# FEDERAL RESERVE BANK
# OF NEW YORK

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### Contents




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# The Business Situation

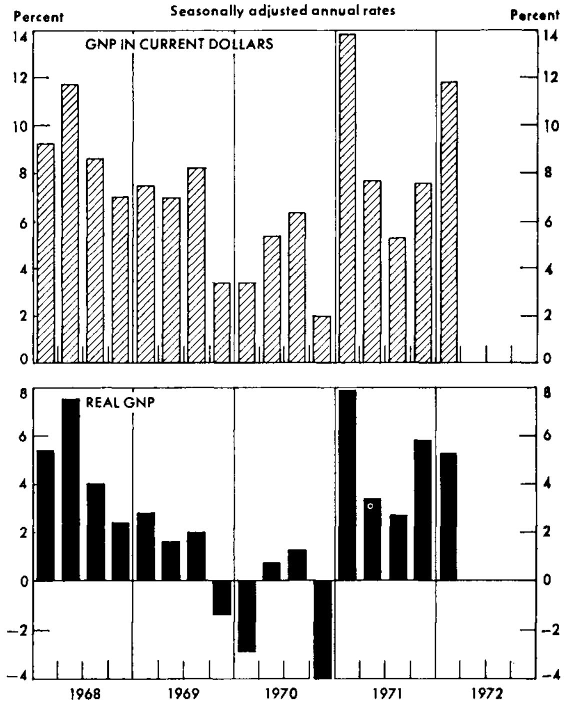
The most recent business statistics provide further evidence of a broadly based quickening in the pace of economic activity. Industrial production posted a pervasive and strong increase in March, and payroll employment continued to show upward momentum in April. Real gross national product (GNP) advanced at a healthy 5.3 percent annual rate in the first quarter as almost all sectors shared in the advance. Retail sales rose sharply in March, and scattered indications of an improvement in consumer attitudes suggest that some further gains may occur in this area during the months ahead. In spite of these signs of strengthening economic activity, business spending for inventories has remained cautious and unemployment has remained at recent high levels.

The latest readings on prices and wages have been somewhat mixed and do not yet provide a clear indication of the overall effectiveness of Phase Two policies. Certainly the most favorable price development in the Phase Two period thus far was the virtual stability displayed by consumer prices in March. On the other hand, the implicit GNP price deflator and compensation per hour of work in the private economy—the broadest measures of prices and wages, respectively—posted large increases in the first quarter. These rapid gains were in part a reflection of the bunching of wage and price increases in the aftermath of the freeze. Thus, neither of these advances is necessarily representative of the underlying inflationary situation within the quarter. In April, industrial wholesale prices continued to rise at the same disappointingly rapid pace of the previous four months.

## GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary estimates by the Department of Commerce, the market value of the nation's output of goods and services rose by $30.3 billion during the first quarter to a seasonally adjusted annual rate of $1,103.2 billion. About half of this growth was accounted for by price increases, as the GNP implicit price deflator advanced rapidly in the aftermath of the price freeze. After adjustment for changes in the price level, the first-quarter increase in real GNP was at a 5.3 percent annual rate. This gain, coming on the heels of the sizable advance in real GNP in the fourth quarter of 1971, brought growth in the six months ended in March to an annual rate of 5.6 percent. With the exception of the first half of 1971,

Chart I
CHANGES IN NOMINAL AND REAL GROSS NATIONAL PRODUCT
Seasonally adjusted annual rates




Source: United States Department of Commerce.

when activity was artificially boosted by the recovery from the automotive strike, this was the largest gain in real GNP over any two consecutive quarters since the middle of 1968 (see Chart I).

The rapid growth in GNP in the first quarter was accomplished despite persistent sluggishness in inventory spending. Based on incomplete data, inventory accumulation in GNP terms amounted to only $0.6 billion (annual rate) in the January-March period, compared with the already low $2.4 billion rate in the preceding quarter, thus causing a $1.8 billion drag on the overall advance of GNP. While available data do not provide evidence that the long-anticipated expansion in inventory investment has begun, the potential for an acceleration in inventory spending in the months ahead was enhanced by some developments in the first quarter. For example, the substantial gain in new orders for durable goods is expected to add to inventories of goods in process during the coming months as production of these goods progresses. Moreover, with inventory-sales ratios low in virtually every sector, further strengthening in capital spending should increase the demand for inventories.

The first-quarter rise in current-dollar final expenditures —i.e., GNP net of inventory accumulation—amounted to a strong $32.2 billion, or 12.6 percent at an annual rate. In real terms, final spending rose at a rapid 6.5 percent annual rate, considerably above the pace of the three preceding quarters. The overall gain in final spending was paced by a significant expansion in business fixed investment spending and by large increases in outlays for new residential construction (see Chart II).

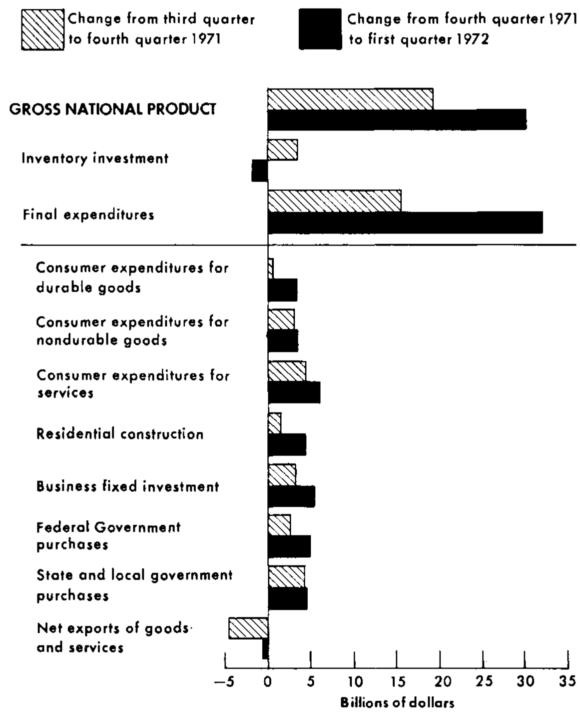
Business fixed investment grew by $5.5 billion in the January-March period. The gain was concentrated almost exclusively in expenditures for producers' durable equipment, including trucks and aircraft. This exceptional advance in capital spending provides evidence of the stronger pace of investment outlays which had been anticipated for 1972. For example, the February survey of capital spending plans conducted by the Department of Commerce revealed that such investment was expected to rise by approximately 10½ percent in 1972, and a more recent McGraw-Hill survey indicated an even stronger advance of about 14 percent. In comparison, plant and equipment expenditures rose by a small 1.9 percent in 1971. The improved outlook for business fixed investment spending is also seen in the recent strengthening in production of business equipment and in new orders for capital goods.

Spending on residential construction expanded sharply in the first quarter, rising by $4.6 billion to a record level, as the upward momentum in the home-building boom continued. Moreover, despite the duration and intensity of the current upswing in the housing sector, there are indications that further—though smaller—gains in spending may yet materialize. For example, although housing starts eased somewhat in March from the record levels attained earlier in the quarter, over the January-March period as a whole starts averaged an unprecedented 2.5 million units at an annual rate. Furthermore, current and near-term conditions in the mortgage markets remain favorable insofar as the availability of mortgage credit is concerned. This is suggested by the strong first-quarter flow of deposits to thrift institutions and the sharp rise in their mortgage commitments.

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted




Source: United States Department of Commerce.

