FEDERAL RESERVE BANK OF NEW YORK

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The Business Situation

Despite continuing signs of some moderation, the economy remains vigorous and inflationary expectations are still strong. Industrial production registered a substantial gain in May, primarily because of sizable advances in the output of business equipment and materials. Moreover, the latest survey of 1969 business capital spending plans indicated that the aggregate volume of anticipated outlays was initially little affected by the late-April proposal for repeal of the investment tax credit, undoubtedly in part because of the desire to offset rising wage costs. It is therefore to be expected that the demand for equipment will continue to expand. Furthermore, steel production was strong again in June, according to early evidence, while auto assemblies, receiving a boost from a brisk sales pace, rebounded swiftly from the strike-depressed levels of the previous two months. On the other hand, overall sales at retail outlets have been displaying a moderating trend for many months, and with pressures easing somewhat in the labor market the growth of personal income has apparently slowed. As was to be expected, private housing starts moved lower in May for the fourth consecutive month, largely in response to increasingly tight mortgage market conditions. In addition, new orders placed with manufacturers of durable goods dropped, lending support to the view that a good part of the April surge had resulted from the ordering of business equipment in anticipation of the move to repeal the investment tax credit.

Business demands on the credit markets remain intense, even though the prime lending rate of commercial banks moved up in early June by a full percentage point to a record 8½ percent and interest rates generally are at the highest levels in this century. The uncertainty that developed in the late spring over the prospects for extension of the income tax surcharge may have strengthened expectations of persistent inflation. Nevertheless, the extremely tight financial situation—in part the result of a highly restrictive monetary policy—should ultimately slow the growth of real economic activity sufficiently to lead to a less inflationary environment.

PRODUCTION, ORDERS, AND HOUSING

A strong further expansion in business equipment output led to a substantial advance in industrial production during May. The Federal Reserve Board's aggregate production index recorded a gain of a full percentage point to reach a seasonally adjusted 172.8 percent of the 1957-59 average (see Chart I). The rise in equipment output was centered in goods for industrial and commercial business, where a vigorous growth trend emerged some months ago. Other components entering into the business equipment index—farm, freight, and passenger transportation equipment—have been much less buoyant. Gains in the output of iron and steel and most other materials also contributed to the overall May advance, while production of goods for consumer markets and of defense-related equipment was essentially unchanged. The steel industry has been benefiting from strong demand conditions both at home and abroad. The spring and early summer seasonal slack in orders and production appears to be quite mild this year, and available evidence points to a further advance in seasonally adjusted output in June.

Business equipment output since the summer of 1968 has paralleled the surge in capital spending. The vigorous growth of equipment production implies that a good part of the capital spending uptrend reflects an enlarged volume of physical investment and not simply rising prices. Indeed, the step-up in equipment purchasing seems to be the main factor in the recent rapid expansion of overall capital spending. Outlays for commercial and industrial construction have moved downward, even before allowing for rising prices, after a sharp gain around the turn of the year. When the figures are adjusted for price movements, they indicate that the real volume of commercial and industrial construction was relatively stable throughout 1968 and has fallen in 1969 to a level below the average for last year.

Excluding automotive products, aggregate output of goods for consumer markets was little changed again in

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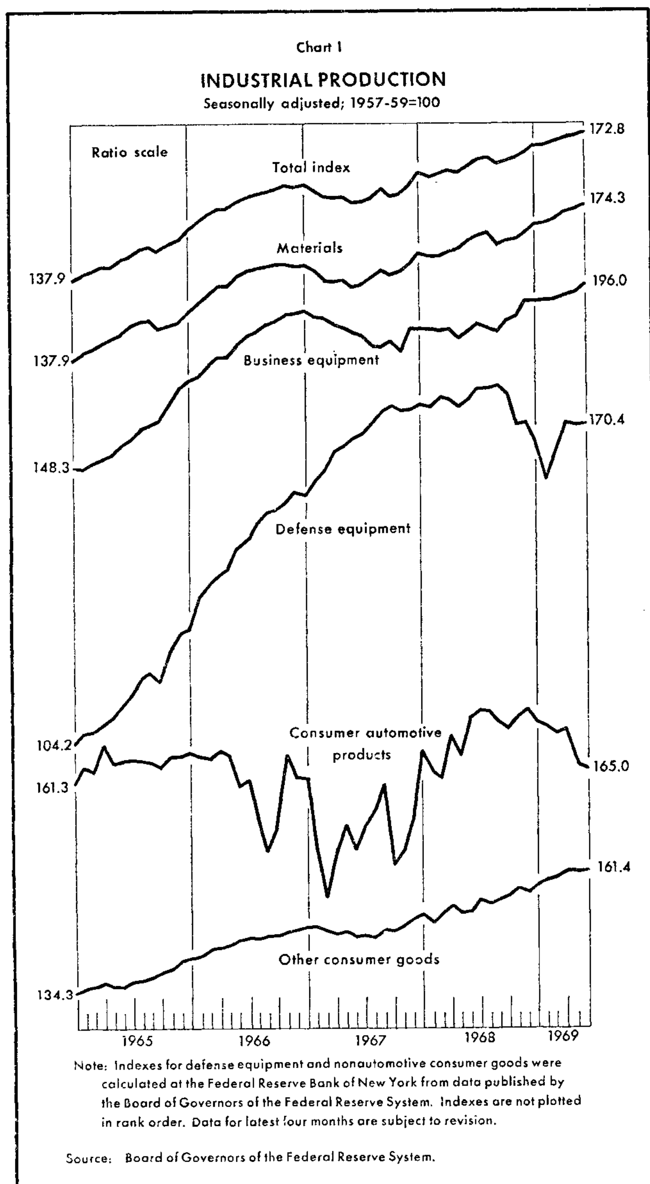

May, while the production index for automobiles and related goods fell a bit further. The May reduction in the automotive index, as in April, was largely due to the depressing effect of strikes in the auto industry. In both months the actual number of new cars built was substantially below the volume originally scheduled. With normal operating conditions generally restored in June, output rebounded sharply to a seasonally adjusted annual rate of about 8.6 million units, compared with about 7.6 million in each of the preceding two months. The unexpected curtailment of assembly operations, coupled with a strengthening in sales, has reduced inventory holdings of auto dealers. It appeared several months ago that dealers' stocks might well be excessive relative to actual and prospective sales, but the relationship has since shown a marked improvement.

The volume of new orders received by durable goods manufacturers fell back in May by an amount almost as large as the sharp April advance. From $30.9 billion in April, orders declined in May to $29.9 billion. It is apparent that the volume of orders has moved along an essentially horizontal path since last October, when bookings reached $30.3 billion on the strength of a single sharp jump of $1.9 billion. The April advance was in large measure due to a surge in orders for railroad equipment, though most major durables industries shared in the improvement. The May decline included a steep cutback in railroad equipment ordering but, like the April gain, was broadly spread through the durables sector. The plateau in aggregate durables orders since last fall can be seen also in the orders figures of most of the major durables industries.

The huge addition to manufacturers' inventories in May, $980 million, was the largest since August 1966. Because the rise was accompanied by a commensurate expansion in sales, it left the ratio of inventories to sales at the same level as a month earlier. However, this maintenance of overall balance was not reflected in component figures. The inventory-sales ratio of durables manufacturers rose substantially as a result of a very large buildup in stocks and a slight decline in shipments. For nondurables manufacturers, a large gain in sales reduced the ratio noticeably despite a sizable accumulation of inventories. It is too early to judge the significance of the huge increase in stocks, but a survey of manufacturers' inventory and sales expectations conducted by the Commerce Department in May indicated that manufacturers were indeed planning a rise in inventories in excess of expected sales during the second and third quarters. These plans seem to have reflected, at least in part, anticipations of additional boosts in materials prices. Presumably, the recent further rise in the cost of financing stocks, signaled by the June hike in the prime rate, will cause many of these firms to review their inventory positions.

