

# FEDERAL RESERVE BANK OF NEW YORK



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## **America's Role in Making the World Financial System Work\***

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It is a privilege to address this influential and well-informed gathering, and I find it especially gratifying to return here because of pleasant memories of my service as a panel member of this international finance session on several occasions many years ago. At a time like the present, with a change of national administration in the offing, it would seem useful to take stock briefly of where the United States economy stands and where it seems to be heading, and to see how it fits into the current world financial picture. I have no thought of presenting a detailed economic analysis but would merely like to underline a few of the major facts and problems that seem important to me. Because this gathering has a broad world outlook, I shall talk principally about the international aspects of our economic position, but inevitably the international and the domestic aspects are closely interwoven.

As we survey the international financial scene, I think we can find some cause for satisfaction in the resiliency of the world financial system itself and the remarkable growth of central bank cooperation. We have come through a twelve-month period during which the world financial structure has been subjected to extreme strains, including the devaluation of sterling, tremendous speculation in the foreign exchange and private gold markets, and major civil disorders in France. Not only has the structure survived, but world trade has continued to expand, and international investment flows have reached new peaks despite numerous artificial barriers placed in their way. The dollar has been faring better in the exchange markets than in a good many years.

The fact that the present system, based on fixed ex-

change rates clustered around the centerpiece of the \$35 gold price, has not only served the world well for more than twenty years but has withstood the shocks of the past year is testimony to its fundamental soundness and adaptability to changing circumstances. In the light of this record, we should think more than twice before subjecting this system to radical revisions. Fortunately, we hear less these days than we did a while ago about the alleged benefits of a higher gold price or the demonetization of gold. On the other hand, exchange rate flexibility has recently received renewed attention from some quarters. For the most part, suggestions for radical change in the system of fixed exchange rates have come from those not closely associated with the workings of the market itself. Certainly the burden of proof is on the proponents of such change, and there has been no support for these suggestions from the major monetary authorities.

Now, my comments so far might prompt the hasty conclusion that all goes well with the dollar and that the future should give us little cause for worry. Unfortunately, such a conclusion would be entirely false. The underlying tendencies in the United States balance of payments justify continuing concern. For years the persistent United States payments deficits, together with their counterpart of persistent European surpluses, have cried aloud for effective action to bring about the necessary international adjustments. Of course there is no agreement even in academic theory as to how the adjustment burden should be apportioned between deficit and surplus countries. Still less is there agreement in practice. But I think it is obvious, especially in view of the dollar's enormous importance as a trading and reserve currency, that the responsibility for cutting our deficit to a manageable size must ultimately rest on the United States, even though the surplus countries must share in this responsibility.

Until the acceleration of the Vietnam war in 1965, our

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\* An address before the international finance session of the fifty-fifth National Foreign Trade Convention, New York City, November 18, 1968.

record was not bad. We had made considerable progress in improving our trade balance for five years or so, mainly because we had kept our costs and prices remarkably steady while many other important countries were experiencing a good deal of inflation. At the same time, we were gradually reducing our net military outlays abroad. We did have trouble on the side of capital movements, in part because the relatively easy monetary policy associated with stimulation of a lagging domestic economy kept interest rates here low in relation to the rest of the world. And to meet this problem we experimented with various monetary techniques that I need not describe here, we shifted more of the burden of stimulating business to fiscal policy in the form of important tax reductions, and we were even forced to resort to interference with the export of capital in the form of the interest equalization tax and the voluntary credit restraint program. On balance we were making painfully slow but visible progress toward equilibrium, and the rest of the world was helping us, whether actively or passively, by allowing expansionary and even inflationary policies to dominate their own economies.

The story is very different since mid-1965. I do not see how we can escape the conclusion that since that time the United States has handled its adjustment responsibility very badly. By failing to foresee the stimulative effects of a sharply stepped-up war effort and to take promptly the needed countermeasures, especially in the fiscal area, our authorities acquiesced in the development of a price-wage spiral of the classical type, where bloated demand leads to price increases and excessive wage settlements; the latter intensify the readiness of producers to raise prices, and in turn the rising cost of living gives a new impetus to rapid wage gains. The inflationary spiral has had a tremendous psychological effect that has shown up in many ways, including an upsurge in land prices as well as the rapidly growing preference of investors for equities over fixed-income securities. In all this perhaps the most ironic aspect is that in the past three years, at long last, the policies needed to meet our domestic and our international needs have converged, after many years when we had to weigh carefully domestic against international considerations. On both counts we have had every reason to counter inflation since 1965, and yet we have not succeeded in bringing it under control.

The damaging effects on our trade balance of a booming inflationary economy have been all too clear, and especially so in 1968. For years we had thought of a favorable United States trade balance of at least \$4 billion to \$6 billion as a *sine qua non* of overall payments equilibrium—an item that would go a long way toward paying for both private capital outflows and government ex-

penditures abroad. These private and official outflows have burgeoned rapidly as American industry has moved dynamically to extend its activities throughout the world and as our government has taken on ever-growing responsibilities, stemming from our political, military, and economic leadership. To see our trade surplus reduced to something like \$1 billion is a shock indeed. In fact, if one excludes government-financed exports, we have had an actual deficit on trade account in each of the past four quarters. Under other circumstances the effect on the dollar's standing in exchange markets might have been disastrous.

But this year powerful factors were working in the opposite direction. Not the least was the startling and salutary rise in foreign investment in United States equities to something approaching a \$2 billion annual rate. Undeniably inflation, by contributing to the upward movement of stock prices, was one of the reasons for this inflow, although basic faith in the American economy and superior marketability of American stocks were also of great importance. At the same time the program of restraints on United States capital outflows—voluntary in the case of banks and other financial institutions and mandatory in the case of the nonfinancial corporations—was producing big dividends in terms of our balance of payments. An unprecedented volume of offshore financing of United States direct investment was a major factor contributing to the effectiveness of the program. Also, tight money in this country combined with rather liberal credit policies in certain foreign countries—notably Germany—set the stage for a \$3 billion rise in borrowings of dollars by United States banks from their branches abroad. The events in France and Czechoslovakia, by creating new doubts as to the political stability of Europe, clearly enhanced the relative standing of the United States as a safe depository for invested funds. As a result of these and other developments, some of the important foreign central banks which customarily worry about excessive holdings of dollar resources have been hard put to find enough dollars for their minimal needs. Hence the better performance of the dollar in the exchange markets to which I referred earlier.

