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Remarks of the Honorable John B. Connally Secretary of the Treasury

Editor's Note: *These remarks, dealing with national and international economic policy issues, were presented before the International Banking Conference of the American Bankers Association, Munich, Germany, May 28, 1971.*

The opportunity to participate in this monetary conference has been of great value to me. It is a privilege, and I'm greatly honored by the invitation to share some of my thoughts with you at this closing session.

The hospitality of our Bavarian hosts is alone enough to make it worthwhile being here.

But we are here on serious business at a serious time. We are aware of the strains upon the monetary framework upon which we all depend to carry on our international commerce.

These monetary tensions are a warning. Elements of international monetary cooperation, built with so much effort in the postwar period, are being questioned.

There are also questions about the direction of our policies in the United States. I intend to deal with these questions openly and frankly, lest doubts corrode our purposes and our success. Most importantly, we need to recognize that the disturbances on the surface of the exchange markets are only symptomatic of deeper issues of national and international economic policies.

No group is more aware than bankers that our post-World War II prosperity has relied on the close integration of the world economy and money markets. We have seen nothing less than an economic revolution, with benefits widely shared.

In our exhilaration over the gains, let us not forget that there are costs. Rapid progress in trade and investment has meant vast changes—changes with an uneven impact. As a result, particular industries and even entire countries face difficult adjustment problems.

By definition, an allied international economy implies some squeeze on independent national action.

Basic elements of economic and political power, and responsibilities for leadership, have drastically shifted since the main outlines of postwar policy were shaped a generation ago.

We must recognize, respond, and adapt to these new realities.

Internal stability and social tranquility are legitimate goals of every society, yours and mine. But along the road there are temptations. It is easy to understand how one country or another can be tempted to shirk its responsibilities to the international community, including the maintenance of monetary order.

A stable monetary order requires nations to know and accept the "rules of the game". But let us not confuse cause and effect. It has been wisely said that money is but a veil. Monetary disturbances could help speed the processes of economic nationalism and disintegration. But we would be unrealistic to anticipate workable monetary solutions for essentially nonmonetary problems.

There is no magic that can reconcile incompatible objectives. Money is not a substitute for productive efficiency and competitive strength. It cannot assure fair and equitable trading conditions. The plain danger is that, by expecting too much from the monetary system alone, we may fail to address the underlying need for change in other aspects of our economic life and policies.

What matters most is the spirit and attitude we each bring to this task. Here, I believe we in the United States have a special responsibility to make our approach and intentions crystal clear. I hope I do so.

Our economy is large and rich. We have a high level of trade. Our markets are relatively open. Our currency is a world currency.

Obviously, what we do matters a great deal—not just to our 200 million citizens, but to others as well. The manner in which we in the United States pursue our interests is crucial to any effort of the world community to move ahead together in a constructive, cooperative way. What can be expected of the United States in the years ahead? That early patriot, Patrick Henry, once shrewdly observed: "I know of no way of judging the future but by the past." If there are those who doubt our basic intentions and motivations, I commend that standard to you. You will find, I believe, our record to be a proud and constructive one, aimed not at dominance but at mutual growth and strength.

Even before the end of World War II—with the cooperation of many, but primarily with American initiative and support—the foundations of the present monetary system were set out at Bretton Woods. Today, only monetary historians may recall that this approach was not adopted without a struggle. An important segment of American opinion favored the so-called "key currency" approach. Arguing essentially that the economic ascendancy of the United States justified enshrining a kind of informal dollar-sterling standard with other currencies assuming a more or less permanent subsidiary role.

But policy makers embraced another line of thought. It led to the International Monetary Fund (IMF)—a thoroughly multilateral system, with proportional participation and voting by all members.

The same issue was posed—and answered in the long debate over the introduction of special drawing rights. Again, the United States joined enthusiastically in a deliberate decision to seek a broader, multilateral base for reserve creation, building on the mechanism of the IMF.

I recognize, of course, that the monetary system established at Bretton Woods did not abrogate the reality that the United States emerged from World War II as the principal producer of many goods in a war-shattered world. Our allies and former enemies alike lacked the financial resources to buy those goods or rebuild their economies.

Our interests and compassion combined to provide vast resources devoted to reconstruction through the Marshall Plan and otherwise. New trading arrangements were put in place and codified in the General Agreement on Tariffs and Trade.

The competitive recovery of other countries was speeded by a series of large devaluations of other currencies in 1949 and thereafter. We came to acquiesce in restrictive practices by many countries. Investments by our industry overseas were strongly encouraged by our tax and other policies. And, as the need for financial assistance tapered off in Europe, we pioneered in assistance to the developing world. At this point, there was a shortage of, and a cry for, the United States dollar.

I recite this brief record not to elicit either praise or thanks. My point is simple. We have consistently felt through the years that our basic national interest lies in an outward orientation of economic policy—alert and responsive to the needs of others.

Today:

—The United States continues as the major capital exporter;

—We make heavy outlays for defense costs in Europe;

—The aid burden remains large, despite increasing participation by others.

As any nation, it might have been possible for us to redress our payments balance sharply and decisively by turning inward:

—By heavily protecting our markets,

—By sharply cutting our aid, and

—By retreating into a "Fortress America". But we refrained.

Our markets have remained among the most open in the world, in the face of massive increases in imports. We have supported the growth of the Common Market, despite its commercial and economic costs. We led repeated efforts to cut tariffs multilaterally, while continuing to accept the pleas of Japan and the Common Market that major areas of their economies should be shielded from international competition.

I leave it to others to judge whether the policies of the United States for more than the past quarter century have been benign. But I submit they have not been policies of neglect.

We are now dealing with not one but two problems simultaneously in the interest of the monetary system and, more broadly, a liberal trading order.

I refer first to our underlying deficit—running at $2 billion to $3 billion a year.

The second problem is one of enormous short-term money flows. In a sense, it grows out of the success in achieving broad, fluid, and integrated international capital and money markets throughout the free world. But now we see signs that the child of success is threatening the mother that nurtured it—the system of fixed exchange rates and freely convertible currencies.

Neither of these problems is uniquely American. We must all be concerned with the stability of the system, and the stability of the dollar that is a cornerstone of the system—whether we planned it or not and whether we like it or not.

The relevant issue is not to fix blame for how we got where we are—and then engage in destructive recriminations. We need a more constructive approach. Let us fix national responsibilities to deal with the problem now and in the future—responsibilities that can realistically be met because they are well rooted in present circumstances and present capabilities—not those of the first postwar decade.

Let us, too, identify and undertake those joint actions necessary to deal with short-term flows—without in the process tearing apart the essential fabric of the system and institutions that serve us all.

Our own responsibilities are clear enough. The largest trading nation and custodian of the reserve currency is properly asked to meet high standards of economic performance. Prosperity and price stability are essential ingredients of that performance.

In the late 1950's and early 1960's we did achieve virtual price stability. Our current account reflected the benefits. I fully recognize that in more recent years our record has been a less happy one.

But the fact is that we had the will and the courage during the past 2½ years to bring our inflation under control by stern fiscal and monetary policies. Specifically, we raised taxes, and in 1969 and early 1970 money was tighter and interest rates higher than in any time in the last one hundred years.

The domestic cost has been heavy. Excess demand has given way to economic slack, low profits, and unemployment of five million people, more than the entire labor force of the Netherlands, Belgium, or Switzerland.

Inflation has been slow to yield—but it is yielding. Now tight money and fiscal restraint have been replaced by ease and stimulation. In the circumstances, is this wrong? I think not. Certainly, it would make little sense to ask for high interest rates in the United States at the expense of more unemployment, and at the same time bless higher rates of interest abroad because other nations believe it is in their interest to use that weapon to combat inflation.

Inflation has contributed to the prolongation of our balance-of-payments deficit. But it is far from the only factor.

Specifically, we today spend nearly 9 percent of our gross national product on defense—nearly $5 billion of that overseas, much of it in western Europe and Japan. Financing a military shield is a part of the burden of leadership; the responsibilities cannot and should not be cast off. But twenty-five years after World War II, legitimate questions arise over how the cost of these responsibilities should be allocated among the free world allies who benefit from that shield. The nations of western Europe and Japan are again strong and vigorous, and their capacities to contribute have vastly increased.

I find it an impressive fact, and a depressing fact, that the persistent underlying balance-of-payments deficit which causes such concern, is more than covered, year in and year out, by our net military expenditures abroad, over and above amounts received from foreign military purchases in the United States.

