

FEDERAL RESERVE BANK OF NEW YORK



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Contents

The Business Situation	199
The Money and Bond Markets in August	204

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The Business Situation

President Nixon's announcement on August 15 of a set of new economic policies for the country has apparently provided a significant and welcome boost to confidence in the nation's economic prospects. Such a gain in confidence will, if sustained, help greatly in bringing about the stronger business expansion the President hopes to achieve.

Prior to the President's announcement, business developments had continued to attest to the sluggish character of the recovery. In July, industrial production declined for the second consecutive month as labor contract deadlines and strikes precipitated decreases in the output of steel and other raw materials. Moreover, there was only a small increase in personal income after making allowance for a special factor that had caused an unusually large rise in June. In addition, the advance report on retail sales indicated a contraction in July. Furthermore, the unemployment rate in August, according to a survey in the second week of the month, rose from 5.8 percent to 6.1 percent, almost back to the recent 6.2 percent high of May. One area of economic strength was residential construction. Housing starts increased sharply in July to a figure that eclipsed the previous record, and building permits moved appreciably higher, suggesting that further gains in starts might be forthcoming.

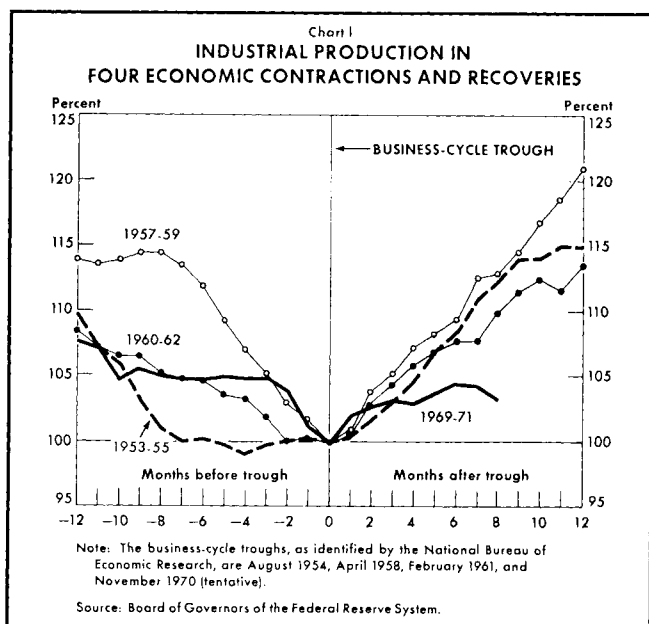
It was against the background of generally slow economic expansion, accompanied by persistent inflation and mounting international financial pressures, that a basic change in the approach to achieving both economic growth and price stability was announced by President Nixon in mid-August. He used the powers available under the Economic Stabilization Act of 1970 to order a ninety-day freeze on wages and prices. A surcharge of 10 percent was imposed on a wide range of products imported by the United States. The convertibility of dollars into gold and other reserve assets was temporarily suspended. And several changes in taxes to stimulate a more rapid expansion in production and employment were recommended to the Congress. These recommendations included the elimination of the 7 percent excise tax on automobiles, retro-

active to mid-August; the establishment for one year, also retroactively, of a 10 percent investment tax credit on new machinery and equipment, provided it is American made, to be followed by a permanent 5 percent credit; and the bringing forward to January 1972 of reductions in personal taxes previously scheduled to take effect at the beginning of 1973 through higher standard deductions and personal exemptions.

PRODUCTION, SHIPMENTS, AND INVENTORIES

The Federal Reserve Board's index of industrial production declined by 0.8 percent in July, the second consecutive monthly drop. Reduced output of raw materials—notably steel, copper, and coal—accounted for most of this latest decline, with labor disputes playing an important role. In the steel industry, production was depressed as users worked down the ample stocks of steel mill products that had been accumulated earlier in the year in anticipation of a strike. Moreover, a number of large producers began to bank their furnaces as the July 31 contract settlement deadline approached, thereby cutting further into steel output. A strike in the copper industry significantly curtailed the output of nonferrous metals, while the railroad labor dispute cut progressively into coal production because of the reduced availability of freight cars. Even apart from these special situations, industrial production was distinctly lackluster. The output of consumer goods showed essentially no change, while the output of both business and defense equipment declined.

The July decrease in production underscored the continued slow pace of the current economic recovery. In the eight months following November 1970, which has been tentatively designated by the National Bureau of Economic Research as the trough month of the 1969-70 recession, total industrial production rose only 3.3 percent even though output had been abnormally depressed in the trough month by the General Motors strike. In sharp contrast, the gains in industrial output over the first eight



months after the troughs of the three previous post-Korean war recoveries ranged from 10 to 13 percent (see Chart I). The limited data available for August do not indicate there was any step-up in production during the two weeks immediately before the President's new economic program was announced.

The policy changes initiated on August 15, however, will probably have a stimulating effect on economic activity, and perhaps most immediately on the sale and production of domestic automobiles. There may be a quickened pace of demand for automobiles in general in response to the proposed elimination of the excise tax. Sales may be additionally spurred by the temporary price freeze. Beyond this, the Administration's new economic policies will tend to reduce the prices of domestic automobiles relative to prices of imported cars. The latter are now bearing a temporary surcharge of 6.5 percent in addition to the regular 3.5 percent duty. (The surcharge is not the full 10 percent inasmuch as total import duties on any item may not exceed the ceiling prescribed by the Tariff Act of 1930, which for autos is 10 percent.) Upward movements in the exchange rates of foreign currencies will also tend to push up the prices of imported cars.

