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Contents

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Inflation in a Sluggish Economy — Trouble for Monetary Policy*

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I am very glad to have the opportunity to address this important gathering of the nation's savings bankers. Not surprisingly, my banking contacts tend to be primarily with the commercial banks of this District, since most of them are member banks of the Federal Reserve System. The System exercises a direct and powerful influence over their reserves for the purpose of carrying out national monetary policy. But while our relationship with your institutions is not as direct, we recognize that you play an important role in the national economy, especially where mortgage credit is concerned. We also recognize that the System's supervisory role and regulatory powers with respect to state member banks often take us into areas of direct interest to savings banks. So I welcome this chance to share with you a few thoughts on significant monetary problems that we face today. Before dealing with monetary policy as such, I would like to touch on a few questions bearing on your own industry.

I am sure you know that, while the first impact of monetary policy is felt by the commercial banks, savings institutions have also proven to be very vulnerable to tight credit restraint. The last five years have provided two significant testing periods: first, during the 1966 "credit crunch" and, more recently, during the even more severe restraint of 1969 and early 1970. During the 1966 episode, you may remember, the Federal Reserve System was prepared to use its emergency powers in order to insure a flow of credit to the thrift institutions. We were similarly prepared last summer had the need arisen. These experiences involving drastic curtailments of deposit inflows and the consequent strains on savings bank liquidity led to widespread suggestions that only fundamental changes in the way savings banks do business could rescue them from a situation that was not only unpleasant for them but which also created unnecessary handicaps for the smooth execution of monetary policy.

Even without fundamental changes, however, thrift institutions have shown remarkable ability in negotiating the difficulties of the past two years. They had the foresight to provide larger liquid reserves than had been customary in the past. In addition, during much of 1970 they have been able to realize a sizable increase in deposits despite the fact that competing investments have been yielding far higher rates than savings institutions are permitted to pay on deposits. Admittedly, mutual savings banks, located as they are near the eastern financial markets, felt most keenly the competition of market instruments and did not fare so well as other thrift institutions in this regard. Nevertheless, in recent months, deposit flows to mutual savings banks have also strengthened considerably. In any event, the recent deposit experience speaks well for the public's confidence in the safety of funds entrusted to the savings institutions and for their handling of customer relationships. Their success has borne fruit in the form of larger flows of mortgage funds and a better pickup in housing construction than credit conditions themselves might have suggested. I might add, however, that recent generous flows of savings to the thrift institutions are probably due in part to a temporary desire for safe harbor by consumers as they try to evaluate the uncertainties of world developments and the dilemma posed by the persistently rapid rate of inflation despite a sluggish economy and rising unemployment.

In any case, the fact remains that your organizations are highly dependent on one type of long-term asset which is none too well matched with your principal form of liability. It is thus no wonder that savings bankers have

* An address before the annual midyear meeting of the National Association of Mutual Savings Banks, New York City, December 8, 1970.

been turning their attention to possible ways of diversifying both assets and liabilities through a wider variety of customer services. The fact remains, too, that because of the enormous social significance and political influence of the housing industry, your activities have been the object of much attention on the part of various legislative bodies and regulatory authorities. Artificial ceilings on deposit interest rates have never struck me as consistent with a free enterprise system, but a major argument in their favor has of course involved the desire to protect the thrift institutions from some of the consequences of tight money that have followed from your specialization in mortgage financing while holding essentially short-term liabilities.

I would hope that basic changes in your industry might in time obviate the need for such artificial protection. One of the most fundamental of these, variable interest rate mortgages, has made very little headway—though I would add that it seems to offer some promise. Perhaps the propitious time for experimentation is now, when continuing high interest rates might give the proposal considerable public appeal.

Recent efforts to expand your activities—notably by adding checking deposits and the making of personal loans—have captured the interest and support of thrift institutions. A significant first step is the recent authorization granted to Federal savings and loan associations to make certain third-party transfers. I would agree that such moves carry considerable appeal from the standpoint of public convenience and need. On the other hand, I would stress that piecemeal modifications of the savings institutions' present rights and privileges probably do not give adequate consideration to questions of competitive equality among financial institutions (including even-handed tax treatment) or to questions of monetary policy. In the latter connection I should like to point out that, if the savings banks are to become a new source of demand deposits and hence to perform a full-fledged money-creating function, they must accept the likelihood that in due course they will become subject to the reserve requirements of the Federal Reserve if we are to avoid an undesirable weakening of the effectiveness of monetary policy instruments.

The type of difficult questions I have touched on so briefly will be solved only if all concerned will devote their best efforts to solving them. I have no doubt you yourselves will be in the forefront of this movement, and I can assure you that the subject is receiving much thought in the Federal Reserve; we also can hope for constructive suggestions from the Presidential Commission on Financial Structure.

Let's turn now to the part that monetary and fiscal policy have tried to play in promoting the nation's major economic goals: sustainable economic growth, high employment, reasonable price stability, and equilibrium in our international payments. Nearly two years ago I referred in a speech to a severe testing period through which monetary and fiscal policy would have to perform, to determine whether these broad impersonal methods of economic control could bring a halt to the inflationary spiral without subjecting the country to a serious recession. The testing continues and the answer is not yet apparent. By the time effective policies were marshaled against inflation in mid- and late 1968, inflationary psychology had become so deeply embedded that it was very hard to dent it, much less to dislodge it completely. Policy was successful in bringing about a pronounced slowdown of business—indeed, culminating in two quarters of negative real growth in the last quarter of 1969 and the first of 1970. Since then the rate of positive growth has been very modest, and unemployment has been climbing faster than most economists had predicted. Whether all this has constituted a recession is largely a matter of semantics; the essential point is that we have reached a range of unemployment which it would be socially undesirable and politically impracticable to exceed for any length of time. Yet on the other side of the picture we see continuing inflation, now almost entirely of the cost-push variety, with grossly excessive wage settlements the order of the day. These settlements are far in excess of any conceivable productivity gains and hence bound to contribute to either lower profits or higher prices, or both. Evidence of a slower trend of cost-of-living increases is still too fragmentary to be very convincing. And there is a constant danger that, if business picks up too rapidly, we may again see demand pressures reinforcing the cost-push in raising prices further. The evidence of recent years raises serious questions as to whether very low unemployment rates are compatible with a reasonable degree of price stability—particularly if such rates are approached through a rapid upswing in economic activity. As for inflationary psychology, it seems to me that most businessmen and most consumers tend toward a fatalistic view that prices are likely to go on rising substantially for a long time to come.

