

# FEDERAL RESERVE BANK OF NEW YORK



## MONTHLY REVIEW

JULY 1966

### Contents

The Business Situation.....	154
Recent Developments in the Capital Markets....	158
The Money and Bond Markets in June.....	163

Volume 48

No. 7

## The Business Situation

Many important business indicators have recently shown improvement from their April performance, when strikes and poor weather contributed to declines in production and sales in several sectors of the economy. While the current pace of the expansion still remains below the very sharp and strongly inflationary first-quarter advance, the pressure of aggregate demand continues to place the economy's productive resources under considerable strain. The price situation clearly remains a cause for concern. Although prices of farm products have ceased their sharp uptrend and have even declined somewhat in recent months, other prices continue to move up. Over the first five months of the year industrial wholesale prices climbed at an annual rate of 3.5 per cent, on average, and there appears to have been a further rise in June.

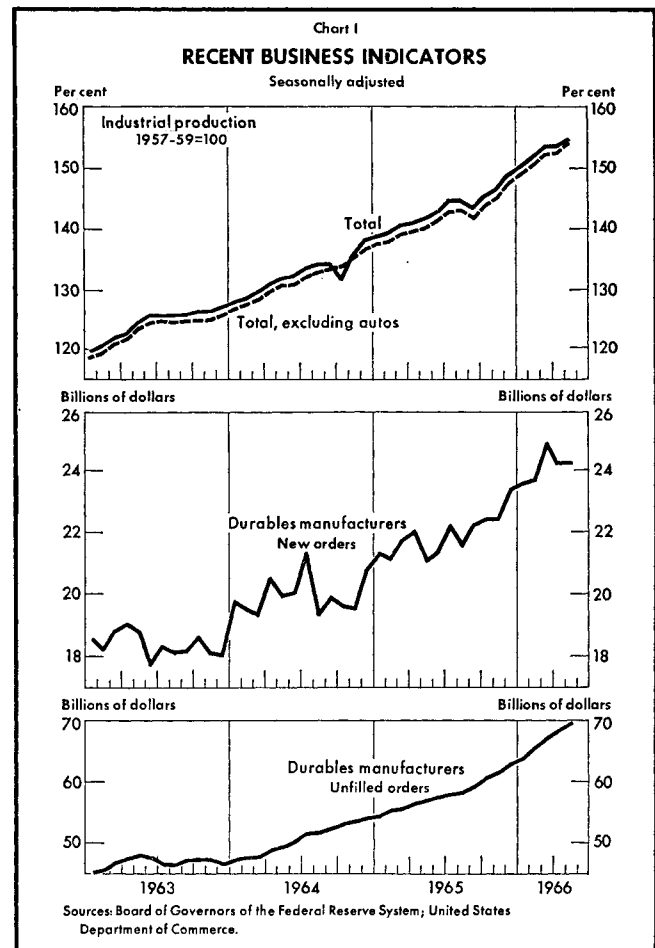
One unfavorable element in the outlook for price behavior is evidence suggesting that the rate of advance in labor productivity has been slowing down recently. Moreover, past increases in consumer prices, expanded profits, and generally tight labor market conditions may lead organized labor to press for relatively substantial settlements in the important wage negotiations that are coming up in the months ahead. Wage rates in non-organized industries are also under pressure. Against this background, the past stability in labor costs per unit of manufacturing output—a key factor accounting for the relative price stability over much of the current expansion—may be difficult to maintain.

### CURRENT ECONOMIC DEVELOPMENTS

Industrial production, as measured by the Federal Reserve Board's index, rose by a sizable 0.8 per cent in May (seasonally adjusted), despite a further decline in automobile assemblies (see Chart I). This advance partly reflected a recovery from the effects of strikes during April in the coal-mining and railroad industries, which were a major factor in holding the April rise to a small 0.2 per cent. Nevertheless, the May expansion in production was

broadly based: output of consumer goods other than automobiles advanced, iron and steel activity moved higher, and production of equipment rose by a strong 2.2 per cent to a level some 17 per cent above a year earlier.

Lagging automobile sales and high inventories led to a large cutback in the production of new cars in May.



Several reasons for the weakness in sales have been noted, including the exceptionally high rate of auto sales in the first quarter, the reimposition of the January excise tax cut on automobiles, and the recent public discussion of the car-safety problem. These factors may have only a temporary dampening influence on car sales, and a clearer picture of the basic demand for automobiles should emerge after the 1967 models come on the market. Auto sales did improve materially from May to June on a seasonally adjusted basis, but the near-term outlook for auto production remains affected by the currently high level of inventories. At the end of June, dealer inventories of new cars represented about sixty days' sales at that month's selling pace, largely unchanged from the May inventory-sales ratio which was the highest figure in five years. Accordingly, while new-car assemblies in June rose by about 2 per cent to a seasonally adjusted annual rate of 8.7 million units, a large reduction in automobile assemblies is now scheduled for July when some plants will be closed earlier than usual for the annual model changeover.

Reflecting the reduced rate of new-car output, automotive orders for finished steel products declined sharply in May. Overall steel demand held firm at most major mills, however, as defense orders were reportedly taking up much of the automotive slack. Despite a possible further decline in shipments to car manufacturers through early summer, steelmakers apparently remain generally optimistic about near-term prospects, and anticipate continuing good steel demand for appliances, construction, and capital goods as well as a stream of orders for military purposes. In June, steel output was near the high annual rate of roughly 140 million tons (seasonally adjusted) turned out in May.

Other major suppliers to the auto industry are also feeling the effects of the cutback in assemblies. In several cases, however, the resulting sales loss is being partially offset by heavy demands for trucks, railroad rolling stock, and capital equipment generally. To some producers, moreover, moderation from the recent pace in the flow of orders would not be altogether unwelcome in view of heavy backlogs of orders and the need to provide for equipment maintenance that has been deferred during recent periods. In the case of the steel industry, for example, reports in trade publications indicate that a heavy flow of orders during the summer could create problems, since equipment repairs are "long overdue".

The overall volume of new orders received by manufacturers of durable goods was roughly unchanged in May, remaining at the high monthly average of the first quarter of the year (see Chart I). New orders received by manufacturers of machinery and equipment continued to reflect

the strength of capital spending, and in May were nearly 18 per cent above May 1965 bookings. For all durables manufacturers combined, incoming orders stayed well ahead of shipments, and the backlog of unfilled orders on these producers' books registered another large advance. This gain brought the stock of unfilled orders to a level equal to three months' shipments at the present monthly rate, up by about a week from the start of the year.

Manufacturers' inventory plans also point to continued near-term strength in production. According to a Commerce Department survey taken in the middle of the second quarter, manufacturers anticipated adding \$1.3 billion to the book values of their inventories during that quarter. While such a gain would be below the quarterly inventory additions of \$1.6 billion to \$1.7 billion realized since mid-1965, the survey found producers expecting to raise the accumulation rate back up to \$1.6 billion in the third quarter. Moreover, during the last year and a half, manufacturers' inventory projections for the ensuing quarter have tended to underestimate actual accumulation—in some cases by more than \$1 billion. The planned additions to inventory stocks in the third quarter are about in line with manufacturers' sales projections for that quarter. If both sets of expectations are realized, inventories at the end of September will approximate 1.6 months of sales, representing little change from the relationship prevailing since early 1965.

