FEDERAL RESERVE BANK
OF NEW YORK

MONTHLY REVIEW

AUGUST 1970

Contents

Volume 52 No. 8

The Business Situation

The economy drifted unevenly in the second quarter. Industrial production and employment fell throughout the April-June period, although real output of the economy as a whole was virtually unchanged after two quarters of decline, according to the preliminary estimate. Some June indicators furthermore suggested a flattening or perhaps even some renewed advance. Durables new orders and shipments stayed at their improved May level. Housing starts advanced after earlier increases in permits and scattered signs of a better financing picture. Auto sales and output gained further, following a slump last fall and winter that had been an important factor in the economic slowing. Evidently the various Federal actions bolstering personal income within the quarter had their expected effect on spending. Total consumer outlays continued to advance at around the first-quarter rate despite the lack of growth in private wage and salary payments. In July, disposable income was boosted by the expiration of the income tax surcharge and by the increase in the personal exemption. Financial conditions also seem favorable for some renewed growth in real output. The money supply continued to advance at a moderate pace in the second quarter, and financial markets have become noticeably calmer, with substantial declines taking place in a wide spectrum of interest rates over the past several weeks.

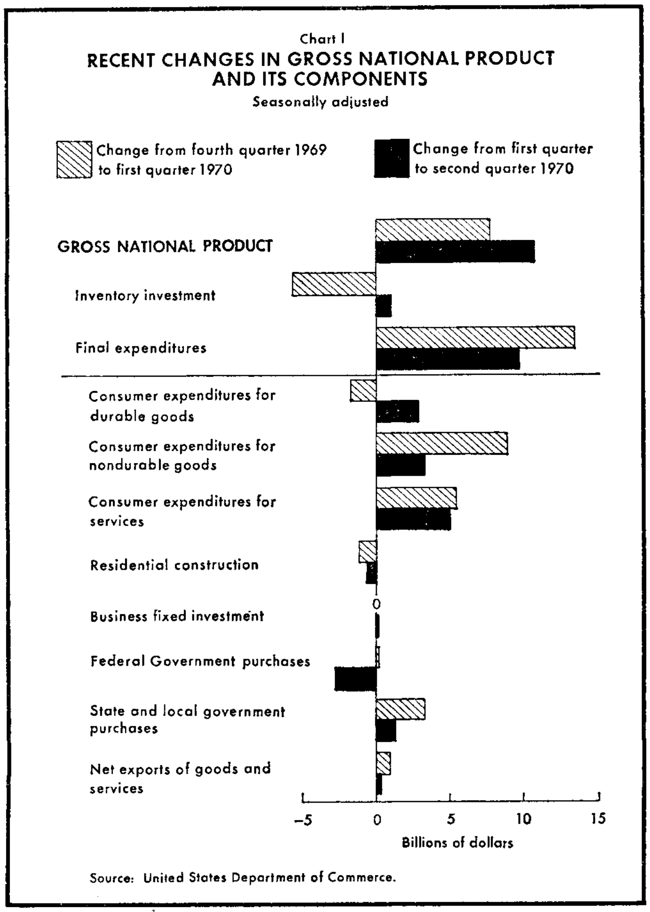
Despite some scattered and hopeful signs of improvement in the price picture, solid evidence of a real slowdown in the rate of inflation is still lacking. The apparent sharp reduction in the rate of growth of the GNP deflator during the second quarter largely represented technical factors rather than a real improvement. In July, the wholesale price index jumped sharply as agricultural prices surged. In June and July, some moderation in the rate of advance in wholesale industrial prices mainly reflected seasonal factors. While the rise in the consumer price index slowed to a 4½ percent seasonally adjusted pace in June, such one-month slowdowns have occurred before and subsequently proved to be false signals. Rising productivity in manufacturing has helped to hold down the advance in unit labor costs in that sector, but the pay increases won in recent collective bargaining settlements have far outpaced any conceivable further progress in productivity and extend to industries in which there is no evidence of significant productivity gains. In short, the inflation problem is still very much with us.

GROSS NATIONAL PRODUCT IN THE SECOND QUARTER

The real value of the nation's output of goods and services was virtually unchanged in the second quarter, although continued price increases led to a rise in the market value of the nation's product. Coming on the heels of two successive quarterly declines, the approximate stability of real gross national product (GNP) in the April-June period gave rise to the hope that the downtrend of the previous six months had ended. According to the preliminary estimate of the Department of Commerce,[1] current-dollar GNP rose by $10½ billion (see Chart I) to a seasonally adjusted annual rate of $970 billion. Excluding price increases, GNP edged up by a scant 0.2 percent annual rate. In the October-March period, real GNP had fallen at a 2.0 percent annual rate.

The GNP deflator—which is the broadest measure of price trends in the economy—rose at a 4 percent annual rate, compared with a 6½ percent increase in the first quarter. This decline did not indicate an easing in basic inflationary price trends, for it mostly reflected technical factors that boosted the rate of advance in the first quarter

[1] The Commerce Department's annual midyear revisions of the national income and product accounts reduced GNP for the fourth and first quarters by $0.5 billion and $0.1 billion, respectively, to seasonally adjusted annual rates of $951.7 billion and $959.5 billion. The GNP estimate for 1969 was revised down by $0.7 billion to $931.4 billion. For 1968, GNP was reduced by $0.7 billion, bringing the total for that year to $865.0 billion. GNP for 1967 was revised up by $0.4 billion to $793.9 billion.



and lowered it in the second quarter. The deflator climbed at an unusually high rate in the first quarter because the Federal Government pay raise, which added nothing to real output, did increase outlays.[2] The lower second-quarter rate largely resulted from a shift in the composition of demand. This change in composition affected the total GNP deflator, which is the weighted sum of deflators for individual components. The weights are equal to each component's share of total GNP in the period under consideration. In the first quarter a relatively large proportion of GNP was spent in components with high deflators, but in the April-June period there was a shift in spending to components having lower deflators. If these technical factors—the shift in the composition of spending and the impact of the pay raise—are ignored, the resulting GNP deflator would have risen at an annual rate of about 5 percent in both quarters. On a monthly basis, consumer prices and industrial wholesale prices rose less steeply as the quarter ended, but it is still too early to tell if this letup indicates a basic change in trend. In June, consumer prices rose at a 4½ percent seasonally adjusted annual rate, compared with a 6 percent rate in the first five months of 1970. The easing reflected a decline in seasonally adjusted food prices. Prices of nonfood commodities and of services—which are much more indicative of inflationary pressures than are food prices—continued to advance sharply. Industrial wholesale prices rose slowly in June, but spokesmen at the Bureau of Labor Statistics attributed the slowdown to seasonal declines. Preliminary data for July indicate that industrial wholesale prices advanced at a faster rate than in June and that there was a big jump in agricultural prices.