As we look ahead, I think we must recognize that this is not a situation that can be counted on to last. It may be true that much of the feeling about the superior safety and profit opportunities of American equities may endure indefinitely. Thanks in part to the energetic sales efforts of American financial institutions, a steadily growing number of foreign investors are becoming interested in our equity market. But, if there should be a sharp setback in American stock prices, the inflow of funds could

shrink rapidly, at least for a time. Also, it is unlikely that in the coming year United States banks will increase their net borrowings from foreign branches at anything like the rate of the past year. Nor can we expect as much benefit to our payments balance in 1969 as was the case in the past year from capital export restraints on United States banks and corporations. In this respect much of the improvement in 1968 represented a one-shot adjustment to the restraints imposed at the start of the year.

This brings us back to the key question: How are we going to make real and lasting progress toward equilibrium in the United States balance of payments? Without such progress there will be grave jeopardy to the continued functioning of an international financial system that has, on the whole, served the cause of world trade and investment better than any visible alternative. From what I have already said I am sure you can guess where I believe the main part of the answer lies. We simply must rebuild our trade surplus to at least the \$4 billion to \$6 billion range of a few years ago, and that means that we have to check, and check unmistakably, the inflationary forces and expectations that are so dominant in the economy today. There are ample reasons for doing this from a purely domestic standpoint. But the international reasons are equally compelling.

At this point I might digress for a moment to touch on some of the principal current problems of domestic economic policy. With the passage of the fiscal package in June, it was widely expected that the pace of business would be slowed very markedly and without too many months' delay. There were many economists who even feared that the slowing effect would be excessive and would send the economy into a recession by early 1969. I never espoused this view, and by the same token differed from some who believed that the tax-spending package required a deliberate and substantial easing of monetary policy. On the other hand, I was content to see market expectations last summer bring some appreciable decline of interest rates from their earlier record highs, partly because this promised some relief to the savings institutions, a consequent better flow of mortgage funds, and greater encouragement to residential construction activity. Such encouragement served as a useful form of insurance against the possibility of an unexpectedly sharp slowing of the economy.

In retrospect, I think nearly everyone underestimated the strength of the economy. Few observers guessed that consumers as a group would raise their spending rapidly in the third quarter, despite higher taxes, by saving a very much lower proportion of their after-tax income. Other sectors of the economy also turned in a somewhat stronger

performance than had been expected. The degree of restraint on total Federal spending has turned out to be rather less than hoped for. The result of all this has been that resources have been more fully used than the earlier forecasts had suggested, and so far there has been no conclusive evidence of a slowdown in the rate of increase of costs and prices. As we look back over the past six months, the rate at which bank credit has grown has, in my view, been faster than was desirable in this inflationary environment even though some of the increase could be explained by special circumstances. Although economic growth is always an important goal of national policy, under present conditions I believe we must accept a slower than normal growth rate, for some period ahead, if we are to have any hope of stopping the inflationary spiral. If we do not stop it, then growth at the excessive pace we have seen earlier this year, accompanied by sharply rising prices for goods and labor, can only prove illusory. In the long run, mounting inflation would encourage further speculative excesses, would be clearly inimical to a solution of our pressing social and economic problems, and would bring about a very sharp correction at some later date. A rational and gradual slowdown at this time would be far wiser.

Over the years there has been much discussion of the fiscal-monetary policy mix, and the possibilities for varying this blend for the purpose of dealing most effectively with both domestic and international objectives. Such efforts have occasionally met with some success. However, it has been apparent that fiscal policy is very difficult to apply in a timely way, whereas monetary policy is by nature highly flexible, although less effective than fiscal policy when massive results are needed. We should continue to try for as sound a mix as possible, and in practice I believe most of the short-run adjustments will have to be made on the monetary side. On the other hand, we must recognize that an extremely loose fiscal policy poses such difficult debt management problems that monetary policy may be very severely handicapped, as was true during much of the 1966-68 period.

One significant fiscal decision in the coming year will be whether or not to continue the 10 per cent surcharge after June 30. In the absence of developments dramatic enough to alter the whole inflationary environment, it appears to me that the surcharge may still be needed after June 30. Furthermore, even with suitable fiscal and monetary policies, we will need restraint by business and labor with respect to prices and wages. An understanding of the need for wage and price policies that are compatible with underlying productivity gains is an essential element in a concerted attack on the forces of inflation.



While appropriate monetary and fiscal policies are essential to improving our international payments position, we should also strengthen programs designed specifically to create favorable conditions for an inflow of both foreign capital and foreign tourists. The measures taken a few years ago to reduce the tax burden on foreign investors were quite useful, and I would assume that additional measures along similar lines may commend themselves to the Administration and the Congress in the future. The need for active encouragement of exports is so obvious, especially in a gathering like this, that I need do no more than touch the point.

Another very important area for possible balance-of-payments improvement has to do with curtailing government outlays abroad when this can be done without undue sacrifice of political or military objectives. The possibilities in Europe, however, look rather more limited than they did before the Czechoslovakian crisis. Of course a lasting settlement in Vietnam would bring large savings. As for economic aid, the needs are so enormous in the developing countries that there are serious risks in the cuts that have already been made in our aid program. Thus there seems to be little or no scope for further cuts in our total foreign outlays in this sector. However, balance-of-payments considerations aside, it may be hoped that multilateral aid will grow both absolutely and relatively, and this may mean greater recourse to our private capital markets and less direct government-to-government assistance.

As for the complex of voluntary and mandatory restraints on the export of American capital, there is, I fear, no easy answer. These were always intended as stopgap measures, a sort of holding action while more fundamental improvements were given time to operate. It follows, however, from the inflationary distortions in the domestic economy and their dire consequences for our trade balance that the time for getting rid of this apparatus has been further delayed. Repugnant as these restraints may be to our basic belief in the maximum freedom for international trade and investment, they are vastly preferable to the chaotic state to which the world payments system would be reduced if confidence in the dollar were to be lost. They are also vastly preferable to any reversion to protectionism, which could easily degenerate into a mutual international competition in retaliatory measures.

To those who point out that restraints on direct investment may be seriously counterproductive in the long run, I would answer that American enterprises abroad have so far, fortunately, not felt a very heavy restraint upon their activities. Gross foreign investment of such enterprises has reached a new high this year, thanks mainly to the

development of the Euro-bond market; and after all it is their gross investment, not the flow of investment funds from the United States, that will have the greatest influence on their future profits and competitive position abroad. In sum, I hope American business, finance, and government will not press for dismantling these restraints with undue haste. Despite the understandable impatience of United States banks and corporations, it might also be well to note that there is no escape from these restraints by tampering with the basic financial mechanism—the fixed \$35 gold price and a system of fixed exchange rates. In fact, such tampering would make balance-of-payments adjustment much more painful than it is now.