It does not seem likely, on the other hand, that the proposed 10 percent investment tax credit will generate sizable near-term gains in the output of business equipment. Most businessmen presumably will defer any firm decisions about undertaking additional new investments

until the Congress, which reconvened on September 8, acts on the President's recommendation. Moreover, business spending on plant and equipment during the immediate future will certainly be tempered by the rather sizable amounts of excess capacity that currently exist in many industries. In the second quarter, the rate of capacity utilization in manufacturing was only 73 percent or well below the rates that prevailed in 1968, the last full year of economic expansion. The most recent Department of Commerce-Securities and Exchange Commission survey of plant and equipment spending intentions underscored the weakness in the near-term outlook for capital spending. This survey, which was completed too early to be influenced materially by the President's announcement, showed further cutbacks in plans for 1971, indicating a rise over 1970 of merely 2.2 percent, compared with the 4.3 percent increase that had been slated six months ago. However, the fact that the President's proposal calls for a 10 percent tax credit only until August 1972, and for a subsequent drop in the rate to 5 percent, provides a special incentive for businesses to undertake new capital spending programs within the period during which the higher tax credit will be in effect.

The most recent data on business inventories and sales continue to show improvement in the inventory-sales ratios for most sectors. Total manufacturing and trade sales increased in June by \$1.4 billion, while inventories rose by a less than proportionate \$0.4 billion.¹ Consequently, the inventory-sales ratio for all business fell to the lowest figure since mid-1966. Data for both shipments and inventories were somewhat distorted by the completion of billings in June on a large amount of aerospace equipment, which reduced reported inventories by over \$500 million while increasing shipments by the same amount. However, even after adjusting for this special factor, there was a decline in the overall inventory-sales ratio. To be sure, these adjusted inventory data indicate

¹ The Department of Commerce has announced an upward revision of \$0.8 billion in the gross national product (GNP) estimate for the second quarter, reflecting in part the availability of inventory spending data for the entire quarter. GNP for the quarter is now estimated at \$1,041.3 billion on a seasonally adjusted annual rate basis, and the annual rate of real GNP growth is put at 4.1 percent rather than 3.7 percent. Net exports, however, are reported as having dropped by \$6.4 billion (seasonally adjusted annual rate) rather than \$4.1 billion, but this downward revision was more than offset by upward adjustments in other components including \$0.8 billion in consumption spending, \$0.9 billion in business fixed investment, and \$1.0 billion in inventory accumulation. Corporate profits before taxes are shown as rising during the quarter by \$2.9 billion to \$82.0 billion (seasonally adjusted annual rate).

a more expansionary pace of inventory spending than do the unadjusted data. After the adjustment, the book value of total business inventories shows a rise in June at an annual rate of \$11.3 billion, more than double the gain suggested by the unadjusted figures. This more robust rate of inventory accumulation exceeded the increases registered in the three preceding months and was well ahead of the rate of spending in January and February, when relatively high inventory-sales ratios tended to dampen inventory investment.

In July, data for the manufacturing sector alone show there was a decline in inventories and a relatively greater decrease in sales. Consequently, the inventory-sales ratio rose. However, after adjusting the previous month's data for the unusually large aerospace equipment billings, the July decrease in inventories was larger than that in sales, and the inventory-sales ratio was virtually unchanged from the May and June levels.

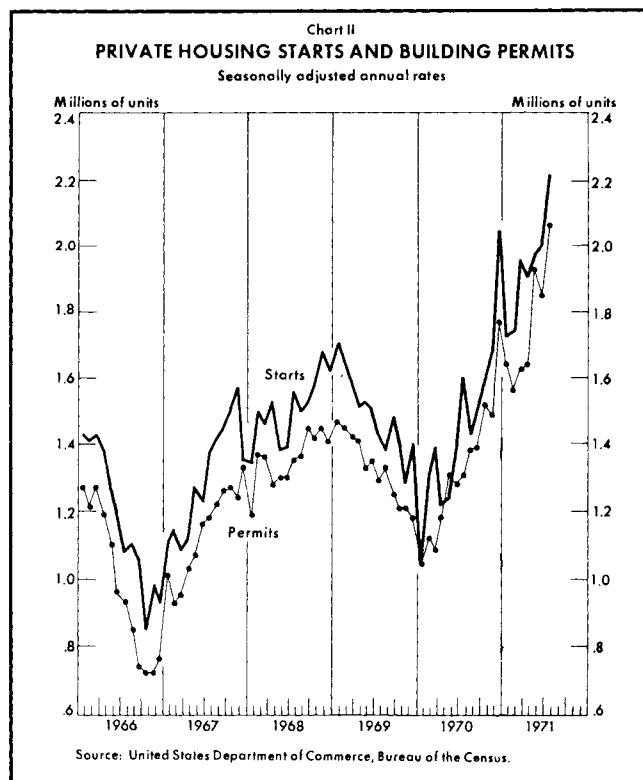
New orders received by manufacturing industries in July advanced by \$1.0 billion, owing entirely to a 3.3 percent rise in orders for durable goods. Heavier orders for defense goods, which tend to be especially large in the first month of the fiscal year, accounted for about \$500 million of the overall advance. Sizable gains in new orders were also recorded in the automobile, aerospace, and machinery industries. Bookings for primary metals declined, however, largely as a result of the labor contract negotiations in the copper and rail industries. On balance, the pattern of new orders for manufacturers' goods has not yet displayed the clear and pervasive upward thrust that accompanied the other post-Korean war recoveries.

