FEDERAL RESERVE BANK
OF NEW YORK

MONTHLY REVIEW

FEBRUARY 1968

Contents

Volume 50 **No. 2**

Inflation and the Defense of the Dollar*

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A year ago I spoke of the difficulties of 1966 and expressed the hope that in 1967 the stresses and strains would be less severe, and the problems less perplexing, than in the year we had just lived through. That hope was only partially fulfilled. In domestic banking matters the year, while not without its problems and challenges, was far more manageable than 1966. But in the international financial sphere the late fall of 1967 brought new crises of almost unprecedented severity. The crises appear to have been surmounted, through a forceful United States balance-of-payments program designed to underline the firm determination of the United States to defend the fixed relationship of the dollar to gold at $35 per ounce coupled with an impressive show of solidarity among the major industrial countries in recognition of their mutual interest in preserving the existing world financial structure. But, while we have made an excellent start, a great deal remains to be done before we can say that we have grappled effectively with this nagging balance-of-payments problem and that we have laid the necessary foundations for restoring unquestioned faith in the dollar, both here and abroad.

Perhaps the critical developments of November and December have served a very useful purpose in one regard if they have convinced more Americans than before that our record of persistent balance-of-payments deficits constitutes a problem that must be dealt with in a comprehensive and conclusive fashion. During recent years we have had frequent assurances of our need and determination to reduce or eliminate the deficit, and we have had a good many programs to attack specific elements in our payments problem. But, as gains were made on one or another front, new problems continually opened up and we made no progress overall. Moreover, the whole payments problem remained distant and esoteric to the great majority of Americans.

It was of course the devaluation of sterling which, not unexpectedly, triggered the violent onslaught against the dollar as the basis of the international monetary system. This attack took the form of a huge rise in speculative purchases of gold on the London market. Fear of just such a sequence of events had been a major motive for the various cooperative actions to defend sterling undertaken by the principal industrial nations over the past three or four years. And even in the final crisis there was no lack of willingness to provide enough international credit to back up a strong effort to preserve the former parity. The decision to devalue was a deliberate one on the part of the British government. Naturally it was up to the British to make a judgment, after due consideration of their domestic problems and the probable world reaction, as to whether devaluation was necessary or desirable, or both. But there is no doubt whatever that it was a highly disturbing move from the standpoint of world financial stability.

There are, of course, worlds of difference between the position of sterling and the position of the dollar. The dollar is vastly stronger as the currency of the world's largest and technologically most advanced economic unit —a nation with a huge excess of total foreign assets over its foreign liabilities. Nevertheless, the experience of sterling should serve as a salutary warning that a country whose currency is widely used for reserve purposes has

* An address before the fortieth annual midwinter meeting of the New York State Bankers Association, New York City, January 22, 1968.

some special aspects of vulnerability, and thus some special responsibility for even more scrupulous financial behavior than those countries whose currencies are less widely used internationally.

Although individuals are bound to differ somewhat in their judgment with respect to the particular features of the President's balance-of-payments program, the program as a whole deserves the nation's full support, both because the Administration now seems determined to conquer this hitherto intractable problem and because there is an evident desire to spread the burden of remedial measures as widely as possible rather than concentrating it on only a few shoulders. I can well understand the initial reluctance of some to accept a program of controls on the free flow of international capital and on spending abroad by American tourists, for this seems a violation of the very trends we have been trying so hard to nurture since World War II. But it seems to me that this reluctance overlooks two facts of great importance: (1) We are in a war economy, with military expenditures accounting for much of our balance-of-payments deficit as well as for much of our Federal budget deficit. "Business as usual", or even "travel as usual", is not consistent with the needs of a war economy. (2) The payments crisis had reached a point where immediate and dramatic action was essential to break the back of a violent and concerted attack on the dollar. And the consequences of failure to defend the dollar as the keystone of the international monetary structure would have been far more disruptive of international payments flows than any of the measures proposed in the program. International confidence in the continued ability and willingness of the United States to sell gold at the $35 price is, of course, crucial to the dollar's role as a reserve currency. The gold reserve requirement on Federal Reserve notes should be eliminated immediately, as proposed by the President last week.

I have mentioned the probable salutary effect of the crisis in alerting Americans to the need for forceful action. At the same time, I can see a risk that some Americans may mistake a necessary remedial crash program for a permanent cure. Interference with the free movement of capital and with tourist spending is certainly neither a desirable nor a practicable long-run solution of the problem. For this we must look mainly to a stronger trade surplus, which means improving our competitiveness in the world and avoiding an overheated economy that pulls in excessive imports. We should also take a more critical look at Government outlays abroad, especially military outlays, to make sure that their heavy economic cost is still justified in the light of political and military conditions of today. Foreign aid is in a different category, for genuinely productive expenditures in less developed countries are called for not only for moral and humanitarian reasons but also because they will contribute to a sounder world structure, political and economic, from which the United States will clearly benefit. This does not mean, however, that aid outlays should not also be subject to careful review to make sure that they really are soundly programmed. And I believe we should continue to press the major European industrial nations to give more effective recognition to their own responsibilities for help to the less developed areas. Moreover, countries with balance-of-payments surpluses must be mindful of their own responsibilities to follow fiscal, monetary, trade, and capital export policies which contribute to international equilibrium.

Mention of the vital importance of our competitive position in the world leads us squarely to an examination of how well or how poorly the United States has lived up to one of its major economic goals, i.e., cost and price stability. During the early sixties the record was quite creditable, for we enjoyed a much more stable cost-price structure than did most of the other leading industrial countries—and as a result we were making considerable progress toward a smaller overall payments deficit. All this changed radically for the worse after the Vietnam fighting accelerated in mid-1965. A rapid burgeoning of Federal defense outlays, coupled with a failure of fiscal policy to meet this increase through higher taxes, was largely responsible for upsetting the earlier record of cost-price stability, and inflationary pressures became quite severe in the overheated economy of 1966. Higher prices and high profits in that boom year, coupled with low unemployment and scarcities of skilled labor, in turn laid the groundwork for wage demands—and wage settlements—far in excess of national average productivity gains. Thus, our country was caught up in the familiar inflationary spiral in which cost-push and demand-pull are mutually reinforcing. In much of 1967 there was some letup on the demand-pull side (although none on the side of excessive wage increases), but more recently, as the business expansion has resumed speed, both elements are again operating with great force.

I am acutely troubled by the evidence on all sides that many of our citizens, while recognizing that a rather sizable pace of inflation—say at a 3 to 4 per cent rate—is undesirable, nonetheless regard it as inevitable. This view has found expression recently in speculative excesses in stocks, real estate, and corporate acquisitions. I hardly think it necessary to dwell on the dangers and inequities of inflation before this audience. Bankers are characteristically much more alert to them than is the public at large. But somehow a way must be found to bring these risks and injustices more forcefully to the attention of those who are in the strongest position to do something about it—and here I am thinking especially of leaders in labor, business, and government.