A second area where action is plainly overdue lies in trading arrangements. The comfortable assumption that the United States should—in the broader political interests of the free world—be willing to bear disproportionate economic costs does not fit the facts of today. I do not for a moment call into question the worth of a self-confident, cohesive Common Market, a strong Japan, and a progressing Canada to the peace and prosperity of the free world community.

The question is only—but the only is important—whether those nations, now more than amply supplied with reserves as well as with productive power, should not now be called upon for fresh initiative in opening their markets to the products of others.

Is it natural or inevitable that fully 30 percent of Japanese exports go to the United States market—or do restrictions in Europe help account for the direction of that flow?

After years of income growth averaging more than 10 percent, should not the Japanese consumer have free access to the products of the outside world?

Must Canada maintain tariffs on private purchases of United States autos at a time when a balance-of-payments surplus has resulted in a "floating" exchange rate?

Is it right that United States agricultural products find access to the densely populated continent of Europe increasingly limited?

I would suggest that all of these, and more, are proper matters for negotiation and resolution among us on a more equitable basis.

On the side of financial policy, I think we have all become more aware of the limitations placed on coordinated action by domestic policy requirements. Repeated reference has been made in this conference to the difficulties—with the best will in the world—of synchronizing international monetary and fiscal policies. The hard fact is that the business cycle is not uniform from country to country—indeed, it is perhaps fortunate that it is not.

In these circumstances it is still a dream—a worthy dream to be sure, but no more than that—to achieve a common level of interest rates. There are large disparities today—there have been before—and there will be again. If we are not all to take refuge behind a shield of comprehensive exchange controls or split exchange rates, money will move from nation to nation, and often in larger volume and faster than we would like to see.

Here is a clear and present danger to our monetary system. We must reconcile the stability needed to facilitate trade and investment with the flexibility needed to cope with massive flows of funds, actual and potential.

I am convinced the solution cannot be one dimensional. And I will not now attempt to set forth a finished blueprint for a comprehensive approach.

But two lines of attack seem to me both promising and potentially practical. In combination, they could go a long way.

Flexibility is essential. This requires a certain elasticity in financing. Much has been done already on an *ad hoc* basis.

In the present situation the United States has made clear its willingness to help by absorbing some funds from the Euro-dollar market or elsewhere, recycling these funds to the United States before they reach official hands abroad. The recent short-term borrowings of $3 billion by the Treasury and the Export-Import Bank are a case in point. In specific instances, additional dollar investment outlets tailored to the needs of central banks might have a useful subsidiary role. At the same time, we have a right to anticipate that other central banks will not themselves add to the market supply of dollars by contributing to the multiplication of Euro-dollars.

Further exploration of these matters needs, and is receiving, urgent attention. Moreover, in the interest of both equity and financial order, we must ask ourselves whether the Euro-dollar market should be accorded a position free of supervision and regulation which we deny to our domestic banking systems.

Secondly, in the light of recent pressures, the question of codifying a degree of additional flexibility with regard to exchange rate practices is clearly relevant. *De facto* events have brought some elements of flexibility. But I doubt that any of us could be satisfied with the variety of responses to the imperatives of speculative pressures.

The danger is plain. To revert to the use of exchange rates as a supplementary tool of domestic policy is fraught with danger to the essential stability and sustainability of the system as a whole.

As time and events change, we must respond with a recognition of mutual needs and confidence. We all recognize there is no more room for monetary or economic isolation.

It is to our mutual interest to work out the world's monetary problems, so that trade and commerce may expand and thus support national needs.

Helpful to the solution of any problem is the understanding that there are necessarily some unalterable positions of any participant. Believing this, I want without arrogance or defiance to make it abundantly clear that the Nixon Administration is dedicated to assuring the integrity, and maintaining the strength, of the dollar.

We are not going to devalue.

We are not going to change the price of gold.

We are controlling our inflation. We also are stimulating economic growth at a pace which will not begin new inflation.

So far as other nations are concerned: We fully recognize you are not willing to live with a system dictated by the United States.

But, as you share in the system, we have the right to expect more equitable trading arrangements.

We also expect you to accept the responsibility to share more fully in the cost of defending the free world.

Finally:

No longer does the United States economy dominate the free world. No longer can considerations of friendship, or need, or capacity justify the United States carrying so heavy a share of the common burdens.

And, to be perfectly frank, no longer will the American people permit their government to engage in international actions in which the true long-run interests of the United States are not just as clearly recognized as those of the nations with which we deal.

And it is with this understanding that I say to you that increased cooperation among us all must play a key role in maintaining a stable monetary system.

You can be assured that we will do our part.

The Business Situation

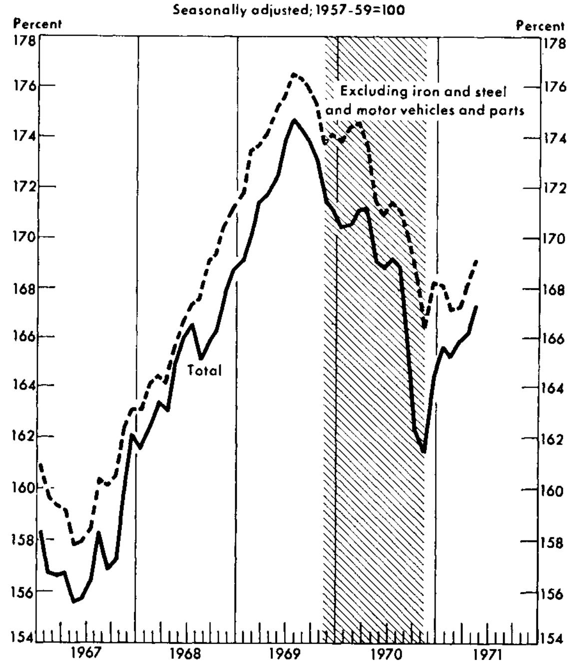
The economic recovery continues to be moderate. Thus, although industrial production posted a strong and broadly based advance in May, the overall recovery from the November trough is still relatively small. The decline in the unemployment rate in June to 5.6 percent from May's reported 6.2 percent was associated with a record fall in the civilian labor force, suggesting that the reduction in the unemployment rate may not necessarily signify an important improvement in labor demand conditions. Personal income registered a relatively large increase in May, although growth of personal income this year has so far been modest when special factors are excluded. In June, personal income soared as the rise in social security benefits took effect. This initial payout included lump-sum retroactive payments to the first of the year, so that the total advance in income was huge. One area of major strength continues to be the residential construction sector, and a very large jump in building permits during May suggests that further gains are quite possible over the near term. The overall inventory situation appears to be favorable. The pace of inventory spending accelerated in the March-April period, yet equally strong gains in business sales left the inventory-sales ratios in most sectors well below their year-end levels. Inventories of manufacturers advanced only slightly further in May, as shipments rose sizably.

The price situation is thoroughly unsatisfactory. Industrial wholesale prices recorded very large advances for the three months ended in May, and the consumer price data for May show sizable increases in virtually every product grouping. The most discouraging aspect in the May consumer price performance was the sharp acceleration in the rate of advance in nonfood commodity prices, which had shown a marked trend toward moderation earlier in the year. Price increases of the magnitude experienced recently are without precedent in other periods of economic slack since the Korean war.

PRODUCTION AND ORDERS

The Federal Reserve Board's index of industrial production registered a sizable gain of 0.7 percent in May (see Chart I). However, the recovery in production from the low point reached last November has been relatively mild, amounting to 3.6 percent. This increase is smaller than that recorded in the first six months of the recoveries from other recessions in the post-Korean war period. Six months after the February 1961 trough, for example, production had risen 7.6 percent—more than twice the recent rise. The comparison is even less favorable for the current production recovery when consideration is given to the major role that strike-related factors have played in the advance over the six months ended in May. In recent months, however, there have been in-

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



Note: The National Bureau of Economic Research has tentatively placed the peak and trough points of the recession at November 1969 and November 1970, respectively. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

creasing signs of a general strengthening of production outside the automobile and steel industries where output has been swollen, in the first case, by recovery from a strike and, in the second, by expectations of a strike.

Excluding the automobile and steel industries, industrial output has risen for three successive months by a total of 1.2 percent. In terms of market groupings, output of nonautomotive consumer products, which accounts for nearly one third of the overall production index, has been an area of pronounced strength. Since its November low, output of these goods has risen 3.2 percent, with almost all components recording substantial increases in recent months.