RESIDENTIAL CONSTRUCTION

Residential construction continued to be an economic bright spot in July, as total private housing starts jumped 11.2 percent to a seasonally adjusted annual rate of over 2.2 million units (see Chart II). At this rate, starts exceeded the previous record for a single month (in August 1950) by about 100,000 units. The strength of the current housing boom is underscored by the fact that the July figure was approximately 500,000 units above the peak level of starts recorded in January 1969 at the end of two full years of expansion in residential construction. Most of the July gain reflected an increased volume of multifamily units. However, single-family starts amounted to 1.2 million units, a relatively high figure by historical standards. The seasonally adjusted number of building permits also soared in July, reaching a record annual rate of almost 2.1 million units (see Chart II). This high level, together with a large backlog of permits

for which actual construction activity has not yet begun, indicates that further gains in housing starts may well be forthcoming in the months ahead. The total supply of living units is being enlarged by continued strength in the demand for mobile homes. In June, factory shipments of mobile homes were running at a seasonally adjusted annual rate of 490,000 units, up dramatically from the 369,000 units shipped a year earlier.

The value of total new construction declined in July for the first time in twelve months. Industrial construction continued its generally downward movement from the high of October 1969, and commercial construction dropped sharply after a June surge. However, expenditures on both public construction and private residential construction showed strong gains. The near-term outlook for residential construction has been bolstered, moreover, by recent developments in the mortgage market that should have a favorable influence on the supply and cost of mortgage credit. Perhaps the most important of these developments was the sizable decline in interest rates on corporate bonds in the week following President Nixon's announcement of the wage-price freeze. If these declines are at least partially maintained, existing rates on new



home mortgages will make the latter a more attractive investment for thrift institutions and other suppliers of mortgage credit. Furthermore, the Administration indicated in early August that it would seek to preserve the 7 percent ceiling on Government-underwritten mortgages by allowing the Government National Mortgage Association (GNMA) to purchase up to \$2 billion in mortgages at a price not below 95 percent of par. In turn, GNMA will sell the mortgages at competitive rates in the secondary market while absorbing the interest cost differential by means of its special assistance fund. In another move taken in August to support the flow of funds to the mortgage market, the Federal Home Loan Bank Board reduced the liquidity requirements of member savings and loan associations from 7.5 percent to 7.0 percent.

INCOME, EMPLOYMENT, AND CONSUMER DEMAND

In July, personal income declined by \$11.0 billion, falling to a seasonally adjusted annual rate of \$859.1 billion. While this decrease reflected primarily the fact that personal income had been temporarily boosted in June by an increase in social security payments retroactive to the first of the year, the \$2.3 billion rise that occurred in July after allowance for this special factor was still relatively small. The average monthly rise between December 1970 and May 1971 had been \$5.8 billion. Emphasizing the underlying weakness of personal income in July, total wage and salary disbursements were essentially unchanged, and in manufacturing such disbursements actually declined by about \$1.1 billion.

In August, the seasonally adjusted unemployment rate increased to 6.1 percent from the 5.8 percent registered in July, according to the Bureau of Labor Statistics survey of households, as a rise of 500,000 persons in the civilian labor force outpaced an advance in employment of 300,000 persons. This was the second consecutive monthly rise in unemployment and brought the rate almost back to the May high of 6.2 percent. Most of the increase was caused by rising unemployment among teen-age and adult males. The expansion in unemployment of adult men was attributable primarily to the curtailment of production in the steel industry. Nonfarm payroll employment remained essentially unchanged, with construction and manufacturing showing minor declines. Employment in manufacturing has been especially weak during the current recovery, declining slightly from its November 1970 level. In sharp contrast, during the three most recent previous recoveries the number of workers on manufacturing payrolls over the nine months following the

business-cycle trough had risen an average of 4 percent.

Retail sales declined by 0.8 percent in July, according to the advance report. This drop, which was centered at nondurables outlets, followed a large increase in retail activity in June. However, the significance of this decline is questionable in view of the highly tenuous nature of the preliminary data. In every month of 1971 the advance report on retail sales has been revised upward, frequently by a significant amount. Whatever the final reading on the July data, the near-term course as well as the interpretation of the retail sales figures will in all probability be substantially affected by the new economic policies. With the savings rate at historically high levels, any bolstering of consumer confidence should have favorable ramifications for retail sales. Moreover, temporary increases might develop if purchases of domestic goods are accelerated on the expectation that prices will rise after the price freeze is terminated. As with other monthly indicators that are stated in dollar terms, however, changes in monthly retail sales throughout the price freeze period will be difficult to interpret relative to recent experience, during which sizable shares of the increases in dollar volume reflected simply advances in prices.

