System—Its Behavior in the Short Run**

*By* PAUL MEEK and JACK W. COX\*

The Federal Reserve System is concerned both with assuring that the country's monetary machinery functions smoothly from day to day and week to week and with helping to achieve the nation's economic goals over a longer horizon that stretches out into months and years. Monetary policy makers are naturally concerned primarily with the latter objective. But sorting out longer run trends in monetary data from the short-lived swings characteristic of a flexible banking system is a recurring analytical problem. In order to make judgments on whether monetary developments over a succession of weeks are adding up to the desired long-run result, it is necessary to understand in some detail how the banking system responds to short-run variations in demands for bank credit and deposits.

The present article examines two interrelated aspects of this problem. The first is the mechanism by which the banking system, in conjunction with Federal Reserve open market operations, responds to short-run changes in demands for funds by the economy as a whole. The second aspect is the mechanism by which short-run shifts in demands for bank credit and deposits impinge on particular groups of banks, with concomitant shifts in the distribution of reserves, deposits, and credit among these different groups of banks and associated changes in money market pressures. An understanding of these mechanisms is necessary for prompt assessment of whether developments over a period of weeks reflect normal responses to regularly recurring credit demands or more fundamental shifts in the financial atmosphere that may reflect new currents in the economy at large.

### **MEETING THE ECONOMY'S SHORT-RUN CASH NEEDS**

**THE MECHANISM.** The banking system functions on a day-to-day basis to provide currency and demand deposits on tap in order to meet the transactions and other money needs of the economy. As a result of weekly and monthly concentrations of payroll disbursements, quarterly corporate dividend and tax dates, holidays and vacations, and Treasury and private financings, the demand for cash balances is highly variable in the short run. It is not at all unusual for the economy's cash holdings to rise by \$5 billion, or about 3 per cent, within two or three weeks and then to fall back about as far in the next few weeks. Moreover, the ebb and flow of payments within the banking system often result in large geographic shifts of commercial bank deposits and reserves within an even shorter period. Despite their magnitude, these special demands on the financial system are usually handled without real difficulty and without major disturbing effects on money market interest rates. Thus, the daily affairs of economic life proceed routinely in the confidence that liquid assets can be exchanged for demand deposits, that demand deposits can be turned into currency, and that payments can be made with currency, check, or wire as required. The uncertainties, risks, and costs associated with the payments mechanism are minimal.

The responsiveness of the banking system to the economy's changing need for cash stems both from operational policies of the Federal Reserve System and from the relative ease with which individual commercial banks are able to adjust their reserve positions in the face of shifting demands for cash balances and credit. In recent years the Federal Open Market Committee (FOMC) has generally instructed the Federal Reserve Bank of New York to conduct open market operations over

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a given ensuing period in such a way as to maintain specified conditions in the money market while accommodating an expansion in aggregate bank reserves. Such an approach, revised as to details when conditions warrant, recognizes the extent to which the economy's cash demands at each season vary from one year to the next. It also recognizes that the variation within the year is large in relation to the growth in cash balances that takes place over the year as a whole. Except when policy is in the process of change, the Federal Reserve acts to maintain steady conditions in the money market by providing reserves promptly in the short run as required by the demands for cash that emerge from each period's particular constellation of economic forces and by the variation in other factors affecting reserves (float, for example). Subsequently, when cash needs recede, the System seeks to absorb redundant reserves—all in the context of specified money market rates, average levels of member bank borrowings from the Federal Reserve Banks, and free reserves. Once above a frictional minimum, member bank borrowings from the Reserve Banks tend to rise, or decline, as the Federal Reserve's actions fall short of, or exceed, the banking system's marginal reserve needs.

While the FOMC can instruct the Federal Reserve Bank of New York to accommodate week-to-week changes in reserves within a general framework of over-all pressure of ease or restraint on bank reserve positions, the Committee itself must necessarily be concerned with developments over a longer time span than just a few weeks. The Committee must weigh the actual behavior of the money supply, bank credit, and interest rates that emerges from week-to-week changes. As its policy judgments of the appropriate relation between monetary conditions and past and prospective economic developments change, the Committee alters its specification of the terms on which reserves are to be made available to the banking system. Thereby it seeks to influence credit terms and availability, and aggregate spending, in the interest of promoting national economic goals. In the very short run, the Federal Reserve's open market operations are mainly a response to shifting demands for cash balances rather than the instigator of the change in those balances. Over the longer run, however, monetary policy exerts the important influence that is generally attributed to it.

The banking system's short-run responsiveness to changing demands for credit and deposits is also due to the manner in which commercial banks conduct their daily operations. In a system of over 6,000 member banks, the individual bank has to be able to adjust quickly to the changes in its vault cash and its balance at the Federal

Reserve Bank that result from the transactions of the bank or its customers. For day-to-day adjustments many banks rely on balances they keep with correspondent banks and on their ability to borrow (buy) or to lend (sell) Federal funds—balances Federal Reserve member banks keep on deposit with their Reserve Bank.<sup>1</sup> Member banks also have the privilege of borrowing directly from the Reserve Banks under the conditions stated in Regulation A.

The larger banks especially depend on the Federal funds market in keeping their reserve positions in line with their reserve requirements. Usually they step up their bids for Federal funds whenever they lose reserves from acquiring securities or from deposit outflows. They reduce their net demands on the Federal funds market, or become sellers of Federal funds, whenever their reserve positions improve temporarily. Changes in secondary reserves or in the volume of negotiable time certificates of deposit outstanding are, of course, likely to be set in motion by any protracted change in reserve positions. Nevertheless, the Federal funds market remains the most important short-run avenue of adjustment.

A good illustration of the way the banking system meets the economy's changing need for cash balances is provided by the quarterly dates on which corporations pay their Federal income taxes. On these dates, businesses borrow directly from banks and also exchange maturing negotiable time certificates of deposit for demand deposits in order to pay the Treasury. At the same time, the nonbank dealers in Government securities look to the banks to refinance securities returning from maturing repurchase agreements with corporations, and sales finance companies borrow from banks to pay off maturing paper held by tax-paying corporations. The counterpart of this large increase in bank loans is, of course, an expansion in demand deposits that corporations immediately pay over to the Treasury, which leaves them in Treasury Tax and Loan Accounts at commercial banks for the time being. With the required reserves of the banking system increasing rapidly because of the rise in deposits, banks step up their collective demand for Federal funds to meet their requirements. The Manager of the System Open Market Account, armed with forecasts based on past experience, sees that reserve availability rises, but at a rate geared to the demands actually emerging in the Federal funds market. Subsequently, the Treasury draws down its enlarged balances in the normal

<sup>1</sup> See Dorothy M. Nichols, *Trading in Federal Funds* (Board of Governors of the Federal Reserve System, 1965).

course of paying the Government's bills. These payments by the Treasury flow to individuals and to corporations, which are at the same time also acquiring deposits from their sales of goods and services across the nation. Loans at banks tend to be repaid, as some corporations reduce their indebtedness and others rebuild their holdings of short-term earning assets out of corporate cash flow. Declining deposits bring reductions in required reserves, the supply-demand balance in the Federal funds market shifts, and the System withdraws reserves to prevent the undue