So far I have been speaking entirely of what we can and should do to help ourselves. I believe that the major surplus countries can do much on their side to speed the needed adjustment. Most important, perhaps, is their obligation to foster strong economic growth and to take some modest risks in weighing the dangers of inflation against those of recession. However, we certainly cannot urge that they deliberately court inflation. At present there are hopeful signs of stronger expansion in some of the leading industrial nations.

We might also expect the surplus countries to do everything that is possible to reduce trade restrictions, including nontariff barriers, and encourage capital outflows, both private and government. For the past year or so Germany has provided an outstanding example of how a country can finance a large trade surplus with long-term capital outflows.

The foreign-aid record of some European countries seems to me to leave something to be desired. The expanded program of aid by the World Bank should provide a fine opportunity for the surplus countries to contribute a larger share of the overall flow of economic aid to the less fortunate countries. And a more equitable sharing of mutual defense costs, with Europe increasing its participation, would seem essential. I hope there will be even more effort in the future than in the past to bring together the major industrial countries so that these adjustment questions may be attacked in an atmosphere of mutual understanding and cooperation.

Meanwhile I am sure that international cooperation will continue to play a big role in preserving and improving the financial mechanism that supports all of the world's trade and investment activities. I find it most heartening that the monetary authorities of the leading industrial countries are in full agreement as to the need to defend the essential elements of this mechanism. While recognizing that the new special drawing rights will play an increasingly important part in providing monetary resources

over the years, the authorities also see the need to preserve the existing role of gold and dollars as international reserves. I am glad to note that this means a general disposition to reject suggestions for radical change of the financial mechanism. It was also heartening that the principal industrial countries were able to reach agreement in Washington two months ago as to the best working relationship between the two-tier gold system and the distribution of newly mined gold.

The world has made major headway in the past decade or so in learning how to supplement owned monetary reserves with judicious use of credit to absorb payments imbalances that might otherwise have very damaging effects. First and foremost, the International Monetary Fund has grown in strength and influence, with its larger quotas and its borrowing arrangements placing it in an ever-better position to deal with relatively persistent payments swings. I would assume that both quotas and borrowing arrangements may be expanded further to meet developing needs over the coming years. Mr. Schweitzer discussed one interesting possibility at the recent Washington meeting, i.e., greater use of borrowing arrangements with individual countries to meet special needs for particular currencies.

Turning to the Federal Reserve System, I think we can look with justifiable pride on the development of the swap network, which started on a very modest scale in 1962 and has grown to its present aggregate of over \$10 billion. In recent years these swap facilities have provided an invaluable mechanism to absorb the initial shock of unusually heavy movements of funds across the exchanges, thus permitting gold to play a much less active role in

the settlement of temporary imbalances. Over the past seven years, credits extended under the swap network have amounted to more than \$15 billion. Both the Federal Reserve and our partners in this network have constantly stressed the temporary nature of these facilities. As recently as last July, all Federal Reserve borrowings under the swap lines had been fully repaid, leaving the entire facilities available on a standby basis. I should like to take this occasion to pay tribute to the splendid spirit of understanding and cooperation among central bankers that has characterized this swap development from the outset.

As we look ahead, there is ample ground for optimism on the outlook for world trade and investment, provided the major countries, including the United States, can nurture this spirit of cooperation and keep in check the ever-present forces of short-sighted nationalism. In our arrangements with other nations there must always be some willingness to compromise on what may seem at first glance to be our own best interest, in order to produce maximum benefits for the international trading and financial community as a whole. If we are to avoid resort to special treatment or protection, we must follow general fiscal and monetary policies that enable business to be vigorously competitive in markets at home and abroad. In contrast, a protective shield would, in time, leave our business firms too flabby to venture forth into the world. As I have argued throughout these remarks, our domestic and our international goals require the same policies.

No group can see the need or be more influential in pressing for the best solutions than you gentlemen who are gathered here today. I urge your wholehearted cooperation in working toward our common goals.

## The Business Situation

Current indicators of business activity remain strong on balance. On the plus side, industrial production increased in October while new orders for durable goods jumped almost 7 per cent. Nonfarm employment scored substantial gains during the month, unemployment continued at a low 3.6 per cent rate, and the volume of new housing starts and building permits, though fractionally lower than in September, remained at high levels. Also, recent surveys of business spending plans have pointed to an accelerated rate of increase in capital outlays next year. On the other hand, retail sales eased slightly again in October, and the rise in personal income was the smallest in nearly a year. Price increases have continued at an excessive pace. The rate of advance at the consumer level had moderated in August and September, but this was followed by a very sharp October increase. Moreover, industrial wholesale prices rose markedly in September and October, and advanced a bit further in November. The generally strong economic picture is reflected in continued heavy credit demands in the financial markets accompanied by higher levels of interest rates. The pressures on the financial markets were underscored in early December when most commercial banks throughout the country, faced with unexpectedly strong business loan demand and increased costs of loanable funds, raised the interest rate on prime business loans to  $6\frac{1}{2}$  per cent from  $6\frac{1}{4}$  per cent.

### OUTPUT, INVENTORIES, AND CONSTRUCTION ACTIVITY

Total industrial output rose in October for the second month in a row. The Federal Reserve Board's index of industrial production (seasonally adjusted) climbed 0.6 percentage point to 165.0 per cent of the 1957-59 average, following a 0.5 percentage point gain in September. The initial estimate of the September production index had shown a decline, but the figure has been revised upward by a full percentage point to reflect revisions in basic data on man-hours and output in selected industries—particularly nondurable materials and business equipment. Iron

and steel output rose in October, and apparently the drag on total industrial production caused by the sharp cut-back in the steel industry is over. The October index for iron and steel nevertheless was some 25 per cent below the level in early summer when users were stockpiling steel as a hedge against a possible strike. While most industry observers feel it will still be some time before the stockpiles are worn down enough to warrant a return to more normal production levels, preliminary data indicate that steel output rose substantially further in November.