One factor aiding the May performance was a leveling in the long downtrend in both business and defense equipment production. The earlier decline in defense output, which directly accounts for about 3½ percent of overall industrial activity, has been so large that production is now down to about the level existing in the first half of 1965. This decline, of course, followed a climb in output of over 60 percent between the mid-1965 start of the Vietnam buildup and the mid-1968 peak in arms output. Production of equipment for business purposes, which accounts for about 12 percent of the production index, has also been a substantial factor in the weakness in overall activity in the past two years. In May the index of business equipment output was 15 percent below its October 1969 peak.

The May increase in output of motor vehicles and parts was about the same size as the overall advance, and that for steel a bit stronger. Output in the steel industry has climbed rapidly this year in response to inventory-stockpiling demands by steel users, who have been hedging against a possible strike when the steel industry's labor contract expires on July 31. According to industry spokesmen, however, the climb in production is about over. Stockpiling had been dampened this year by the sluggish nature of the economy and by the likelihood that a large number of mills would continue operating even if other firms were struck. Foreign steel has not been a major factor in curtailing the inventory buildup. Voluntary steel import quotas for 1971, although greater than in 1970, are substantially smaller than the amount imported in 1968, when the industry also went through an inventory-hedging cycle. Moreover, hedging by steel consumers may have peaked in June, rather than later this summer, as users attempted to acquire additional stocks in advance of further steel price increases.

The recent seesawing in new orders for durable goods sheds little light on the outlook for industrial production. In May, the volume of new orders received by manufacturers of durable goods rose by $0.4 billion. While the climb was broadly based, it followed two successive monthly declines including a very large drop in bookings during April. Thus, at the May rate of $31.1 billion, durables orders remained 2.5 percent below their February peak. Excluding the volatile transportation equipment group, however, orders in May were substantially above the February level.

BUSINESS INVENTORIES AND SALES

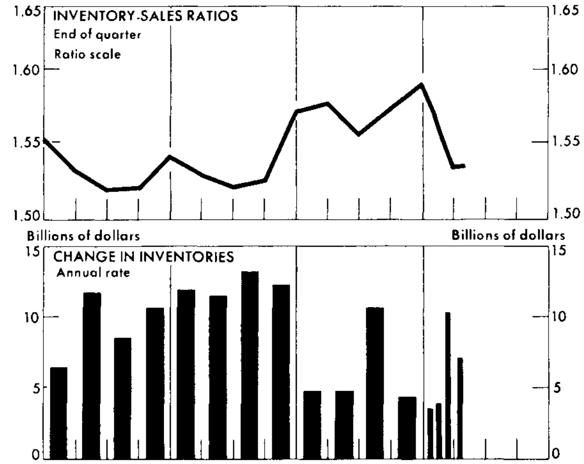
One of the most reassuring developments in the current outlook is that businessmen appear to have begun stepping up the rate of inventory accumulation. In April the book value of manufacturing and trade inventories rose at a seasonally adjusted annual rate of $7.2 billion (see Chart II). While below the $10.3 billion gain registered in March, the April rate was well above the average rate of only $4.1 billion during the previous five months. It is also noteworthy that about two thirds of the April rise in inventories occurred outside the automotive and steel industries. This contrasts sharply with the experience of the first quarter, when inventories held by other industries actually declined. Despite the relatively large overall rise in inventory spending in March and April, inventory-sales ratios were little changed, since business sales kept pace with additions to stocks. For example, the inventory-sales ratio for all manufacturing and trade businesses combined was 1.53 in April, little changed from the March level and decidedly below the position at the beginning of the year. Preliminary data for May, which so far are available for manufacturing only, indicate a further improvement in the inventory-sales ratio of that sector. Manufacturers added only $100 million to stocks in May, while shipments jumped by $700 million.

The moderate levels of the inventory-sales ratios suggest that improved sales are likely to be accompanied by stepped-up inventory accumulation which will, in turn, provide further impetus to the recovery. Earlier slowdowns in economic activity have each been characterized by a pronounced drop in inventory spending. When economic activity began to taper off, businesses first experienced a run-up of excess stocks as sales expectations failed to be realized. Businesses then responded to this situation by reducing their rate of inventory investment, and this in turn led to cutbacks in orders and production. A distinguishing element in the current cycle was that the rate of inventory spending was kept relatively low before the economic activity peaked late in 1969. In the third quarter of 1969, the quarter immediately preceding the period now tentatively designated by the National Bureau of

Chart II

INVENTORY ACCUMULATION AND INVENTORY-SALES RATIOS FOR TOTAL BUSINESS

Book value, seasonally adjusted



Note: Data for 1971 are monthly. Changes are from end of quarter to end of quarter.

Source: United States Department of Commerce, Bureau of the Census.

Economic Research as the peak of the expansion, inventory accumulation on a book value basis was running at a seasonally adjusted annual rate of $13 billion. Over the next two quarters, spending fell by $8 billion to a $5 billion rate. By comparison, in the fourth quarter 1966, which preceded the slowdown of 1967, inventory accumulation had climbed to an $18½ billion annual rate, and then in the following two quarters dropped by almost $16 billion to an annual rate of $2½ billion. The smaller size of the swing in the current cycle helped moderate the severity of the downturn.

RESIDENTIAL CONSTRUCTION

Activity in the residential construction sector continues to be vigorous. Spending for new private residential housing has climbed sharply this year. By May, outlays were running at a rate fully 15½ percent above the December level. The outlook for continued strength in this area remains firm. The volume of private housing starts rose to a seasonally adjusted annual rate of 1.93 million units in May, marking the third successive month in which starts have run at an annual rate of 1.9 million or higher. Thus, it now appears that the average number of starts in the half year ended in June will be well above the 1.8 million unit mark. This compares with an average of 1.6 million in the second half of 1970 and 1.3 million in the January-June period of last year. The recent starts data also show continuing strength in single-family units, which tend to have a higher unit value than do apartments. The building permits data for May indicate that further advances in housing starts are likely in the months ahead. Indeed, in May, the volume of newly issued building permits rose by a substantial 230,000 units on a seasonally adjusted annual rate basis. At the May level of 1.87 million units, the permits series far exceeded the previous record level for a single month. It might also be noted that there is still a fairly substantial backlog of building permits for residential structures which have not yet been started. This too suggests that the residential construction sector should continue to show gains in the months ahead.

PERSONAL INCOME AND EMPLOYMENT

In May, personal income rose by $6 billion, a gain of 8.6 percent in annual rate terms, equal to the average monthly increment in personal income so far this year. However, when allowance is made for special nonrecurring factors, the May rise was one of the two largest in the last twelve months. The overall advance in income was paced by a $3.9 billion rise in private wage and salary disbursements. Increased hours contributed to a substantial strengthening in the manufacturing sector, where income trends have been the weakest. Transfer payments continued to surge ahead in May, moving up by $1.1 billion. Last month the 10 percent increase in social security benefits, including retroactive payments to the first of the year, caused an unusually large spurt in these payments.

After improving for several months, nonagricultural employment in June suffered a puzzling setback which completely wiped out the gains of the previous three months. The overall decline totaled 300,000, with the number of persons on the payroll in manufacturing and trade establishments falling by about 100,000 each. Declines elsewhere were relatively small. The employment series that is based on a survey of households rather than firms indicated the June employment decline was accompanied by an unprecedented fall in the civilian labor force of 1 million persons. The labor force series has recently been volatile—growing by a total of 700,000 in the previous two months. Although a shrinkage in June seems reasonable, the size of the decline suggests that there may have been unusually difficult seasonal adjustment problems, particularly in the teen-age component. The fall in the labor force far outweighed the decline in employment, and the seasonally adjusted unemployment rate thus fell from 6.2 percent in May to 5.6 percent in June, the lowest since last October.

RECENT PRICE DEVELOPMENTS

In May the upward trend in consumer prices accelerated sharply to a 6.7 percent seasonally adjusted annual rate of increase, the steepest one-month advance since February 1970. During the first four months of 1971, consumer price increases had moderated considerably relative to the experience of the two preceding years, although the degree of this moderation had been exaggerated by falling mortgage interest rates. In May, the decline in mortgage rates came to a virtual halt and, as a consequence, this factor did not exert any sizable further drag on the rise in services prices. Prior to May, the other major factor accounting for the more moderate rise in the overall consumer price index had been the very modest rise in nonfood commodity prices. In May, however, these prices soared at a seasonally adjusted annual rate of 8.3 percent. Sharply higher apparel and used car prices contributed significantly to the acceleration in nonfood commodity prices. The apparent deterioration of consumer prices, combined with the continued steep climb of industrial wholesale prices, suggests that little progress has been made in combating inflation.