Cost-price stability and the closely related goal of payments equilibrium are, of course, not our only major national economic goals. Others are maximum sustainable economic growth and high use of resources, particularly of manpower resources. But I suspect that as a nation we have encouraged more rapid increases in aggregate demand than have been consistent with reasonable wage and price stability. In saying this, I am not belittling the goal of high resource utilization—quite the contrary. But I would stress the importance of reducing unemployment through structural improvements in the labor force and in job markets. For example, close attention must be given to better education and job training and to elimination of discriminatory practices in employment and union membership.

In recent years we have witnessed a profound change of public psychology with respect to economic growth and cyclical swings. There is much more confidence in the Government's ability to avoid recessions by means of various stimulative measures in the event of need. The counterpart of this should be a widespread acceptance of public policy measures designed to avoid inflation; but here we seem to face some kind of cultural lag. There is grudging recognition that monetary policy has to pay attention to inflationary as well as recessionary dangers. However, the past two years' experience suggests that the American people and their elected representatives are still a long way from accepting fiscal policy as a means of promoting economic stability in a time of inflation. Perhaps we should have been warned that this might be the case when in the early sixties even a tax *cut* to promote economic growth took some two years to come to fruition. Now, after two and a half years of rapidly expanding Federal expenditures, we have not yet used a tax increase to apply suitable brakes to the economy.

A few years ago many economists, as well as many of us in the Federal Reserve, were hopeful that fiscal policy might become a much more flexible instrument—although it could never be as flexible as monetary policy—so that a suitable "mix" of fiscal and monetary policy could be developed to meet whatever specific problems might occur. To some extent, this was actually accomplished at the time of the 1964 tax cut, when monetary policy was thereby enabled to be firmer than it could otherwise have been, with consequent benefits to our balance of payments. However, it has emphatically not been accomplished in the reverse direction since mid-1965, with the result that monetary policy has had to bear most of the burden when a public policy of restraint has been called for. What this could mean in terms of rapid interest rate increases and fears concerning credit availability was vividly demonstrated in the summer of 1966.

In the last few months, it has become clear that a key reason tax rate changes are a less flexible instrument than had been hoped is that legislators are unwilling to consider restrictive tax measures without also considering the possibilities of reducing Federal expenditures. In general this is as it should be, and economy in Federal spending is especially desirable in the present setting. But, in my view, reductions in Federal spending that would be large enough to deal with our present problems are simply not feasible. Under current circumstances, characterized by rapidly rising prices and accelerating business activity, a tax increase along the lines proposed by the President is essential to achieve fiscal restraint on the scale needed. Without such an increase, we run the risk of increased price pressures, more trouble for our balance of payments, and a recurrence of the mid-1966 credit conditions. I am hopeful that the sheer necessity of a tax rise will bring it into being without further delay.

While it is true that long-term interest rates have moved back to or beyond the peak levels of the summer of 1966, fortunately banking conditions are now quite different from those prevailing at that time. Since then bank liquidity has grown very appreciably, and I have the impression that loan demands, while substantial, have been rather less than most bankers had expected. Doubtless this is due in part to the record volume of offerings in the bond market which prevailed through 1967. The general public has also added a good deal to its liquid assets in the past year or so. The Federal Reserve System has been criticized for permitting bank credit to grow in 1967 at a rate of about 11 per cent, and I confess that we in the System have felt some concern on this score for several months. However, very unsettled conditions in the financial markets, the uncertain outlook for a tax increase, worries over the sterling situation, and the massive financing requirements of the Treasury all posed strong constraints on monetary policy until late in the year. Moreover, a somewhat higher than average growth of bank credit was to be expected after the unusually severe liquidity squeeze of 1966. It should also be noted that banks accounted for an increased share of total credit growth in 1967, and the unusually rapid pace of bank credit expansion was not matched by an equivalent rate of expansion of total credit.

Bank credit grew much more slowly on average in the last four months of 1967 than in the first eight months, and the slowdown was most pronounced in November and December. While the vagaries of seasonal adjustments and Treasury financing schedules make analysis of the actual statistics unusually difficult, the general tendency toward more modest bank credit growth seems clear, and it is most welcome. Obviously monetary policy is not seeking a cessation of bank credit expansion, but merely a pace more in keeping with the economy's potential for sustainable growth.

As we look ahead to the new year, the gravest question in the economic sphere is whether we can reduce the inflationary tendencies that are now so painfully apparent. Let me stress again that price stability is not only urgently needed to protect the value of the dollar at home. It is also most urgently needed to maintain and improve our competitive position in world markets. Our success in riding out the recent gold crisis is no cause for complacency. The Administration's new balance-of-payments program has to be buttressed, and eventually supplanted by more permanent remedies, including above all the elimination of inflationary pressures. Success will call for a concerted attack by appropriate public policies, especially a tax increase coupled with economies in Federal spending, strengthening of efforts to discourage inflationary wage and price increases, and maintenance of an appropriately firm monetary policy. But the degree of success that these public policies can achieve will depend very largely on the extent to which they are backed by a cooperative attitude on the part of labor, business, and the general public. The stakes are high enough so that such cooperation should be forthcoming without hesitation. I trust that the country's bankers will use their position of influence in the business and financial community to support this many-pronged attack on the greatest present threat to sustainable economic growth and survival of our international financial system.

The Business Situation

The economy posted strong gains in the closing months of 1967 and continues to move ahead vigorously. Gross national product (GNP) rose substantially in the fourth quarter of 1967 despite cautious spending on the part of the consumer and a relatively small advance in Federal Government spending. While a substantial portion of the fourth-quarter increase in GNP was accounted for by a jump in the rate of inventory accumulation, virtually all the components of aggregate demand rose. The continuing strength of the economy is clearly evidenced by the strong December advance in industrial production, the sharp rise in new orders for durable goods, and the substantial growth of employment. At the same time, prices on both the consumer and wholesale levels continued to rise, reflecting persisting demand and cost pressures. Indeed, about half of the fourth-quarter increase in GNP represented price increases rather than a larger volume of real output.