The strength in overall production during May showed up in the long hours put in by production workers in the manufacturing industries. To be sure, a reduction in hours at automobile plants did produce a small 0.1 hour decline (seasonally adjusted) in average weekly hours worked. Nevertheless, the workweek remained at a high 41.4 hours, around the level prevailing since the fourth quarter of last year. Overtime hours continued at the record high first-quarter rate of 4.1 hours a week. The number of workers on factory payrolls, however, rose by only 58,000 (seasonally adjusted) in May, about one half the strong average rate of increase recorded in the first quarter of the year. Some of the slackening in factory employment growth reflected the weakness in the automotive industry, although small declines in employment were noted in a few other manufacturing groups. With small employment gains reported in wholesale and retail trade, together with a sharp drop in construction workers, total nonfarm payroll employment increased in May at about half the rapid first-quarter rate.

The further growth in nonfarm payroll employment in May resulted in another gain in total personal income, but as in the case of employment, the monthly advance was considerably below the average increase experienced in the

first quarter. The slower growth of income, in turn, was partly responsible for the weakness in consumer demand during May, when retail sales fell for the second consecutive month. As in April, lower auto sales accounted for a sizable portion of the decline, although consumer expenditures for other durable goods apparently were also lower. Spending on nondurables was largely unchanged from the record level of the previous month.

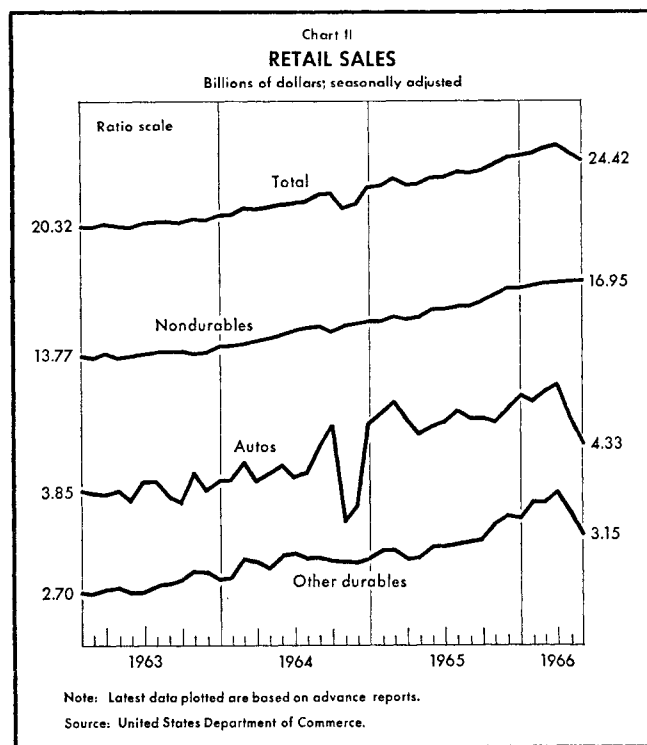
Along with the more modest rate of gain in personal income, and the increase on May 1 in the level of personal income tax withholdings, some of the moderation in spending undoubtedly also reflects a reaction to the exceptionally heavy buying in previous months. Consumer outlays for automobiles (as noted earlier) as well as purchases of other durable and nondurable goods were at unusually high levels in the first quarter of the year (see Chart II), and the ratio of saving to disposable income declined significantly. Consumer spending now appears to be adjusting to a more normal relationship to incomes. Part of the enlarged outlays on nondurables in recent past months was attributable to higher food prices; the present leveling-off in these prices may now be holding down the dollar advance in nondurables purchases.

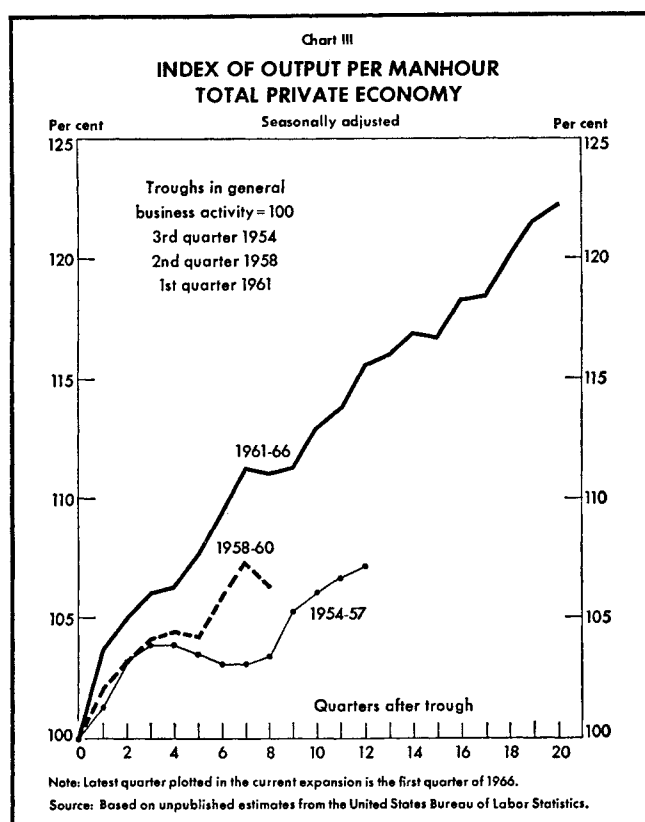
In another area related to consumer demand, outlays for new residential construction were up moderately in May;

however, some near-term easing appears in process in this sector, reflecting the higher cost and reduced availability of mortgage money. In May, seasonally adjusted private nonfarm housing starts and newly issued building permits fell to around their lowest levels of the current expansion. These indicators are heavily influenced by weather conditions and hence tend to be highly variable from month to month. Nevertheless, the annual rate of housing starts during the first five months of the year was about 2.5 per cent below the 1965 total, while permits dropped about 3.6 per cent. Much of the recent weakness in the residential sector has been offset, however, by strong gains in commercial and industrial construction. Indeed, aggregate spending for new construction during the first five months of the year, measured at an annual rate, was more than 6 per cent ahead of the total in 1965. Given the buoyancy of business capital spending plans for 1966, commercial and industrial construction will likely make up for continued sluggishness in new home building.

#### PRODUCTIVITY TRENDS AND THE OUTLOOK FOR PRICES

Certainly one of the most noteworthy features of the current business expansion has been the sharp and unusually prolonged rise in output per manhour (see Chart III). This growth of productivity has made an important contribution to the high degree of price stability that prevailed until late 1965, and may therefore have been one of the more important factors contributing to the record length of the expansion. Recent developments, however, have raised questions about the sustainability of high rates of productivity gain, while at the same time the outlook for continued moderation in the size of wage increases has dimmed appreciably. Because forthcoming wage contracts in important "pace-setting" industries will be negotiated against the background of sharply higher consumer prices, low unemployment, expanded profits, and large order backlogs, some observers foresee wage settlements in excess of the Administration's guideposts for noninflationary increases. These guideposts are intended to approximate the long-run trend of productivity growth and currently call for wage increases of no more than 3.2 per cent per year. If productivity growth falls below this rate of increase while wage settlements go substantially beyond it, labor costs per unit of output will increase. Moreover, as long as currently strong demand conditions persist, businesses would be very likely to pass on part or all of any increases in labor costs in the form of higher prices. Thus, the behavior of productivity in the period ahead will be important in determining whether or not price increases





remain within tolerable limits.

Output per manhour in the private sector of the economy has advanced at an average annual rate of 4.1 per cent since the beginning of this expansion, and the total rise over this period has amounted to 22 per cent.<sup>1</sup> In comparison, productivity advanced at an annual rate of only 3.1 per cent during the 1958-60 business expansion, and by an even smaller 2.3 per cent annual rate in the 1954-57 upswing.

