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The Challenge to the Dollar in a Changing World*

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In the past few months Americans have felt a sense of national emergency such as they have not experienced since World War II. Worst of all, crises have occurred on several fronts at once—in our military and political stance in the Far East, in our efforts to make democracy at home a meaningful way of life for all Americans regardless of color, and in confidence in the dollar as the world's most important reserve and trading currency. Of course to a considerable extent all three crises are related. However, I propose to concentrate my attention today on the crisis of the dollar—to sketch briefly how it occurred, what steps have been taken to meet it, what misleading and dangerous proposed remedies must be rejected, and what kind of measures we must take to maintain the dollar as the key currency of the international financial structure. I hasten to add that my solicitude for the dollar is not based on some mystical worship of our currency as such, but rather on a recognition of what a vital role it now plays in the world and of what a tragedy it would be for the future course of international trade and investment, as well as for our domestic economy, if the dollar were no longer to command the world's confidence.

For too long we have tended to take for granted the dollar's impregnable position, based as it has been on the tremendous strength of the United States economy and on our dominant world role in the early postwar years. So great was this reservoir of strength that we could run huge balance-of-payments deficits year in and year out for ten years, aggregating some $27 billion, and still the dollar retained much of its earlier reputation. Americans were often told that these steady deficits were undermining the dollar, but somehow they couldn't quite believe it—at least not enough to do something really effective about it. To be sure there were frequent official statements of determination to move toward equilibrium. And temporizing measures were adopted from time to time, designed mainly to check outward capital flows while more fundamental remedies were being worked out. For a while, until the Vietnam escalation of mid-1965, we were making considerable progress toward a larger trade surplus and reduced military outlays abroad; but that event put a quick stop to the improvement, brought a sharp jump in foreign military expenditures, and set in train inflationary tendencies that are still accelerating and that have already been instrumental in cutting our trade surplus to a dangerously low level.

In the political, military, and economic spheres we appeared still to be working on the assumption that we could take on substantial commitments throughout the world without paying close attention to our ability to finance such spending through exports and other earnings. This may have been valid enough right after World War II, but certainly did not remain so. The fact is that in the intervening twenty years the spectacular recovery of Europe and Japan had radically reduced our dominance as an exporter and that our annual outlays abroad, such as those for direct investment and tourism, had grown to a very large size. Small wonder that in these circumstances payments equilibrium remained as elusive as ever.

We had only to look to the United Kingdom to see how costly it could be to disregard the inexorable pressures of the balance of payments. In their case continual financial crises reflected essentially an unwillingness to recognize the full implications of the vital need for internal discipline and increased productive efficiency. Although our much greater economic strength is one of several major differences between this country and the United Kingdom, the November devaluation of sterling flashed a clear warning for the United States that we cannot ignore.

It had long been apparent to many of us that the fate of sterling and of the gold market were very closely linked in terms of market psychology and that sterling devaluation could easily trigger a severe run on gold. Such a major breakdown in the exchange-parity network was bound to

*An address before the New York Chamber of Commerce celebrating its 200th anniversary, New York City, May 2, 1968.

lessen confidence in all other currencies and especially to raise new doubts as to the relationship between gold and the dollar.

As expected, a violent eruption in the London gold market occurred immediately after the devaluation of sterling. It was effectively countered at first by a statement issued in Frankfurt of solidarity of the major central banks and of their determination to defend the existing exchange structure with all means at their command. Another flare-up in December was calmed only after a similar statement and an assurance that the United States intended to take effective steps to bring its payments much closer to balance. The latter promise was reinforced by the President's balance-of-payments program announced on January 1. But while this had an important calming effect for several weeks, there was a growing feeling among close observers of the gold market that the gold pool—which meant in large part the United States—could no longer afford to continue to feed in monetary gold on the scale required to prevent the London price from exceeding $35.20. It had become more and more obvious that the major countries would not and should not deplete their monetary gold stocks further to supply a huge demand of individual and corporate gold buyers all over the world, especially when citizens of the United States, the United Kingdom, and several other countries had long been forbidden to own gold. All these pressures came to a head in the record market flare-up of mid-March, to which the temporary closing of the London market with the accompanying termination of the gold pool was the only reasonable answer. In my judgment it would have been far better if these actions had come some months earlier. With reaffirmation in the March 17 Washington communiqué of international support for the $35 official price, coupled with establishment of the so-called "two-tier system" and recognition of future supplies of special drawing rights (SDR's) as a new reserve asset, the worst exchange market fears quickly subsided. The market has remained generally quiet since that time, although an underlying feeling of deep concern persists because needed fundamental measures have not been taken.

In that hectic weekend of March 17, before the Washington communiqué was released, American travelers all over the world had for the first time the traumatic experience of seeing the world really question the soundness of the once unquestioned dollar. For a day or two, dollar traveler's checks and dollar currency often proved impossible to change into local foreign currencies, except perhaps at a sharp discount. For those Americans involved, this experience may have done more than any other recent event to awaken them to the seriousness of our payments problem.

The two-tier system adopted in March in essence represented a decision to accept the inevitable consequences of a distorted gold supply-and-demand position by separating the circuit of monetary gold transactions from all trading in gold as a commodity or speculative vehicle. Those who doubt whether it is viable should, I believe, bear in mind that, before the London market was reopened in 1954, free prices for gold far above $35 often prevailed in local markets in other countries without casting any doubt on the firmness of the official $35 price. In October 1960, after the run-up to $40 an ounce in the London gold market, there was a deliberate tactical decision by the American authorities to prevent the London price from going above $35.20, which was roughly the United States official selling price plus shipping charges to London. The decision was almost universally supported by opinion abroad, and this international backing was formalized with the organization of the gold pool in 1961. However, we should remember that it was never an essential feature of the gold exchange standard. The pool had been a substantial net buyer of gold over its entire life up to the time of the sterling devaluation of last November. But when the cost involved very large inroads into monetary stocks, the time had come to terminate it.

The question "Is the two-tier system viable?" merely masks a more fundamental question, namely, "Will the United States at long last take the steps needed to bring its international payments somewhere near equilibrium?" If not, we face dire consequences, and not because of the two-tier arrangement or of a fault in the gold exchange standard itself. No international monetary system can be devised that is strong enough to withstand persistent abuse by the world's major industrial nations. By the same token it is utterly misleading to suggest that we have viable alternatives, such as raising the price of gold or embargoing gold payments, to doing what must be done with our balance of payments. Either of these moves would, in my judgment, have disastrous results in and of themselves. Yet neither one would relieve us of the burden of adjusting our international payments. It is a sad commentary on the present state of affairs that such proposals have moved out of the academic area to open discussion in financial circles.

Increasing the price of gold would, temporarily at least, cause chaotic conditions in the exchange markets, with a consequent check to trade and investment flows that foster economic development. After the initial confusion there would be a period when each country would weigh the advantages and disadvantages of fixing a new rate for its own currency in terms of gold and the dollar, a rate that might or might not coincide with the view of the United States. We would then face the danger of a series of competitive devaluations, as countries sought to assure the safety of their trade balances. There would be a strong prospect for moves toward trade protectionism, capital restrictions, exchange controls, and other forms of retaliation. In the best of circumstances, it is difficult to see how we could preserve the present momentum toward attaining a more rational system of international liquidity centered on the SDR's and the various forms of international credit laboriously built up in the last twenty-five years. We would instead be taking a backward step by tying future reserve creation more or less permanently to the vagaries of world gold production.

And that is not all. A change in the gold price would constitute a gross breach of faith with all those monetary authorities who have held dollars as an important component of their monetary reserves. It could do irreparable damage to future confidence in the dollar as a reserve currency and perhaps also to future use of the dollar as the chief vehicle currency for world trade and investment. It would reward disproportionately and—economically speaking—irrationally the countries with large gold production or large gold hoards, public or private. From a selfish United States viewpoint, it would cause a major decline in our political influence. Finally, years would be needed to convince speculators that the new price could last. Since a revaluation of gold would produce very large windfall profits for gold-holding countries, and since it may be doubted that politicians would be slow to spend such profits, the speculators might have ground for thinking that continued inflation would before too long create the need for a new revaluation.