We should not lose sight of the fact that inflation not only produces gross inequities in our domestic economy, threatens sound economic expansion, and causes severe social losses, but it is also the greatest threat to restoration of a reasonable approximation to balance-of-payments equilibrium, with all that that implies for the dollar's international standing and world trade.

The Federal Reserve deserves high marks for its performance during the period of severe financial stress that developed in June and July. The System has shown that it can and will act effectively to prevent financial panic when this threatens as a result of tight money conditions and deterioration in corporate liquidity and corporate credit standards. The atmosphere of extreme uneasiness in financial markets during the early summer clearly called for decisive Federal Reserve action in an area that the market tends to forget for years at a time, i.e., in our function as lender of last resort. When the Penn Central collapse threatened to dry up much of the commercial paper market and thus to put great strains on major corporate borrowers, the Federal Reserve System moved promptly to assure the banks that reserves would be available at the discount window to enable them to fill the gap by providing bank loans. I am especially proud of the role played in this by my associate, William F. Treiber, First Vice President. And at about the same time the Board of Governors took the equally important step of removing the Regulation Q interest rate ceiling on certificates of deposit maturing in less than ninety days, thus providing the banks with a more lasting source of funds to serve the same purpose. The rest is now history. The commercial banks jumped into the breach with speed and effectiveness, and fears of some kind of general financial collapse soon vanished. Incidentally, the legacy of this episode is by no means all bad. Credit standards in the banks and investment markets are undoubtedly appreciably sounder now than they were six months ago.

On the whole, fiscal policy has performed reasonably well over the past two years or so. In fiscal 1969 and 1970, it contributed to the slowdown by eliminating the large deficit which had been recorded in fiscal 1968. While the present fiscal year's deficit threatens to be quite large, its size can be attributed in large part to a decline in revenues caused by greater than expected business weakness and consequent shortfalls in revenue estimates. To this extent the deficit is tolerable and it may even be helpful.

What troubles me most about the Federal budget is not the prospective deficit this fiscal year, but rather a feeling of unease as to the probable direction and magnitude of spending and revenues over the next several years. There are real hazards in placing excessive emphasis on the full-employment budget concept. Useful as that concept is, there are two cautionary notes with respect to its use: (1) the fact that a great many assumptions must be made concerning what constitutes "full employment" and concerning the course of real economic growth, prices, and tax revenues, all of which leave an enormous margin for error in the calculations of the full-employment surplus and (2) the fact that, regardless of the state of the full-employment budget at a given time, it is the actual budget deficit that must be financed. The deficit can have severe consequences both in terms of pressures in the financial markets and for the orderly provision of credit by the Federal Reserve.

As for the outlook for Federal spending, I am struck by the magnitude of the rise in nondefense outlays in the last year or two. It is only the sharp curtailment of defense spending that has permitted a rather good showing by total expenditures. With a number of important nondefense programs still in their infancy, there is a real risk of accelerating increases in these outlays over the coming years, while at the same time we may soon have exhausted the possibilities of large cuts in spending on defense. In addition, while agency financing outside the budget seems to be slackening this year as housing funds become more available, there is a large volume of potential financing by new as well as existing agencies on the more distant horizon. All of this has a bearing on whether fiscal restraint will be readily forthcoming if it should be needed again within the next year or two.

Meanwhile, what about monetary policy's present role? As I said earlier, some easing of credit conditions and provision of adequate liquidity during the summer's financial troubles constituted one important feature of our policy this year. But our overriding concern has been to encourage moderate expansion of money and bank credit to help the economy stage an orderly and gradual recovery. It is never possible to know exactly what rates of increase for these aggregates are most likely to bring the desired results, especially since the effects usually involve an uncertain lag. With respect to the money supply, some adjustment should be made for shifts in the public's desire to hold money balances—which is another way of saying that money velocity is bound to show unforeseen fluctuations from time to time. For example, the General Motors strike doubtlessly lessened the demand for money and credit and made it harder to induce a desired growth of money with a given injection of reserves into the banking system or a given set of conditions in the money market. I should also like to repeat a point that can hardly be overemphasized, i.e., it is always dangerous to set much store by short-term (say, month-to-month) swings in rates of gain for money or credit. These series are subject to so many unpredictable and uncontrollable influences, or later revisions, that a longer perspective is essential if valid conclusions are to be drawn from the figures. Even quarterly data may be subject to temporary distortions that should be discounted—not to mention the fact that the data may be substantially revised after the initial publication. The rather wholesale revision of the money supply data released about ten days ago is a case in point. Furthermore, the bank credit data must always be viewed in the light of the factors encouraging or discouraging intermediation of the banking system in the savings-investment process. A very high rate of bank credit growth was fully justified when withdrawal of buyers from the commercial paper market forced borrowers back into the banks. But fortunately a much slower rate of growth has reappeared since the commercial paper situation has pretty well stabilized.