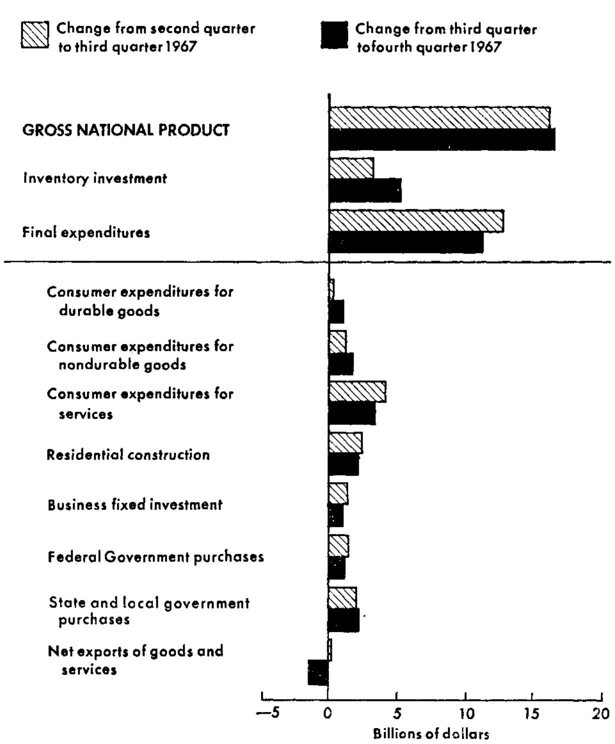
GNP IN THE FOURTH QUARTER

The nation's total output of goods and services increased by $16.4 billion in the final quarter of 1967 (see Chart I) to a seasonally adjusted annual rate of $807.6 billion, according to preliminary estimates by the Department of Commerce. This advance was the largest for any quarter since the beginning of 1966. During the second half of 1967, real output grew at a 4.5 per cent annual rate, sharply higher than the 1.1 per cent growth rate in the first half of the year. The substantial gain in real output in the second half was accompanied by accelerating price pressures. The GNP price deflator rose at an annual rate of 4.0 per cent in the period, nearly twice the first half's rate of increase and the sharpest six-month advance in the GNP deflator in more than a decade.

An unusually large rise in inventory investment accounted for more than 30 per cent of the fourth-quarter growth in GNP. Inventory accumulation increased to a $9 billion annual rate from a $3.8 billion pace in the preceding quarter. This gain was in marked contrast to the sharp drop in the rate of accumulation in the first half of 1967. Fourth-quarter inventory growth reflected increases in trade stocks, as auto inventories were rebuilt, as well as a temporary increase in farm inventories.

In contrast, business spending on structures and equipment rose by a modest $1.0 billion in the fourth quarter of 1967 to an annual rate of $83.8 billion. The increase appears to have reflected higher prices for capital equipment, so that business fixed investment spending in real terms was stable at the third-quarter pace.

Chart I
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rates



Source: United States Department of Commerce.

The continued growth of GNP has received only moderate support from consumer demand. The $6.1 billion fourth-quarter increase in consumption expenditures was slightly larger than the quite modest rise in the preceding quarter. More than half of the advance was attributable to the growth of spending on services, with purchases of both durable and nondurable goods showing only small increases.

The strike-related slowdown in purchases of new automobiles was one factor restraining consumer spending. Auto sales in the fourth quarter were at an annual rate of only 7.3 million units, well below the 7.7 million annual sales pace during the first nine months of 1967. For 1967 as a whole, sales were 7.6 million units, considerably below the 1966 and 1965 sales figures of 8.4 million and 8.8 million, respectively. January sales, however, moved up substantially from the December level to an annual rate of over 8 million units.

Disposable personal income expanded by a healthy $9.3 billion in the fourth quarter, and this in conjunction with the relatively slow growth in consumer spending meant that the savings rate climbed to 7.5 per cent, the highest since 1953. Contributing to the growth in income was a substantial year-end pay increase for both military and civilian employees of the Federal Government. The raise was retroactive to October 1, 1967, though it was not received by Government workers until late in December. This surge in income probably contributed to the sharp fourth-quarter rise in the savings rate, since it is likely that only a relatively small part of the retroactive increase was spent by the year's end.

Demand for housing has remained strong, and residential construction expenditures rose $2.3 billion in the fourth quarter, reaching the highest level since the final quarter of 1963. To be sure, private nonfarm housing starts, which had risen rapidly in October and November, fell precipitously in December to 1.2 million units at a seasonally adjusted annual rate. However, housing starts are often erratic, and much of the December decline in starts may have been due to abnormally cold weather and snowstorms in the South and West. This explanation appears the more likely in view of the sharp December rise in the number of residential building permits issued, an activity which would not be significantly slowed down by adverse weather conditions.

Total government spending for goods and services boosted GNP by $3.3 billion in the fourth quarter. However, Federal Government expenditures rose by only $1.1 billion as the marked slowdown in the growth of defense spending, which became evident in the third quarter, continued in the final three months of 1967. Defense expenditures rose by a relatively modest $1 billion, following an increase of only $0.8 billion in the third quarter; the increase in the first and second quarters averaged, in contrast, $3.5 billion. At the same time, the fourth quarter saw only a negligible rise in Federal Government purchases of nondefense goods and services. Indeed, the fourth-quarter increase in Federal spending is more than accounted for by the pay rise granted to Government employees late in the year. State and local government expenditures continued to expand in the fourth quarter at the high rate evident in the first three quarters.

Net exports of goods and services fell by an unusually large $1.4 billion in the fourth quarter. Imports rose sharply, reflecting the rapid growth of aggregate demand as well as special factors such as the long copper strike. Exports, on the other hand, did not rise during the quarter.

PRODUCTION, PERSONAL INCOME, AND EMPLOYMENT

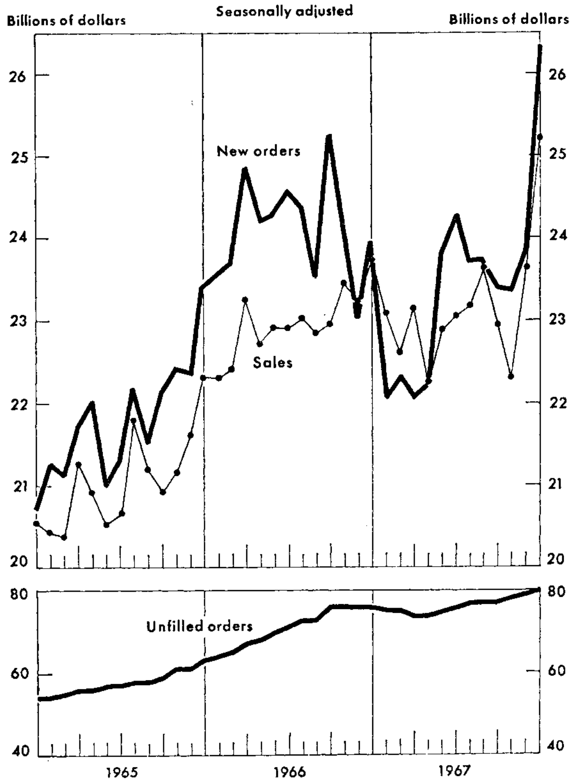
In December, the Federal Reserve's seasonally adjusted production index jumped 2.3 percentage points to a new high of 161.6 per cent of the 1957-59 average, after showing a 2.7 percentage point gain in November. The strong upsurge in industrial production in the closing months of 1967 was in striking contrast to the performance of earlier months when production had been dampened, first by the largest inventory adjustment on record and later by labor disputes. Nearly half of the December increase in industrial production was accounted for by the motor vehicle and parts component, as auto producers tried to make up for production lost during the earlier strikes at Ford and Chrysler. In December, auto production reached 8.9 million units at an annual rate, but in January strikes at General Motors held back output so that auto production slipped back to an annual rate of 8.4 million units. Production of other consumer goods and of business equipment continued to expand in December. Materials production rose strongly, buoyed by the continuing surge in steel output. Increased production caused the manufacturers' utilization rate to edge up to 84.3 per cent of capacity in the fourth quarter, the first increase since the second quarter of 1966.