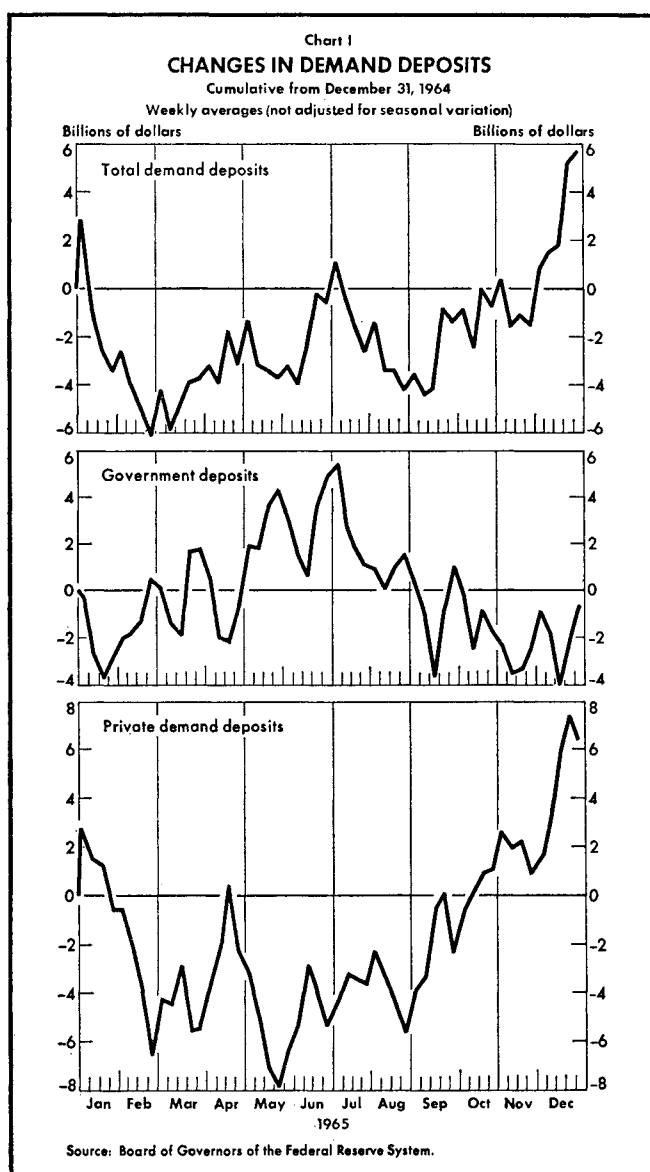
easing in the money market that would otherwise result from the reduction in cash needs.

The main outlines of the economy's variable need for demand deposits within every year are reasonably clear, although the exact size and timing of the movements change considerably from year to year. (The broad movements can be seen in the 1965 behavior presented in Chart I.) Total demand deposits decline precipitously in the first two months of the year and then rise irregularly to a peak around Christmas time. The private demand for deposits is particularly strong during the pre-Christmas shopping season when spending is high. At other times within the year, Federal financial operations lead to a bulge in total deposits at certain periods. In March, June, and September corporate tax payment dates are accompanied, as already indicated, by a surge in total deposits as the banking system creates the bulk of the deposits that are paid to the Treasury. Large Treasury cash financings sometimes leave a similar trace, although the gain in Treasury balances tends to be short-lived when such financings coincide with large Treasury cash needs. Thus, in early October 1965 when the Treasury sold \$4 billion of March and June 1966 tax anticipation bills for cash, allowing banks to pay by crediting Treasury Tax and Loan Accounts, bank credit and deposits rose as payment was made for the new issue. However, the Treasury soon drew heavily on these balances to make payments, so that data on weekly average Treasury balances show a lesser increase.

The interaction of private and Government deposits underscores the extent to which the present monetary system facilitates the economizing of cash balances by economic units. Corporations—and increasingly state and municipal governments as well—plan and administer their cash flow with a view to keeping their cash holdings at a minimum consistent with their need to make payments. In effect, the banking system, as we have seen, stands ready to supply cash on demand to depositors and credit-worthy borrowers so that working balances can be held quite low in relation to the volume of transactions. The ability of the banking system to do this without substantial fluctuations in money market interest rates is made possible, in turn, by Federal Reserve responsiveness to short-term shifts in the banking system's need for reserves.

#### THE DISTRIBUTION OF MEMBER BANK RESERVES

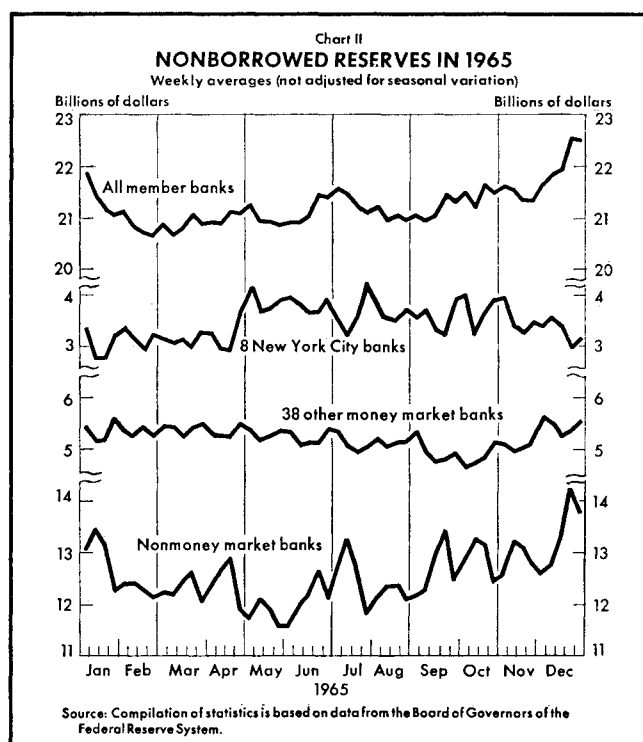
The banking system not only expands and contracts to provide for the economy's changing need for cash balances, it also handles a large volume of cash transfers. These payments, which amount to billions of dollars daily, reflect the transactions of the banks' customers and the



lending and investment decisions of the banks themselves.<sup>2</sup> They produce large shifts of deposits and of bank reserves within the banking system. Understandably, the necessity of maintaining reserves at the required level makes member banks sensitive to shifts in the distribution of reserves that leave their reserves above or below required levels. These shifts may lead, in time, to variations in the availability of reserves in the Federal funds market and tend to put pressure on money market interest rates if compensating Federal Reserve action is not taken.

**NONBORROWED RESERVES.** A useful way to portray the distribution of reserves within the banking system is to calculate the reserve positions of major groups of member banks as they stand before recourse to the Federal funds market and the "discount window" of the Reserve Banks—in other words, the nonborrowed reserve positions of the banks in question.<sup>3</sup> This can be done directly for a group of eight New York City banks and of thirty-eight other money market banks outside New York City, for which data on Federal funds transactions are collected daily. For the remaining member banks, one can derive the nonborrowed reserve position because the net Federal funds purchases of the forty-six banks represent net sales by these "other" banks, henceforth to be called the "non-money market banks".<sup>4</sup>

A number of interesting points emerge from the



<sup>2</sup> In 1965 the volume of currency, checks, and wire transfers cleared through member bank reserve accounts at the twelve Reserve Banks and their twenty-four branches was about \$25 billion daily. Debits to reserve accounts would be only about half this amount since this figure includes credits, as well as debits, to reserve accounts. Even with this adjustment, the turnover rate of member bank reserve deposits still averaged about 150 times per year or once every 1.5 business days. (Were it not for local clearing houses, the turnover rate would have been even higher since only the net effect or clearing house transactions are cleared through the reserve accounts.)

<sup>3</sup> Nonborrowed reserves equal total reserves minus net Federal funds purchases minus borrowings from Reserve Banks. Since the intergroup transfer of reserves through the Federal funds market washes out in the total, the sum of the nonborrowed reserve positions of the three bank groups utilized in this discussion is total nonborrowed reserves.

<sup>4</sup> The group of nonmoney market banks includes 159 reserve city banks and 6,000 "country" banks, which together account for about three fifths of member bank reserves. It should be noted that the Federal funds data used herein exclude net purchases of Federal funds from foreign agency banks, Government securities dealers, and a few others—purchases that are quite sizable for the New York City banks. In effect, this procedure treats such purchases as internal to the New York City banks—which appears to be approximately the case. It is believed that the resultant picture of reserve distribution between the eight, thirty-eight, and non-money market banks is a more meaningful one than if the agency banks and other sellers were included with the nonmoney market banks. Additional study is needed, however, before one can be sure that this choice is the best.

resultant picture of reserve distribution. (See Chart II.) First, the nonborrowed reserve positions of the eight New York City banks and the nonmoney market banks are subject to larger variations than total nonborrowed reserves, reflecting large short-run shifts in reserve distribution that take place independently of the public's changing total demand for cash balances. Secondly, the eight New York City banks in the central money market bear the brunt of the short-run changes in reserve distribution that are spread over the reserve positions of the more than 6,000 nonmoney market banks. To be sure, the variations in the nonborrowed reserve positions of the nonmoney market banks are larger in absolute terms than those of the City banks, but they are smaller in relation to their reserve base. Faced with frequent reserve swings of 20 per cent or more, the New York City banks are the mainstay of the market for Federal funds, which greatly facilitates the management of their volatile reserve positions.