I would not like to give the impression that the System is concerned only with the rates of growth of the money and credit aggregates. Early this year there was a change of emphasis in this direction, but no more than that, and we continue to regard credit conditions and interest rates as important considerations in the setting of policy. Of course, interest rates are influenced primarily by the size of investment demands and the volume of available savings; our ability to affect rates, especially long-term rates, is decidedly limited. For some time now, short-term interest rates have been moving sharply lower in response to slackened business activity and reduced loan demand along with an accommodative Federal Reserve policy. But until recently long-term rates, despite the sluggishness of business, were slow to respond under the influence of an enormous flow of new issues in the capital markets. The widening spread between short- and long-term rates appeared to be a natural result of supply and demand forces, and I have seen no need for special actions to push long rates lower. Within the last few weeks, in any case, long-term rates have also turned sharply lower.

While it has seemed reasonable and, indeed, essential for monetary policy to encourage moderate business expansion, there is no assurance that a policy of this type either will be consistent with checking the deeply embedded inflation or will keep unemployment within politically tolerable limits. We are not yet visibly winning in the test of monetary and fiscal policy—so it is in no way surprising that calls for further Government efforts to exert direct influence on wages and prices are heard in an ever-increasing crescendo. I was encouraged to note the Administration's recent initiative with respect to allowable oil production and import quotas, and the defeat of a protectionist trade bill would be an important step from an anti-inflation point of view. It is certainly true that past experiments with incomes policies, both here and abroad, have not been startling successes. Yet we really have little alternative but to keep on experimenting in this area hoping to find some reasonably acceptable and effective approach, not as a substitute for proper fiscal and monetary policies but as an additional support for them. A simple call for wage and price controls does not offer a practical solution. Those who advocate such an approach are often prone to forget the elaborate administrative trappings needed to make them work. Moreover, short of a wartime emergency, elaborate and rigid controls would probably not command sufficient public understanding and support. Yet I am hopeful that our ingenuity can devise some sort of workable incomes policy, whether backed by jawbone or some more tangible carrot or stick, that would command reasonable public support and would permit speedier progress against both unemployment and inflation. There may also be a need for a greater effort to reduce the social hardships associated with any given degree of unemployment, in order to reduce the seductive appeal of treatment by sharply accelerated increases in overall demand. I would like to emphasize that in any case I can see a great need for cautious fiscal and monetary policy as long as inflation remains the challenge that it is today. As savings bankers, you have as great a stake as anyone in the solution of this exasperatingly stubborn problem.

PERSPECTIVE '70

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

Perspective '70 is available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045. A copy is being mailed to *Monthly Review* subscribers.

The Business Situation

Though obscured somewhat by the effects of the General Motors strike, recent business indicators suggest continued sluggishness in most sectors of the economy. In November, industrial production declined, personal income posted only a small increase, and retail sales continued to put on a lackluster performance. Continuing the trends which began in earlier months, businesses accumulated inventories at a relatively rapid pace while their sales generally fell; as a result, some areas of the economy —particularly the wholesale and manufacturing sectors— have a surfeit of inventory stocks. Although the automotive strike was partly responsible, the slackening in the economy seems to go beyond the direct and indirect effects of the work stoppage. In sharp contrast to much of the rest of the economy, residential construction activity has continued to gain upward momentum. With the resumption of production at GM, the stepped-up activity in the automobile and related industries should provide a substantial impetus to production and employment in the months immediately ahead.

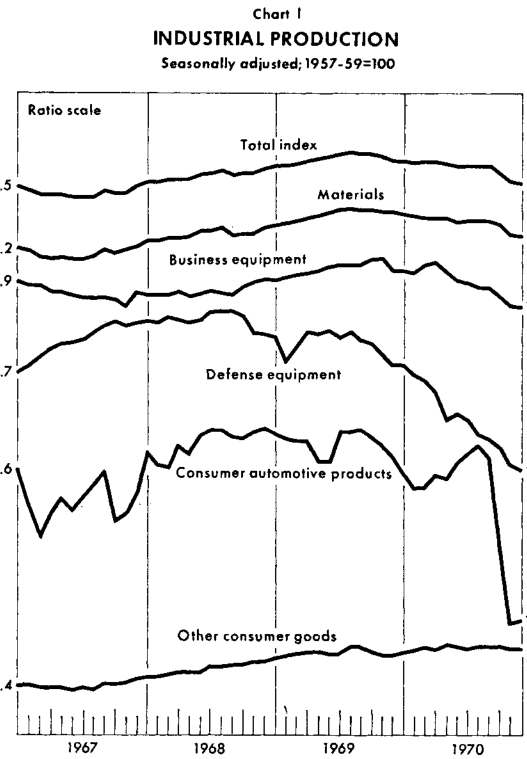
Despite the pervasive slack within the economy, consumer prices have continued their steep ascent. There has been some moderation in the rate of advance of the overall consumer price index as a result of a marked slowing in the pace of food price increases. However, this development has obscured somewhat the extremely rapid rise in prices of nonfood consumer commodities and consumer services. At the same time, the rate of advance of wholesale industrial prices does appear to have moderated somewhat during 1970, affording some encouragement that prices of consumer nonfood commodities may soon respond similarly. Thus far, however, there have not been any clear signs of abatement in the rate of consumer price increases.

PRODUCTION, ORDERS, AND INVENTORIES

Industrial production continued its downtrend in November, contracting by 0.6 percent on a seasonally adjusted basis (see Chart I). Unlike the preceding two months when the fall in production was partially attributable to the strike at GM, the indirect effects of this work stoppage appear to have added little downward impetus to the overall index. The November drop centered in the business and defense equipment and the materials components. At its November level of 161.4 percent of the 1957-59 base, the Federal Reserve Board's index of industrial production was 7.6 percent below the peak attained in July 1969. Thus, measured in terms of this index, the current business slowdown is comparable in magnitude to the 7.3 percent fall during the 1960-61 contraction but is considerably milder than the 14 percent decline recorded in the 1957-58 recession. With the resumption of production at GM in late November, the index will probably show considerable gains in the near term as the effects of the ten-week strike unwind themselves.