PRICE DEVELOPMENTS

The behavior of prices in the months immediately ahead will of course be dominated by the wage and price freeze. While it would be premature to speculate to what extent the freeze will affect the rate of inflation in the longer run, the large drop in long-term interest rates in the days following the President's August 15 announcement suggested that the freeze had the effect at least of temporarily reducing inflationary expectations. However, a lasting reduction in the rate of inflation will depend heavily upon decisions that are yet to be made for Phase Two, the time after the ninety-day freeze. The Cost of Living Council, which was appointed last month by the President, is currently considering various proposals for the achievement of price and wage stability over the longer run.

The highly inflationary background against which the freeze was initiated is illustrated by the recent performance of industrial wholesale prices. In August, the index of these prices rose at a seasonally adjusted annual rate of 6.4 percent, with almost all of the increase having taken place before the price freeze. This huge rise had been exceeded in July, when the index jumped at an annual rate of 8.4 percent, a record increase for the last fifteen years. Industrial prices during the first half of the year had advanced at an annual rate of 4.0 percent, a somewhat more rapid pace than for 1970 as a whole. In short,

despite almost two full years of distinctly sluggish activity in the industrial sector, prices had continued to advance at inflationary rates that were without modern precedent for a period characterized by such marked weakness in demand.

The overall performance of the consumer price index has been modestly better this year than that experienced in 1970. During the first half of the year, this improvement had partially reflected declining home mortgage interest rates. In July, on the other hand, there was a small increase in mortgage interest rates; nonetheless, the consumer price index rise slowed further to a 2.4 percent

annual rate. This followed much larger increases in the two preceding months. Smaller advances in food, non-food commodities, and to a less extent service prices all contributed to the July easing. This substantial slowing, however, might well have proved temporary with no price freeze, in view of the steep rise in wholesale industrial prices during the preceding several months. Increases in wholesale prices usually affect consumer prices after some lapse of time. The mid-August freeze may therefore have prevented the recent advances in wholesale prices from having as much repercussion on consumer prices as would otherwise have occurred.

**TREASURY AND FEDERAL RESERVE
FOREIGN EXCHANGE OPERATIONS**

The semiannual report on Treasury and Federal Reserve foreign exchange operations will appear in the October issue of this *Review*. The report is written by Charles A. Coombs, Senior Vice-President in charge of the Foreign function of the Federal Reserve Bank of New York and Special Manager of the System Open Market Account. It will cover the period March to September 1971. Exceptional conditions in the foreign exchange markets have forced postponement of publication.

The Money and Bond Markets in August

The financial markets staged a dramatic rally in mid-August in response to President Nixon's announcement of a basic shift in the nation's economic policies. Participants in the bond market were particularly encouraged by the ninety-day freeze on wages and prices as a step toward reducing domestic inflation.

The rally produced a record decline of 54 basis points in *The Weekly Bond Buyer's* index of municipal bond yields during the third week of the month. Yields on newly issued high-quality corporate bonds tumbled by as much as 80 basis points, while yields on Treasury securities of all maturities also fell rapidly. These precipitous declines in yields suggest that investors were trimming the inflationary expectations that had become embedded in yield structures. Stock markets also reflected the new-found optimism. On August 16 alone, the Dow-Jones average of industrial stock prices rose a record 32.93 points.

The euphoria sustaining the mid-August rally soon faded, but confidence remained strong that the new program had greatly improved the prospects for declining or at least steady interest rates in the months ahead. On September 2 the *Bond Buyer's* index of yields on municipals stood at 5.39 percent, down 66 basis points from the July 29 figure. On balance, yields on most long-term Treasury bonds fell during August by 28 to 35 basis points. At the end of the month, yields on Treasury issues with intermediate-term maturities were between 85 to 108 basis points below their levels at the end of July and rates on most Treasury bills were 79 to 112 basis points lower.

While yields in the capital and Government securities markets moved sharply lower over the month, developments in private money market rates were mixed. Interest rates on directly placed commercial paper with maturities of less than ninety days declined by about 25 basis points, but the offering rate on dealer-placed four- to six-month prime commercial paper fluctuated within a narrow range. The Federal funds rate remained steady in the vicinity of $5\frac{1}{2}$ percent.

According to preliminary data, the narrowly defined money supply (M_1), adjusted for seasonal variation, in-

creased in August at about a $3\frac{1}{2}$ percent annual rate, the smallest percentage gain in seven months. M_2 , a broader measure of the money supply, rose in August at a seasonally adjusted annual rate of approximately 5 percent, while the adjusted bank credit proxy increased by about 11 percent.

THE GOVERNMENT SECURITIES MARKET

A cautious atmosphere persisted in the market for United States Government securities during the first half of August. Market participants were apprehensive over the continued evidence of inflation and the increased pressure on the dollar in foreign exchange markets. There was concern that a rise in the prime rate and a firming in monetary policy lay ahead. Market sentiment changed dramatically at midmonth, however, when President Nixon made his announcement of a major shift in the nation's domestic and international economic policies. Investors responded optimistically to the Administration's program for a wage and price freeze and were further encouraged by the President's action to improve the international competitive position of the dollar. Yields on Government securities of all maturities plunged in the wake of the President's announcement, as many concluded that his program might foster a decline in interest rates during the next several months. Prices fluctuated thereafter as market participants began to assess the longer range implications of the new policies, but bidding in the August 31 auction of \$1.25 billion of a $6\frac{1}{4}$ percent five-year two-month Treasury note was aggressive.