The stronger performance of total GNP in the second quarter reflected a turnaround in inventory spending. Based on incomplete data,[3] net inventory spending is estimated to have increased by $1 billion to a $2½ billion annual rate, which is still a very low level of accumulation. The $1 billion increase in April-June followed declines totaling $10 billion in the final quarter of 1969 and the first quarter. While this drag was the main cause of the GNP slowdown in those two quarters, the adjustment was much milder than in the mini-recession of 1967, when inventory accumulation fell by $15 billion in six months. Inventory accumulation was kept at a slow pace over the first half of this year, as businessmen continued to bring stocks into a better line with sales. Inventory-sales ratios—particularly among trade firms—improved over the first two months of the quarter, but some modest imbalances still exist among durables manufacturing firms despite progress during the second quarter in reducing inventory-sales ratios. In general, cuts in inventory spending in response to sluggish sales patterns have prevented any major imbalances in inventory-sales positions from

[2] The pay raise was enacted in April but was made retroactive to January. The retroactive portion of this increase was treated differently in the GNP accounts than it was in personal income. In GNP, the retroactive part was included in first-quarter spending, as if it had been a simple pay raise beginning in January and continuing on at that new level. In terms of personal income, however, the retroactive portion of the raise was included in wage and salary payments for the second quarter, when these payments were actually disbursed. Thus, the increase in personal income in the April-June period reflected the actual pay raise plus a nonrecurring bulge due to the back payments.

[3] In the preliminary GNP numbers, the inventory component is estimated from data for the first two months of the quarter. Thus, this component is particularly subject to revision.

developing. Unless there is a deterioration in sales, the recent adjustment in inventories may prove to have run its course.

Final expenditures, which exclude the inventory component from GNP, advanced at a slower pace than in the first quarter, chiefly because of a moderation in the government sector. Federal Government spending declined by over $2½ billion, with most of this drop arising from cuts in defense spending. A similar decline would have taken place in the first quarter but for the Federal employee pay raise. While expenditures by state and local governments rose in the second quarter, the quarterly increase was the smallest in six years. Spending was dampened by delays in construction projects, which partly reflected the continued financing difficulties faced by many state and local governments and the effects of trucking strikes.

Consumer spending rose by about $11 billion in the second quarter. This increase was actually slightly larger than in the first quarter despite the general weakness in private income payments during the April-June period that resulted from cutbacks in both total employment and the workweek. The impact of these cutbacks was more than offset by two government actions that in fact caused a record increase in personal and disposable incomes in the second quarter. Thus, the Federal pay raise became effective in April and the retroactive portion of the increase was also paid out in April and May. Similarly, there was an increase in social security benefit payments which began in April, with retroactive payments also being made in that month. Without these special factors, personal income would have changed little over the April-June period.

While all broad categories of consumption spending rose in the second quarter, the most notable increase was in the durables sector, where consumer spending had actually fallen in the first quarter of the year. The major factor in this turnaround was the partial recovery of new car sales from their January-March slump. In addition to the renewed growth of auto sales, the outlook for consumer spending in the current quarter is strengthened by the boost to disposable income that resulted from the July 1 expiration of the surtax.

Business fixed investment was about unchanged over the first half of the year. Although recent surveys of plant and equipment spending plans for this year had pointed to a small increase (and earlier surveys to a fairly strong rise), the actual spending figures for the first and second quarters suggest that capital investment may not contribute much to GNP growth this year. Weak profits, the uncertain sales picture, and excess capacity are important factors tending to dampen the near-term outlook for capital outlays. In addition, tight money and the growing concern over corporate liquidity positions may have caused some corporations to reexamine their borrowing and investment plans.

Investment in residential construction was again a drag on the growth of current-dollar GNP, but the second-quarter decline was small—amounting to $½ billion, compared with a drop averaging over $1½ billion in the three previous quarters. The moderate size of the second-quarter easing reflected a bottoming of the downtrend in housing starts. Starts had been falling since the first quarter of last year, when they averaged a seasonally adjusted annual rate of 1.6 million units. Since the January low of 1.1 million units, starts have been stronger—running at an annual rate of almost 1.4 million units in June. Moreover, residential building permits issued by local authorities in the April-June period exceeded the first quarter's average by 20 percent. This series tends to lead starts by several months, and thus the recent strength in permits points to a somewhat more buoyant outlook for residential construction. Improved deposit flows to thrift institutions and the likelihood of increased Federal aid have also enhanced the outlook for the housing sector.

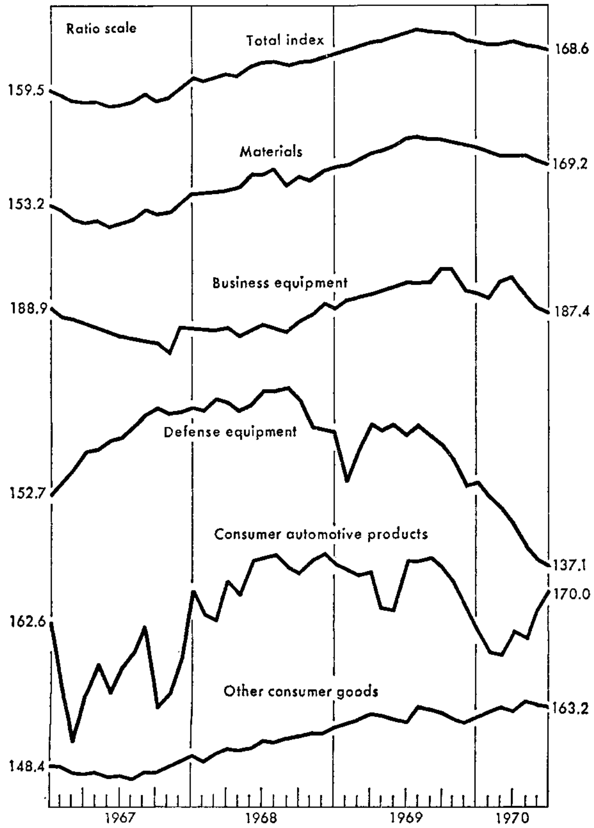
PRODUCTION, PRODUCTIVITY, AND LABOR COSTS

Industrial activity slackened a bit further in June, as declines in equipment and construction materials outweighed increases in production of consumer automotive products. The Federal Reserve Board's index of industrial production slipped 0.3 percent in June to 168.6 percent of the 1957-59 average (see Chart II), bringing the total drop since last July's peak to 3.4 percent.

As in the two previous months, the major decline in the June index was among equipment producers. Defense production fell 0.9 percent and brought the retreat from its 1968 peak to a total of 25 percent. Defense output had soared by 75 percent between early 1965 and its mid-1968 peak. Production of business equipment dropped 0.8 percent in June. Since last October, equipment output has declined by 7 percent, a further indication that the planned rise in outlays indicated by surveys of business spending plans may have been overstated.