Output of consumer goods was virtually unchanged despite the fact that the production of automobiles actually edged upward. Consumer goods output exclusive of automobiles was sluggish throughout the year; for the first eleven months of 1970 the index has risen by only 0.9 percent. Moreover, among selected consumer goods categories, such as furniture and apparel, output actually decreased in 1970. The November declines in defense and business equipment output were further extensions of downward trends which have been under way for some time. Defense goods production has been on the downslide since August 1968, while business equipment production has declined 11.9 percent from the October 1969 peak.

Following three consecutive—and at least partly strike-related—monthly declines, new orders for durable goods advanced by 1.9 percent in November on a seasonally adjusted basis. However, at $29.0 billion, orders in November were still 5.2 percent below the monthly average in 1969. The principal factors underlying the November increase in durables orders were the sharp spurts in orders for nonautomotive consumer durables and producers' capital goods. Having jumped 5.8 percent to $6.9 billion, orders for producers' capital goods reached the highest level since September 1969. Capital goods orders appear to have strengthened somewhat in the last three months, although the monthly average for the first eleven months of 1970 was still below the average for 1969. In view of the general lack of growth in planned plant and



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.

equipment expenditures projected by recent surveys, it is uncertain whether this uptrend in orders is indicative of some future strengthening in investment spending. While orders for durables increased in November, durables shipments continued to edge down to the lowest level since December 1968, marking the fourth successive monthly decline.

There apparently continue to be some areas in the economy where inventory stocks are a bit high relative to the volume of sales, though the extent of the imbalances has been clouded by the automotive strike. Large accumulations of inventories in October at wholesale outlets, retail stores, and manufacturing firms more than offset a $1.0 billion contraction of retail automobile dealers' stocks, so that total business inventories rose by only a small amount. Within the trade category, the inventory-sales ratio for nonautomotive retailers actually dipped slightly. At wholesale outlets, however, accumulations of stocks continued to outrun sales, and the inventory-sales ratio rose to its highest level in a decade. Manufacturers' inventories swelled by $0.8 billion in October, more than double the average increase in earlier months of 1970. This inventory accumulation coupled with a $1.5 billion fall in sales pushed up the inventory-sales ratio, with the imbalance problem concentrated in the durables sector. Because much of the October decline in durables sales was strike related, it appears that the inventory-sales ratio for durables manufacturing somewhat overstates the extent of any inventory-imbalance problem in this sector. However, November data—which are available for manufacturing only—indicate that the problem of excess stocks in the manufacturing sector was exacerbated in that month. Durables manufacturers accumulated another $0.4 billion of inventories in November, while their sales dropped by $0.6 billion. Unlike that in the previous month, the November fall in sales was widely distributed and was not primarily associated with the automotive strike. Indeed, even the large decline in the sales of transportation equipment was accounted for by reductions in the shipments of the aerospace industry.

RESIDENTIAL AND NONRESIDENTIAL CONSTRUCTION ACTIVITY

After having bottomed out in the first quarter, residential construction activity has progressively strengthened throughout the third quarter. This trend continued in November when total private housing starts expanded by 122,000 units to a seasonally adjusted annual rate of about 1.7 million units. This represented the largest number of starts initiated in any one month since January 1969 and exceeded the average number of starts recorded in the first quarter of 1970 by 35 percent. About 60 percent of the November surge in starts occurred in the multifamily category. However, starts of single-family structures, which typically have a higher value per unit, also rose by about 50,000 in November to the highest level since December 1968. Because construction activity is spread out for several months after new units are begun, residential housing expenditures tend to lag the series on housing starts. Thus, following the trend in housing starts, outlays for nonfarm residential buildings have also accelerated sharply in recent months. Since June, when outlays fell to a recent low of $28.1 billion on a seasonally adjusted annual rate basis, spending on housing has expanded at an annual rate of 20.4 percent through November. Moreover, the November surge in starts would suggest some further gains in outlays in the months immediately ahead. In a similar vein, the recent strength in building permits also suggests some further strength in this sector. Marking the fourth consecutive monthly increase, new permits advanced slightly in November to a record high 126.0 percent of the 1957-59 base.

Residential construction activity continues to be favorably influenced by the large deposit flows to the nation's mutual savings banks and savings and loan associations, the major suppliers of mortgage credit. While these flows have, of course, expanded the availability of mortgage credit, there is some evidence that the increased supply of funds is beginning to produce some easing in the terms under which mortgages are granted. Mortgage interest rates, which tend to be quite sticky, have edged down slightly. Between July and October, the interest rate on thirty-year Federal Housing Administration mortgages fell by 14 basis points and that on conventional mortgages declined by 10 basis points. The latest data show an increase in the loan-price ratio for conventional mortgages on new homes, suggesting a reduction in down-payment requirements. This easing in mortgage market conditions bodes well for an extension of the strength in residential construction activity into 1971.