The available evidence suggests that the faster rate of advance in overall productivity in the current expansion relative to the two prior cyclical upswings has been due to a more rapid growth of productivity outside of manu-

<sup>1</sup> In this section, the quarterly data on labor productivity for the entire private economy and for its nonagricultural and agricultural subsectors are unpublished estimates from the Bureau of Labor Statistics. Labor productivity data for manufacturing are unpublished estimates computed by the Federal Reserve Bank of New York. Estimated manhours are based primarily on data derived from the Government's monthly survey of payroll employment.

facturing. Indeed, the 4.3 per cent rise in productivity in manufacturing during the current expansion has only roughly equaled the average of the two preceding expansions. While direct data on other nonfarm sectors—i.e., services, utilities, trade, and mining—are lacking, productivity growth in these industries as a group has apparently been more rapid in the current advance than earlier. Moreover, gains in farm productivity since early 1961, at about 5 per cent per year, have been notably above the roughly 3 per cent and 4 per cent rates recorded in the 1954-57 and 1958-60 upswings, respectively.

In previous expansions, productivity gains have tended to be substantially slower after the economy has reached relatively full resource utilization than in the earlier stages of the upturn. This tendency probably reflects in part the fact that once the slack in the economy has been taken up, additional output requires drawing more heavily upon less qualified workers and either reactivating older plant and equipment or working newer facilities beyond the point of greatest efficiency. The comparatively high unemployment rates and low rates of capacity utilization that prevailed during the first years of the current expansion may partly account for the maintenance of productivity gains at so high a rate for so long a period. More recently, the margin of unused resources has shrunk, and there appear to have been some signs of a slackening-off in productivity growth. After rising by 3.6 per cent in 1964, total private output per manhour advanced by only 2.8 per cent in 1965 and slowed down further to a 2.4 per cent annual rate in the first quarter of this year. The current shortages of many types of skilled labor and relatively high rates of plant utilization may well tend to restrain productivity growth in the future.

At the same time that productivity gains have narrowed, tightening labor market conditions and rising consumer prices are adding to wage pressures. The unemployment rate averaged a low 3.8 per cent in the first five months of this year, down from a 4.6 per cent rate in 1965 and the lowest rate since 1957. Since the end of last year, the unemployment rate for married men—the main reservoir of skilled and experienced workers—has averaged slightly more than 1.8 per cent, the smallest figure in the eleven-year history of this series. With respect to prices, the consumer price index advanced by 2.7 per cent in the year ended May 1966, after increasing by a moderate 1.2 per cent on average in the first four years of the expansion. Taking into account also the increase in social security contributions last January, the purchasing power of the take-home pay of many workers has declined since May 1965.

There is thus a real danger that both labor supply and



price factors may push up wage demands in the coming round of negotiations. While the collective-bargaining calendar for the remainder of this year is light, many contracts are reopening in 1967, covering workers in such key fields as the automobile, machinery, trucking, rubber, communications, paper, food products, and apparel industries. Additional gains in productivity will continue to

moderate the effect of higher wages on unit labor costs. As already indicated, such an offset is not likely to be so important as it was earlier in the upswing. Nevertheless, the currently rapid growth in industrial capacity gives hope that the rise in productivity will not slow down as much as it did in previous periods of high resource utilization.

## Recent Developments in the Capital Markets

The continued advance of economic activity has led to a considerable intensification of pressures on the nation's capital markets during the past several months. Overall demands for funds have attained record levels, and yields on long-term obligations of corporations and governments have risen strongly to postwar highs following a period of comparative stability which had begun in late 1961. Home mortgage rates have also increased sharply, after having remained virtually unchanged at reduced levels in 1964 and most of 1965, as depository institutions specializing in mortgage lending found it increasingly difficult to attract and retain interest-sensitive savings accounts in the face of higher yields available elsewhere. While commercial bank credit has continued to expand at a rate only modestly reduced from last year's rapid pace, the total volume of funds available through financial intermediaries as a group has not kept up with overall credit demands. At the same time, direct (unintermediated) market lending by businesses, households, and governments has recently assumed a major role in financial flows for the first time since 1960. In this environment, many borrowers have found it necessary to resort to other than their normally preferred sources of credit.

### BUSINESS FINANCE

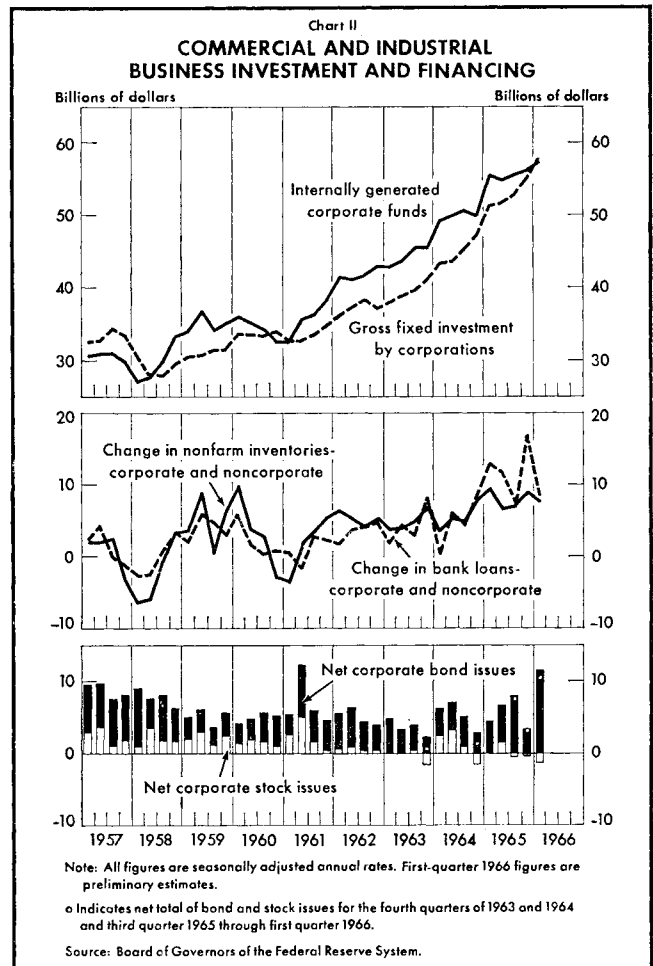
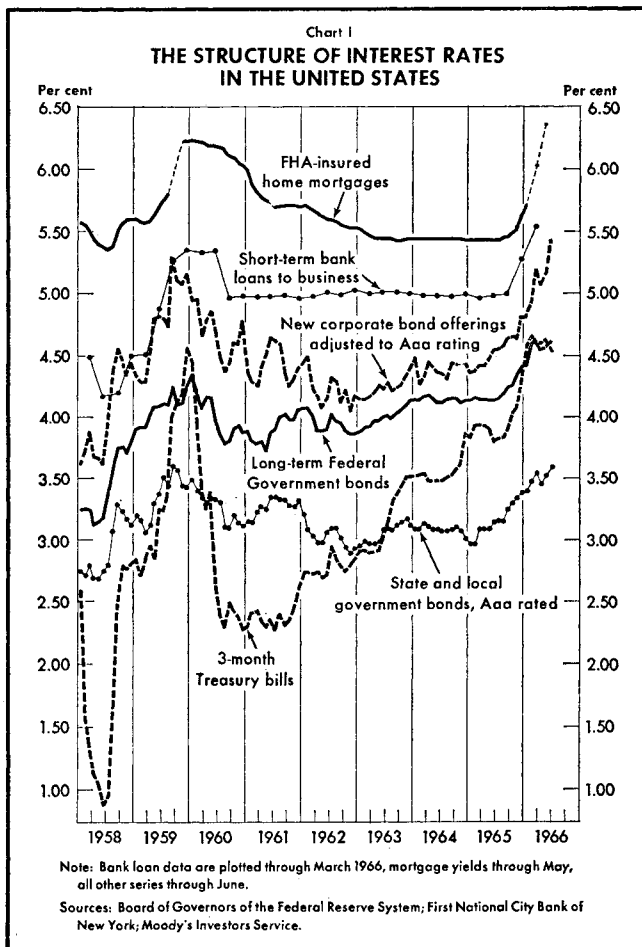
Despite continued growth in internally generated funds, business firms are now experiencing exceptionally large cash requirements, and are relying increasingly on the capital markets for additional funds. This is true although capital market rates have risen substantially (see Chart I),

