

FEDERAL RESERVE BANK OF NEW YORK



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Volume 50

No. 11

The Business Situation

The economy expanded far more rapidly in the third quarter than most observers had expected a few months ago. Final spending registered a large gain, as personal consumption expenditures increased sharply and business fixed investment showed renewed growth. At the same time, total business inventory accumulation slowed only moderately despite the working-down of strike-hedge steel inventories. Consumer spending kept pace with rapidly expanding pre-tax personal incomes even though higher withholding rates, reflecting the 10 per cent tax surcharge, greatly limited the growth of disposable income during the quarter. A large part of the increase in consumption was financed by record use of consumer credit. As the quarter drew to a close, retail sales and a few other economic indicators appeared to ease slightly, but many others strengthened, including housing starts and new orders for durable goods.

The failure of business activity to slow appreciably in the third quarter—in the face of the fiscal restraint program and the decumulation of excess steel inventories—underscored the momentum of the economy and the strength of inflationary wage, price, and profit expectations. While the cumulative effects of fiscal restraint are likely to become more clearly visible as time passes, the delay in getting the economy back to a slower rate of growth has unquestionably complicated the task of restoring reasonable price stability and achieving the much needed improvement in our international trade balance.

GNP IN THE THIRD QUARTER

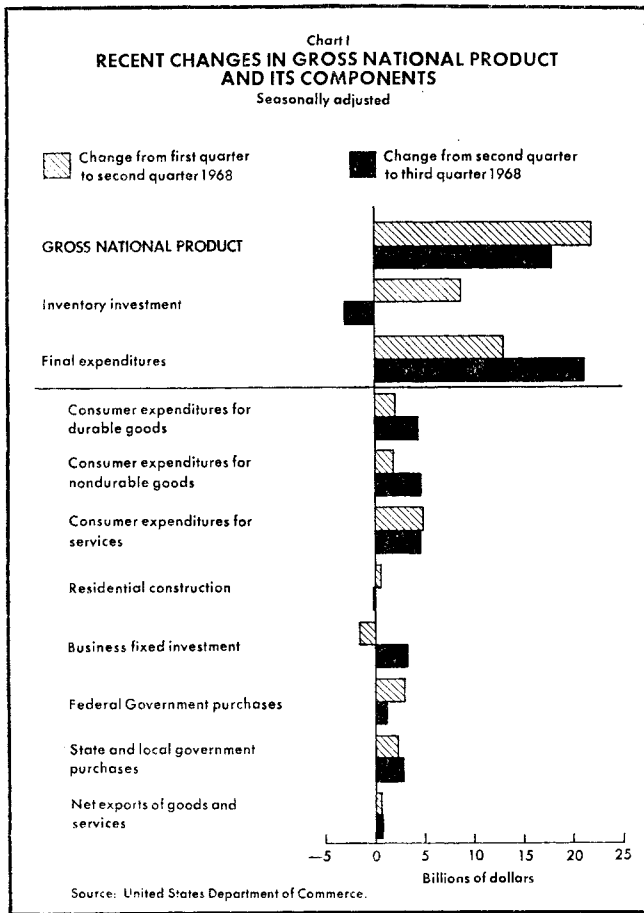
The nation's total output of goods and services showed a strong further increase in the third quarter. According to preliminary estimates by the Department of Commerce, gross national product (GNP) climbed \$17.9 billion (see Chart 1) to a seasonally adjusted annual rate of \$870.8 billion. While this was somewhat less than the record \$21.7 billion GNP increase recorded in the second quarter of 1968, it still must be regarded as excessively large. Real GNP, which is an estimate of national product excluding the influence of price changes, grew at a 4.9 per cent an-

nual rate in the third quarter, down somewhat from the very large increase of more than 6 per cent in both the first and second quarters of the year but still higher than what is generally considered sustainable in a full employment economy.

According to the preliminary data, there was a slowing in the rate of increase in the implicit price deflator, which converts GNP at current market prices into 1958 prices. This price measure rose at a 3.6 per cent annual rate in the third quarter, with roughly one fifth of the gain attributable to the July pay increase for Federal employees. In the preceding four quarters, the implicit price deflator had climbed at an average annual rate of about 4 per cent. Paradoxically, the third-quarter slowing of the overall GNP deflator was centered in the personal consumption component despite very strong demand for consumer goods and services. The consumer price index, which is a measure of prices paid by consumers that differs in both coverage and method of computation from the deflator for GNP consumption expenditures, rose at a 5 per cent annual rate in the third quarter, the steepest increase this year.

Heavy consumer spending, financed in large part by exceptional use of credit, was the predominant factor in the third-quarter GNP advance. Consumer purchases of goods and services rose by \$13.4 billion, accounting for about 75 per cent of the quarter's total growth in GNP. The increase was a good deal smaller than the record spending surge of \$17.2 billion in the first quarter but was nevertheless the third largest quarterly increase on record.

Most of the increase in consumption was accounted for by expanded purchases of goods, in both the durables and nondurables categories. Expenditures for services rose by an estimated \$4.6 billion, an amount generally in line with the recent trend. Consumer purchases of nondurable commodities rose by 8 per cent at an annual rate, with spending on food and clothing accounting for most of the gain. Consumer buying of durables, led by surging auto sales, also turned sharply higher after only a modest second-quarter gain. Indeed, sales of new cars, including

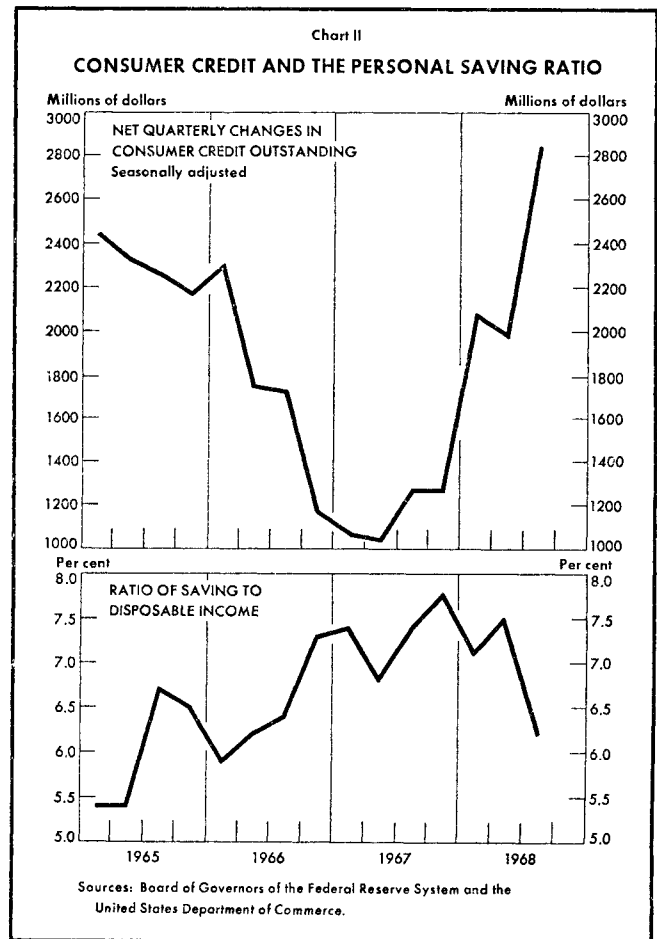


the amount of income saved fell by an unusually large \$7.2 billion. The rate of saving—personal saving as a percentage of disposable income—dropped to 6.2 per cent from the very high second-quarter figure of 7.5 per cent (see Chart II), the second largest quarter-to-quarter decline since the Korean war.