The volume of new orders received by manufacturers continues to increase. In December, new orders for durable goods shot up 12 per cent, the strongest advance since 1956. The December increase was broadly based, but gains in the steel, auto, equipment, and defense industries were particularly vigorous. Though durables shipments reached a record high in December, they were exceeded by the volume of new orders, and the unfilled orders backlog

Chart II

DURABLES MANUFACTURERS' SALES AND ORDERS

Seasonally adjusted



Source: United States Department of Commerce.

adjusted), following an even larger increase in November.

Civilian employment grew by 1.5 million persons in 1967. As indicated by the nonfarm payroll survey, nearly all the 1967 rise in nonagricultural employment occurred in the nonmanufacturing sector. However, factory employment in both the durables and nondurables sectors showed strong gains in the fourth quarter, after declining throughout the first nine months of the year.

The civilian labor force rose by a record 1.6 million persons in 1967 to an average level of 77.3 million. In contrast to the experience of the past few years, when much of the increase in the labor force resulted from the entrance of teen-agers, all the 1967 increase was accounted for by adults—about 600,000 men and 1.0 million women. The teen-age civilian labor force was virtually unchanged because of increased military demands. The sizable expansion in the adult labor force in 1967 reflected the combined effects of population growth and a heavy demand for additional workers. The big population group born soon after World War II has now moved out of the teens into the early twenties. Approximately one third of the 1967 labor force growth took place in this age category. The sizable increase in the number of adult women in the labor force during 1967 was in part attributable to a change in the definition of the labor force as well as to the heavy demand for additional workers. The labor force participation rates of women, in contrast to those of adult men, tend to be responsive to overall demand conditions—rising in good times when the employment situation is favorable and declining somewhat in periods of slack.

increased by another $1.1 billion (see Chart II).

Rising economic activity as well as the Federal pay increase boosted December personal income, measured at a seasonally adjusted annual rate, by $5.7 billion. While the main factor in the month's income growth was the pay rise, the brisk pace of industrial activity also led to higher employment and earnings and longer hours. The unemployment rate in December fell to an eight-month low of 3.7 per cent. The decline in unemployment was widespread, with the rates for adult men and women as well as teen-agers all dropping back to the levels of early 1967. The December decline brought the unemployment rate for the full year to 3.8 per cent, unchanged from the thirteen-year low set in 1966. Part of the December increase in civilian employment was due to a greater than normal rise in farm employment, caused by a late harvesting season. In addition, the number of persons on the payrolls of nonagricultural establishments advanced in December by 200,000 to reach 67.1 million (seasonally

COST AND PRICE PRESSURES

Labor costs continue to rise. According to the Bureau of Labor Statistics, collective bargaining settlements concluded in 1967 involved median wage and fringe benefit increases totaling 5.6 per cent a year, compared with an increase of 4.5 per cent in 1966. The rapid advance in labor compensation during 1967 was accompanied by a leveling-off in productivity growth, reflecting the sluggish behavior of manufacturing output during most of the year and the consequent decline in the utilization of manufacturing capacity. Output per man-hour in manufacturing in 1967 was only 1.0 per cent larger than in 1966, the smallest increase in the present expansion, and capacity utilization averaged only 85.1 per cent, the lowest level since 1963.

The combination of sizable wage gains and modest growth in output per man-hour resulted in a sharp increase in labor costs per unit of output. In December, the index of unit labor costs in manufacturing stood at 106.7 per cent of the 1957-59 average, 3.6 per cent above December 1966. Between mid-1958 and mid-1966, unit labor costs in manufacturing were essentially stable. This was a major factor behind the general price stability of that period. The rise in unit labor costs over the past year and a half has generated pressures on businessmen to raise prices or to suffer declining profits. While productivity can reasonably be expected to move upward as the economy expands more vigorously, it is unlikely that the growth in output per man-hour will be adequate to offset mounting labor costs.

Increasing demand and cost pressures have already had an effect on the broad index of wholesale prices. In December, the wholesale price index jumped 0.6 percentage point to 106.8 per cent of the 1957-59 average, the sharpest rise in eighteen months. While industrial wholesale prices rose by only 1.8 per cent over 1967 as a whole, price increases have been accelerating and industrial wholesale prices advanced at a 3.4 per cent annual rate in the fourth quarter. Preliminary figures for January indicate a continuing rise in wholesale prices. The total index is expected to increase another 0.3 percentage point as all the major components register advances.

In the consumer area, widespread price increases caused the consumer price index to advance a sharp 0.4 percentage point in December, the eleventh consecutive monthly increase. The consumer price index in December rose to 118.2 per cent of the 1957-59 base, a gain of 3.1 per cent over the year and the second largest annual increase since 1951.

The Money and Bond Markets in January

The money market was firm throughout January, with the effective rate for Federal funds remaining generally above the discount rate. Member bank borrowings at the Reserve Banks were reasonably steady after the first statement week, in which borrowings reflected the usual bank adjustments prior to the year-end statement date. Net free reserves were allowed to ride up and down to compensate for the shifting amounts of reserves retained by "country" banks. By contrast with the firm rates in the market for overnight funds, rates for most short-term debt instruments declined, reflecting an unusually large seasonal expansion in the volume of funds available for investment. Treasury bill rates declined sharply, despite the sale of an additional $2.5 billion of June tax anticipation bills early in the month. Large commercial banks lowered their posted offering rates on new negotiable time certificates of deposit (C/D's), dealers in bankers' acceptances and in prime commercial paper reduced their offering rates, and major finance companies lowered rates for most maturities of paper which they place directly with investors.

Prices of intermediate- and long-term Government securities scored large gains during January. The market developed a buoyant tone at the beginning of the month, as hopes for peace negotiations on Vietnam blossomed and President Johnson announced a program designed to bring the nation's international payments into balance. Prices rose sharply until midmonth, when market hopes for early progress toward peace faded and the domestic fiscal and credit situation was interpreted as generally unfavorable. The brief downward movement of prices at midmonth was reversed toward the close of the month despite a variety of disquieting developments, including new tensions in Korea. The corporate and tax-exempt bond markets also displayed considerable strength early in January, softened around midmonth, and firmed near the close of the month.