**THE BASIC RESERVE POSITION.** Individual banks are not concerned with their nonborrowed reserve position as such but with the extent to which nonborrowed reserves exceed or fall short of required reserves. It is the gap between reserves on hand and reserve requirements that indicates the volume of excess reserves to be disposed of,



or the reserve deficiency that must be covered by borrowing in the Federal funds market, at the Federal Reserve Banks or elsewhere, and/or by asset adjustments. The term "basic reserve position" is used to designate this gap, either for an individual bank or for a group of banks. Equivalently, the basic reserve position may be defined as excess reserves less net Federal funds purchases less borrowings from the Federal Reserve Banks.<sup>5</sup> The shaded areas of Chart III indicate the basic reserve positions of the eight New York City banks, the thirty-eight other money market banks outside New York City, and the nonmoney market banks week by week in 1965. For the banking system as a whole the difference between nonborrowed and required reserves is the familiar measure, net free reserves, which can be either positive or negative.

Several important features of the banking system and the manner in which it functions emerge in Chart III. In the first place, it is apparent that System open market operations are quite successful, on the whole, in keeping nonborrowed reserves for the entire banking system moving in step with the large week-to-week changes in required reserves, which reflect primarily variations in demand deposits.<sup>6</sup> Over the year 1965, there were a number of changes in the instructions of the FOMC to the Manager of the System Account. Thus, the System exerted an increasing degree of pressure on member bank reserve positions early in the year, maintained about the same pressure until the rise in the Federal Reserve discount rate in December, and then allowed a more rapid growth of nonborrowed reserves in the wake of that move. Free reserves were gradually reduced and then became negative in the first part of the year, while member bank borrowings from the Reserve Banks rose to a \$500 million to \$600 million range that prevailed until December.

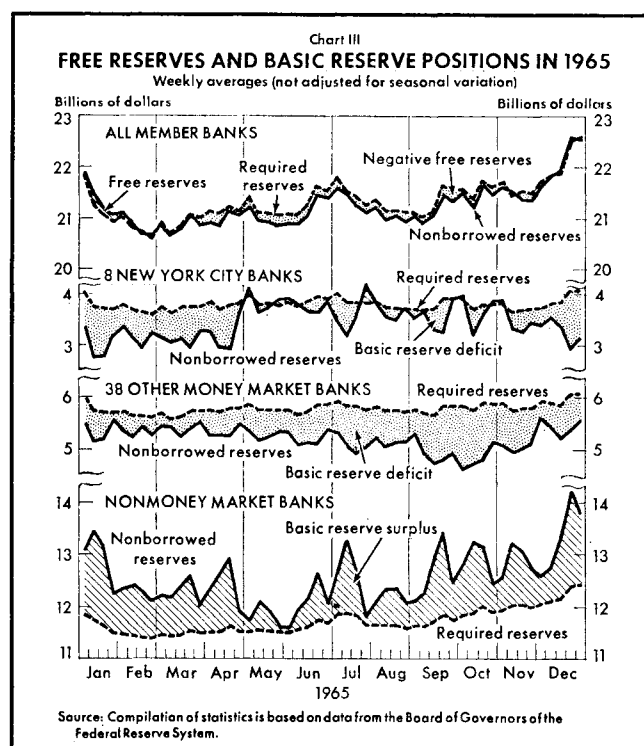
Differences in the roles of the three groups of banks are also apparent in Chart III. The eight New York City

banks typically operated in 1965 with a sizable basic reserve deficiency, one that over the year averaged 10 per cent of required reserves. These banks are able to keep their earning assets higher than would be the case if they could not count on buying Federal funds in volume directly from their extensive network of correspondents as well as on garnering a sizable share of the supply of funds available through brokers in Federal funds. The large New York City banks are a major source of loans to business borrowers, accounting for one third of business loans at weekly reporting member banks at the end of 1965. It is probably significant that the periods of maximum pressure on these banks in 1965 were those in which business loans and bank credit nationally were growing at an accelerated pace. The New York City banks are also active as residual lenders to Government securities dealers—an activity that at times increases their demand for Federal funds.

Similarly the thirty-eight money market banks outside New York City are normally in a basic reserve deficit position—one which also averaged 10 per cent of their reserve requirements in 1965, a higher proportion than in earlier years. Much of the increase in pressure on member bank reserve positions in 1965 fell on these banks—in part, because they were less aggressive than the New York

<sup>5</sup> Basic reserve position = nonborrowed reserves minus required reserves.  
 = (total reserves minus required reserves)  
 minus net Federal funds purchases  
 minus borrowings from Reserve Banks.  
 = excess reserves minus net Federal  
 funds purchases minus borrowings  
 from Reserve Banks.

<sup>6</sup> Of course, a generally steady gap between required and nonborrowed reserves—that is, a generally steady level of free or net borrowed reserves—does not imply that the rate of growth in bank credit or the money supply will necessarily remain steady. See "The Significance and Limitations of Free Reserves", this *Review* (November 1958), pages 162-67, for an early statement of this point within the Federal Reserve System.



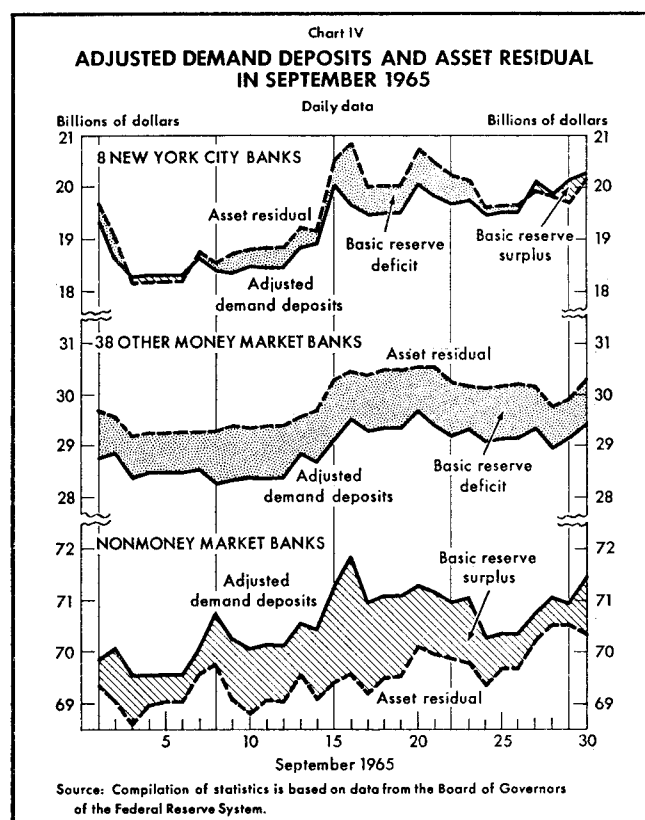
City banks in competing for negotiable time certificates of deposit. Like the New York City banks, however, these thirty-eight money market banks outside New York have cultivated their correspondent banks as a source of Federal funds and are active in the Federal funds market; some of them also regularly finance Government securities dealers.

In contrast, the nonmoney market banks as a group have been consistent net suppliers of Federal funds to the money market banks. Presumably, a large proportion of the banks in this group prefer to operate with a basic reserve surplus position and sell off varying amounts of Federal funds as they gain or lose reserves from week to week. Their average basic reserve surplus in 1965 was equivalent to 7 per cent of required reserves.

The shifts in the distribution of reserves between the money market banks and those banks outside the money centers are of direct concern in the day-to-day conduct of open market policy. These shifts alone tend to change the balance of supply and demand in the Federal funds market. When reserves swing to the nonmoney market banks, for example, upward pressure is very likely to be exerted on the Federal funds rate since the reserves are widely dispersed among a large number of banks, some of whom do not even participate in the Federal funds market. Thus the money market banks cannot fully recapture the reserves lost as their basic reserve positions deteriorate. With the supply of Federal funds falling short of the enlarged demands of the money market banks, upward pressures on rates will develop and member bank borrowings from the Reserve Banks will rise—unless the System supplies new reserves through open market purchases. Conversely, a shift of reserves to the money center banks tends to concentrate reserves in those banks and reduce their net demand for Federal funds more than the supply from other banks falls. The Federal funds rate will tend to decline, and member bank borrowings from the Reserve Banks to fall, unless the System absorbs reserves.

#### FACTORS AFFECTING RESERVE DISTRIBUTION

The changing basic reserve positions of the three bank groups give a reasonably good picture of shifts in reserve distribution, but they tell very little of the dynamics of the banking system. To understand how the system functions, one must find out how the deposits and loans of the three groups of banks actually behave as the economy's total demands for cash balances and bank credit vary. Unfortunately, the balance-sheet data for all banks that are needed to provide such an analysis are not readily available. Nevertheless, it is possible to construct an ap-



proximate picture of the deposit and of the asset changes for the three bank groups on the basis of data on required reserves. The object is to isolate the movements in each bank group's basic reserve position stemming from changes in deposits, on the one hand, and from changes in assets, on the other.