as has the cost of bank loans. Corporate income tax payments, which were speeded up considerably in 1964, were accelerated further beginning April 15 of this year. According to Treasury Department estimates, the adjustment in tax payment schedules added about \$3.2 billion to the total tax remittances of businesses in April and June of 1966. In addition, beginning June 20, large employers were required to make more frequent payments to the Treasury of both social security contributions and withheld individual income taxes, drawing off an estimated additional \$1.3 billion of business working capital. Moreover, while internally generated funds had exceeded business fixed investment earlier in the expansion (at times by a substantial margin), this net source of long-term corporate funds was eliminated during the past year by the continued sharp rise of plant and equipment spending (see Chart II).

The major supplier of funds to finance these expanding capital needs has been the long-term corporate securities market. Estimated total gross new issues of corporate bonds during the first half of this year amounted to \$7,875 million, \$1,175 million higher than the total in the corresponding period of 1965 and the largest volume of bond flotations during any half-yearly period in the past eleven years—including the period of the 1955-57 capital-spending boom. According to preliminary figures, *net* bond issues also expanded, at a rate considerably faster than the previous record increase in 1961. At the same time, the supply of funds available for investment in bonds has become less plentiful at those financial institutions which traditionally have offered major support to the

corporate bond market. Since the beginning of 1965, direct placement of corporate securities with insurance companies and other institutional investors has not grown so rapidly as publicly offered issues. Faced with the heavy volume of bond offerings thus far this year, life insurance companies have not been able to keep pace with corporate borrowing demands and consequently appear to have run up an unusually large backlog of forward commitments, tying up their investment funds for some time to come. Moreover, a larger than seasonal increase in policy loans at some life insurance companies may have placed an additional strain on their cash flows.

With the sharp rise in publicly offered issues, yields on new underwritten corporate bonds have advanced to record postwar levels (see Chart I). Similarly, the spread between underwriters' offering rates on new corporate bonds and market rates on outstanding corporate and Treasury issues has recently approached levels attained in



the 1959-60 period of peak interest-rate pressures.

Net new issues of common and preferred stock remained virtually zero in the first quarter. Gross new stock issues rose substantially, but conversions of outstanding preferred issues into bonds and repurchases of common stock for corporate-administered pension funds and employee stock option plans again apparently provided more than an offset. Nevertheless, the fact that gross new stock issues have recently increased provides some additional evidence of the enlarged need of corporations for long-term funds.

Faced with substantial cash drains and with a sizable rate of inventory expenditures (see Chart II), nonfinancial businesses have continued to place considerable demands on the commercial banks for short- and intermediate-term loans, despite the rise in commercial bank prime lending rates last December, in March, and again in June.

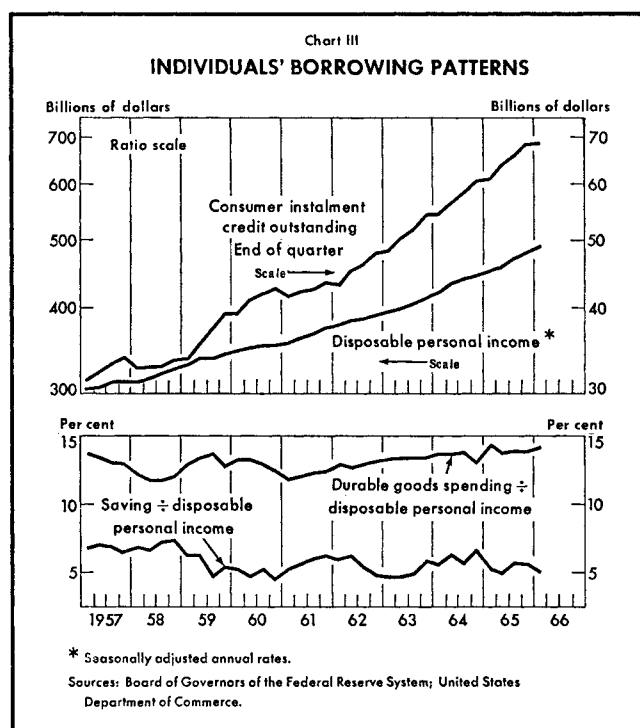
Bank loans to businesses have grown about as rapidly so far in 1966 as the 19 per cent rate for 1965. Also, many large corporations have turned to the commercial paper market for additional short-term credit, as bank borrowing costs have risen relative to this alternative.

There are signs that funds for smaller businesses are also in short supply. Trade credit borrowing by noncorporate business has recently expanded at a rapid pace, with an even larger increase in corporate trade receivables. Thus, nonfinancial corporations with greater access to commercial banks and the capital markets are apparently being called upon to finance more of the short-term needs of their smaller noncorporate customers. Moreover, perhaps also reflecting reduced availability of bank credit to many borrowers, finance companies increased their business lending volume by almost \$1½ billion in the first quarter of 1966, the largest quarterly increase in over fourteen years. Judging from their current heavy borrowings at commercial banks, finance companies most probably have continued to extend a substantial amount of business credit to small- and medium-sized firms in the second quarter of the year.

### CONSUMER FINANCE

Although the increase in social security taxes at the beginning of the year has restrained the growth of take-home pay of individuals, consumer spending nonetheless continued to grow strongly through the first quarter of the year. As a result, saving in the first quarter declined to 5.0 per cent of disposable income,  $\frac{1}{10}$  of a percentage point below its 1961-65 average (see Chart III). Perhaps partly due to anticipation of the reimposition in mid-March of automobile excise taxes, total consumer spending on durable goods absorbed a higher proportion of income in the first quarter of the year than in 1965, and instalment credit, which usually finances much of such expenditures, grew significantly. This pace of consumer borrowing has not carried over into the second quarter, however. Undoubtedly, the recent slowdown in automobile sales has reduced the demand for instalment credit, but credit supply conditions may also have been a limiting factor. Thus, as credit conditions have gradually tightened, lending at commercial banks has become progressively more selective in all areas—including loans to consumers. Moreover, small consumer finance companies have also reportedly been experiencing some difficulty in meeting applications for instalment loans. The extent of these developing pressures on the supply of consumer credit was reflected in recent increases of bank rates on this type of loan.

The supply of mortgage credit to home buyers is also



currently under pressure in many regions of the country. Following an earlier three-year decline, market rates on mortgages remained remarkably stable during 1964 and the first half of 1965. But since mid-1965 these rates have increased markedly, and the rise in the past few months has been especially sharp (see Chart I). The explanation for this development can be found primarily in the changing pattern of individuals' holdings of financial assets as the structure of interest rates has altered. Those thrift institutions which are the major suppliers of home mortgage loans—savings and loan associations and mutual savings banks—had for many years been able to offer their depositors interest rates which were highly competitive with, if not superior to, rates available to individuals on alternative investments. But since mid-1965, when open market rates began to move up, the competitive position of these financial intermediaries has been gradually impaired. Thus, while their deposit rates have changed little in the past twelve months, yields on prime-grade marketable securities have risen by as much as  $\frac{1}{2}$  to  $\frac{3}{4}$  of a percentage point.