Just as bad, if not worse, would be a move by the United States to embargo further sales of gold for monetary purposes. In the past few years some Americans have advocated the use of a threat of embargo to force foreign acquiescence in our financial policies. I think it may be well to remind them that an embargo could prove fully as harmful to the United States as to our foreign partners. Cutting the dollar loose from gold would probably lead promptly to a chaotic system of floating rates in which all trade and credit operations would be severely handicapped and in which each country might feel forced to engage in competitive restrictions on trade and payments. Quite possibly the major European countries would then form a bloc adhering to their present parities in terms of gold, while another group of countries would adhere to the dollar. In this case the dollar might well float in relation to the European bloc, with highly adverse effects on trade and credit relationships similar to those resulting from a general condition of floating rates. In either case the European countries might decide to restrict severely American capital inflows, or American imports, or both.

More generally, it would be illusory to expect that a United States gold embargo would somehow lead to a worldwide demonetization of gold and thereby open the route to a new and more effective system of international payments. Because of their large stake in monetary gold, the European and certain other countries would probably look to gold as the ultimate means of payments settlement and, if any semblance of order in the exchange markets were ultimately to be restored, the United States would from time to time need to pay out gold in settlement of payments deficits. Meanwhile, moreover, inter-central-bank and intergovernmental credit facilities would have been severely damaged, if not totally immobilized, while the current bright prospect of opening up a new source of international liquidity in the form of special drawing rights on the International Monetary Fund would have suffered a serious, or even fatal, setback. The paradoxical consequence of a United States gold embargo, therefore, might be eventually to restore gold to unchallenged primacy in international settlements by undermining, if not actually destroying, all the other supplementary means of settling payments balances that have gradually developed since the Bretton Woods Agreements.

I hope no one, therefore, will look to either a gold embargo or a higher gold price as an acceptable escape route from the measures of internal discipline that are needed if we are to avoid chaos in international financial conditions. What are these measures to which we must look for a way out?

First and foremost, of course, we must slow and ultimately arrest the dangerous upward sweep of costs and prices that has been characteristic of the economy since the Vietnam escalation of mid-1965, but which has accelerated in the past nine months or so after a temporary lull in early 1967. No one can look with equanimity at the first-quarter 1968 rise in overall demand at an annual rate of 10 per cent, with two fifths of this increase merely resulting in a 4 per cent surge in prices. I recognize that there are a few sectors of the economy, particularly some manufacturing fields, where there is relatively little evidence of overheating. But these are clearly exceptional. Skilled labor is extremely scarce in most parts of the country, and the intolerable size of recent wage increases bears testimony not only to this labor scarcity but also to industry's ability and willingness to grant these increases and to labor's desire to offset the climb in the cost of living during the last couple of years. In the absence of adequate fiscal and monetary restraint, there is every reason to look for continuation of this condition of excessive demand and grossly excessive wage and price increases, which can set the stage for recession in which both wages and profits would shrink.

Besides sowing the seeds of future recession and producing a multitude of domestic inequities, the current inflation is doing untold damage to the United States balance of payments by sucking in imports at a very rapid pace and by making United States exports less and less competitive in world markets. The influence on imports has been spectacular in recent months. After leveling off in the first ten months of 1967, imports shot upward, and from October through March have been running 15 per cent above the same period a year earlier, far above the growth in our exports. This is in keeping with experience over a considerable period of years which shows that total imports are extremely responsive to major swings in gross national product.

Under the conditions I have outlined there is no conceivable excuse for a Federal budget operating at a deficit of $20 billion or more per annum. There is no mystery as to the kind of fiscal action that is vitally needed to meet this problem. An income tax surcharge of the magnitude proposed by the President, together with the strictest restraint in spending, would seem to be the minimum that is called for. It would undoubtedly have a pervasive cooling effect throughout our overheated economy. The effects of an income tax rise are bound to be spread more evenly than those, say, of a restrictive monetary policy. Unquestionably there are many types of spending that could be sharply reduced without loss to the nation, but in some areas, such as urban spending, substantial increases rather than cuts are necessary.

I find it impossible to explain satisfactorily to foreign holders of dollars why this obviously necessary fiscal step of increased taxes plus reduced spending has not yet been taken despite almost a year of discussion and strong endorsement by most economic experts. I can think of no more effective way of giving an enormous psychological boost to the dollar than by providing at long last this evidence of fiscal responsibility. Such an invaluable dividend would of course be over and above the obvious domestic benefits in the shape of a less hectic and less inflationary growth rate.

Monetary policy has been doing its part toward restraining excessive growth since last November. While it might be contended that the Federal Reserve started restraining some months too late, there were important inhibiting factors last summer and autumn, including the fear of damaging the prospects of tax legislation, the risk of pushing sterling over the brink, and the reluctance to make the Treasury's huge financing program any more difficult than necessary. In any event the tightening that has been accomplished since November, and more especially since February, has been very sizable. Our restrictive program made use of all three of the major credit policy instruments, i.e., open market operations, discount rate increases, and higher reserve requirements. Last month's discount rate increase was the third ½ per cent upward move since November, and the current rate of 5½ per cent is the highest discount rate in effect since 1929.

Naturally we are aware that a restrictive credit policy bears unevenly on various sectors of the economy, with housing and municipal financing usually feeling the pinch more than other sectors. The Federal Reserve has certainly had to move further and faster than would have been necessary if an appropriate fiscal program had been enacted. As credit tightens and interest rates move up to levels that are historically very high indeed, our financial institutions come under growing pressure and the process of disintermediation becomes clearly visible. The Federal Reserve System must remain on the alert to see that these pressures do not become too extreme, as they did in the summer of 1966. We have no wish to see repeated the highly nervous market atmosphere of that summer, nor have we any wish to see an end to the growth of bank credit.

The System's ultimate goal insofar as credit growth is concerned is a moderate rate of expansion in keeping with a sustainable noninflationary growth of the economy. Recent months have shown an encouraging slowdown in credit growth, but maintenance of firm restraint seems needed to keep this slower pace in the light of heavy and growing credit demand, including resumption of large Treasury borrowing. Fortunately the banks and thrift institutions are in a considerably better liquidity position than they were two years ago, and this should make much easier our efforts to avoid excessive market reaction.

Beyond the immediate need for strong support from fiscal policy to reduce the fever of our overheated economy, looms the need for a return to the conditions of price stability that characterized the earlier years of the current business expansion. One of the important reasons for price stability during that period was the record of matching wage and productivity gains. It has become fashionable to be contemptuous of the wage-price guideposts of that period, and to condemn them as unworkable. The truth, however, is quite clear: it is any substantial deviation from the principle of the guideposts that is unworkable. We must keep off the primrose path that leads to rigid wage, price, and dividend control or freeze; and this means all of us—government, business, and labor—must agree on some acceptable compromise that satisfies us that no one else is going to obtain undue advantage at our expense. A great virtue of the wage-price guideposts was that they promised to help all Americans understand the great difference between real gains and the mirage benefits of inflation-swollen current dollars. In a democratic society, that kind of understanding, together with freedom of labor and capital to respond to shifts in demand, is much to be preferred to a harness of direct controls.

To me these anti-inflationary measures of fiscal and monetary policies and of wage-price guideposts represent a prerequisite for balance-of-payments equilibrium. In this connection, I would like to say a word about strikes that have a major impact on our balance of payments. As one looks back to last year it becomes clear that the London and Liverpool dock strikes dealt a crushing blow to the pound sterling. In our own country, it has been distressing to see the hundreds of millions of dollars' cost to the balance of payments of the copper strike and the hedging against a possible steel strike. Surely the nation has a right to ask that leaders in both management and labor consider carefully the international payments effects of such strikes on the dollar's position.

There are many additional avenues to be explored, with a view to improving our balance of payments. For example, it may be that more could be done both by Government and by the sophisticated business community to increase the interest of small- and medium-sized American concerns in developing an export market. While the Government has done much to facilitate and encourage larger portfolio investment by foreigners in American securities, especially in American equities, more could probably be done in this area. Our stock market already has a very strong appeal throughout the world, but despite recent statutory action there are still too many technical barriers to the translation of this appeal into actual investment.