Production of materials—particularly for construction—moved down in June, although iron and steel output increased. Seasonally adjusted production of steel ingots advanced again in July, suggesting that the iron and steel index may be continuing to rise. In recent months, iron and steel production has been bolstered by the partial recovery of the automobile industry from the slump last fall and winter. In June, production of automotive products climbed 2.8 percent. This brought the index to a level 10 percent above

Chart II
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1957-59=100



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System. Indexes are not plotted in rank order. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

the February low, although output was still about 5 percent below the levels prevailing before the slump began. With the improvement in car sales, the outlook for auto production is good. However, labor contracts with the auto makers expire in September, and a strike appears to be at least a possibility.

The flow of new orders for durable goods, an important indicator of business activity, has apparently leveled out. Orders volume had fallen by $3½ billion between last September and March, but in the April-June period orders picked up, erasing $1 billion of that decline. The improvement in new durables orders has not yet reversed the downtrend in the backlog of unfilled orders. In June, shipments volume again exceeded the orders inflow and the backlog fell to the lowest level in almost two years.

The slowing of economic activity has particularly affected the labor markets. The most marked impact on employment has resulted from the decline in industrial activity. Since the July 1969 peak in industrial production, manufacturing employment and the factory workweek have both fallen sharply, with the number of persons on factory payrolls dropping by half a million and the workweek declining almost a full hour. The slump in total man-hours since last July has been greater than the drop in output in manufacturing, resulting in an improvement in manufacturing productivity. Although productivity is likely to grow in the coming months, recent collective bargaining settlements have called for increases in wages and benefits that far exceed any conceivable gains in output per man-hour. In the first half of this year, negotiated wage and benefit increases averaged 10 percent over the life of the contract and 15 percent for the first year.

Liquidity and Credit in the Second Quarter

Fears of a general liquidity crisis rose to a peak late in the second quarter after the Penn Central Company filed a petition for reorganization on Sunday, June 21. These worries were exaggerated, even though nonfinancial corporations, commercial banks, thrift institutions, and other financial organizations had become less liquid through the extended period of rapid economic expansion in the past decade and the restrictive monetary policy of 1969. Evidence of a decline in liquidity included some increase in business failures and collection delays and greater resort by major banks to nondeposit sources of funds. However, specific instances of acute liquidity problems were relatively few and in some cases symptomatic of deeper difficulties that bore little relation to the recent course of business activity or economic policy.

Nevertheless, concern during the second quarter over the possible widening of liquidity problems aggravated the uneasy atmosphere in the money and bond markets, which were already disturbed by continuing inflation, the erratic but generally downward movement of corporate stock prices, and developments in the Middle and Far East. These pressures were most evident in the commercial paper market where participants became apprehensive that some borrowers would be unable to refinance a large volume of existing debt, some of which was of very short maturity. The Federal Reserve System acted to facilitate refinancing of these debts by the banking system, by suspending Regulation Q ceilings on large short-term time deposits, and by using the discount window and open market operations to guard against liquidity pressures. These actions had a salutary effect on most financial markets, tensions subsided, and rates of interest were declining as the quarter drew to a close.[1]

[1] See "The Money and Bond Markets in July", this *Review*, pages 187-91.

THE CREDIT MARKETS AND INTEREST RATES

Market rates of interest rose during much of the second quarter, as borrowers sought to refinance a large volume of existing short-term debt and to raise longer term funds. Not all the pressures were evident in rate movements, however, since investors also became more selective in their purchases of assets. The impact of monetary restraint had sharply curtailed the role of financial institutions as credit intermediaries, and direct lending in the nonfinancial sector had jumped from an average of 22 percent of total nonfinancial credit extended in 1968 to almost 50 percent in 1969 and the first quarter of 1970. This increase in direct lending meant that the public's holdings of corporate liabilities rose relative to their holdings of bank deposits. Lenders became less willing to part with liquidity, and market rates of interest climbed with only temporary interruptions as demand for funds remained strong.

These developments became particularly evident in the commercial paper market during June. The persistence of record-high interest rates throughout 1969 had prompted many corporations to postpone raising long-term funds through the sale of securities. As a result, a growing number of borrowers had turned to the issuance of shorter term obligations such as commercial paper (see Chart I). Commencing in October 1968, the volume of commercial paper outstanding rose uninterruptedly for nineteen months and large gains were posted in both dealer and directly placed commercial paper. Commercial paper in effect consists of short-term promissory notes that businesses sell at a discount to dealers or place directly with investors to raise cash. These notes are usually unsecured; however, issuers often obtain lines of credit at banks in order to assure purchasers that no matter what happens they will have access to funds to redeem the commercial paper sold by them.

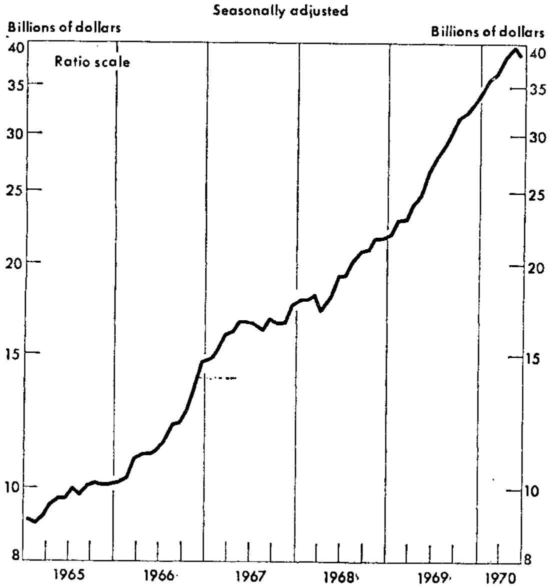
Typically, only large businesses with high credit ratings are able to acquire funds through such promissory notes. Directly placed commercial paper, which accounts for over 60 percent of the volume outstanding, is issued mainly by very large sales and personal finance companies and, more recently, by bank holding companies. Smaller financial intermediaries and nonfinancial businesses usually place their obligations through dealers who then sell the notes to corporations, banks, and others. The commercial paper market is often subject to heavy seasonal pressures around corporate tax dates, when both borrowers' and lenders' demands for cash increase. In addition, at quarterly statement dates, many corporations prefer to hold a relatively larger share of their liquid assets in Treasury bills and bank deposits, and thus a large volume of commercial paper generally matures shortly before the end of each quarter. Although the seasonally adjusted volume of commercial paper outstanding rose substantially in April and May of this year, pressures on the commercial paper market intensified as the June tax date approached and a heavy volume of paper was maturing, in accordance with the usual seasonal pattern.