BANK RESERVES AND THE MONEY MARKET

The money market was somewhat firmer, on average, in January than it had been in December, and the effective rate for Federal funds was generally at the 4⅝ per cent level attained late in the preceding month. Wide week-to-week variations in nationwide net reserve availability did not alter the tone of the Federal funds market, which remained consistently firm during the period.

Aggregate free reserves rose to an average level of $405 million in the second statement week (see Table I). However, the increase compensated for extraordinarily large excess reserves held by country banks in that week. At the same time, the large banks in New York City and other major money centers sustained sharp losses of reserves, and the money market remained firm. During the following statement week, the maintenance of a firm tone was consistent with net borrowed reserves of $70 million, as the large accumulated reserve surpluses of the country banks were released to the Federal funds market.

Over the balance of the month the money market remained generally firm in spite of a pronounced improvement in the basic reserve positions of the New York City banks and other major money market banks (see Table II). While reserve positions of country banks were under some pressure, the New York City banks moved into a position of basic reserve surplus near the end of January, as C/D and Euro-dollar liabilities were maintained at declining interest rates and loans and investments decreased.

Short-term debt instruments were in strong demand during January, as savings banks, corporations, and state and local governments sought to invest a plentiful supply of funds. Dealers in bankers' acceptances lowered their offering rates on ninety-day paper on four occasions, by a total of ½ per cent, to 5⅛ per cent. Commercial paper dealers reduced their offering rates on prime four- to six-month paper by ⅛ per cent to 5½ per cent, and major finance companies lowered their rates on directly placed paper by ¼ per cent to 5¼ per cent for paper maturing in two to six months. Moreover, market yields on Treasury bills declined sharply, by as much as 55 basis points on maturities of six months.

The New York City money market banks lowered their posted offering rates on negotiable time C/D's from the flat 5½ per cent on all maturities that had prevailed at the turn of the year. At the end of January, one- to three-month maturities were generally available at 5 per cent, and three- to six-month maturities at 5¼ per cent, while longer maturities continued to be quoted at the ceiling rate. At a lower pattern of offering rates, large commercial banks throughout the country succeeded in rolling over unusually heavy C/D maturities of $5.9 billion, more than one third of the total outstanding. Moreover, C/D liabilities of these banks rose by $565 million, net, over the four statement weeks ended on January 24. Much of the improvement in C/D sales during January reflected purchases of certificates maturing in more than three months.

THE GOVERNMENT SECURITIES MARKET

The market for Treasury notes and bonds was buoyant until mid-January, and prices rose by as much as 4 points. While the earlier optimism of market participants faded around midmonth, it revived later so that, for the month as a whole, prices of some coupon issues recorded gains of 3 points or more. In the initial surge of prices, yields on intermediate- and long-term issues were driven down roughly 35 basis points from end-of-December levels and 50 basis points from yields at mid-November, prior to the devaluation of the pound sterling. At the month end, long-term Treasury yields were still about 20 basis points below year-end levels.

Investors and professionals alike reacted very favorably to President Johnson's announcement on January 1 of a broad program to bring the nation's international payments into balance. This event, following on the heels of the December 27 increase in member bank reserve requirements, had a beneficial effect on market psychology. Subsequently, the market was given additional encouragement by a series of reports that North Vietnam was taking a more conciliatory position with regard to peace negotiations. Moreover, the declining yield trend in the corporate bond market and the rapid sellout of some key corporate issues favorably affected the Treasury coupon market. In the market atmosphere that prevailed early in the month, announcements of sizable cash financings by the Treasury and the Federal National Mortgage Association (FNMA) had no adverse effect on the coupon sector.

From January 12 through 22, Treasury coupon prices dropped sharply and a considerable part of the earlier gains was lost. Market participants registered some disappointment over the failure of the hoped-for peace negotiations to materialize and over the President's State of the Union Message on January 17, which they had hoped would contain specific proposals for the achievement of peace and a lower level of Federal spending. The market was further sobered by the realization that the President's proposed 10 per cent income tax surcharge seemed no closer to enactment into law now that the Congress was reconvened than it had before the Congressional adjournment in December. After a brief interval, the market resumed its uptrend, though on a more cautious note than earlier. Peace hopes were stirred by further press reports, while new tensions in Korea had little adverse impact.

The market also displayed little apprehension about the approaching Treasury refunding operation and, in fact, began to build up a favorable sense of anticipation as the announcement date approached. After the close of the

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JANUARY 1968

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

Factors	Changes in daily averages—week ended on					Net changes
	Jan. 3	Jan. 10	Jan. 17	Jan. 24	Jan. 31	
"Market" factors						
Member bank required reserves*	— 550	+ 456	— 79	— 147	+ 186	— 134
Operating transactions (subtotal)	+ 207	— 11	+ 29	— 51	— 102	+ 72
Federal Reserve float	— 53	— 1	— 347	— 261	— 284	— 946
Treasury operations†	— 229	— 98	+ 23	+ 90	— 161	— 375
Gold and foreign account	— 449	— 13	+ 6	+ 5	— 11	— 462
Currency outside banks*	+ 659	+ 34	+ 381	+ 278	+ 384	+1,736
Other Federal Reserve accounts (net)‡	+ 279	+ 68	— 34	— 164	— 29	+ 120
Total "market" factors	— 343	+ 445	— 50	— 198	+ 84	— 62
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities	+ 195	+ 65	— 409	+ 405	— 169	+ 87
Bankers' acceptances	— 1	— 1	— 5	— 1	— 2	— 10
Repurchase agreements:						
Government securities	+ 133	— 140	— 17	— 57	+ 34	— 47
Bankers' acceptances	+ 44	— 83	+ 6	+ 49	— 30	— 14
Federal agency obligations	+ 33	— 40	+ 1	— 1	—	— 7
Member bank borrowings	+ 150	— 315	+ 44	+ 9	+ 8	— 104
Other loans, discounts, and advances	—	—	—	—	—	—
Total	+ 554	— 513	— 381	+ 403	— 158	— 95
Excess reserves*	+ 211	— 68	— 431	+ 205	— 74	— 157
	Daily average levels					
Member bank:						
Total reserves, including vault cash*	26,448	25,924	25,572	25,924	25,664	25,906§
Required reserves*	25,795	25,339	25,418	25,565	25,379	25,499§
Excess reserves*	653	585	154	359	285	407§
Borrowings	495	180	224	233	241	275§
Free reserves*	158	405	— 70	126	44	133§
Nonborrowed reserves*	25,953	25,744	25,348	25,691	25,423	25,632§
	Changes in Wednesday levels					
System Account holdings of Government securities maturing in:						
Less than one year	+ 342	—1,032	+ 508	— 56	+ 47	— 191
More than one year	—	—	—	+ 78	—	+ 78
Total	+ 342	—1,032	+ 508	+ 22	+ 47	— 113