It goes without saying that the President's balance-of-payments program of January 1 should enjoy the full support of the nation, although most of us would have serious qualms about more than temporary reliance on restraints on the outward flow of American capital. I would remind you that the effort to slow the flow of direct investment should be viewed against the background of an unprecedentedly high level of direct investment outflow in 1965 and 1966. There is also much that surplus countries can do to aid our efforts at achieving international equilibrium both by their general economic policies and by their specific actions affecting the balance of payments, but primary responsibility falls on us.

Aside from our efforts to improve the trade surplus by stemming inflation, the most hopeful area for further balance-of-payments savings is that of Government expenditures abroad. I am not suggesting ill-considered cuts in foreign economic aid, for such outlays—subject of course to careful screening—are essential if we are to build the kind of prosperous and peaceful world economy that is vital to our own national well-being. As to Vietnam, there are many reasons for hoping for a satisfactory end to the hostilities. On the financial side, it would put an end to the tremendous drain on our balance of payments that now results, directly or indirectly, from our military outlays in that area. It would be too much to expect equilibrium in our international payments simply because of an end to the war, but it would certainly bring a major improvement.

But apart from the specific Vietnam problem, we must face squarely the question of whether the benefits arising from military and political commitments abroad outweigh their balance-of-payments cost. Some hard questions have to be answered, and answered promptly. For example, should not those European allies who stress the importance of having American troops in Europe assume a larger part of the cost? If they are unwilling to do so, are the benefits of maintaining these forces at our own expense worthwhile in view of the substantial burden placed on the dollar? More generally, we must bear in mind the fact that the costs of military and political commitments may include sacrifices in the form of even higher taxes at home, intensified direct controls over capital movements, and restrictions on tourism. Indeed, we have reached a critical point at which the financial consequences of military and political commitments must be weighed carefully whenever decisions are made to initiate or continue such commitments. I am not suggesting that financial considerations should receive top priority, but merely that the financial side deserves a lot more weight than it has had in the past. Further, and I think this needs the greatest possible emphasis, there is now a grave risk that continuation of our balance-of-payments deficit—by undermining the dollar internationally—may in itself endanger world stability and frustrate our ability to achieve our international economic, political, and military goals.

Fortunately, we are not faced with an acute exchange crisis at present. Nevertheless we must recognize that in a more fundamental sense the dollar is—and for some time will be—in a condition of crisis. This condition will persist until we can show real progress toward payments equilibrium. And, as I have tried to suggest, real progress is not an impossible task if we take the necessary measures to reduce economic overheating and to restore our competitive position in world trade. I fervently hope that we shall not need a recurrence of the black prospects of that mid-March weekend to make us take those sound and sensible steps that are clearly required to meet the challenge to the dollar in this rapidly changing world.

The Business Situation

The first three months of 1968 saw a record—and clearly excessive—advance in the dollar value of outlays for goods and services in the United States. Substantial further increases in market prices were partly responsible, but even after adjustment for price changes total output advanced almost 6 per cent at an annual rate, much above the 4 per cent or less that is considered sustainable at full employment. Buoyant consumer demand was the major factor in the overall gain, but most other spending categories also increased. The pronounced caution that consumers had exhibited throughout 1967 appears to be diminishing, as evidenced by a marked drop in the personal savings rate from 7.5 per cent of income in the final quarter of last year to 6.8 per cent.

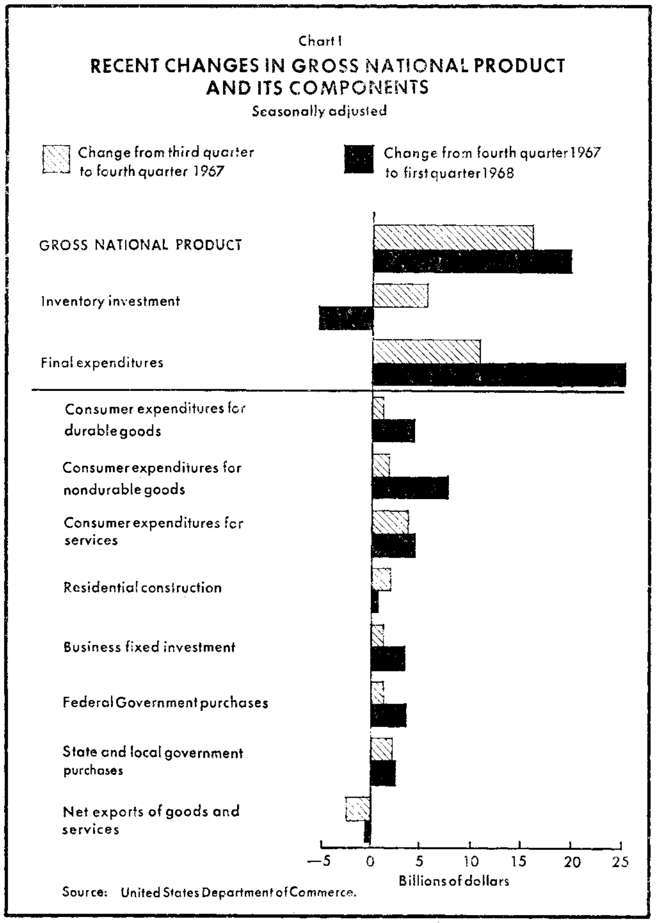
Against this background of rapidly expanding aggregate demand, prices—already under heavy pressure from rising wages and other costs—continued their sharp advance. The gross national product (GNP) deflator, which is the broadest measure of price trends in the economy, rose at a 4 per cent annual rate in the first quarter of 1968, going beyond the already excessive increases of the previous two quarters. The size, persistence, and widespread nature of these price advances raise the threat of a major inflationary spiral unless fiscal measures are undertaken to reduce substantially the economic stimulus now being provided by a huge Federal deficit.

GROSS NATIONAL PRODUCT IN THE FIRST QUARTER

According to preliminary estimates, GNP rose in the first three months of the year by a record-breaking $20.0 billion (see Chart I) to a seasonally adjusted annual rate of $827.3 billion. This economic expansion, which amounted to 9.9 per cent at an annual rate, included a 5.9 per cent increase in physical output and a 4.0 per cent jump in average prices. The gain in real output was the highest since early 1966, and the price inflation was the sharpest in more than a decade.

Consumer spending was a major factor in the steep rise of GNP during the first quarter. Such spending swelled by a record $16.0 billion, compared with an average quarterly rise of only $7.0 billion during all of 1967. The increase was due both to a rapid advance in disposable income and to consumers' willingness to spend a greater portion of their income. Disposable incomes rose by a near-record $13.8 billion, helped in part by the February increase in the minimum wage and the March rise in social security benefits. At the same time, the savings rate, which had been running at an unusually high level since the end of 1966, dropped from 7.5 per cent of disposable income in the fourth quarter to 6.8 per cent. Taken by itself, the decline in the savings rate accounted for about $3.8 billion of the $16.0 billion increase in consumer spending. Consumer demand ended the first quarter on a strong note. Following sizable gains in retail sales in both January and February, preliminary figures indicate that sales in March posted another large advance, rising by $0.5 billion to $28.0 billion. Further, recent surveys of consumer spending plans tend to support the view that consumer optimism and buying interest are on the upswing.

Roughly half of the first-quarter advance in consumer spending was in the nondurables component, where price increases—notably for food and apparel—were substantial. In the durables sector, spending was boosted by a rapid advance in sales of furniture and new cars. Furniture sales were sluggish throughout 1967 because of reduced home purchase and rental, stemming from the previous year's slump in residential construction. With the recovery in the housing sector, an improvement in furniture sales was not surprising. Sales of domestically produced cars increased to a seasonally adjusted annual rate of 8.2 million in the January-March period, up 10.2 per cent from the strike-reduced pace of 7.4 million units in the fourth quarter. At the same time, there was a strong upsurge in imports of foreign cars. While domestic sales of foreign-built cars have been rising in the last five years, the trend accelerated markedly in recent months, perhaps owing in some degree to the price increases on domestically produced cars. During 1967, imports claimed over 9 per cent of the United States market—within striking distance of the 1959 high of 10.2 per cent. In the first quarter of this year, moreover,



sales of foreign-built cars ran at a seasonally adjusted annual rate of 1 million units—up over 40 per cent from the first three months of last year.

