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A Tax Increase Is Essential

Statement of ALFRED HAYES, *President, Federal Reserve Bank of New York, before the House Ways and Means Committee, Washington, D. C., September 14, 1967*

Mr. Chairman and members of the Committee: I am pleased to be here at your invitation to discuss the President's tax recommendations. I propose to address myself to the major component of this program—the 10 per cent surcharge on personal and corporate income taxes. I strongly support this proposal. I believe it is in the national interest. A tax increase is essential if we are to avoid an undue risk of severe price inflation and the evils of recession and unemployment that would follow. It is essential if we are to avoid an undue risk of finding ourselves facing the same financial pressures, and the associated slump in mortgage lending and home construction, that characterized much of 1966. It is essential if we are to maintain the strength of the dollar in international markets.

I strongly believe that unless a tax increase is promptly enacted the country may well face one of the worst outbreaks of inflation in many years. The private sectors of the economy give every indication of resuming a high rate of growth at a time when the Federal and state and local governments are preempting an abnormally large share of potential increases in the national output of goods and services. The war in Vietnam is placing especially heavy demands on the economy, and defense spending is expected to climb still higher over the coming year. In this context, the threat of renewed overheating in the economy is very real. At the same time, wage settlements far in excess of past and potential productivity gains have added a new dimension to the problem. There is, I believe, a clear and present danger that a return to excess demand pressures, piled on top of wage pressures, will result in an inflationary spiral, with both demand-pull and cost-push playing a role.

Such an inflationary development would have severe consequences for the longer run growth and vitality of the economy. It would discourage thrift and would distort business incentives to invest. It would lead to speculative excesses, sowing the seeds of an eventual economic downturn. Rapid price inflation would also aggravate some of our more pressing social problems, especially those of our cities. Increases in prices work to the greatest disadvantage of those in the lowest income brackets who have least ability to adjust their incomes upward as the cost of living rises. Inflation would thus tend to undercut the effectiveness of the many existing and proposed programs to improve the economic situation of the poor and aged. Because of this, inflation is correctly called the cruelest tax of all. Inflation also has other socially undesirable effects on resource allocation. Home building could be expected to suffer once again, and at a time when there is a growing need to improve national housing conditions, especially for low income families. The flow of savings would be distorted, raising new difficulties for those borrowers—especially lower income families and small businesses—who have least ability to compete in the markets for loanable funds, and for those thrift institutions which specialize in home mortgage lending.

Speculation, instability, and high interest rates are characteristics of financial markets during inflationary periods. No doubt, the current financial situation, characterized by speculation in common stocks, record or near-record interest rates in the bond markets, and a general tone of uneasiness, reflects a growing and increasingly widespread belief that the outlook is inflationary. Worries about exceptionally large Federal deficits and Treasury borrowing needs, and their implications for price inflation and upward interest rate pressures, dominate the atmosphere in the financial markets. There is no doubt in my mind that a tax increase, which would substantially cut both the Federal deficit and the Treasury's borrowing requirements, would help to steady our sensitive financial markets.

A tax increase would also do much to protect the international economic position of the United States. By restraining inflation, it would help our trade balance, a vital element in any solution to our overall balance-of-payments problem. The competitiveness of our exports in international markets would be better preserved, and the threat of an upsurge of imports would be lessened. At the same time, a tax increase would help demonstrate that the nation is prepared to make the domestic sacrifices that are essential for successful handling of its international commitments and obligations.

DOMESTIC ECONOMIC TRENDS

After a short period of economic hesitation early this year, the evidence now points convincingly to a resurgence of overall economic expansion that would outrun the nation's productive capacity. Although there is now some unutilized labor and plant capacity, this margin is probably adequate to accommodate for only a short period the fast pace of economic expansion that now seems probable. Once these idle resources are absorbed, the inflationary pressures are likely to be much more severe than those encountered last year.

The weakness in the private economy over the past half year or so, while traceable in part to less vigor in consumer spending and in plant and equipment outlays, was centered primarily in a sharply reduced rate of spending on inventories. Indeed, final demand—total purchases of all goods and services other than inventory spending—remained very strong and continued to grow, stimulated of course by heavy outlays by the Federal and state and local governments. The fact that the inventory correction failed to produce greater weakness in other areas of private demand is itself evidence of the basic strength of the economy.

Within the first six months of the year, moreover, the trend of the economy was definitely upward: the second quarter of the year was both stronger and better balanced than the first quarter. The retarding effect of the inventory correction on overall economic activity was much reduced as midyear approached. At the same time, the spring and early summer months saw a distinct revival of consumer spending and an impressive further recovery of construction starts on new homes and apartments. Evidence of the sustained strength of business confidence was visible in the results of several surveys pointing to continued very high —and probably rising—spending for new plant and equipment.

Turning to the outlook, I believe the economy will be very strong—indeed, without a tax rise, excessively so. In the area of final demand we can expect continued strong gains in consumer spending, as spendable incomes increase and as the recent high rates of personal savings fall back to more normal levels. We can look for further substantial recovery of the housing industry if mortgage conditions do not tighten greatly. And we can expect a return to growth in plant and equipment spending as investment incentives and business profits benefit from higher plant utilization rates. In the very important area of inventory spending, the substantial amount of adjustment already accomplished, plus the prospects of rising business sales, suggests a return shortly to more normal levels of inventory accumulation. But even a stabilization of inventories around present levels would have a profound effect on the economy by eliminating the most important force restraining business activity earlier this year. The current automobile strike will have some depressing effect on the economy while it continues, but subsequently economic growth will be all the stronger as lost production and lost sales are made up. It does not, therefore, change my general assessment of the outlook.

In the absence of a tax increase, the large Federal deficit would be an excessive stimulant for the economy. When the Federal Government pays out far more to the private sector than it withdraws in the form of taxes, it adds greatly to the spendable incomes of businesses and consumers, thereby tending to produce greater private demand for goods and services than would otherwise be the case. These greater demands would add to the expansionary forces already present in the private sectors of the economy.

I fear that in this context, and without a tax increase, price inflation may well develop on a scale unparalleled in many years. Excessively strong advances in overall demand would reinforce the pressures on prices that already exist because of wage increases that are now generally well in excess of productivity gains. We have already had a disturbing rash of price increase announcements. Higher prices in turn are likely to generate still greater wage demands, and may lead to a situation in which wage and price increases interact with one another to produce an inflationary spiral. I am also afraid that inflationary expectations are already beginning to take hold, and that delay in enacting a tax increase might weaken the contribution to price stability that such a tax increase could make.

THE BALANCE OF PAYMENTS

The outlook for our increasingly critical balance of payments would also be improved very importantly by a tax increase. The avoidance of excesses in the domestic economy is vital for the protection of our trade position. I am particularly concerned with this since I believe an expanded trade surplus to be the principal hope for a reduction of our balance-of-payments deficit. First, in helping to curb inflation, a tax increase would aid in preserving the competitiveness of domestic producers in world markets. Second, and especially important for the short run, fiscal restraint would help prevent the surge of imports that typically occurs when domestic demands for goods and services exceed the supplies available from domestic producers. Finally, I might also note that passage of a tax increase, underscoring the resolve of the Congress and the President to foster domestic economic stability, would do much to protect our gold reserves by providing needed reassurance to foreign holders of dollars that the value of those dollars will be maintained. I do not wish to imply that enactment of a tax increase will provide a ready-made solution to our balance-of-payments problem. But without a tax increase the situation may easily become worse rather than better, with adverse effects on our overall international position, both economically and financially —and politically.