These pressures were heightened shortly after the Penn Central Company, which had large commitments in the commercial paper market, filed a petition on June 21 for reorganization of its major operating subsidiary under the Federal Bankruptcy Act. Holders of obligations issued by

Chart I

COMMERCIAL PAPER OUTSTANDING*

Seasonally adjusted



*Includes bank-related commercial paper.

other large corporations became somewhat apprehensive about the low level of corporate liquidity as well as about the ability of borrowers to refinance existing debt, given the tight banking position. The difficulties encountered by a number of brokerage firms, including some of the oldest and largest houses, and the fact that stock prices continued to fluctuate erratically added to the widespread uneasiness. The Federal Reserve, however, acted promptly to reassure the market that the strong demands for short-term funds would be met through the credit markets and the banking system. On June 23, the Board of Governors of the Federal Reserve System voted to suspend Regulation Q interest rate ceilings on 30- to 89-day large certificates of deposit (CD's), effective the following day. This action, which enhanced the ability of the banking system to attract funds, led to substantial improvement in the financial markets. The Board stressed that its action would not lead to an increase in total credit, but would constitute a transfer of borrowings from other financing avenues into the banking system. Shortly after the suspension became effective, purchases of large CD's from commercial banks expanded dramatically, rising by $1.1 billion at weekly reporting banks in the week ended on July 1. When the volume of commercial paper, not adjusted for seasonal variation, declined by more than $2 billion in the last week of June, weekly reporting bank lending to sales and personal finance companies and businesses increased by almost the same amount.

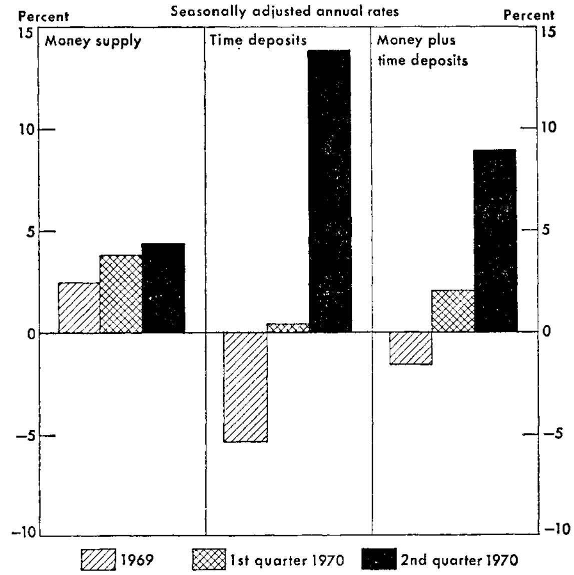
Other short-term financial markets generally functioned smoothly throughout the second quarter. Treasury bill rates rose somewhat in April and May but declined steadily in June, as demand from commercial banks and other investors pressed against a limited supply of issues. The Federal funds rate rose somewhat in April but then declined in late May and on balance fell in June. Over the quarter, the effective rate on Federal funds declined from an average of 8.10 in April to 7.60 percent in June.

Long-term interest rates remained under intensive upward pressures through much of the second quarter. Rate increases were particularly strong during May, when the Treasury conducted an exchange and new cash financing and when the American Telephone and Telegraph Company raised $1.6 billion through the sale of debentures with warrants to purchase the firm's common stock. In addition, concern about developments in the Middle and Far East and their implications for domestic and international affairs exacerbated the deteriorating atmosphere in the securities markets. The persistent downward trend in corporate stock prices heightened the tense atmosphere in other markets. Following a series of record one-day drops, prices of longer term Government securities improved near the end of May, fluctuated narrowly until mid-June, and were rising stongly as the quarter drew to a close.

Prices of longer term corporate and municipal securities, however, did not experience major improvement until mid-June, when pressures on those markets subsided. Corporations, confronted with diminishing profit flows and a reduced availability of credit from financial intermediaries and the nonbank public, had steadily reduced their holdings of liquid assets as the gap between fixed investment spending and internally generated cash flows widened. The ratio of corporate liquid asset holdings of cash, bank deposits, and short-term United States Government securities to current liabilities reached an all-time low of 18 percent at the end of the first quarter of 1970. The low ratio of corporate holdings of liquid assets to liabilities did not necessarily indicate a serious liquidity problem, for this ratio had been declining steadily over the past twenty years. Given the tightness in the short-term credit markets and the banking system, it did suggest that demands for long-term funds would remain strong. However, the sluggish pace of economic activity and concern about the low level of corporate liquidity led business to cut back planned spending on plant and equipment. In addition, state and local governments limited their expenditures a bit. Around mid-June, the calendar of forthcoming publicly offered long-term financing began to taper off and this, combined with the successful flotation of a heavy volume of new issues, lessened the pressures on the corporate and municipal bond markets.

The upward movement in market interest rates during most of the second quarter did not lead to the heavy time deposit outflows and disintermediation of the banking system that it had during 1969 and early 1970, when the savings flows of the public had steadily shifted out of deposits as market rates rose and Regulation Q ceilings remained unchanged. An upward revision of interest rate ceilings in January and the partial suspension of Regulation Q ceilings in June helped reverse this trend.

Chart II
CHANGES IN MONEY SUPPLY AND TIME DEPOSITS AT ALL COMMERCIAL BANKS
Seasonally adjusted annual rates



Source: Board of Governors of the Federal Reserve System.

MONEY SUPPLY AND TIME DEPOSITS

The daily average money supply, the most liquid of financial assets held by the public, expanded moderately during the second quarter. After increasing at a 3.8 percent seasonally adjusted annual rate in the first quarter, the public's holdings of demand deposits and currency grew at a 4.2 percent rate in the April-June period (see Chart II). The gain in the second quarter brought the rate of money supply expansion to exactly 4 percent in the first half of 1970. The modest growth of the money supply was accompanied by a substantially more rapid increase in the public's holdings of other depository assets. Thus, total time and savings deposits expanded at a seasonally adjusted annual rate of almost 14 percent in the second quarter, bringing growth for the first half of the year to just over 7 percent. This behavior represented a marked reversal from the 5.3 percent time deposit decline in 1969, when heavy deposit outflows persisted while banks were constrained to pay rates below those available on alternative investments. The gain in time deposits in the second quarter as a whole was distributed equally between large CD's and other time and savings deposits. Weekly reporting bank data, which are not adjusted for seasonal variation, show a strong increase in large CD's in April, followed by a tapering-off in May and a decline in June as market rates of interest rose. However, bank data will not reflect the effect of the suspension of Regulation Q ceilings on 30- to 89-day deposits until July. Monthly bank data for weekly reporting banks are as of the last Wednesday of each month and the suspension became effective on June 24, the last Wednesday in June.

