

# FEDERAL RESERVE BANK OF NEW YORK



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## **Some Essentials of International Monetary Reform**

By ARTHUR F. BURNS

*Chairman, Board of Governors of the Federal Reserve System*

*Editor's Note: These remarks were delivered before the 1972 International Banking Conference, Montreal, Canada, on May 12, 1972.*

On August 15 of last year, in the face of an unsatisfactory economic situation, the President of the United States acted decisively to alter the nation's economic course. The new policies, especially the decision to suspend convertibility of the dollar into gold or other reserve assets, were bound to have far-reaching consequences for international monetary arrangements. New choices were forced on all countries.

The next four months gave all of us a glimpse of one possible evolution of the international economy. Since exchange rates were no longer tied to the old par values, they were able to float—a prescription that many economists had favored. However, last fall's floating rates did not conform to the model usually sketched in academic writings. Most countries were reluctant to allow their exchange rates to move in response to market forces. Instead, restrictions on financial transactions proliferated, special measures with regard to trade emerged here and there, new twists crept into the pattern of exchange rates, serious business uncertainty about governmental policies developed, fears of a recession in world economic activity grew, and signs of political friction among friendly nations multiplied.

Fortunately, this dangerous trend toward competitive and even antagonistic national economic policies was halted by the Smithsonian Agreement. Despite recent developments in Vietnam, which may cause some uneasiness in financial markets for a time, the Smithsonian realign-

ment of currencies is, in my judgment, solidly based. It was worked out with care by practical and well-informed men, and I am confident that the central banks and governments of all the major countries will continue to give it strong support.

Developments in the American economy since last December have been encouraging. Aggregate activity in the United States has begun to show signs of vigorous resurgence. Price increases have moderated, and our rate of inflation has recently been below that of most other industrial countries. Moreover, the budget deficit of the Federal Government will be much smaller this fiscal year than seemed likely three or four months ago. These developments have strengthened the confidence with which businessmen and consumers assess the economic outlook. International confidence in turn is being bolstered by the passage of the Par Value Modification Act, by the convergence of short-term interest rates in the United States and abroad, and by some promising signs of improvement in the international financial accounts of the United States.

With the Smithsonian Agreement and other indications of progress behind us, it is necessary now to move ahead and plan for the longer future. The Smithsonian meeting was preeminently concerned with realigning exchange rates. It did not attempt to deal with structural weaknesses in the old international monetary system. Yet they must eventually be remedied if we are to build a new and stronger international economic order.

We all have to ponder this basic question: Given the constraints of past history, what evolution of the monetary system is desirable and at the same time practically attainable? For my part, I should like to take advantage of this gathering to consider some of the elements that one might reasonably expect to find in a reformed monetary system.

First of all, a reformed system will need to be characterized by a further strengthening of international consultation and cooperation among governments. Our national economies are linked by a complex web of international transactions. Problems and policies in one country inevitably affect other countries. This simple fact of interdependence gives rise to constraints on national policies. In a smoothly functioning system, no country can ignore the implications of its own actions for other countries or fail to cooperate in discussing and resolving problems of mutual concern. The task of statesmanship is to tap the great reservoir of international goodwill that now exists and to make sure that it remains undiminished in the future.

Sound domestic policies are a second requirement of a better world economic order. A well-constructed international monetary system should, it is true, be capable of absorbing the strains caused by occasional financial mismanagement in this or that country—such as are likely to follow from chronic budget deficits or from abnormally large and persistent additions to the money supply. But I doubt if any international monetary system can long survive if the major industrial countries fail to follow sound financial practices. In view of the huge size of the American economy, I recognize that the economic policies of the United States will remain an especially important influence on the operation of any international monetary system.

Third, in the calculable future any international monetary system will have to respect the need for substantial autonomy of domestic economic policies. A reformed monetary system cannot be one that encourages national authorities to sacrifice either the objective of high employment or the objective of price stability in order to achieve balance-of-payments equilibrium. More specifically, no country experiencing an external deficit should have to accept sizable increases in unemployment in order to reduce its deficit. Nor should a surplus country have to moderate its surplus by accepting high rates of inflation. Domestic policies of this type are poorly suited to the political mood of our times, and it would serve no good purpose to assume otherwise.

I come now to a fourth element that should characterize a reformed monetary system. If I am right in thinking that the world needs realistic and reasonably stable exchange rates, rather than rigid exchange rates, ways must

be found to ensure that payments imbalances will be adjusted more smoothly and promptly than under the old Bretton Woods arrangements.

The issues here are many and complex. There was a consensus at the Smithsonian meeting that wider margins around parities can help to correct payments imbalances, and should prove especially helpful in moderating short-term capital movements—thereby giving monetary authorities somewhat more scope to pursue different interest rate policies. Our experience has not yet been extensive enough to permit a confident appraisal of this innovation. It is clear, however, that no matter how much the present wider margins may contribute to facilitating the adjustment of exchange rates to changing conditions, the wider margins by themselves will prove inadequate for that purpose.

We may all hope that at least the major countries will pursue sound, noninflationary policies in the future. We should nevertheless recognize that national lapses from economic virtue will continue to occur. In such circumstances, changes in parities—however regrettable—may well become a practical necessity. Moreover, even if every nation succeeded in achieving noninflationary growth, structural changes in consumption or production will often lead to shifts in national competitive positions over time. Such shifts will also modify the pattern of exchange rates that is appropriate for maintaining balance-of-payments equilibrium.