The October strength in industrial production was centered in output of business equipment and consumer goods. Automotive products and some appliances, particularly television sets, contributed to advances in the consumer sector. Production of new automobiles rose to a seasonally adjusted annual rate of 9.2 million units, following a slight dip in September. Vigorous consumer and business demand has kept auto production climbing throughout most of this year, and preliminary data indicate that production held at the 9.2 million unit rate in November. Although output of business equipment advanced by about 1 per cent in October, production of defense equipment fell. Between mid-1965 and the beginning of 1968, output of defense equipment rose by 55 per cent, but there has been little further growth this year. Work stoppages in the coal industry resulted in a  $4\frac{1}{2}$  per cent decrease in mining output during October.

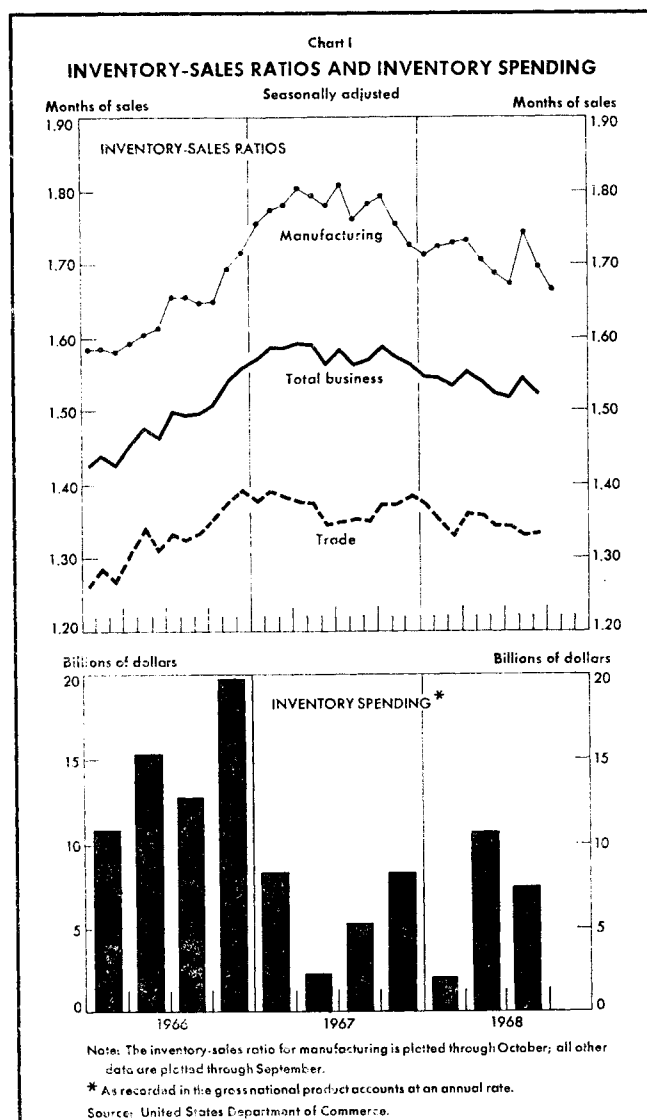
The near-term outlook for industrial production was strengthened further in October when new orders received by manufacturers of durable goods recorded a large and broadly based \$1.9 billion rise, bringing the volume of orders (seasonally adjusted) to a record \$30.3 billion. The advance followed on the heels of a strong September performance. Gains in orders were widespread among the major classes of durables manufacturers, with particularly large increases reported for machinery and equipment producers and for the defense-oriented industries. While shipments by durables manufacturers posted a sizable rise during the month, the increase was not nearly so large as the advance in orders. Thus, the backlog of unfilled orders ex-

panded by a substantial \$1.3 billion to a seasonally adjusted level of \$81.9 billion.

Total business inventory accumulation in the third quarter ran at a seasonally adjusted annual rate of \$7.5 billion, as recorded in the gross national product (GNP) accounts.<sup>1</sup> Overall, this accumulation was right in line with sales, and the inventory-sales ratio for total business was virtually unchanged over the quarter (see Chart I). At the trade level, the surge of consumer demand in July and August apparently cut into inventory accumulation over those two months. In September, however, trade inventories advanced by \$293 million, while sales by trade establishments increased only slightly. Thus, the inventory-sales ratio moved up a bit in September but remained below the July level. The large September increase in retail inventory accumulation was associated with a very strong rise in manufacturers' shipments. This shipments advance, combined with the continued working-off of steel inventories, held total inventory building in the manufacturing sector to a relatively normal \$396 million. Thus, the inventory-sales ratio declined in September, reversing much of the August increase. In October, moreover, the inventory-sales ratio in manufacturing dropped sharply further to the lowest level in two years. Total manufacturers' shipments rose in the month by a very large \$1.1 billion, with most of the gain occurring in durables manufacturing, while inventories advanced less strongly by \$500 million.

The residential construction picture remains generally good even though new housing starts and building permits both dipped in October. The volume of building permits issued by local authorities had put in a healthy performance throughout the summer and then jumped 8 per cent in September. Thus, while permits eased by about 2½ per cent in October, they remained at a high rate. Much the same trend is apparent in the considerably more erratic series on new housing starts. During the third quarter, housing starts averaged a strong annual rate of 1.55 million units (seasonally adjusted), compared with 1.44 million during the spring. Following a sizable rise in September to a rate of 1.59 million units, the starts pace moved back in October to 1.55 million units. In view of recent performance, it now seems quite likely that starts

<sup>1</sup> The Department of Commerce has revised its preliminary estimate of third-quarter GNP, which was discussed in this *Review* (November 1968). Total GNP was revised upward by a slight \$0.2 billion to a seasonally adjusted annual rate of \$871.0 billion. Among the components, most changes from the first estimate were small. The net export figure, however, was revised up by \$0.7 billion to a seasonally adjusted annual rate of \$3.3 billion.



will total more than 1.5 million units for the full year, compared with a 1967 total of 1.3 million.

#### BUSINESS INVESTMENT

Capacity utilization rates in manufacturing have weakened considerably since 1966, as expansion of facilities outstripped production growth. Not surprisingly, the volume of manufacturers' investment in plant and equipment, after adjustment for price increases, has fallen. Total capital spending by all business, on a real basis, also eased somewhat in 1967 and will increase only slightly this year, according to the survey of spending plans taken in Novem-



ber by the Department of Commerce and the Securities and Exchange Commission. In the third quarter, production declines in the steel industry and continued rapid growth of capacity caused a further easing of the capacity utilization rate, bringing it to the lowest level in five years. Nevertheless, capital spending appears to be strengthening. In manufacturing, the National Industrial Conference Board reported that net new capital appropriations rose strongly in the third quarter. Moreover, business spending plans for 1969 point to an increase of about 7 per cent in current dollar terms, according to a survey taken during the third quarter by the Lionel D. Edie Company and the more recent McGraw-Hill survey. A rise in capital outlays next year of around 7 per cent would be enough to insure a significant rate of real growth if capital goods prices continue to rise in line with recent trends. The newest Commerce-SEC survey of spending plans for the first half of next year is consistent with these earlier private surveys covering the full year. The Commerce-SEC study shows capital spending moving up sharply in the first quarter of next year and remaining at a high level in the second quarter.