Data on other time deposits—time and savings deposits less large CD's—show that weekly reporting banks steadily attracted passbook and time accounts, and this appears to reflect liquidity rebuilding in the household sector. Although the data are not adjusted for seasonal variation, the $1.2 billion gain in other time and savings deposits between the end of March and the end of June indicates substantial strength when compared with the $814 million decline and $148 million increase recorded during like periods in 1969 and 1968, respectively. These deposits had picked up, along with flows to thrift institutions, following the revision of Regulation Q ceilings in late January. An increase from $1,000 to $10,000 in the minimum denomination of newly issued Treasury bills, which became effective at the beginning of March, also helped stem disintermediation by the small saver.

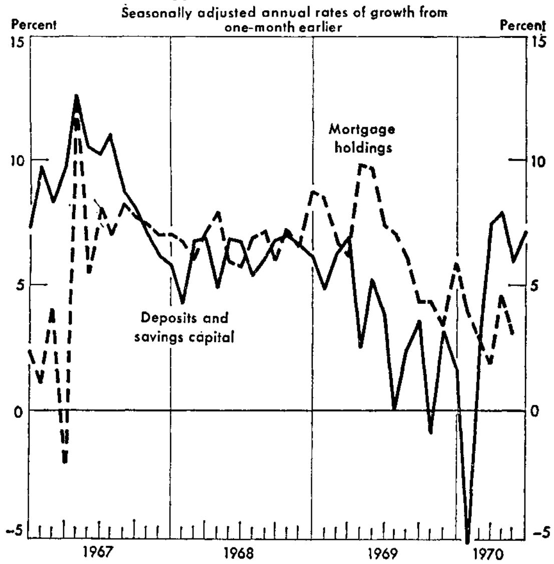
As a result of the increased flow of deposits to banks, the broad money supply—demand deposits and currency plus time deposits, which serves as a measure of the nonbank public's highly liquid asset holdings—grew at a 9 percent annual rate of increase in the second quarter, a substantial advance over the approximately 2 percent gain registered in the first quarter.

THRIFT INSTITUTIONS

Interest rate ceilings at thrift institutions had also been raised at the end of January, and deposit flows to mutual savings banks and savings and loan associations began to increase shortly thereafter. Deposit growth at thrift institutions accelerated further in the second quarter, and combined holdings expanded at an almost 7 percent seasonally adjusted annual rate, the largest quarterly gain since the third quarter of 1967 (see Chart III). Consumers also improved their liquidity position by borrowing relatively less, and the ratio of instalment debt to disposable income declined in April and May.

These developments were associated with only moderate increases in mortgage lending. Deposit growth outpaced mortgage extensions over most of the March-June period as the thrift institutions rebuilt liquidity as well. In the second quarter, savings and loan associations were able to increase their cash holdings for the first time since the fourth quarter of 1968. Similarly, mutual savings banks used some of their increased deposit flows to diversify investments and build reserves. Although member associations increased their borrowing from the Federal Home Loan Banks in the first half of 1970, they did so at a slower pace than in 1969.

Chart III
DEPOSITS AND MORTGAGE HOLDINGS AT THRIFT INSTITUTIONS
Seasonally adjusted annual rates of growth from one-month earlier



Source: Board of Governors of the Federal Reserve System. Mortgage holdings are seasonally adjusted by the Federal Reserve Bank of New York.

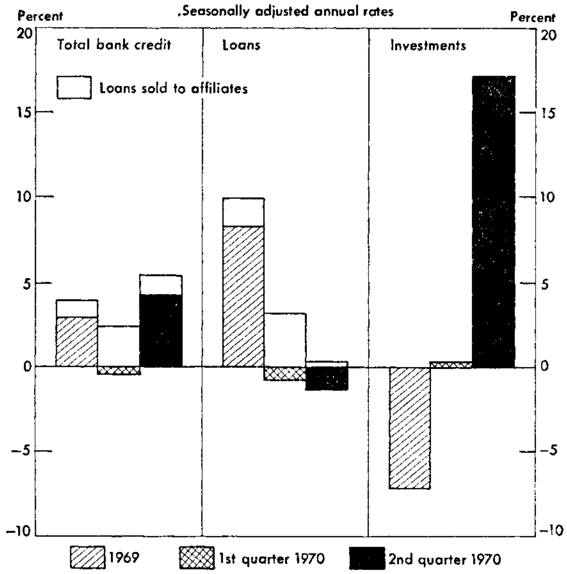
BANK CREDIT

The growth of all commercial bank credit accelerated slightly in the second quarter and was accompanied by an improvement in bank liquidity. This development contrasted strongly with bank credit behavior in 1969 and early 1970. In that period, which was characterized by persistent deposit losses, the continued liquidation of investment holdings accompanied by the expansion of loan portfolios had led to a decline in bank liquidity, as measured by traditional standards. However, it is difficult to obtain an accurate gauge of bank liquidity since the increased use of nondeposit sources of funds mitigated any deterioration of liquidity by providing funds during a period of deposit outflows.

The decline in bank liquidity was nonetheless a problem for commercial banks. During most of 1969 and early 1970, banks had steadily liquidated their investment holdings in order to obtain loanable funds (see Chart IV). From the end of December 1969 to February 1970, bank investment in Government securities fell at a 24.3 percent annual rate, while holdings of other securities, principally state and local government obligations, remained virtually unchanged. By February 1970 the ratio of loans, other than overnight loans, to deposits plus Euro-dollar liabilities reached 78.0 percent at all weekly reporting banks, the highest level on record. A shift from Government securities into loans, such as had occurred during 1969 and early 1970, often implies a general decline in bank liquidity, since bank loans cannot be liquidated as easily as Government securities. However, ratios of

Chart IV

CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS



Source: Board of Governors of the Federal Reserve System.

loans to deposits are not a fully accurate measure of bank liquidity positions, as they consider neither the quality of loan portfolios nor the cash flow arising from loan repayments. The ratio of short- and intermediate-term United States Government securities to deposits plus Euro-dollar liabilities at weekly reporting banks declined rather steadily from about 12 percent in October 1968 to 9 percent in February 1970. A decline in this measure of bank liquidity indicates that banks have relatively fewer readily marketable earnings assets. This measure has its own drawbacks, however, in that it does not include holdings of liquid investments, such as short-term securities, which increased in this period. While both measures overstate an erosion of bank liquidity, banks did have an interest in rebuilding their holdings of highly marketable assets.

The second quarter of 1970 saw a reversal of recent trends in the composition of total bank credit, as investment holdings rose markedly while total bank lending slackened. The growth of total loans, including loans sold to bank affiliates, slowed to a 0.3 percent seasonally adjusted annual rate of increase from a 3.3 percent rate of growth in the first quarter. Bank holdings of investments, on the other hand, grew at a rapid 17.2 percent annual rate, up from less than 0.5 percent growth in the first quarter. The second-quarter increase in bank investment portfolios was the strongest quarterly gain since the third quarter of 1968. Holdings of United States Government securities expanded at a 25.4 percent rate, while holdings of other securities, primarily obligations of state and local governments, grew at an 11.5 percent rate. Bank holdings of Governments, principally short-term Treasury bills, had fallen quite rapidly, while investments in other securities had risen slightly during the period of securities liquidation.