First, assuming that large short-run changes in required reserves solely reflect demand deposit movements, one can inflate required reserve data for each of the three groups by a demand deposit multiplier to obtain a demand deposit equivalent.<sup>7</sup> If one subtracts from this deposit equivalent the associated change in required reserves, the result is a measure that reflects changes in the basic reserve position which stem from the deposit side of the

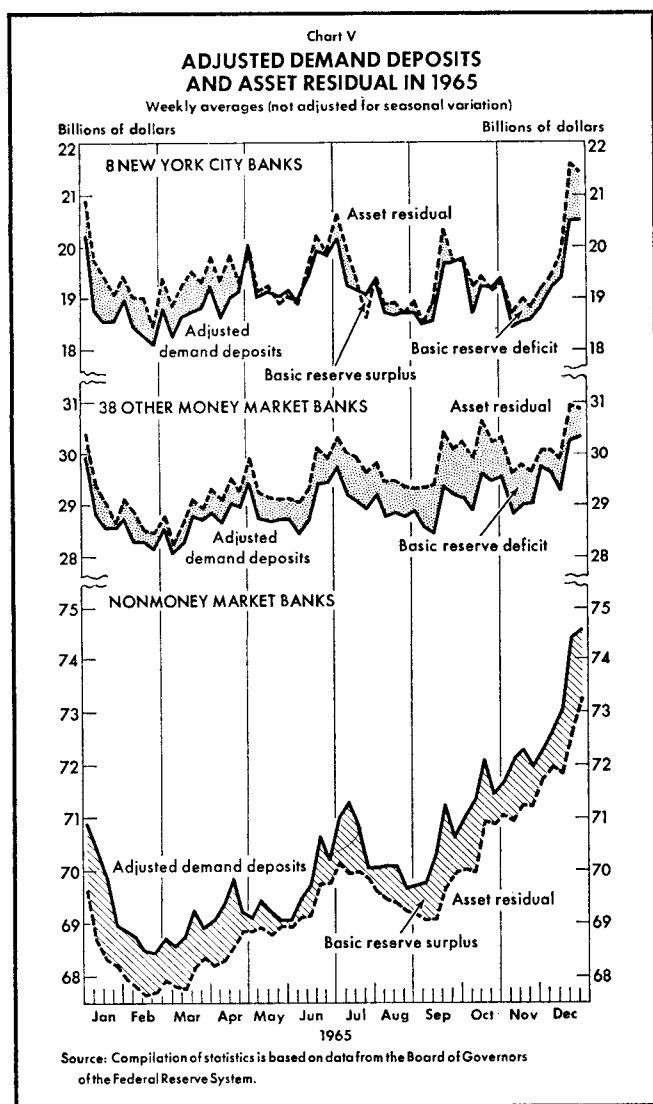
<sup>7</sup> Reserve requirements for the eight New York City banks and the thirty-eight other money market banks were taken as one sixth of demand deposits; requirements were taken as one seventh of demand deposits for the combination of reserve city and country banks included in the group of nonmoney market banks. These are approximately correct.

balance sheet. This measure is denoted "adjusted demand deposits". Secondly, as can be easily shown, a corresponding approximation of the loans and investments of each bank group can be derived by subtracting their basic reserve position from the adjusted demand deposits just described. The result (adjusted demand deposits less the basic reserve position) is called the "asset residual" and reflects changes in the basic reserve position that stem from the assets side of the balance sheet.

Using this procedure, one can present graphically the nature of the response of the banking system to the special demands of the corporate tax date that have already been discussed. Chart IV shows for each of the three major bank groups their adjusted demand deposits and asset residuals

in September 1965, with the differences representing their basic reserve positions. The chart makes clear the source of the deterioration in the basic reserve position of the New York City banks that occurred on September 15, 1965, a quarterly corporate tax date. As economic units liquidated short-term assets and borrowed directly from the City banks on the tax date, assets of these banks rose more sharply than their deposits. The pressure on reserve positions generated in this way was sustained throughout the following week, as assets and deposits moved closely together near the higher levels to which they had jumped on the tax payment date. A similar, though less dramatic, increase in deposits and assets took place at the thirty-eight money market banks outside New York City. As described earlier, the money market banks then increased their net demands for Federal funds to cover their enlarged deficiencies, the supply-demand balance in that market shifted, and the Federal Reserve provided for the additional reserves needed to underwrite the expansion in deposits. The nonmoney market banks, on the other hand, experienced very little change in assets on September 15. The deposits of these banks, however, increased very sharply, reflecting shifts from the money market banks. The reserves thus gained enlarged the basic reserve surplus of the nonmoney market banks and permitted them to supply an expanded volume of Federal funds to that market.

Applying the same procedure to weekly average data on required reserves, one obtains in Chart V a broad picture of the week-to-week asset and deposit movements of the three groups of banks that underly the shifts in basic reserve positions previously shown in Chart III.<sup>8</sup> The sources of several of the major shifts in reserve distribution that took place during the year can be isolated



<sup>8</sup> A number of biases are implicit in the framework. While the movements in the two series approximate reality in the short run, which is normally dominated by demand deposit movements, the cumulative growth in bank deposits and assets falls considerably short of actual growth because of the cumulative importance of time deposits. The asset residual, too, is really an asset-liability residual. A rise in the asset residual could just as well reflect a drop in certificates of deposit outstanding as a rise in assets, and indeed does account for a part of the rise in the asset residual in the weeks encompassing the quarterly corporate tax date. However, a comparison with actual Wednesday data on loans and investments of New York City weekly reporting banks suggests that the direction of the week-to-week movements in actual data is closely approximated by the framework—because of the short-run dominance of demand deposits movements. Finally, a technical inaccuracy in the weekly series stems from the fact that average required reserves relate to the deposits for the week ended each Tuesday rather than for the statement week ended on Wednesday. For present purposes, the distortion involved is not believed to be serious.

with the aid of Chart V. Thus, during late April and early May, deposits at the New York City banks rose very sharply as the Treasury redeposited with money center banks the proceeds of individual income tax payments on April 15 drawn from banks all over the country. The deposit inflow brought a marked improvement in the basic reserve positions of the City banks and a concomitant decline in the basic reserve surplus of the nonmoney market banks. The distribution of reserves shifted again in late June, however, as the money market banks accounted for the bulk of the credit and deposit expansion associated with the June corporate dividend and tax payment dates. With assets rising more rapidly than deposits at the New York City banks, these banks experienced a deterioration in their basic reserve position while the position of the nonmoney market banks improved as their deposits rose more rapidly than their assets. Subsequently, in July and August, there was a marked decline in total deposits as Government deposits fell back very sharply from an exceptionally high level in early July (Chart I). The fall in deposits at the nonmoney market banks was quite large. Since these banks as a group reduced their assets more slowly and with some time lag, their basic reserve surplus again declined. The onset of the September dividend and tax dates again brought a deterioration in the basic reserve positions of the New York City banks, as already described. In December, the New York City banks entered the dividend and tax period with a substantial basic reserve deficit. The deficit became very large indeed in late December as those banks encountered very heavy credit demands which led to a sharper rise in assets than in deposits.