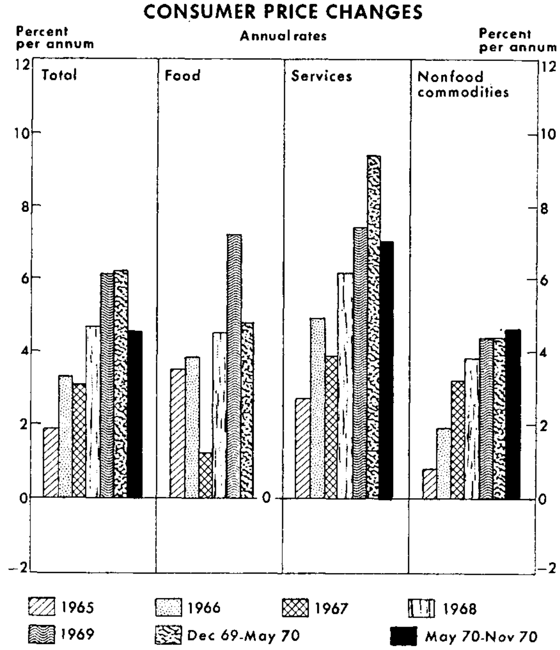
While construction activity in the residential sector has gained upward momentum throughout most of 1970, the opposite trend has emerged in the private nonresidential construction sector. Indeed, for the three months ended in November, the value of new commercial and industrial construction put in place was 10.6 percent below the first-quarter annual rate average of $17.6 billion. Similarly, the F. W. Dodge data on construction contract awards for commercial and industrial structures have been characterized by a distinct downward trend in 1970, and spending on nonresidential structures as measured in the gross national product (GNP) accounts showed absolute declines in both the second and third quarters of 1970. The weakness of new construction activity in the industrial and commercial sector is, of course, in line with the paring-down in business planned capital spending which has characterized 1970. In real terms, outlays on structures have fallen off more sharply than have outlays on producers' capital equipment. This suggests that business firms have attempted to economize on their investment costs by expanding and modernizing productive facilities within existing structures.

PRICE DEVELOPMENTS

Inflation continues to be a more deeply rooted problem than most observers had originally thought; despite the slowdown in economic activity, the pace of inflation does not appear to have noticeably abated. In November, the consumer price index advanced at a seasonally adjusted annual rate of 3.7 percent, down considerably from the 6.4 percent average increase of the preceding two months. In view of the seesaw monthly movements in the rates of change in this index throughout the year, it is too soon to hail November's slowdown as the beginning of a downtrend. Moreover, part of the improvement in November was the result of the decline in food prices, whereas the rise in nonfood commodities prices actually exceeded the average gain in these prices for the first half of 1970.

During the past two years, the price rises originating in various sectors have contributed disproportionately to the gains in the overall consumer price index (see Chart II). While in 1969 rising food prices pulled up the overall index, they have tended to dampen the advances in the consumer price index during 1970, particularly in the closing months of the year. On the other hand, nonfood commodities prices continue to surge ahead. Adjusted for seasonal variation, these prices increased 4.8 percent in November, following rises of 6.8 percent in October and 6.8 percent in September. As shown in Chart II, there has been no abatement in the rate at which nonfood

Chart II
CONSUMER PRICE CHANGES



Note: Seasonally adjusted except for services.
Source: United States Department of Labor, Bureau of Labor Statistics.

commodities prices have been advancing. The failure of these prices to respond to the economic slowdown is one of the most perplexing aspects of the present inflation. Similarly, services prices accelerated in November, growing at a rate of 7.6 percent. (Services include such things as medical care, various modes of public transportation, and insurance.) Price rises in this sector have been the primary source of increases in the consumer price index. Though constituting only about one fourth of the overall index, services prices have contributed a shade more than half the past year's rise. Like those for nonfood commodities, these price rises have also stubbornly persisted.

There has lately been some easing in the rate at which wholesale industrial prices have been advancing. In December, according to preliminary seasonally adjusted estimates, these prices rose at an annual rate of 2.8 percent, reflecting primarily the higher prices of fuels and electrical power. During the second half of 1970, industrial wholesale prices posted a 3.2 percent annual rate gain, compared with the 3.8 percent growth in the first half of 1970 and the 4.2 percent growth in the second half of 1969. It may be that the failure of consumer commodities prices to reflect the slowing in the pace of wholesale industrial prices is in part a consequence of the rapidly rising shipping costs. Wholesale agricultural prices fell 7.2 percent on a seasonally adjusted annual rate basis in December, marking the third successive monthly decline. This decline entirely offset the advance in industrial commodities prices so that the seasonally adjusted overall wholesale price index was unchanged in December.

PERSONAL INCOME AND CONSUMER DEMAND

Personal income posted a relatively small increase of \$2.4 billion in November, less than half the average monthly increase registered in 1969. This gain was depressed somewhat by a roughly \$1 billion nonrecurring payment to retired railroad workers in October, which had buoyed the level of personal income in that month, while the removal of the retroactive payment from the November data depressed the level of personal income in that month. Even allowing for this factor, however, the rise in personal income in November was of a relatively small magnitude. The growth in personal income principally reflected a \$1.8 billion gain in wage and salary disbursements; in turn, this increase in disbursements centered in the government and services sectors which posted expansions in payroll employment in November. In the manufacturing sector, wage and salary disbursements declined slightly, mirroring the November contractions in overtime hours and employment.

According to preliminary estimates, there was a small decline during November in durables retail sales which more than offset the gain in nondurables sales, so that total retail sales on a seasonally adjusted basis edged down 0.5 percent. While consumer spending has been sluggish all year, the purchases of durable goods have been particularly lethargic. Dealer sales of domestically produced new cars during the first eight months of the year were off 8.2 percent from the corresponding average for the last year; during the September-November period when the GM strike was in effect, dealer sales of new cars produced by the other automotive companies contracted further on a seasonally adjusted basis. In addition, retail sales of nonautomotive durables have failed to register any growth during the year; for the first ten months, nonautomotive durables sales in current dollars were virtually unchanged relative to the same period in 1969. Concurrent with the sluggishness in retail sales—and in consumer demand generally—have been large increases in disposable income, which is equal roughly to personal income less personal taxes. As a result, then, the personal savings rate has been abnormally high all year. The large store of savings accumulated in recent quarters may provide the fuel for future step-up in the pace of consumer spending, though its timing and magnitude are still uncertain.