At the same time, commercial banks, due to the relatively short maturities of their loan portfolios, have been able to keep the rate of return on their earning assets closer to prevailing market interest rates than have other depository



institutions. This, in turn, has permitted banks to remain more competitive in the rates they can offer on time deposits of businesses and savings certificates of individuals. (On the other hand, commercial banks are restricted under Regulation Q to a 4 per cent maximum rate on passbook savings accounts.)

The result of the generally diminished competitiveness of savings and loan associations and mutual savings banks has been a shifting of interest-sensitive funds away from these institutions and a resulting contraction in the supply of new mortgage credit from these important sources. Even though individuals have continued to put record amounts of new funds into these thrift institutions, others have withdrawn deposits in record volume. In view of the estimated all-time high of a \$3.3 billion increase in consumer holdings of marketable securities during the first quarter, practically as large as in all of 1965, a substantial portion of the funds withdrawn from thrift institutions has evidently been placed directly in market instruments rather than in the fixed-claim assets of other intermediaries.

#### GOVERNMENT FINANCE

Despite sharply rising revenues, state and local governments have made exceptionally heavy demands on the capital markets thus far in 1966. These borrowers marketed \$2.9 billion of new bond issues (gross) in the first quarter, the largest first-quarter amount on record, and are estimated to have issued another \$3.2 billion in the second quarter as well. At the same time, commercial banks reduced substantially their net purchases of state and municipal bonds, thereby removing much of the important buying support they had given to this market in earlier years. As a result, market yields on these bonds were breaking into new high ground for the postwar period during March, and individuals, partly through bank-administered trust accounts, apparently purchased the bulk of the supply of net new tax-exempt issues brought to market in the first quarter of the year.

The Federal Government has also exerted pressure on the bond markets in 1966 despite larger than anticipated tax receipts. To be sure, the current calendar half year represents a period of seasonal debt repayment by the Treasury, and redemptions have been larger than usual this year. However, offerings of securities by Federally sponsored agencies have been exceptionally heavy. Agency borrowing amounted to an estimated \$3,368 million in the January-June period, an increase of \$2,259 million over the comparable period of 1965. Sales to the public of participations in Federal loans have totaled another \$2,201 million thus far this year, more than twice the

amount offered in all of 1965. The Federal National Mortgage Association increased its outstanding indebtedness by \$764 million in the first three months of the year to finance the largest quarterly volume of mortgage purchases in the 11½-year history of its mortgage market support operations. Also, the sharply reduced net growth of deposits at savings and loan associations, discussed earlier, prompted these institutions to seek record amounts of borrowing from the Federal Home Loan Banks. These banks, in turn, found it necessary to raise \$1,088 million of new funds during the first six months of the year in the short and intermediate sectors of the financial markets.

These numerous agency financing operations had a considerable tightening effect in markets already strained by record corporate and state and local borrowing, especially since agency issues compete relatively directly with some types of private securities. Moreover, the clustering of agency issues in the shorter term area of the market has contributed to the especially sharp rise of interest rates in the one- to five-year maturity area relative to other segments of the maturity spectrum.

New long-term borrowing by the Treasury has been severely restricted by the recent substantial increase in Government bond yields to levels exceeding by a wide margin the 4¼ per cent legal ceiling for coupon rates on securities of five years or longer maturity. With Treasury financing operations confined entirely to short- and intermediate-term issues, the average maturity of the public debt has been shortened somewhat from five years at the close of 1965 to an estimated four years eleven months as of the end of June.

#### ROLE OF THE BANKING SYSTEM

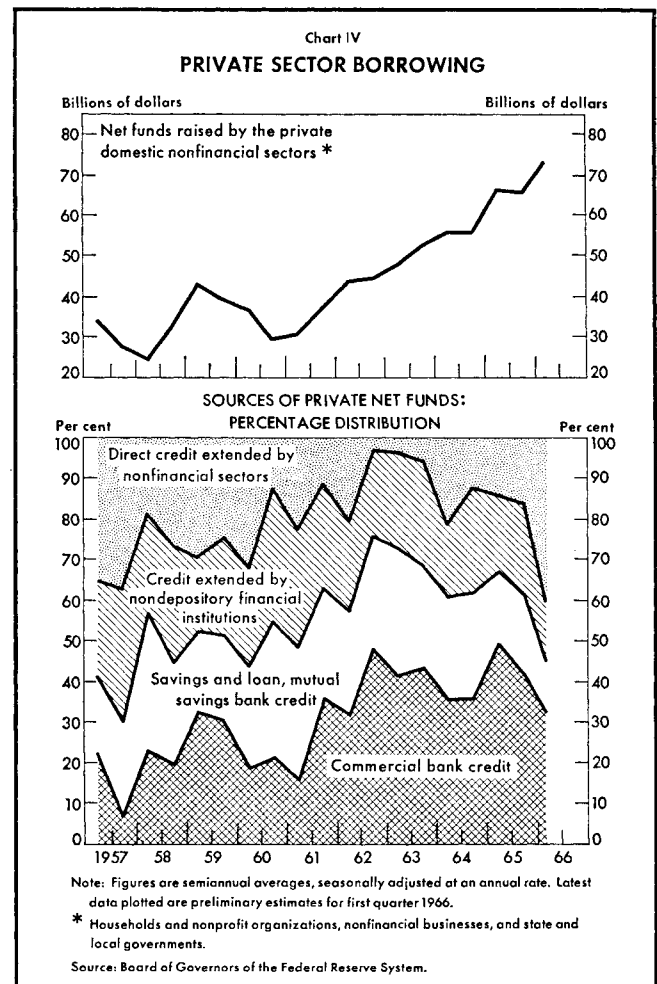
Commercial banks continued to be important suppliers of funds to the capital markets in 1966. But, with the gradual tightening of bank credit conditions, the relative importance of banks in total credit growth declined somewhat and significant shifts of emphasis were apparent in banks' portfolio decisions.

Total bank credit appears to have grown only somewhat less rapidly over the first six months of this year than the 10 per cent annual rate of increase posted for the year 1965. Nevertheless, the recent tightening in credit conditions has been partly reflected in the fact that banks liquidated even more of their United States Government securities in the January-June period of 1966 than the large \$6.1 billion reduction in the like period a year ago. Moreover, as mentioned earlier, bank purchases of the securities of state and local governments were reduced rather sharply from previous levels. Whereas bank pur-

chases of state and local obligations in the earlier years of the current economic expansion ranged between 60 per cent and 90 per cent of the annual net new issues of these securities, in the first quarter of 1966 this participation rate was reduced to perhaps below 20 per cent.

These developments in commercial bank holdings of securities helped make it possible for banks to continue supplying many types of loans in high volume. Business loans in the first six months of the year are estimated to have risen at about last year's rate. Similarly, net extensions of real estate loans have remained only slightly below last year's rate of growth. Consumer loans did, however, experience a decline in growth after a strong first-quarter expansion, but at least a part of this decline was due to a weakening in total demand for consumer credit as a result of the recent downward adjustment of automobile purchases.