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 five weeks ended on January 31.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS JANUARY 1968

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on					Average of five weeks ended on Jan. 31*
	Jan. 3	Jan. 10	Jan. 17	Jan. 24	Jan. 31*	
Eight banks in New York City						
Reserve excess or deficiency(—)†	85	7	15	15	14	27
Less borrowings from Reserve Banks	156	55	51	—	27	58
Less net interbank Federal funds purchases or sales(—)	407	831	518	— 126	— 190	288
Gross purchases	*1,127*	*1,381*	*1,246*	*883*	*840*	*1,095*
Gross sales	*720*	*550*	*728*	*1,009*	*1,030*	*807*
Equals net basic reserve surplus or deficit(—)	— 478	— 880	— 554	140	177	— 319
Net loans to Government securities dealers	1,284	1,299	1,152	974	1,301	1,202
Thirty-eight banks outside New York City						
Reserve excess or deficiency(—)†	99	14	15	22	—	30
Less borrowings from Reserve Banks	181	20	63	77	43	77
Less net interbank Federal funds purchases or sales(—)	659	840	926	532	308	653
Gross purchases	*1,631*	*1,958*	*1,981*	*1,798*	*1,664*	*1,806*
Gross sales	*972*	*1,118*	*1,055*	*1,267*	*1,356*	*1,153*
Equals net basic reserve surplus or deficit(—)	— 741	— 846	— 975	— 587	— 351	— 700
Net loans to Government securities dealers	404	693	737	719	703	651

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

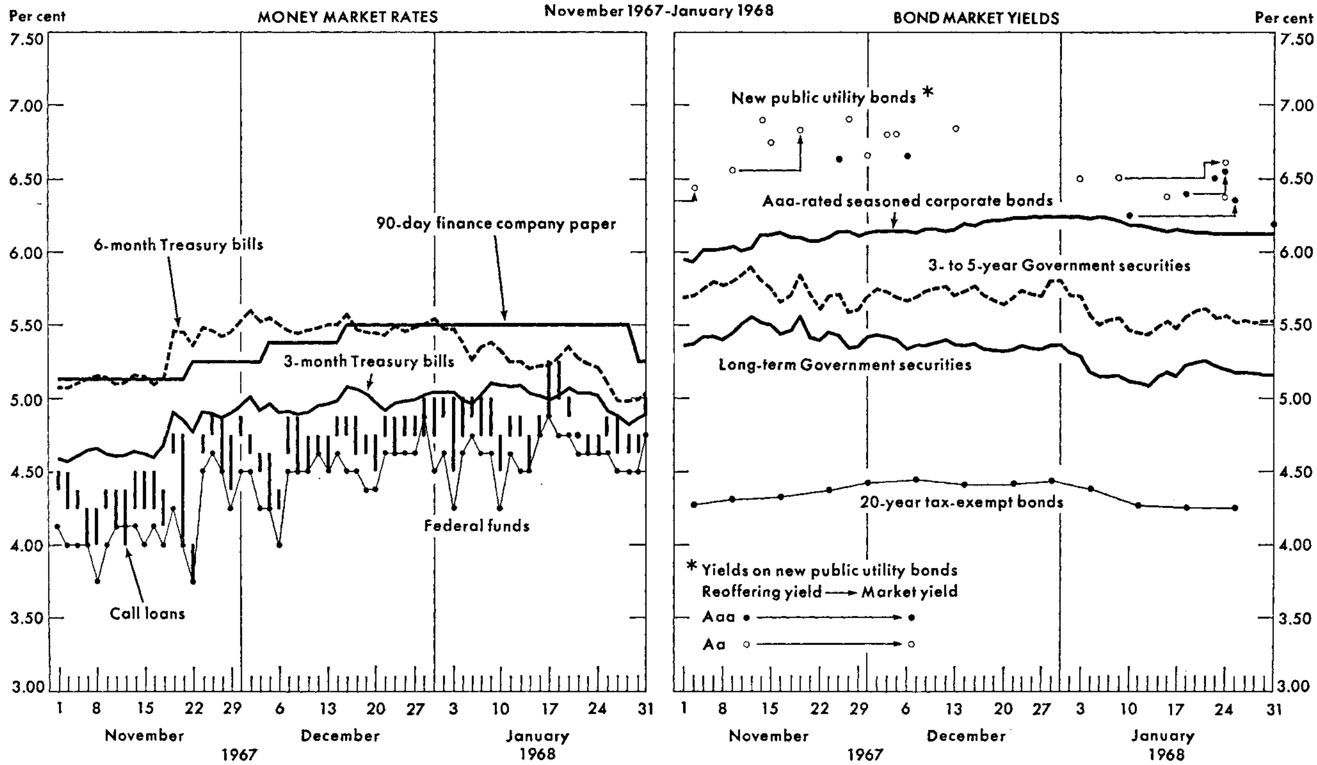
In per cent

Maturities	Weekly auction dates—Jan. 1968			
	Jan. 8	Jan. 15	Jan. 22	Jan. 29
Three-month	5.080	5.072	5.068	4.846
Six-month	5.376	5.238	5.335	4.957

Maturities	Monthly auction dates—Nov. 1967-Jan. 1968		
	Nov. 22	Dec. 26	Jan. 25
Nine-month	5.422	5.555	5.254
One-year	5.430	5.544	5.267

* 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.

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.

market on January 31, the Treasury announced a refunding and prerefunding of five issues of notes and bonds maturing on February 15, August 15, and November 15, 1968. Holders of 5⅝ per cent notes due February 15, 4¼ per cent notes and 3¾ per cent bonds due August 15, and 5¼ per cent notes and 3⅞ per cent bonds due November 15 may exchange their holdings for new 5¾ per cent seven-year notes to be dated February 15, 1968 and to mature on February 15, 1975. Of the $24.3 billion of the maturing securities outstanding, approximately $12.1 billion is held by the public. Subscription books for the exchange will be open February 5 through 7. The Treasury also announced that it will offer about $4 billion of fifteen-month notes for cash on February 13. Terms of the offering will be announced on February 8.

Market yields on Treasury bills declined during January, as a generally strong investment demand—which persisted through the close of the month—frequently encountered a thin supply of offerings. The strength elsewhere in the securities markets also contributed to the downward rate adjustments. Demand centered largely in issues with maturities of more than three months, and rates on these bills fell 19 to 55 basis points. Shorter issues, on the other hand, were subjected to some selling pressure by commercial banks, reversing purchases of these bills which had been made for statement purposes prior to the year-end.

The market took in stride the sale by the Treasury on January 9 of an additional $2.5 billion of tax anticipation bills maturing on June 24, 1968 and acceptable at face value in the payment of Federal income taxes on June 15.