The strength of capital spending in the face of relatively low utilization rates is striking in view of the current high level of interest rates and the trimming of corporate profits due to the surtax. In the third quarter, after-tax profits recorded a small \$0.3 billion increase to a seasonally adjusted annual rate of \$51.0 billion, compared with an advance of \$1.6 billion in the previous quarter. However, these presumably dampening factors have apparently been partly offset by strong expectations of sustained real growth and rising capital goods prices, both of which have made it advantageous for businesses to plan over a longer time horizon. Tight labor market conditions are probably also causing producers to try to substitute capital for labor in the production process. Businesses have been adversely affected not only by the steep climb in labor costs but also by skilled labor shortages, which in some cases have actually held capacity utilization down.

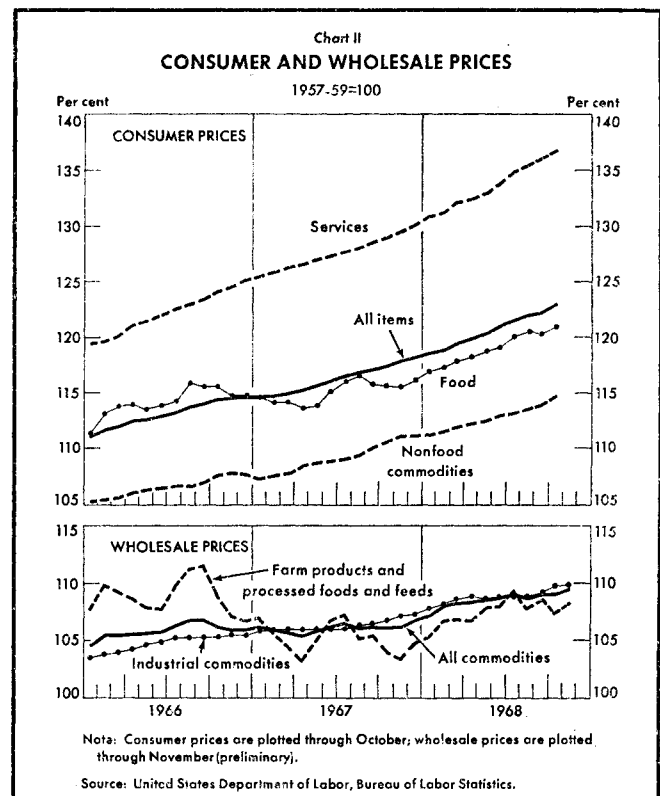
#### EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Tight conditions continued to prevail in the labor market in October. The unemployment rate remained at 3.6 per cent, and nonfarm payroll employment recorded a substantial advance despite the two-week coal strike which cut mining payrolls by about 40,000. Gains were particularly large in manufacturing, trade, and state and local government. Although the rise in nonagricultural employment was sizable, agricultural employment declined sharply in Octo-

ber and total employment was thus unchanged. Reflecting this stability, aggregate personal income in October expanded by only \$2.5 billion—about half the average monthly gain of the last year. This slowing in the rate of growth was centered in wages and salaries, which rose by \$1.4 billion, compared with an average \$3.7 billion increase in the last twelve months.

Total retail sales declined by about ½ per cent in October, following a similar drop in the previous month. The October decline was centered in automotive sales, which include dollar sales of used as well as new cars and of auto parts and repairs. On the other hand, unit sales of new cars reported by domestic manufacturers rose by 1 per cent during the month to a seasonally adjusted annual rate of 9.1 million units. The latest survey of consumer buying intentions, taken in October, suggests that consumer plans for buying new cars and other durables were virtually unchanged from those reported last July just before the increased withholding rates went into effect.

The unexpected surge in consumer spending during the third quarter was financed in large part by a record expansion of consumer credit. This trend continued in October when total consumer credit expanded almost \$1.1



billion, only slightly below the record gain posted in August. Instalment credit increased a record amount, as personal loans and loans to purchase automobiles were both particularly strong in October.

#### PRICE DEVELOPMENTS

Prices moved sharply higher in October. The consumer price index rose at an exceedingly rapid 7 per cent annual rate, to 122.9 per cent of the 1957-59 average (see Chart II). This advance followed two months of relatively small increases which had raised some hope that inflationary pressures were moderating at the consumer level. The October rise was particularly large in the indexes for medical care, apparel, household furnishings and operation, and transportation, which rose in response to higher new car prices. So far in 1968 the price rise at the consumer level has amounted to a 4.8 per cent annual rate, steeper than for any full calendar year since 1951. The picture at the wholesale level is not much better. To be sure, preliminary reports indicate that industrial wholesale prices increased only slightly in November. However, the limited size of the gain appears to have been due largely to major price cuts on selective steel products, and these cuts have since been rescinded by some major producers. Moreover, the November moderation followed a steep

climb in each of the previous two months, when prices of hides, textile products and apparel, lumber, and steel all recorded big increases. The total wholesale price index advanced 0.4 percentage point in November, as the farm products component increased sharply and the processed foods and feeds component also rose.

#### PERSPECTIVE '68

Each January this Bank publishes *Perspective*, a brief, informative review of the performance of the economy during the preceding year. This booklet is a layman's guide to the economic highlights of the year. A more comprehensive treatment is presented in our *Annual Report*, available in March.

*Perspective '68* will be available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. (A copy will be mailed with the January 1969 issue of the *Monthly Review*.) A Spanish version will also be available upon request.

## The Money and Bond Markets in November

The tone of the capital markets remained heavy in November. Interest rates generally continued to move higher in the face of persistently large credit demands and considerable investor restraint. In the early days of the month, the suspension of the bombing of North Vietnam generated some optimism in the capital markets, but the favorable market reaction was tempered by caution on the eve of the national elections. Subsequently, the uncertain status of the Vietnam peace negotiations, together with evidence of continuing economic strength and rather firm money market conditions, generated widespread caution. Large-scale speculation in the foreign exchange markets, which reflected the view that the German mark might be revalued upward and that the French franc might be devalued, was also unsettling to the domestic capital markets but only temporarily.