The Money and Bond Markets in December

Interest rates continued to decline on a broad front until about mid-December, and then generally leveled off or rose somewhat over the latter half of the month. On balance, most interest rates were little changed for the month, following the sharp declines of November (see Chart I). Over the fourth quarter as a whole, however, both short- and long-term rates declined considerably and in several instances fell to their lowest levels in a year and a half or more. Thus, the average issuing rates on new three- and six-month bills reached their lowest point since late 1967, while *The Weekly Bond Buyer's* index of yields on twenty municipal bonds fell to its May 1969 level by the close of 1970.

Both the money supply and the adjusted bank credit proxy[1] rebounded in December following two months of relatively slow growth. Over the fourth quarter as a whole, the money supply apparently grew at about a 3½ percent annual rate and the adjusted credit proxy at about an 8 percent rate. Over the year 1970 the money supply increased by about 5½ percent, compared with 3 percent during 1969. The adjusted bank credit proxy grew by about 8¼ percent over 1970 after virtually no growth during the previous year.

THE MONEY MARKET

Conditions in the money market eased further during December, when the effective rate on Federal funds averaged 4.90 percent, some 50 basis points lower than in the preceding month. Reflecting in part the substantial provision of reserves by System open market operations, as well as continued sluggishness of loan demand, member bank borrowings from the Federal Reserve Banks declined further in December. Such borrowings averaged $348 million for the month (see table), down $61 million from the November average and the lowest monthly level since January 1968.

Business loan demand at weekly reporting banks continued in the sluggish pattern which began in mid-September. During the week containing the December 15 corporate tax payment date, business loans (adjusted for sales to affiliates) grew by only $1.2 billion, compared with an increase of $1.6 billion in the same period last year when bank reserve positions were under considerably more pressure. Moreover, for the fourth quarter as a whole, repayments of business loans exceeded new borrowing at weekly reporting banks. Consequently, outstanding loans fell by $1.4 billion, whereas during the comparable periods of 1968 and 1969 they rose by $4.4 billion and $3.1 billion, respectively. In response to the contraseasonal slackening of loan demand, commercial banks had reduced their prime lending rate by ½ percentage point in two steps during November. Then, following the mid-December corporate tax date experience, major banks lowered their prime rate an additional ¼ percentage point to 6¾ percent, compared with the high of 8½ percent earlier in the year. The prime rate was again reduced by ¼ percentage point to 6½ percent in early January.

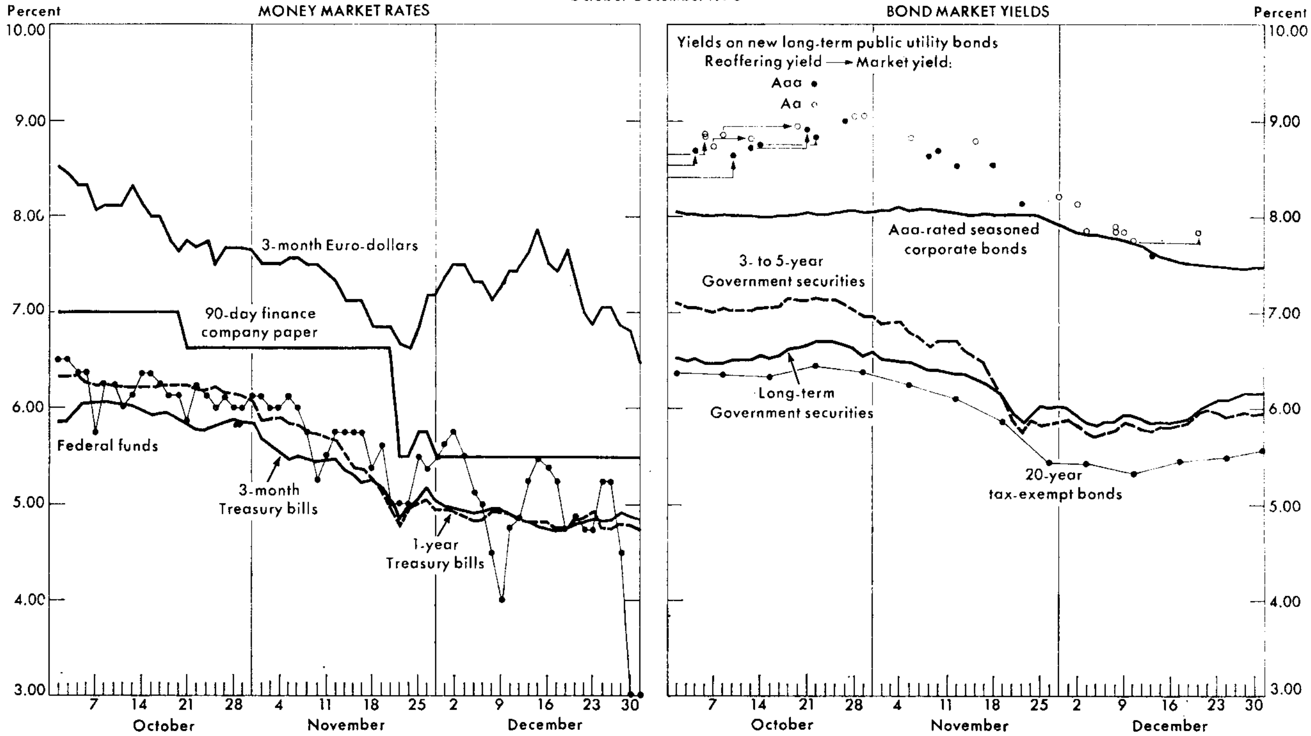
Preliminary data indicate that the money supply grew at about a 6 percent annual rate during December following gains of only 1.1 percent and 2.8 percent in October and November when economic activity was depressed by the strike in the automotive industry. Over the three months as a whole, the money supply grew at about a 3½ percent rate. The adjusted bank credit proxy showed an even greater rise in December, growing at an annual rate of about 15 percent compared with increases of 1.1 percent and 7.0 percent in the preceding two months. This brought the growth rate of the adjusted proxy over the fourth quarter to about 8 percent. Continued heavy inflows of time deposits (see Chart II), particularly large certificates of deposit, were the primary factor in the substantial rise in the proxy. Large CD's at weekly reporting banks climbed to $26.1 billion at the end of December, surpassing the late-1968 peak by $1.8 billion.