Most major categories of bank loans expanded at modest rates during the three-month period ended in June. The nonbank financial institutions, however, relied on the banking system to a somewhat greater extent. Loans to nonbank financial institutions rose substantially in May and June, and grew at a 19.2 percent seasonally adjusted annual rate for the quarter as a whole, following a 35 percent decline one-quarter earlier. The rate on prime commercial paper of four- to six-month maturity was well above the bank prime lending rate in May and June, and these institutions may have transferred some of their borrowing to banks from the commercial paper market. Business lending quickened slightly in the second quarter, and commercial and industrial loans, including business loans sold to affiliates, expanded at a 6.2 percent rate as opposed to 5.2 percent in the first quarter. The strongest advance, 12 percent, was recorded in May and in part reflected anticipatory borrowing by business in preparation for payment of corporate taxes in mid-June. The other major categories of bank loans grew at slower rates in the second quarter, compared with the first three months of the year. Consumer loans were unchanged in each month, and real estate lending grew at only 1.1 percent annual rate, down from 5.1 percent in the first quarter. These developments, in combination with the renewed inflow of deposits, led to an improvement in bank liquidity during the second quarter.

The Money and Bond Markets in July

The nation's financial system demonstrated great resiliency during July by withstanding its most strenuous trial in years. Confidence in the commercial paper market was severely tested in the wake of the filing on June 21 of a petition for reorganization by the Penn Central Company covering its railroad subsidiary. The prompt response of the Board of Governors of the Federal Reserve System in suspending Regulation Q ceilings on large short-term time deposits, effective June 24, helped to prevent the emergency from snowballing into a cumulative spiral of business failures. The Board's action promoted a rechanneling of credit through the banking system. Banks were able to obtain funds through sales of negotiable certificates of deposit (CD's), thereby facilitating lending to firms having difficulty rolling over maturing commercial paper. Banks also obtained liberal accommodation at the Reserve Banks' discount window. The Federal Reserve System thus fulfilled its historic role as lender of last resort.

The severe pressures affecting the commercial paper market did not spread to other securities markets. Although some uneasiness was evident, rates generally declined. The Federal funds rate moved slightly lower in July, as did Treasury bill rates despite the Treasury's auction of \$4¾ billion of tax anticipation bills (TAB's). The capital markets were buoyant and yields on United States Government, municipal, and high-grade corporate bonds declined substantially over the month. Yields on lower rated corporate issues remained at record levels, however, reflecting a shift in investor preference toward minimization of credit risk. Market sentiment was encouraged by an apparent improvement in the prospects for peace in the Middle and Far East and by indications that the slowdown in the economy was bottoming out. There was also a growing belief that securities yields had seen their peaks for the current cycle.

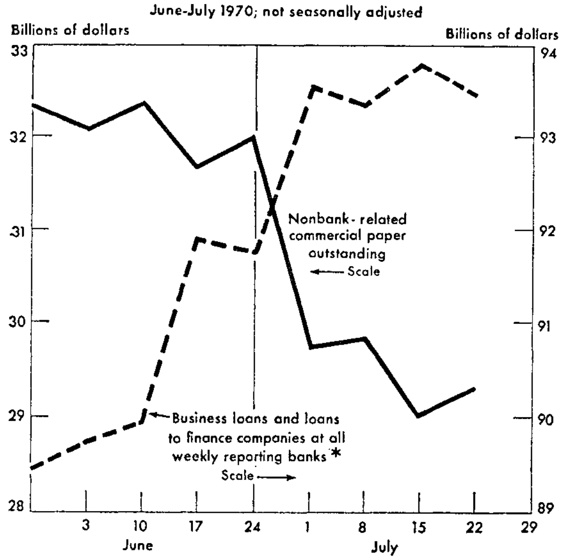
BANK RESERVES AND THE MONEY MARKET

The commercial banking system met a rapidly expanding demand for short-term credit in July (see Chart I), when many borrowers were unable to obtain adequate financing in the commercial paper market. The value of outstanding commercial paper (not seasonally adjusted) issued by institutions other than banks dropped by \$2¾ billion in the four weeks ended on July 22, reflecting the new emphasis placed by investors on higher quality assets. This shift in investor preference forced borrowers of lesser standing to approach commercial banks for loans or, in some instances, to sell receivables. Banks were able to meet the higher credit demand through additional deposits made possible by the partial suspension on June 24 of Regulation Q ceilings and through increased reserves supplied by the System. CD's at weekly reporting banks increased by \$3.9 billion during the four weeks ended on July 22. In the same four-week period, member bank

Chart I

COMMERCIAL PAPER AND BUSINESS LOANS

June-July 1970; not seasonally adjusted



* Including business loans sold to affiliates.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JULY 1970

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

Factors	Changes in daily averages—week ended on July 1	July 8	July 15	July 22	July 29	Net changes
"Market" factors						
Member bank required reserves	— 360	— 222	— 259	— 164	+ 134	— 871
Operating transactions (subtotal)	— 93	— 64	— 680	+ 328	+ 157	— 352
Federal Reserve float	— 544	+ 574	— 524	+ 480	— 681	— 695
Treasury operations*	+ 99	— 179	+ 109	+ 145	— 25	+ 149
Gold and foreign account	+ 44	— 23	— 39	+ 44	+ 8	+ 34
Currency outside banks	+ 360	— 365	— 315	— 448	+ 910	+ 142
Other Federal Reserve liabilities and capital	— 53	— 70	+ 88	+ 106	— 55	+ 16
Total "market" factors	— 453	— 286	— 939	+ 164	+ 291	—1,223
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 440	— 72	+ 794	+ 110	— 305	+ 967
Outright holdings:						
Government securities	+ 445	— 73	—	+ 638	— 42	+ 968
Bankers' acceptances	— 5	+ 1	—	— 1	+ 4	— 1
Repurchase agreements:						
Government securities	—	—	+ 632	— 444	— 188	—
Bankers' acceptances	—	—	+ 63	— 22	— 41	—
Federal agency obligations	—	—	+ 99	— 61	— 38	—
Member bank borrowings	+ 106	+ 303	+ 384	— 293	— 156	+ 344
Other Federal Reserve assets†	+ 97	— 143	— 128	—	+ 7	— 167
Total	+ 643	+ 88	+1,050	— 183	— 456	+1,142
Excess reserves	+ 190	— 198	+ 111	— 18	— 167	— 82

Member bank:	Daily average levels					Monthly averages
Total reserves, including vault cash	27,828	27,847	28,217	28,362	28,063	28,062‡
Required reserves	27,550	27,772	28,031	28,195	28,061	27,922‡
Excess reserves	273	75	186	168	1	141‡
Borrowings	991	1,294	1,680	1,387	1,231	1,317‡
Free, or net borrowed (—), reserves	— 718	—1,219	—1,494	—1,219	—1,230	—1,176‡
Nonborrowed reserves	26,832	26,553	26,537	26,975	26,832	26,746‡
Net carry-over, excess or deficit (—)§	78	158	53	119	130	108‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					Net changes
Less than one year	+ 709	— 43	+1,168	— 701	+ 200	+1,333
More than one year	—	—	—	—	—	—
Total	+ 709	— 43	+1,168	— 701	+ 200	+1,333

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 five weeks ended on July 29.