The big factor in the slowdown of saving was the record third-quarter expansion of consumer credit outstanding (also shown on Chart II). Rapidly increasing disposable income in earlier quarters had enabled consumers to build up their financial assets and still increase consumption spending with modest reliance on credit. This left individuals in a strong financial position and with relatively light loan repayment burdens, permitting them to turn heavily to instalment credit in the third quarter when the surtax slowed the growth of disposable income. Indeed, when expressed at an annual rate, consumer credit rose \$11½

imported vehicles, ran at an annual rate of roughly 10 million units throughout the summer. After introduction of the new models, sales of domestically produced autos continued strong; they rose to an annual rate of 9.0 million units in September and were unchanged in October. Reflecting the strength of consumer demand, the dollar volume of sales at retail outlets reached a record level in the third quarter. Sales advanced substantially in both July and August, but preliminary estimates indicate that retail buying slipped fractionally in September.

The increase of personal tax withholding rates in mid-July as the surtax went into effect resulted in a sharp reduction in the growth of disposable income. Thus, although total personal income—measured before taxes—continued to expand strongly in the third quarter, the increase in disposable after-tax income was the smallest in more than two years. Indeed, the quarter's \$6.3 billion gain in disposable income was less than half as large as the \$13.4 billion rise in consumption. As a consequence,



billion in the third quarter, about \$3 billion more than in the first and second quarters.

The third-quarter surge in consumption expenditures apparently limited business inventory accumulation at wholesale and retail trade establishments. In fact, total inventories held by retailers and wholesalers are estimated to have shown no net change over the course of the third quarter. On the other hand, manufacturers' inventories expanded substantially, accounting for virtually all the \$7.7 billion addition to total stocks indicated in the preliminary GNP estimates. These estimates, however, were based on data for only the first two months of the quarter and may well be revised substantially once complete data are available.

Business fixed investment moved ahead briskly in the third quarter, rising by \$3.2 billion to an annual rate of \$90.2 billion. This expansion was roughly in line with the pattern projected by the survey of business capital spending plans taken in August by the Department of Commerce and the Securities and Exchange Commission. The quarter's entire gain in capital investment was accounted for by equipment purchases; expenditures for construction of new plant remained virtually unchanged.

Residential construction spending was little changed in the third quarter, reflecting the drop-off of housing starts in May and June. At an annual rate of \$29.4 billion, residential outlays were down by \$0.1 billion from the second-quarter rate. However, new housing starts, which lead actual expenditures, advanced strongly through the summer and by the quarter's end had reached an annual rate of roughly 1.6 million units, equaling the peak levels recorded last spring. Strong demand for new housing and more readily available mortgage funds appear to be offsetting the restrictive influence of high mortgage interest charges, and the near-term outlook for the residential construction industry remains good. The prevalent view now is that the year 1968 will see more than 1.5 million housing units started, up sharply from the totals of 1.3 million and 1.2 million in 1967 and 1966, respectively.

Total purchases of goods and services by all levels of government rose \$3.8 billion in the third quarter, the smallest gain in a year. Expenditures by state and local governments grew at a pace about in line with the rate of increase in 1966 and 1967. Federal Government purchases expanded by only \$1.1 billion, much of which was accounted for by the July Federal pay raise. The increase in Federal spending was the smallest for one quarter since before the mid-1965 start of the Vietnam buildup. The slowdown in the growth rate of Federal outlays was divided about equally between defense and nondefense expenditures.

RECENT DEVELOPMENTS IN PRODUCTION AND EMPLOYMENT

Industrial production registered a second consecutive monthly decline in September, as falling steel output continued to be a depressing influence. The Federal Reserve Board's index of industrial output fell 0.5 percentage point to a seasonally adjusted 163.4 per cent of the 1957-59 average. Iron and steel output dropped 27 per cent in the two months following the July 30 labor contract settlement. Exclusive of iron and steel, industrial output was virtually unchanged through the third quarter after a full year of rather rapid advance. This leveling-off was widespread, with most sectors showing only marginal changes in either direction. Mining activity and motor vehicle production were down somewhat, utilities and consumer goods output were up a bit, and the index of equipment production was unchanged.

While manufacturing production remained about unchanged in the third quarter, new manufacturing capacity—which is primarily the result of plant and equipment spending decisions made several quarters earlier—climbed substantially. Consequently, the rate of capacity utilization dropped 1.4 percentage points to a five-year low of 83.3 per cent.

The short-term outlook for industrial production was bolstered in September, when new orders received by manufacturing establishments rose 3 per cent to a record level of \$51.6 billion. The construction materials and steel industries registered particularly impressive gains, while new orders in the consumer durables sector turned higher after a two-month decline. Orders received by nondurable goods producers also advanced, roughly offsetting a decline in the volatile defense products industries. Manufacturers' shipments moved a good deal higher in September, but remained below the record level achieved in July. Manufacturers' new orders exceeded shipments in September by \$400 million, increasing the backlog of unfilled orders to a level of \$83.6 billion.

On balance, the employment situation shows little indication of easing from the very tight conditions which have prevailed for the last year or so. The total number of jobs in nonfarm establishments increased by 136,000 in October, and the gain would have been substantially larger but for a strike in the coal-mining industry. Employment in manufacturing concerns increased after two consecutive months of decline and surpassed the previous record level of last June. Federal Government employment eased for the fourth consecutive month, reflecting the Congressional restrictions on replacement hiring. Employment in the remaining sectors of the economy was strong except in

mining, where payrolls declined by 50,000 because of strikes, and in transportation and utilities, where employment was unchanged. The overall unemployment rate remained unchanged in October at 3.6 per cent of the civilian labor force. There was a slight increase in the very low unemployment rate for adult men, but a small decrease for adult women.

PRICE AND COST DEVELOPMENTS

The rate of advance in the consumer price index eased somewhat during September. After climbing at a 4 per cent average annual rate for about a year, the index surged to a 6 per cent rate in June and July, returned to a 4 per cent rate in August, and then slowed to a 3 per cent advance in September. However, nearly all the September slowdown in the overall index was due to a leveling-off of food prices following rapid increases earlier. The consumer price index excluding food climbed at an annual rate of just under 4 per cent in September, only marginally below the advances of preceding months. Increased prices of clothing led the continued rise in commodities prices, while higher housing and medical care costs contributed to the further rapid climb in the cost of services.