Despite the continued strong showing of overall bank lending, commercial banks have recently experienced a reduction in their share of the private credit markets (see Chart IV). Thus, while net funds raised by domestic nonfinancial borrowers other than the Federal Government have continued to grow sharply, bank credit to these borrowers has moderated. In the first half of 1965, bank credit reached a record 50 per cent of total household, business, and state and local government borrowing, but this ratio dropped in the second half of 1965 and then declined to only slightly more than 30 per cent in the first quarter of this year. Moreover, in view of the continued strength of borrowing by these sectors, contrasted with the April and May bank credit growth at a rate unchanged from its first-quarter pace, the ratio is likely to have remained near this level in the second quarter as well. This banking development was paralleled by an even sharper decline in the credit market share of other groupings of financial intermediaries, as direct credit extended by the nonfinancial sectors, discussed earlier, advanced to a record 40 per cent of the market (see Chart IV). To an important extent, the ability of banks to maintain a comparatively sizable share of private credit reflected their continued competitiveness in the market for time deposits. Recently, however, banks have found it necessary to offer



the maximum 5½ per cent rate on large time certificates of deposit with shorter and shorter maturities in order to maintain the attractiveness of these deposits relative to other money market instruments. With these certificates of deposit rates now at the Regulation Q ceiling, many banks may find it increasingly difficult to attract the funds they need to maintain their past rates of lending.

## The Money and Bond Markets in June

The money market remained very firm in June. Bank credit expanded strongly over the mid-June corporate tax period and also in the latter part of the month, while nationwide reserve availability held steady on average at the reduced May volume. As both credit demand and reserve supply pressures converged upon the money market in June, interest rates came under general upward pressure. This pressure was highlighted by a rise on June 29 and June 30 in the prime lending rate of most commercial banks from  $5\frac{1}{2}$  per cent to  $5\frac{3}{4}$  per cent. In addition, rates on bankers' acceptances, commercial paper, and sales finance company paper were increased by  $\frac{1}{8}$  of a per cent in late June. Federal funds traded at generally high rates throughout the month; toward the end of the period the effective rate climbed for the first time to  $5\frac{1}{2}$  per cent, 1 percentage point above the discount rate, while some funds even traded at  $5\frac{5}{8}$  per cent.

In sharp contrast to the firmness of most other money market rates, yields on Treasury bills continued to edge lower during most of the month in response to a broadly based demand from public funds and other sources which pressed upon scarce market supplies. Even over the June 10 and June 15 corporate dividend and tax payment dates, bill offerings were not heavy and market pressures were minimal. The technical position of the bill sector subsequently improved further when \$4.5 billion of tax anticipation bills matured on June 22. A hesitant tone developed in the bill market late in the month, however, when offerings increased and rates rose.

Bond yields continued to move higher in early June, but capital market sentiment improved markedly during the second third of the month, when many traders began to feel that interest rates might be near their peaks. In part, this feeling reflected the better receptions then being accorded new corporate, tax-exempt, and Government agency offerings, all of which carried near-record yields. An additional factor was the feeling on the part of some traders that the pace of economic expansion was slackening.

As bond market sentiment strengthened, a good investment and dealer demand developed for Treasury notes and bonds, and prices of these securities rebounded sharply around midmonth. Later in June, prices of coupon issues

first drifted below their highs of the month in profit-taking activity, and then fell sharply when renewed concern developed over the viability of prevailing interest rate levels. Contributing to the reemergence of a cautious atmosphere throughout the bond markets was the increase from 4 per cent to 5 per cent in reserve requirements against certain time deposits of member banks announced by the Board of Governors of the Federal Reserve System on June 27. The increase will apply to each member bank's time deposits—other than passbook savings accounts—in excess of \$5 million. (The first \$5 million of time deposit accounts will continue to be subject to a 4 per cent reserve requirement.)

In the markets for corporate and tax-exempt bonds, new issue yields continued to rise through midmonth. Prices then generally edged slightly higher for almost two weeks when many offerings attracted fairly good investor interest. In the closing days of June, interest in new issues became more selective at the higher price levels and, as dealer inventories increased, a heavier tone reemerged.

### THE MONEY MARKET AND BANK RESERVES

The money market was quite firm in June, especially in the week following the midmonth quarterly corporate tax payment date when accelerated payment schedules for withheld personal income and social security taxes went into effect for large- and medium-sized firms. Net borrowed reserves fluctuated in a somewhat wider range in June than in other recent months, although the average for the month as a whole was about the same as in May. Member bank borrowings from the Federal Reserve Banks also fluctuated widely in June, increasing moderately on a monthly average basis (see Table I). Most transactions in Federal funds occurred in a 5 to  $5\frac{3}{8}$  per cent range,  $\frac{1}{8}$  to  $\frac{1}{4}$  of a per cent higher than the range predominating in May, and some trading even took place for the first time at rates as high as  $5\frac{1}{2}$  per cent and  $5\frac{5}{8}$  per cent, 1 to  $1\frac{1}{8}$  of a per cent above the discount rate. Rates posted by the major New York City banks on call loans to Government securities dealers generally rose from  $\frac{1}{8}$  to  $\frac{3}{8}$  of a percentage point from their May peaks, ranging as high as  $5\frac{7}{8}$  per cent on several days and climbing to  $6\frac{1}{8}$  per

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

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

Factors	Changes in daily averages— week ended					Net changes
	June 1	June 8	June 15	June 22	June 29	
<b>"Market" factors</b>						
Member bank required reserves*	- 5	- 65	+ 136	- 871	- 53	- 558
Operating transactions (subtotal)	- 498	- 161	- 56	+ 627	- 207	- 295
Federal Reserve float	- 313	+ 95	+ 44	+ 445	- 275	- 4
Treasury operations†	+ 17	+ 125	- 175	+ 96	- 78	- 15
Gold and foreign account..	- 17	+ 2	+ 10	- 47	- 70	- 122
Currency outside banks*...	- 174	- 401	+ 14	+ 68	+ 186	- 307
Other Federal Reserve accounts (net)‡	- 11	+ 17	+ 54	+ 62	+ 31	+ 153
<b>Total "market" factors..</b>	<b>- 503</b>	<b>- 226</b>	<b>+ 80</b>	<b>+ 56</b>	<b>- 260</b>	<b>- 853</b>
<b>Direct Federal Reserve credit transactions</b>						
Open market instruments						
Outright holdings:						
Government securities ...	+ 442	+ 204	- 60	- 73	+ 267	+ 780
Bankers' acceptances ....	+ 1	-	+ 1	-	- 2	-
Repurchase agreements:						
Government securities ...	-	+ 21	+ 37	- 58	-	-
Bankers' acceptances ....	+ 25	+ 34	- 34	+ 4	+ 48	+ 77
Member bank borrowings ....	+ 159	- 265	+ 241	- 97	+ 80	+ 118
Other loans, discounts, and advances	- 1	-	- 8	- 6	- 1	- 16
<b>Total .....</b>	<b>+ 625</b>	<b>- 4</b>	<b>+ 176</b>	<b>- 230</b>	<b>+ 393</b>	<b>+ 960</b>
<b>Excess reserves*</b>	<b>+ 122</b>	<b>- 230</b>	<b>+ 255</b>	<b>- 174</b>	<b>+ 133</b>	<b>+ 107</b>

Member bank:	Daily average levels					
	June 1	June 8	June 15	June 22	June 29	
Total reserves, including vault cash*	22,368	22,203	22,323	22,720	22,906	22,504‡
Required reserves*	21,932	21,997	21,861	22,432	22,485	22,141‡
Excess reserves*	436	206	462	288	421	363‡
Borrowings	812	547	788	691	771	722‡
Free reserves*	- 376	- 341	- 326	- 403	- 350	- 359‡
Nonborrowed reserves*	21,556	21,656	21,535	22,029	22,135	21,782‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					
	June 1	June 8	June 15	June 22	June 29	
Less than one year	+ 255	+ 156	+ 1	+ 34	+ 288	+ 734
More than one year	+ 33	+ 47	- 108	-	+ 49	+ 21
<b>Total .....</b>	<b>+ 288</b>	<b>+ 203</b>	<b>- 107</b>	<b>+ 34</b>	<b>+ 337</b>	<b>+ 755</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 June 29.