§ Not reflected in data above.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS JULY 1970

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on July 1	July 8	July 15	July 22	July 29	Averages of five weeks ended on July 29
Eight banks in New York City						
Reserve excess or deficiency (—)*	46	— 44	39	38	3	16
Less borrowings from Reserve Banks	93	360	468	139	29	218
Less net interbank Federal funds purchases or sales (—)	1,012	1,821	1,709	1,087	831	1,292
Gross purchases	2,339	2,699	2,689	2,221	2,135	2,417
Gross sales	1,327	878	980	1,134	1,304	1,125
Equals net basic reserve surplus or deficit (—)	—1,059	—2,223	—2,138	—1,188	— 857	—1,493
Net loans to Government securities dealers	473	661	345	563	934	605
Net carry-over, excess or deficit (—)†	6	32	— 9	31	44	21
Thirty-eight banks outside New York City						
Reserve excess or deficiency (—)*	— 131	— 47	15	39	— 76	— 40
Less borrowings from Reserve Banks	260	412	571	531	528	460
Less net interbank Federal funds purchases or sales (—)	2,745	2,874	3,827	3,701	3,479	3,325
Gross purchases	4,963	5,299	5,760	5,583	5,138	5,349
Gross sales	2,218	2,425	1,933	1,882	1,659	2,023
Equals net basic reserve surplus or deficit (—)	—3,136	—3,333	—4,383	—4,193	—4,083	—3,826
Net loans to Government securities dealers	126	245	151	304	853	336
Net carry-over, excess or deficit (—)†	16	36	4	21	25	20

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

* Reserves held after all adjustments applicable to the reporting period less required reserves.

† Not reflected in data above.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

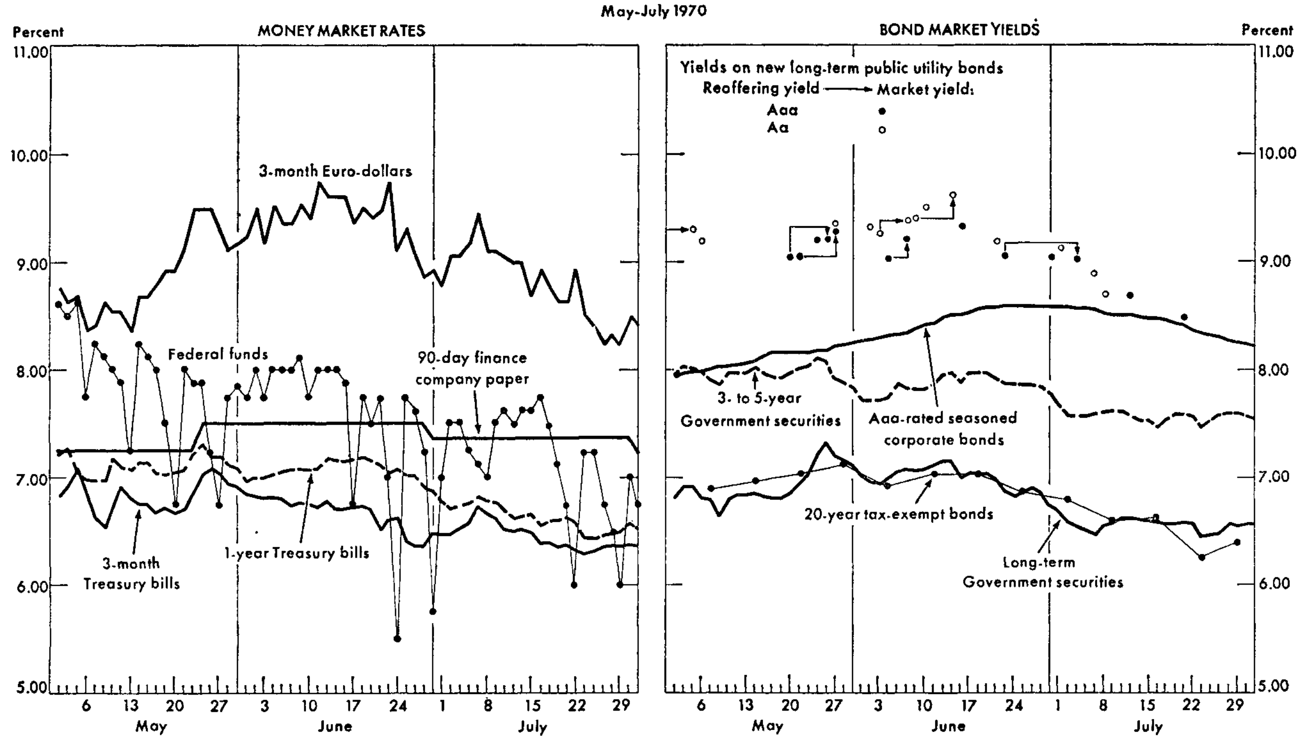
In percent

Maturities	Weekly auction dates—July 1970: July 6	July 13	July 20	July 27
Three-month	6.642	6.547	6.385	6.345
Six-month	6.656	6.644	6.442	6.429

Maturities	Monthly auction dates—May-July 1970: May 26	June 23	July 23
Nine-month	7.352	7.069	6.467
One-year	7.277	7.079	6.379

* 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.

Chart II
SELECTED INTEREST RATES
May-July 1970



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; 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-month and one-year Treasury bills.