Preliminary October data indicate that the wholesale price index was unchanged from the September level of 109.1 per cent of the 1957-59 average. The overall index has been stable since July, but price movements in various commodity groups suggest continued upward pressures in many important areas. Indeed, in October the industrial commodities price index rose at an estimated 4.4 per cent annual rate, the largest one-month gain since February of this year. During most of the spring, the rise in the industrial index was slowed by a rapid decline in prices of copper and copper products, following the settlement of the long strike in that industry. By mid-summer, the copper price readjustment had been completed. Since that time the continued increase in the prices of other products has been manifest in the accelerating rise in the price index of all industrial commodities. On the other hand, prices of farm products and processed

foods and feeds have been fluctuating for several months but have shown a generally downward trend since July. This downtrend has been the principal factor in the stability of the overall wholesale price index, offsetting the increases in industrial prices.

Labor costs per unit of output in manufacturing jumped 0.8 percentage point in September to a record level of 112.7 per cent of the 1957-59 average. Following the pattern set in August, the gain was due to a combination of higher labor costs per man-hour and an actual drop in productivity. Labor costs have been rising sharply for some time, but the decline in output per man-hour is a recent development, probably resulting in large measure from a steeper reduction of steel output than of hours worked in the steel industry.

THE BALANCE OF PAYMENTS

The ABC's of the United States balance of payments are presented in nontechnical language in a six-page leaflet, entitled *The Balance of Payments*, recently published by the Federal Reserve Bank of New York. The folder discusses the dominant role of the United States dollar in world trade and investment, analyzes the factors contributing to the persistent payments deficit, and explains why it is of utmost importance that the United States achieve "approximate equilibrium" in its international accounts. It also presents in easily understood terms a line-by-line explanation of our international payments accounts.

Requests for copies should be directed to the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045. No charge for limited quantities.

The Money and Bond Markets in October

The capital markets were under considerable pressure during October, and both short- and long-term interest rates rose. Credit demands remained substantial, as evidenced by an accelerated flow of new corporate and tax-exempt bond offerings. At the same time, mounting indications that the economy was continuing to expand quite vigorously and that inflationary pressures were persisting generated a perceptible shift of sentiment in the money and bond markets. Observers grew increasingly uncertain about the likely course of monetary policy and interest rates in the months ahead. Against this background, the first half of the month saw a fairly steady drop in prices of Treasury notes and bonds, sharp price-cutting in the corporate and tax-exempt bond sectors, where yields approached the historic highs reached last spring, and a general rise in rates on Treasury bills and other short-term money market instruments.

On October 16, however, reports began to circulate that the Paris peace talks had reached a critical stage and that an agreement to de-escalate the Vietnam conflict might soon be forthcoming. These reports sparked a rally in the capital markets. Participants anticipated that any reduction in the United States military involvement in Vietnam would eventually contribute to an easing of pressures in the credit markets as well as in the economy at large. Investment demand for corporate and tax-exempt bonds expanded considerably, and prices rebounded from their depressed levels. Prices of Government securities also rallied in reaction to the Vietnam peace conjectures. Subsequently, peace hopes began to fade and interest rates tended to rise as the Treasury's November refunding approached. Market participants initially responded favorably to the Treasury announcement on October 23 that it would offer a new eighteen-month note, priced to yield 5.73 per cent, and reopen the 5¾ per cent note of November 1974 as alternative replacements for \$11.9 billion of outstanding notes and bonds maturing in November and December. In the closing days of the month, market interest in the Treasury refunding ebbed and flowed with changing prospects for a Vietnam agreement. The financing results, summarized below, indicated a satisfactory market response to the offering.

BANK RESERVES AND THE MONEY MARKET

The tone of the money market was generally firm during October despite intermittent periods of relatively comfortable conditions. Member banks made additional progress toward a more economical management of reserve positions following the inauguration during September of the new reserve-accounting procedure for all member banks.¹ Under these rules, the reserve city banks followed a pattern of building up large excess reserve positions during alternate weeks and carrying the excess over to intervening weeks in which deficiency positions were maintained. Consequently, pressures on the money market tended to increase during settlement periods when excess reserve positions were built up and to diminish when the excess was carried over to the subsequent period. This effect became especially pronounced during the latter half of October.

On a nationwide basis, excess reserves of all member banks averaged only \$241 million during the five statement weeks ended on October 30 (see Table I), compared with \$332 million during the four weeks in September. Member bank borrowings at the Federal Reserve Banks showed little change, declining by \$34 million on average during the five statement weeks to \$458 million. Largely in reflection of the decline in average excess reserves, net borrowed reserves averaged \$217 million for the five weeks, compared with \$160 million during the four weeks ended in September.²

Firm conditions prevailed in the money market at the

¹ Required reserves are now computed on the basis of average deposits held two weeks prior to the current statement week, and the vault cash component of total reserves is calculated with the same two-week lag. Moreover, reserve excesses or deficiencies up to a limit of 2 per cent of average required reserves may be carried over to the next settlement period. For further details of the new reserve-accounting procedures, see this *Review* (October 1968), page 212.

² Data cited above for excess reserves and net borrowed reserves do not include the carry-over of excess reserves or deficiencies.

Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, OCTOBER 1968

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

Factors	Changes in daily averages— week ended on					Net changes
	Oct. 2	Oct. 9	Oct. 16	Oct. 23	Oct. 30	
	"Market" factors					
Member bank required reserves	- 342	- 280	- 328	+ 181	+ 108	- 711
Operating transactions (subtotal)	- 579	+ 55	- 98	- 65	- 35	- 720
Federal Reserve float	- 392	+ 126	+ 59	+ 183	- 486	- 610
Treasury operations*	- 330	+ 143	+ 103	- 60	- 51	- 185
Gold and foreign account... ..	- 22	- 11	+ 24	+ 1	+ 4	- 4
Currency outside banks	+ 206	- 174	- 272	- 359	+ 482	- 117
Other Federal Reserve accounts (net)†	- 40	- 31	- 13	+ 162	+ 17	+ 96
Total "market" factors ...	- 921	- 225	- 426	+ 88	+ 73	- 1,431
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities	+ 985	+ 234	+ 334	- 165	+ 113	+ 1,501
Bankers' acceptances	-	+ 4	+ 2	+ 2	- 1	+ 7
Repurchase agreements:						
Government securities	+ 63	- 63	+ 96	- 46	+ 7	+ 57
Bankers' acceptances	+ 5	- 5	+ 51	- 49	- 2	-
Federal agency obligations	+ 1	- 1	+ 3	+ 4	- 7	-
Member bank borrowings	+ 65	- 158	+ 116	- 183	+ 162	+ 22
Other loans, discounts, and advances	-	-	-	-	-	-
Total	+ 1,119	+ 30	+ 603	- 433	+ 272	+ 1,566
Excess reserves	+ 198	- 195	+ 177	- 370	+ 345	+ 155

Member bank:	Daily average levels					
	Oct. 2	Oct. 9	Oct. 16	Oct. 23	Oct. 30	
Total reserves, including vault cash	26,370	26,455	26,960	26,459	26,696	26,588‡
Required reserves	26,000	26,280	26,608	26,477	26,369	26,347‡
Excess reserves	370	175	352	- 18	327	241‡
Borrowings	540	402	518	355	497	458‡
Free (+) or net borrowed (-) reserves	- 170	- 227	- 166	- 353	- 170	- 217‡
Nonborrowed reserves	25,830	26,053	26,442	26,124	26,199	26,130‡
Net carry-over, excess or deficit(-)§	61	160	78	172	2	95‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					
	Oct. 2	Oct. 9	Oct. 16	Oct. 23	Oct. 30	
Less than one year	+ 975	- 630	+ 803	+ 415	- 263	+ 1,300
More than one year	- 227	+ 83	-	-	-	- 144
Total	+ 748	- 547	+ 803	+ 415	- 263	+ 1,156

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ Average of five weeks ended on October 30, 1968.
§ Not included in average levels of excess or free reserves.