Against this background, yields on corporate and tax-exempt bonds and on all but the shortest maturities of Government securities rose progressively. Very firm conditions generally prevailed in the money market during the first half of the month, when the reserve positions of banks in the leading money centers came under mounting pressure. Subsequently, the tone of the market eased considerably as reserve distribution shifted in favor of banks in the major money centers. In the closing days of the month, a firm tone again predominated but no pronounced pressures were evident in the money market.

### BANK RESERVES AND THE MONEY MARKET

The basic reserve positions of banks in the leading money centers were generally under substantial pressure during the first half of November. As a result, these banks borrowed heavily in the Federal funds market—where most trading occurred in a 6 to 6½ per cent range—and filled a portion of their residual needs at the Federal Reserve “discount window”. Over the last two statement weeks of the month, the average basic reserve deficit of the forty-six major money market banks declined, while the effective rate on Federal funds eased to a predominant 5½ to 6 per cent range.

On a nationwide basis, excess reserves of all member banks averaged \$242 million during the four statement weeks ended on November 27 (see Table I), little changed from October.<sup>1</sup> Member bank borrowings from the Federal Reserve Banks rose by \$82 million on average in November.

In the first statement period of November, the basic reserve positions of the forty-six major money market banks deteriorated sharply. Reserves were absorbed in part as a result of an expansion in loans to Government securities dealers and nonbank financial institutions, while borrowings from foreign branches also contracted. As a result, the average basic reserve deficit of the forty-six leading reserve city banks soared by \$1.2 billion in the November 6 statement week to a \$3.3 billion average level (see Table II), and a substantial demand for Federal funds produced trading in volume at 6¼ per cent. At the same time, the major money market banks also increased their borrowings from the Federal Reserve Banks.

The money market remained quite firm through most of the following week. The major city banks managed their reserve positions cautiously in preparation for the Veterans Day holiday weekend. The New York City banks, which were experiencing considerable reserve pressure primarily as a result of a contraction in demand deposits and a lagged increase in required reserves, borrowed heavily at the Federal Reserve discount window over the long weekend and increased their purchases of Federal funds (then trading predominantly at 6⅞ per cent) to near-record levels. A similar pattern of behavior was evident at large banks in other money centers, which had to cover net reserve deficiencies carried over into the November 13 statement week. Toward the end of the period, however, the reserve positions of the money market banks improved somewhat, the large amount of reserves which these banks had accumulated earlier flowed into the Federal funds market, and the tone of the money

<sup>1</sup> Data cited for excess reserves do not include the carry-over of excess reserves or deficiencies.

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

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

Factors	Changes in daily averages— week ended on				Net changes
	Nov. 6	Nov. 13	Nov. 20	Nov. 27	
<b>"Market" factors</b>					
Member bank required reserves .....	+ 204	- 403	- 174	+ 336	- 37
Operating transactions (subtotal) .....	- 231	+ 39	+ 301	+ 88	+ 197
Federal Reserve float .....	- 28	+ 348	+ 636	- 410	+ 546
Treasury operations* .....	+ 30	+ 63	+ 426	- 32	+ 487
Gold and foreign account .....	+ 12	- 17	- 23	- 64	- 92
Currency outside banks .....	- 198	- 357	- 584	- 79	- 1,218
Other Federal Reserve accounts (net)† ..	- 47	+ 2	- 153	+ 673	+ 475
<b>Total "market" factors .....</b>	<b>- 27</b>	<b>- 364</b>	<b>+ 127</b>	<b>+ 424</b>	<b>+ 160</b>
<b>Direct Federal Reserve credit transactions</b>					
<b>Open market instruments</b>					
Outright holdings:					
Government securities .....	- 51	+ 261	- 53	- 557	- 400
Bankers' acceptances .....	-	+ 3	+ 3	- 1	+ 5
Repurchase agreements:					
Government securities .....	+ 31	+ 84	- 172	-	- 57
Bankers' acceptances .....	-	+ 27	- 27	-	-
Federal agency obligations .....	+ 7	+ 6	- 13	-	-
Member bank borrowings .....	- 105	+ 283	- 164	+ 71	+ 85
Other loans, discounts, and advances ..	-	-	-	-	-
<b>Total .....</b>	<b>- 117</b>	<b>+ 664</b>	<b>- 428</b>	<b>- 487</b>	<b>- 368</b>
<b>Excess reserves .....</b>	<b>- 144</b>	<b>+ 300</b>	<b>- 301</b>	<b>- 63</b>	<b>- 208</b>

Member bank:	Daily average levels				
	Nov. 6	Nov. 13	Nov. 20	Nov. 27	
Total reserves, including vault cash.....	26,348	27,051	26,924	26,525	26,712‡
Required reserves .....	26,165	26,568	26,742	26,406	26,470‡
Excess reserves .....	183	483	182	119	242‡
Borrowings .....	392	675	511	582	540‡
Free (+) or net borrowed (-) reserves ..	- 209	- 192	- 329	- 463	- 298‡
Nonborrowed reserves .....	25,956	26,376	26,412	25,943	26,172‡
Net carry-over, excess or deficit (-)§ ..	143	60	226	121	138‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels				
	Nov. 6	Nov. 13	Nov. 20	Nov. 27	
Less than one year .....	+ 88	+ 79	- 7,631	+ 823	- 6,641
More than one year .....	-	-	+ 6,294	-	1,604
<b>Total .....</b>	<b>+ 88</b>	<b>+ 79</b>	<b>- 1,337</b>	<b>+ 823</b>	<b>- 347</b>

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 four weeks ended on November 27, 1968.

§ Not included in average levels of excess or free reserves.

**Table II**  
**RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS**  
**NOVEMBER 1968**

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on Nov. 27
	Nov. 6	Nov. 13	Nov 20	Nov. 27	
Eight banks in New York City					
Reserve excess or deficiency(—)*...	24	78	78	— 63	29
Less borrowings from					
Reserve Banks	36	129	43	51	65
Less net interbank Federal funds					
purchases or sales(—) .....	1,171	1,809	1,114	312	1,102
Gross purchases .....	1,950	2,276	1,942	1,493	1,915
Gross sales .....	779	466	828	1,181	814
Equals net basic reserve surplus					
or deficit(—) .....	—1,182	—1,860	—1,079	— 426	—1,137
Net loans to Government					
securities dealers .....	886	765	579	489	680
Net carry-over, excess or deficit(—)†	9	18	44	57	32

**Thirty-eight banks outside New York City**

Reserve excess or deficiency(-)* .....	- 68	127	- 79	19	-
Less borrowings from					
Reserve Banks .....	119	242	168	154	171
Less net interbank Federal funds					
purchases or sales(-) .....	1,944	2,029	1,877	1,595	1,861
Gross purchases .....	3,112	3,309	3,122	2,867	3,102
Gross sales .....	1,167	1,280	1,246	1,272	1,241
Equals net basic reserve surplus					
or deficit(-) .....	- 2,132	- 2,144	- 2,124	- 1,730	- 2,032
Net loans to Government					
securities dealers .....	857	412	575	318	541
Net carry-over, excess or deficit(-)† ..	57	10	83	1	32

Note: Because of rounding, figures do not necessarily add to totals.