The leading indicators of residential construction activity continued to trend downward in May. The pace of private housing starts declined for the fourth consecutive month, reaching a seasonally adjusted annual rate of just over 1.5 million units, and the rate of building permit authorizations for new units also slipped. At its May level, the starts rate was just equal to the 1968 average.

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The May reduction in starts, rather surprisingly, was the result of a steep drop in starts of multi-unit housing that more than offset an upturn in starts of single-family homes. While single-unit starts have occasionally fluctuated sharply from month to month, the trend of their movement since early 1967 has been generally horizontal, with recent months suggesting a clear downturn. In view of the progressive tightening of the mortgage conditions facing home buyers, and steep increases in construction costs, pressures on single-family home construction are especially great, and it is possible that the substantial May jump in single-unit starts was largely a reflection of the month-to-month volatility that characterizes the starts data. In the multi-unit sector, where most building is of structures with five or more units, starts in recent months had been averaging as high as 700,000 units annually, an exceptionally high rate by historical standards. The demand for apartments has been very strong due to the recent sharp uptrend in household formation, and the supply of mortgage credit for apartment construction has been well sustained.

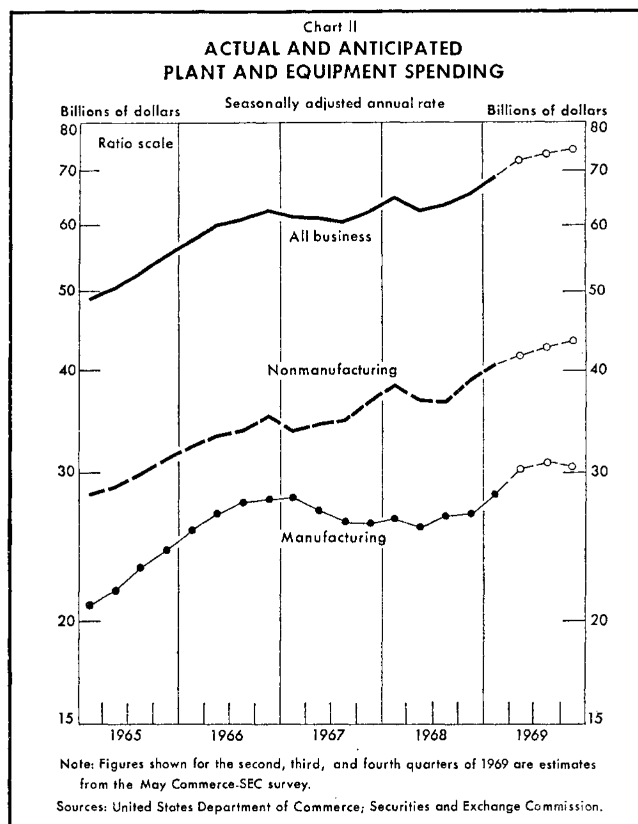
CAPITAL INVESTMENT PLANS

The strength of business expectations is evident in the capital spending plans reported in the latest quarterly Government survey, taken in late April and May. In the three months separating that survey and the preceding one, credit became very much costlier and harder to obtain, and there were also firm and frequent official reaffirmations of the intent to pursue restrictive economic policies as far as necessary in the battle against inflation. Moreover, on April 21 the President asked an apparently receptive Congress for repeal of the tax credit for investment in capital equipment. Yet, when the Commerce Department and the Securities and Exchange Commission surveyed business spending plans, they found only a very modest cutback in the size of the anticipated 1969 increase. The survey results point to an $8.1 billion rise this year in plant and equipment outlays, representing a 12.6 percent advance; the February survey had indicated an increase of $8.9 billion, or 13.9 percent. The aggregate spending rate is expected to increase throughout the year, but the gains anticipated after the second quarter are moderate (see Chart II), suggesting that capital investment will provide little expansionary thrust to the overall economy in the latter half of the year.

The Commerce-SEC surveys canvass anticipated spending, not the reasons underlying the spending plans. However, the strength of the planned 1969 rise certainly must reflect substantial business optimism about the outlook for demand and little concern over the prospects for any significant slowdown in economic activity. Undoubtedly, plans are also influenced by a desire to offset rising costs and the shortages of skilled manpower. The pervasiveness of inflationary expectations poses a major problem to be overcome in the progress toward the vital goal of halting inflation.

The May spending survey found that first-quarter outlays were at a seasonally adjusted annual rate of $68.9 billion, up by $3 billion from the fourth quarter but close to $3 billion below the figure anticipated in February. In view of the fact that the February survey had indicated an extraordinary spending rate advance of nearly $6 billion, it is very likely that much of the shortfall from that expectation was due to delivery problems and related difficulties. In several industries where first-quarter spending was reported to have fallen short, second-quarter plans were scaled up, but little if any revision was made in estimates for the full year. This suggests that in these industries—including mining, nonrail transportation, nonelectrical machinery manufacturing, and the aggregate of commercial and communications firms—some spending

Chart II
ACTUAL AND ANTICIPATED
PLANT AND EQUIPMENT SPENDING



Note: Figures shown for the second, third, and fourth quarters of 1969 are estimates from the May Commerce-SEC survey.

Sources: United States Department of Commerce; Securities and Exchange Commission.

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was in fact pushed from the first to the second quarter.

On the other hand, the recent survey indicated that in many industries where first-quarter spending was below anticipations the shortfall is not being made up, and that in a number of sectors plans have been revised down not only for the first half of the year but also for the second. The most notable retrenchment was reported by the railroads, and may well reflect a particular sensitivity to the proposal for repeal of the investment tax credit. Following two years of sizable declines in investment spending, the railroads had planned in February a rise of nearly 30 percent this year, but the May survey reported a cutback to 15 percent, which is still a large gain.

The survey found a notable difference in spending plans between durables and nondurables manufacturers. Virtually every nondurables industry showed a cutback from the 1969 plans reported in February, with the downward revisions spread throughout the year. In most durables manufacturing industries, however, first-quarter spending exceeded the February anticipation, and at the same time plans for the remainder of the year were revised upward. The steel industry was the only marked exception, and even there the downward revision of second-half plans was modest. If expectations of rising costs of planned capital investment contributed to the upward revisions by durables producers, the different pattern in the reports from the nondurables sector is surprising.

THE CONSUMER SECTOR

Retail sales volume declined by 1 percent in May, following a recovery of almost 2 percent in April, according to revised data. May sales were lower at both durable goods and nondurable goods stores. The overall decline carried the retail sales estimates further along the rather flat trend that has been apparent since last September. Indeed, in view of the distressingly rapid advance in consumer prices, the retail sales figures probably imply some drop in physical volume since early last fall.

Retail outlets in the broad automotive goods group reported a very small decline in total dollar volume in May, but unit sales figures indicate that buying of new cars picked up substantially. Unit sales of domestic models rose by 4 percent, from an annual rate not far above 8 million cars in April to a pace of 8½ million in May. The sporadic strikes that cut into production in these two months apparently caused some dampening of sales as a result of model shortages, particularly in April. To some extent, the strong further sales gain in June—to an annual rate of 9 million units—represented a rebound from the effects of the strikes. For the three months April through June, sales of new domestic-model cars were at a seasonally adjusted annual rate of 8½ million units. This was up moderately from the average pace registered in the preceding three months as well as from that in the first half of 1968, but substantially below the exceptionally strong showing through most of last year's second half when sales ranged narrowly around an annual rate of 9 million units.