There was little change in yields on coupon securities during the early part of August, when a mood of apprehension continued to prevail in the market. On August 5, the Treasury auctioned \$2.5 billion of new $6\frac{1}{2}$ percent eighteen-month notes, which covered the attrition from an August refunding and raised about \$1.1 billion of new cash. Bidding in the auction resulted in an average issuing price equivalent to a 6.54 percent yield. The auction elicited moderate interest from banks, which were permitted to pay for 50 percent of the awards by credits to their Treasury Tax and Loan Accounts. Toward the end

Table I
AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS
 In percent

Maturities	Weekly auction dates—August 1971				
	August 2	August 9	August 16	August 23	August 30
Three-month	5.273	5.372	4.921	4.747	4.549
Six-month	5.618	5.770	5.202	4.860	4.771
	Monthly auction dates—June-August 1971				
	June 24	July 27	August 24		
Nine-month	5.425	5.944	5.090		
One-year	5.567	5.953	5.126		

* 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.

of the second week of the month, yields on coupon securities drifted lower. This decline was mainly a result of professional demand and System purchases. Light dealer inventories at the start of the week created an excellent technical position, but investors remained very cautious.

When the market opened on Monday, August 16, investors responded enthusiastically to the President's announcement of the evening before. Yields on coupon securities fell sharply during the morning hours. Trading was extremely active as participants scrambled to cover short positions. Although investor demand contracted at midday, yields edged upward only slightly. Afternoon trading was less hectic, and yields fluctuated somewhat above the low levels prevailing during the morning. The following day, however, yields dropped sharply again as the rally continued despite occasional profit taking. Over this dramatic two-day period, yields on long-term Treasury bonds declined by about 20 basis points while yields on intermediate-term coupon issues plunged about 65 basis points.

During the remainder of the month, yields on coupon securities fluctuated over a wide range. The Treasury's announcement on August 25 that it would auction \$1.25 billion of a new 6¼ percent five-year two-month note on August 31 prompted an initial rise in yields. However, the weakness was short-lived; many participants expected that bidding for the new notes would be strong, since the size of the financing was small and banks would be able

to pay for the issue by crediting their Treasury Tax and Loan Accounts. The notes were subsequently auctioned at an average issuing price equivalent to a 5.98 percent yield. Over the month as a whole, yields on intermediate-term Treasury securities declined by 85 to 108 basis points while yields on most long-term bonds fell by 28 to 35 basis points.

Investor caution and a strong technical position also influenced the Treasury bill market in early August. Rates on Treasury bills were little changed during the first week of the month and trended moderately lower over the second week. Investor caution over the interest rate outlook and concern over the growing pressure on the dollar led to a steady demand for shorter maturities, and rates on bills were also pushed downward as foreign central banks invested a large volume of dollars acquired in exchange operations.

The President's August 15 announcement elicited a response in the Treasury bill market that was much the same as the response in the market for coupon issues. Rates on outstanding bills declined sharply during the early trading hours of Monday, August 16. Many participants viewed the rate levels reached in the morning as unrealistically low, and bidding in the regular weekly bill auction in the afternoon was hesitant. Nonetheless, reflecting the steep rate declines in outstanding issues, the average issuing rates for the new three- and six-month issues were set at 4.92 percent and 5.20 percent, respectively, 45 and 57 basis points below the levels established for comparable issues in the preceding week's auction (see Table I). Rates on outstanding bills plunged sharply again on Tuesday, and fluctuated over a wide range during the remainder of the month. Foreign demand continued and, in addition, dealers rebuilt their depleted inventories. By the end of August, rates on most issues were 79 to 112 basis points lower than at the beginning of the month.

The large foreign demand for bills that contributed to this dramatic decline in August materialized as a result of the massive flow of dollars to foreign institutions during the period, with some of these dollar balances being channeled into the bill market for short-term investment purposes. Marketable United States Government securities held in custody by the Federal Reserve Banks for foreign and international accounts rose to \$20.0 billion on August 25, a gain of almost \$1.6 billion in three weeks.