\* Reserves held after certain adjustments 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—November 1968			
	Nov. 4	Nov. 8	Nov. 18	Nov. 25
Three-month .....	5.554	5.483	5.483	5.448
Six-month .....	5.616	5.602	5.679	5.573
	Monthly auction dates—September-November 1968			
	Sept. 24	Oct. 24	Nov. 22	
Nine-month .....	5.202	5.446	5.693	
One-year .....	5.108	5.401	5.568	

\* 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.

market eased sharply. Thus, the effective rate on Federal funds declined to  $5\frac{1}{4}$  per cent on November 13, and funds traded at rates as low as  $\frac{1}{4}$  per cent late that day.

The tone of the money market was comfortable during the November 20 statement period, in part because member banks had carried a substantial volume of excess reserves into the period (see Table I). The average basic reserve position of the eight major New York City banks improved markedly (see Table II) as a result of an increase in demand deposits and a contraction in loans to Government securities dealers, while their liabilities to foreign branches also expanded. Against this background, these banks sharply reduced their borrowings in the Federal funds market and from the Federal Reserve Banks. The effective rate on Federal funds was 6 per cent early in the week but fell to  $2\frac{1}{2}$  per cent on November 20, when some funds traded at rates as low as  $\frac{1}{8}$  per cent. In the final statement period of the month, a firmer tone reappeared in the money market but no real stress developed. Federal funds traded primarily in a  $5\frac{1}{2}$  to  $5\frac{7}{8}$  per cent range, although some trading occurred at higher rates late in the period. Member bank borrowings from the Reserve Banks increased somewhat, although the reserve positions of the money market banks improved further.

Rates on bankers' acceptances and some maturities of commercial paper rose by  $\frac{1}{8}$  per cent over the month as a whole. Offering rates posted by the major New York City banks on negotiable time certificates of deposit (C/D's) of two- through five-month maturity were increased in several steps during the month to the ceiling levels of  $5\frac{3}{4}$  per cent for 60- to 89-day maturities and 6 per cent for 90- to 179-day C/D's, while C/D's of longer maturity were reportedly sold at times at their  $6\frac{1}{4}$  per cent ceiling rate. The volume of C/D's outstanding at the weekly reporting banks in New York City rose by \$523 million in November, as against a \$513 million rise in October. Liabilities of United States banks to their foreign branches rose by \$168 million in November, compared with a decline of \$51 million in October.

#### THE GOVERNMENT SECURITIES MARKET

Prices of intermediate- and long-term Treasury notes and bonds moved irregularly lower in November. At the very beginning of the month, market sentiment was buoyed by hopes that the cessation of United States bombing operations in North Vietnam and expanded peace negotiations would prove fruitful. However, a less optimistic tone quickly emerged in the coupon sector, first as a reflection of domestic political uncertainties prior to the November 5 Presidential election, and then in response to indications

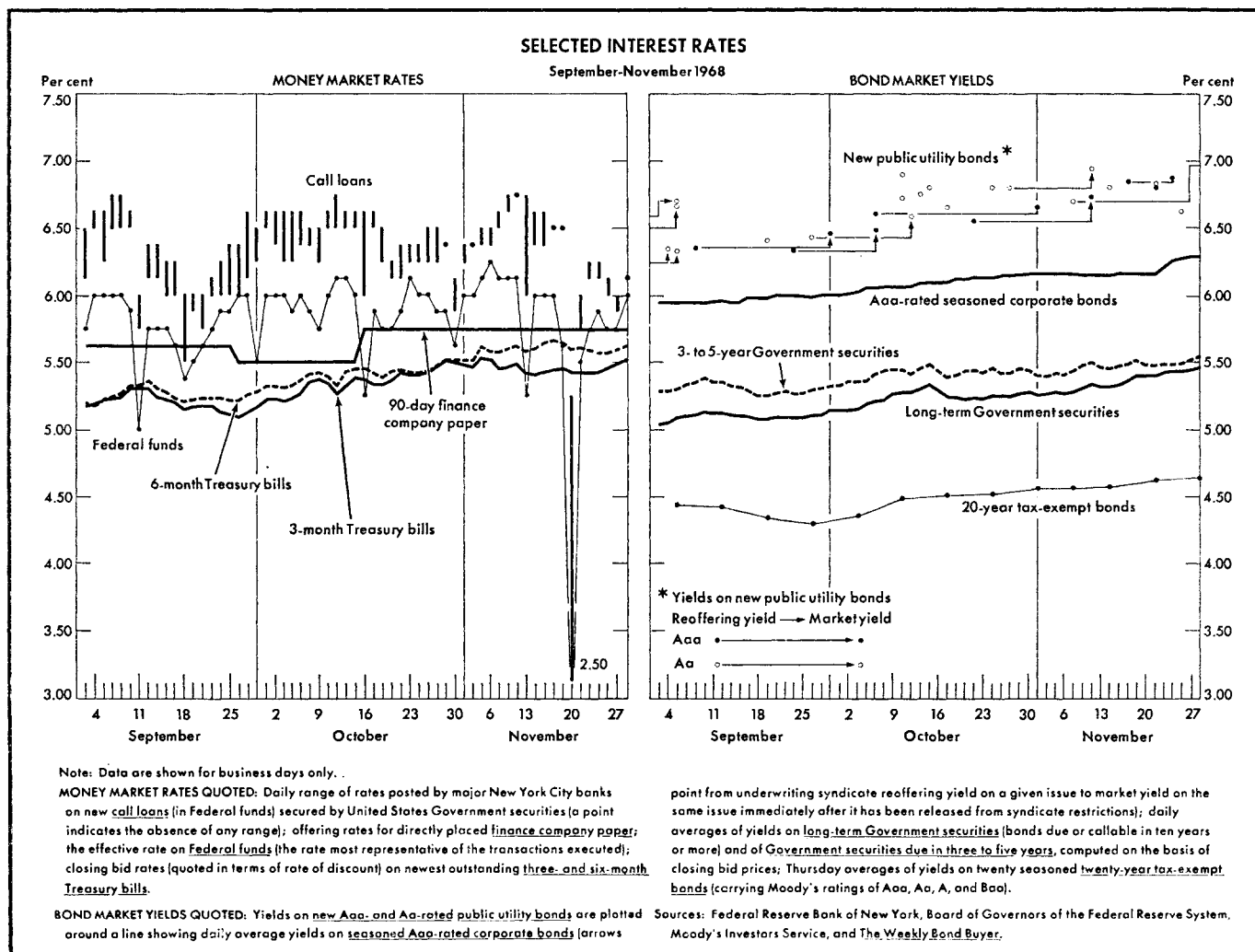
that new obstacles might impede the Vietnam peace talks. In this atmosphere, prices of Treasury notes and bonds generally fluctuated narrowly in quiet trading during the first statement period of November.