A slowing in employment growth dampened the expansion of personal income in both April and May. In the latter month, the seasonally adjusted annual rate of personal income rose by $3.8 billion, a gain slightly larger than April's but noticeably below the figure of some $5 billion that was typical during the preceding twelve months. The slowing in growth was centered in wages and salaries, which account for the bulk of total income. Expansion of aggregate personal income does not, of course, necessarily imply that individuals are, on average, experiencing a rise in real purchasing power. On a per capita basis, disposable personal income, which is defined as personal income less taxes and is estimated quarterly, continued to expand at a fairly strong rate in the first quarter. However, after allowing for the effect that rising prices have on purchasing power, per capita disposable income in the first quarter showed little change from the early-1968 level; and, for a considerably longer span of time, there has been little growth in the purchasing power of the average nonfarm worker's "take home" pay.

Following a span of four or five months in which the labor force and civilian employment showed exceptional strength, some moderation developed in April and May. From November through March, both employment and the labor force had been registering seasonally adjusted increases far in excess of the normal growth trend. The expansion of employment was especially sharp, and the unemployment rate held during the winter months at a very low 3.3 percent. Employment growth was only about seasonal in March, however, and in April and May it fell short of seasonal expectations. Though the seasonally adjusted civilian labor force also declined in the latter two months, the unemployment rate moved up to 3.5 percent. A similar picture is found in figures on the number of persons reported as working in nonagricultural establishments. The growth in such employment tapered off in the spring after several months of very strong advance. Though these developments suggest an easing of conditions, the labor markets remain very firm. In any event, some readjustment could be expected after the recent period of exceptionally rapid employment growth. Figures for the summer months will be of particular interest in view

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of the expected heavy seasonal influx of young people seeking both temporary and permanent employment following the end of the school year.

PRICE DEVELOPMENTS

Consumer prices continued to climb in May, although the gain was far smaller than in the preceding two months. The overall index rose at an annual rate of some 3¾ percent, still excessive but down markedly from the March-April average pace of almost 9 percent. At the wholesale level, on the other hand, the uptrend of the aggregate price index accelerated. In recent months the major force behind this advance has been the steep increase in prices of agricultural commodities. The index for industrial commodities has been stabilizing meanwhile and, on the basis of preliminary data, did not rise at all in June.

The May slowdown in the growth rate of the consumer price index was shared by each of the major index components. The price level for services rose in May at an annual rate of 6 percent; while sizable, this was the smallest advance since last autumn. A moderating of the rise in the index for nonfood commodities was largely traceable to declines in prices of new and used cars. Consumers, however, have been particularly conscious in recent months of rising food prices, and these prices have indeed shown little tendency to ease their rate of growth. The May advance, led by a further increase in the cost of beef, was at an annual rate of 5 percent, only slightly below the pace in March and April.

Another sharp rise in June in agricultural prices at the wholesale level clouds the prospects for near-term easing of the pressure on consumer food prices. The farm products index climbed at an annual rate of 9 percent in that month, and the index for processed foods and feeds advanced at a rate of 18 percent. On the strength of these increases, overall wholesale prices registered a 4¼ percent rate of gain. The index for the industrial commodities component, however, was unchanged after rising marginally for two months. This performance of industrial prices, as in April and May, apparently resulted from another drop in lumber and wood products prices. Steep declines since March in the quotations on several commonly used building materials—plywood prices, for example, are off as much as 50 percent from their peaks—presumably are associated with the weakening in the outlook for residential construction. In April and May, months for which full reports are available, the precipitous fall in timber products prices dampened the rise in the overall industrial commodities index. Excluding this component, the index in those two months advanced at an annual rate in excess of 3 percent, with substantial gains in the prices of metals, nonmetallic mineral products, machinery and equipment, and paper products.

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The Money and Bond Markets in June

Rates on most money and bond market instruments moved higher during June as pressures intensified further. This tendency was highlighted by the unexpectedly large increase in the prime lending rate posted on June 9 by almost all commercial banks. The 1 percentage point rise brought the prime rate to a record 8½ percent and was followed by sharp increases in rates on many market instruments. While the renewed investor interest that was stimulated by these higher rates resulted in price improvements on some instruments after the initial reaction, rates on commercial paper and bankers' acceptances moved steadily higher in several steps over the month. Prime dealer-placed commercial paper maturing in four to six months was offered at 8⅝ percent on June 30, up 1⅛ percentage points from the close of May, while offering rates on directly placed paper of 60 to 270 days' maturity increased by ⅝ percentage point to 7½ percent over the same period. In the market for bankers' acceptances the bid and offered rates on ninety-day paper rose from 7¾-7½ percent to 8¾-8½ percent during the month.

Prices on both corporate and municipal bonds moved lower during the first week in June and then fell sharply in initial reaction to the prime rate rise. This was followed by an improved tone in the corporate market as investors responded favorably to the higher yield levels, but investor interest in the municipal market remained subdued until the final part of the period. The decline in the stock market and the subsequent switching of funds was an additional factor in the recovery of fixed-income corporate and municipal securities. The market for United States Government securities also was jolted by the prime rate increase, although prices of long-term Treasury bonds quickly recovered and closed higher for the month. In addition, the bill market came under pressure early in the month from heavy sales by foreigners. These sales resulted largely from the reversal of speculative flows into the German mark during May. Bill rates subsequently declined in the face of some reinvestment demand from holders of tax anticipation bills and other maturing Government securities as well as demand associated with midyear publication of financial statements.

In response to the rapid rise in Euro-dollar liabilities of commercial banks in recent months, the Board of Governors of the Federal Reserve System on June 26 proposed to amend its regulations governing member bank reserve requirements and the foreign activities of member banks. In releasing the proposals for comment, the Board stated that the changes are designed to remove a special advantage to member banks of using Euro-dollars for adjustment to domestic credit restraint. The Board stated that the increasing magnitude of this practice has had a distorting influence on credit flows in the United States and abroad. The proposed amendments would impose a 10 percent reserve requirement on certain member bank liabilities which have been free of reserve requirements, and on certain assets of member banks' foreign branches which have likewise been free of reserve requirements. Borrowings by member banks from their foreign branches as well as assets acquired by such branches from their parent banks—above the amount of such borrowings and assets in a base period—would be subject to a 10 percent reserve requirement. The reserve requirement would also be imposed on credit extended to United States residents by a member bank's foreign branch, to the extent that such credit exceeds the amount outstanding in a base period. In addition, a 10 percent reserve requirement would be imposed on member bank borrowings from foreign banks.

On June 27 the Board of Governors also invited comments on a proposal to bring a member bank's liability on certain so-called Federal funds transactions with customers other than banks within the coverage of the regulations dealing with reserves of member banks and payment of interest on deposits. Recently, some banks have been making the Federal funds market available to their corporate depositors as a means of providing them with interest on short-term funds. In the Board's judgment, there is no justification for a bank's liability on such transactions to be exempt from the rules governing reserve