[1] A measure of bank liabilities, which includes deposits subject to reserve requirements and nondeposit items such as Euro-dollar liabilities and bank-related commercial paper.

Chart I

SELECTED INTEREST RATES

October-December 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.

Nondeposit liabilities of banks declined further during the month, however. Since Euro-dollar rates far exceeded domestic interest rates, banks reduced their Euro-dollar liabilities by an additional \$1.1 billion. Outstanding Euro-dollar liabilities of weekly reporting banks totaled \$7.7 billion on December 30, just one half of their October 1969 high. Bank-related commercial paper—the other major nondeposit component of the adjusted credit proxy—also declined in December, continuing a trend which has been evident since the late-August announcement of the imposition of reserve requirements on these liabilities. As a result of the accompanying reduction of the reserve requirement on large time deposits to the same level as that on commercial paper, CD's and bank-related paper were placed on a more nearly equal basis. Since both banks and their customers tend to prefer deposits to commercial paper, the volume of bank-related paper outstanding was reduced to \$2.4 billion at the end of the year, down from a high of \$7.8 billion at the end of July.

THE GOVERNMENT SECURITIES MARKET

The market for United States Treasury issues continued to advance over the first half of December, and yields on all maturities registered additional declines. The rally faltered after midmonth, however, and prices generally declined thereafter, particularly in the coupon sector. As a result of the consolidation in the coupon market, yields on most longer dated securities were higher at the close of December than they were at the start of the month. Yields on intermediate-term issues generally rose 3 to 27 basis points, while those on most long-term coupon issues ranged between 3 and 20 basis points higher.

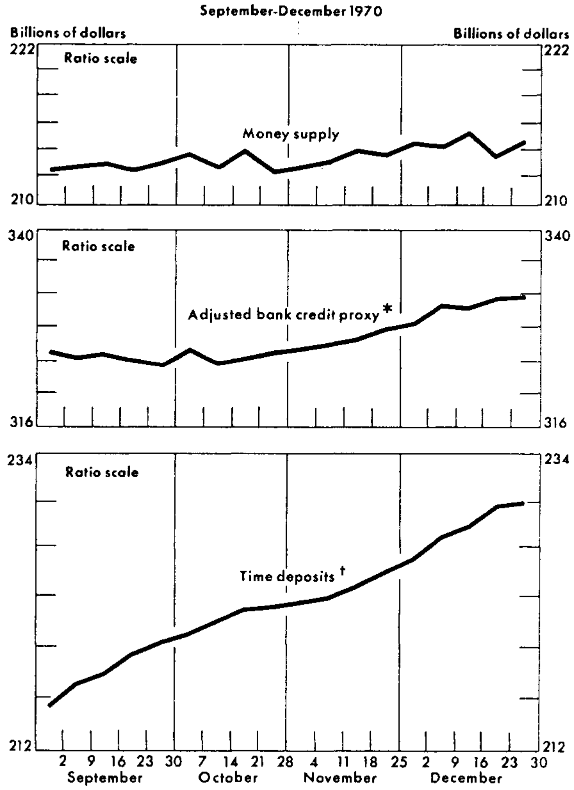
The month-long rally in the bond market was sustained in the first week of December by the reduction in the discount rate on November 30, System purchases of coupon issues on the following day, and active investor demand. Some profit taking then emerged, as participants reflected upon the sizable rise in prices which already had occurred, but after a few days the coupon market resumed its advance. The gains at this time were triggered in large part by the expectation of further reductions in interest rates, particularly in the prime rate in view of the contra-seasonal sluggishness of business loan demand at commercial banks. Increased demand for Treasury securities on the part of both investors and professionals was an additional factor in the renewed advance, and over the December 1-14 period yields on most coupon issues showed net declines of 8 to 24 basis points.

The better tone was short-lived, however, and yields on Treasury notes and bonds began to rise on December 15 in reaction to the unenthusiastic response given by investors to a large, aggressively priced new corporate bond issue. On several succeeding days coupon yields continued to rise, as investors and dealers attempted to reduce their holdings. Increasingly as the month progressed there was discussion of the forthcoming Treasury refunding in February, the terms of which will probably be made known late in January, and a reluctance on the part of dealers to add to their already large inventories in the face of the imminent refunding.

An additional factor which weighed upon the coupon market in the latter half of December was the possibility that, after the turn of the year, insurance coverage on Treasury and Federal agency bearer securities held by banks, dealers, and brokers might be drastically curtailed. The Federal Reserve Bank of New York, in cooperation with the financial community, formulated contingency plans to ensure the continued functioning of the market in the event that one or more major banks or dealers curtailed its securities operations. Late in the month, the major insurer in this field made known its intention of extending coverage with respect to banks through the first three months of 1971, thereby removing for the time being the threat of disruption of trading in the Government securities market. Meanwhile, the Federal Reserve Bank is pressing ahead with plans for the further expansion of its Government securities clearing arrangement and of the book-entry procedure for Government securities, as a means of minimizing the physical handling of bearer Government securities by market participants.