Personal consumption expenditures rose $13 billion in the first quarter to a seasonally adjusted annual rate of $690.2 billion. The rise in consumer spending was broadly based as outlays on durables, nondurables, and services all posted relatively good gains. The rise in durables was paced by a substantial gain in purchases of furniture and household equipment which was at least partially related to the housing boom. The first-quarter rise in consumption spending, as measured in the GNP accounts, reflected the marked upsurge in retail sales activity that occurred toward the end of the quarter. Retail sales expanded in February and then posted a huge increase in March. Scattered indications of improved consumer confidence, moreover, enhance the possibility of further substantial expansion in consumer spending.

The underlying behavior of personal income, disposable income, and the savings rate in the first quarter was obscured by a number of special factors. Personal income rose by a substantial $23.2 billion, a seasonally adjusted annual rate of gain of 11.0 percent. In part, this advance reflected the strong showing of employment as well as Federal civilian and military pay increases. Beyond this, the clustering of pay increases in the aftermath of the freeze, as well as the incorporation into the data of retroactive pay raises granted by the Pay Board, also contributed to the first-quarter rise in personal income. While an exact calculation is not possible, it is estimated that these nonrecurring factors added $8 billion to $9 billion to personal income in the first quarter. However, despite the large increase in personal income, disposable (after-tax) income rose by only $10.7 billion. The large difference was the result of the substantial overwithholding of Federal personal income taxes which occurred in the quarter as a consequence of changes in withholding schedules that took effect in January. It has been estimated that overwithholding increased Federal tax payments by $8 billion (annual rate) and thereby reduced disposable income by a similar amount. Thus, insofar as disposable income is concerned, the overwithholding situation largely counterbalanced the impact of the nonrecurring gains in personal income noted above. Against this background, the first-quarter decline in the savings rate to 7.4 percent may be indicative of a greater willingness to spend on the part of consumers.

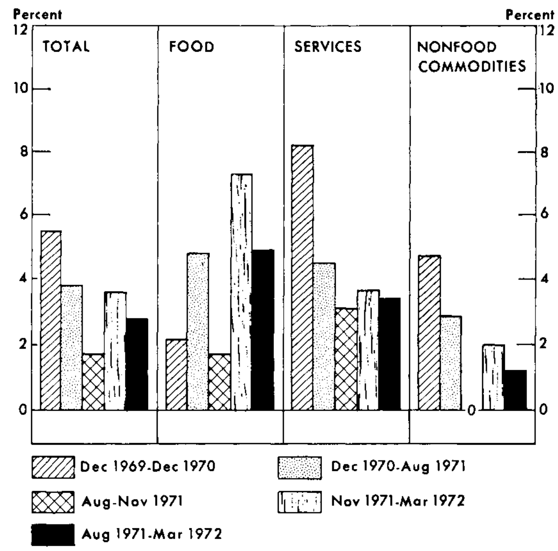
Government purchases of goods and services contributed $9.6 billion to the first-quarter GNP advance. Federal spending increased by $5.0 billion, a little more than half of which reflected Federal civilian and military pay increases. Even apart from the pay increases, however, defense spending quickened in the first quarter. In combination, this brought Federal sector spending for defense back to its highest level since the first quarter of 1970. However, the recovery in defense spending still appears to be of modest proportions, as the industrial production index for defense goods has merely leveled out in recent months at a reading about 31 percent below the August 1968 peak. At the state and local level, spending rose $4.6 billion, a bit larger than the increase of the previous quarter.

## PRICES, WAGES, PRODUCTIVITY, AND EMPLOYMENT

In Phase Two thus far, most of the broader price indexes have risen at about the same rates that had prevailed over the eight-month period prior to the price freeze. To a considerable extent, however, these data overstate underlying inflationary forces, since increases that might otherwise have occurred in earlier months tended to be bunched in the post-freeze period.

Certainly the most favorable price development in the Phase Two period has been the stability displayed by consumer prices in March, when the index, seasonally adjusted, was virtually unchanged from its February level. Over the first four months of Phase Two, consumer prices moved up at a seasonally adjusted annual rate of 3.6 percent, barely below the pace of the first eight months of 1971 but sharply below the advance during 1970 (see Chart III). Much of the recent rise reflected the surge in retail food prices, which climbed at a 7.3 percent annual rate from November through March. Food prices are in part exempt from controls and respond rather quickly to changes in agricultural supply conditions. Nonfood commodity prices, on the other hand, advanced at a more modest 2.0 percent rate during the first four months of

Chart III
RECENT CHANGES IN CONSUMER PRICES
Annual rates




Note: Data are seasonally adjusted with the exception of services.

Source: United States Department of Labor, Bureau of Labor Statistics.

Phase Two, thus continuing the improvement already evident in this category before the price freeze.

At the wholesale level, the rise in prices over the five-month period ended in April was at about the same rate as during the first eight months of 1971. This is, to a considerable extent, a manifestation of the catch-up bulge that had been expected as well as the net advance in agricultural prices. In the industrial sector, wholesale price increases slowed only modestly during Phase Two relative to their pre-freeze pace, a disappointing result. At the same time, the farm products and processed foods and feeds component rose sharply. However, over the eight months since August, covering the freeze and Phase Two, there has been perceptible improvement in the performance of industrial wholesale prices and of the index in general. A potentially favorable development was the mid-April announcement by major steel producers imposing a virtual freeze on prices of most steel mill products. Industrial wholesale prices could benefit directly from this action, and there may be spillover benefits as well since steel is an important intermediate product.

The most comprehensive available measure of price behavior, the implicit GNP price deflator, increased at a 6.2 percent annual rate in the first quarter, according to preliminary estimates. Even after making allowance for a probable downward revision in the deflator in light of the March consumer price data (which were not available when the GNP estimates were prepared), the first-quarter rise represented a pronounced acceleration from the 1.7 percent rate of increase in the previous quarter. However, because of nonrecurring factors, including the post-freeze clustering of price increases and the Federal pay raises, the first-quarter showing of the deflator does not provide an accurate representation of the underlying inflationary situation during this period. For example, the Federal pay raises contributed approximately 1 percentage point to the first-quarter jump in the deflator. Beyond this, shifts in the composition of output in the first quarter toward relatively high-priced goods, such as residential structures, also contributed to the acceleration in the deflator because this index is a weighted average of component price indexes, with the weights determined by the composition of output in each quarter. Thus, the chain price index for the private economy—which eliminates price changes stemming from Government pay raises and changes in the composition of output—rose at a 4.6 percent annual rate in the first quarter. Even this index does not eliminate the bulge arising from the post-freeze clustering of price changes. Nevertheless, it is noteworthy that the rise in the private deflator for the four quarters ended in the first quarter of 1972 was 3.3 percent, a distinct slowing relative to the performance of the last several years. For example, the increase over the four quarters ended in the first quarter of 1971 amounted to nearly 5 percent.

Recent data on wages and salaries also have been affected by a post-freeze clustering of increases. As expected, compensation per hour of work in the private economy rose rapidly in the first quarter, posting an 8.6 percent annual rate of increase. This advance was spurred both by the post-freeze clustering in pay raises and by increased employer contributions to social security. Average hourly earnings—one of the monthly sources for the series on compensation per hour of work—posted sharp gains in December and January, in part stemming from the concentration of increases after the termination of the freeze. All these factors contributed to the first-quarter rise in compensation per hour of work and, while there was a deceleration in the advance of average hourly earnings on balance over the February-April interval, gains remained large nevertheless.