THE FINANCIAL SITUATION

So far I have stressed the need, domestically and internationally, for a tax increase to assure reasonably noninflationary economic growth. The uneasy financial atmosphere also calls for a tax increase. I believe that the present record or near-record high interest rates in the credit markets primarily reflect the collective judgment of borrowers and lenders that inflation and huge Treasury borrowing demands are likely over the next year or so. The importance of market forces in the rise of interest rates this year is all the more striking in view of the ready availability of bank credit.

The rise in long-term rates, which has brought the general structure of capital market yields back to the 1966 record peak, has had many causes. The widespread desire of business to rebuild liquidity, following the drains that occurred in 1966, has certainly been an important factor in the market. The liquidity positions of business still remain comparatively low, and there are as yet no convincing signs of a significant cutting back of the demand for long-term funds by private borrowers. At the same time, the recovery of residential construction and home purchases portends a very rapid expansion of mortgage loan demand in coming months. Moreover, borrowing by state and local governments continues at record levels; the wide variety and high social priority of purposes for which this borrowing is being undertaken suggest that the demands of these borrowers are unlikely to moderate in the foreseeable future.

Another basic factor in heavy borrowing demands has been the fear of still higher interest rates later on—partly based on doubts as to whether necessary measures of fiscal restraint would be applied. Basically, borrowers and lenders are reacting in a predictable manner to fears of a return to inflation which diminishes the value of fixed-income securities. Striking further evidence of such inflationary hedging in the financial markets is to be found in the recent burst of speculative activity in the stock market—activity characterized by excessively wide price movements in lower quality issues and record high levels of trading volume.

The present uneasy financial climate stems in good part from the Federal deficit and the prospects for record peacetime borrowing by the Treasury. Recently, as the current period of heavy financing approached, Treasury bill rates increased at a very sharp pace, providing clear evidence of the market's great concern over the complex financing problems that will confront the Treasury in coming months, especially if no tax increase is forthcoming.

ALTERNATIVES TO A TAX INCREASE

The question may be raised whether there are any practical and acceptable alternatives to a tax increase. It seems to me that there are only two other means of effectively cutting down excessive overall demand: (1) prompt and very substantial reduction in total Government spending, (2) a severely restrictive monetary policy.

The Federal budget deficit and overall demand can, of course, be reduced by cutting expenditures, by increasing taxes, or by some combination of both. In his message to the Congress on August 3, the President emphasized the importance of restraint on Federal expenditures. They should be carefully controlled and reduced as much as possible. But it is not realistic to expect that sufficiently large cutbacks in spending can be accomplished with sufficient promptness to make a tax increase unnecessary. Indeed, even if large cutbacks were feasible, the time required to explore possibilities for cuts and to make them effective would unduly postpone the fiscal restraint that is so badly needed immediately.

As for monetary policy, it seems to me that principal reliance on this alternative would fail to attack the problem at its basic source. Since so much of the fiscal stimulus and financial pressure is caused by a large Federal deficit, fiscal measures would go to the heart of the problem. With interest rates already at record or near-record levels, a drastic cutting back on the supply of credit might bring on distortions in financial flows much along the lines of 1966. The burden of economic restraint would again fall hardest on the housing industry, on the thrift institutions that specialize in the mortgage market, and more generally upon those borrowers who have the least ability to compete for the available supply of credit. Believing as I do that this would be the outcome of almost exclusive reliance upon monetary restraint, I am led inevitably to the conclusion that a highly expansionary fiscal policy is clearly inappropriate under present economic circumstances.

THE RISKS IN A TAX INCREASE

I think it is clear from what I have already said that I do not share the fear, frequently expressed in these hearings, that a 10 per cent tax increase would run a high risk of tipping the country into recession. It is true that an excessively strong economic expansion is still more a forecast than a reality, but policy decisions aimed at economic stabilization—fiscal as well as monetary—must always rest in large part on forecasts of future developments made on the basis of the best information and judgments currently available. The forecasts and judgments may, of course, prove to be wrong, but this possibility does not excuse a failure to act on the basis of clear probabilities.

It is important to remember that any policy action is reversible or capable of offset, should that prove necessary. Fiscal restraint applied through a tax surcharge could be quickly reversed by simply removing that surcharge sooner than otherwise contemplated. And monetary policy remains available as a flexible tool.

However, in my assessment, the President's 10 per cent surcharge proposal runs a greater risk of being less than what is needed to achieve economic stability rather than more. If some of the contingencies mentioned in the new fiscal 1968 budget estimates—notably an extra $4 billion rise of defense spending—occur and result in an even larger rise in total spending, I am afraid that a 10 per cent surcharge might prove too little. But that situation is not with us today. I trust that the 10 per cent tax surcharge will be adequate on the assumption that Federal spending overall can be held to the total now estimated. I support the tax surcharge at the 10 per cent level and urge its enactment at the earliest possible date.

The Business Situation

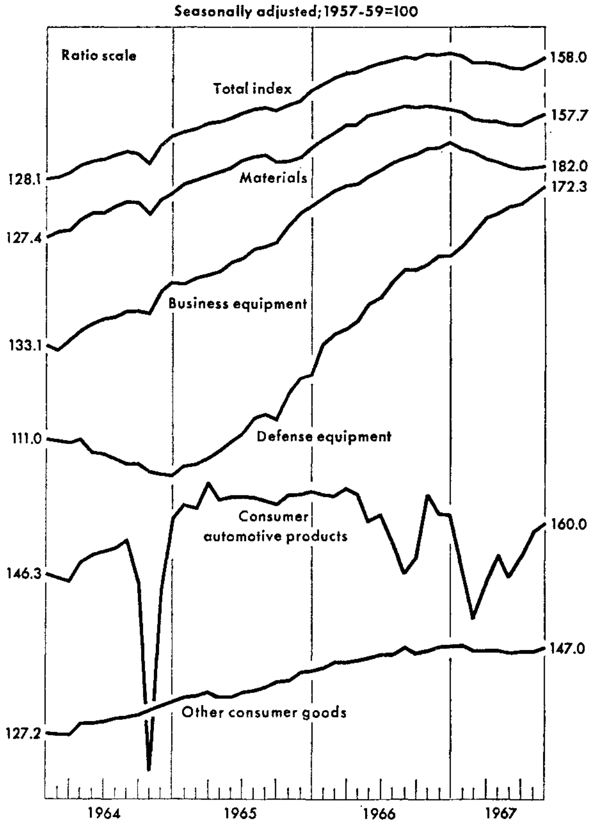
The advance in business activity strengthened on a broad front during the summer. In August, industrial production increased again and residential construction activity continued to improve, while employment and personal income also rose strongly. Moreover, preliminary figures indicate that retail sales, which have shown renewed vigor in recent months, registered another large advance in August. The latest Government survey of capital spending plans confirms that business is stepping up outlays on plant and equipment in the second half, and two recent private surveys indicate further gains in these outlays in 1968. Thus, virtually all indicators are now pointing to a resumption of rapid growth in the private economy at a time when the Federal and state and local governments are claiming a large share of the increases in the nation's output of goods and services. The automobile strike of course dampened the pace of economic activity in September. Barring a prolonged strike, however, the effect on the overall economy is not expected to be large, and a surge in production will undoubtedly follow the eventual settlement. Meanwhile, price pressures are mounting. In the past five months the consumer price index has risen at an annual rate of 4 per cent, and industrial wholesale prices, which had remained stable throughout the first half of 1967, have increased substantially in the last two months.

PRODUCTION, INVENTORIES, AND NEW ORDERS

The nation's industrial production moved up strongly in August, marking the second consecutive month of increase, though special factors were again responsible for much of the rise. With output of materials, equipment, and consumer goods all registering gains, the Federal Reserve Board's seasonally adjusted production index rose by 1.3 percentage points to 158.0 per cent of the 1957-59 average (see Chart I). The August improvement came after an almost equally strong gain in July, following six months during which the production index had generally declined. The July-August advance, totaling 2.5 percentage points, brought the index to a level only 1.0 percentage point below the record high reached last December. In September, however, the automobile strike had a dampening effect on industrial activity, and it is likely that any further sizable advances in the overall production index will be delayed until after a settlement in the auto industry.