Table II
RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS
OCTOBER 1968

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on					Averages of five weeks ended on Oct. 30
	Oct. 2	Oct. 9	Oct. 16	Oct. 23	Oct. 30	
Eight banks in New York City						
Reserve excess or deficiency(-)*	64	- 43	52	- 48	7	6
Less borrowings from Reserve Banks	150	60	161	21	12	81
Less net interbank Federal funds purchases or sales(-)	1,493	1,786	1,813	952	609	1,331
Gross purchases	1,871	2,167	2,245	1,710	1,599	1,918
Gross sales	378	382	432	758	990	588
Equals net basic reserve surplus or deficit(-)	- 1,379	- 1,889	- 1,922	- 1,021	- 614	- 1,405
Net loans to Government securities dealers	1,189	901	652	642	760	829
Net carry-over, excess or deficit(-)†	5	53	8	48	- 2	22
Thirty-eight banks outside New York City						
Reserve excess or deficiency(-)*	30	- 14	46	- 75	74	12
Less borrowings from Reserve Banks	29	117	115	81	100	88
Less net interbank Federal funds purchases or sales(-)	1,071	2,043	1,883	1,724	1,426	1,629
Gross purchases	2,468	3,325	3,093	2,818	2,682	2,877
Gross sales	1,397	1,282	1,210	1,094	1,256	1,248
Equals net basic reserve surplus or deficit(-)	- 1,070	- 2,174	- 1,952	- 1,880	- 1,452	- 1,706
Net loans to Government securities dealers	1,013	1,342	756	624	580	863
Net carry-over, excess or deficit(-)†	14	20	10	36	- 33	9

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after certain adjustments not applicable to the reporting period less required reserves.
† Not reflected in data above.

Table III
AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—October 1968			
	Oct. 7	Oct. 14	Oct. 21	Oct. 28
Three-month	5.277	5.345	5.396	5.471
Six-month	5.362	5.428	5.457	5.473
Monthly auction dates—August-October 1968				
	Aug. 27	Sept. 24	Oct. 24	
Nine-month	5.245	5.202	5.446	
One-year	5.151	5.108	5.401	

* 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.

beginning of the month. In the statement week ended on October 2, Federal funds traded primarily at 6 per cent, while both reserve city and "country" banks accumulated excess reserves. During the next two statement periods, the major New York City banks labored under the pressure of record basic reserve deficits that averaged \$1.9 billion, compared with \$1.3 billion during the four statement periods in September. Reserves released as a result of a sharp curtailment of lending to securities dealers were more than absorbed by current declines in demand deposits and higher required reserves which, under the new lagged reserve-accounting procedures, reflected a buildup of deposits in the latter half of September. Banks in money centers outside New York City were also under reserve pressure as evidenced by an average basic reserve deficit of \$2.1 billion at a group of thirty-eight major banks. All reserve city banks, which had carried over a sizable reserve surplus from the previous week, had a deficit reserve position on average in the week ended on October 9, and the Federal funds rate eased slightly to a 5¾ to 6 per cent range. Money market conditions grew tighter in the following week, when the reserve city banks accumulated excess reserve positions and Federal funds traded predominantly in a 6 to 6⅛ per cent range.

After midmonth, a decline in loans and investments at the major New York City banks, coupled with gains in time deposits and Euro-dollar balances, resulted in a sharp improvement in their basic reserve position. These reserve gains, combined with the carry-over of excess reserves from the preceding week, contributed to reduced pressure in the money market during the October 23 statement period. The predominant rate on Federal funds generally eased to a 5¾ to 5⅞ per cent range, and member banks ended the week with a reserve deficiency averaging \$18 million, not including a carry-over excess of \$172 million from the preceding week. The basic reserve positions of money market banks eased further in the week ended on October 30 (see Table II), as gains in demand deposits and repurchase agreements against securities exceeded the growth in credit outstanding. Both reserve city and country banks, however, accumulated excess reserves during the week, and money market conditions firmed somewhat, with Federal funds trading generally in a 5⅞ to 6 per cent range.

Commercial paper dealers increased their offering rate for prime four- to six-month paper from 5¾ per cent to 5⅞ per cent on October 18. In the course of the month, direct issuers raised rates for some selected shorter maturities by ¼ percentage point to 5¾ per cent. Rates for bankers' acceptances edged ¼ percentage point higher in two steps during the first half of the month. Most deal-