**INTRAMONTHLY MOVEMENTS.** The flow of deposits, credit, and reserves that is evident during special periods of heavy demands for cash balances, apparently also occurs on a smaller scale within each month, reflecting primarily the settlement of accounts between economic units. Monthly payroll and trade-credit payments, although occurring throughout the month, are typically concentrated in the first part of each month. The intramonthly demand for cash rises between the end of the month and the tenth of the next month, and falls thereafter.<sup>9</sup> The money market banks apparently provide the

bulk of the deposits. Large corporations meet their cash requirements directly by borrowing at the money market banks and/or by liquidating earning assets which, in turn, places additional loan demands on these banks from sales finance companies, Government securities dealers, and other money market institutions. The related increase in deposits, however, is widely dispersed throughout the economy with the settlement of accounts. Thus, the gain in assets at the money market banks exceeds their deposit additions, and reserves in the first part of each month flow from these banks to the nonmoney market banks. Reserves later return to the money market banks, as corporations repay loans or prepare for their next monthly payments by building up their earning assets and thus reducing the need of the money market institutions for bank loans.<sup>10</sup>

#### CONCLUDING COMMENT

It is clear that there are substantial short-run shifts in the demands placed by the economy on the banks for credit and deposits, as well as substantial short-run changes in the distribution within the banking system of these demands. Indeed, since increases in these demands appear to impinge primarily on the money market banks, such increases also set in motion shifts in the distribution of reserves, credit, and deposits within the banking system. Were it not for the ability of the Federal Reserve to supply additional reserves when needed through open market operations and the existence of a well-developed Federal funds market to redistribute reserves to the points of greatest stress, these shifting money market pressures might well lead to considerable instability in short-term interest rates. As it is, the rate pressures created by short-run shifts in demands are moderated. A knowledge of the possible sources, timing, and effects of these short-run and seasonal shifts in demands is necessary, not only for the Manager of the System Open Market Account as he acts on the basis of unfolding developments, but also for the Federal Open Market Committee and other analysts who try to sort out the effects of purely temporary and probably reversible phenomena from developments of more fundamental significance.

<sup>9</sup> This pattern is evident in the weekly seasonal factors for the demand deposit component of the Federal Reserve Board's money supply series. See "Revision of the Money Supply Series", *Federal Reserve Bulletin* (July 1965), page 943. The bulge in deposits in the first week in each month is also evident in Chart I.

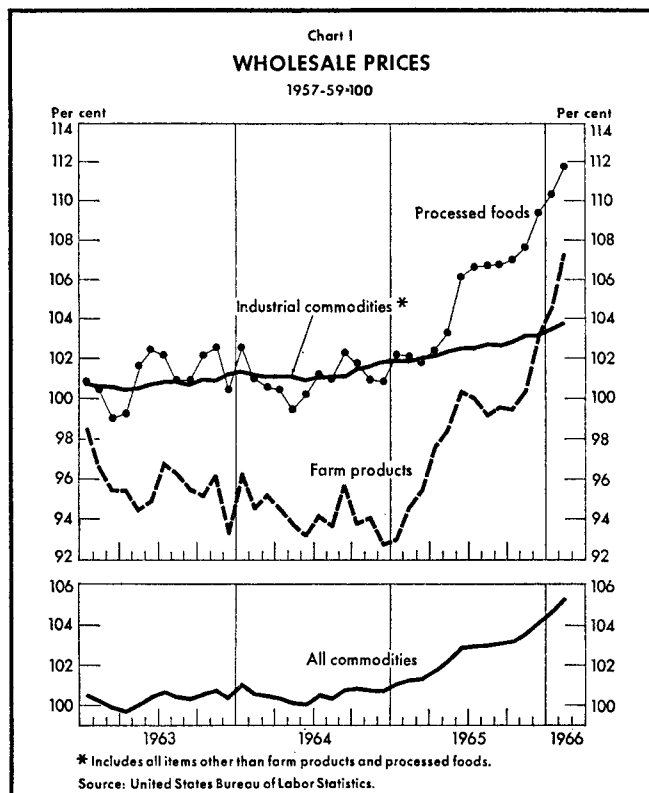
<sup>10</sup> The intramonthly pattern of reserve distribution is also apparently augmented by the intramonthly swings in Federal Reserve float, together with Federal Reserve operations undertaken to offset the effect of float movements on the member bank reserve base. See "New Series on Federal Funds", *Federal Reserve Bulletin* (August 1964), page 948.

## The Business Situation

The vigor of the domestic business expansion continues unabated. Indeed, the strength of economic activity during the opening months of the year has led to intensified pressures on the economy's resources of manpower and physical capacity. Conditions in the markets for labor have become tighter over all than at any time in more than ten years. Rates of capacity utilization have also risen significantly further in recent months, to around the highest levels since the Korean war. Current indications continue to point toward a further substantial growth in economic activity over the months ahead and to stepped-up demands upon available resources. Thus, for example, the results of the latest survey of business plans for capi-

tal investment point to another very strong rise in such outlays this year—a rise so strong, in fact, as to raise some question regarding the ability of capital goods producers to meet the indicated production requirements.

In mid-March, Congress passed the tax legislation requested by the President in January. While helpful, these measures taken alone are unlikely to eliminate the continued upward pressure on wages, materials costs, and the selling prices of goods and services. Meanwhile, the overall wholesale price level rose sharply once again in February, with the largest advances continuing to be centered in the agricultural sector where unusually bad weather curtailed supplies (see Chart I). During the past year, a combination of supply shortages and strong demand has put very heavy upward pressure on agricultural prices, but analysts expect that market conditions will be easier this year, and farm and food prices apparently did move somewhat lower in March. The rise in industrial wholesale prices, while much more moderate, has nevertheless persisted now for well over a year. In February, prices advanced for a broad range of individual products and the industrial price index rose at a substantial annual rate of about 3½ per cent, the same as in January and much ahead of the increase of roughly 1½ per cent recorded for the year 1965. At the consumer level, February witnessed modest price increases for a broad range of nonfood commodities, while the prices of services continued their steady advance and food prices registered an exceptionally sharp further increase. Largely as a result of this jump, the overall consumer index rose by ½ per cent, reaching a level 2½ per cent higher than in February 1965.



## PRODUCTION AND EMPLOYMENT

Industrial production expanded significantly further in February, as the Federal Reserve Board's seasonally adjusted index rose by 1.2 percentage points to 151.3 per cent of the 1957-59 average. The growth of output continued to be broadly based: over-all consumer goods production increased despite a modest further reduction in the automobile assembly rate, and there was another

sizable advance in the output of defense equipment. Business equipment production, buoyed by the strong pace of capital spending, surged further and reached a level some 16½ per cent higher than in February 1965. The pace of activity in the steel industry moved up once again, contributing to an over-all rise in the output of materials. At the same time, an indication of further production gains over the near term was provided by the February volume of new orders for durable goods. The total orders flow expanded slightly to reach a new record, despite a sizable drop in new bookings in the defense-oriented industries—an orders component which tends to move quite erratically from month to month. Thus, new orders for civilian goods rose substantially in February, and the over-all backlog of unfilled durables orders grew once again.

In March, further gains in steel production were recorded amid industry reports of a continued strengthening in demand. On a seasonally adjusted basis, the March increase represented the fourth consecutive monthly advance, putting output almost 30 per cent above the October-November level, when industry production was at its lowest point in the readjustment period following the contract settlement. Automobile production also expanded in March, more than recouping the modest declines of the two preceding months. Indeed, the seasonally adjusted annual rate of new car assemblies in March, at 9.4 million units, was the highest since last summer. New car sales were at an annual rate of about 9.1 million units in February and March, and the production advance apparently reflects the buildup of new car inventories in preparation for the spring selling season.

Reflecting the brisk pace of economic activity, the demand for civilian workers has continued to expand in recent months. Although the growth of the total labor force in the first quarter was about equal to the large fourth-quarter gain, the growth of the civilian labor force slowed down somewhat as the expansion of the armed forces cut into the labor supply. The further tightening of civilian labor markets led to another substantial decline in the over-all unemployment rate, which averaged 3.8 per cent in the first quarter as compared with 4.2 per cent in the fourth quarter and 4.8 per cent in the first quarter of 1965. The rate in fact dropped to 3.7 per cent in February, but that low reading resulted partly from contraseasonal developments in the teen-age labor force, and in March the rate edged back to 3.8 per cent.