Unlike yields on most Government coupon issues, Treasury bill rates declined on balance during December. The bill market was buoyed early in the month by some of the same factors that led to an improvement in coupon issues. At midmonth, when the rally in the capital markets faltered, the bill market performed quite well in the absence of the usual selling pressure in connection with the corporate tax date. In addition, there was steady investor demand for bills much of the time and yields continued working down. As the holidays approached, however, apprehension over the uncertain insurance situation and a slackening of investor interest were felt in this sector as well, and yields edged somewhat higher. Nevertheless, rates on most issues declined by a net of 7 to 19 basis points over the month.

Chart II
CREDIT AND MONETARY AGGREGATES
Seasonally adjusted weekly averages
September-December 1970



Note: Data for December 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.

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

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

Factors	Changes in daily averages — week ended on Dec. 2	Dec. 9	Dec. 16	Dec. 23	Dec. 30	Net changes
"Market" factors						
Member bank required reserves	— 168	— 109	— 344	— 156	— 331	—1,108
Operating transactions (subtotal)	— 410	+ 100	— 419	+ 395	+ 507	+ 173
Federal Reserve float	— 317	+ 152	— 103	+ 905	+ 741	+1,378
Treasury operations*	+ 34	+ 103	— 107	+ 1	— 376	— 345
Gold and foreign account	+ 5	— 8	+ 3	— 8	— 19	— 27
Currency outside banks	— 6	— 81	— 260	— 665	+ 232	— 780
Other Federal Reserve liabilities and capital	— 126	— 65	+ 47	+ 161	— 70	— 53
Total "market" factors	— 578	— 9	— 763	+ 239	+ 176	— 935
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 967	— 138	+ 588	— 48	— 88	+1,281
Outright holdings:						
Government securities	+ 516	+ 32	+ 328	+ 286	+ 42	+1,204
Bankers' acceptances	— 1	+ 4	+ 6	+ 8	+ 2	+ 19
Repurchase agreements:						
Government securities	+ 337	— 177	+ 258	— 321	— 45	+ 52
Bankers' acceptances	+ 42	+ 33	— 28	— 14	— 23	+ 10
Federal agency obligations	+ 73	— 30	+ 24	— 7	— 64	— 4
Member bank borrowings	+ 18	— 163	+ 108	— 75	— 54	— 166
Other Federal Reserve assets†	— 61	+ 26	+ 28	+ 45	+ 45	+ 83
Total	+ 924	— 275	+ 724	— 80	— 96	+1,197
Excess reserves	+ 341	— 281	— 37	+ 159	+ 80	+ 262

	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash	28,885	28,710	29,015	29,330	29,741	29,136‡
Required reserves	28,463	28,572	28,916	29,072	29,403	28,885‡
Excess reserves	417	136	99	258	338	250‡
Borrowings	455	290	399	324	270	348‡
Free, or net borrowed (—), reserves	— 38	— 154	— 300	— 66	68	— 98‡
Nonborrowed reserves	28,430	28,420	28,616	29,006	29,471	28,788‡
Net carry-over, excess or deficit (—)§	70	204	122	137	117	130‡

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 December 30.
§ Not reflected in data above.

OTHER SECURITIES MARKETS

In the corporate and municipal bond markets, yields on both new and seasoned issues showed further decreases in the early part of the month, but then some investor resistance developed in the market for tax exempts. Profit taking and investor unwillingness to pay higher prices later extended to the corporate bond market, and by mid-December the approximately six-week-long rally had faltered in both sectors.

Rates on new and seasoned corporate bonds moved lower as the month opened, and on December 3 a long-term Aa-rated utility issue was priced to yield 7.85 percent, the first instance in sixteen months that the return on such a new issue was less than 8 percent. The reception to these bonds was quite favorable, despite the fact that the return was 37 basis points lower than that on a similar issue sold three days earlier, and over the next several days additional Aa-rated offerings were marketed at this same yield. The response of the market was somewhat cooler, however, and these later issues were initially only partially sold. When on December 10 another utility bond was even more aggressively priced to provide investors with a return of only 7¾ percent, however, the remaining 7.85 percent bonds were snapped up. The last large corporate issue to be sold in 1970 was a $200 million offering of New York Telephone Company bonds, which was marketed on December 14. Priced to yield 7.60 percent—56 basis points below the yield offered on the most recent comparable issue on November 23—the bonds moved slowly and the bulk of them remained in the underwriting syndicate's inventory at the end of the year.

Prices of municipal bonds continued to rise during the first week of December, but the rally began to falter during the next week when the market faced one of the heaviest calendars on record. Indicative of the improvement during the rally is the fact that for almost two years the state of Texas had been unable to sell certain bonds because of a 4.5 percent interest ceiling but finally marketed them on December 7 at a net cost of 4.07 percent. On the following day, however, more than $400 million in new tax-exempt securities was offered, and investor interest was decidedly restrained. Yields were raised somewhat on succeeding new offerings, but dealer inventories continued to rise as an unusually heavy December calendar was marketed. The Blue List of advertised inventories climbed to more than $1 billion during the December 10-14 period. Finally in the third week of December, underwriters began pricing new issues more attractively to investors, and several bond offerings were quickly sold out. In the face of such sizable inventories and the success of these new, lower priced bonds, a number of outstanding issues were released from syndicate price restrictions with upward yield adjustments of 20 to 40 basis points. Dealer inventories were reduced, but the Blue List was still at a very high $937 million on December 31.

An interesting development in the tax-exempt market during December was the sale of some $46 million in bonds by the Vermont Municipal Bond Bank, which in turn will purchase the bonds of several small Vermont communities and school districts that individually would not have ready access to nationwide capital markets. The Aa-rated bonds of the bank were well received and may set a pattern for other states which are considering ways to raise additional funds for financing local governments.

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