Productivity, as measured by the index of real output per hour of work, increased at a 3.7 percent annual rate in the private nonfarm economy in the first quarter. While this rise was somewhat slower than that posted in the preceding quarter, it was considerably more rapid than the corresponding productivity gain registered over the six-month period ended in September 1971. In contrast to the first-quarter advance in productivity in the private nonfarm economy, there was a decline in output per hour of work in the farm sector which resulted primarily from a decrease in real output. As a consequence, productivity in the private economy as a whole rose at a relatively sluggish 2.1 percent annual rate in the January-March interval. With the substantial gain in compensation per hour of work and small growth in productivity in the private economy, labor costs per unit of output climbed at a 6.3 percent annual rate, the fastest quarterly rise in unit labor costs in two years. However, over the six months ended in March, including much of the freeze and Phase Two, the advance in unit labor costs was at a 3.6 percent rate, a somewhat less disturbing picture of cost pressures. Moreover, it is still too early at this stage to evaluate the overall effectiveness of the wage controls because of the special factors which have influenced recent data.

The latest Bureau of Labor Statistics survey reveals some moderation in the rate of increase in wages and benefits under major collective bargaining agreements during the first quarter relative to the performance of recent years. Perhaps the most promising development occurred in the manufacturing sector, where settlements approved during the first three months of this year provided for mean life-of-contract wage and benefit increases of 6.1

percent, down significantly from 7.7 percent for 1971 as a whole. Similarly, the average life-of-contract settlement for all industries slowed in the first quarter, although overall improvement was tempered by the large gains granted to railroad workers. The rail contract, which was negotiated prior to the freeze but not approved by the Pay Board until January, weighed heavily in the first-quarter collective bargaining results because it covered more than one third of the total number of workers included in the settlement data. It might also be noted that there apparently were a fairly sizable number of wage contracts involving fewer than 1,000 workers that took effect in the quarter and provided for wage increases well below those experienced in the major contract settlement data referred to above.

The underlying trend in employment continues to exhibit strength. According to the Bureau of Labor Statistics survey of employers, seasonally adjusted nonfarm payrolls rose by 182,000 workers in April, after increasing by more than 800,000 workers during the first quarter. Over the six-month period ended in April, nonfarm payroll employment rose at an annual rate of 3.7 percent. Notably, employment in manufacturing industries climbed substantially over the first four months of 1972, after stagnating during most of 1971. These gains brought manufacturing employment in April to the highest level since September 1970. At the same time, the average factory workweek and hours of overtime have risen above the levels prevailing throughout 1971. Nevertheless, the monthly household survey indicated that the unemployment rate remained at a seasonally adjusted 5.9 percent in April, little changed from the average for 1971 as a whole.

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# Monetary and Bank Credit Developments in the First Quarter

The first quarter of 1972 was marked by substantial increases in the monetary and credit aggregates. The large rise in the narrowly defined money supply ($M_1$), after several months of little growth, was particularly notable. Other measures of money and credit posted strong advances as well. The growth of the broadly defined money supply ($M_2$) had already begun to pick up during the final three months of 1971, when time deposits other than large certificates of deposit (CDs) recovered from the weakness exhibited in July and August. The subsequent acceleration in the growth of $M_2$ reflected a further step-up in the expansion of time deposits as well as the faster growth of private demand deposits and currency. Inflows of funds to thrift institutions also accelerated in the first quarter, to near-record rates.

Bank credit gained strength in the early months of 1972, as loans expanded more rapidly than they had in late 1971. Business loans, in particular, achieved a healthy advance as the pace of economic activity quickened. Short-term interest rates generally declined until about mid-February but rose thereafter, while long-term rates tended to drift slightly upward over the quarter. In general, however, interest rates closed the period below the levels that had prevailed before the inauguration of the new economic program on August 15, 1971.

### THE MONETARY AGGREGATES

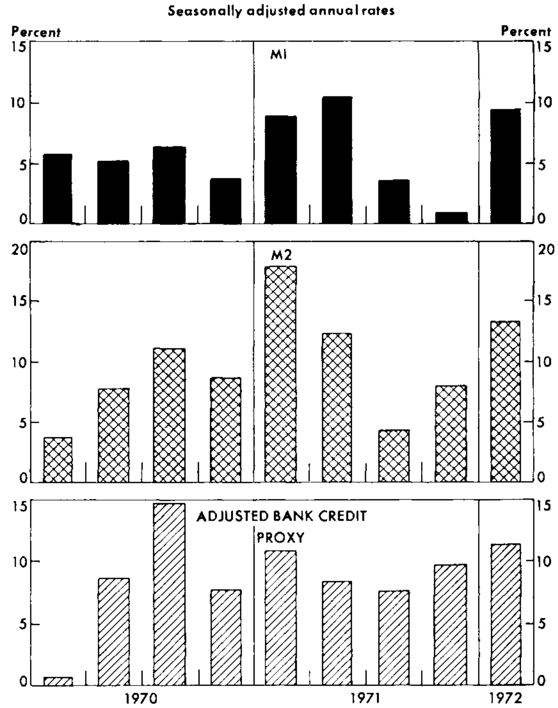
The resurgence in the growth of $M_1$—adjusted demand deposits and currency held by the public—began late last year. After having advanced at a scant 0.4 percent seasonally adjusted annual rate in the four months from July through November 1971, $M_1$ moved up at a 3 percent annual rate during the following two months. Then it leaped ahead at a 12 percent rate during February and March. As a result, $M_1$ rose at a 9.3 percent rate over the quarter (see Chart I). The advance in the first quarter tended to compensate for shortfalls in the second half of 1971. Thus, over the six months that ended in March, $M_1$ expanded at a 5.2 percent annual rate, compared with an average growth rate of 6 percent over the years 1970 and 1971.

The substantial acceleration in the growth of $M_1$ during the first quarter reflected a combination of demand and supply factors. On the demand side, the general quickening of economic activity as evidenced by the $30.3 billion advance in nominal gross national product in the first quarter, on the heels of the $19.5 billion rise of the previous quarter, probably increased the transactions de-

Chart I

CHANGES IN MONETARY AGGREGATES

Seasonally adjusted annual rates




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

M2 = MI 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 sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

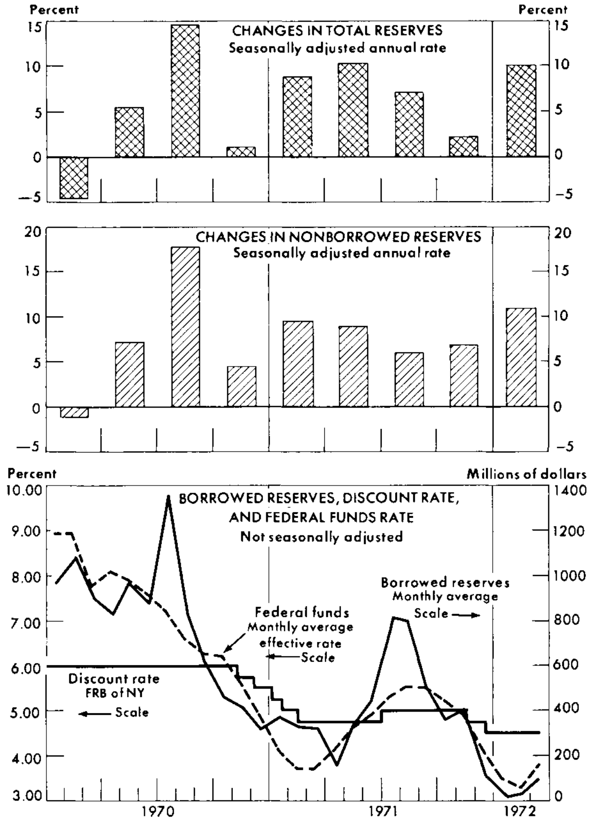
mand for money. This effect was reinforced by the general decline in interest rates, beginning in the latter part of 1971 and continuing into February 1972. Inasmuch as declines in interest rates reduce the cost of holding cash balances in the sense of income sacrificed, they tend to increase the demand for money. However, these effects often occur with considerable time lags. Hence, it is likely that the declines in interest rates that were touched off by the inauguration of the New Economic Policy last August were reflected to some extent in the demand for money in the first quarter.