The first-quarter surge in consumer spending apparently cut heavily into the buildup of business inventories, especially at the retail and wholesale level. Due partly to this factor, inventory spending by all business declined to a $3.9 billion annual rate during the quarter, down $5.3 billion from the preceding quarter. But, while accumulation in the trade sector lessened, manufacturers added to their total inventories at a relatively strong pace during the quarter, in part because of the buildup in steel and auto stocks.

Both business fixed investment outlays and residential construction spending increased during the quarter. The $3.2 billion advance in business fixed investment was the largest since the final quarter of 1965 and confirmed survey expectations of an upturn in the growth of capital spending this year. Moreover, the most recent survey of plant and equipment spending plans, taken by McGraw-Hill, Inc., in March, indicates that businesses have revised their 1968 capital spending plans upward to a level 8 per cent above that spent last year. The sizable fourth-quarter increase in corporate profits—the first substantial advance since the fourth quarter of 1965—had strengthened the outlook for plant and equipment spending, and early indications are that corporate profits expanded still further in the first quarter of 1968. In the housing sector, spending rose to a record $28.3 billion annual rate, up $0.7 billion from the final quarter of last year. Data on recent housing starts, building permits, and contract awards for residential construction suggest that spending should continue at a high rate in the next few months. Despite some tightening of the home mortgage market, both housing starts and permits were little changed in March from the high February pace and new residential construction contract awards jumped 9 per cent over the February level. Moreover, the low vacancy rates in existing structures continue to indicate a strong potential demand for new homes.

In the public sector, total Federal and state and local government purchases of goods and services climbed by $5.8 billion in the first quarter—the largest increase in a year. The rise was chiefly due to a $2.4 billion gain in defense spending and a $2.4 billion rise in expenditures by state and local governments. The defense increase followed two quarters of small advances, whereas state and local spending was in line with the strong and steady upward trend in that sector.

The strong pull of aggregate demand and the strike by New York longshoremen in March further weakened the trade surplus in the first quarter, and net exports declined again. While exports advanced during the quarter, rising purchases of foreign-produced steel, copper, automobiles, machinery, and civilian aircraft parts contributed to a more than offsetting increase in total imports. Based on data for January and February alone, the Commerce Department had estimated that net exports in the first quarter declined to an annual rate of $2.6 billion, the lowest since the first quarter of 1960. Moreover, this figure is expected to be revised lower when the March results are incorporated. In March, when the Port of New York was struck for eleven days, the merchandise trade balance, as recently reported by the Census Bureau, actually registered a small deficit, the first time this has occurred in five years.

RECENT DEVELOPMENTS IN PRODUCTION AND EMPLOYMENT

The Federal Reserve Board's index of industrial production advanced for the second consecutive month in March. Output rose 0.6 percentage point to a record 162.1

per cent of the 1957-59 average. Gains were widespread, but were centered in the automotive and steel components. Production of motor vehicles and parts jumped 5½ per cent in March, following two months in which output had been adversely affected by local labor disputes. Passenger car production climbed by over 9 per cent to a seasonally adjusted annual rate of 8.9 million units. In April, however, the civil disorders following the assassination of Dr. Martin Luther King, Jr., curtailed production early in the month, and initial indications are that output fell 3½ per cent to a rate of 8½ million units. Iron and steel production rose again in March, as buyers continued to hedge against a possible steel strike this summer. According to preliminary figures, steel output in April gained fully 6 per cent over the March level, reaching an all-time record of 12.7 million tons at a seasonally adjusted monthly rate. Production increases in most other industries were small in March, but coal output jumped by 10 per cent from the strike-reduced pace of January and February.

The near-term outlook for production was bolstered somewhat by the rise in new orders received in March by manufacturers of durable goods. On the strength of a big increase in orders for civilian aircraft, new orders rose $1.3 billion to $26.1 billion. Among other durables manufacturers, the flow of new orders generally continued at a high rate. Shipments by durables manufacturers rose $0.5 billion in March to $25.2 billion, and because the advance in shipments was less than the rise in orders, the backlog of unfilled durables orders rose for the second month, reaching a new record of $80.3 billion.

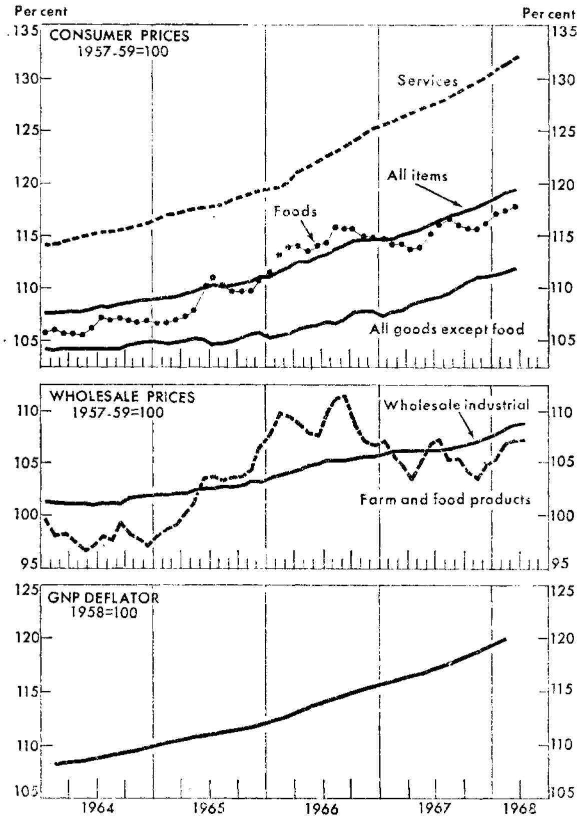
Recent increases in manufacturing production, although substantial, have trailed overall GNP growth. Moreover, manufacturers in general still report some excess plant capacity. Plant and equipment spending has continued at a high level, and new production facilities are being brought on line at a fast clip. These additions to plant capacity, coupled with the weakness in production during 1967, brought about a substantial decrease in capacity utilization rates. Although manufacturing production rose at an annual rate of about 5 per cent in the first quarter, the growth in capacity is estimated to have outstripped this increase, and the overall capacity utilization rate edged off by 0.3 percentage point to 84.1 per cent. (The preferred operating rate in manufacturing is usually judged to be around 90 per cent.)

In contrast to current utilization rates, developments in the labor market continue to highlight the fact that labor is now a critical factor limiting further expansion of real output. Following a large February increase, nonagricultural employment rose in March by 143,000 to a level of almost 68 million. Gains were centered in public and private services and in the trade sector. Advances in some manufacturing categories were offset by additional layoffs due to the glassblowers' strike. The civilian labor force eased slightly during the month, but the increase in employment resulted in a 0.1 percentage point decline in the overall unemployment rate to 3.6 per cent. Although teenage unemployment rose, the unemployment rates for both adult men and adult women fell. At 2.2 per cent of the labor force, adult male unemployment was equal to the lowest rate since 1953.

PRICES AND COSTS

The price situation deteriorated further in the first three months of the year (see Chart II.) A steep escalation in wage costs in a tight labor market and rapidly rising

Chart II
PRICES



Note: The GNP deflator is plotted on a quarterly basis. All other data are monthly. Wholesale prices for April are preliminary.

Sources: United States Department of Labor and Department of Commerce.

prices at the wholesale and retail levels have become major threats to the orderly growth of the economy. During the 1961-65 phase of the expansion, prices and costs rose on average at a fraction of the recent rates of increase. The GNP deflator moved up at an average annual rate of 1.5 per cent in those five years. Industrial wholesale prices averaged annual increases of 0.4 per cent, and consumer prices—reflecting mounting service as well as other costs—advanced at an average yearly rate of 1.4 per cent. At the same time, labor costs per unit of output actually declined by an average of 0.3 per cent per year, as productivity grew faster than wages. The overheating of the economy in 1966 changed all this, however. Prices in that year moved up sharply in response to excess demand, while depressed agricultural production accentuated the rise in food prices. Then in 1967 cost pressures, inherited partly from the demand-pull inflation in 1966, pushed prices up on all fronts, particularly in the last half of the year when demand conditions began to improve. Thus, the GNP deflator rose 3.0 per cent in that year even though demand pressures were generally moderate. Industrial wholesale prices turned up sharply last summer, after virtual stability in the first half of the year, and increased 1.8 per cent over 1967 as a whole. In manufacturing, unit labor costs—reflecting strong competition in the labor markets, increasingly large negotiated wage settlements, and slow productivity growth—climbed 4.0 per cent last year, and consumer prices rose 3.1 per cent.