The August rise in industrial production was broadly based, though a substantial part of the strength was due to

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1957-59=100



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System.

Source: Board of Governors of the Federal Reserve System.

special factors. These included the further recovery of production in the rubber industry from the strike that was settled in mid-July and another boost in crude oil output in response to the curtailment of supplies from the Middle East. The special factors affecting oil and rubber output contributed to the strong rise in the index of materials production, although an increase in iron and steel output also figured in the advance. In September, on the other hand, a truckers' strike apparently dampened iron and steel output, while at the same time the Texas authorities cut back allowable oil production because of a resumption of shipments from the Middle East.

Production of equipment moved up again in August on the strength of a 1½ per cent rise in the defense component. At the same time, the slackening in business equipment output appears to be leveling off. Following six months of uninterrupted declines, production of business equipment edged up in July and then held steady in August, at a level about even with that of a year ago.

Consumer goods production was boosted in August by an extremely sharp jump in the output of television sets, which reflected both an improved sales outlook and the settlement of a strike at a major producer. That strike had followed six months of industry-wide cutbacks which were made because of a substantial gap between actual and projected consumer buying. In anticipation of a continuing improvement in overall consumer demand, production of television sets and other consumer goods is now apparently on the upswing. Another sizable gain was registered in August by the automotive industries, as the pace of auto assembly operations increased once more, reaching a seasonally adjusted annual rate of 8.3 million units—the highest this year. The industry's original production schedules for September had pointed to another sharp rise in the assembly rate, but the strike at the Ford Motor Company of course meant that the original schedules were not met. Preliminary figures indicate that September output fell about 20 per cent to an annual rate of less than 7 million units.

The upturn of industrial activity in recent months has been helped by the much improved inventory situation. During the first half of 1967, the overall rate of business inventory accumulation was cut back sharply. For several months, stocks were actually reduced in the trade sector, and June saw a decumulation in manufacturing as well. In both July and August, manufacturers' inventories rose, with the increase occurring entirely in durables manufacturing. Total accumulation was centered in stocks of goods in process, although in August materials inventories also rose. Shipments made by manufacturers increased during the summer. In July the rise was larger than the increase in inventories, thus reducing the inventory-shipments ratio for the third consecutive month. In August, however, inventory accumulation exceeded the gain in shipments, and the ratio rose.

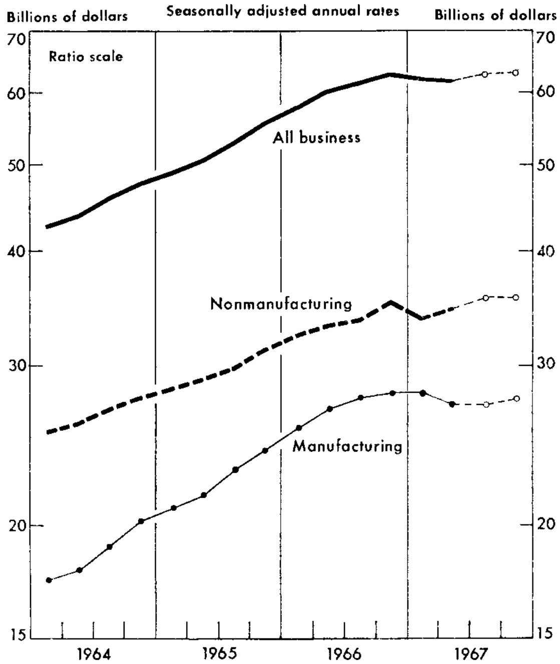
Recent information on manufacturers' expectations regarding inventories and shipments indicates that producers anticipate an accelerating rate of inventory accumulation. According to the Commerce Department's latest quarterly survey, taken in August, manufacturers were expecting to continue a slow rate of inventory building in the third quarter, but anticipated a step-up in the pace of accumulation toward the year-end. The prospective acceleration of inventory investment is centered in durables manufacturing. Producers of both durable and nondurable goods formulated their inventory anticipations on the basis of an expectation that shipments would be increasing rapidly throughout the second half of 1967. Taken together, the reported inventory and shipments expectations point to a modest second-half decline in the stock-shipments ratio in durables manufacturing and a sharper drop in the nondurables ratio.

Following an upturn during the spring, the volume of new orders for durable goods dropped sharply in July and edged off in August. In both July and August, however, the decline resulted from substantial reductions in the volatile defense component. The total August volume of durables new orders exclusive of those received by defense-oriented industries was the highest this year, and fully 7½ per cent above the slower pace of last spring. The machinery and equipment industries reported another rise in their orders volume, bringing it close to the record high set a year ago. Shipments of durable goods, which have been growing steadily since April, advanced again in August and the backlog of unfilled orders edged off.

BUSINESS INVESTMENT PLANS AND CONSTRUCTION

The latest Government survey of business spending plans provides confirmation of the expectation that capital investment is rising in the second half of 1967, following a dip in the first two quarters. According to the August survey by the Commerce Department and the Securities and Exchange Commission, outlays on new plant and equipment in both the third and fourth quarters were planned at a seasonally adjusted annual rate of about $62½ billion, compared with a first-half spending rate of about $61½ billion (see Chart II). This increase would bring total 1967 outlays to $62.0 billion for a 2.3 per cent rise over 1966. Although most major industries plan to spend more this year than last, the increases in individual industries and in the total are modest when compared with

Chart II
ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING



Note: Figures shown for the third and fourth quarters of 1967 are estimates from the August Commerce-SEC survey.
Sources: United States Department of Commerce; Securities and Exchange Commission.

the rate of expansion in the past three years. However, according to two surveys taken recently by private firms, the rise in the second half is expected to continue, gaining strength in 1968.

It was clear that the exceptionally rapid growth of capital spending last year was contributing significantly to the buildup of serious inflationary pressures. It was for this reason that President Johnson asked the Congress to suspend the investment tax credit and certain accelerated depreciation methods; their suspension, between October and March, was one factor dampening investment spending in 1967. Possibly in response to the restoration of the investment incentives, some upward revisions have been made by nonmanufacturing industries since the Commerce-SEC's spring survey of spending plans for the second half of 1967. These upward revisions were notable in the plans of nonrail transportation industries and public utilities. At the same time, however, business capital investment programs generally have continued to be moderated by a number of factors, including the anticipation of a tax increase, the relatively high cost of credit, the easing of corporate profits from the very high levels reached last year, and the slackening of capacity utilization rates in manufacturing.

The 1967 slowdown in capital spending has been reflected in activity in the construction industry. Following a brief bulge at the beginning of the year, commercial and industrial building outlays have declined steadily from the high 1966 rate. Activity in the housing industry has continued to improve, however. In August, nonfarm housing starts rose again, following a large gain in July, and the number of housing units authorized by new building permits also increased. Thus far, the recovery in residential building has progressed almost as rapidly as the precipitous decline experienced in 1966. From a seasonally adjusted annual rate of 1.40 million units in March of last year, housing starts plunged for seven months to a rate of 0.82 million units in October. Seven months of recovery lifted the starts rate to 1.25 million in May 1967, and continuing advances brought the pace up to the 1.36 million units indicated by the preliminary August figures.

INCOME, CONSUMER DEMAND, AND PRICES

Reflecting the more rapid tempo of industrial activity, employment showed strong gains during the summer months. These advances were, in turn, the chief factor behind the recent acceleration in the expansion of personal income. Following two months of substantial increases, personal income in August registered the largest advance since last January. At an annual rate, the August gain amounted to \$4.5 billion, of which \$3.5 billion stemmed from increased wage and salary payments. In contrast, several earlier months this year saw wage and salary gains of only about \$0.5 billion.