The pressures for expansion emanating from the demand side were complemented by increased reserve availability—intended, in part, to promote more rapid growth in $M_1$ in the wake of its persistent sluggishness over the latter half of 1971. The growth of nonborrowed reserves accelerated to a seasonally adjusted annual rate of 11 percent in the first quarter of 1972 from 6.8 percent in the previous quarter (see Chart II). The speedup in the growth of total reserves was even more pronounced. The increase in total reserves had been at an annual rate of only 2.3 percent in the closing quarter of last year, as member bank borrowings from the Federal Reserve Banks fell sharply. Such borrowings shrank from an average of \$424 million in the final week of September to \$14 million by the end of February. The discount rate was reduced from 5 percent to 4½ percent in two stages in November and December but has remained unchanged since then. Meanwhile, the effective Federal funds rate declined by 138 basis points over the fourth quarter and by a further 71 basis points through the end of February. Under such circumstances, it is not surprising that banks made progressively less use of the discount window. In March, however, the effective Federal funds rate increased by 75 basis points to an average of 4.09 percent in the final week, and borrowings increased to \$155 million. As a result of this reversal, the growth rate of total reserves over the quarter as a whole was almost as great as that of nonborrowed reserves.

The growth of $M_2$—consisting of $M_1$ plus time deposits other than large CDs—also accelerated, reflecting in part the resurgence in $M_1$ growth. Over the quarter as a whole, $M_2$ advanced at a seasonally adjusted annual rate of 13 percent, more than double the rate of increase experienced over the previous six months. Of course, the rise in $M_2$ during the second half of 1971 had been restrained by the sluggishness in $M_1$. Indeed, during that period, time deposits other than large CDs rose at a fairly strong 10 percent annual rate. Toward the end of 1971, time deposit growth accelerated appreciably as competing market rates fell relative to the yields on most time deposits. This

Chart II

MEMBER BANK RESERVES AND RELATED INTEREST RATES




Note: Reserve requirements on time deposits over \$5 million were lowered from 6 percent to 5 percent on October 1, 1970.

Sources: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

acceleration culminated in the extremely rapid 24 percent seasonally adjusted annual rate of growth in these deposits in January. A few large commercial banks cut their offering rates on passbook savings from 4½ percent to 4 percent in late January and early February. Other short-term interest rates leveled off and then began to rise in February and March. In part as a result of the narrowing of the yield differential in favor of time deposits, the growth of these deposits began to decelerate, first to a 15 percent rate in February and then to an 11 percent rate in March.

The adjusted bank credit proxy rose at an annual rate of 11.3 percent during the first quarter, up from 8.8 percent over the latter half of 1971. It followed a somewhat different pattern of growth over the quarter than either $M_1$ or $M_2$, growing moderately in January, slowing in February, and speeding up substantially in March. The pattern of fluctuation in seasonally adjusted Government deposits—which are included in the proxy but not in $M_1$ or $M_2$—was largely responsible for this divergent behavior. The Treasury was carrying high balances in December and early January in the wake of the tentative agreement on exchange rates reached at the Smithsonian conference on December 18. At the time, it had been widely expected that the agreement would precipitate a substantial return flow into dollars from abroad. Foreign central banks would then be expected to liquidate a large part of their holdings of Treasury securities to maintain the new exchange rates. By February, however, when it became apparent that the foreign demand for dollars was not imminent and the approach of the debt to the statutory ceiling restricted borrowing possibilities, the Treasury reduced its balances.

The Treasury raised only $660 million in February through $300 million additions to the last two weekly bill auctions and from $60 million in bond sales to individuals in conjunction with the February refunding. That sum was considerably less than the $1.3 billion cash drain from the attrition in the refunding. The Treasury delayed any new cash offering until the beginning of March when it auctioned a $3 billion strip of Treasury bills. Moreover, the additions to the weekly bill auction were discontinued after March 23 because of greater than anticipated tax receipts arising from substantial overwithholding of personal income taxes.

Nondeposit liabilities also dipped temporarily in February, but they have shrunk so much in magnitude that they no longer constitute a major part of the proxy. Large CDs, another component of the proxy, not included in $M_1$ or $M_2$, declined in January and March, although they increased sharply in February, thereby tending to mitigate the effects of the movements in Treasury balances on total member bank deposits. On balance, CDs outstanding were little changed over the quarter, after allowance for normal seasonal variation. The sluggishness of CDs appeared to be related in part to their extensive use to meet corporate tax payments in March. Banks did raise offering rates several times during March, indicating some effort to hold on to these funds as rates on competing market instruments rose.

## BANK CREDIT AND INTEREST RATES

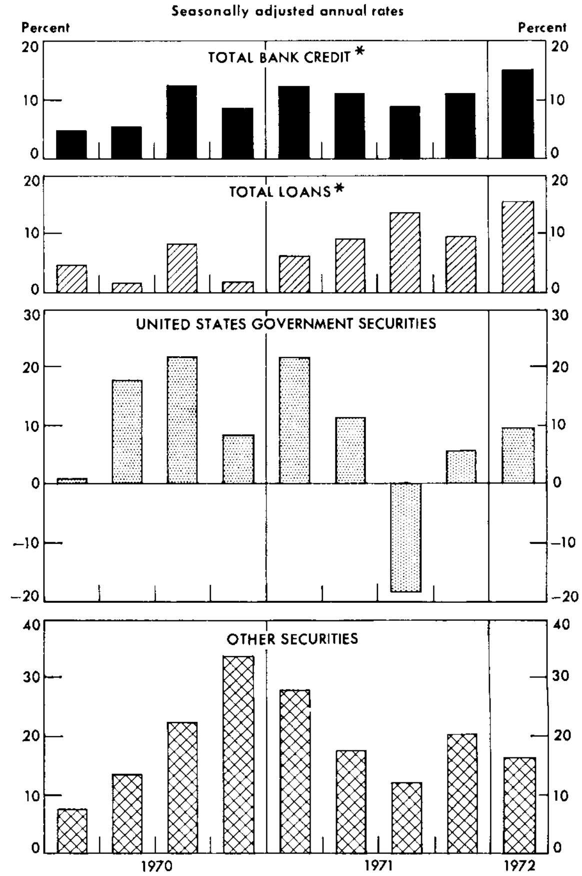
Total bank credit and most of its major components showed considerable strength in the first quarter of 1972. Bank credit, including loans sold to affiliates, increased at a 15 percent seasonally adjusted annual rate over the quarter (see Chart III). The acceleration from the 11 percent growth rate of the fourth quarter reflected a pickup in loans, as total loans, including loans sold to affiliates, advanced at a 15½ percent pace, compared with a 9½ percent rate in the fourth quarter. Increased purchases of Government securities also contributed to the resurgence, but the rate of increase in holdings of other securities slackened somewhat.

A particularly noteworthy development was the strengthening of domestic business loan demand, which reflected the large advance in GNP. With the exception of the third quarter of 1971 when business loans had been inflated by borrowing related to international developments, business loans had been relatively weak in most months since mid-1970. In the fourth quarter of 1971, for example,

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS

Seasonally adjusted annual rates




*Adjusted for loans sold to affiliates.