A STUDY OF BANK CUSTOMERS IN CENTRAL NASSAU COUNTY

The Banking Studies Department of this Bank has published a report entitled "A Study of Bank Customers in Central Nassau County". This report by Patrick Page Kildoyle examines in detail the results of a 1970 survey of banking affiliations of business firms, households, and professional individuals in Central Nassau County, Long Island. The summary findings of this survey were presented in the November 1970 issue of this *Review*. A copy of the report may be obtained upon request from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

The Money and Bond Markets in June

Interest rates in the money and capital markets generally surged higher during the first half of June, then leveled, and finally resumed their climb toward the end of the month. The continued rapid expansion of the money supply generated apprehension over the implications for monetary policy and the consequences for interest rates. Market observers paid close attention to the gradual but steady climb in the Federal funds rate during the month.

As money market rates pressed up against the bank prime lending rate, a Philadelphia bank lifted its key lending rate by ¼ percentage point to 5¾ percent on June 14, followed on the next day by a California bank which raised its rate to 6 percent. The major money center banks, however, did not follow this lead until early July. Expectations of a general rise in the prime rate and rumors of an increase in the Federal Reserve discount rate diminished after the announcement on June 16 of the Treasury's cash financing. Over the remainder of June, most short-term interest rates continued to rise, closing the month about 30 to 90 basis points above the end-of-May levels. Illustrating the general pattern of rate movements over the month, three-month Treasury bill rates pushed just above 5 percent by mid-June, eased off, and then jumped sharply to 5.22 percent on June 30, 88 basis points above the May 28 rate and the highest level since mid-November 1970.

The rise in capital market yields also halted briefly during the third week of June. Corporate bond prices rallied sharply, as participants took encouragement from the lighter calendar of new bond flotations and from the absence of a general rise in the bank prime lending rate. The improvement in the corporate market extended to the market for Treasury coupon issues. Concern over inflation reemerged on June 21, however, when the Bureau of Labor Statistics announced a sharp increase in the consumer price index during May, and the prevailing market atmosphere turned gloomy once again. On balance, yields on intermediate-term Treasury coupon issues rose 55 to 85 basis points, while yields on long-term maturities increased by 4 to 29 basis points. Tax-exempt yields, as measured by *The Weekly Bond Buyer's* twenty-bond index, climbed by 37 basis points from late May to late June. Corporate bond yields, however, ended the month slightly below their late-May levels.

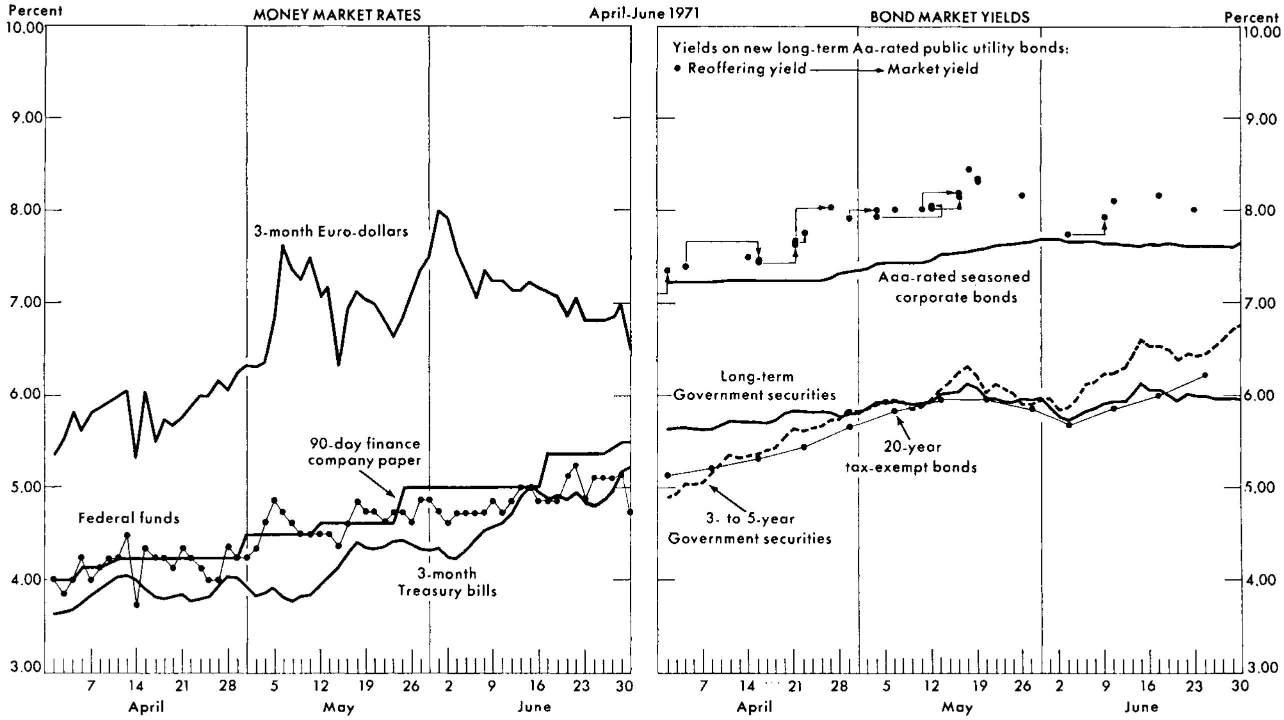
THE MONEY MARKET

After stabilizing in the latter part of May, money market rates rose sharply in the first half of June. The uptrend across a broad spectrum of rates triggered an increase in the bank prime lending rate to 5¾ percent at a large Philadelphia bank on June 14 and to 6 percent at a California bank. The major money center banks, however, maintained the prevailing 5½ percent rate throughout June. Banks may have been reluctant to raise the prime rate at that time because loan demand exhibited only moderate strength over the mid-June dividend and tax dates. During the month, the effective rate on Federal funds averaged 4.91 percent (see Chart I), up 28 basis points from May and the highest monthly average since November 1970. In addition, the rate most frequently quoted on new 60- to 179-day negotiable certificates of deposit (CD's) at large New York City banks rose 38 to 50 basis points from the end of May. Major finance companies raised their offering rates on ninety-day commercial paper by ½ percentage point to 5½ percent, and dealers raised offering rates on ninety-day bankers' acceptances by ⅝ percentage point to 5⅝ percent.

Total reserves of member banks decreased by $231 million (not seasonally adjusted) on a daily average basis from May to June. Member bank borrowings from the Federal Reserve Banks rose to an average of $514 million in June (see Table I), up $302 million and the highest monthly level since September 1970. Thus, nonborrowed reserves decreased by $533 million in June. Member banks of the Federal Reserve System had net borrowed reserves averaging $286 million during June, compared with a net free reserve position of $6 million in May. During the two statement weeks ended June 16, a rapid decline in the Treasury's balances, associated

Chart I

SELECTED INTEREST RATES



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 Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new 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.

partly with the redemption of special Treasury certificates held by foreign central banks, injected \$920 million of reserves. However, the subsequent rebuilding of those balances over the remainder of the month drained about \$1.4 billion of reserves, more than offsetting the earlier injection.

The closely watched monetary aggregates continued to expand rapidly during June, though the rates of increase in the popular measures of the money supply were considerably below the very fast May rates. Over the second quarter, M_1—currency plus demand deposits held by the public—rose at an 11½ percent seasonally adjusted annual rate (see Chart II), compared with the 8.9 percent rate of expansion recorded in the first quarter and the 5.4 percent rate during all of 1970. The broader measure of the money supply, M_2—defined to include M_1 plus commercial bank savings and time deposits other than large CD's—grew at a 12½ percent annual rate in the April-June period, but this was below the extraordinary 17.8 percent rate of expansion in the first quarter. The slowdown reflects a diminution in the growth of commercial bank savings and time deposits following the unusual growth that occurred during the first quarter of 1971, when yields on competing market instruments fell sharply.

The adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—also grew more slowly in the second quarter than in the previous period. The credit proxy rose at a 6½ percent seasonally adjusted annual rate over the April-June quarter, compared with a 10.9 percent expansion rate in the preceding quarter. The more modest second-quarter growth of the bank credit proxy, by comparison with money supply expansion, reflects the fact that over most of the April-June period Treasury deposits and nondeposit liabilities fell while the rate of growth of CD's slowed. During June, however, banks bid aggressively for CD's as market rates advanced, and the level of CD's outstanding at all weekly reporting banks rose by roughly $500 million over the month. After the downtrend in the first five months of 1971, liabilities to foreign branches at all weekly reporting banks bottomed out at the end of May and then rose to an average level of $2.0 billion for the five weeks ended June 30, up $100 million from the average over the preceding five weeks.[1] The narrowing of the spread between domestic and foreign rates has apparently reduced the incentive for banks to continue repaying Euro-dollar borrowings from their foreign branches. Bank-related commercial paper has also leveled out and has remained fairly stable at $1.7 billion since mid-May.

THE GOVERNMENT SECURITIES MARKET

Prices of United States Government securities declined sharply over the first half of June, following the short-lived rally that extended from late May into the first few days of June. The steady price erosion reflected the highly sensitive market atmosphere, as participants focused their attention on the continued rapid expansion of the monetary aggregates. Widespread concern developed over a possible tightening of monetary policy and the consequences for near-term movements of interest rates. Some observers construed Federal Reserve System bill sales before a weekly Treasury bill auction on June 7 to be a confirmation of market expectations. Besides, the increase in the prime lending rate at several banks a week later reinforced the expectations of higher short-term interest rates, and by midmonth there was some discussion about a possible increase in the discount rate. The frequency and size of the Treasury calls on its Tax and Loan Accounts prior to the mid-June corporate income tax collections, moreover, generated apprehension, especially in the bill market, that the Treasury might conduct a larger than expected cash financing in the near future.

Several factors contributed to an improvement in the

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JUNE 1971

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

Factors	Changes in daily averages— week ended					Net changes
	June 2	June 9	June 16	June 23	June 30	
"Market" factors						
Member bank required reserves	+ 81	+ 169	− 147	+ 274	− 361	+ 16
Operating transactions (subtotal)	− 347	+ 616	+ 51	− 462	− 809	− 951
Federal Reserve float	− 330	+ 324	− 161	+ 315	− 301	− 153
Treasury operations*	+ 169	+ 522	+ 398	− 648	− 776	− 335
Gold and foreign account	—	+ 36	+ 1	− 5	− 11	+ 21
Currency outside banks	− 80	− 251	− 366	− 109	+ 346	− 460
Other Federal Reserve liabilities and capital	− 105	− 16	+ 180	− 15	− 68	− 24
Total "market" factors	− 266	+ 785	− 96	− 188	−1,170	− 935
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	− 74	− 481	− 48	− 56	+1,025	+ 366
Outright holdings:						
Treasury securities	+ 13	− 439	− 463	+ 242	+1,178	+ 531
Bankers' acceptances	+ 2	+ 1	− 1	− 1	—	+ 1
Special certificates	—	+ 94	+ 416	− 510	—	—
Repurchase agreements:						
Treasury securities	− 70	− 73	—	+ 162	− 119	− 100
Bankers' acceptances	− 11	− 37	—	+ 28	− 25	− 45
Federal agency obligations	− 8	− 27	—	+ 23	− 9	− 21
Member bank borrowings	+ 379	− 493	+ 250	+ 215	+ 134	+ 485
Other Federal Reserve assets†	+ 72	− 12	+ 48	+ 48	+ 40	+ 196
Total	+ 377	− 985	+ 249	+ 208	+1,198	+1,047
Excess reserves	+ 111	− 212	+ 165	+ 20	+ 28	+ 112
	Daily average levels					**Monthly averages**
Member bank:						
Total reserves, including vault cash	30,276	29,907	30,207	29,953	30,342	30,137‡
Required reserves	29,991	29,822	29,969	29,695	30,056	29,907‡
Excess reserves	285	73	238	258	286	228‡
Borrowings	646	153	403	618	752	514‡
Free, or net borrowed (−), reserves	− 361	− 80	− 165	− 360	− 466	− 286‡
Nonborrowed reserves	29,630	29,754	29,804	29,335	29,590	29,623‡
Net carry-over, excess or deficit (−)§	103	171	39	112	106	106‡

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 June 30.

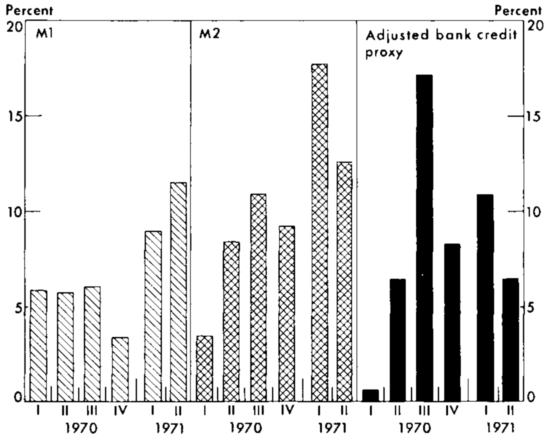
§ Not reflected in data above.

[1] These figures do not reflect a recent revision in the liabilities to foreign branches series at weekly reporting banks in New York City to include liabilities to branches in United States possessions, territories, Puerto Rico, and overseas military installations. This series also has been revised to include those loans sold to branches outside the United States if the loan sales are subject to the provisions of Regulation M.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates of change



Note: Data for 1971-II are preliminary.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit liabilities, such as Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

market atmosphere at midmonth. On Wednesday, June 16, the Treasury announced plans to raise $4 billion of cash through the auction of $2.25 billion of 6 percent 16½-month notes and $1.75 billion of September tax anticipation bills (TAB's). The Treasury said that these auctions, together with additions of $100 million of bills to each of the regular weekly auctions, were expected to satisfy its cash needs through July. The terms of the offerings met a favorable market reception and encouraged those participants who had expected a larger financing of bills with a longer maturity. In addition, relatively light dealer inventories characterized a good technical position of the Government securities market, and the turnaround in the corporate bond market added further encouragement. The 16½-month notes were auctioned on June 22 at an average yield of 6.00 percent, with tenders accepted at yields as high as 6.05 percent. The TAB's were auctioned on June 30 at an average yield of 5.04 percent.

Against this background, rates on three-month Treasury bills climbed by 78 basis points from June 3 to June 15, peaking out at 5.02 percent. The rise in bill rates was particularly sharp in the second week of June. In the weekly auction on June 14, the average issuing rates on new three- and six-month issues were established at 4.99 percent and 5.20 percent, respectively, both up 48 basis points from the preceding week's auction (see Table II). Rates edged irregularly lower over the next few days, but reversed direction on June 25. Some market participants grew apprehensive over the possibility of the liquidation of large amounts of bills by the German central bank to raise funds for the sizable sales of dollars that it was reportedly making in the foreign exchange market. Bidding proved quite weak in the weekly bill auction on June 28. The average issuing rates on the three- and six-month bills were 5.08 percent and 5.28 percent, respectively, and tenders were accepted over an unusually wide range of prices. Bill rates rose precipitously after the auction, and the three-month bill closed the month at 5.22 percent. Over the month, most bills closed on quotations which were 56 to 120 basis points higher than at the end of May.

Market yields on Treasury coupon securities moved in a pattern similar to the course followed by bill rates. From early June to midmonth, yields on issues due in three to five years rose as sharply as bill rates—up an average of 77 basis points—while the increase in long-term Treasury bond yields amounted to 35 basis points. The rally in the corporate bond market contributed to a significantly better atmosphere in the Treasury coupon market during the third week of June when prices pushed steadily higher. The decline in yields was interrupted, however, as market participants reacted to the large May increase in the consumer price index, announced on June 21, which underscored the fact that inflation still presented a stubborn problem. Thereafter, yields on intermediate-term issues turned upward, rising sharply in the closing days of the month. On balance, yields on these issues increased by 55 to 85 basis points during June. Reflecting the better tone in the corporate bond market, yields on long-term Treasury bonds were steady during the latter part of June and closed below their midmonth levels. Over the month as a whole, however, these yields were 4 to 29 basis points higher.