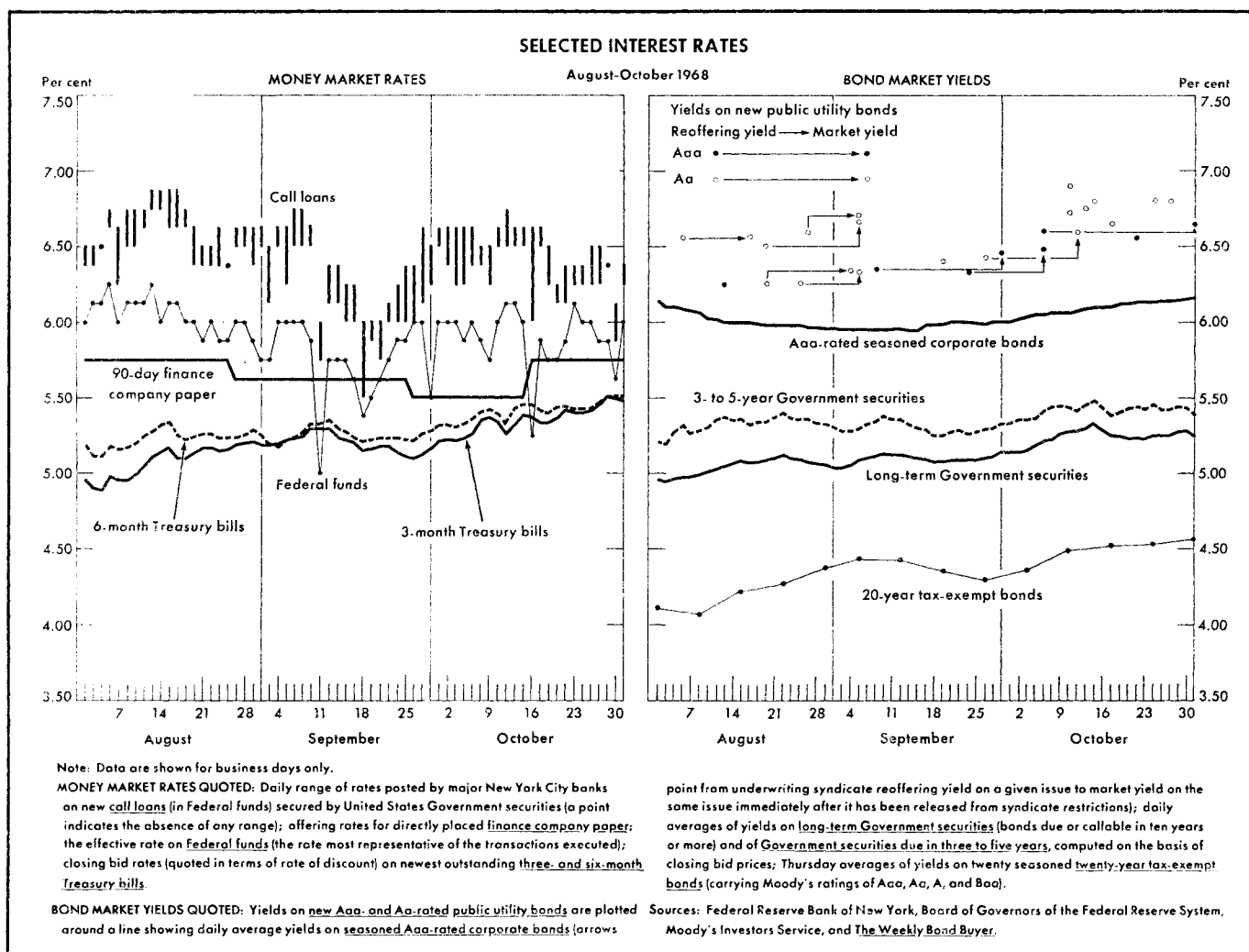
ers quoted ninety-day unendorsed paper at 6 per cent bid (5⅞ per cent offered) at the month's end. Posted rates for three-month negotiable certificates of deposit (C/D's) rose to 5¾ per cent at most major New York City banks, and a few banks posted 6 per cent by the end of the month. The volume of outstanding C/D's at the weekly reporting banks in New York City expanded to \$7.0 billion on October 30, an increase of \$513 million from September 25. In contrast, a decline of \$81 million had occurred in September. Liabilities of United States banks to their foreign branches declined by \$31 million during the five weeks ended on October 30, compared with a rise of \$95 million during the previous four weeks.

THE GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds generally moved lower in the first half of the month in a climate of increasing caution regarding the outlook for monetary policy and interest rates. The coupon sector was also adversely affected by the firm conditions prevailing in the money market, the heavy tone evident in the markets for corporate and tax-exempt bonds, and the apparent growing investor enchantment with equities. Government securities dealers marked prices progressively lower as they attempted to reduce their sizable inventories prior to the Treasury's November refunding operation. Prices of most coupon issues declined during the first half of the month by from ½ to as much as 2½ points, with the largest losses recorded at the longer end of the maturity spectrum. (Associated yield increases are illustrated in the right-hand panel of the chart.)

A more favorable climate emerged in the Government coupon sector when reports began to circulate that a breakthrough in the Vietnam peace negotiations might be imminent. Prices of Treasury notes and bonds rallied sharply on October 16 and 17, and demand from professional sources expanded substantially. As the month progressed, activity subsided again when the outlook for a quick Vietnam settlement dimmed somewhat. The stronger than expected expansion in GNP during the third quarter, which was reported at midmonth and had temporarily been overlooked by the coupon sector in the flurry of market activity, also influenced market sentiment as participants awaited the terms of the Treasury's November refunding.

The Treasury announced on October 23 that it would offer holders of \$11.9 billion of notes and bonds maturing in November and December the opportunity to exchange these securities either for a new issue of the 5⅞ per cent note, maturing in May 1970 and priced at a discount to



yield about 5.73 per cent, or for an additional amount of the outstanding 5¾ per cent note of November 1974 at par. Private investors held approximately \$5.6 billion of the eligible maturing issues. Market observers generally considered the Treasury's terms to be relatively attractive, although there was some surprise at the inclusion of an intermediate-term issue in the exchange. The market response was also influenced by the reiteration of official forecasts of an appreciably lower Federal budget deficit for fiscal 1969, as well as by the prediction that the Treasury would not have to raise net new cash over the balance of calendar 1968. Late in the month, a more cautious tone reappeared in the coupon sector, largely in reflection of renewed uncertainty about the Vietnam outlook. The month closed on a stronger note,

however, when reports again circulated that a United States bombing halt was imminent. In fact, on the evening of October 31, the President announced that the bombing of North Vietnam would cease on November 1.

On November 1, the Treasury released the preliminary results of its refunding operation. Approximately 84.5 per cent of the \$11.9 billion of November and December maturities eligible for exchange was converted into the two note issues offered by the Treasury. Subscriptions totaled \$7.8 billion for the new 5½ per cent note of 1970 and \$2.3 billion for the reopened 5¾ per cent note of 1974. Approximately 66 per cent of the eligible maturing issues held outside the Federal Reserve Banks and Government accounts was exchanged, including \$2.9 billion of November maturities and \$0.8 billion of December maturities.

In the market for Government agency obligations, prices generally eased in the first half of the month, primarily in reflection of the prevailing weakness in other capital market sectors. Several large agency issues were floated during this period, including offerings amounting to \$1.1 billion—of which about \$400 million provided new money—from the Federal Home Loan Banks, the Federal land banks, and the Export-Import Bank. These issues were initially accorded mixed receptions by investors. Demand expanded, however, as a better tone emerged in the agency market during the second half of the month in response to the widespread speculation about progress in the Vietnam peace negotiations. In the improved atmosphere, offerings from the Banks for Cooperatives and the Federal intermediate credit banks were well received.

A heavy atmosphere pervaded the Treasury bill market during the early part of October. As in other sectors, widespread uncertainty over the near-term outlook for monetary policy and interest rates set the tone. Moreover, as firm conditions prevailed in the money market and rates posted by the major city banks on call loans to Government securities dealers remained in a high range, dealers became restive and attempted to reduce their inventories. Selling pressure from professional sources was also prompted by expectations that the Treasury would soon announce a special bill offering. Against this background, and in the face of quite limited investment demand and some investor selling, bill rates generally moved higher through October 9 (see chart). Over the next few days, however, demand expanded and the tone of the bill sector improved briefly. A factor in this development was the favorable response of market participants to the Treasury's announcement on October 10 that it would raise only \$3 billion of new cash through the sale of June 1969 tax anticipation bills to be auctioned on October 17 and issued on October 24. The size of the offering was smaller than had been anticipated by many observers and, in response to this news as well as to expanded investment demand, bill rates declined on October 10 and 11.