Consumers appear to be increasingly willing to translate income gains into greater spending. Retail sales have shown a steady upward trend since the spring, and the advance seems to be strengthening. Further, recent surveys of consumer sentiment suggest that this uptrend will continue through the rest of the year and into 1968. According to preliminary figures, the volume of retail sales rose appreciably in August. In contrast to the several preceding months when sales of durable goods moved up rapidly, the August increase stemmed entirely from a large advance in sales at nondurables outlets. Total sales of durables edged off slightly in August, with the decline primarily reflecting a drop in new car sales that was not quite offset by gains in other durables lines. One factor behind the slippage in automobile sales was the exceptionally low level of stocks in popular model lines. In September, supply shortages continued to affect sales until the introduction of the new models late in the month. While the strike against Ford may create new shortages, apparently it did not have much direct effect on sales in September.

Price increases were widespread in August. The consumer price index rose by 0.3 per cent, making August the fifth straight month of substantial advance. Gains were recorded in virtually all major components—most notably in the services, housing, and food categories. Consumer food prices, which had declined last winter, rose strongly in the May-August period. However, a recent easing in the wholesale food index suggests that the rise in retail food prices may moderate. The overall wholesale price index declined in August, as lower food prices offset a rather sizable increase in the index of industrial commodities. Preliminary figures for September, on the other hand, indicate that further rises in industrial prices outweighed the reduced food prices, resulting in a small rise in the overall wholesale index. In addition, there has recently been a wave of price increases which are not yet incorporated in the indexes; these included higher prices for automobiles, color television sets, a variety of steel products, nickel alloys, sulfur, and other chemical products.

The Money and Bond Markets in September

The money market was generally comfortable during September, with no significant pressures evident around the midmonth tax and dividend payment dates. Free reserves fluctuated in a range slightly higher than in August, and Federal funds traded at about 4 per cent throughout the month. The basic reserve positions of banks in leading money centers deteriorated sharply during the first half of the month. These banks, however, had little difficulty covering their reserve needs through the Federal funds market, and borrowings from the Federal Reserve System were relatively light. A large volume of negotiable certificates of deposit (C/D's) matured during September. In order to limit attrition of these funds, a number of banks increased offering rates for C/D's.

Continuing the pattern of recent months, the comfortable tone of the money market during September coincided with further increases in yields on capital market instruments. The month opened with prices of Treasury coupon issues buoyed by prospects of possible new peace feelers following the election in South Vietnam. However, the price situation quickly deteriorated after the Labor Day holiday (September 4), as apprehension grew that Treasury financing needs in the months ahead would be considerably larger than previously anticipated even with passage of the Administration's proposed surtax. Also, hopes faded for a near-term solution in Vietnam, and it appeared likely that a long automobile strike might create additional difficulty for the Administration's tax proposals. Treasury bill rates declined briefly early in the month, but then rose almost steadily until September 25, after which rates again declined. During the month, rates on some bills climbed to new 1967 peaks, while yields on long-term Treasury bonds exceeded last year's highs.

The market for corporate securities also began the month with an improved tone. The calendar of new offerings scheduled for September was lighter than in August, and there was good investment demand. Early in the month prices increased from their lows for the year, although receptions were mixed when dealers attempted to price new offerings more than slightly above previously accepted levels. During the last half of the month, corporate bond prices declined moderately as dealer inventories and the calendar of prospective new offerings mounted. Tax-exempt securities were under pressure throughout September, and underwriters generally had difficulty reducing inventories without deep price concessions. The prevailing caution was enhanced by a growing calendar of future issues.

BANK RESERVES AND THE MONEY MARKET

The money market remained generally comfortable in September: average nationwide free reserves were $274

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, SEPTEMBER 1967

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

Factors	Changes in daily averages—week ended on				Net changes
	Sept. 6	Sept. 13	Sept. 20	Sept. 27	
"Market" factors					
Member bank required reserves*	— 363	— 62	— 253	— 58	— 736
Operating transactions (subtotal)	— 7	+ 583	+ 400	— 543	+ 433
Federal Reserve float	+ 120	+ 134	+ 210	— 258	+ 206
Treasury operations†	+ 399	+ 520	— 151	— 560	+ 208
Gold and foreign account	— 48	+ 6	—	— 4	— 46
Currency outside banks*	— 524	— 64	+ 245	+ 272	— 71
Other Federal Reserve accounts (net)‡	+ 45	— 13	+ 97	+ 6	+ 135
Total "market" factors	— 370	+ 521	+ 147	— 601	— 303
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 351	— 459	— 86	+ 397	+ 203
Bankers' acceptances	— 2	— 6	— 3	— 5	— 16
Special certificates	—	+ 66	— 66	—	—
Repurchase agreements:					
Government securities	+ 87	— 87	—	—	—
Bankers' acceptances	—	—	—	+ 86	+ 86
Federal agency obligations	+ 6	— 6	—	—	—
Member bank borrowings	+ 33	— 9	+ 36	— 32	+ 28
Other loans, discounts, and advances	—	—	—	—	—
Total	+ 476	— 501	— 119	+ 446	+ 302
Excess reserves*	+ 106	+ 20	+ 28	— 155	— 1

	Daily average levels				
Member bank:					
Total reserves, including vault cash*	23,944	24,026	24,307	24,210	24,122§
Required reserves*	23,578	23,640	23,893	23,951	23,766§
Excess reserves*	366	386	414	259	356§
Borrowings	79	70	106	74	82§
Free reserves*	287	316	308	185	274§
Nonborrowed reserves*	23,865	23,956	24,201	24,136	24,040§

	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 840	—1,176	+ 170	+ 591	+ 425
More than one year	+ 52	—	—	+ 56	+ 108
Total	+ 892	—1,176	+ 170	+ 647	+ 533

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 of four weeks ended on September 27.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS SEPTEMBER 1967

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on Sept. 27*
	Sept. 6	Sept. 13	Sept. 20	Sept. 27*	
Eight banks in New York City					
Reserve excess or deficiency(—)†	23	16	18	2	15
Less borrowings from Reserve Banks	21	—	21	—	11
Less net interbank Federal funds purchases or sales(—)	282	876	671	70	475
Gross purchases	*1,144*	*1,360*	*1,355*	*1,008*	*1,217*
Gross sales	*862*	*485*	*684*	*938*	*742*
Equals net basic reserve surplus or deficit(—)	— 280	— 860	— 674	— 68	— 471
Net loans to Government securities dealers	1,069	1,168	1,020	776	1,008
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)†	36	27	7	— 21	12
Less borrowings from Reserve Banks	12	7	35	13	17
Less net interbank Federal funds purchases or sales(—)	397	908	1,095	1,019	855
Gross purchases	*1,792*	*2,214*	*2,241*	*2,257*	*2,126*
Gross sales	*1,395*	*1,306*	*1,146*	*1,238*	*1,271*
Equals net basic reserve surplus or deficit(—)	— 375	— 888	—1,123	—1,053	— 860
Net loans to Government securities dealers	571	794	893	803	765

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—September 1967			
	Sept. 1	Sept. 11	Sept. 18	Sept. 25
Three-month	4.324	4.360	4.490	4.629
Six-month	4.765	4.951	4.998	5.143

Maturities	Monthly auction dates—July-September 1967		
	July 25	August 24	September 26
Nine-month	5.164	5.098	5.145
One-year	5.150	5.100	5.124

* 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.

million, and average member bank borrowings from the Federal Reserve Banks were $82 million (see Table I). Federal funds continued to trade predominantly at 4 per cent, the level of the Federal Reserve discount rate. No significant pressures developed around the September 15 payment date for the quarterly instalment of corporate income taxes. Although loans extended by commercial banks rose substantially in the week ended on September 20, the advance was apparently no greater than expected, and investments also increased moderately during the week.