In the first three months of this year, price advances continued to accelerate. The GNP deflator increased at an annual rate of 4.0 per cent, and by the end of the quarter industrial prices had soared at an annual rate of 4.5 per cent over the December level, although preliminary figures suggest that this upward trend moderated a bit in April. Wage costs increased even more than other price trends. Higher wage rates and other labor costs, such as the increased social security contribution required of employers, combined with lagging productivity gains to push labor costs per unit of output up at an annual rate of fully 10.1 per cent in the first three months of the year. Reflecting this broad upward movement, consumer prices advanced at an annual rate of 4.4 per cent in the quarter, and in March the index rose at a yearly rate of 5.0 per cent. Against this background of rising wage costs, a tight labor supply, and the recent increases in industrial wholesale prices, the first-quarter surge in consumer demand adds further to the likelihood that consumer prices will rise sharply in the coming months.

The Money and Bond Markets in April

Short-term interest rates continued to climb during April, under the impact of sustained pressure on member bank reserve positions and further moves by the Federal Reserve System to restrain inflationary forces in the economy and to strengthen the position of the dollar. On April 18, the Board of Governors of the Federal Reserve System announced that it had approved increases in the discount rates of the Federal Reserve Banks of New York, Philadelphia, and Minneapolis to 5½ per cent from 5 per cent, effective the following day. At the same time, the Board announced the adoption of a liberalized schedule of maximum interest rates payable by member banks on large-denomination negotiable certificates of deposit (C/D's), with ceiling rates scaled upward from 5½ per cent on the shortest maturity category to 6¼ per cent on the longest. In the next week, similar discount rate action was taken by the other nine Reserve Banks.[1] Immediately following the initial moves by the System, large commercial banks across the country raised their prime lending rate—the minimum rate charged on loans to the largest and best-rated business borrowers—to 6½ per cent, and major money market banks in New York City and outside

[1] The discount rate increase became effective on April 19 at the San Francisco Reserve Bank, on April 22 at the Atlanta Reserve Bank, on April 23 at the Boston and St. Louis Reserve Banks, and on April 26 at the remaining five.

Table I

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

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

Factors	Changes in daily averages—week ended on April 3	April 10	April 17	April 24	Net changes
"Market" factors					
Member bank required reserves*	+ 32	+ 118	— 539	+ 169	— 220
Operating transactions (subtotal)	— 196	— 274	+ 471	— 154	— 153
Federal Reserve float	— 85	+ 188	+ 167	+ 37	+ 307
Treasury operations†	+ 308	+ 22	+ 94	— 616	— 192
Gold and foreign account	+ 23	+ 14	+ 20	— 12	+ 45
Currency outside banks*	— 236	— 544	+ 29	+ 462	— 289
Other Federal Reserve accounts (net)‡	— 206	+ 47	+ 160	— 26	— 25
Total "market" factors	— 164	— 156	— 68	+ 15	— 373
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 13	+ 316	+ 2	— 25	+ 306
Bankers' acceptances	— 1	—	—	—	— 1
Repurchase agreements:					
Government securities	+ 164	+ 30	+ 66	— 260	—
Bankers' acceptances	— 3	+ 20	— 49	— 14	— 46
Federal agency obligations	+ 45	— 36	— 2	— 7	—
Member bank borrowings	+ 114	— 50	+ 117	— 112	+ 69
Other loans, discounts, and advances	—	—	—	—	—
Total	+ 333	+ 279	+ 134	— 418	+ 328
Excess reserves*	+ 169	+ 123	+ 66	— 403	— 45

	Daily average levels				
Member bank:					
Total reserves, including vault cash*	25,463	25,468	26,073	25,501	25,626§
Required reserves*	25,133	25,015	25,554	25,385	25,272§
Excess reserves*	330	453	519	116	355§
Borrowings	696	646	763	651	689§
Free reserves*	— 366	— 193	— 244	— 535	— 334§
Nonborrowed reserves*	24,767	24,822	25,310	24,850	24,937§

	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 676	— 424	+ 331	— 905	— 322
More than one year	+ 128	—	—	+ 9	+ 137
Total	+ 804	— 424	+ 331	— 896	— 185

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 April 24.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS APRIL 1968

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on April 3	April 10	April 17	April 24*	Averages of four weeks ended on April 24*
Eight banks in New York City					
Reserve excess or deficiency(—)†	18	121	— 2	— 7	33
Less borrowings from Reserve Banks	—	127	46	49	56
Less net interbank Federal funds purchases or sales(—)	436	1,131	1,211	672	863
Gross purchases	*950*	*1,479*	*1,726*	*1,466*	*1,405*
Gross sales	*514*	*348*	*515*	*793*	*543*
Equals net basic reserve surplus or deficit(—)	— 418	—1,137	—1,259	— 729	— 886
Net loans to Government securities dealers	758	729	736	513	684
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)†	12	44	33	31	30
Less borrowings from Reserve Banks	278	71	407	293	262
Less net interbank Federal funds purchases or sales(—)	356	624	884	1,191	764
Gross purchases	*1,603*	*1,910*	*2,018*	*2,298*	*1,957*
Gross sales	*1,247*	*1,287*	*1,134*	*1,107*	*1,194*
Equals net basic reserve surplus or deficit(—)	— 622	— 650	—1,258	—1,453	— 996
Net loans to Government securities dealers	232	406	635	371	411

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—April 1968: April 1	April 8	April 15	April 22	April 29
Three-month	5.146	5.309	5.463	5.542	5.499
Six-month	5.265	5.400	5.568	5.689	5.612

Maturities	Monthly auction dates—February-April 1968: February 21	March 26	April 23
Nine-month	5.239	5.424	5.665
One-year	5.281	5.475	5.663

* 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.

posted higher offering rates on new C/D's.

While nationwide net reserve availability averaged about the same in April as in March, the reserve positions of the major money market banks in New York City deteriorated sharply, and most Federal funds trading took place at 5¾ or 5⅞ per cent, compared with 5¼ to 5½ per cent in the latter half of March. During the three statement weeks ended on April 17, covering the income tax date and preceding the increase in the Regulation Q ceiling, the city banks experienced a C/D attrition of $503 million, substantially greater than the $186 million attrition in the comparable period of March which also included a tax date. After the March 31 quarterly statement date, banks liquidated Treasury bills in volume, so that bill rates came under strong upward pressure early in April. They were marked up further after an announcement by the Treasury of an addition to its weekly auction of six-month bills, and still further after the discount rate increase. The latter action also prompted increases in rates on bankers' acceptances, finance company paper, prime commercial paper, and Euro-dollars.

In contrast to the pronounced upward trend of short-term interest rates, yields rose only slightly on intermediate-term issues and declined moderately on long-term Treasury securities during April. Prices of Treasury coupon issues rose sharply at the beginning of the month after President Johnson announced on March 31 that he had ordered a limitation of the bombing of North Vietnam and was seeking early peace negotiations. However, price gains were limited by increasing disappointment in the market over the delay in reaching agreement on a site for peace talks and over the failure of the Congress to act affirmatively on a tax increase. The announcement of increases in the discount rate and in the Regulation Q ceiling on April 18 caused a sharp markdown of prices, but revived hope of peace negotiations and tax action served to steady the market later. However, the approach of the Treasury's May financing was a restraining influence on prices. Similarly, in the markets for corporate and tax-exempt bonds, an atmosphere of buoyancy early in the period was later replaced by one of hesitancy and caution, and yields established on new offerings rose.

BANK RESERVES AND THE MONEY MARKET

Average net borrowed reserves of member banks amounted to $334 million during the four statement weeks ended in April (see Table I), only moderately higher than the $311 million average (revised) in the four statement weeks of March. Net reserve availability varied widely within the period, however, with average net borrowed reserves easing to the $200 million level in the second and third statement weeks and deepening to $535 million in the final week of the month.