The recent trend of employment in nonfarm establishments provides further evidence of the heavy demands in the labor markets. The number of persons on the payrolls of such establishments has been growing this year at a very substantial pace—significantly faster than the monthly

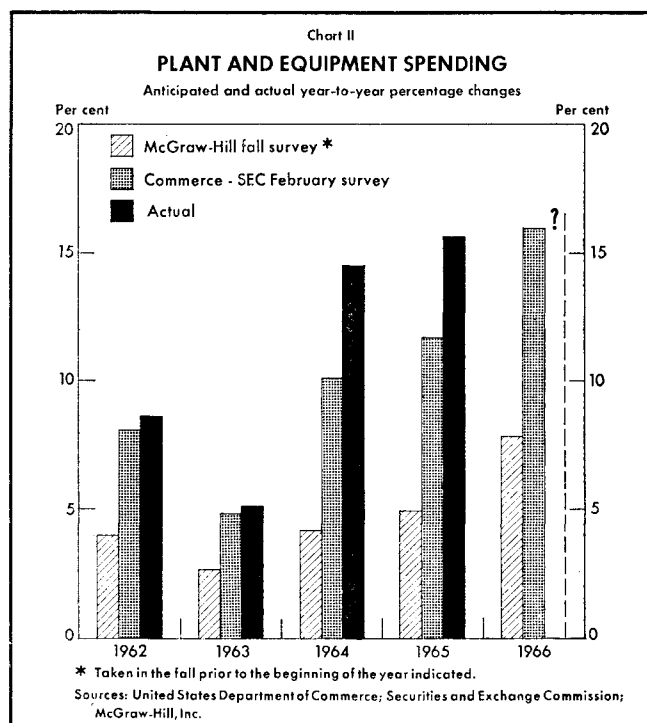
average for 1965 as a whole and not far below the exceptional rate of gain witnessed in the final months of 1965. The expansion of manufacturing employment has been particularly strong. At the same time, the average number of hours put in each week by manufacturing production workers has risen substantially, as employers have found it necessary to make increasing use of overtime. In both February and March, the workweek averaged 41.6 hours, the longest since World War II. The strong demand for labor in manufacturing is also reflected in the increasing willingness of workers to quit one job in favor of another: both the rate of voluntary quits per hundred employees in manufacturing and the rate of hirings have recently reached the highest levels since 1953.

#### **BUSINESS INVESTMENT PLANS**

According to the latest Government survey of business plans for capital investment, the rate of spending on new plant and equipment will very likely continue to expand rapidly throughout 1966. The Commerce Department-Securities and Exchange Commission survey, taken in late January and February, found that businessmen plan to spend a total of \$60¼ billion on new facilities this year. That figure represents a 16 per cent increase for the year as a whole, fractionally larger than the very substantial growth rate recorded in 1965 (see Chart II). The rate of advance, moreover, is expected to be about as rapid in the second half of the year as in the first half. This very strong showing for over-all investment reflects the buoyancy of spending programs in most of the individual industries. Manufacturers, taken altogether, reported that they plan to spend 19.2 per cent more than in 1965, just a bit under last year's 20.8 per cent gain. Outside of manufacturing, the indicated rise in capital spending this year is more rapid than last year, largely reflecting a planned increase in spending reported by firms in the communications-trade-service category.

Intensifying pressure on productive capacity throughout the economy is a major factor underlying the plans for a continued high rate of growth in plant and equipment spending. In the manufacturing sector, according to data gathered by McGraw-Hill, the over-all operating rate has increased appreciably since last fall and a number of industries are running in excess of their "preferred" rates. It is noteworthy that the manufacturing industries ranking first and second in terms of the planned percentage rise in capital spending—nonautomotive transportation equipment and textiles—had already exceeded their "preferred" rates by the end of 1965. The machinery producers, whose operating rates have reached or exceeded "preferred"





levels in recent months, also rank near the top in terms of the planned percentage growth in spending. Manufacturers apparently see little prospect of any significant near-term reduction in demand pressures. Although productive capacity is now growing more rapidly than it did in the earlier years of this business expansion, expectations regarding sales growth are also more buoyant. According to the February Commerce-SEC survey, manufacturers' sales anticipations add up to an expected overall gain of 8 per cent this year, compared with expected rises of 6 per cent reported by the comparable surveys in both 1965 and 1964. The actual sales gains were 8½ per cent in 1965 and 7 per cent in 1964.

In the past two years, business outlays for plant and

equipment have substantially exceeded the volume indicated by the Government's February surveys of spending plans (see Chart II). The current prospects for a continued strong rate of growth in over-all economic activity at least suggest the possibility of a similar upgrading of expenditure programs during 1966. It is noteworthy, however, that the amount of upgrading in spending plans for the first half of 1966 between the Government's November and February surveys was much smaller than the upgrading between the comparable November and February surveys of the two previous years. Moreover capital investment projects this year are pressing more heavily on the economy's capacity to undertake them, and limitations of supply may well play a role in dampening any tendency toward still further expansions of 1966 investment plans. Some restraining influence may also be exerted by the increasing scarcity and the rising cost of capital funds, especially since it is generally expected that business will have to rely more heavily this year on external sources of financing. In this connection, it might be noted that the Government's February survey was taken prior to the latest increase in the prime lending rate at commercial banks. During the past month, moreover, the President has urged businessmen to consider whether they might cut back somewhat on their capital investment programs for 1966.

The investment plans most recently reported are certain to put intense pressure on the capital goods industries, even without any further upgrading. By the end of 1965, business fixed investment already accounted for a larger proportion of over-all gross national product than at any time since the investment boom of 1956-57. The proportion can be expected to move still higher this year since 1966 is likely to be the third consecutive year in which the growth rate of capital spending exceeds that of GNP. In marked contrast to the experience of a decade ago, the rate of increase in capital goods prices has thus far remained modest—though in recent months there has been evidence of some acceleration. In any event, the continued rapid growth of capital spending will likely put persistent upward pressure on such prices.

## The Money and Bond Markets in March

The money market displayed a firm tone during March. Net reserve availability in the banking system was reduced somewhat during the month and, with member banks unable to cover all their reserve needs in the Federal funds market, borrowings from the Reserve Banks averaged somewhat higher than in the preceding two months. While many observers had expected a considerable buildup of tension in the money market around the mid-March quarterly corporate dividend and tax dates, the pressures turned out to be unusually mild and were weathered without difficulty.

In response to the persistent strength of loan demands and to advances in open market rates, the major commercial banks raised the rate charged prime business borrowers to  $5\frac{1}{2}$  per cent from 5 per cent on March 10. This move triggered further upward adjustments in several closely allied market rates, including those on commercial paper placed by dealers and directly placed finance company paper. Rates on new negotiable time certificates of deposit issued by commercial banks also moved higher during the month, as banks replaced the \$4.1 billion of certificates maturing over the month as a whole. Rates on Treasury bills, on the other hand, dropped back rather sharply through much of the month from the heights to which they had risen in February. Only a modest amount of bills were returned to the market from maturing corporate repurchase agreements around the dividend and tax dates, and a persistent demand for bills pressed steadily against the very limited supply of most issues available in the market.

The tone of the bond markets improved considerably in March. Prices of Treasury coupon issues rose sharply for the first time since early January, as participants gradually took heart from the apparently growing support for Federal tax increases to combat inflationary pressures. The market was already in a very strong technical position and, as sentiment changed, professional short-covering operations were a major factor in the ensuing advance in prices. The month closed on a strong note in the wake of a statement by President Johnson that a "modest" tax increase might prove necessary. In the markets for corporate and tax-exempt bonds, a very large volume of new offerings

was bought by investors at declining yields. The postponement of several large scheduled flotations also removed a good portion of the immediate supply pressures from the market. As a result, except for a brief pause after the prime rate announcement, prices of many corporate and tax-exempt bonds edged higher during the remainder of the month.

### THE MONEY MARKET AND BANK RESERVES

The money market displayed a generally firm tone in March, and most Federal funds transactions took place at a  $4\frac{5}{8}$  per cent rate, with some trading occurring at rates as high as  $4\frac{3}{4}$  per cent. After rising somewhat in the December-January period and falling back again in February, average nationwide bank reserve availability contracted somewhat further in March. Reserve needs, which member banks could not fully satisfy in the Federal funds market, spilled over in the form of expanded borrowings from the Federal Reserve (see Table I). System open market operations supplied \$315 million of reserves from the last week of February to the final week of March, but this amount did not fully offset the reserve drains which resulted from the net effect of changes in "market" factors. On average, the major banks in New York City were in basic reserve surplus during the month (see Table II), as they first prepared for possible pressures around the dividend and tax dates, then found the pressures rather mild, and finally experienced quick repayment of loans after the dates had passed. Weekly reporting member banks had about \$4.1 billion of negotiable time certificates of deposit reaching maturity during the month with some \$1 billion maturing on the dividend and tax dates alone. By making their rates on new time certificates of deposit more attractive, the banks were successful in replacing the maturing certificates with new ones. Indeed, they even made progress in preparation for heavy maturities scheduled for April. As a result of these various factors, considerably less strain was experienced in the money market during the dividend and tax period than many observers had expected a few weeks earlier.