The basic reserve positions of the major money market banks deteriorated sharply during the first half of the month. The shift of reserves away from banks in the leading money centers reflected attrition of C/D's and Euro-dollar holdings, as well as sizable calls on Treasury Tax and Loan Accounts, at a time when loans to securities dealers were increasing. The reserve positions of the major banks in New York City improved after the September 15 corporate tax date, due largely to an inflow of Euro-dollars, an increase in Government deposits as corporate tax payments were credited to Treasury Tax and Loan Accounts, and a decline in lending to Government securities dealers. On the other hand, the basic reserve deficit of the major banks outside New York City continued to deepen through September 20 and, although there was some improvement toward the close of the month, the average deficit remained substantial (see Table II).

Approximately $5.1 billion, or one fourth, of the C/D's outstanding at weekly reporting banks matured in September. Of that total, more than $1.1 billion fell due on September 15 alone. In view of the heavy volume of maturing C/D's, several banks raised their offering rates and generally succeeded in replacing a substantial portion of their maturities. At the end of the month, the most often posted rates ranged from 4¼ per cent for the shortest maturities to 5⅜ per cent for certificates maturing in one year or longer. The corresponding rates a month earlier were 4⅛ per cent and 5¼ per cent, respectively. Rates on bankers' acceptances rose by ⅛ percentage point to 5 per cent during September.

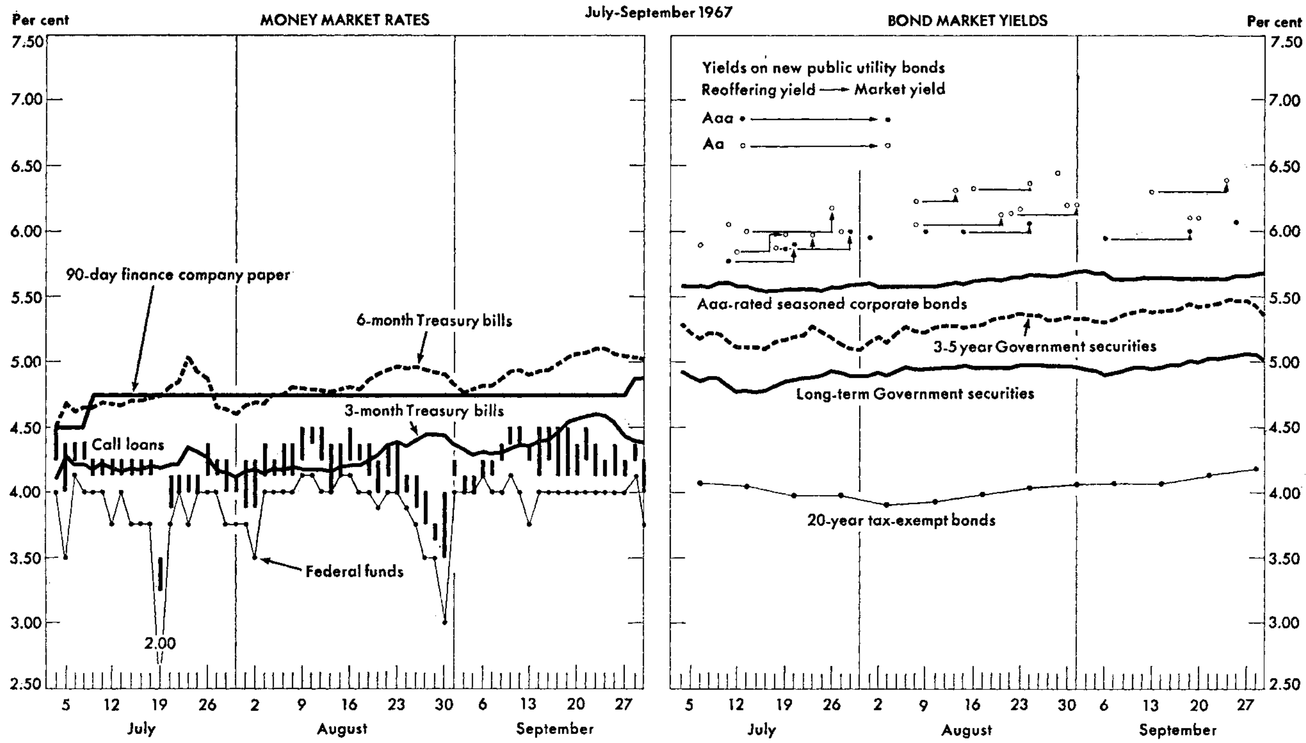
THE GOVERNMENT SECURITIES MARKET

A cautious atmosphere continued to pervade the Government securities market during September, and prices generally declined. Prior to the Labor Day holiday, however, prices of fixed income securities increased slightly as professional traders covered short positions and rebuilt inventories. Moreover, underlying investment sentiment was buoyed by an improved tone in the corporate bond market, the possibility of new peace efforts following the election in South Vietnam, and the prospect that a strike in the automobile industry might temporarily dampen economic activity. Reports of lagging loan demand also appeared to have a favorable impact on the market.

Market sentiment deteriorated after the holiday, however, and price declines during the second week wiped out almost all the increases of the preceding two weeks. The underlying tone became cautious and indecisive, as opinions differed concerning the probable length and economic impact of the automobile strike and its possible effect on passage of the Administration's tax proposals by the Congress. In addition, hopes faded for near-term peace in Vietnam and there was some discussion of the likelihood of a shift from ease in monetary policy, although most participants felt that no such change was imminent. In this environment, professional traders began to lighten inventories accumulated over the preceding two weeks, thereby further depressing prices. Prices of Treasury notes and bonds continued to drift lower as market participants considered the possibility that, even with the passage of the Administration's tax proposals, Treasury financing needs stemming from the expected large deficit would probably be appreciably greater than previously anticipated. By the end of the month, prices of many long-term Government bonds were below their lowest levels of last year, although prices of intermediate-term issues remained well above their 1966 lows.

The Treasury bill market began the month on a comparatively steady note, with dealers making fairly good sales at slightly lower rates. The Federal Reserve System entered the market to meet the reserve needs associated with the long holiday weekend, and there was good demand from the public and commercial banks. The market bid rate for three-month bills fell to 4.29 per cent at the end of the first week, about 10 basis points below the level in the final week of August (see chart). In subsequent days, however, the demand for bills abated, especially for shorter maturities, as dealers focused their attention on the possibility of an increased supply of bills to the market during the dividend and tax payment period. Treasury bill rates then continued to rise under investor selling and dealers' desire to prepare for the possibility that the Treasury might soon be entering the market to sell up to $5 billion of new tax anticipation bills. At the last regular weekly auction of the month on September 25, the average issuing rate for the new three-month bills was 4.629 per cent (see Table III), about 14 basis points higher than the average rate of the last regular auction in August and the highest auction rate since January 23, 1967. The average rate on the six-month issue was 5.143 per cent, about 15 basis points higher than that of the last auction in August and the highest since De-

SELECTED INTEREST RATES



Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields on seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

cember 5, 1966. Strong demand developed for Treasury bills at the higher rates, partly as commercial banks bought before the September 30 statement publishing date. As a consequence, bill rates fell sharply and the rates on three- and six-month bills closed the month at 4.39 per cent and 5.02 per cent, respectively.