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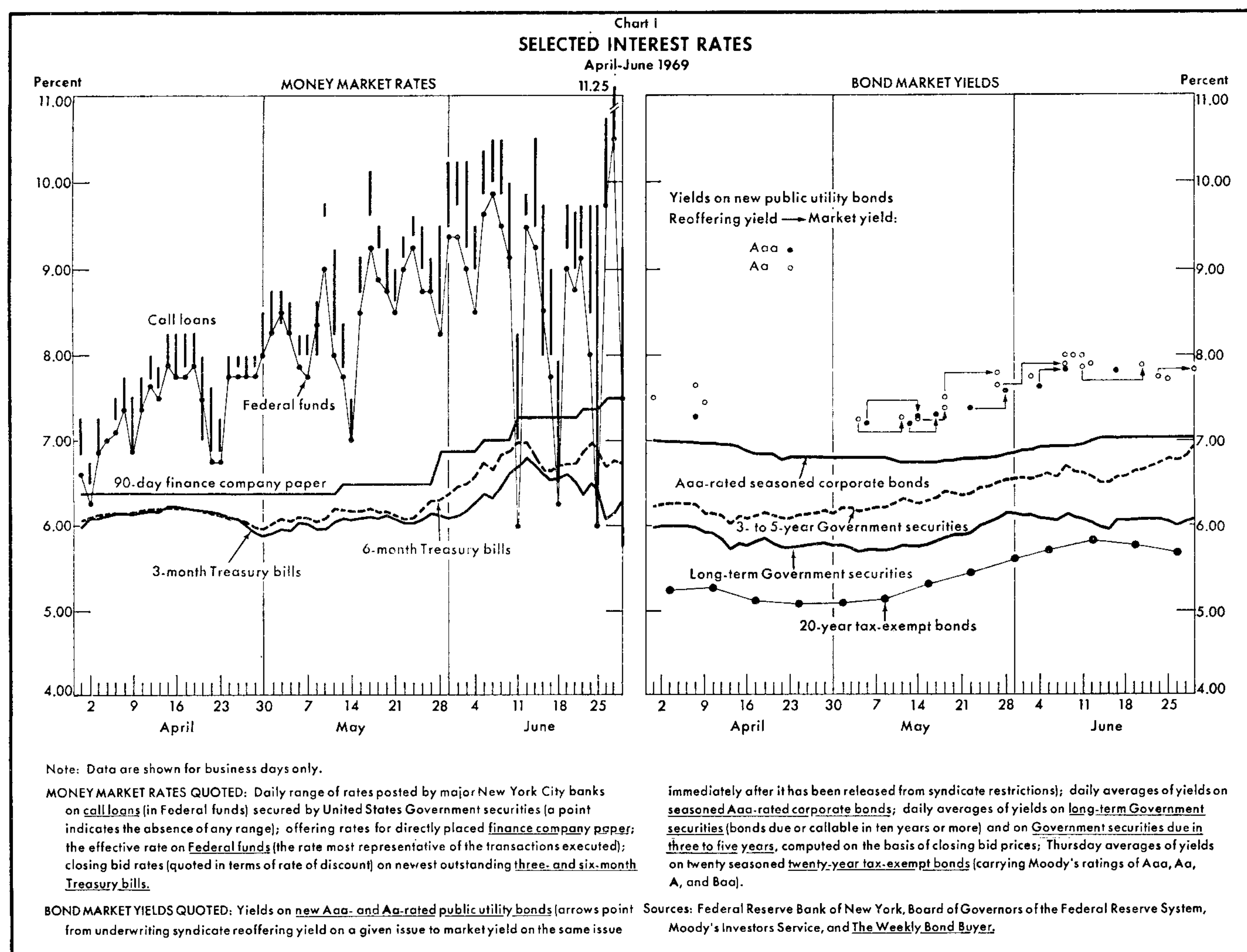
requirements and the legal prohibition against payment of interest on demand deposits.

BANK RESERVES AND THE MONEY MARKET

Pressures on bank reserves continued firm during June, as member bank borrowings at the discount window remained at the high level reached in May and rates on Federal funds averaged about the same as in the last half of May. For the month as a whole, daily borrowings from the Federal Reserve Banks averaged $1.4 billion (see Table I), virtually unchanged from the preceding month. Excess reserves averaged some $20 million higher, however, resulting in a decline of approximately the same size in the average net borrowed reserves of all member banks.

Increased demand for Federal funds in the first business week of June drove the effective rate as high as 9⅞ percent on June 6, a new record (see Chart I), as major money center banks bid aggressively in the market for these funds. The basic reserve deficit of the forty-six major banks rose from an average of $2,840 million in the week ended on May 28 to $4,287 million in the settlement week of June 11 (see Chart II). In contrast to the pattern of other money market instruments, however, the effective rate on Federal funds declined to 9½ percent on the following Monday when the commercial bank lending rate increase was announced. The Federal funds rate moved progressively downward over the remainder of the statement week, reaching 6 percent on June 11 with some trading as low as ½ percent when



Note: Data are shown for business days only.

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

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

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

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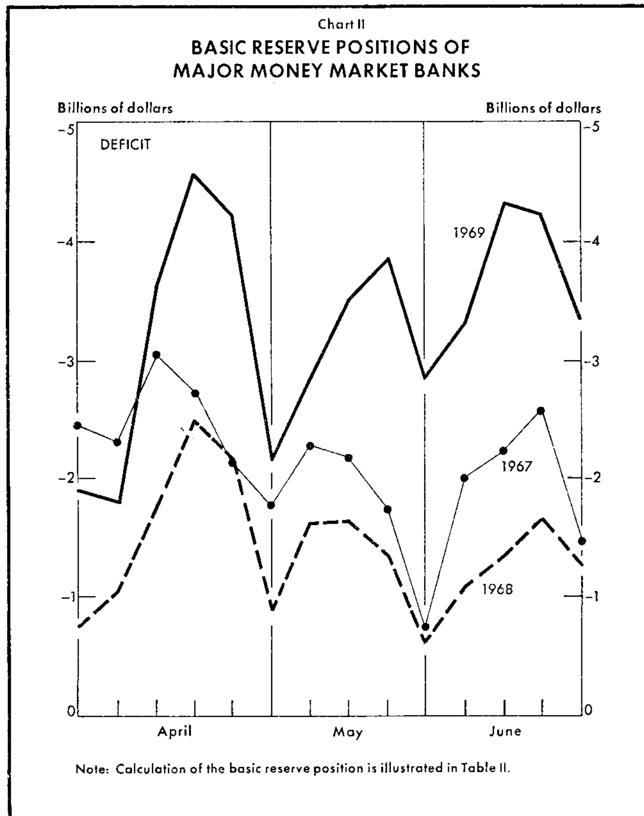

excess reserves of money center banks were brought to the market. During the period from June 12 to June 30, most Federal funds trading occurred in a 6 to 10½ percent range, somewhat wider than the range prevailing during May. The record 10½ percent effective rate occurred on June 27, the day after the proposed regulations were announced concerning Euro-dollars.

Although there had been apprehension on the part of some market participants concerning the problems which might confront the banking system at the mid-June corporate tax and dividend dates, commercial banks weathered the period with apparently little difficulty. The effective rate on Federal funds fell to 8½ percent on Monday, June 16, and business loans at large weekly reporting commercial banks increased in the week ended on June 18 by some $365 million less than in the 1968 tax payment week. It is probable, however, that some corporations borrowed earlier in the month in anticipation of encountering difficulties during the tax week; the increase in business loans at weekly reporting banks for the first two statement weeks of the month was some $250 million greater than in the same period in 1968. Major money center banks borrowed heavily in the Euro-dollar market in the weeks of June 11 and June 18 in preparation for sizable loan demand, and the rates on these funds rose considerably from their May level. The steepest rise, however, was in conjunction with the prime rate increase, when three-month Euro-dollars reached 12.5 percent. The rate then fell back, closing the month at 10.5 percent.

During the first two statement weeks ended in June, a period of increased tautness in the money market, the System through open market operations injected reserves amounting to $447 million on a daily average basis. This was done primarily through outright purchases of Government securities (see Table I). Over the remainder of the month, however, System operations resulted in a net absorption of funds, effected to a large extent by the use of matched sale-purchase transactions for the temporary withdrawal of excess funds from the market. On balance the System provided reserves of $198 million on a daily average basis during the four statement weeks of June.

Daily average deposits subject to reserve requirements (the bank credit proxy) declined in June at a seasonally adjusted annual rate of about 13 percent, following a decline of 2.5 percent in May. After adjustment to include the changes in liabilities to foreign branches, however, the June decline was only 4 percent, comparing with a 1 percent decline in May. The major factors accounting for the steep drop in June were a sizable runoff in United States Government deposits and a somewhat smaller decline in time deposits. Preliminary data on the seasonally adjusted money supply show a gain of 1.2 percent in June, bringing the rise since March to a 2.9 percent rate.