The money market was continuously firm during April, and Federal funds were generally quoted at a substantial premium over the prevailing discount rate. This premium rose as high as ⅞ percentage point at the start of the month, when the major money market banks in New York City began to feel the effects of a marked deterioration in their basic reserve position. The average basic reserve deficit of the forty-six reporting money market banks mounted to more than $2.5 billion in the week of April 17 (see Table II) from $0.7 billion in the final week of March, reflecting the continuing heavy financing needs of dealers in United States Government securities and an increased demand for business and sales finance company loans. In the statement week of April 17, moreover, the city banks, along with banks elsewhere in the country, sustained a sharp loss of C/D's as maturities around the income tax date were not renewed. Prior to the increase in the discount rate, rates charged by the city banks on new call loans to Government securities dealers were quoted at about 6 to 6½ per cent, compared with 5½ to 5¾ per cent in late March (see chart). Money market rates moved generally higher following the increase in the discount rate. Later in the statement week ended on April 24, however, conditions tended to ease temporarily, mainly because of the release of accumulated excess reserves by the "country" banks. In that week, moreover, the basic reserve position of the money market banks improved, largely because of a rapid repayment of business loans and a sharp decline in the financing needs of dealers in United States Government securities. At the end of the month, however, pressures in the money market intensified; the effective rate for Federal funds rose to 6¼ per cent, the highest since November 1966, and new call loans to dealers were quoted at 6⅝ to 6¾ per cent.

Under the new schedule of maximum rates of interest payable on C/D's, rates of 5¾ per cent may be offered on 60- to 89-day maturities, 6 per cent on 90- to 179-day maturities, and 6¼ per cent on maturities of 180 days or more. The 5½ per cent ceiling, which had previously applied to all maturities, continues in effect for maturities of 30 to 59 days. Immediately after the ceilings were lifted, the money market banks in New York City raised their posted offering rates on new C/D's maturing in 90 days or more to 5⅞ per cent, and a rate of 6 per cent was posted by the end of the month. The new C/D offering rates posted at the end of April compared with dealer offering rates of 5⅞ per cent on 90-day unendorsed bankers' acceptances and 6 per cent on prime four- to six-month commercial paper, with a published offering rate of 5⅞ per cent on directly placed finance company paper maturing in 30 to 270 days and with a bond equivalent yield of 5.88 per cent on six-month Treasury bills.

During the statement week ended on April 24, the weekly reporting banks in New York City gained $184 million through an increase in large C/D's, after having lost $359 million through C/D runoffs in the preceding week. At large commercial banks throughout the country, the net contraction of C/D's in the April 17 statement week amounted to $697 million, a substantial proportion of the $1,243 million that had been scheduled to mature on the April 15 tax date. In the following statement week, however, C/D liabilities of these institutions rose by $286 million, in response to the higher issuing rates posted subsequent to the increase in the Regulation Q ceiling.

THE GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds rose sharply during the first three days of April, in reaction to the speech by President Johnson on March 31 announcing a halt in the bombing of much of North Vietnam and calling for peace negotiations, and to subsequent indications that this deescalation move had met with a favorable response from the Hanoi government. The coupon market was further strengthened by news that the United States Senate, on April 2, had approved legislation providing for a 10 per cent income tax surcharge and a $6 billion reduction in Federal Government spending. Optimism in the market soon faded, however, as progress toward peace negotiations was stalled by the failure of the Washington and Hanoi governments to reach agreement on a site for the talks, and as further consideration of income tax legislation by the Congress was postponed until after the Easter recess. Moreover, market participants began to reflect that the Vietnam negotiations might be quite lengthy and that even a total cessation of hostilities in Vietnam would not bring about an immediate sizable reduction in defense spending. They saw further cause for concern over the outlook for intermediate- and long-term yields in the recent resurgence in the demand for business loans at commercial banks, in the sizable calendar of new corporate financing, and in increasing evidence of strong monetary restraint. As midmonth approached, in fact, there was growing speculation about an increase in the commercial bank prime lending rate.

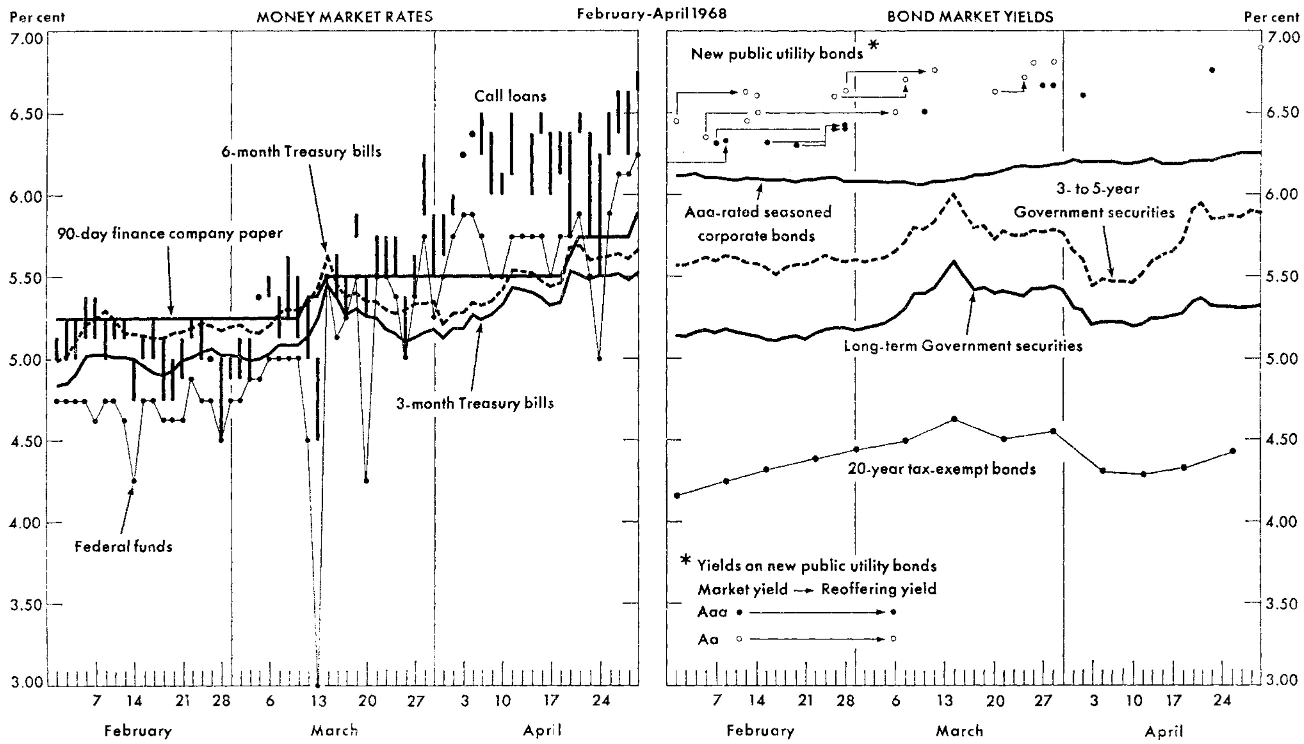
After the announcement of the discount rate increase on April 18, prices of Treasury coupon issues were marked down sharply. Over the remainder of the period, however, prices fluctuated irregularly, mainly in response to varied news reports regarding the outlook for peace negotiations and for enactment of income tax legislation. Activity was limited, as participants awaited an announcement of the terms of the Treasury's refunding of May maturities expected near the month end. (The Treasury announced on May 1 that it was offering at par a 6 per cent seven-year note in exchange for the 4¾ per cent note and 3⅞ per cent bond maturing on May 15. The maturing issues total $8 billion, approximately $3.9 billion of which is publicly held. Additionally, the Treasury announced a concurrent offering for cash of about $3 billion of a fifteen-month note, priced at par to yield 6 per cent. The payment and delivery date for both of the new issues is May 15.)