The first part of March was marked by a continua-

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

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

Factors	Changes in daily averages— week ended					Net changes
	March 2	March 9	March 16	March 23	March 30	
<b>"Market" factors</b>						
Member bank required reserves*	- 115	+ 138	- 73	- 263	+ 126	- 187
Operating transactions (subtotal)	+ 123	- 521	+ 176	+ 274	- 294	- 242
Federal Reserve float	- 67	- 195	- 38	+ 346	- 346	- 300
Treasury operations†	+ 53	+ 227	+ 98	- 177	- 102	+ 99
Gold and foreign account..	- 6	- 22	- 23	+ 11	- 67	- 107
Currency outside banks*	+ 142	- 527	+ 89	+ 16	+ 226	- 54
Other Federal Reserve accounts (net)‡	+ 1	- 2	+ 49	+ 78	- 4	+ 122
<b>Total "market" factors..</b>	<b>+ 8</b>	<b>- 383</b>	<b>+ 103</b>	<b>+ 11</b>	<b>- 168</b>	<b>- 429</b>
<b>Direct Federal Reserve credit transactions</b>						
Open market instruments						
Outright holdings:						
Government securities ...	- 72	+ 273	- 73	- 41	+ 194	+ 281
Bankers' acceptances ...	- 1	-	+ 2	+ 2	-	+ 3
Repurchase agreements:						
Government securities ...	-	-	+ 47	- 47	-	-
Bankers' acceptances ...	+ 14	+ 27	+ 2	+ 17	- 29	+ 31
Member bank borrowings ....	- 56	+ 150	- 78	+ 66	- 94	- 12
Other loans, discounts, and advances .....	-	-	-	+ 1	- 1	-
<b>Total .....</b>	<b>- 114</b>	<b>+ 451</b>	<b>- 101</b>	<b>- 1</b>	<b>+ 69</b>	<b>+ 304</b>
<b>Excess reserves*</b>	<b>- 106</b>	<b>+ 68</b>	<b>+ 2</b>	<b>+ 10</b>	<b>- 99</b>	<b>- 125</b>

Member bank:	Daily average levels					
	March 2	March 9	March 16	March 23	March 30	
Total reserves, including vault cash*	22,116	22,046	22,121	22,394	22,169	22,169‡
Required reserves*	21,823	21,685	21,758	22,021	21,895	21,836‡
Excess reserves*	293	361	363	373	274	333‡
Borrowings .....	464	614	536	602	508	545‡
Free reserves*	- 171	- 253	- 173	- 229	- 234	- 212‡
Nonborrowed reserves*	21,652	21,432	21,585	21,792	21,661	21,624‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					
	March 2	March 9	March 16	March 23	March 30	
Less than one year .....	+ 59	+ 291	+ 60	+ 110	- 34	+ 486
More than one year .....	-	-	+ 1	+ 9	-	+ 10
<b>Total .....</b>	<b>+ 59</b>	<b>+ 291</b>	<b>+ 61</b>	<b>+ 119</b>	<b>- 34</b>	<b>+ 496</b>

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 March 30.

**Table II**  
**RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS**  
**MARCH 1966**

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended					Average of five weeks ended March 30*
	March 2	March 9	March 16	March 23	March 30*	
Eight banks in New York City						
Reserve excess or deficiency (—) †	19	7	79	10	9	25
Less borrowings from Reserve Banks	—	21	21	110	21	35
Less net interbank Federal funds purchases or sales (—)	— 16	— 154	194	26	— 306	— 51
<i>Gross purchases</i>	1,035	869	1,166	1,002	1,013	1,017
<i>Gross sales</i>	1,050	1,023	972	976	1,319	1,068
Equals net basic reserve surplus or deficit (—)	35	140	— 137	— 127	294	41
Net loans to Government securities dealers	405	382	519	347	462	423

**Thirty-eight banks outside New York City**

Reserve excess or deficiency (-)†	25	18	45	19	25	26
Less borrowings from Reserve Banks .....	87	184	112	206	108	139
Less net interbank Federal funds purchases or sales(-)	660	588	512	684	530	595
Gross purchases .....	1,438	1,318	1,476	1,534	1,373	1,428
Gross sales .....	777	730	963	850	843	833
Equals net basic reserve surplus or deficit(-)	- 722	- 753	- 579	- 871	- 613	- 708
Net loans to Government securities dealers .....	159	90	169	186	213	163

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

\* Estimated reserve figures have not been adjusted for so-called "as of" debits and credits. These items are taken into account in final data.

† 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—March 1966			
	March 7	March 14	March 21	March 28
Three-month .....	4.620	4.718	4.576	4.555
Six-month .....	4.816	4.915	4.776	4.755
One-year .....	Monthly auction dates—January-March 1966			
	January 25	February 23	March 24	
	4.699	4.945	4.739	

\* 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.

tion of the intraweekly pattern of movements that had developed during the latter part of February. In each of these weeks, signs of tautness emerged on Thursday and Friday, with Federal funds trading at a  $\frac{1}{4}$  percentage point premium above the discount rate. The Federal Reserve sought to head off these pressures by injecting reserves through open market operations, but member banks still saw their reserves falling somewhat short of needs and thus tended to borrow heavily from their Reserve Banks over the weekends. Then, as excess reserves—augmented by such borrowings—spilled into the market after the weekends, a more comfortable atmosphere emerged, and the Federal Reserve sold securities to absorb the reserve surplus.

Such a pattern was particularly noticeable in the week ended March 16, which included both the dividend and tax dates. In anticipation of the possible credit demands around the tax date, member banks borrowed more than \$800 million from the Federal Reserve Banks over the March 12-13 weekend. Toward the end of the period the excess reserves thus accumulated flooded the central money market. With reserves in great abundance despite the credit and deposit expansion which occurred over the tax date—as evidenced by a nearly \$600 million increase in member bank required reserves during the week—Federal funds, which had traded at  $4\frac{5}{8}$  per cent and at  $4\frac{3}{4}$  per cent before the weekend, went begging at  $\frac{3}{4}$  of a per cent toward the close of the week.

The large credit demands of the dividend and tax period unwound at an unusually rapid pace in the statement period ended March 23. The money market banks experienced a swift reduction in their loans to Government securities dealers, and sizable repayments also occurred in other loan categories. In addition, the New York City banks continued to attract new negotiable certificates of deposit at rates ranging as high as  $5\frac{1}{2}$  per cent on 1967 maturities. During this period, however, the money market was quite firm. Federal funds traded mainly in a  $4\frac{5}{8}$  to  $4\frac{3}{4}$  per cent range, and average member bank borrowings from the Federal Reserve rose to \$602 million. Nationwide reserve availability contracted as market factors absorbed a larger volume of reserves than had generally been expected, while the injection of reserves by System Account after the weekend was hindered by scarcities in the market supply of Treasury bills and short-term coupon issues. System operations were minimal in the last statement week, and net borrowed reserves remained essentially unchanged. Weekly reporting member banks increased their loans and investments sharply, and banks in the central money market maintained comfortable reserve positions.