THE GOVERNMENT SECURITIES MARKET

The prices of Treasury securities moved somewhat irregularly during the month of June, but on balance most issues with maturities of less than seven years provided higher rates of return at the close of the period than at the end of May. Yields on long-term securities, however, generally showed declines of 1 to 19 basis points over the month, reflecting some investor demand after the steady rise in yields during May and very little selling pressure due in part to the fact that dealer inventories were quite light.

The Treasury bill market had not experienced a general deterioration in May similar to that of longer term United States Government securities because of generally thin supply and strong demand, emanating to a large extent from foreign sources. During June, in contrast, these influences were reversed and yields on several bill issues climbed to record levels. Dealer financing costs were high,

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JUNE 1969

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

Factors	Changes in daily averages—week ended on				Net changes
	June 4	June 11	June 18	June 25	
"Market" factors					
Member bank required reserves	+ 340	+ 259	+ 80	+ 162	+ 841
Operating transactions (subtotal)	— 561	— 133	— 376	+ 87	— 983
Federal Reserve float	+ 182	+ 177	+ 105	+ 153	+ 617
Treasury operations*	— 108	— 217	— 354	— 179	— 858
Gold and foreign account	+ 18	+ 3	—	— 7	+ 14
Currency outside banks	— 344	— 78	— 388	+ 123	— 687
Other Federal Reserve accounts (net)†	— 306	— 20	+ 261	— 1	— 66
Total "market" factors	— 221	+ 126	— 296	+ 249	— 142
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 221	+ 226	— 73	— 176	+ 198
Outright holdings:					
Government securities	+ 424	+ 284	+ 118	— 174	+ 652
Bankers' acceptances	— 1	— 1	+ 1	— 2	— 3
Repurchase agreements:					
Government securities	— 116	— 28	— 151	—	— 295
Bankers' acceptances	— 36	— 9	— 12	—	— 57
Federal agency obligations	— 50	— 20	— 29	—	— 99
Member bank borrowings	+ 219	— 262	+ 56	+ 9	+ 22
Other loans, discounts, and advances	—	—	—	—	—
Total	+ 441	— 36	— 17	— 167	+ 221
Excess reserves	+ 220	+ 90	— 313	+ 82	+ 79
	Daily average levels				
Member bank:					
Total reserves, including vault cash	27,576	27,407	27,014	26,934	27,233‡
Required reserves	27,278	27,019	26,939	26,777	27,003‡
Excess reserves	298	388	75	157	230‡
Borrowings	1,522	1,260	1,316	1,325	1,356‡
Free, or net borrowed (—), reserves	—1,224	— 872	—1,241	—1,168	—1,126‡
Nonborrowed reserves	26,054	26,147	25,698	25,609	25,877‡
Net carry-over, excess or deficit (—)§	51	171	207	127	139
	Changes in Wednesday levels				
System account holdings of Government securities maturing in:					
Less than one year	+ 324	— 35	— 835	+ 243	— 303
More than one year	—	—	—	—	—
Total	+ 324	— 35	— 835	+ 243	— 303

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 for four weeks ended on June 25.
§ Not reflected in data above.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS JUNE 1969

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on June 25
	June 4	June 11	June 18	June 25	
Eight banks in New York City					
Reserve excess or deficiency(—)*	60	121	— 11	20	48
Less borrowings from Reserve Banks	43	86	—	97	57
Less net interbank Federal funds purchases or sales(—)	1,278	1,806	1,340	775	1,300
Gross purchases	*2,286*	*2,425*	*2,187*	*1,997*	*2,224*
Gross sales	*1,008*	*619*	*846*	*1,222*	*924*
Equals net basic reserve surplus or deficit(—)	—1,261	—1,771	—1,352	— 852	—1,309
Net loans to Government securities dealers	587	391	802	741	630
Net carry-over, excess or deficit(—)†	— 3	29	49	16	23
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	58	100	— 39	— 20	25
Less borrowings from Reserve Banks	552	371	465	460	462
Less net interbank Federal funds purchases or sales(—)	1,558	2,245	2,359	2,026	2,047
Gross purchases	*3,529*	*3,876*	*4,006*	*3,636*	*3,762*
Gross sales	*1,972*	*1,631*	*1,647*	*1,610*	*1,715*
Equals net basic reserve surplus or deficit(—)	—2,052	—2,516	—2,863	—2,506	—2,484
Net loans to Government securities dealers	— 75	— 71	67	90	3
Net carry-over, excess or deficit(—)†	10	47	66	19	36

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

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—June 1969				
	June 2	June 9	June 16	June 23	June 30
Three-month	6.191	6.591	6.666	6.524	6.456
Six-month	6.454	6.927	6.654	6.866	6.944

Maturities	Monthly auction dates—April-June 1969		
	April 24	May 27	June 24
Nine-month	5.977	6.307	7.387
One-year	5.931	6.270	7.342

* 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.

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inhibiting inventory accumulation, and retail demand for new issues was less than had been anticipated. Concern about the selling of bills, which usually accompanies June tax and dividend payment dates, and a sizable supply from foreign sources further stimulated dealers to pare their inventories.

In response to the commercial bank prime loan rate increase on Monday, June 9, all segments of the Government securities market underwent upward yield adjustments. Treasury bill rates generally rose by 3 to 52 basis points on Monday, while yields on most notes and bonds registered increases of 4 to 36 basis points. On Tuesday, prices of notes and bonds recouped a healthy amount of the preceding day's losses. Sizable investor selling contributed to further deterioration in the bill market over the remainder of the week, and rates on Treasury bills for the most part ended the statement week of June 11 up 10 to 47 basis points from the preceding Wednesday. Quotations on intermediate-term coupon issues were unchanged to ½ point lower between June 4 and June 11, while long-term bonds recovered enough for the majority to show a gain of 4/32 to 18/32.

A better tone emerged in the market for Government notes and bonds during the following statement week, strengthened to some extent by a continuing decline in the stock market which, for many investors, enhanced the attractiveness of high-yielding fixed-income securities. The improvement extended to bills maturing in two months or longer but not to those of shorter maturity which came under some additional foreign selling pressure early in the week. A major factor contributing to the improved market conditions for most sectors was the lack of any significant selling pressure associated with the June 16 corporation tax date. The possibility of such pressure had been given considerable press coverage as the next test of stringency in the money and capital markets.

Prices of intermediate-term notes and bonds moved steadily lower over the final part of the month in largely professional activity. A cautious tone resulted from official statements concerning the need to continue monetary restraint and from the uncertainty surrounding the fate of the surtax extension in the Congress. In addition, sizable selling emerged in response to a rise in long-term Treasury bill rates. Rates on shorter term bills, which were in thin supply, declined in the wake of reinvestment demand from holders of the maturing tax anticipation bills and some commercial bank buying in connection with midyear financial statements. Some heaviness developed in all segments of the Government securities market following announcement of the proposed changes regulating Eurodollar and certain nonbank Federal funds borrowing.

At the regular monthly auction on June 24, average issuing rates on the nine- and twelve-month bills were set at record levels of 7.387 and 7.342 percent, respectively, 108 and 107 basis points higher than comparable rates at the auction a month earlier (see Table III). At the final weekly auction on June 30, average issuing rates for the new three- and six-month bills were set at 6.456 and 6.944 percent, respectively, 33 and 73 basis points above the average rates established at the last weekly auction in May.

OTHER SECURITIES MARKETS

During the first week of June, prices drifted somewhat lower in the market for long-term corporate securities while municipal securities showed a more substantial deterioration. *The Weekly Bond Buyer's* index of twenty municipal issues rose 13 points to a historic high of 5.73 percent on Thursday, June 5. Investor response to high-yielding new issues was selective, however: a $100 million offering of five-year Aaa-rated bonds was a quick sellout at 7¾ percent, but a similarly rated thirty-year issue yielding 7⅝ percent met with only moderate success the following day. News of additional industrial price increases and reports of difficulties with Congressional extension of the income tax surcharge contributed to an underlying tone of caution in these markets.