Source: Board of Governors of the Federal Reserve System.

seasonally adjusted business loans declined slightly.

Interest rates on business loans declined along with other market rates. As the quarter began, the prevailing prime rate stood at 5¼ percent, but by the end of the first week in January most banks had lowered their prime rate to 5 percent. By the third week, declines in commercial paper rates spurred the majority of those banks that have adopted a floating prime rate to drop this rate to 4¾ percent. This move was soon followed by similar reductions at banks that still administer the rate. Further decreases—to 4½ percent—by most of the banks with floating rates were not widely followed by others, and by mid-March most of these banks had returned to a 4¾ percent rate. By the end of the quarter the prime rate had generally been raised to the 5 percent level that had prevailed in early January.

Most other categories of loans were at least as strong seasonally in the first quarter of 1972 as they had been in the final quarter of 1971. Real estate and consumer loans, which had contributed most of the strength in total bank lending in the fourth quarter, continued their healthy advances, albeit with a slight slackening in consumer loans. Loans to nonbank financial institutions and securities loans staged dramatic turnarounds in the quarter, growing particularly rapidly in January. Increased loans to brokers to finance the buildup in their margin stock accounts played a part in the securities loan resurgence. Total margin credit to customers, which is financed in part by bank loans to brokers, increased substantially in each month of the quarter to a record $9,145 million at the end of March.

Total investments of commercial banks grew at a 14 percent seasonally adjusted annual rate in the first quarter. Banks continued to acquire securities other than those issued by the Federal Government at a rapid rate. In the first quarter, holdings of these securities increased at a 16 percent rate, down from 20 percent in the previous quarter.

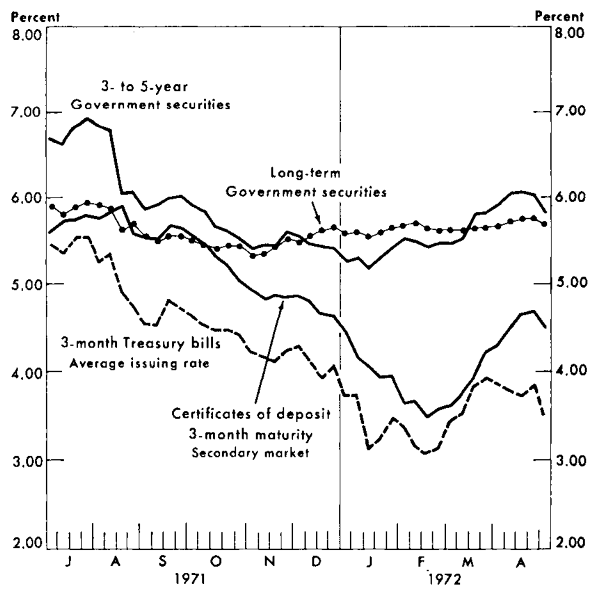
United States Government securities holdings advanced sharply in February and March, after having fallen off in January, and grew at a seasonally adjusted annual rate of 10 percent over the quarter. This acceleration represented an important recovery in these holdings, which had declined in each of the five months, July through November 1971. The last time bank holdings of Government securities had sustained such a lengthy decline was in late 1969, when heavy loan demand in a period of tight credit conditions precipitated the runoff in bank investments. The decline in 1971, however, appears to have been related to the peculiarities of the international situation. Foreign central banks were absorbing dollars and buying Treasury bills as well as special nonmarketable Treasury issues with the proceeds, driving bill rates to unusually low levels. Although foreign central banks continued to purchase Treasury securities in the first quarter, bill rates moved up beginning in mid-February (see Chart IV) under the pressure of an increased supply of Treasury bills and firmer conditions in the money market.

Other short-term interest rates also generally declined until mid-February. After that, most rates turned around and by the end of March were about back to where they had been when the quarter began. Nevertheless, short-term interest rates at the end of March were about 1½ percentage points below those prevailing before August 15.

Intermediate- and long-term rates, on the other hand, dipped early in January, then climbed through the rest of the quarter. Interest rates on intermediate-term Treasury notes rose about 70 basis points over the quarter. Long-term Government bond yields advanced much less—by an average of about 10 basis points. Even so, rates on three- to five-year notes remained more than 80 basis points below their pre-August 15 level, while long-term rates were only about 20 basis points lower than they were before price and wage controls were introduced. Of course, long-term rates are typically less volatile than are shorter term rates, as expectations are revised for the near future more easily than for the distant future. The sharper advance in

Chart IV

SELECTED INTEREST RATES




Sources: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

intermediate maturity rates was spurred by aggressive liquidation of dealers' positions in March, in part because of concern about the projections of a large Federal budgetary deficit and expectations that much of the financing of that deficit would probably involve new note issues in the intermediate maturity range.[1]

## THRIFT INSTITUTIONS

Deposits flowed into thrift institutions during the first quarter at close to a 21 percent seasonally adjusted annual rate. Although this fell short of the record 22½ percent pace of the corresponding quarter last year, it was still extraordinarily rapid by historical standards. At savings and loan associations, the expansion was greatest in January when, spurred by reductions in interest rates on competing instruments, these deposits grew by a seasonally adjusted $4.1 billion, a record for the month. Deposit inflows remained high in February and March, however, even though market interest rates edged back up. Although there were scattered reductions in interest rates offered on certain classes of time deposits, the preponderance of passbook rates remained at the 5 percent ceiling level. Mutual savings bank deposit advances were spread more evenly through the quarter, with the most rapid advance coming in March.

Mortgage holdings did not keep pace with the deposit inflows in early 1972. The growth in mortgage loans at mutual savings banks actually decelerated slightly in the first quarter of 1972 in spite of an increase in the rate of deposit inflows. Mortgage growth has lagged deposit advances for some time at these institutions, so that this behavior is not at all unusual. At savings and loan associations, mortgages advanced at about the same 15 percent annual pace as in late 1971 notwithstanding much greater inflows of funds and decreases in the effective rates on conventional and Federal Housing Administration-insured mortgages. The savings and loan associations took advantage of these deposit inflows to pay off some of their indebtedness to the Federal Home Loan Banks. Nevertheless, mortgage loan commitments of all savings and loan associations rose strongly over the quarter to a record $10 billion, suggesting that there will be considerable advances in mortgage lending by these institutions in the future.

[1] The Treasury's announcement on April 26 of its plans for the May refunding caused some revision in these expectations and sparked a rally in the market for Government securities. For details see this *Review*, page 124.

# The Money and Bond Markets in April

Interest rate movements in the money and bond markets were mixed during April, as yields on most United States Government securities, municipal bonds, and Eurodollars declined on balance while those on corporate bonds and most money market instruments rose. The increases in money market rates were not so sharp as in March, however, and were partially reversed late in April. Investors displayed little interest in the bond market during the first half of the month, and prices declined fairly sharply as dealers sought to lighten their positions. Sizable amounts of dealer inventories of corporate and municipal issues were released from syndicate price restrictions to clear the shelves for the new issues which were scheduled for sale. Despite the fact that yields on many bonds climbed to their highest levels since last fall, investors remained quite selective during this time. After midmonth, however, a better tone developed in all sectors of the bond market and a number of new issues were quickly sold.