On September 22, the Treasury announced plans to raise $4.5 billion of cash through the sale of tax anticipation bills maturing in April and June 1968. The bills were auctioned on Tuesday, October 3, for payment on Monday, October 9. Of the $4.5 billion total, $1.5 billion represented an additional offering of tax anticipation bills maturing on April 22, 1968, of which $2.0 billion was already outstanding. The remaining $3.0 billion comprised a new issue of tax anticipation bills maturing on June 24, 1968. The shorter maturities were sold at an average yield of 4.93 per cent, and the longer maturities yielded 5.11 per cent. Commercial banks were allowed to pay for 75 per cent of the bills allotted to themselves and their customers through credits to Treasury Tax and Loan Accounts. The Treasury also announced that it would continue adding $100 million each week to the weekly offerings of three-month bills through another full thirteen-week cycle. The previous cycle of $100 million weekly additions was completed with the bills paid for on October 5. Subsequent weekly offerings will consist of $1.5 billion of three-month bills and $1.0 billion of six-month bills.

Several new Government agency obligations were marketed during September. Among the larger issues, the Federal Home Loan Banks offered two $300 million issues on

Tuesday, September 12, to replace a $650 million maturity on September 27. The two issues were offered at yields of 5.45 per cent and 5.50 per cent for ten- and sixteen-month maturities, and both were trading at small premiums by the end of the week. Shortly after midmonth, the announcement by the Federal National Mortgage Association of a $400 million three-year debenture issue to be offered September 22 tended to depress the market, as it was a larger amount than the outstanding issue being refunded. However, at a yield of 5.82 per cent it was generally well received, although there were slight price declines in subsequent trading.

OTHER SECURITIES MARKETS

Many of the factors influencing the Government securities market early in the month also affected the corporate market, but perhaps of most immediate influence was the decline in the calendar of new issues scheduled for September to $860 million, still large but well below the average monthly volume floated publicly during the summer months. In this environment, Aa-rated utility issues with five years of special call protection, which had reached yields of 6.20 per cent or more during the last week of August, posted price advances during early September large enough to bring yields down to around 6.10 per cent. However, underwriters who bid aggressively for a sizable Aaa-rated telephone issue at the start of the month encountered considerable investor resistance at a reoffering yield of 5.95 per cent. This was roughly 12 basis points under the yield on a similar issue marketed the previous week and the lowest rate on this type of security since June. Only offerings which came out at yields around the levels of the preceding month tended to be well received. After midmonth, underwriters became increasingly concerned with their rather large unsold balances of recently marketed bonds; and, in view of the growing calendar of scheduled offerings, bidding turned cautious. An offering of $100 million Aaa-rated telephone debentures with five years of special call protection was priced to yield 6.06 per cent, 11 basis points higher than had been offered on the earlier telephone issue and the highest interest cost incurred by the company in over forty-five years. Nevertheless, the issue was accorded a poor reception, with lagging sales in part due to competition from sizable dealers' inventories of the earlier telephone issue. Other large corporate offerings toward the end of the month were mostly convertible issues and were generally accorded excellent receptions. The average yield on Moody's Aaa-rated seasoned corporate bonds was 5.68 per cent at the end of September, virtually unchanged from August.

The market for tax-exempt securities labored under pressure throughout most of the month, although some short-lived relief appeared during the second week as underwriters experienced a good distribution from their heaviest weekly schedule of new offerings since early in the year. To attract buyers, however, yields on new issues moved almost to the high levels reached in July, prior to the President's request for a tax surcharge. For most of the month, underwriters had difficulty reducing unsold balances of older issues without deep price concessions, and investor interest in new issues was only fair despite higher reoffering yields. The prevailing caution was further influenced by growing concern over the fate of the proposed tax surcharge. *The Weekly Bond Buyer's* average yield series for twenty seasoned tax-exempt bonds, carrying ratings from Aaa to Baa, rose to 4.19 per cent at the month end, from 4.06 per cent at the close of August (see chart). By the end of the month, the volume of tax-exempt issues advertised on the Blue List stood at $469 million, compared with $433 million at the end of August.

Term Lending by New York City Banks in the 1960's*

One of the outstanding features of lending to business by New York City banks is its strong orientation toward medium-term lending. Term lending has developed unevenly over the past three decades, with the sharpest advances occurring in the midfifties and midsixties when business demand for longer term funds was especially strong. The latest rise in term lending—an increase of about 70 per cent from mid-1964 to late 1966—established term loans as the largest single category of assets in the portfolios of New York City banks. Many factors undoubtedly contributed to this development. The investment spending boom of the sixties, which in its later stages greatly exceeded the internal financial resources of business, was unquestionably the major reason for increased term-loan demand at New York City banks. On the supply side, the rapid growth of time deposits at city banks—a growth facilitated by the development and promotion of the certificate of deposit—greatly enhanced the supply of loanable funds available to these banks, and served to strengthen their preferences for higher yielding and longer maturity earning assets. This article seeks to provide some information and perspective on these developments, and to assess the role of New York City banks in the national market for term loans.

RECENT TRENDS IN NEW YORK CITY TERM LOANS

The two major expansions during the past fifteen years in term lending by New York City banks were associated with upsurges in capital expenditures by business. In the first of these expansions, lasting from early 1955 to mid-1957, outstanding term loans at city banks rose at the very high rate of about 25 per cent a year, and the amount outstanding grew to over $5 billion from $3 billion at the start of the period.[1] Moreover, in the second expansion, roughly covering the 2½-year period ended in December 1966, term loans grew just as rapidly in percentage terms, and the amount outstanding rose from about $7 billion at the start of the period to over $12 billion at the close (see Chart I).

During the seven years that separated these two expansions, term-loan growth was comparatively slow. From mid-1957 to mid-1964, term loans of New York City banks grew only about 4 per cent a year, on average. This sluggish growth was due to the relatively weak demand for external financing by business firms (see Chart II). From mid-1957 to mid-1964, expenditures of business firms for fixed investment were about equal to their internal cash flows (retained earnings and depreciation allowances), whereas capital expenditures had exceeded cash flows by an average of nearly $2 billion annually during the two-year period ended in mid-1957. The reduced need for external financing was particularly pronounced for large corporations, the typical customers of New York City banks. Thus, the medium-term bank indebtedness of large manufacturing corporations (those with assets of $50 million or more) rose between June 1957 and June 1964 by only 2 per cent a year, compared with a 26 per cent growth rate during the 1955-57 investment boom.[2]

* George Budzeika, Economist, Financial Statistics Division, had primary responsibility for the preparation of this article.

[1] Developments during the 1950's were described in "Term Lending by New York City Banks", this *Review* (February 1961), pages 27-31. That article also described the statistics covering term loans by New York City banks, which were first collected by the Federal Reserve Bank of New York in 1960. These statistics underlie the analysis presented in this article. Term loans are defined here as commercial and industrial loans with an original term of more than one year. Term loans secured by real estate are not included; they are currently estimated at only 5 per cent of the term-loan total of city banks.

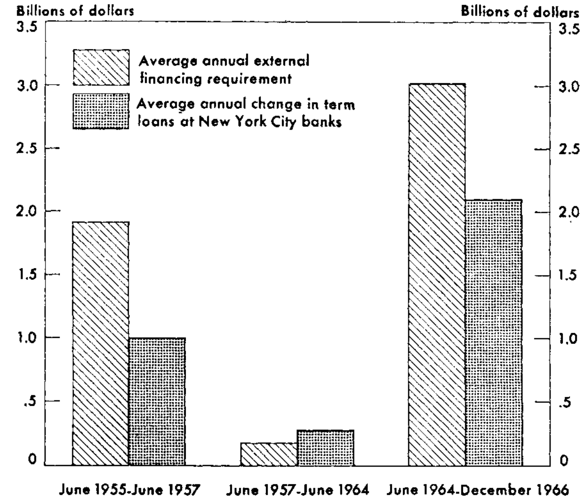
[2] Estimates of bank indebtedness of corporations are derived from statistics compiled by the Federal Trade Commission and the Securities and Exchange Commission and published in the *Quarterly Financial Report for Manufacturing Corporations.*

The strong term-loan expansion at New York City banks that followed this slack period started around mid-1964. The annual rate of growth of term loans accelerated to 17 per cent in the second half of 1964, and then jumped sharply in the first half of 1965 to an unprecedented rate of nearly 40 per cent. After mid-1965 term-loan growth slowed somewhat, but nonetheless continued at an unusually strong rate of over 25 per cent a year before coming to a gradual halt in the second half of 1966.