On Monday, June 9, prices of corporate and municipal securities fell sharply in reaction to the surprising rise of 1 percentage point in the commercial bank prime lending rate. Some outstanding corporate bonds were reduced in price by as much as 1½ points on that day. In addition, three recently marketed issues were released from price restrictions, with upward yield adjustments of up to 24 basis points, and announcement was made of the postponement of two previously scheduled issues. Two Aa-rated thirty-year utility issues that were marketed on Monday and Tuesday were priced to yield 8 percent; at this high level they elicited favorable investor response and moved to premiums from their offer prices. In the period after June 10, with bond yields at a level reportedly not matched since Civil War days and with key stock market indexes at their lowest readings since the summer of 1968, a decidedly improved tone developed in the corporate bond market. Reports from several dealers indicated sizable demand from small investors, who were switching funds out of the stock market, as well as increased interest from various pension funds and other institutional investors. Moreover, market participants anticipated additional demand from holders of savings accounts following the dividend-crediting period at the end

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of June. The rally in the corporate bond market was sustained over the remainder of the month but with a note of caution injected by those who feared that any sizable decline in yields would be short-lived because of the previously postponed new issues waiting in the wings. Despite the market's generally improved tone, moreover, a new record was set on a Aaa-rated $150 million telephone issue offered on June 17 at a net interest cost of 7.91 percent, the highest ever for a top-grade Bell System financing. The issue was an immediate sellout and moved to a premium on the next day.

There was apparently little immediate spillover from the improved corporate market to that for tax exempts, and the already record-high *Bond Buyer* index rose to 5.82 percent on June 12 before moving lower in the final weeks of the month. At the close of June the index stood at 5.68 percent, 8 basis points higher than at the end of May. Despite an unusually light calendar of new issues during June, investor demand for tax exempts was generally unenthusiastic although some new offerings in the final half of the month were priced attractively enough to arouse interest. Dealers' advertised inventories declined by some $200 million over the month to $336 million on June 30, reflecting in part the light pace of new issue activity as market conditions and self-imposed interest rate ceilings led to further deferments of scheduled offerings.

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Recent Capital Market Developments

The nation's capital markets in the first half of 1969 were subjected to steadily increasing pressures, arising both from heavy overall borrowing demands and a tightly restrictive credit policy on the part of the Federal Reserve System. By midyear, interest rates had moved well above levels prevailing at the start of the year and, in most cases, were the highest in this century. Nonetheless, credit flows remained large. Business borrowing increased, spurred by a further growth in capital spending and substantial inventory accumulation. The demands for residential mortgage credit continued strong as home-building activity remained at high levels, and borrowing by Federal agencies to finance the expansion of their activities in support of the mortgage market added to pressures in the securities markets. Aside from the Treasury, state and local governments comprised one of the few major classes of borrowers to reduce substantially their borrowing in the financial markets. This appears, however, to have been due mostly to inability to borrow within their own statutory interest rate ceilings. A large volume of planned state and local issues was postponed during the first half of 1969, constituting a backlog of unsatisfied credit demands which will undoubtedly influence the capital markets in the future.

Commercial banks contributed little to total credit flows in the first half of 1969, but it appears that direct (unintermediated) lending in the financial markets provided a substantial offset to the declining role of bank-intermediated credit. The Regulation Q interest rate ceilings on large certificates of deposit (CD's) resulted in massive losses of time deposits at banks as competing interest rates rose. Much of this deposit money, however, apparently reentered the credit markets through other channels, perhaps principally through investment in commercial paper and Treasury and Federal agency obligations. Moreover, despite the high level of competing rates, deposit inflows to thrift institutions were fairly well maintained and residential mortgage credit continued to expand at a goodly pace though lending terms did tighten substantially further.

BUSINESS FINANCE

Capital spending by nonfinancial corporations kept on rising at a fast clip during the first two quarters of 1969, and inventory accumulation was also substantial. This increase in expenditures, coming during a period when the growth of internally generated funds was tapering off, resulted in heavy business demands for external financing. Indeed, the gap between capital spending and internally available funds rose to a record seasonally adjusted annual rate of $24¼ billion in the first quarter of the year, almost $2¼ billion above the previous peak set in the fourth quarter of 1966 (see Chart I).

Corporate borrowing in the long-term capital markets accelerated during the first six months of 1969. Gross publicly offered and privately placed corporate bond issues totaled an estimated $9.4 billion during the period, almost $1 billion above offerings during the second half of 1968. The increase was centered primarily in public offerings, which rose $850 million to $6 billion, while private placements increased only slightly to approximately $3.4 billion. Corporate bond financing in the first half of 1969 had a decided equity market orientation, as corporations strove to offset the impact of the upward spiral in long-term interest rates. More than 30 percent of the new corporate issues sold to the public during the period was convertible into the common stock of the issuer, a proportion well above that during the last half of 1968 and only barely below the all-time peak reached in the second half of 1967.

Yields on newly issued corporate bonds, after increasing sharply in the last half of 1968, showed little change in the first two months of this year (see Chart II). They surged upward in March, however, amid a generally gloomy atmosphere in the financial markets and did not fully retrace this increase in the easier financial atmosphere that developed in April and May. Moreover, toward midyear, as financial pressures again mounted, yields moved up to new peaks, and some highly rated issues with protection against early redemption were offered to investors at record yields in excess of 8 percent. To avoid being locked

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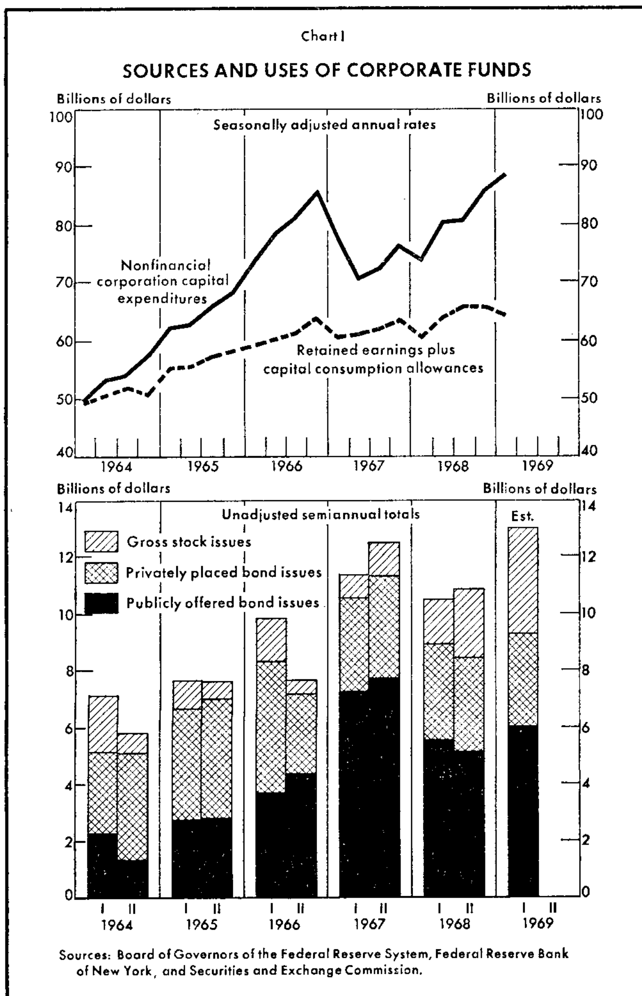
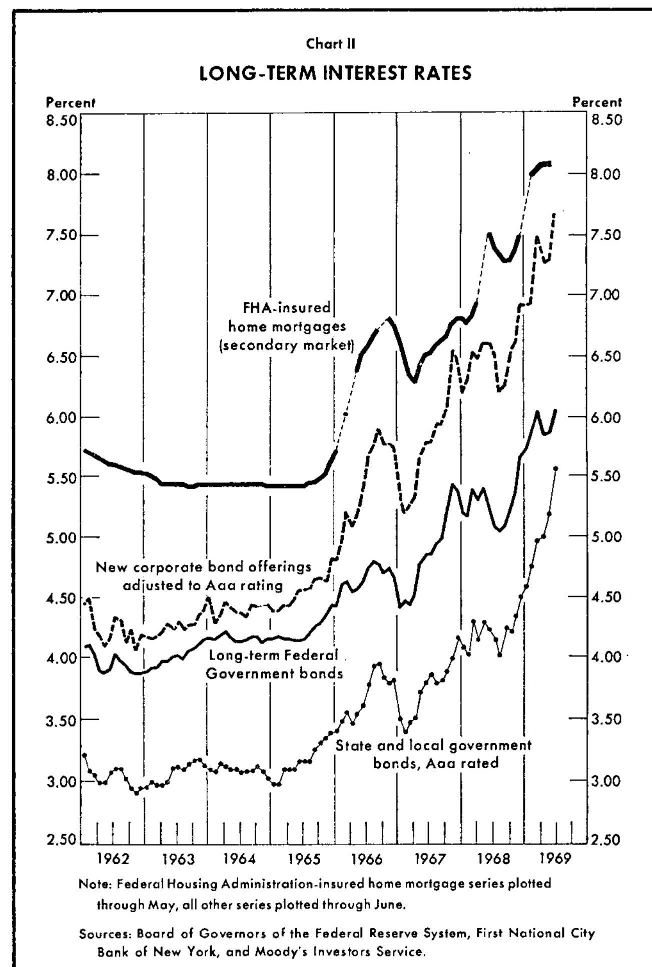


Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, and Securities and Exchange Commission.

into paying record-high interest rates on long-term bond issues, several corporations issued bonds with shortened maturities in the range of two to five years. Approximately $1½ billion of such securities was issued during the second quarter of 1969.

The enlarged needs of corporations for long-term funds during the first half of 1969 were also reflected in a sharp rise in the volume of new common stock offerings. Gross cash offerings totaled a new half-year record of approximately $3¾ billion. This was more than $1¼ billion above the previous record set during the last six months of 1968 and, in fact, only barely below total common stock issues in all of 1968.

Business demands for short-term financing also expanded sharply during the first half of 1969, as inventory investment remained high and trade credit swelled. However, some short-term borrowing may have reflected the unwillingness of these corporations to engage in long-term financing at the peak interest rates prevailing on new bond issues. Indeed, the seasonally adjusted annual rate of increase in business loans at commercial banks over the first half of the year appears to have been about equal to the rapid, 14 percent pace of growth during the second half of 1968. The continued pressure of heavy loan demand by businesses at commercial banks during a period of increasing monetary stringency contributed to a further increase to 8½ percent in the bank prime lending rate in early June. At the same time, corporate financing in the commercial paper market surged. The rise in outstanding open market paper issued by nonfinancial corporations over the first five months of the year appears to have exceeded by a wide margin the record $1.6 billion increase during all of 1968. It is interesting to note, moreover,



Note: Federal Housing Administration-insured home mortgage series plotted through May, all other series plotted through June.

Sources: Board of Governors of the Federal Reserve System, First National City Bank of New York, and Moody's Investors Service.

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that nonfinancial corporations have also stepped up sharply their purchases of open market paper, as the rising margin between the rate of return available on these instruments and on commercial bank time deposits apparently induced many firms to invest funds from maturing CD's in the commercial paper market.

There are signs that credit to small businesses has been in increasingly short supply this year and that large corporations may have found it necessary to expand their own borrowing to help finance their smaller customers. Indeed, preliminary data indicate that net trade credit extended by nonfinancial corporations expanded by a record $9 billion (seasonally adjusted annual rate) during the first quarter of 1969, and reports suggest that a further large increase is likely in the April-June period.

CONSUMER AND MORTGAGE FINANCE

During the first quarter of 1969 consumer spending expanded faster than disposable income, resulting in a decline in the personal savings ratio to 6.1 percent. This was the lowest rate for any quarter since early 1966, and was almost ½ percentage point below the ratio during the second half of 1968 (see Chart III). Although outstanding consumer credit continued to increase at a relatively high rate during the first five months of 1969, the $878 million (seasonally adjusted) average monthly rise during the period was about 15 percent below the record pace of expansion recorded during the last half of 1968.

Individuals seem to have exhibited a marked preference for direct investment in the obligations of state and local governments throughout the first half of the year. Preliminary flow-of-funds data show that household acquisitions of municipal securities surged during the first quarter of 1969 to a record $11 billion seasonally adjusted annual rate, equal to more than four fifths of the net increase in such obligations during the period. Moreover, household participation in the corporate bond market has apparently continued at the high level evidenced during the fourth quarter of 1968 as yields available on such securities moved still higher. At the same time, a combination of rising interest rates and sagging stock prices has resulted in a considerable drop in the use of margin credit to finance stock market investments. Margin credit extended by New York Stock Exchange member firms has declined almost without interruption since reaching a peak in June 1968, but the $0.6 billion dip during the first five months of this year was, on a monthly average basis, one-third greater than the decline during the second half of 1968.

The growth of consumer savings at mutual savings banks and savings and loan associations diminished somewhat during the first five months of 1969, but remained quite strong despite the increasingly attractive yields on alternative market investments available to consumers. Deposits and share capital increased at a 5.2 percent seasonally adjusted annual rate during the January-May period, only about 1 percentage point below the rate of gain during the second half of 1968. The continued flow of savings into deposit-type institutions reflects in part the efforts by thrift institutions over the past few years to increase the attractiveness of their deposit liabilities by offering longer maturity and higher yielding savings certificates. However, it appears also that the high market rates of interest prevailing over the past several years have resulted in the thrift institutions appealing mainly to the less interest-sensitive savers, with the consequence that the growth in flows to these institutions, while not so spectacular as before, is now much less vulnerable to changes in open market interest rates.

Funds continued to move into the residential mortgage market at a relatively brisk rate in early 1969. In spite of a moderation in the flow of new savings, mortgage holdings at savings and loan associations and mutual savings banks over the first five months of the year rose at a 7.9 percent seasonally adjusted annual rate—about 1 percentage point faster than in the second half of 1968. To finance the widening disparity between deposit gains and the growth of mortgage lending, many thrift institutions borrowed funds from the Federal Home Loan Banks (FHLBs). Advances by the latter to their members—mainly savings associations—rose by almost $1.2 billion during the January-June period. Although this was more than three times the net rise in such advances during the second half of 1968, at the end of June outstanding FHLB advances were still almost $1 billion below the 1966 peak of $7.3 billion. In a further step designed to free more funds for mortgage lending, the FHLB Board in June reduced by ½ percent, to 6 percent, the minimum liquidity requirement imposed on member thrift institutions.

The Federal National Mortgage Association (FNMA) also took steps during the first half of 1969 to increase its support of the home mortgage market. FNMA mortgage purchases surged to $1.2 billion, almost $½ billion more than in the second half of 1968 and barely below the Association's peak rate of mortgage buying in the first half of 1966. Moreover, FNMA participation in the residential mortgage market promises to be sustained at a high level over the near future. At midyear, its outstanding mortgage purchase commitments totaled $2.6 billion, about double the total outstanding at the end of 1968.