(June tax anticipation bills in the amount of $3 billion were already outstanding.) Commercial banks were permitted to make payment for the bills on January 15 by crediting the full amount of purchases to Treasury Tax and Loan Accounts. This feature of the offering was estimated by the market to have been the equivalent of roughly 40 basis points in yield to commercial banks. The bills were awarded in strong bidding at an average issuing rate of 5.058 per cent. Average issuing rates on the regular issues of three- and six-month bills trended lower over the month. In the final weekly auction held on January 29, average issuing rates on the three- and six-month issues were set at 4.846 per cent and 4.957 per cent (see Table III), respectively, 26 and 64 basis points lower than in the last December auction.

Prices of Federal agency securities followed movements in other sectors of the capital market during January. On January 16, the FNMA sold $1,250 million of participation certificates, $800 million to the public and $450 million to Government investment accounts. The public offering consisted of $500 million of three-year certificates, priced to yield 6 per cent, and $300 million of twenty-year certificates, priced to yield 6.084 per cent, about 32 basis points lower than the yield offered on a FNMA long-term financing in November 1967.

OTHER SECURITIES MARKETS

The corporate and tax-exempt bond markets reacted vigorously to the President's balance-of-payments program and to the seemingly more concrete hopes for peace that pervaded the capital markets early in January. Corporate bond prices extended their December gains, and pressures lifted from the tax-exempt market. The Blue List of dealers' advertised inventories of tax-exempt bonds plummeted to $311 million near midmonth from $506 million at the end of December. By the close of January, however, the Blue List figure had risen to $444 million, as a result of the mild deterioration in market sentiment around midmonth and a sharp increase in the volume of tax-exempt offerings in the final week of the month.

New corporate bonds were offered at sharply lower interest rates in early January (see chart), and a few offerings that had been postponed previously were brought to market during this period. However, issues for which underwriters had bid very aggressively encountered some resistance from investors. At midmonth, a large offering of Aaa-rated long-term telephone debentures carrying five-year call protection received only a fair reception at a reoffering yield of 6.25 per cent, 40 basis points less than the yield on a similar offering early last December. At the month end, a comparable utility issue, priced to yield 6.20 per cent, received only a lukewarm response from investors.

The average yield on Moody's Aaa-rated seasoned corporate bonds declined by 12 basis points to 6.12 per cent during January, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues, carrying ratings ranging from Aaa to Baa, fell by 19 basis points to 4.25 per cent.

Banking and Monetary Developments in the Fourth Quarter

The fourth quarter of 1967 witnessed a moderation of the bank credit and deposit expansion in progress since late 1966. While the growth of most banking and monetary indicators declined for the quarter as a whole, the slowdown was uneven. The growth of total commercial bank credit dropped sharply during November and December and was negligible in the latter month. The money supply—privately held demand deposits plus currency outside banks—continued to advance in October and November at about the same high rate as over the first nine months of the year, but grew very little in December. During the quarter, both long- and short-term interest rates on Government and private debt issues reached peaks for the year. Treasury bill rates attained their highs in early December and receded slightly over the balance of the month. Yields on intermediate- and long-term Treasury securities peaked in mid-November and declined gradually throughout the second half of the quarter. On the other hand, corporate bond yields reached a 1967 high near the end of December.

These developments emerged against a background of movement toward a firmer monetary policy during the latter part of the September-December period. On November 19 it was announced that the Board of Governors of the Federal Reserve System had approved an increase in the discount rate from 4 per cent to 4½ per cent, effective the next day, at ten Federal Reserve Banks. (The same action was approved for the two remaining Reserve Banks shortly thereafter.) This action was taken after the devaluation of the pound sterling and the concurrent increase in the British bank rate. On December 27 the Board of Governors announced an increase of ½ percentage point in reserve requirements on demand deposits in excess of $5 million, effective in January.[1] The effective rate on Federal funds moved up to about 4½ per cent from 4 per cent after the discount rate increase, and Federal funds generally traded at 4⅝ per cent in the second half of December. During December, daily average free reserves declined to $103 million, after having ranged generally between $250 million and $300 million since March.

[1] See this *Review* (January 1968), page 6.

BANK CREDIT

The growth of total commercial bank credit slowed to a seasonally adjusted annual rate of 5.8 per cent in the fourth quarter (see Chart I), well below the 12.6 per cent growth rate for the first nine months of the year. Quarterly bank credit growth rates varied substantially throughout 1967, and—as in other quarters—the change in bank credit in the fourth quarter reflected in large part changes in bank holdings of United States Government securities and securities loans—loans made primarily for the financing of securities dealers. In contrast, the growth of the sum of all other components of bank credit (other securities plus total loans minus securities loans) was quite even from quarter to quarter during 1967.

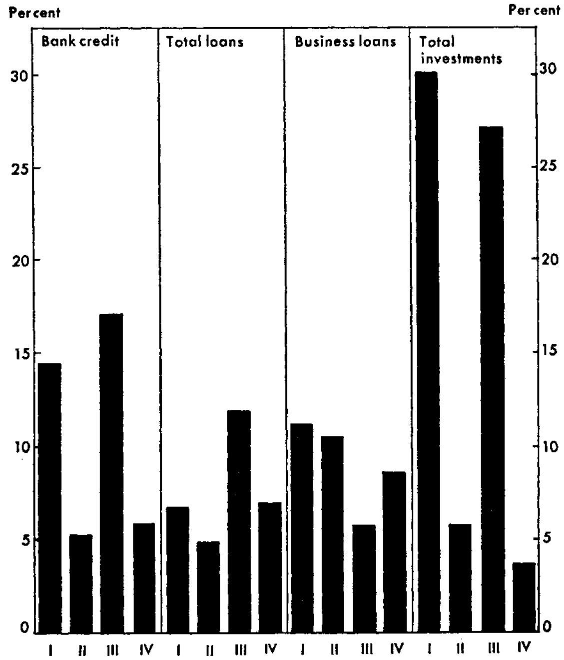
During the fourth quarter, bank holdings of Government securities declined at a 10.4 per cent annual rate. The reduction was concentrated in December, when a net liquidation of $1.8 billion was recorded. At the beginning of the month, banks were still distributing the fifteen-month and five-year notes acquired in the mid-November Treasury financing. In addition, the banks apparently liquidated some intermediate- and longer term Governments for tax purposes during December. To some extent, the December decline may also have reflected the larger than anticipated gain in business loans and sizable outflows of funds from maturing certificates of deposits (C/D's).

The decline in bank holdings of United States Government securities in the fourth quarter was more than offset by acquisitions of other securities—primarily in the tax-exempt sector—so that total investments showed a modest rise. Bank acquisitions of securities other than Governments rose at an annual rate of 18.7 per cent in the fourth quarter, almost twice the rate of growth in the previous quarter, in spite of the fact that such additions were negligible in December. In part, the slowdown in that month may be attributed to a somewhat lighter volume of new tax-exempt offerings.