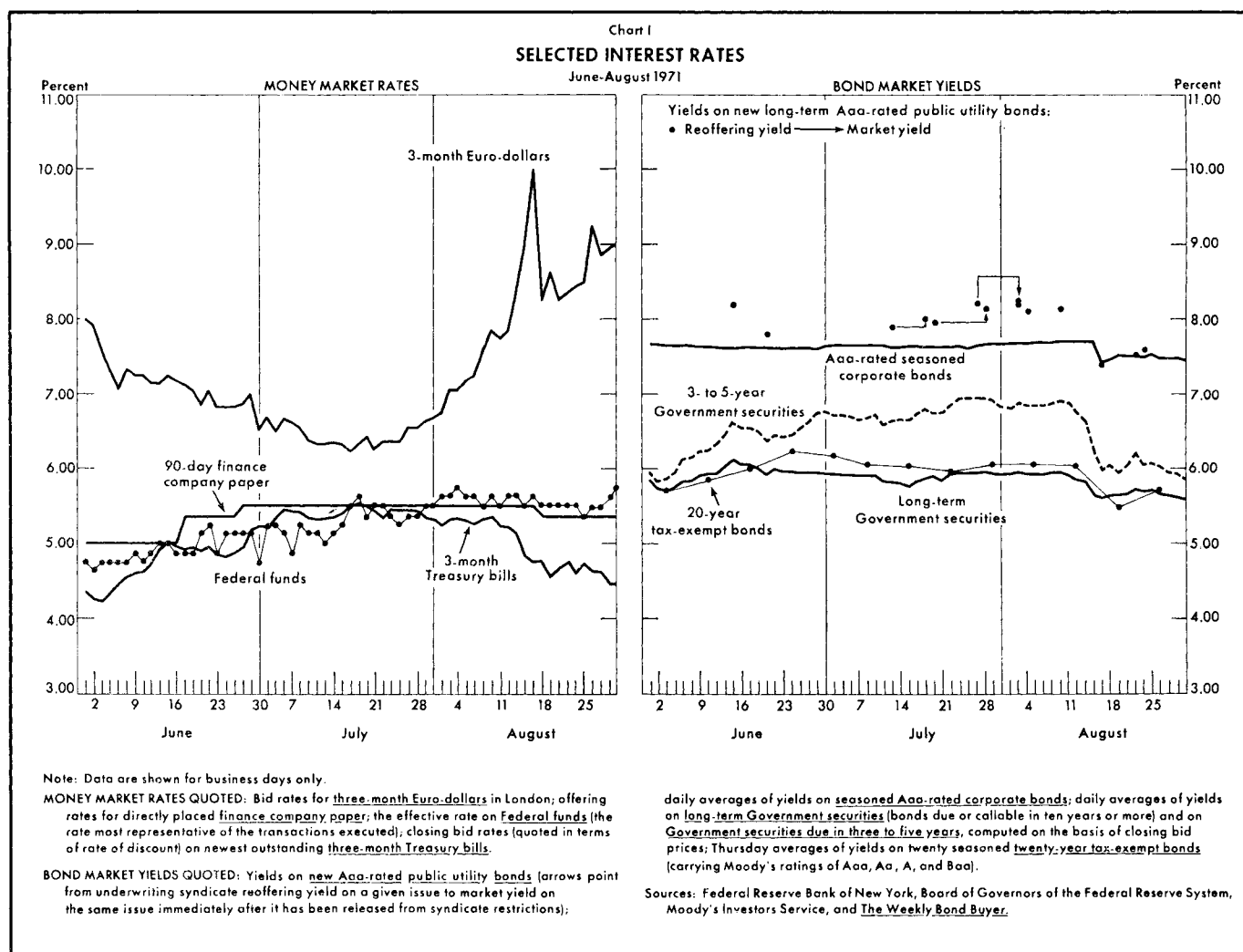
OTHER SECURITIES MARKETS

President Nixon's midmonth announcement triggered a dramatic and in some ways unprecedented rally in the corporate and tax-exempt bond markets. Indeed, in the

days immediately following the President's statement the declines in some interest rates were the largest ever recorded over such a short interval, with the returns on some securities being pushed down to the lowest levels in almost four months. After a few days, however, investor enthusiasm waned somewhat and rates retraced part of the declines recorded earlier. Late in the month, rates declined again, leaving yields at the end of August far below their end-of-July levels.

Prior to the President's announcement, yields on corporate bonds had been little changed in quiet trading. The highlight of this period occurred on August 3, when the \$100 million of Aaa-rated Indiana Bell Telephone Com-

pany debentures was marketed at an 8.20 percent yield. This yield provided about the same return as that on a smaller telephone issue marketed a week earlier, but 30 basis points more than another telephone issue of comparable size sold on July 13. The debentures received an enthusiastic response from institutional investors and sold quickly. Other newly issued corporate securities also sold well during the first half of August, aided by the relatively light schedule of new financing. On August 10, a \$60 million Aaa-rated Consumers Power Company issue was marketed at an $8\frac{1}{8}$ percent yield. The issue met a warm reception and was almost entirely sold at the end of the day. A \$175 million issue of Aaa-rated International



Bank for Reconstruction and Development bonds was marketed the following day at the same yield. Response to this offering was also favorable.

On Monday, August 16, corporate bond yields plummeted, and they continued to fall the following day, as investors responded to the President's new economic program with enthusiasm. Moody's index of yields on Aaa-rated seasoned corporate bonds plunged 27 basis points over this two-day period to 7.44 percent (see Chart I). This was the lowest level in over three months. The rally encouraged underwriters to offer on August 17 a Cincinnati Bell Telephone Company issue rated Aaa and priced to yield 7.40 percent, 80 basis points below the similarly rated Indiana Bell debentures marketed on August 4. Despite the aggressive pricing, 95 percent of the \$50 million issue was reported sold on the first day. It appeared, however, that a substantial portion of the issue had been purchased by dealers anticipating still further price increases. As the third week of the month drew to a close, investor resistance started to develop in the corporate market and this issue was still not entirely sold.