Subsequently, concern over the prospective course of monetary policy once more emerged as a significant restraining factor in the market. Rates again began to edge upward toward midmonth in quiet trading. Then, as the possibility of progress in the Vietnam peace negotiations came increasingly to the forefront, demand for Treasury bills expanded moderately and rates stabilized. At the October 17 auction of the new tax anticipation bills, good interest was evident on the part of commercial banks, which were attracted by the allowance for full payment

in the form of credits to Tax and Loan Accounts and the two-week delay in providing required reserves against these deposits. The bills were sold at an average rate of 5.178 per cent, 22 basis points below the average rate on a comparable offering in July.

Rates for outstanding bills rose irregularly during the remainder of the month. At the regular monthly auction of nine- and twelve-month bills held on October 24, average issuing rates were set at 5.446 per cent and 5.401 per cent, respectively, 24 and 29 basis points above average rates established a month earlier (see Table III). At the final regular weekly auction of the month held on October 28, average issuing rates for the new three- and six-month bills were 5.471 per cent and 5.473 per cent, respectively, 29 and 19 basis points above average issuing rates at the comparable auction held in late September.

OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices declined on a broad front during the first half of October. The heavy volume of new flotations in these markets was a major source of pressure. Although new issues were offered at progressively higher yields, considerable investor resistance was encountered. As dealer inventories of unsold offerings expanded and the calendar of scheduled flotations gave no indication of significant respite in the future, syndicate price restrictions were terminated on several slow-moving recent offerings, triggering upward yield adjustments of as much as 70 basis points in the tax-exempt sector and 40 basis points in the corporate bond sector. Concurrently, seasoned bond yields also moved higher. *The Weekly Bond Buyer's* index for twenty-year tax-exempt bonds soared from 4.30 per cent in late September to 4.51 per cent in mid-October, while Moody's index for seasoned Aaa-rated corporate bonds rose during the first half of October by 10 basis points to 6.10 per cent.

As the month progressed and bond yields reached more attractive levels, investor interest gradually revived. Nevertheless, the major forward impetus emerged only when hopes that some progress might have been made in the Vietnam peace negotiations generated a much more optimistic tone throughout the capital markets. Consequently, new offerings marketed around midmonth were for the most part accorded more favorable receptions, dealers were able to make substantial sales out of their inventories, and the technical position of both the corporate and tax-exempt sectors improved considerably. Investor demand contracted, however, when underwriters attempted to lead to lower yield levels. As the month

drew to a close, market participants again adopted an attitude of caution and the market tone deteriorated somewhat.

At the end of October, *The Weekly Bond Buyer's* yield index of twenty seasoned tax-exempt issues was quoted at 4.56 per cent, 26 basis points higher than a month earlier,

while Moody's index for seasoned Aaa-rated corporate bonds, at 6.16 per cent, was 16 basis points higher than a month earlier. The Blue List of advertised dealer inventories of tax-exempt securities totaled \$876 million at the end of the month, a new high for the year and well above the \$695 million on the first day of the month.

Banking and Monetary Developments in the Third Quarter of 1968

The growth of total bank credit and total deposit liabilities accelerated in the third quarter. Reserve pressures eased slightly during the period, banks' large-denomination certificates of deposit (C/D's) once again became competitive in the market for short-term funds, and overall credit demands in the economy remained strong. The Federal Reserve System in July moved through open market operations to accommodate tendencies toward less firm conditions in the money market, and then in the final two weeks of August each of the twelve Reserve Banks lowered its discount rate by $\frac{1}{4}$ percentage point to $5\frac{1}{4}$ per cent. This latter action was designed to bring the discount rate into better alignment with the reduced level of short-term rates that had already emerged, largely as a result of passage of the tax surcharge and the companion program of Federal spending restraint.

The decline of short-term interest rates gave banks renewed market competitiveness under the Regulation Q ceiling rates for large C/D's established last April. In this environment, banks were able to sell new large C/D's at declining interest rates to recoup deposit losses suffered earlier in the year, to replenish their depleted holdings of liquid investments, and to meet the strong credit demands of a still rapidly expanding economy. Indeed, the growth of large C/D's was the major factor in the stepped-up growth of banks' deposit liabilities to private holders during the third quarter, although consumer-type time deposits also grew substantially. Privately held demand deposits, on the other hand, expanded at a rate well under half the second-quarter pace. The sharp reduction in the growth rate of such deposits was reflected in a marked

slowing of money supply growth, as the rise in currency in circulation outside banks—the other component of the money supply—also moderated.

INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

Short-term market rates of interest declined considerably in the third quarter, with the bulk of the downward adjustment taking place from mid-June to early August. Thereafter, many short- and intermediate-term rates drifted up again, but most closed the quarter at levels significantly below those which had prevailed at the opening of the period. The steep downward adjustment from mid-June to early August reflected passage of the fiscal restraint program and widespread belief that monetary policy would have to ease to prevent undue restraint on the economy. The subsequent upturn of rates was associated with a growing recognition in the markets that the economy was continuing to expand strongly and that monetary policy might therefore be unlikely to ease substantially. In mid-July the Federal Reserve System began conducting open market operations with a view toward accommodating the slightly easier money market conditions that had already developed. Then, beginning with an action on August 16 by the Federal Reserve Bank of Minneapolis, the discount rate was lowered by $\frac{1}{4}$ percentage point to $5\frac{1}{4}$ per cent in a technical move designed to align the rate with the reduced rates already prevailing on other money market instruments. Over the ensuing two weeks the other Reserve Banks followed suit.

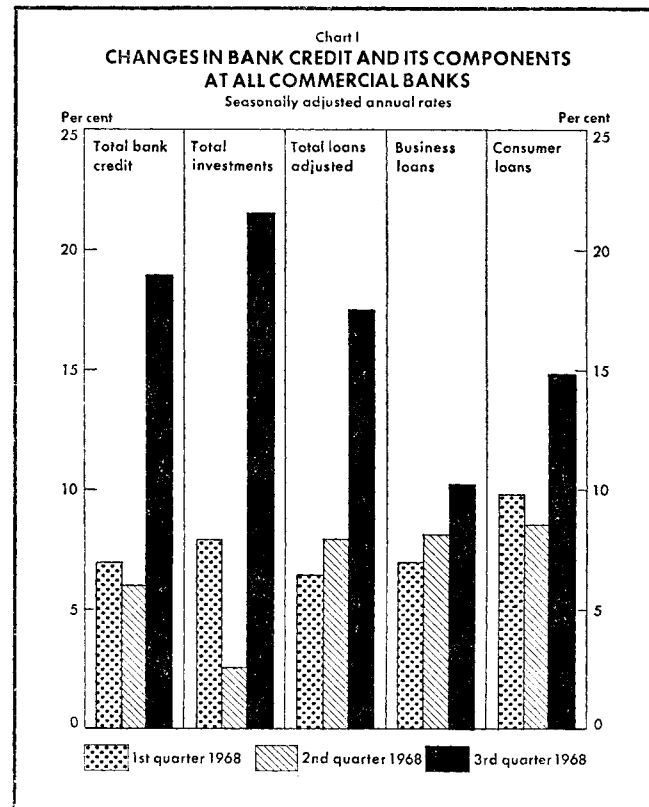
The Federal Reserve Banks of Atlanta, San Francisco, St. Louis, and New York were the last to act, lowering their rate on August 30. Another major interest rate development was a reduction late in the quarter in the commercial bank prime rate. While a few smaller banks had lowered their prime rate around mid-September, the first action by a major money market bank was a ½ percentage point reduction (to 6 per cent) by a New York City bank on September 24. Over the next few days other major banks around the country also reduced their prime rate, but by ¼ percentage point to 6¼ per cent.