Rates on Treasury bills rose substantially during April, attaining their highest levels since the fall of 1966. The news of a reduction in hostilities in Vietnam produced only a limited markdown in bill yields on the opening day of the period. Over the first half of the month, rates tended to rise in response to aggressive selling by commercial banks meeting increased pressure on their reserve positions and by dealers attempting to reduce inventories in the face of substantially higher financing costs. On April 11, rates were marked up sharply after an announcement by the Treasury that the size of the regular weekly offering of six-month bills would be increased by $100 million. Around midmonth, however, the market firmed in response to the reappearance of investment buying. Demand was strong from public funds and other investors, including holders of April tax anticipation bills who redeemed for cash bills not tendered in payment of income taxes. Frequently such demand encountered a thin supply of offerings. Bill rates were adjusted roughly 20 to 30 basis points higher on April 19, when increases in the discount rates of four Reserve Banks and in the Regulation Q ceilings on C/D's became effective.

Bidding in the regular weekly auctions of three- and six-month bills was unenthusiastic in the first two auctions held during the month, but was quite aggressive in later auctions at the higher rate levels after investment buying reappeared. In the auction held on April 15, the first in which the additional $100 million of six-month maturities was offered, bidding resulted in average issuing rates of 5.46 per cent and 5.57 per cent for the three- and six-month issues, respectively, 15 and 17 basis points higher than corresponding rates established in the preceding weekly auction (see Table III). Issuing rates rose further in the next auction, but tapered off in the final weekly auction of April. In the regular monthly auction of longer bill maturities held at the end of April, the nine-month and one-year bills were awarded at average issuing rates of 5.67 per cent and 5.66 per cent, respectively, 24 and 19 basis

SELECTED INTEREST RATES

February-April 1968



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.

points above rates established on comparable offerings in the March auction.

In the market for Federal agency securities, a $445 million issue of nine-month debentures of the Federal intermediate credit banks, originally intended to be offered just before the discount rate increase, was postponed until April 24, when it received an excellent market reception at a yield of 6.10 per cent. On April 17, the Export-Import Bank of the United States, for the first time, began selling short-term discount notes in order to obtain supplemental funds for its various export programs. Maturities of the notes, ranging from 30 to 360 days, are selected by investors with the approval of the agency. The Attorney General has ruled that contractual obligations of the Export-Import Bank are general obligations of the United States.

OTHER SECURITIES MARKETS

Prices of corporate and tax-exempt bonds moved sharply higher at the beginning of April in the wake of the announcement of new attempts by the Administration to seek a negotiated settlement of the Vietnam war. Dealers' inventories of both corporate and tax-exempt debt issues were reduced substantially: unsold balances of recent offerings were quickly taken from dealers, and new issues being marketed at higher prices met a favorable response from investors. As the month progressed, however, signs of investor resistance to the higher price levels became apparent. A few issues were postponed, and one prospective corporate borrower canceled an offering after obtaining financing through a commercial-bank term loan.

After the discount rate increase, prices in the corporate and tax-exempt markets weakened considerably. Illustrating the sharp change of sentiment in the corporate market, a large issue of Aaa-rated long-term telephone bonds was sold late in the month at a reoffering yield of 6.75 per cent, whereas a comparable offering at the start of the period had been successfully marketed at a yield of 6.60 per cent. Although many participants in the tax-exempt market were hopeful that the increase in the Regulation Q ceiling would provide some assurance of continued bank buying, more apparently felt that the increase in monetary restraint taking place did not augur well for the market over the months ahead. Thus, *The Weekly Bond Buyer's* average yield series of twenty seasoned tax-exempt issues, which had declined sharply from 4.54 per cent at the start of April to 4.29 per cent just prior to the discount rate and Regulation Q actions, rose to close the month at 4.43 per cent. Over the latter part of April, inventories of both corporate and tax-exempt issues tended to accumulate in dealers' hands. The Blue List of dealers' advertised inventories of tax-exempt bonds climbed to $585 million at the month end, substantially higher than the $454 million at the end of March.

Banking and Monetary Developments in the First Quarter of 1968

The growth of money and bank credit slowed further in the first quarter of 1968 as the movement toward credit restraint, which began in the closing months of 1967, intensified. Dangerous stresses in the international monetary system, resulting in large part from this country's continuing balance-of-payments deficit, plus growing inflationary pressures in the domestic economy necessitated the coordinated use during the first quarter of all the principal instruments of monetary policy. In mid-January, reserve requirements on demand deposits in excess of $5 million at member banks were increased by ½ percentage point, absorbing about $550 million of member bank reserves. Then, on March 14, following unprecedented speculative demand for gold abroad, the Board of Governors of the Federal Reserve System announced approval of an increase in the discount rate from 4½ per cent to 5 per cent, effective the next day, at nine Federal Reserve Banks.[1] The new 5 per cent discount rate was the highest in nearly four decades. (After the quarter closed, monetary restraint moved a step further in April with another increase in the discount rate to 5½ per cent.)[2] Moreover, open market operations were adjusted progressively during the quarter to restrain further the expansion of money and credit. As one measure of the increasing restraint brought to bear on bank reserve positions, daily average free reserves declined steeply during the quarter, dropping from an average of about $100 million in the first weeks of the year to an average of minus $310 million in March. At the same time, the effective rate on Federal funds increased sharply, rising from just over 4½ per cent in early January to roughly 5½ per cent in late March.

The System's move toward progressively tauter monetary conditions was reflected in slower rates of growth in most credit and liquidity indicators during the January-March period. The growth of total commercial bank credit fell to a seasonally adjusted annual rate of 6.8 per cent from 7.5 per cent in the fourth quarter of 1967, markedly below the growth in 1967 as a whole. The rate of increase in the money supply also slowed during the first three months of this year, as did the growth of commercial bank time deposits. At the same time, nonbank thrift institutions experienced relatively modest growth in their deposits and share capital.

The progressive tightening of money market conditions was also manifested in upward pressure on market interest rates. While yields on most short- and long-term Government and private debt issues declined during the first part of the quarter, they climbed thereafter as monetary restraint intensified and, for the most part, closed the quarter at higher levels than those prevailing three months earlier.

[1] The Federal Reserve Banks of San Francisco and Philadelphia posted increases in their rates effective on March 15 and 18, respectively, while the Federal Reserve Bank of New York did not take similar action until March 21, effective the following day.

[2] For details, see page 95 of this *Review*.

Rates on short-term Treasury bills were relatively stable until mid-March, when they rose in response to the increase in Federal Reserve Bank discount rates. Yields on intermediate- and long-term Government issues matched, and in some cases surpassed, their 1967 peaks in mid-March and then declined slightly over the remainder of the month. Corporate and tax-exempt bond yields continued to climb throughout March, however, and tax-exempt yields reached the highest levels in thirty-five years.

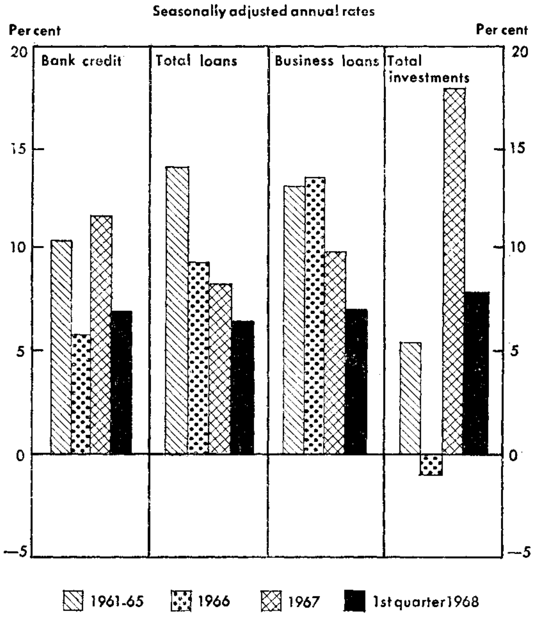
BANK CREDIT

Although the rate of expansion of total commercial bank credit moderated on balance in the first quarter of 1968 (see Chart I), the pattern of growth within the period was highly uneven. In January and February bank credit increased at annual rates of 10.8 per cent and 13.8 per cent, respectively, while the final month of the period witnessed a small decline. This extreme unevenness largely reflected wide swings in holdings of United States Government and other securities and in loans for the financing of securities dealers.

Chart I

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

Seasonally adjusted annual rates



Note: Changes are computed from levels on the last Wednesday of the month before and at the end of each period.