Investor enthusiasm dampened further on Monday, August 23, when the Federal National Mortgage Association (FNMA) announced that it would sell \$1 billion of debentures on Thursday of that week, the biggest FNMA offering ever. On that same Monday, a \$60 million Aaa-rated Baltimore Gas and Electric Company issue was marketed at a yield of 7.52 percent. Investor response to this offering was poor, and less than 25 percent of the issue was sold the first day. This prompted underwriters to offer on the next day a \$100 million Aaa-rated Southern Bell Telephone Company debenture issue at a yield of 7.60 percent, up 20 basis points from the Cincinnati Bell issue marketed on August 17. Despite the increase in yield, this issue also met first-day buyer resistance. Sales began to pick up toward the end of the month, however, after several major banks announced reductions in their interest charges on installment and mortgage loans. By the end of August, the Southern Bell Telephone debentures were entirely sold, although approximately 5 percent of the Cincinnati Bell Telephone issue and 40 percent of the Baltimore Gas and Electric Company issue were still in syndicate hands.

Yields on municipal bonds remained steady over the first half of August and then dropped sharply after the Presidential announcement. *The Weekly Bond Buyer's* twenty-bond index of municipal bond yields was illustrative of these yield movements, fluctuating within 4 basis points over the first two weeks of the month and then plunging a record 54 basis points to 5.49 percent on August 19 (see Chart I). The decline brought this index

to its lowest point in almost four months. Yields on some individual newly issued securities showed even more spectacular declines. On August 18, for instance, Tulsa, Oklahoma, awarded \$16 million of A-rated bonds at a net interest cost of 4.78 percent. Underwriters offered the securities to the public the same day to yield from 3.10 percent on those maturing in 1973 up to 5.40 percent on those coming due in 1996. By comparison, another A-rated municipal bond issue had been marketed on August 10 with yields of 3.70 percent to 6.40 percent for similar maturities. Despite the lower yields of 60 to 100 basis points on the later securities, investors responded favorably. During the remainder of the month, yields on municipal bonds fluctuated widely. On September 2 the *Bond Buyer's* twenty-bond index stood at 5.39 percent, down 66 basis points from July 29.

A series of measures taken in August to keep down rates on mortgages, particularly those on home mortgages, should help support prices of corporate and municipal securities. Early in the month, the Federal Government, in a move designed to hold the ceiling rate on subsidized mortgages at its current level of 7 percent, announced that it would allow the Government National Mortgage Association (GNMA) to purchase up to \$2 billion in mortgages at a discount. In turn, GNMA would sell the mortgages in the secondary market at competitive rates while absorbing the interest cost differential by means of its special assistance fund. Later in the month, the Federal Home Loan Bank Board reduced the required liquidity ratio at member institutions to free additional funds for mortgages. Since mortgages compete with corporate and municipal bonds for funds, these steps to hold down mortgage rates will also tend to reduce upward pressure on bond rates.

An interesting development in the tax-exempt market during August was the reduction in the size of a New York housing agency issue as a result of the Administration's freeze on prices. The New York agency had originally planned to offer \$166 million worth of bonds on Monday, August 16, but delayed the offering to assess the impact of the President's program on the credit markets. The issue was finally marketed later in the week, but the amount of the financing was reduced by about \$39 million. Reportedly, the reduction was made because eight of the agency's housing projects would have required increased rentals and, therefore, had to be postponed.

THE MONEY MARKET

Rate trends were mixed in the money market in August, with some rates rising, some fluctuating narrowly, and

others declining. The average effective Federal funds rate advanced to 5.56 percent (see Chart I), up 25 basis points from July's average. Reflecting the disturbance in the international currency markets, three-month Euro-dollar rates soared to 10 percent on August 17 as participants scrambled to liquidate dollar claims and to borrow dollars for conversion into other currencies. At the close of the month, this rate stood at 9 percent, up $2\frac{5}{16}$ percentage points from the end of July. On August 3, a medium-sized Detroit bank raised its prime rate by $\frac{1}{2}$ percentage point to $6\frac{1}{2}$ percent, and late in the month a small St. Louis bank cut its prime rate to $5\frac{3}{4}$ percent. However, major money market banks held their prime lending rates at 6 percent. The offering rate on dealer-placed four- to six-month prime commercial paper and bid rates on bankers' acceptances fluctuated in a narrow range. On the other hand, interest rates on directly placed commercial paper with maturities of less than ninety days declined by about 25 basis points over the month.

The firm pressure on member bank reserve positions that had emerged in July was maintained in August as net borrowed reserves averaged \$612 million (see Table II), little changed from the net reserve position that prevailed in July. Member bank borrowings dropped somewhat below their July average during the first two weeks of August, but then rose sharply during the third statement week. For the month of August as a whole, borrowings averaged \$827 million, down \$3 million from the average in July. As a result of this decline in borrowings and a \$22 million fall in nonborrowed reserves, total member bank reserves decreased by \$25 million, before seasonal adjustment. However, because bank reserves are typically characterized by a fairly large seasonal decline in August, member bank nonborrowed and total reserves, adjusted for seasonal variation, rose rapidly after declining substantially the previous month.