The especially rapid surge during late 1964 and early 1965 in term lending at city banks was due in part to rising demand from foreign borrowers as well as from domestic corporations. The strong foreign demand during this period probably stemmed largely from expectations—later borne out—that the United States would soon impose restrictions on domestic bank lending to foreigners for balance-of-payments reasons. From the limited data available, it is estimated that New York City banks extended a net of about $500 million to $750 million in term loans to foreign businesses over the nine-month period ended in March 1965, representing roughly half of the sharp increase in total outstanding term loans during those months. After March 1965, however, when the Federal Reserve announced voluntary guidelines for the foreign lending activities of commercial banks under the President's balance-of-payments program, the growth of term lending to foreign businesses came to a halt. In mid-1967 the amount of term loans outstanding to foreign businesses was reported by city banks at $1.6 billion, equal to about one eighth of these banks' total outstanding term loans and to about three quarters of term loans to foreigners outstanding at all commercial banks.[3]

Thus, after March 1965 demand from domestic sources, sparked mainly by the sharply rising level of capital expenditures by nonfarm business, became for all practical purposes the exclusive source of term-loan growth. Although capital expenditures had expanded very substantially each year since 1963 (at an annual rate of about 14 to 17 per cent), business firms had been able early in the boom to finance their needs largely from internal

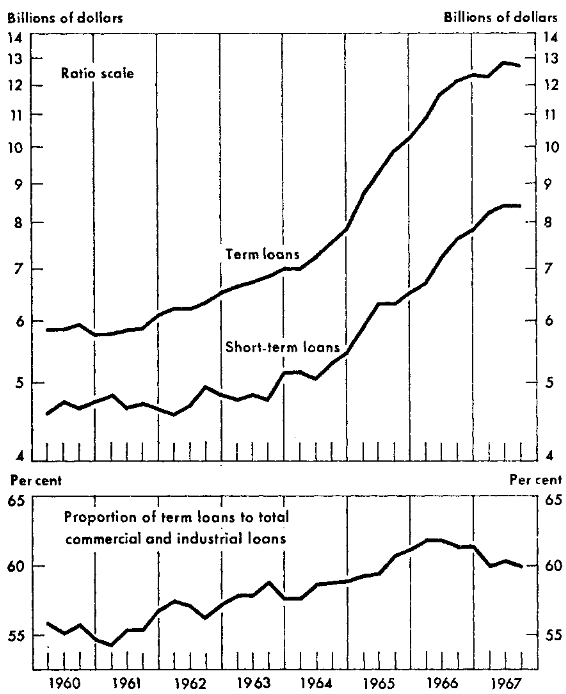
Chart II
EXTERNAL FINANCING REQUIREMENTS OF BUSINESS AND CHANGES IN TERM LOANS



Note: External financing requirements are defined as the excess of fixed investment spending by domestic nonfarm,nonfinancial businesses over funds available internally from retained earnings and depreciation allowances. The figures for term loans include those made to foreign businesses, and the figures for external financing requirements exclude funds needed for working capital.

Source: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

Chart I
COMMERCIAL AND INDUSTRIAL LOANS AT LARGE NEW YORK CITY BANKS



Note: Data plotted are seasonally adjusted March, June, September, and December averages of Wednesday figures.

[3] Banking statistics on business loans to foreigners became available on a current basis for the first time in January 1967.

sources of funds. In 1965, however, internal cash flows fell short of fixed investment expenditures by $3 billion, and in 1966 by $4 billion. The financing needs of nonfarm business during these years were swollen still further by increased inventory accumulation, which rose from $6½ billion in 1964 to over $13½ billion in 1966, and by the speedup in Federal income tax payments of corporations.

This greatly expanded business demand for external funds was met only in part by new securities flotations: such flotations by nonfinancial corporations rose from a net of $5½ billion in 1964 and 1965 to $11½ billion in 1966. That corporations during this period also borrowed heavily from banks was probably due to the relatively favorable terms on which bank credit could be obtained, especially up until late 1965. From mid-1964 to mid-1965, the bank prime rate—the rate charged the most creditworthy of business borrowers—was maintained at 4½ per cent, only very slightly above offering rates on prime new corporate bond issues. In the second half of 1965, moreover, the issuing rate on high-grade bonds rose above the prime rate for several months preceding the December 1965 prime rate increase.

Favorable rate considerations may also have been reinforced by other features of bank loans. For one thing, bank credit can ordinarily be arranged and drawn down more quickly than capital market borrowings. This may have been especially important in the earlier part of the recent term-loan expansion, when credit from banks was readily available and business plant and equipment spending was persistently outrunning earlier spending plans. Also, part of the heavy borrowing at banks may have constituted interim financing to be paid out of expected future increases in internal funds or subsequent long-term bond flotations. The latter possibility is supported by the trend toward greatly increased bond market flotations in 1966 and 1967, and by the fact that an increased proportion of these issues has been for the stated purpose of repaying bank loans.

The favorable terms of bank borrowing through late 1965 were attributable to the ample supply of funds at banks, especially in the early part of the period. This in turn was due importantly to the banks' ability to raise funds in the money market by means of a new financial instrument—the large-denomination negotiable certificate of deposit. The city banks attracted some $6½ billion over the five-year span ended by mid-1966 through these certificates. They also raised an additional $4 billion from sales of United States Government securities from their own investment portfolios over the same period.

About mid-1966, however, the efforts of New York City banks to raise funds from sales of securities and in the money market became less successful. The financial latitude given the large-denomination certificate of deposit by the action of the Board of Governors in December 1965, which raised from 4½ per cent to 5½ per cent the maximum rate payable on bank time deposits, proved to be short-lived. Money market rates rose swiftly in early 1966, and by midyear banks found themselves unable to offer rates comparable to those on competing credit instruments. As a result, the city banks began to encounter slower growth in total time and savings deposits around mid-1966, and actually suffered a net decline of these deposits toward the end of the year on the order of some $2 billion. During

Table I

ASSETS AND LIABILITIES OF WEEKLY REPORTING MEMBER BANKS IN NEW YORK CITY

June 1964 and December 1966

Assets and liabilities	Amount outstanding: June 1964	Amount outstanding: December 1966	Amount outstanding: December 1966	Compound annual rate of growth June 1964-December 1966
	Billions of dollars		Per cent	Per cent
Assets				
Commercial and industrial loans with an original maturity of:				
More than one year	7.1	12.2	23.5	24.0
One year or less	5.1	8.0	15.5	20.2
Loans to financial institutions	3.5	4.7	9.1	13.0
Loans for purchasing or carrying securities	3.4	2.6	5.0	− 10.2
Real estate loans	2.0	3.2	6.2	21.3
All other loans	3.5	3.8	7.3	3.2
United States Government securities	5.4	4.4	8.5	− 8.4
Other securities	5.0	5.3	10.2	2.2
Cash	4.3	4.8	9.3	3.8
All other assets	2.4	2.8	5.4	6.8
Total assets	41.7	51.8	100.0	9.1
Liabilities				
Demand deposits	20.3	21.4	41.3	2.2
Time deposits	8.0	11.7	22.7	16.3
Savings deposits	4.4	4.6	8.9	1.4
Capital accounts	4.2	5.1	9.9	8.4
Borrowings	1.5	2.8	5.3	27.3
Other liabilities	3.3	6.2	11.9	29.2
Total liabilities	41.7	51.8	100.0	9.1