OTHER SECURITIES MARKETS

The market for corporate bonds displayed widely fluctuating yields in June. For example, yields on major new high-quality utility issues dropped from 8.18 percent on May 26 to 7.73 percent on June 3 and then climbed back to 8.20 percent on June 15. By the end of June, a new high-grade utility issue carried an 8.00 percent return to investors. In the municipal sector, securities prices were steadily eroded after the first few days of June. *The Weekly Bond Buyer's* twenty-bond yield index declined from 5.86 percent at the end of May to 5.70 percent, but backed up sharply to 6.23 percent by June 24, before easing to

6.19 percent at the beginning of July. During June, an estimated $4.8 billion of new corporate and municipal issues came to market, roughly $0.8 billion above the monthly average issued in the record year of 1970. Although no significant decrease in the municipal calendar is sighted, the calendar of future corporate bond issues has lightened considerably.

Among the significant issues during the month, $27 million of Aa-rated utility bonds, marketed on June 3, was very aggressively priced to yield 7.73 percent, 45 basis points below a similarly rated issue sold a week earlier. The bonds sold slowly, and when they were subsequently freed from price restrictions, the yield rose by 20 basis points. On June 10, the sale of a $100 million Aa-rated utility issue underscored the turnaround that had occurred in the corporate sector. The bonds were reoffered to investors with an 8.10 percent yield, which represented an increase of 37 basis points in about five trading days, but the issue met investor resistance. Then, on June 15, underwriters bid aggressively for $60 million of Aaa-rated (by Moody's) utility bonds which were reoffered to yield 8.20 percent, 83 basis points above the last Aaa-rated utility issue marketed in mid-April. Broadly based retail demand quickly absorbed the unusual offer and helped to reverse the week-old slide of bond prices.

The rally halted, however, in the wake of the scattered increase in the prime rate at several banks and the dismal reception accorded a $150 million Bell System offering on June 21. The Aaa-rated issue was aggressively priced to yield 7.80 percent, which was 40 basis points below the yield provided on comparable bonds marketed on May 25. Prices generally retreated in the capital markets following the languid market response to the Bell System bonds. The sharply accelerated rise in the consumer price index in May also depressed market sentiment.

No new utility bonds came to market in the last days of June. The scarce supply fostered fairly active trading, and prices of seasoned issues inched up by as much as ⅜ point. Dealers whittled down their unsold balances of outstanding issues and, after a slow start, a utility issue rated Aa was finally successfully distributed at an 8 percent yield.

In contrast to the behavior of corporate bond yields, yields on tax-exempt securities spiraled steadily upward during June, uninterrupted by the rally that brought relief to both the corporate and Treasury securities markets. Participants expected no near-term relief from the heavy financing calendar, and $1.9 billion of new issues was sold, compared with the $2.2 billion of financing in May. Furthermore, commercial bank buying appeared to slacken as the month progressed, falling below the vigorous pace evidenced earlier in the year. Dealer inventories, as recorded in the Blue List, were relatively low early in June, rose sharply in midmonth, but then receded to $487 million on June 29, the lowest level since July 1970.

Early in June, the calendar included two sizable Aaa-rated state government offerings: $100 million of Illinois anti-pollution bonds and $75 million of New Jersey various-purpose bonds. The Illinois issue was reoffered at yields ranging from 20 to 45 basis points below those on a similar issue marketed on May 20. The issue met a favorable investor reception at these sharply lower yields, which reflected the general improvement in the market as June began and also the scarcity of Illinois bonds. A day later, the New Jersey issue was awarded at yields running about 5 to 15 basis points above the corresponding maturities in the Illinois package. The higher yields were explained largely by the more frequent entry of New Jersey into the market and by the larger volume of the state's outstanding obligations. Despite good buying interest on the part of commercial banks, insurance companies, and other institutions, $28 million of the issue remained unsold at the end of the day.

On Tuesday, June 8, a bellwether New York State issue of $90 million of highway bonds was marketed, and participants hoped that prices in the tax-exempt market would continue the uptrend exhibited in early June. The Aa-rated issue sold slowly, however, but initial sales may have been inhibited by the huge $1.3 billion of New

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—June 1971			
	June 7	June 14	June 21	June 28
Three-month	4.510	4.989	4.953	5.080
Six-month	4.720	5.200	5.133	5.277
	Monthly auction dates—April-June 1971			
	April 27	May 27	June 24	
Nine-month	4.402	4.688	5.425	
One-year	4.422	4.790	5.567	

* 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.

York State notes auctioned the same day. Two weeks later, the managing syndicate released the $25 million unsold balance into the market, and yields rose by 20 to 30 basis points. On June 22, a key issue of $100 million of California various-purpose bonds came to market. Also rated Aa, this issue elicited only a lukewarm response from investors at yields that ranged from 15 to 30 basis points above the returns on corresponding maturities in the New York issue. Market participants had withdrawn to the sidelines, as they pondered the sharp increase in the consumer price index registered during May. Attempting to lure investors back into the market, dealers released several recent issues from syndicate price restrictions. Prices subsequently plunged, raising yields by 25 to 30 basis points.

After prices nosedived to their lowest levels since November 1970, the tax-exempt market stabilized on June 29 when excellent retail demand met two new state bond offerings. The Aa-rated Delaware and Kentucky issues totaled $70 million and carried yields which were 10 to 30 basis points above the returns on comparable securities available about two weeks earlier.

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Recent Developments in the Capital Markets

During the latter half of 1970 and early 1971, sluggish economic activity together with the Federal Reserve System's pursuit of stimulative monetary policy gave rise to considerable relaxation of capital market conditions. Consequently, interest rates throughout the maturity spectrum declined appreciably from their peaks of 1970 even though debt financing by corporations and state and local governments reached record proportions. More recently, capital market conditions have firmed somewhat, and the earlier dramatic decline in rates has been partially reversed although rates remain well below their 1970 highs.

The lower interest rates and the Federal Reserve's policy of monetary expansion have also significantly reshaped the pattern of financial flows in the economy. One manifestation of this development has been the growth and restructuring of the commercial banking sector's balance sheet and the reemergence of the banking sector as a primary supplier of credit in the economy. For example, over the nine-month period ended with the first quarter of 1971, commercial banks supplied about 49 percent of the funds advanced in credit markets, whereas in the three preceding quarters commercial banks provided only 13 percent of the total volume of funds. This has been accompanied by the renewed inflow of deposits to savings and loan associations and mutual savings banks. As a result, the mortgage markets have become less dependent upon the Federal agencies for housing as a source of support, though some recent difficulties in the secondary mortgage market have caused a resumption of active participation by the Federal National Mortgage Association (FNMA).

Shifts in the composition and maturity structure of credit market demands have also been dramatic. In 1969 and early 1970, state and local borrowings in the tax-exempt market were sharply curtailed, but the improvement of credit market conditions since then has prompted them to step up their borrowings. Corporate demands for funds have remained heavy despite the slowing of investment spending. In part, this reflects the continued wide spread between investment outlays and internally generated funds. In addition, corporate liquidity building and the substitution of long-term for short-term debt has produced a record volume of bond financing. In the household sector, consumer credit demands have remained relatively modest at the same time that mortgage borrowing has increased substantially. Recent data indicate that consumer credit may be resuming a more rapid rate of expansion. Nevertheless, consumers continue to acquire time and savings deposits at a rapid rate, reflecting both a high rate of saving out of current income and the reinvestment in interest-bearing deposits of the proceeds of maturing short-term securities purchased in 1969 and 1970 when open market rates were high relative to deposit rates.

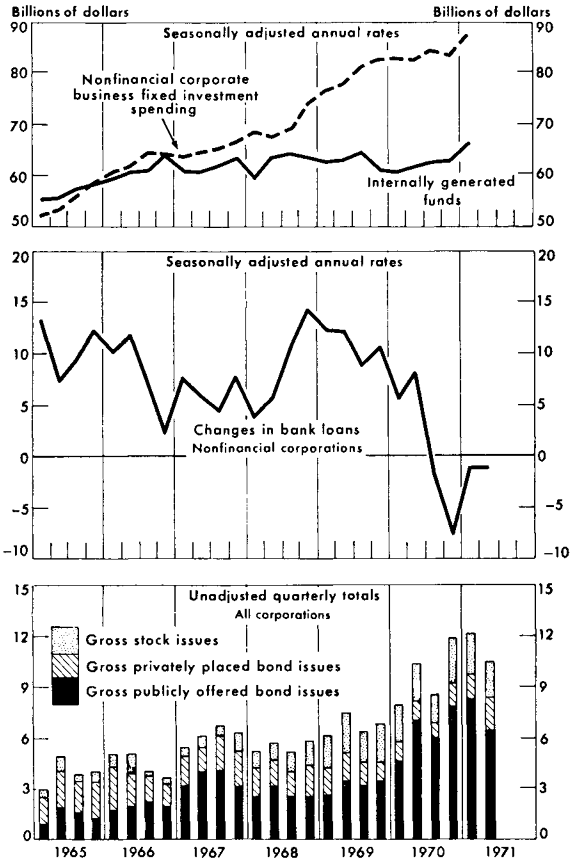
BUSINESS FINANCE

The slackened pace of fixed investment spending and inventory accumulation in 1970 and early 1971 has resulted in a somewhat reduced rate of advance in overall business financing requirements. To some extent, this trend has been reinforced by a slight narrowing of the gap between total capital expenditures and internally generated funds. In the first quarter of 1971, the ratio of fixed capital outlays to internally generated funds was 1.32, whereas at the end of 1969 that ratio stood at 1.36. However, even at its first-quarter level, that ratio reflects a $21 billion spread between fixed investment spending and funds generated internally (see Chart I). Thus, corporate demands for external funds have remained relatively heavy despite the economic slowdown and the reduced pace of inventory spending.