Member bank borrowings at the "discount window" declined in the third quarter, while the level of required reserves advanced sharply. Borrowings declined from an average level of about \$700 million in the second quarter of the year to \$535 million in the third quarter. Since excess reserves contracted only slightly, net borrowed reserves fell from the second-quarter level of \$360 million to a third-quarter average of \$210 million. With the lessening of reserve pressures and the discount rate cut, the Federal funds rate eased over the quarter from an average of 6.07 per cent in June to 5.78 per cent in September. September saw wide fluctuations in the Federal funds rate, however, as banks sought to adjust to the new reserve-accounting procedures.¹

BANK CREDIT

The growth of total bank credit accelerated substantially in the third quarter of 1968 (see Chart I). Commercial bank holdings of loans and investments expanded over the quarter at a seasonally adjusted annual rate of 19 per cent, more than three times the rate of gain during the second quarter of the year. Close to two fifths of the \$17.0 billion advance in total bank credit was accounted for by a step-up in acquisitions of investments. Banks were heavy purchasers of Treasury issues, including those offered in the July and August financings, and also acquired a sizable share of the large flow of new tax-exempt securi-

¹ Under the new procedures, which took effect in the statement week ended on September 18, member bank required reserves in a given week are based on average deposits two weeks earlier, rather than on current deposits, and the vault cash component of banks' reserves is also that amount held two weeks earlier. Moreover, banks now carry over from the previous statement week daily average reserve excesses or deficiencies of up to 2 per cent of their average required reserves. The new procedures require that all member banks settle their daily average reserve requirements on a weekly basis; previously, a two-week settlement period had applied to "country" banks.



ties issues available throughout the period. Commercial banks increased their holdings of United States Government securities in the third quarter by \$3½ billion, seasonally adjusted, in sharp contrast to a decline of \$1 billion over the preceding nine months. Holdings of "other securities"—mainly tax-exempt obligations of states and municipalities—also moved up sharply in the July-September period, by \$3 billion seasonally adjusted. In the second quarter, holdings of other securities had remained virtually unchanged when banks came under heavy pressure from losses of large C/D's.

Liquidity rebuilding, facilitated by renewed ability to attract funds through large-denomination C/D's, was undoubtedly a principal reason for the sharp gains in bank investments during the third quarter. But banks may also have been influenced by changing interest rate expectations in the financial community at large. As the third quarter opened, the fiscal restraint legislation—comprising the tax surcharge and a cutback in Federal spending—was just going into effect. Rates on most money market instruments were declining, and there was widespread discussion of prospects for further significant declines. A near-term

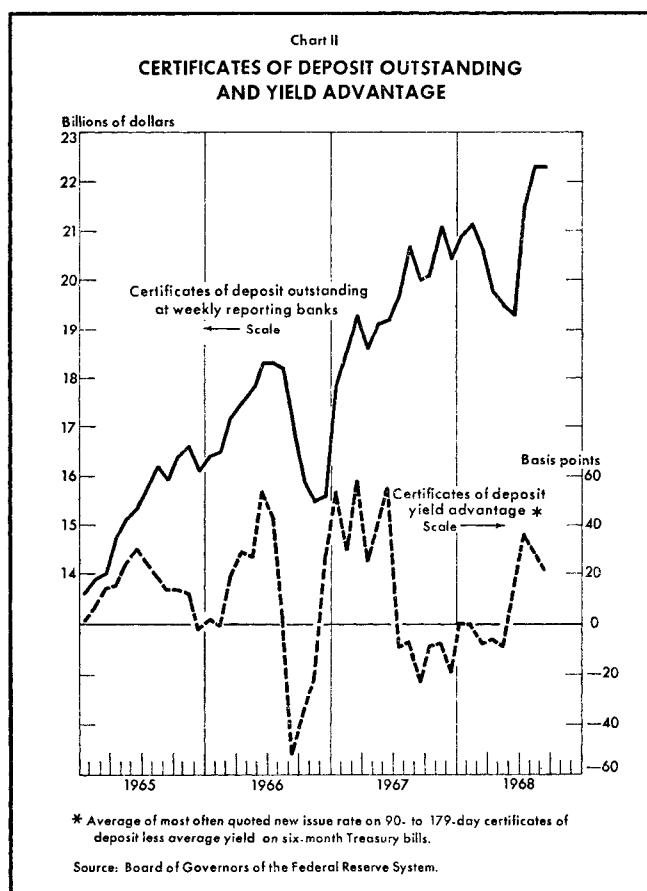
slowdown in economic activity was widely expected, and this in turn was thought likely to result in a significant easing of monetary policy.

Against this background, not only banks, but also Government securities dealers, began to add aggressively to their inventories of Treasury obligations. Dealers attempted to cut back on their inventories after early August, as further interest rate declines failed to materialize, but their average holdings in September remained nearly \$2 billion higher than in June. Reflecting the heavy financing requirements of their positions, borrowing at banks by United States Government securities dealers showed a sharp advance over the quarter, following a decline in the first half of the year. Loans to stock market brokers and dealers were also quite strong, no doubt in some measure because of the continuing high level of stock market trading. As a consequence of these heavy demands, total securities loans spurted in the third quarter by close to \$4 billion, seasonally adjusted, following a decline in each of the previous three quarters.

Loans other than securities loans strengthened in the third quarter, advancing at a seasonally adjusted annual rate of 11½ per cent, compared with 9 per cent in the April-June period. Business loans expanded at a rate of just under 10½ per cent, or somewhat more rapidly than in the second quarter, although the rate of expansion moderated substantially as the quarter progressed. The August-September moderation in the growth rate of commercial bank business loans can be related in part to reduced demands stemming from the slowdown in the rate of business inventory accumulation and in part to increasing competition from the commercial paper market. Business inventories, as measured in the GNP accounts, increased in the third quarter by an estimated \$7.7 billion (seasonally adjusted annual rate), down from a \$10.8 billion rate of accumulation in the second quarter. At the same time, borrowing costs in the commercial paper market moved lower throughout the quarter. Before the ¼ percentage point reduction in the commercial bank prime loan rate in late September, commercial paper rates were about 75 basis points lower than the prime rate.