The Government securities market responded exuberantly to the April 26 announcement of the Treasury's plans for its May refunding. Not only did the Treasury decide against raising any new money in conjunction with the refunding of its notes maturing on May 15, but it actually planned to redeem in cash a substantial portion of those securities. Even more significantly, the Treasury indicated that its revenue outlook was so strong that it expected to raise less cash in the money and capital markets in the second half of the calendar year 1972 than in the similar period of last year. The strong rally that was touched off by this announcement accounted for the bulk of the price gains on intermediate-term Treasury securities in April.

## THE MONEY MARKET

Short-term interest rates—other than those on United States Government securities—generally rose during April, although some decreases were posted toward the end of the month. Over about the first three weeks in April, rates on all maturities of dealer-placed prime commercial paper were raised by ¼ percentage point while the rate on ninety-day bankers' acceptances was increased ⅜ percentage point. These rates were subsequently lowered by ⅛ and ¼ percentage point, respectively, resulting in over-the-month increases of ⅛ percentage point in each case. The net increases on directly placed paper ranged between ⅛ and ½ percentage point. Several commercial banks raised their rates on negotiable certificates of deposit by ⅛ to ⅜ percentage point, and the outstanding volume of these certificates climbed to a new high at the New York City weekly reporting banks. In addition, several major banks raised their prime rate to 5¼ percent from the 5 percent rate which most banks adopted early in April. In the wake of declines in other market rates late in the month, most of these banks reduced their rates to 5 percent or 5⅛ percent early in May.

Federal funds rates, after having moved decisively higher during March, fluctuated around the levels established at the end of March (see Chart I). Consequently, the effective rate on Federal funds averaged 4.18 percent in April, 35 basis points above the average for March. With Federal funds rates still generally below the 4½ percent discount rate, member bank borrowings from the Federal Reserve Banks were negligible on most days. Such borrowings were relatively heavy at the beginning of the month, however, as major banks managed their reserve positions conservatively. In consequence, banks ended the April 5 statement week with unusually large holdings of excess reserves. The large banks grew less cautious in managing their reserve positions thereafter and in some cases found themselves short of reserves on settlement dates. For example, on April 19 the supply of Federal funds dried up late in the afternoon after trading predominantly at 3½ percent during most of the day. As a result, member banks turned to the Federal Reserve for $245 million of borrowings that night, after having borrowed less than $12 million on average earlier in the week. In spite of this experience, banks were again slow in covering their reserve requirements in the following statement week. In the scramble to meet these requirements on the settlement day, April 26, Federal funds were bid up as high as 7 percent—the effective rate was set at 5 percent—and member bank borrowings from the Federal Reserve surged to nearly $1.8 billion. For the four weeks that ended April 26, member bank borrowings from the Federal Reserve Banks averaged $120 million (see Table I), compared with an average of $90 million during the five statement weeks ended in March.

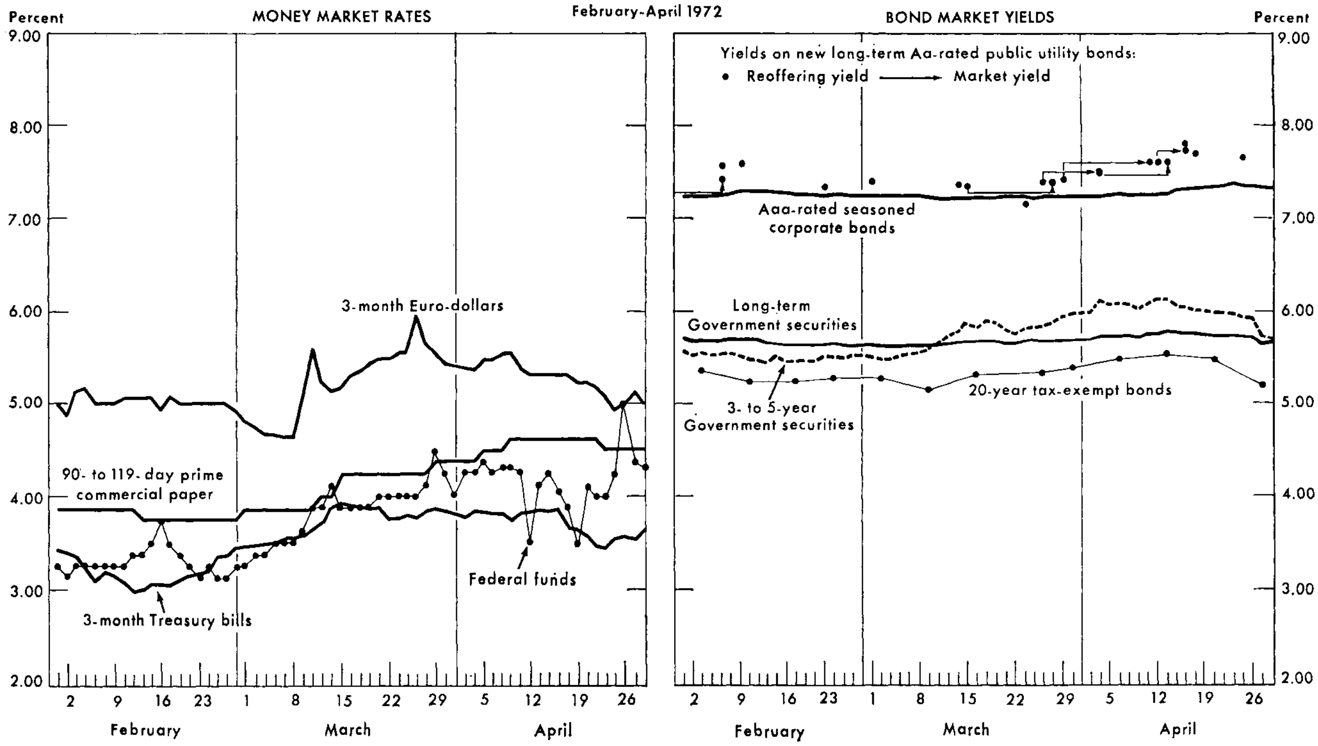
In seeking to counter the undue tautness emerging in the Federal funds market toward the end of the April 26 statement week, the Federal Reserve Bank of New York injected reserves through repurchase agreements with non-bank dealers in Government securities and bankers' acceptances. Under a newly authorized procedure, the rates on the contracts were determined competitively. That is, this Bank indicated to the nonbank dealers the maturity of the agreements sought and asked how much they wished to do at what rates. Offerings were accepted on a competitive basis up to the amount of reserves to be injected. The new procedure is analogous to that used in absorbing reserves through matched sale-purchase transactions. In the past, when this Bank had elected to supply reserves through repurchase agreements, it would specify the rate at which it would enter into contracts.

Based on preliminary estimates, there was a decided deceleration in the growth of all the monetary aggregates during April, but the pace continued strong. The narrow money supply ($M_1$)—adjusted demand deposits and currency held by the public—grew at a seasonally adjusted annual rate of about 7¼ percent in April, compared with an 11.9 percent rate of increase in March (see Chart II). Over the three months ended in April, the annual growth

Chart I

**SELECTED INTEREST RATES**

February-April 1972




Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the four dealers that report their rates, or the midpoint of the range quoted if no consensus is available; 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.

rate was about 10¾ percent, reflecting the more rapid growth in February and March. Since the monetary aggregates tend to fluctuate widely during short-run periods, their growth rate over longer intervals is often more relevant. In this connection the growth of $M_1$ over the twelve-month period ended in April was about 6¼ percent.

The growth of the broader money supply ($M_2$) also slowed during April to a seasonally adjusted annual rate of about 7¼ percent from 11.6 percent in March. The deceleration in this aggregate resulted from the fact that both of its components—consumer-type time and savings deposits at commercial banks as well as $M_1$—grew less rapidly than in the preceding month. In the three months ended in April, $M_2$ grew at an annual rate of about 11¼ percent, while since April a year ago the gain amounted to approximately 9½ percent.