A weaker tone subsequently predominated in the coupon sector. Market sentiment was adversely affected by increasing uncertainty over the Vietnam negotiations, by the heavy tone in the markets for corporate and tax-exempt bonds, and by some investment switching out of longer term Treasury issues into higher yielding corporate bonds. Furthermore, the persistent firmness in the money market during the first half of November made the positions of Government securities dealers relatively costly to finance and stimulated professional efforts to reduce inventories. The decision of a leading New York City bank to raise its prime lending rate on November 13 from 6 per cent to  $6\frac{1}{4}$  per cent (thus bringing its rate into line with the prime rate then quoted by most other banks<sup>2</sup>) and the increase in the French bank rate to 6 per cent also had a minor bearish impact on the market for intermediate- and long-term Government securities.

The coupon sector reacted only moderately around mid-month to news of the resurgence of speculative pressures in the foreign exchange markets and to reports of possible imminent changes in the parities of some European currencies. Investment activity diminished, and dealers cautiously marked prices of coupon issues lower. Subsequently, the tone of the market improved somewhat as participants grew confident that international consultations being held by financial officials would produce constructive measures to cope with the situation. As the month drew to a close, prices edged irregularly lower in light trading. Over the month as a whole, prices of Treasury issues maturing in two to ten years were  $\frac{2}{32}$  to  $1\frac{9}{32}$  point lower. Prices of longer term obligations were  $1\frac{1}{8}$  to  $2\frac{3}{4}$  points lower, partly in reaction to pressures evident in the corporate and tax-exempt bond markets. (Associated yield increases are illustrated in the right-hand panel of the chart.)

Mixed trends were apparent in the Treasury bill market in the first half of November. During this period, there was good investment demand for bills of short maturity, which were in relatively scarce market supply, and rates on such issues declined. At the same time, however, rates on longer term bills were under persistent upward pressure (see the left-hand panel of the chart). Commercial bank sales of tax anticipation bills accelerated. In addition, the

<sup>2</sup> Beginning on December 2, most major banks throughout the country raised their prime rates to  $6\frac{1}{2}$  per cent.



firm tone of the money market as well as expectations that additional tax bills would be offered by the Treasury in late November led Government securities dealers to raise rates on longer term bills in order to reduce their inventories. Over the midmonth period, bill rates generally rose throughout the maturity range, partly in reaction to the new problems which were besetting the international financial markets. At the same time, market participants cautiously awaited the Treasury's late-November bill auctions — including an expected offering of tax anticipation bills.

On November 19, the Treasury announced that it would auction on November 26 (for payment on December 2) \$2 billion of additional June 1969 tax anticipation bills which will be acceptable at face value in payment of income taxes due next June 15. Commercial banks were

permitted to pay for their allotments through credits to Treasury Tax and Loan Accounts. The size of the offering, which only moderately exceeded the \$1.8 billion of attrition in the Treasury's recent refunding operation,<sup>3</sup> was smaller than many market observers had anticipated. This factor contributed to the emergence of a somewhat better tone in the bill sector. In addition, market participants became more hopeful that the international financial difficulties would soon subside. Subsequently, investment demand for outstanding bills was augmented by expanded

<sup>3</sup> For details of the refunding, see this *Review* (November 1968), pages 232-33.



demand from professional sources, and bill rates declined irregularly for a time. In the last few days of the month, however, market supplies were swelled by bank selling of the reopened June tax bills and bill rates generally edged higher.

At the regular monthly auction of nine- and twelve-month bills held on November 22, average issuing rates were set at 5.693 per cent and 5.568 per cent, respectively, 25 and 17 basis points above average rates established a month earlier (see Table III). At the final regular weekly auction of the month held on November 25, average issuing rates for the new three- and six-month bills were set at 5.448 per cent and 5.573 per cent, respectively, 2 basis points lower and 10 basis points higher than average issuing rates at the comparable auction held in late October. At the November 26 auction of June tax anticipation bills, an average issuing rate of 5.489 per cent was set.

#### OTHER SECURITIES MARKETS

Prices of corporate and tax-exempt bonds declined steadily through most of November, and yields approached or in some instances exceeded the previous record levels. Investor demand was sporadic, while the sizable calendar of scheduled flotations and heavy dealer inventories of bonds triggered widespread price cutting in both sectors.

New corporate and tax-exempt bonds were marketed at progressively higher yields and were accorded mixed receptions by investors. At the same time, underwriters removed price restrictions on several slow-moving recent corporate and tax-exempt issues and prices were adjusted sharply lower. Over the midmonth period, disturbances in the international financial markets adversely affected the domestic bond market. During this period, an \$85 million Aaa-rated telephone company issue with five years of call protection was priced to yield 6.85 per cent, 10 basis points above the earlier record high yield on a comparable offering in early June. Later, as yields on new and recent issues rose, investment demand occasionally improved somewhat and a slightly better tone emerged at times in the corporate and tax-exempt sectors. Prices generally continued to edge lower through the end of the period, however.

At the close of November, *The Weekly Bond Buyer's* yield index of twenty seasoned tax-exempt issues was quoted at 4.64 per cent, 8 basis points higher than a month earlier, while Moody's index for seasoned Aaa-rated corporate bonds, at 6.29 per cent, was 13 basis points higher than a month earlier. The Blue List of advertised dealer inventories of tax-exempt securities totaled \$858 million at the end of the month, as against its October 31 level of \$876 million.