Mortgage acquisitions by commercial banks continued

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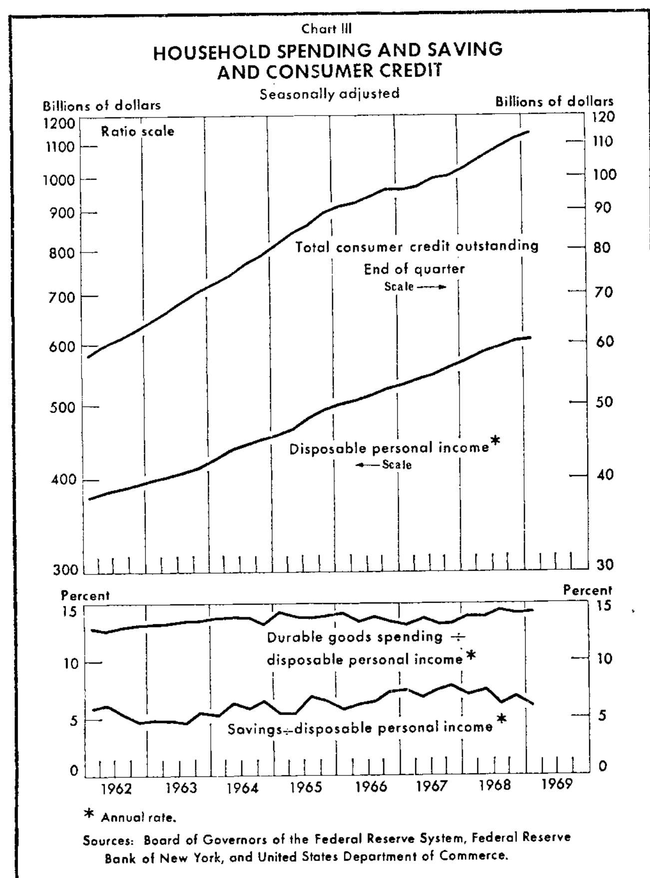

* Annual rate.

Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, and United States Department of Commerce.

at a rapid pace during the early months of 1969, but have since tapered off in an atmosphere of heightened reserve pressure and substantial losses of time deposits. Similarly, life insurance company mortgage holdings expanded sharply during the first quarter of 1969, but reports of a marked rise in policy loans this year suggest some possibility of a cutback in the availability of mortgage credit from this source.

Mortgage debt formation has apparently been spurred this year by innovations in the arrangements for financing apartment buildings. It appears that a growing number of apartment loans now provide institutional lenders with an equity participation, enabling the lender to receive in addition to regular interest some share of net operating earnings and in some cases a portion of the profits from any later sale of the property. This type of arrangement has, of course, greatly strengthened the attractiveness of residential mortgage lending relative to other uses of loanable funds.

GOVERNMENT FINANCE

The flow of new long-term securities offerings from state and local governments abated markedly during the first half of 1969. Gross issues totaled slightly more than $6 billion, almost $3 billion less than in the second half of 1968 and the lowest half-year volume since the last six months of 1966. Interest rates on municipal securities rose almost without interruption, and this forced the cancellation or postponement of a large number of issues which could not be marketed at or below the maximum interest rates legally payable by many state and local borrowers. Reported postponements and cancellations of offerings exceeded $1¼ billion during the first six months of 1969, more than triple the total during the second half of 1968 and more than the deferred borrowing during all of 1966 when state and local government financing was heavily restrained by capital market conditions.

State and local governments have placed heavy reliance on short-term financing in the attempt to offset part of the difficulty encountered in raising long-term funds. Net issues of short-term securities totaled about $2½ billion during the January-June period, by far the largest half-year total ever recorded and more than $2 billion above the volume of such financing during the second half of 1968.

Investor participation in the municipal bond market this year has differed substantially from that of the second half of 1968. Commercial banks, traditionally the major purchasers of such securities, acquired less than 4 percent of the net issues during the first quarter of 1969, a drop of slightly more than 75 percentage points from their share during the second half of 1968. It appears, moreover, that banks may have been net sellers of state and local government securities during the second quarter of 1969 as they attempted to obtain additional funds to satisfy a heavy demand for loans. Reduced bank acquisitions in the first three months of the year were offset by a sharp rise in household sector purchases, and there are signs that this trend continued during the second quarter of the year.

Turning to Treasury finance, Federal revenue and expenditure patterns traditionally result in a budget surplus during the first half of the calendar year and a deficit during the last half. However, the swing to a surplus was especially dramatic this year. The deficit had been $10¼ billion during the second half of 1968, and it now appears that the surplus in the first half of 1969 was about $11½ billion—a swing of nearly $22 billion. Reflecting the greatly improved budget situation, the Treasury retired, on balance, more than $10 billion of its outstanding mar-

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ketable obligations in the first half of 1969. In the comparable months of 1968, Treasury financing operations had resulted in a small amount of net borrowing.

The easing effect on the financial markets of debt redemption by the Treasury was to some extent offset by the impact of expanded borrowing by the major Federally sponsored credit agencies, especially those that provide direct and indirect support to the residential mortgage market. Faced with increased demand from member institutions for advances, the Federal Home Loan Banking System raised more than $800 million during the first half of 1969, whereas it had engaged in no new borrowing during the second half of 1968. Moreover, to finance the enlarged FNMA purchases of residential mortgages, outstanding obligations of this agency rose by $1.7 billion during the first half of 1969, the largest half-year financing ever undertaken by the Association. Similarly, borrowing by the Federal Intermediate Credit Banks and the Federal Land Banks also exceeded the pace that had been registered during the second half of 1968.

ROLE OF THE BANKING SECTOR

In a period marked by growing reserve stringency, total commercial bank credit appears to have expanded at a very moderate 3 percent seasonally adjusted annual rate over the first half of the year, less than one fourth the rate of increase during the second half of 1968. However, banks were able to maintain loan expansion at a high level by undertaking substantial portfolio adjustments. Their United States Government securities holdings were cut back at an estimated seasonally adjusted annual rate of 18 percent, and they made virtually no net acquisitions of state and local government obligations. All major loan categories registered gains except loans to securities brokers and dealers, which declined at a 23 percent annual rate in response to lightened dealer inventories and to a generally lower level of stock market credit. The almost 14 percent annual rate of expansion in business loans was about unchanged from the pace recorded during the previous half year. Moreover, although real estate lending tapered off during the second quarter, the 10½ percent rate of increase in commercial bank real estate loans in the January-June period was only slightly below the growth recorded during the second half of 1968.

Preliminary flow-of-funds data indicate that during the first quarter of 1969 there was a sharp reversal in the pattern of lending to nonfinancial borrowers. The virtual standstill in overall commercial bank credit expansion was almost completely offset by a surge to $60 billion, at a seasonally adjusted annual rate, in direct lending by households, businesses, and state and local governments. This unintermediated lending provided nearly two thirds of the $91 billion of net funds raised by nonfinancial borrowers during that quarter. In contrast, during the second half of 1968, direct credit flows from these sectors had accounted for only 3 percent of total borrowing.

In the first half of 1969 there was a steady erosion in commercial bank time deposit liabilities, while demand deposits expanded only slightly. The 5 percent seasonally adjusted annual rate of decline in time deposits during the January-June period was the first half-year decline ever recorded, and reflects principally the impact of a marked rundown in outstanding CD's. The increasingly wide differential between yields available on short-term open market credit instruments and the Regulation Q ceilings on interest rates that can be paid on CD's prompted a $7.6 billion runoff in outstanding CD's at weekly reporting member banks between the end of December and late June. In the effort to offset the growing impact of this deposit drain, bank demands for Euro-dollar funds increased sharply. Outstanding liabilities of United States banks to their foreign branches rose to a record $14.1 billion in late June, more than double the amount reported at the start of the year. On June 26, in a move designed to moderate any further flow of Euro-dollars to United States banks, the Federal Reserve Board proposed to impose reserve requirements on borrowings from foreign branches in excess of the daily average amount during the four weeks ended on May 28.

Banks have also been experimenting with other devices in their quest to secure additional loanable funds. These include the sale of loans and of participations in the banks' loan portfolios to their foreign branches and to domestic corporations, and the sale of commercial paper by the parent corporation in the case of banks which are part of bank holding companies. Although these maneuvers do not generally lead to an expansion of total outstanding commercial bank credit, they do lead to a rise in credit flows through the banking system.

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