Largely because of a substantial slowdown in the increase in United States Government deposits at member banks, coupled with an actual decline in their nondeposit liabilities, the adjusted bank credit proxy rose at about a 13½ percent seasonally adjusted annual rate in April, down from the very rapid 17.7 percent rate in March. The absolute gain in the time deposit component of the adjusted credit proxy was larger than in March, but the increase in demand deposits was slightly less. Because of its relatively slow growth rate in February which offset the fast pace in March, the growth in the proxy for the three months ended in April is estimated at a 12½ percent seasonally adjusted annual rate. For the twelve-month period that ended in April, the proxy rose only slightly more rapidly than did $M_2$, by about 10 percent.

Table I

**FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, APRIL 1972**

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

| Factors | Changes in daily averages—week ended: April 5 | April 12 | April 19 | April 26 | Net changes |
|---|---|---|---|---|---|
| **"Market" factors** | | | | | |
| Member bank required reserves | — 294 | + 51 | — 454 | — 224 | — 921 |
| Operating transactions (subtotal) | — 650 | — 168 | + 119 | — 721 | — 1,420 |
| Federal Reserve float | + 155 | + 53 | + 423 | — 159 | + 472 |
| Treasury operations* | — 350 | — 4 | — 258 | — 853 | — 1,465 |
| Gold and foreign account | — 28 | — 49 | + 78 | + 25 | + 26 |
| Currency outside banks | — 255 | — 163 | — 322 | + 319 | — 421 |
| Other Federal Reserve liabilities and capital | — 171 | — 6 | + 200 | — 53 | — 30 |
| Total "market" factors | — 944 | — 117 | — 335 | — 945 | — 2,341 |
| **Direct Federal Reserve credit transactions** | | | | | |
| Open market operations (subtotal) | + 1,006 | — 16 | + 76 | + 524 | + 1,590 |
| Outright holdings: | | | | | |
| Treasury securities | + 494 | + 447 | + 255 | + 175 | + 1,371 |
| Bankers' acceptances | + 11 | + 1 | — | + 1 | + 12 |
| Federal agency obligations | — | — | — | + 144 | + 144 |
| Repurchase agreements: | | | | | |
| Treasury securities | + 436 | — 432 | — 132 | + 184 | + 56 |
| Bankers' acceptances | + 42 | — 24 | — 31 | + 17 | + 4 |
| Federal agency obligations | + 23 | — 8 | — 16 | + 3 | + 2 |
| Member bank borrowings | — 12 | — 127 | + 31 | + 234 | + 126 |
| Other Federal Reserve assets† | + 41 | + 52 | + 53 | + 49 | + 195 |
| Total | + 1,035 | — 91 | + 160 | + 807 | + 1,911 |
| **Excess reserves** | + 91 | — 208 | — 175 | + 310 | + 18 |

| | Daily average levels | | | | Monthly averages |
|---|---|---|---|---|---|
| **Member bank:** | | | | | |
| Total reserves, including vault cash | 32,604 | 32,345 | 32,624 | 32,710 | 32,571‡ |
| Required reserves | 32,230 | 32,179 | 32,633 | 32,409 | 32,363‡ |
| Excess reserves | 374 | 166 | — 9 | 301 | 208‡ |
| Borrowings | 141 | 14 | 45 | 279 | 120‡ |
| Free, or net borrowed (—), reserves | 233 | 152 | — 54 | 22 | 88‡ |
| Nonborrowed reserves | 32,463 | 32,331 | 32,579 | 32,431 | 32,451‡ |
| Net carry-over, excess or deficit (—) § | 123 | 216 | 166 | — 22 | 121‡ |

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 April 26.
§ Not reflected in data above.

### THE GOVERNMENT SECURITIES MARKET

A gloomy atmosphere pervaded the market for Government coupon securities during the first half of April. Expectations of higher interest rates were encouraged by the multiplying indications of a quickening in the pace of the economic recovery, with its implications for eventual stronger demands for credit, and by the generally upward trend of the Federal funds rate throughout March. The deterioration in the corporate bond market also tended to depress prices of longer term Government issues, since it increased the inducement for investors to switch out of Government bonds into higher yielding corporate securities. The intensification of hostilities in South Vietnam further contributed to the nervousness in the market. Against this background, investor demand for Government coupon issues was weak and dealers continued to lighten their positions aggressively. Dealer inventories had been reduced sharply during March and, by early April, dealers who report their inventories and trading activity daily to the Federal Reserve Bank of New York had negative net positions in Treasury issues maturing in more than five years.

The persistent downward drift of prices of Government coupon securities halted about midmonth, however, and prices generally rose during the latter half of April. The leveling-off of the Federal funds rate, together with news of the virtual stability of consumer prices in March and the calm in the foreign exchange markets, encouraged more optimistic expectations of the near-term outlook for lower interest rates. The strengthening of corporate bond prices was also reflected in the market for long-term Treasury bonds. Furthermore, the market's strong technical position was seen as enhancing its capacity to absorb without significant pressure whatever issues the Treasury might offer in the May refunding.

After the close of business on April 26, the Treasury announced the terms of the refinancing. To refund in part the $2.45 billion of publicly held notes maturing May 15, it would auction $1.75 billion of securities on May 2. The remaining $700 million of the publicly held notes would be redeemed through use of the Treasury's available cash. The new offerings to the public included $1.25 billion of 4¾ percent one-year notes and an additional amount of up to $500 million of the 6⅜ percent bonds originally marketed in February. The bonds have a current maturity of nine years and nine months. Any qualified depository bank would be permitted to make settlement for the securities allotted to itself and to its customers by credit to its Treasury Tax and Loan Account. Additional amounts of these notes and bonds would be allotted to Government accounts and the Federal Reserve Banks in exchange for their holdings of $2.5 billion of maturing notes.

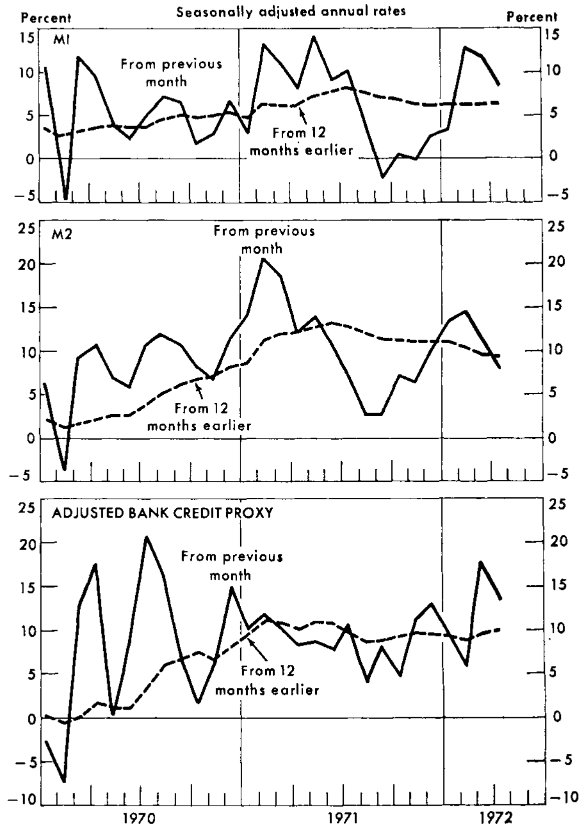
The May financing operation was particularly noteworthy in two respects. First, the $700 million repayment is highly unusual in a cash refinancing. It was made possible by the Treasury's persistently strong revenue position, which has stemmed in large part from the sizable overwithholding of personal income taxes under the revised withholding schedules that went into effect in January 1972. Beyond this, larger than expected tax receipts have also been stimulated by the strengthening economic recovery. Second, the nine-year nine-month issue is the longest maturity that the Treasury has sold at public auction since it resumed auctioning coupon-bearing securities in November 1970.