Bank lending to consumers accelerated sharply in the third quarter. Consumer loans outstanding at banks increased at a seasonally adjusted annual rate of 15 per cent, compared with 8½ per cent in the preceding three months. Total consumer indebtedness to banks and other lenders expanded sharply in each month of the quarter as consumers relied heavily on credit to increase their spending. Despite the income tax surcharge, which cut significantly into the rate of growth of disposable income, personal consumption expenditures accelerated sharply in the third quarter, with spending on both durables and nondurables showing impressive advances.² The strong credit demands stemming from the consumer sector also affected banks indirectly by giving rise, in the final two months of the quarter, to increased loan demand by nonbank financial institutions. The major borrowers in this category are sales and personal finance companies, and in the third quarter they not only stepped up their borrowing from commercial banks but also relied heavily on placing their own paper in the open market.

The third-quarter rate of growth of real estate loans was about unchanged from that of the second quarter. There was a marked strengthening in such loans in September, however, perhaps reflecting the sharp nationwide



² For a more detailed discussion of third-quarter income and product developments, see "The Business Situation", this Review, pages 226-29.

increase in housing starts as well as the increased attractiveness of such loans under the higher usury law ceilings established during the summer in several populous Eastern states.

Since almost two thirds of banks' large inflows of funds during the third quarter was placed in investments and in loans to brokers and dealers, their loan-deposit ratios³ declined over the quarter. The ratio for all commercial banks in the aggregate fell from the very high June level of 65.4 per cent to 64.2 per cent at the end of September. As noted earlier, the major source of new funds for banks was a sharp increase in large C/D's made possible by declining rates on competing short-term instruments (see Chart II on page 237). The large New York City banks, however, did not build up their C/D's as rapidly as did the other banks, relying instead on large borrowings of Euro-dollars through their own foreign branches. As a result, these banks were able to increase their outstanding loans relative to their deposit liabilities. Thus, the loan-deposit ratio at large weekly reporting banks in New York climbed further in the third quarter, from an average of 80.0 per cent in June to 80.5 per cent in September. However, when their Euro-dollar balances are counted as deposits in the computation of the loan-deposit ratio, these New York City banks showed a decline of about the same magnitude as at all commercial banks.

MONEY SUPPLY AND TIME DEPOSITS

The money supply—privately held demand deposits plus currency in circulation outside banks—grew at a seasonally adjusted annual rate of 4½ per cent in the third quarter, down substantially from the 8½ per cent rate in the second quarter. For the latest quarter as a whole, the slowing in money stock growth probably reflected somewhat reduced needs for transactions balances as the pace of stock market activity moderated slightly, coupled with a flow of deposits from the private sector into the Treasury. Within the quarter there was considerable variation in month-to-month movements in the money stock. In July, a very rapid increase in privately held demand deposits pushed money supply growth to a rate of just under 13 per cent. The run-up in deposits reflected, on the one hand, the continuing high level of economic and financial activity, and sharp declines in Treasury deposits at commercial

banks, on the other. However, money supply growth moderated substantially in August, to a rate of 5½ per cent per annum, and in September the money stock actually declined. The August-September slowdown centered in private demand deposits, as the large Treasury financing in August and the increased tax collections in September drew funds out of the private sector.

Time and savings deposits at commercial banks expanded in the third quarter at a very rapid seasonally adjusted annual rate of 18 per cent, in marked contrast to the sluggish 5 per cent growth rate recorded in the first half of the year. The time deposit strength was attributable to heavy inflows of funds in the form of large C/D's and consumer-type deposits. Throughout much of the second quarter, maximum offering rates on large C/D's had been limited by Regulation Q ceilings to levels generally lower than those on competing money market instruments. Toward the end of that quarter, however, short-term market rates began to decline and the competitive position of C/D's improved. In July, market rates dropped sharply and banks were able to move their offering rates below the Regulation Q ceilings and still attract a large volume of funds. At weekly reporting banks alone, the volume of large C/D's outstanding climbed in July by \$2.2 billion, more than offsetting the second-quarter loss of \$1.3 billion. In August and September, New York City banks turned to Euro-dollars as a source of funds, but banks outside New York City continued to issue C/D's in substantial amounts. Thus, by the end of the quarter, large C/D's outstanding at weekly reporting banks were \$3 billion above the level at the end of June. The other major factor accounting for the third quarter's rapid time deposit growth was the surprising strength in consumer-type time deposits. While passbook savings accounts continued to show weakness, time certificates and open account time deposits grew at an increased pace. There are no data available on these deposits at all commercial banks, but weekly reporting bank figures—which are not adjusted for seasonal variation—show a third-quarter rise in consumer-type deposits of \$1.8 billion, compared with a second-quarter gain of \$0.8 billion.

THRIFT INSTITUTIONS

Flows of savings into thrift institutions slowed further in the third quarter of the year. The reduced inflows to thrift institutions occurred despite a substantial narrowing of spreads between rates at these institutions and yields on competing money market instruments, suggesting that the third quarter's large cutback in consumer saving out of disposable income may have had some effect in this

³ The loan-deposit ratio is here defined as loans adjusted less loans to brokers and dealers, expressed as a percentage of total deposits less cash items in the process of collection.

area. Share capital at savings and loan associations increased at a seasonally adjusted rate of 5½ per cent, down only slightly from the second-quarter increase. On the other hand, the growth of deposits at mutual savings banks dropped in the third quarter to 6 per cent, a marked slowing from the second-quarter rate of 7½ per cent.

The thrift institutions cut back on their net acquisitions of mortgages during the third quarter, in line with their somewhat slowed deposit inflows. Savings and loan associations added to their mortgage portfolios at a 6½ per cent annual rate in the third quarter, down from just over

7 per cent in the second quarter, while mutual savings banks curtailed their new mortgage lending more strongly, from an annual rate of 6 per cent in the second quarter to 4½ per cent in the third. A large proportion of the savings banks' net inflows continued to be invested in corporate bonds. Apparently the substantial increases in residential mortgage rates, subsequent to the liberalization of usury law ceilings in several states where mutual savings banks are important lenders, came too late to affect third-quarter mortgage loan disbursements by the savings banks.

Per Jacobsson Foundation Lecture

The Per Jacobsson Foundation in Washington, D. C., has made available to the Federal Reserve Bank of New York a limited number of copies of the 1968 lecture on international monetary affairs. In sponsoring and publishing annual lectures on this topic by recognized authorities, the Foundation continues to honor the late Managing Director of the International Monetary Fund.

The fifth lecture in this series was held on May 16, 1968 in Stockholm, Sweden. Dr. M. W. Holtrop, former President of De Nederlandsche Bank, spoke on "Central Banking and Economic Integration". Supplementary comments were made by The Earl of Cromer, Managing Director of Baring Brothers & Co., Limited.

In consideration of this Bank's support of the Foundation's aims, we will make copies of the lecture available without charge to the many readers of this *Review* who have an interest in international monetary affairs.

Requests should be addressed to the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045. French and Spanish versions of the lecture are also available.