Source: Board of Governors of the Federal Reserve System.

Bank holdings of Government securities rose sharply in February, when banks were accorded full Tax and Loan Account privileges in connection with the Treasury's sale during the month of $4 billion of new notes. However, a large proportion of these securities was then distributed to the nonbank public in March, and over the quarter as a whole bank holdings of Government securities increased only modestly. Even so, this slight gain did represent a substantial turnaround from the fourth quarter of 1967 when Government securities were liquidated. On the other hand, acquisitions during the first quarter of other securities—primarily tax-exempt issues—were at only half the pace recorded in the final three months of 1967. This slowdown about offset the greater relative strength in holdings of Government securities, and total investments rose in the first quarter at an annual rate of 7.9 per cent, only slightly faster than in the fourth quarter and markedly below the advance in 1967 as a whole. This modest advance undoubtedly reflected tighter monetary conditions and slower deposit inflows in the January-March period.

Total commercial bank loans increased at a seasonally adjusted annual rate of 6.4 per cent in the first quarter, somewhat below the 8.5 per cent advance in the fourth quarter of last year. Loans gained sharply in January, moderately in February, and then actually declined slightly in March. This pattern was influenced by sharp fluctuations in securities loans. In January, sales of Federal National Mortgage Association participation certificates and tax anticipation bills swelled dealer inventories, giving rise to substantial dealer borrowing at commercial banks. Securities loans advanced again in February, though more moderately than in January, as dealers borrowed at banks to finance purchases of the Treasury notes issued just after midmonth. The sharp drop in securities loans outstanding in March was attributable in large part to a reduction in dealer inventories, which was facilitated by the lack of any significant Treasury financing during the month, and was encouraged by the sharply higher rates charged by banks on call loans to securities dealers. Indeed, call loan rates were almost a full percentage point higher after mid-March than they had been during most of January.

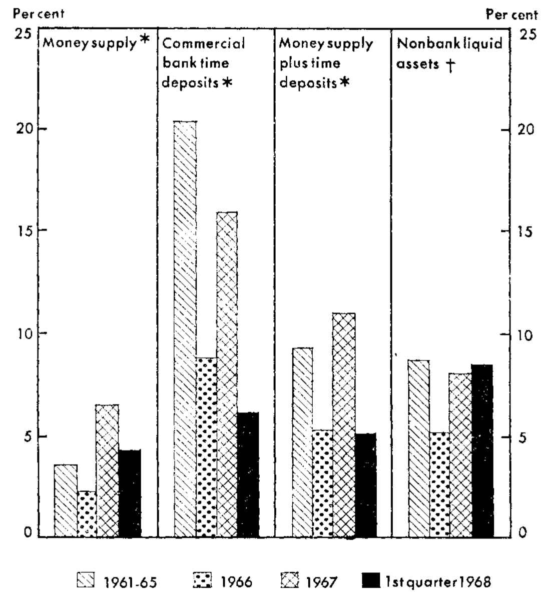
The demand for bank loans by business was relatively modest in the first quarter as a whole, although a more aggressive demand did emerge toward the end of the period. Commercial bank loans to business increased at a seasonally adjusted annual rate of 7 per cent in the January-March period, substantially slower than the 10 per cent rate of advance during the fourth quarter of 1967. Business loan demand strengthened in March, however, even though corporate income tax payments were roughly $2.5 billion less than they were on the same tax date in the previous three years. The March advance was broadly based, as business activity expanded rapidly in most sectors of the economy. A strong surge in business loans after mid-March may have reflected in part increased expectations that commercial bank prime rates would rise following the discount rate increase.

Construction activity remained strong in the first quarter, and real estate loans held by banks expanded at an 11 per cent annual rate, continuing the relatively rapid growth that began in the second half of 1967. At the same time, extensions of consumer credit by commercial banks also advanced sharply, reflecting the record advance in consumer spending during this period. The 13.7 per cent annual rate of growth was twice the increase in the fourth quarter of 1967 and represented the largest quarterly gain in this loan category since the third quarter of 1965.

Chart II

RATES OF CHANGE IN LIQUIDITY INDICATORS

Seasonally adjusted annual rates



* Computed from daily average levels during the week prior to and at the end of each period.

† Computed from levels at the beginning and end of each period.

Source: Board of Governors of the Federal Reserve System.

MONEY SUPPLY AND DEPOSITS

The rate of expansion of the daily average money supply —privately held demand deposits plus currency outside banks—continued to moderate in the first quarter, when the annual rate of growth fell to 4.2 per cent from 5.1 per cent in the final quarter of 1967. The money supply rebounded in January, after growing very slowly in December, but then remained virtually unchanged in February as Treasury deposits in commercial banks swelled and private deposits declined. (This inverse relationship between Treasury and private deposits often holds over short periods of time.) In March, when Treasury deposits declined, the money supply expanded once again.

The growth of daily average time deposits at commercial banks fell sharply in the first quarter to an annual rate of 6.1 per cent, after an 11 per cent rise in the fourth quarter of last year. In January commercial banks actually lost time deposits, but inflows recovered in February and March. The relatively slow growth in time deposits over the quarter was attributable in large part to the weak performance of large-denomination certificates of time deposit (C/D's representing deposits of $100,000 or more). At weekly reporting banks, outstanding C/D's advanced by $224 million during the first quarter, about half of the previous quarter's increase and far below the $3.6 billion gain in the first quarter of 1967. Increases in January and February were smaller than in the same months of the previous year, and in March large C/D's fell sharply, declining by $500 million during the tax week alone. The relatively slow growth of C/D's in the first quarter resulted largely from a $644 million net loss by large New York City banks. Indeed, reporting banks outside New York City recorded a net gain of $868 million over the quarter. However, large outflows were also experienced by these banks in March, indicating the widespread difficulty in rolling over maturing certificates. Although rates most often posted on certificates of 180-day maturity or longer were at the 5½ per cent Regulation Q ceiling throughout the quarter, and rates on shorter maturities were at the ceiling before the end of the period, yields on alternative forms of investment were becoming more attractive than the maximum allowable C/D rate.[3]

The ratio of loans to deposits at all commercial banks increased slightly over the quarter as a whole, from an average of 62.7 per cent in December 1967 to 63.1 per cent in March. The ratio rose a full percentage point in March, however, after declining in January and edging up only slightly in February. The loan-deposit ratio at large New York City banks, where C/D losses were substantial,

[3] On April 18, the Board of Governors of the Federal Reserve System announced increases in Regulation Q ceiling rates for most maturities of large denomination C/D's. For details, see page 97 of this *Review*.

increased rather sharply during the quarter. Moreover, these banks borrowed quite heavily from their foreign branches during the January-March period, permitting loans to expand relative to deposits.

BROAD LIQUIDITY TRENDS

Liquid assets held by the nonbank public increased at a seasonally adjusted annual rate of 8.6 per cent during the first quarter (see Chart II), somewhat slower than the 9.3 per cent growth rate in the final quarter of 1967. The expansion of deposits and share accounts at commercial banks, mutual savings banks, and savings and loan associations failed to keep pace with the growth of other liquid assets. Deposits held by the nonbank public at thrift institutions advanced at a seasonally adjusted annual rate of 6.6 per cent from December through March, slightly faster than in last year's fourth quarter but considerably slower than the 9.1 per cent growth over 1967 as a whole. Both mutual savings banks and savings and loan associations experienced reduced growth in January, following year-end interest and dividend crediting, but their growth rates picked up in February and March.

The public continued in the first quarter to acquire large amounts of Government securities maturing within one year, after having purchased $2.3 billion in the final quarter of 1967. Indeed, holdings of these liquid assets increased by $5.6 billion in the January-March period, a larger gain than in the entire second half of the previous year. Fully 40 per cent of the gain in total liquid assets in the January-March period was accounted for by the increase in short-term Government securities. Undoubtedly, the high and rising yields on securities market investments relative to deposit rates offered by commercial banks and thrift institutions exerted an important influence on this development.

The relative liquidity of the nonbank public, as measured by the ratio of total liquid assets to gross national product, remained virtually unchanged in the first quarter. This ratio was 79.4 per cent, slightly below the 79.6 per cent of the previous quarter but equal to the average for the year 1967.

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