While the overall demands of corporations on the credit markets have continued relatively heavy, changing financial market conditions have resulted in a significant restructuring of the patterns of corporate borrowing. For example, during 1969 very high long-term interest rates prompted many corporations to step up their short-term financing. As a result, the ratio of net long-term bond issues by nonfinancial corporations to their fixed investment expenditures declined to .15 in 1969, having been as high as .23 in 1967. This ratio rose to .17 in the first

Chart I

SOURCES AND USES OF CORPORATE FUNDS



Sources: Board of Governors of the Federal Reserve System and the Securities and Exchange Commission. Second-quarter estimates by the Federal Reserve Bank of New York.

quarter of 1970, as corporate debt flotation began to increase. After the liquidity crisis of mid-1970 and the eventual turndown in interest rates, a massive shift to long-term financing took place and by the first quarter of 1971 the ratio had risen to .29. This shift toward bond financing reached a peak in the first quarter of 1971 when the gross proceeds from issues of new publicly offered corporate bonds reached $8.4 billion, with $4.1 billion of that total being marketed in March. The volume of public offerings apparently tapered off in the second quarter, though it stood at a level above any ever recorded prior to 1970.

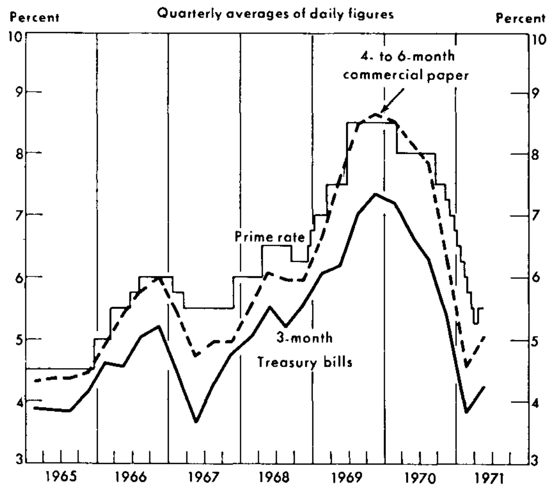
This record volume of new corporate debt offerings over the past year has been accompanied by substantially reduced reliance on business loans at commercial banks as well as lessened dependence on other forms of short-term credit. Moreover, corporations have made substantial additions to their holdings of short-term assets. As a result of these developments, there has been considerable improvement in corporate liquidity positions. Thus, for nonfinancial corporations, the modified quick asset ratio—which divides the sum of demand deposits, time deposits, currency, United States Government securities, and open market paper by total current liabilities—had declined to its record low of .261 at the end of 1969. By the end of the first quarter of 1971 it stood at .306, the highest level since the second quarter of 1966.

The yields corporations must offer on their long- and short-term debt instruments have declined dramatically since their peaks in 1970 (see Charts II and III), although long-term yields remain high by historical standards. Interestingly, however, even after the rises of the past three months, yields are still below the levels that prevailed at the cyclical trough in economic activity, which has been tentatively identified by the National Bureau of Economic Research as November 1970. Indeed, throughout the contraction phase of the current cycle, bond yields displayed an atypical behavior pattern. Traditionally, bond yields, together with short-term money market rates, decline as real activity contracts, reaching a low point about the same time as the trough in real activity is reached (see Chart IV). During the recent cycle, however, the heavy volume of bond financing placed unusually strong pressure on the long-term credit markets at the same time that inflationary expectations made investors reluctant to commit them-

Chart II

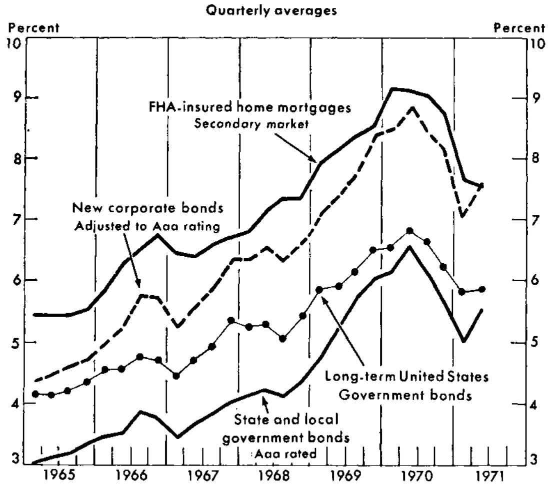
SHORT-TERM INTEREST RATES

Quarterly averages of daily figures



Source: Board of Governors of the Federal Reserve System.

Chart III
LONG-TERM INTEREST RATES
Quarterly averages



Note: In the mortgage yield series, estimates for periods for which the Federal Housing Administration does not provide data were obtained by linear interpolation. Estimate for second quarter 1971 based on April and May data.

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

elves to fixed income securities. Once the trough was eached, bond yields joined money market rates in a steep lecline which continued further into the recovery phase ıf the business cycle than is usual. Although rates have ;enerally been rising since about mid-March, they are till low in relation to their levels at the time of the rough in business activity when viewed in the context of revious post-Korean war cycles.

The high absolute level of long-term interest rates əflects the price expectations premium that has been built ıto rates in the wake of the rapid inflation experienced uring the past few years. As long as prices and profits re expected to rise rapidly, lenders will demand high ields and borrowers will be willing to pay them. Only ; inflationary expectations are curbed can long-term in-ːrest rates be expected to decline markedly from their ırrent levels.

Private placements of corporate bonds have risen in ːcent quarters, reflecting the renewed ability of life in-ırance companies to participate in the bond markets. uring 1969 and early 1970 the volume of life insurance ɔmpany policy loans increased greatly, as policy holders ok advantage of the relatively lower yields on these ans. As a result, life insurance companies were able to ılarge their holdings of corporate bonds by only $0.63 llion in the last quarter of 1969 and the first half of ›70, compared with an increase of $3.9 billion in their bond holdings during 1968. At the same time, these companies decreased their holdings of home mortgages. With the decline of policy loans in late 1970 and the first quarter of 1971, these companies have again become active in the bond market, adding a net amount of $0.7 billion in bonds to their portfolios during the first quarter of 1971. While this development is augmented by the continuing decline of mortgage holdings by these companies, it is restrained somewhat by the greater interest of these companies in the acquisition of equity securities.

CONSUMER FINANCE AND THE MORTGAGE MARKET

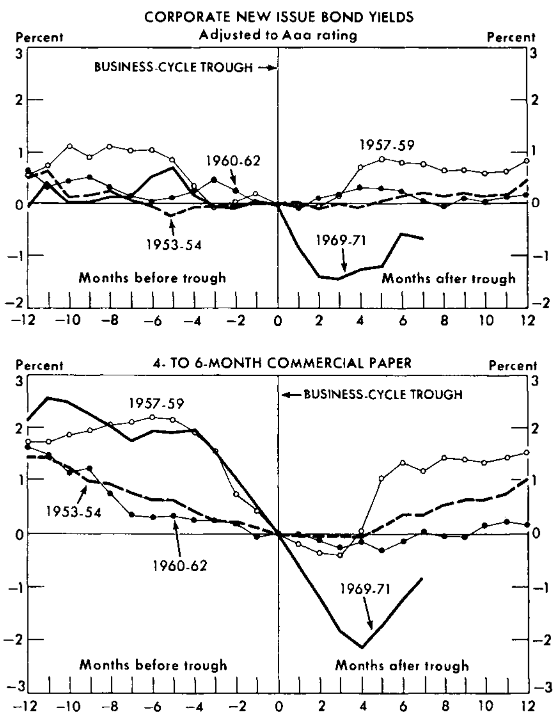
Over the last several quarters, consumer spending and saving decisions have been affected by the uncertainties arising from increasing unemployment and the unsettled behavior of the economy generally. In part, these factors have fostered attempts to rebuild liquidity positions, as indicated by the high savings ratio and the rapid rate at which consumers have acquired time and savings deposits at both commercial banks and thrift institutions. Concurrently, the pace at which households have incurred additional liabilities in recent quarters has remained well below the rates which prevailed in 1968 and 1969. Thus, for the nine-month period ended in March 1971 the volume of outstanding consumer credit had increased at an annual rate of 1.2 percent, compared with its average growth of 8.3 percent during the preceding two-year period. In large part, the sluggish pace at which consumer credit expanded over this interval was a reflection of the reduced pace of consumer spending on durable goods.