Chart I

QUARTERLY RATES OF CHANGE IN BANK CREDIT AND COMPONENTS AT ALL COMMERCIAL BANKS DURING 1967

Seasonally adjusted annual rates



Source: Board of Governors of the Federal Reserve System.

The sharp decline in securities loans in the fourth quarter exerted a moderating influence on the growth of total loans, which expanded at a 6.9 per cent annual rate over the quarter as compared with an 8 per cent rise during the first nine months of the year. The demand for bank credit by business, which had been weak from July through November, was very strong in December. Indeed, the rate of growth of business loans for that month was the highest in almost eighteen months and carried the quarterly gain in business loans to 8.6 per cent annually, only slightly below the 9.3 per cent rate for the first nine months. Although corporate tax payments on December 15 were not unusually large, borrowings during the tax week were much larger than in the same period of previous years. There was also a very large volume of special loans to firms in the extractive industries (e.g. mining, petroleum)—often referred to as "carve-out" loans—during December. These transactions, secured by assignments of production, often involve tax benefits. Moreover, preliminary data indicate that, on a seasonally adjusted basis, retail sales dropped slightly in December. The impact of the weakness in sales on liquidity positions of retail firms was reflected apparently in a greater than seasonal December rise in bank credit to this sector.

Real estate loans posted a strong 10 per cent gain in the fourth quarter, and net additions on a seasonally adjusted basis equaled those for the entire first half. This faster growth was also evident in the third quarter, when additions of other securities and business loans were moderate. Much the same pattern applied to extensions of consumer credit by commercial banks. The 9 per cent fourth-quarter expansion was slightly above the third-quarter increase, and both were well above consumer loan growth rates in the first two quarters of the year.

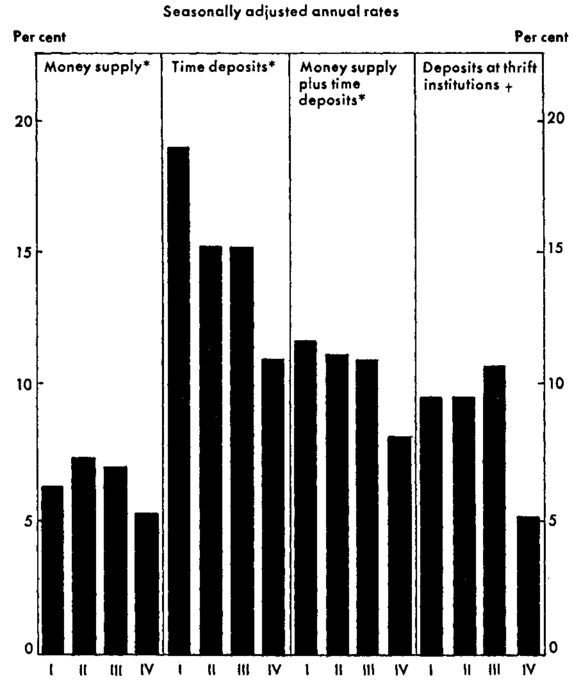
MONEY SUPPLY AND DEPOSITS

Although the expansion of the daily average money supply slowed substantially in the fourth quarter of 1967, it nevertheless averaged a relatively high annual rate of 5.1

Chart II

QUARTERLY RATES OF CHANGE IN LIQUIDITY INDICATORS DURING 1967

Seasonally adjusted annual rates



*Average of daily figures.

† Computed from levels at the beginning and end of each quarter for savings and loan associations and mutual savings banks.

Source: Board of Governors of the Federal Reserve System.

per cent (see Chart II). In October and November, the money supply expanded at a 6.7 per cent annual rate—the same as that for the first nine months of the year—but in December the rate of increase fell to 2.0 per cent. Erratic movements in the money supply are not unusual in December, and developments in that month should be viewed in the context of a longer period. In fact, the money supply grew very rapidly again in January 1968.

The growth of daily average time deposits at commercial banks during the fourth quarter also fell short of the rapid pace of expansion over the first nine months. This development was significantly influenced by changes in outstanding amounts of large negotiable C/D's. During October and November, C/D's outstanding at large weekly reporting banks rose more than in the same months in earlier years, while in December the decline in outstandings appeared to be somewhat larger than seasonal. By the end of November, interest rates on certificates with maturities of ninety days or more were at the 5½ per cent Regulation Q ceiling. Rates in the thirty- to eighty-nine-day sector ranged from 5⅛ per cent to 5½ per cent during December, and new issues of C/D's were predominantly in this maturity sector. On balance, large commercial banks lost $731 million of C/D's during the December 15 tax week, about $200 million more than in the September tax week. However, the December outflow was somewhat smaller than had been anticipated by the banks, and no unusual money market pressures resulted. Movements of savings deposits and other time deposits, although less volatile than C/D's, generally followed similar patterns throughout the period. For the quarter as a whole, the growth rate was 10 per cent, down from the 13.5 per cent expansion of the first nine months, and this slowdown reflected in part the increasing attractiveness of yields on alternative forms of investment.

NONBANK LIQUID ASSETS

Liquid asset holdings of the nonbank public rose at a seasonally adjusted annual rate of 8.4 per cent in the fourth quarter, slightly above the 7½ per cent growth rate for the first nine months of 1967. However, for the first time since the second quarter of 1966, expansion of deposits and share accounts at mutual savings banks and savings and loan associations failed to keep pace with the aggregate gain in other liquid assets: commercial bank deposits, Government savings bonds, and other Government securities maturing within one year. The growth in holdings by the nonbank public at savings banks and savings and loan associations slowed to 5.3 per cent in the fourth quarter, about one half of the increase during the preceding three quarters. In fact, the advance of deposits and share accounts with thrift institutions in December (on a seasonally adjusted basis) was the smallest on a monthly basis since the critical period in mid-1966.

The sharpest relative increase in components of nonbank liquid assets in the fourth quarter was in holdings by the public of Government securities maturing within one year. The growth of $2.3 billion (seasonally adjusted) during the fourth quarter—or 19 per cent—was in sharp contrast to the decline of $5.7 billion over the first nine months of the year. Indeed, in December alone holdings rose by $1.4 billion. This reversal was undoubtedly influenced by the increasingly attractive yields on these issues—particularly in relation to rates offered on bank C/D's and consumer-type thrift deposits.

The ratio of total liquid assets to GNP, a measure of relative liquidity of the nonbank public, was 79.5 per cent in the fourth quarter. This level was little changed from the previous quarter and close to the average of 79.4 per cent for all quarters of 1967.

Publications of the Federal Reserve Bank of New York

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