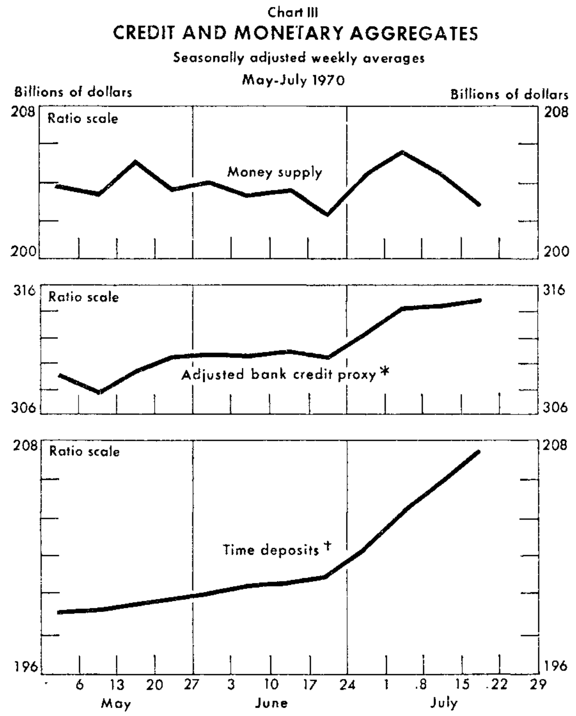
BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on seasoned Aaa-rated 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.

borrowings from the System rose almost $½ billion (see Table I) over the average of the previous four weeks in June. The basic reserve position of the forty-six major reserve city banks averaged $5.3 billion in the five weeks ended on July 29 (see Table II).

The Federal funds rate hovered around 7½ percent for most of July before moving somewhat lower at the end of the month (see Chart II). Euro-dollar rates remained at the lower levels established in late June, as United States banks further reduced their Euro-dollar borrowings.

The impact of recent financial developments is clearly evident in the growth of time deposits in July. The upsurge in CD's after the partial suspension of Regulation Q led to a jump in time deposits (see Chart III). Daily average time deposits at all commercial banks expanded at a 40½ percent seasonally adjusted annual rate during the four weeks ended on July 22, compared with the average of the previous month. The July advance followed a 7¾ percent annual rate of increase in June. Similarly, the adjusted bank credit proxy, which includes time deposits as well as all other member bank deposits and nondeposit liabilities, showed substantial growth in July, rising at a 17½ percent annual rate during the four-week period ended on July 22. In June, the bank credit proxy had increased at a 7 percent rate. The seasonally adjusted average money supply rose during the same four weeks in July at an annual rate of 5¾ percent after declining at a 1¾ percent annual rate in June.



Note: Data for July are preliminary.
* Total member bank deposits subject to reserve requirements plus nondeposit liabilities, including Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.
† At all commercial banks.

THE GOVERNMENT SECURITIES MARKET

The downward movement in yields on United States Government securities continued during July in response to optimistic reports on both the domestic and international fronts. Developments in the shorter term area of the market were punctuated by two auctions of TAB's on July 2 and July 16. Activity in the longer term sector was quiet and overshadowed, particularly later in the month, by participants' anticipation of the upcoming August refunding.

The market for United States Government notes and bonds remained firm in July. During the first days of the month, yields on long- and intermediate-term Treasury securities showed substantial declines in continuation of the rally that began late in June. Subsequently, however, yields on most issues fluctuated in quiet trading that reflected some profit taking and a movement by investors into corporate securities. Activity increased in the third calendar week of July, after improved prospects for a Middle East truce stimulated investor demand. However, yields showed little change during this and the final week of the month, as the market awaited details of the Treasury's August refunding.

The Treasury bill market continued to receive an inflow of funds from other financial markets, as investors placed increased emphasis on the quality of their investment holdings. Treasury bill rates moved somewhat higher during the first full business week in July, when dealers reduced their positions in bills prior to receipt of the newly auctioned TAB's. Conditions improved in the second week of the month, however, with Federal Reserve purchases and increased foreign demand for bills contributing to the better atmosphere. In the third week, modest but steady investor demand continued to lower rates on most bills, but this tendency diminished toward the end of the month. Over the month as a whole, rates on bills due within three months were generally 8 to 30 basis points higher while rates on longer term bills were from 1 to 40 points lower. The average issuing rates on new Treasury bills set at the weekly and monthly auctions declined (see Table III). The March 1971 TAB's auctioned on July 2 were issued at an average rate of 6.452 percent, while the April 1971 TAB's auctioned two weeks later yielded 6.504 percent.

On July 29 the Treasury announced the terms of its August refunding. The Treasury offered holders of the $6.5 billion of 6⅜ percent notes and 4 percent bonds maturing August 15 the option of exchanging their holdings for a 7¾ percent 3½-year note, priced at par, or a 7¾ percent seven-year note which will be discounted to yield about 7.80 percent. In addition, the Treasury announced it will offer for cash approximately $2¾ billion of a 7½ percent eighteen-month note which will be priced to yield about 7.54 percent. Payments for this note would cover the unexchanged portion of the August 15 maturities and raise some new cash. Qualified depositories will be permitted to make payment for the eighteen-month note by crediting up to 50 percent of their purchases to their Treasury Tax and Loan Accounts. The subscription period for the 3½- and seven-year notes will run from August 3 through August 5, while subscriptions for the eighteen-month note will be accepted only on August 5.

OTHER SECURITIES MARKETS

The corporate and municipal securities markets rebounded strongly in July, and yields fell to their lowest levels since March. Some uneasiness, however, was apparent in the shift of investor preference away from less highly rated offerings. Issuing rates on lower rated securities remained at very high levels over the month, prompting some postponements of previously planned new financings.

The resurgence of demand for corporate securities that developed during the second half of June continued into the first week of July amid light new issue activity. The rally culminated in substantial declines in yields on July 7 and 8, but some profit taking and a buildup of the schedule of new offerings later caused yields to fluctuate until mid-month. Subsequently, yields resumed their declines until late in the month, when heavier new issue activity and uncertainty over the terms and market effect of the Treasury's refunding briefly caused yields to rise. The downward trend in yields since mid-June was underscored by an offering on July 21 of $100 million of Aaa-rated telephone company bonds. The bonds, which were due in thirty-six years and carried five years of call protection, were offered at a yield of 8.50 percent, or 55 basis points below a similar offering on June 30 and 85 basis points below another top-rated telephone company flotation marketed on June 16. Although not all the bonds were placed with investors at that price, a World Bank issue consisting of $200 million of Aaa-rated 25-year bonds was offered two days later at 8.625 percent and met an excellent reception.

Yields on most outstanding and new tax-exempt issues declined decisively during most of July. New issue activity was heavier than usual, as declining yields allowed some issuers, who were unable to float new securities earlier because of interest rate ceilings, to return to the market. A boost was given to the tax-exempt market on July 22, when a long-anticipated Internal Revenue Service ruling indicated that interest costs incurred by banks in the ordinary course of business would be deductible for tax purposes unless there were circumstances demonstrating a direct connection between these borrowings and tax-exempt investments. Prior to this ruling, there was considerable controversy over whether banks would be allowed to deduct costs of acquiring funds which were then used in part to obtain tax-exempt securities. Over the month as a whole, yields were sharply lower and *The Weekly Bond Buyer's* index of seasoned tax-exempt bonds declined 46 basis points, the largest such decline since February of this year.

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