Toward the end of the first quarter and into the second quarter, however, there were indications that both consumer spending and consumer credit were beginning to expand at a more robust rate. In April and May, total outstanding consumer credit rose at seasonally adjusted annual rates of $928 million and $638 million, respectively. The April increase was the largest monthly rise in consumer credit since May 1969. Similarly, commercial bank loans to consumers appeared to strengthen late in the first quarter and into the second quarter.

While consumer credit growth slowed during 1970 and early 1971, home mortgage credit expanded at a strong pace, reflecting not only the demand for such credit but also the changing pattern of its supply. Together with the high rate of consumer saving, the decline of money and credit market yields caused the combined total of savings capital at savings and loan associations and deposit shares at mutual savings banks to grow at an average annual rate of $31.1 billion during the three-quarter period ended March 1971, compared with its growth at an average annual rate of $6.9 billion in the preceding nine-month period (see Chart V). At the same time, household holdings of United States Government securities declined sharply at an average annual rate of $29.5 billion. The inflow to thrift institutions was assisted by the growing use of savings certificates and other forms of special deposits which offer higher yields than passbook accounts. Growth of deposits took place at a historically high annual rate of $49.1 billion during the first quarter of 1971 but subsided somewhat in April and May, the last two months for which figures are available. As a result of this strengthening of deposit flows, savings and loan associations were able to increase their participation in the home mortgage market at the same time that they began repaying their advances from the Federal Home Loan Bank System—which in 1969 had provided 47 percent of the net new liabilities of its members. Coincident with this development, the mutual savings banks continued their more restrained participation in the home mortgage markets and greatly added to their portfolios of corporate bonds.

Chart IV

CYCLICAL PATTERNS OF INTEREST RATE MOVEMENTS



Note: Yields during each cycle are shown relative to average yield in month of cycle trough, which is set equal to zero. The business-cycle troughs, as identified by the National Bureau of Economic Research, are August 1954, April 1958, February 1961, and November 1970 (tentative).

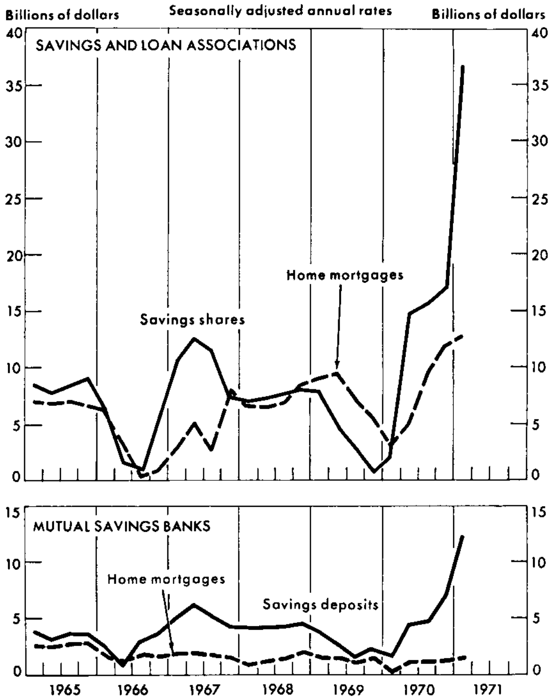
Sources: Board of Governors of the Federal Reserve System and the First National City Bank.

These large inflows of funds to thrift institutions and the resultant greater availability of home mortgage credit prompted a significant easing in the terms under which mortgages are granted, a development that was encouraged in early 1971 by two reductions of the Federal Housing Administration interest ceiling on the mortgages FHA insures. From their peak level in February 1970, mortgage interest rates had declined about 2 percentage points by the spring 1970 when the markets began firming. FNMA took advantage of the better market tone by lengthening the maturity of its debt and in January 1971 raised funds by selling mortgages from its portfolios, the first time it had done so under its new auction technique. With the rise of interest rates in the second quarter of the year, the new FHA-insured and Veterans Administration-guaranteed mortgages began selling at deep discounts, causing disturbance in the secondary market. To alleviate the unsettled market conditions that arose, FNMA held a special auction on June 9 at which no limitations were placed on bid size and all commitments were for delivery in ninety days. This marked a departure from FNMA's regular auction technique in which an individual bid may not be for more than $3 million of commitments and commitments are accepted for delivery in six to twelve months as well as in ninety days. This auction seemed to stabilize the market somewhat, as yields in the regular June 14 auction were slightly below those set in the June 1 auction.

GOVERNMENT FINANCE

Over the last several quarters, the net capital market borrowings of state and local governments reached record shattering proportions. Indeed, during the first three months of 1971, borrowings by these political jurisdictions ran at an annual rate of $26 billion—more than double the volume of borrowings undertaken in the year 1970. In the second quarter, these borrowings tapered off somewhat from the hectic pace of the preceding three months but nevertheless remained at high levels by historical standards. In part, this huge volume of financing activity by state and local governments reflects the continued strong demand for public services. Beyond this, however, a sizable fraction of the recent surge in financing activity reflects "catch-up" borrowings which had been postponed in 1969 and early 1970 when market interest rates exceeded the rates that many of these borrowers could legally pay. Some of it represents the replacement of short-term obligations with long-term debt.

Chart V
THRIFT INSTITUTION DEPOSIT FLOWS AND HOME MORTGAGE LENDING



Source: Board of Governors of the Federal Reserve System.

The decline in interest rates on tax-exempt bonds that developed in the second half of 1970 and carried into early 1971 was a major factor in prompting the stepped-up pace of borrowings by state and local governments. Rates on high-grade municipals reached a peak of 6.81 percent in June 1970 and then tumbled 189 basis points before reaching a recent low of 4.92 percent in February 1971. More recently, rates on tax-exempt bonds have moved irregularly higher but at the end of June were still some 116 basis points below their 1970 peak. While declining interest rates have paved the way for the increased volume of state and local borrowings, it should also be noted that in many states and localities the statutory limits on rates payable have been raised or eliminated. These actions have helped to ease the earlier bottlenecks in the tax-exempt markets and should insure a more stable flow of funds to this sector in the future.

A major share of the newly issued state and local bonds floated over the last four quarters was absorbed by the commercial banks, as these institutions resumed their leadership in municipal lending. Since 1961 the commercial banking sector's end-of-year holdings of municipals have averaged 38.9 percent of all outstanding municipal issues, with its holdings increasing at an average annual rate of 14.7 percent. In the last half of 1969, however, banks liquidated municipal securities holdings to finance the growing volume of bank loans. The sluggishness in loan demand in 1970 and the first half of 1971, coupled with the massive flow of time deposits to commercial banks beginning in mid-1970, resulted in a sharp reversal in this situation. Thus, over the nine months ended March 1971, commercial bank holdings of state and local government securities rose by $10.8 billion—an annual rate of gain of 23.5 percent. More recently, a marked slowdown in commercial bank participation has been a major factor in the rise in municipal bond yields.

Reflecting the large Federal deficit expected for the fiscal year ended June 30 and the prospect of a large deficit in fiscal 1972, financing requirements of the United States Treasury have also been heavy. While a sizable part of the funds needed to finance the fiscal 1971 deficit was raised in the first half of the fiscal year, net borrowing activity in the January-June half year was relatively large despite the clustering of tax receipts in this period. In part, the heavy demand for funds by the Treasury toward the end of the second quarter was related to the sizable cash needs that are expected to materialize in the summer months.

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