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

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended					Average of five weeks ended June 29*
	June 1	June 8	June 15	June 22	June 29*	
<b>Eight banks in New York City</b>						
Reserve excess or deficiency(-)†	68	- 2	16	44	15	28
Less borrowings from Reserve Banks	80	14	103	185	147	106
Less net interbank Federal funds purchases or sales(-)	- 161	128	161	676	569	275
Gross purchases	626	811	911	1,245	1,078	934
Gross sales	788	683	750	569	509	660
Equals net basic reserve surplus or deficit(-)	150	- 143	- 247	- 816	- 701	- 351
Net loans to Government securities dealers	632	503	568	524	543	554
<b>Thirty-eight banks outside New York City</b>						
Reserve excess or deficiency(-)†	- 2	53	32	26	15	25
Less borrowings from Reserve Banks	63	72	113	45	150	89
Less net interbank Federal funds purchases or sales(-)	199	571	547	744	495	511
Gross purchases	1,038	1,308	1,242	1,603	1,351	1,308
Gross sales	840	738	695	859	858	798
Equals net basic reserve surplus or deficit(-)	- 264	- 590	- 628	- 763	- 630	- 575
Net loans to Government securities dealers	341	275	232	337	227	282

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—June 1966			
	June 6	June 13	June 20	June 27
Three-month	4.573	4.575	4.470	4.435
Six-month	4.744	4.707	4.591	4.610
Monthly auction dates—April-June 1966				
One-year	April 26	May 25	June 23	
	4.773	4.966	4.697	

\* 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.

cent at the end of June. Late in the month, rates on bankers' acceptances, commercial paper placed by dealers, and directly placed finance company paper were adjusted upward by  $\frac{1}{8}$  of a per cent. Moreover, most large commercial banks raised the prime loan rate from  $5\frac{1}{2}$  per cent to  $5\frac{3}{4}$  per cent on June 29 and June 30. Offering rates posted by the leading money market banks on time certificates of deposit continued to increase in June when the ceiling rate of  $5\frac{1}{2}$  per cent was reportedly paid by prime banks on new certificates maturing in as little as thirty days. The weekly reporting member banks were able to replace a considerable portion of the substantial \$3.9 billion of certificates maturing during the quarterly corporate dividend and tax month.

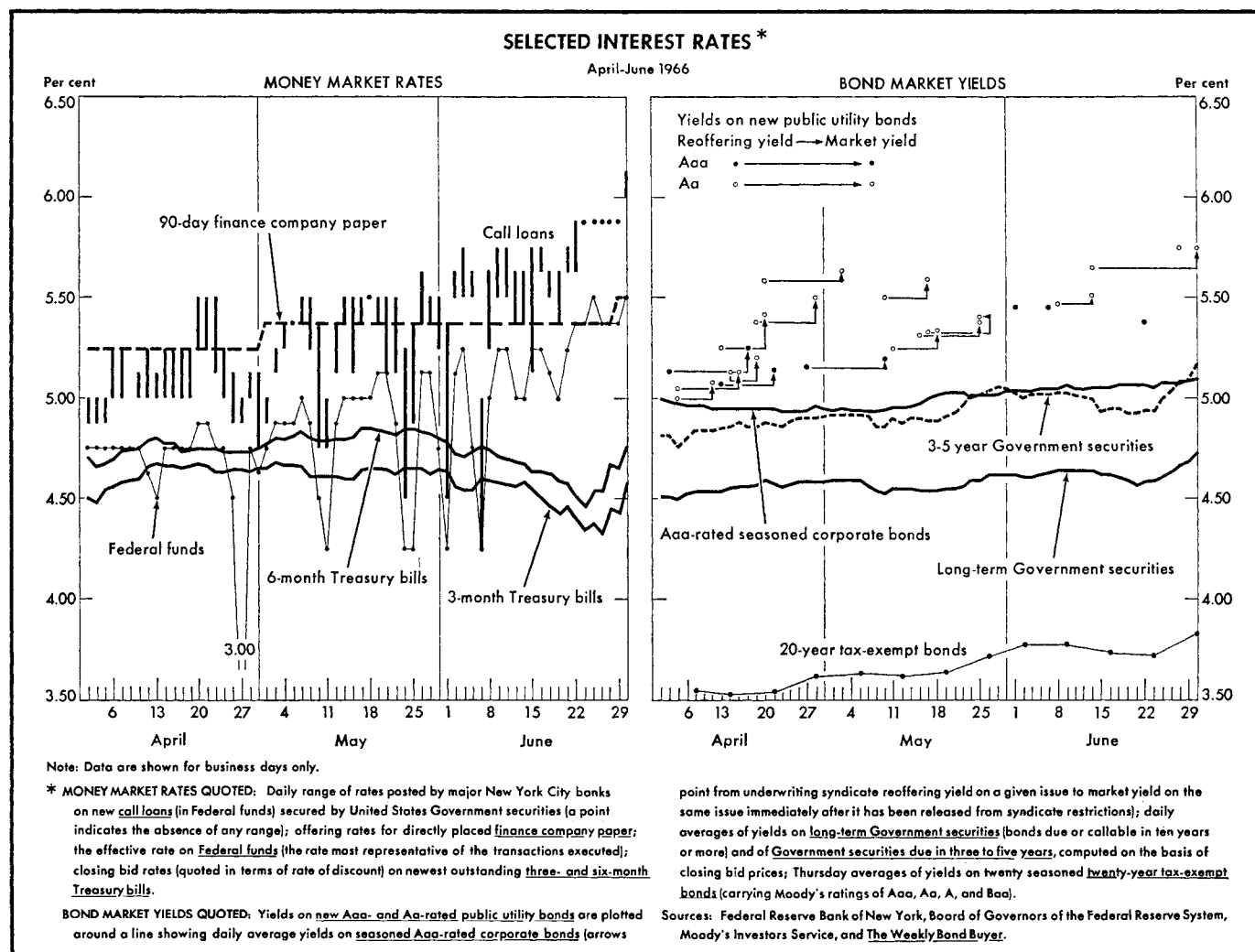
As the banking system helped to service the substantial June credit demands of the economy, the reserve positions of commercial banks remained under considerable pressure. The rate of growth of bank credit, after having slowed in May, expanded more rapidly in June as credit requirements showed more than seasonal strength. During the midmonth corporate dividend and tax payment period, banks extended a large volume of loans to accommodate the seasonal credit demands of businesses and nonbank financial intermediaries. As usual, the New York City banks bore the brunt of the pressures over this period. At the New York City weekly reporting member banks, bank credit rose by approximately \$1.5 billion during the statement period ended June 15 which included the dividend and tax payment dates, as against a \$1.1 billion increase in the comparable week of 1965. These banks also experienced a net decline of \$428 million in their negotiable time certificates of deposit outstanding during the June 15 statement week, compared with only about a \$168 million drop during the comparable period a year earlier. Total demand deposits (including checks in process of collection) at weekly reporting member banks in New York expanded by a substantial \$3.4 billion, however, as corporations accumulated deposits with which to pay dividends and Federal taxes. Even after the midmonth tax date had passed, loans and investments extended by city banks continued to rise. Associated increases also occurred in their deposit liabilities as they filled the strong supplementary loan demands from businesses making accelerated payments of withholding taxes. During the June 22 statement period, bank credit outstanding at the New York City banks rose by approximately \$84 million, as against a decline of \$232 million in the comparable week last year. By the last Wednesday of the month, bank credit extended by the New York weekly reporting banks had grown by \$2.4 billion from the May 25 level, while total demand deposits had increased by \$1.8 billion.