The Treasury's financing announcement touched off an explosive rally in the Government securities market. Encouragement was derived not only from the relatively small size of the May offering but also from the optimistic forecast of relatively moderate Treasury cash needs for the second half of 1972. Prices of intermediate-term issues rose especially sharply because of the absence of an intermediate maturity among the Treasury's offerings. Over the month as a whole, yields on Treasury securities maturing in three to seven years generally declined 20 to 30 basis points. Yields on shorter term issues dropped even more sharply, by about 25 to 75 basis points. In contrast, yields on long-term Treasury bonds were little changed on balance, ranging from 4 basis points lower to 2 basis points higher. In the auction on May 2, the one-year notes were sold at an average yield of 4.44 percent and the

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates




Note: Data for April 1972 are preliminary estimates.

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 sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

nine-year nine-month bonds at an average yield of 6.29 percent.

Sentiment in the Treasury bill market was affected by many of the same factors placing upward pressure on yields of coupon securities during the first half of April. However, sizable investor demand for bills outweighed selling pressure, and bill rates actually edged lower. To a considerable extent, the early April demand for bills was seasonal, including the investment of tax receipts by public authorities. With investor demand continuing strong and dealer inventories becoming relatively depleted, most market participants expected aggressive bidding in the regular weekly Treasury bill auction on April 10. Indeed, the average issuing rates of 3.731 percent on the three-month issue and 4.223 percent on the six-month issue were 12 and 13 basis points, respectively, below the rates that had been established in the last auction of March. However, the range of prices at which tenders were accepted was somewhat wider than most participants had anticipated, and the tone of the market weakened temporarily. Some concern developed over the sustainability of the level of bill rates, which were low in relation to other short-term rates.

The market's hesitancy was short-lived, however, as persistently strong investor demand pressed against a relatively thin market supply of bills. Demand from other sources was augmented by reinvestment demand from some holders of the maturing April 21 tax anticipation bills. Rates declined sharply after midmonth, and the final weekly auction and the regular monthly auction elicited aggressive interest. In the weekly auction held on April 24, the average issuing rates on the three- and six-month bills were 3.513 percent and 4.004 percent, respectively, the lowest such rates since the first week in March. On April 25 the new nine- and twelve-month issues were auctioned at average issuing rates of 4.234 percent and 4.362 percent, respectively, about 28 and 30 basis points below the rates established in the previous month's auction (see Table II). Over the month of April, rates on most Treasury bills maturing within three months declined by about 20 to 25 basis points and rates on longer maturities were generally about 25 to 40 basis points lower.

**Table II**

**AVERAGE ISSUING RATES***
**AT REGULAR TREASURY BILL AUCTIONS**

In percent

| Maturities | Weekly auction dates—April 1972 | | | |
|---|---|---|---|---|
| | April 3 | April 10 | April 17 | April 24 |
| Three-month | 3.798 | 3.731 | 3.849 | 3.513 |
| Six-month | 4.367 | 4.223 | 4.278 | 4.004 |

| Maturities | Monthly auction dates—February-April 1972 | | |
|---|---|---|---|
| | February 22 | March 24 | April 25 |
| Nine-month | 3.862 | 4.511 | 4.234 |
| One-year | 4.091 | 4.661 | 4.362 |

* 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.

## OTHER SECURITIES MARKETS

There was a considerable amount of investor apathy toward corporate bonds during the first half of April, as the cautious atmosphere which had begun in mid-March continued. During the final week in March, two highly rated utility company bonds had encountered strong investor resistance, and the forward calendar for April—which, though relatively light overall, included the largest volume of utility issues in more than a year—threatened further downward pressure on prices. At the beginning of April, the remaining $120 million balance of four recently offered bonds was released from syndicate and allowed to trade without price restriction. The resultant yield increases ranged between 10 and 28 basis points. At the same time, a new Aa-rated utility issue of $125 million of thirty-year bonds sold slowly even though it bore the highest rate on such an offering since early December. The return of 7.50 percent on these bonds was 10 basis points greater than that on a similar issue a week earlier and 50 basis points above the year's low in January.

Although some buying interest was aroused by the lowered prices on the issues released from syndicate, the purchases were not enough to change the tone of the market and yields continued to rise. On April 10, two issues of Bell System securities totaling $150 million were marketed and, while the seven-year notes sold well, the $100 million of 33-year debentures ran into difficulty despite the fact that their 7.46 percent return was the highest offered on such securities in six months. Two days later, much the same fate befell a $150 million offering of A-rated utility bonds. Disappointed by the lack of investor interest, the underwriters freed the issue from price restrictions on the very next day, and in free market trading the yield climbed to 8.06 percent from the 7.90 percent at which it was originally priced. Over the next few days, several other issues were also released from syndicate with upward yield adjustments in each case.

Market sentiment improved around midmonth, and prices of seasoned corporate bonds began to rise. New issues generally encountered enthusiastic receptions at declining yields. For example, new long-term A-rated utility issues were successfully marketed at yields of 7.85 percent on April 19 and 7.73 percent on April 24. A comparably rated issue encountered some investor resistance, however, when offered on April 26 to yield 7.65 percent.

The market for tax-exempt securities was also in the doldrums during the first half of April, but investors showed some selective interest in new issues throughout the period. Thus, on April 4, two issues totaling $110 million sold very well but a third one from a city that recently had its credit rating downgraded was apparently overpriced and did not move. To elicit investor interest in some of the seasoned bonds, dealers reduced prices on several days and freed some small balances from syndicate price restrictions. Reflecting this situation, *The Weekly Bond Buyer's* index of yields on twenty municipal bonds rose to 5.54 percent on April 13, its highest level since last August.

By far the largest issue marketed in April was the $255 million issue of medium-grade New York City bonds sold on April 11. Despite the size of the offering and its rating, these bonds, which are exempt from the high income taxes in New York City and State as well as from Federal taxes, sold very well. The bonds were priced to yield between 4.00 percent and 6.90 percent, depending upon maturity, and cost the city an average of 6.28 percent. Again in illustration of the selectivity that was shown, on the same day a $90 million Aa-rated Massachusetts issue was offered with yields about 15 to 25 basis points higher than a similar issue two weeks earlier, but the bonds sold slowly and the prices had to be lowered a few days later.

Another large issue, Connecticut's $105 million of Aaa-rated bonds, was marketed on April 18 at yields some 10 to 15 basis points higher than those on Aa-rated bonds the week before and, after the success of these bonds, the municipal market began to firm. On the following day, two smaller new issues were swift sellouts at somewhat higher prices than had originally been planned, and prices on several outstanding issues were raised. As a consequence, the *Bond Buyer's* index declined on April 20, for the first time in six weeks, to 5.50 percent from 5.54 percent the previous Thursday. The better tone continued into the final week when a $147 million issue of New York State bonds was quite successfully marketed and moved to a premium on the second day. The Treasury's financing announcement contributed to the improved climate in the tax-exempt market as the month closed. During the week ended April 27, the *Bond Buyer's* index fell an unusually sharp 30 basis points to 5.20 percent, its lowest level since March 9.

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