As for the monetary aggregates, preliminary data indicate that the growth in M_1 slowed to a seasonally adjusted annual rate of approximately $3\frac{1}{2}$ percent in August (see Chart II). The gain for the most recent three months thus was only about $7\frac{1}{2}$ percent, down from an increase of 11.6 percent for the three months ended in July. The growth in M_2 continued to slacken, with the August increase estimated at a 5 percent seasonally adjusted annual rate. However, there were very large increases in August in two categories of deposits that are not included in either M_1 or M_2 . Government deposits at member banks rose rapidly, largely reflecting extensive purchases of Treasury nonmarketable certificates of indebtedness by foreign central banks, and large negotiable certificates of deposit at member banks also grew at a rapid pace. As a result,

the adjusted bank credit proxy, which includes these deposits, increased at a seasonally adjusted annual rate of approximately 11 percent in August, the largest percentage gain since February and a rate well in excess of the ex-

Table II
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, AUGUST 1971

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

Factors	Changes in daily averages— week ended				Net changes
	August 4	August 11	August 18	August 25	
“Market” factors					
Member bank required reserves	+ 96	+ 157	— 77	+ 360	+ 536
Operating transactions (subtotal)	— 99	— 392	+ 68	— 106	— 529
Federal Reserve float	— 152	— 66	+ 226	+ 26	+ 34
Treasury operations*	+ 266	— 17	+ 125	— 113	+ 261
Gold and foreign account	— 37	— 81	— 121	— 8	— 247
Currency outside banks	— 51	— 161	— 372	+ 3	— 581
Other Federal Reserve liabilities and capital	— 126	— 66	+ 212	— 14	+ 6
Total “market” factors	— 3	— 235	— 9	+ 254	+ 7
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 116	— 33	— 103	+ 292	+ 272
Outright holdings:					
Treasury securities	+ 101	+ 50	+ 84	+ 397	+ 632
Bankers’ acceptances	— 3	— 5	— 2	+ 6	— 4
Repurchase agreements:					
Treasury securities	+ 40	— 49	— 157	— 101	— 267
Bankers’ acceptances	— 8	— 4	— 10	—	— 22
Federal agency obligations	— 14	— 25	— 18	— 10	— 67
Member bank borrowings	+ 219	— 171	+ 587	— 409	+ 226
Other Federal Reserve assets†	+ 35	+ 32	— 213	— 318	— 464
Total	+ 370	— 172	+ 271	— 434	+ 35
Excess reserves	+ 367	— 407	+ 262	— 180	+ 42

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash.....	30,894	30,330	30,669	30,129	30,506‡
Required reserves	30,460	30,303	30,380	30,020	30,291‡
Excess reserves	434	27	289	109	215‡
Borrowings	764	593	1,180	771	827‡
Free, or net borrowed (—), reserves.....	— 330	— 566	— 891	— 662	— 612‡
Nonborrowed reserves	30,130	29,737	29,489	29,358	29,679‡
Net carry-over, excess or deficit (—)\$....	18	230	79	135	116‡

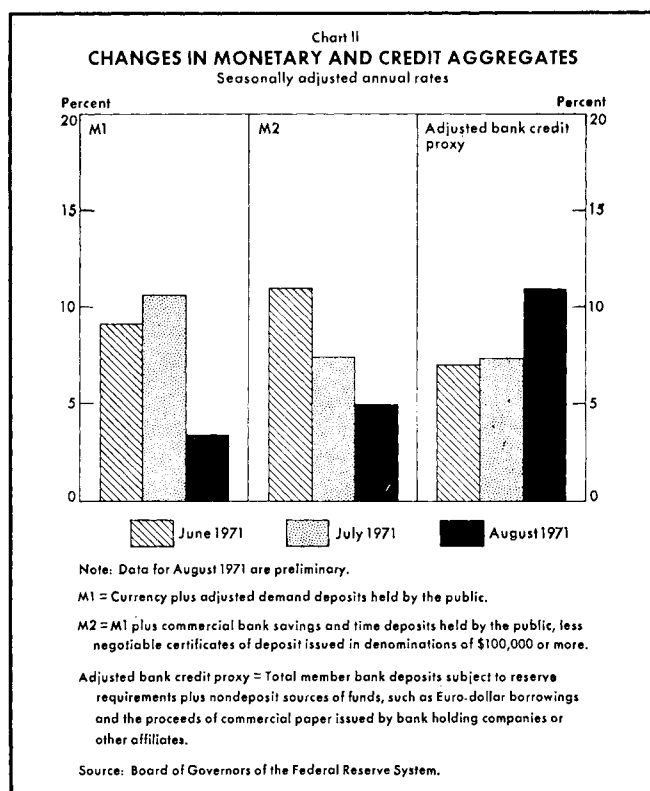
Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Average for four weeks ended August 25.

§ Not reflected in data above.



pansion of both M_1 and M_2 . In each of the four preceding months, the expansion of the proxy had been quite modest relative to the money supply measures.

Commercial bank loans rose substantially in August, with the increase at least partly related to the international currency crisis. Most of the rise occurred during the third statement week of the month, immediately following President Nixon's statement concerning the temporary suspension of the convertibility of the dollar into gold. During that week, business loans at weekly reporting banks, including loans sold to affiliates, climbed by \$799 million, contrasting with the \$277 million decline registered over the comparable period in 1970. Almost half of the increase was in bankers' acceptances, many of which were apparently related to foreign transactions, while loans to foreign industrial and commercial businesses accounted for almost one quarter of the gain. Borrowings at weekly reporting banks by foreign commercial banks also jumped that week by \$700 million. Presumably, foreign corporations and banks borrowed dollars to exchange them for other currencies in anticipation of a depreciation of the dollar in foreign exchange markets. A similar surge in commercial bank loans to foreigners occurred during the last major currency crisis in May.

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