As a result of this sizable deposit and credit expansion, member bank required reserves expanded by an estimated \$622 million from the last Wednesday in May through the last Wednesday in June, in contrast with the decline in required reserves which had taken place in May. The rise in required reserves absorbed a particularly large volume of member bank total reserves in the week ended June 22, when net borrowed reserves increased to an average of \$403 million.

Against this background of an expanded demand for bank credit in June and the persisting limited supply of available reserves, the money market banks accumulated increasingly large reserve deficits as the month progressed (see Table II). The reserve position of the eight major New York banks swung from an average surplus in the June 1 statement week to a deficit which reached as high as an average of \$816 million in the June 22 statement period. At thirty-eight large banks outside New York, the basic reserve deficit also grew substantially during the month, rising by \$242 million on average in June. The reserve needs of the money market banks were satisfied both through purchases of Federal funds at rising rates and through a continuing heavy volume of borrowings at the Federal Reserve "discount window".

#### THE GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds fluctuated within a fairly wide range during June. In the opening days of the month, the Treasury coupon sector was buoyed by news from the corporate bond market where a fairly large new Aaa-rated utility issue offered at the highest yield in several decades was accorded an enthusiastic investor reception. At the same time investment demand for Treasury coupon issues, both outright and in switching transactions, expanded and sparked professional demand as well. As a result, prices of coupon issues rose fairly sharply as the month began, with the largest gains recorded by intermediate-term maturities. The rally was of short duration, however, and in the following week a cautious atmosphere reappeared in the coupon sector. During the latter period, the market was affected by the reported weakness of the pound sterling in the foreign exchange market, by the continuing buildup in offerings scheduled in other sectors of the capital market, by renewed heaviness in the corporate bond market, and by developments in Vietnam. Against this background, dealer offerings of coupon issues expanded considerably, investor selling also increased—particularly in the five- to ten-year maturity area, and prices of intermediate- and long-term Treasury issues again edged downward from June 3 through June 9. (The



right-hand panel of the chart on this page illustrates the rise in yields which accompanied this decline in prices.) Subsequently, selling pressures subsided, demand expanded modestly, and prices of coupon issues started to inch higher. The price recovery gained momentum at mid-month, when market participants began to feel that the growth rate of the domestic economy might be moderating and that, if this proved to be the case, prices of debt obligations might soon rise from their relatively low levels. At the same time, the improved tone emerging in the markets for corporate, tax-exempt, and Government agency issues, as well as the intermittent rumors of peace moves in Vietnam, also buoyed the Treasury bond market. These developments triggered further investor and professional demand for coupon issues and, against this background,

prices of Treasury notes and bonds generally moved higher from June 10 through June 21. Subsequently, offerings expanded as some traders realized profits, demand contracted, and prices generally receded from June 22 through June 24. In the closing days of the month, prices of coupon issues moved sharply lower in response to the revival of uncertainty over the future course of interest rates.

Demand for Treasury bills was quite strong during most of June, as the increasingly firm tone taking shape in many parts of the money market again failed to influence the bill sector. In recent months, Treasury bills have been in especially heavy demand from investor groups who for various reasons tend to have a strong preference for these bills even at times when rates on competing money market instruments may be considerably higher.



Continuing this trend, a broadly based demand for bills prevailed in June. Public funds made substantial bill purchases, and holders of maturing June 22 tax anticipation bills who did not turn in these bills for taxes reinvested part of their proceeds in other issues. In addition, commercial banks built up bill positions in preparation for their June 30 statement-publishing date. Late in the month the Federal Reserve System bought bills in order to supply reserves to the banking system prior to the long July 4 holiday weekend. In the face of the persisting widespread demand for bills through much of June, dealers' overall bill positions held steady at very low levels, and there were pronounced scarcities of many individual issues. In this setting, the popular June 10 corporate dividend payment date, the midmonth corporate tax date, and the June 20 accelerated withholding-tax payment date passed without giving rise to any real pressure in the bill sector. The moderate bill offerings that did arise, including bills supplied through maturing corporate repurchase agreements with dealers, were readily absorbed. Reflecting the strength of the bill market, rates generally receded during most of June (see the left-hand panel of the chart). At the end of the month, however, offerings expanded and bill rates moved higher when traders began to weigh the possibility that the recent period of strong bill demand might be drawing to a close.

In the market for United States Government agency obligations, new flotations continued to be issued at a rapid pace in June. However, as yields rose, investor interest expanded considerably, and this contributed to the improvement in sentiment throughout the bond markets during the second third of the month. Agency offerings totaled approximately \$1.7 billion, of which \$1.2 billion represented new money. Early in the month, a \$125 million flotation by the Federal Land Banks, consisting of eight-month 5.60 per cent bonds offered at par, encountered investor resistance. Subsequently, investors responded quite enthusiastically to a \$530 million June 9 offering of new loan participation certificates. These obligations were offered under the auspices of the Federal National Mortgage Association and were initially priced at par to yield from 5.70 per cent up to 5.75 per cent on one- to five-year issues and from 5.40 per cent down to 5 $\frac{3}{8}$  per cent on thirteen- to fifteen-year issues. Around midmonth, the Federal Home Loan Banks marketed \$750 million of short-term securities priced at par to yield from 5.65 per cent on seven-month obligations to 5.75 per cent on one-year securities. This offering was smaller than the market had generally expected, and its high yields again attracted

a very good interest on the part of investors. In the wake of this experience, investors began to feel that pressure in the agency market might be abating for a while, and a better feeling emerged throughout the capital markets. On June 21, a flotation by the Federal Intermediate Credit Banks of \$283 million of nine-month debentures was fairly well received at an offering yield of 5.60 per cent, the same rate that had been placed on a comparable Credit Bank issue in May.

#### OTHER SECURITIES MARKETS

The markets for corporate and tax-exempt bonds generally remained under pressure during the early part of June, when sizable additions were made to an already large volume of current and prospective new offerings. At the beginning of the month, a new \$50 million Aaa-rated issue of utility debentures, carrying five-year call protection and priced to yield a near-record 5.45 per cent, was accorded an excellent investor reception. This development temporarily buoyed sentiment in various sectors of the bond market. A more restrained atmosphere quickly reappeared, however, as the weight of current and planned June corporate and tax-exempt offerings prompted dealers to make further price concessions on slow-moving accounts (see the right-hand panel of the chart). A better atmosphere took shape in the corporate and tax-exempt sectors for almost two weeks after mid-month, when the higher prevailing yields generated greater investor demand and traders also began to focus upon the lighter July financing calendar and the strengthening tone of the Government agency market. During this period, several new corporate and tax-exempt issues were reoffered at yields as much as 10 basis points below those set on comparable flotations in early June and were accorded good investor receptions. Late in June, however, a more hesitant tone again developed in both sectors. Many new issues encountered investor resistance, and prices moved lower once more.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 6 basis points to 5.10 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) increased by 11 basis points to 3.83 per cent (see the right-hand panel of the chart). These indexes are, however, based on a limited number of seasoned issues and do not necessarily reflect market movements fully, particularly in regard to new and recent issues.