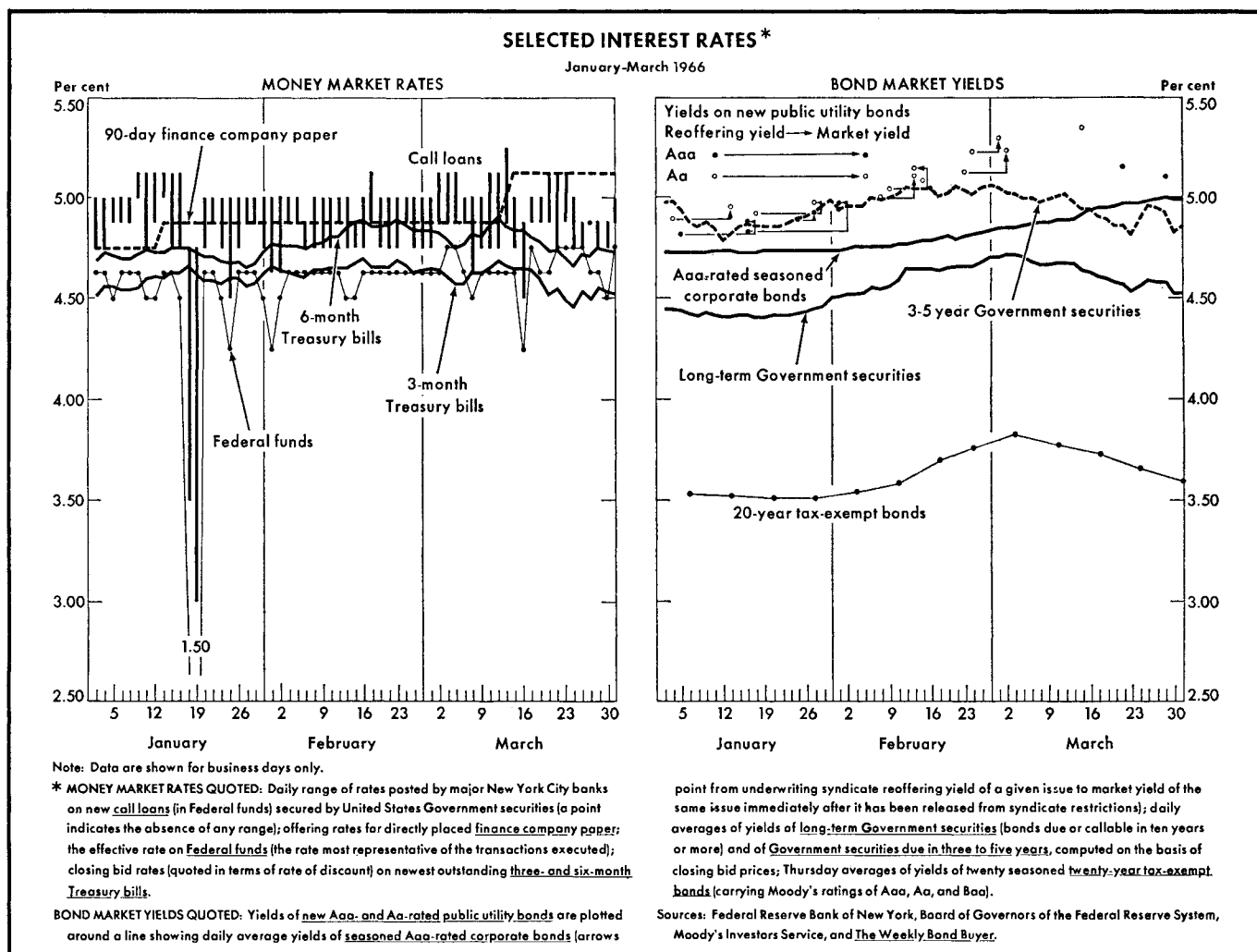
Just before the prime rate increase, dealers in bankers'

acceptances raised their rates on several maturities by  $\frac{1}{8}$  of a per cent. Subsequent to the March 10 increase in the prime rate, a number of other money market rates adjusted upward. By the end of the month, rates on commercial paper placed by dealers were  $\frac{3}{8}$  per cent higher, and finance company paper rates had been marked up by  $\frac{1}{4}$  of a per cent. In addition, most of the major New York City banks had raised their offering rates on new negotiable time certificates of deposit by  $\frac{1}{8}$  to  $\frac{1}{4}$  of a per cent, with  $5\frac{1}{4}$  per cent the most frequently posted rate on new three-to six-month certificates. As a result, the principal New York City banks managed to increase the volume of their certificates of deposit outstanding by almost \$350 million during the five-week period ended March 30.

#### THE GOVERNMENT SECURITIES MARKET

The price decline in the coupon sector of the Government securities market that had extended over the first two months of 1966 came to a halt in early March, and a much better atmosphere emerged as the month progressed. At the beginning of the month, dealers had trimmed their inventories to very small proportions and, in fact, had a sizable net short position in issues maturing in more than one year. Then, as market sentiment changed in response to the widespread discussion in the press and elsewhere of the need for more restrictive fiscal measures to contain inflation, professionals began to cover their short positions. The coupon sector also reacted favorably to the sharp decline in stock market prices then taking place. A modest investment demand for Treasury notes and bonds also developed, primarily from institutional investors. With the market supply of most Treasury issues very thin, bond prices moved sharply upward. (The right-hand panel of the chart illustrates the decline in yields which accompanied this rise in prices.)

The advance was temporarily interrupted on March 10 and 11 when dealers cautiously marked prices of intermediate- and long-term issues lower, in reaction to the long-expected news of the prime loan rate rise and to the publication of data indicating a somewhat deeper level of nationwide net borrowed reserves. Little investor selling developed, however, and a strong market tone quickly reappeared with prices of coupon issues moving up once more. The postponement of several corporate and tax-exempt flotations—including a huge tax-exempt bond issue which had been scheduled for March 17—also encouraged the market for Government securities, as did the success of the issues that were floated, including a large issue of participation certificates sold by the Federal National Mortgage Association. These postponements



moderated the current demand for funds from the capital markets and triggered the release of funds which investors had earmarked for the purchase of the various postponed issues. The price rally in the coupon sector temporarily faltered on March 24 and 25, when the market reacted hesitantly to the latest banking statistics indicating a further decline in nationwide reserve availability and a gold outflow. Moderate investment selling stimulated increased professional offerings, and prices of most issues declined rather sharply. Subsequently, however, prices rebounded as the market reacted to the good reception accorded a \$250 million American Telephone and Telegraph Company bond flotation and to President Johnson's comments on the possibility of a future tax increase.

In the market for Treasury bills, an excellent tone

persisted in March, primarily reflecting an unseasonable scarcity in the market availability of many bill issues. Early in the period, rates for most issues trended lower when a broadly based buying interest—particularly from public funds—encountered limited offerings (see the left-hand panel of the chart). An undertone of caution was evident during this period, however, as traders anticipated the usual increase in the supply of bills over the approaching March dividend and tax period. In the wake of the March 10 increase in the prime loan rate and news of the contraction in nationwide reserve availability during the March 9 statement period, bill rates briefly jumped higher, largely reflecting the wary reaction of professional participants. Soon, however, bill rates dropped again, as a steady investment demand confronted growing market

scarcities. Both March 10, a popular dividend payment date, and the midmonth corporate tax payment date passed without the appearance of any real pressures in the bill market. In fact, the amount of securities returned to dealers on March 10 and March 15 from maturing corporate repurchase agreements was somewhat less than in March 1965, and considerably less than in the intervening quarterly dividend and tax dates. Bill rates continued to edge lower during the remainder of the month, in response to a good demand from public funds and from commercial banks purchasing securities in preparation for the Cook County tax date and for end-of-quarter statements.

United States Government-sponsored agencies sold \$2.2 billion in new securities during March, raising over \$1.1 billion in new money. Rates on new issues moved higher under the weight of these offerings until around midmonth when a \$410 million offering of Federal National Mortgage Association participation certificates was very well received. The Commodity Credit Corporation auctioned, on March 30, \$500 million of 117-day "certificates of interest" in a pool of its price-support loans on agricultural commodities. The certificates, which were issued on April 6 and will mature on August 1, were sold at an average issuing rate of 5.194 per cent.

#### OTHER SECURITIES MARKETS

The deeply cautious undertone, which had permeated the corporate and tax-exempt markets during much of the year, carried over into the early part of March as investors apprehensively awaited a heavy calendar of scheduled offerings. During this period, the continuing terminations of syndicate price restrictions on slow-moving corporate and tax-exempt issues produced substantial upward adjustments in reoffering yields. These adjustments, however, generated increased investor demand and enabled dealers to make large reductions in their inventories of older bonds.

Subsequently, the successful marketing of several new corporate and tax-exempt bond issues, priced in line with the prevailing higher yields, reinforced the growing impression that yields had at last climbed to a point at which investors were prepared to commit a large volume of funds. There was also increasing evidence of developing borrower resistance to the mounting interest charges. Several offerings were canceled or postponed during the month, the most important of them being the \$440 million New Jersey Turnpike issue which had been scheduled for March 17 and would reportedly have been the largest tax-exempt bond flotation in United States financial history. With both demand and supply factors contributing to an improved market tone, prices of many corporate and tax-exempt bonds edged higher during the remainder of the month. After the Turnpike issue was postponed, investors began to turn loose funds which they had stockpiled for that issue and for other postponed flotations. As a result, dealers made good progress in reducing their inventories of corporate and tax-exempt bonds, while new issues which were subsequently marketed were accorded generally good receptions. By the end of March the Blue List of dealers' advertised inventories of tax-exempt issues had declined by \$200 million to \$333 million. In the corporate sector, the long awaited \$250 million American Telephone and Telegraph issue was marketed late in the month. The issue, which consisted of Aaa-rated 5½ per cent debentures maturing in 2001, was reoffered to yield 5.11 per cent and was very well received.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 15 basis points to 4.99 per cent, while, *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) fell by 17 basis points to 3.59 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.