Note: Medium-term loans to business secured by real estate were estimated at approximately $0.6 billion in 1966; they are included in the class labeled "real estate loans". The breakdown of commercial and industrial loans into those with an original term of more than one year and those with one year or less was estimated for 2 per cent of the total on the basis of the breakdown available for 98 per cent of the total. All loan figures are shown gross. Cash figures exclude cash items in process of collection. Demand deposit figures are gross demand deposits less cash items in process of collection. Valuation reserves are included in "other liabilities". Percentage distribution and dollar figures are monthly averages of Wednesday figures.

this period, they began to bid aggressively through their European branches for Euro-dollar deposits, and raised about $1¼ billion by these means. But, with shrinking time deposits and depleted holdings of United States Government securities, banks were able to meet loan demands after midyear only by effecting some net reduction in their holdings of municipal obligations. The city banks thus were not able in the second half of 1966 to marshal sufficient funds to finance loan expansion at the record high rates of previous months. It was apparently for this reason that the growth of term loans slowed to a 12 per cent annual rate in the second half of 1966, and ceased completely by the end of the year. This marked the end of the rapid 2½-year expansion of the midsixties that had raised the share of term loans in the total of loans and investments of New York City banks to over one quarter, making these loans the largest single category in the banks' assets portfolio (see Table I). In the course of this expansion, term loans also increased in relation to total commercial and industrial loans, reaching about 60 per cent as compared with an average of about 55 per cent during 1960-61. (The proportion was 47 per cent in 1955 and 51 per cent in 1957.)

Table II

TERM LENDING BY WEEKLY REPORTING MEMBER BANKS IN NEW YORK CITY AND CAPITAL EXPENDITURES BY BUSINESS, 1961-66

In per cent

Industry of borrower	Distribution of term loans outstanding		Compound annual rate of growth	
	December 1961	December 1966	Term loans December 1961-December 1966	New plant and equipment expenditures 1961-66
Manufacturing:				
Durable goods industries	19.4	21.1	17.3	17.4
Nondurable goods industries	21.8	21.6	15.0	11.9
Mining (including crude petroleum and natural gas)	15.6	18.0	18.6	8.4
Public utilities (including transportation and communications)	30.4	23.4	9.4	11.5
Trade	3.6	4.6	21.5	8.5
All other	9.2	11.3	20.0	
Total	100.0	100.0	15.3	12.0
Total (millions of dollars)	6,081	12,235	—	—

Note: Percentage distribution and dollar figures are monthly averages of Wednesday figures.

Sources: Statistics are based on data from the Federal Reserve Bank of New York, United States Department of Commerce, and the Securities and Exchange Commission.

TRENDS BY INDUSTRY

The growth of term loans at city banks in the mid-1960's was fairly well balanced, with the basic contours of the distribution by industry of borrower showing little change between 1961 and 1966 (see Table II). The proportion represented by manufacturers of nondurable goods remained stationary at 22 per cent. Public utility borrowing (including transportation and communications) lost ground dropping from 30 per cent to 23 per cent, but utilities still represented the largest single borrower group. Offsetting this relative decline were moderate increases distributed rather evenly among the other industries—notably durable goods manufacturing (from 19 per cent to 21 per cent), mining (from 16 per cent to 18 per cent), and trade (from 4 per cent to 5 per cent).

In several industrial classifications, covering about two thirds of the total of term loans, the relative growth rate in term borrowing reflected the relative rate of expansion in capital expenditures. Manufacturers of durable goods, for example, expanded both their capital outlays and their term indebtedness at annual rates that were higher than the average for all business firms; in the nondurable goods manufacturing sector both rates were at the average level; and in the public utilities sector, both were lower than average. Term lending to the mining industry, however, appears to have been little influenced by changes in capital expenditures. In this sector, capital spending grew at a pace well below the average for all industries, but term loans expanded at a higher than average rate. The primary reason was heavy borrowing by firms engaged in crude petroleum and natural gas extraction. This type of business is very well suited to medium-term accommodation by banks, because sales of crude petroleum from underground reserves provide sufficient flows of funds for the retirement of debt in some five to eight years—the typical maturity preferred by commercial banks. In addition, firms engaged in petroleum extraction received several fairly large loans from New York City banks in this period for financing acquisitions of other companies. The extension of sizable credits to foreign petroleum companies also contributed to the relatively fast growth of term lending to the mining industry.

THE CITY BANKS AND THE NATIONAL TERM-LOAN MARKET

The rapid expansion of term lending during the investment booms of the midfifties and midsixties was evident at banks throughout the country, but in New York City the expansion in each period was faster than in other sectors of the country. The extent to which term-loan demands were focused on New York City banks is suggested by the accompanying changes in these banks' share of the national market. One of several measures of this relationship is the city banks' share in total term loans outstanding at all commercial banks.[4] That share, currently estimated at about one third, has fluctuated in the past fifteen years from about 30 per cent to nearly 40 per cent, rising in periods of heavy investment spending and declining in periods of weak demand for funds. This cyclical variation is more clearly evident when measured with regard to the net increase in term loans outstanding: during the 1955-57 and 1964-66 investment booms, the city banks accounted for about 40 per cent of the estimated net increase in term loans of all commercial banks, compared with only a 20 per cent share of the increase in the late 1950's and early 1960's. And, finally, the reliance on New York banks in periods of heavy demand can be judged from the contributions of these banks' term loans to the total net flow of funds to nonfinancial business from external sources. In the late 1950's and early 1960's that figure was only 2 per cent, but it rose to about 8 per cent in the midfifties and the midsixties.

This increased concentration on New York in periods of investment boom is attributable to the fact that the city banks generally cater to large corporations, both domestic and foreign, whereas small- and medium-sized corporations account for most of the business credit outstanding at banks outside New York. Large firms normally finance their operations from internal sources and in the capital market, relying on commercial banks to a much lesser extent than small business. But in periods of high-level capital expenditures large firms make much greater use of bank credit, not only as a supplement to their other sources of funds but possibly also as a temporary substitute for capital market credit to be refunded in long-term bonds when monetary conditions become easier. Smaller firms normally depend on commercial banks more steadily, and thus their demand for bank credit tends to be more evenly spread over time. The relevance of these behavior patterns is indicated by figures on the increase in medium-term indebtedness to banks of manufacturing corporations. For corporations with assets of $50 million or more, the annual rise of such indebtedness during 1965-66 was 45 per cent, but it was only 13 per cent for corporations with assets under that amount. During the preceding seven years, the growth pattern was opposite—2 per cent for the large corporations and about 7 per cent for the small firms.

In addition to the marked cyclical variation in the share of New York City banks in nationwide term loans, there has been a mild long-run downtrend in the city banks' share from the early 1950's to the mid-1960's. Between 1952-53 and June 1964, the city banks' share in total term loans declined from 37 per cent to 30 per cent. A number of factors contributed to this downward trend; the most important were the relatively weak demand for bank accommodation by large corporations during most of the period in question and the relatively slow growth of business activity in New York City. Since mid-1964, the city banks' share of total term loans has advanced sharply, reaching 34 per cent by late 1966. However, it is too early to judge whether this recent gain represents a reversal of the long-run downtrend or is merely a temporary cyclical upswing.

[4] This total can be only roughly estimated, using a variety of sources. In December 1966 it was an estimated $37 billion, consisting of $29 billion of commercial and industrial loans with an original term of more than one year and about $8 billion of medium-term loans to business secured by real estate. The estimate for the comparable total at New York City banks is nearly $13 billion including the real estate loans, which in this section must be admitted to the definition because in the nation as a whole, in contrast to New York City, they represent a substantial fraction of term lending.