In my judgment, therefore, more prompt adjustments of parities will be needed in a reformed monetary system. Rules of international conduct will have to be devised which, while recognizing rights of sovereignty, establish definite guidelines and consultative machinery for determining when parities need to be changed. This subject is likely to become one of the central issues, and also one of the most difficult, in the forthcoming negotiations.

Let me turn to a fifth element that should characterize a reformed monetary system. A major weakness of the old system was its failure to treat in a symmetrical manner the responsibilities of surplus and deficit countries for balance-of-payments adjustment. With deficits equated to sin and surpluses to virtue, moral as well as financial pressures were very much greater on deficit countries to reduce their deficits than on surplus countries to reduce surpluses. In actual practice, however, responsibility for payments imbalances can seldom be assigned unambiguously to individual countries. And, in any event, the adjustment process will work more efficiently if surplus countries participate actively in it. In my view, all countries have an obligation to eliminate payments imbalances, and the rules of international conduct to which I referred

earlier will therefore need to define acceptable behavior and provide for international monitoring of both surplus and deficit countries.

Sixth, granted improvements in the promptness with which payments imbalances are adjusted, reserve assets and official borrowing will still be needed to finance in an orderly manner the imbalances that continue to arise. Looking to the long future, it will therefore be important to develop plans so that world reserves and official credit arrangements exist in an appropriate form and can be adjusted to appropriate levels.

This brings me to the seventh feature of a reformed international monetary system. It is sometimes argued that, as a part of reform, gold should be demonetized. As a practical matter, it seems doubtful to me that there is any broad support for eliminating the monetary role of gold in the near future. To many people, gold remains a great symbol of safety and security, and these attitudes about gold are not likely to change quickly. Nevertheless, I would expect the monetary role of gold to continue to diminish in the years ahead, while the role of special drawing rights (SDRs) increases.

The considerations which motivated the International Monetary Fund to establish the SDR facility in 1969 should remain valid in a reformed system. However, revisions in the detailed arrangements governing the creation, allocation, and use of SDRs will probably be needed. In the future, as the SDRs assume increasing importance, they may ultimately become the major international reserve asset.

Next, as my eighth point, let me comment briefly on the future role of the dollar as a reserve currency. It has often been said that the United States had a privileged position in the old monetary system because it could settle payments deficits by adding to its liabilities instead of drawing down its reserve assets. Many also argue that this asymmetry should be excluded in a reformed system. There thus seems to be significant sentiment in favor of diminishing, or even phasing out, the role of the dollar as a reserve currency. One conceivable way of accomplishing this objective would be to place restraints on the further accumulation of dollars in official reserves. If no further accumulation at all were allowed, the United States would be required to finance any deficit in its balance of payments entirely with reserve assets.

I am not persuaded by this line of reasoning, for I see advantages both to the United States and to other countries from the use of the dollar as a reserve currency. But I recognize that there are some burdens or disadvantages as well. And, in any event, this is an important issue on which national views may well diverge in the

early stages of the forthcoming negotiations.

I come now to a ninth point concerning a new monetary system, namely, the issue of "convertibility" of the dollar. It seems unlikely to me that the nations of the world, taken as a whole and over the long run, will accept a system in which convertibility of the dollar into international reserve assets—SDRs and gold—is entirely absent. If we want to build a strengthened monetary system along one-world lines, as I certainly do, this issue will have to be resolved. I therefore anticipate, as part of a total package of long-term reforms, that some form of dollar convertibility can be reestablished in the future.

I must note, however, that this issue of convertibility has received excessive emphasis in recent discussions. Convertibility is important, but no more so than the other issues on which I have touched. It is misleading, and may even prove mischievous, to stress one particular aspect of reform to the exclusion of others. Constructive negotiations will be possible only if there is a general disposition to treat the whole range of issues in balanced fashion.

We need to guard against compartmentalizing concern with any one of the issues, if only because the various elements of a new monetary system are bound to be inter-related. There is a particularly important interdependence, for example, between improvements in the exchange-rate regime and restoration of some form of convertibility of the dollar into gold or other reserve assets. Without some assurance that exchange rates of both deficit and surplus countries will be altered over time so as to prevent international transactions from moving into serious imbalance, I would deem it impractical to attempt to restore convertibility of the dollar.

My tenth and last point involves the linkage between monetary and trading arrangements. We cannot afford to overlook the fact that trade practices are a major factor in determining the balance-of-payments position of individual nations. There is now a strong feeling in the United States that restrictive commercial policies of some countries have affected adversely the markets of American business firms. In my judgment, therefore, the chances of success of the forthcoming monetary conversations will be greatly enhanced if parallel conversations get under way on trade problems, and if those conversations take realistic account of the current and prospective foreign trade position of the United States.

In the course of my remarks this morning I have touched on some of the more essential conditions and problems of international monetary reform. Let me conclude by restating the elements I would expect to find in a new monetary system that met the test of both practicality and viability:

First, a significant further strengthening of the processes of international consultation and cooperation;

Second, responsible domestic policies in all the major industrial countries;

Third, a substantial degree of autonomy for domestic policies, so that no country would feel compelled to sacrifice high employment or price stability in order to achieve balance-of-payments equilibrium;

Fourth, more prompt adjustments of payments imbalances, to be facilitated by definite guidelines and consultative machinery for determining when parities need to be changed;

Fifth, a symmetrical division of responsibilities among surplus and deficit countries for initiating and implementing adjustments of payments imbalances;

Sixth, systematic long-range plans for the evolution of world reserves and official credit arrangements;

Seventh, a continued but diminishing role for gold as a reserve asset, with a corresponding increase in the importance of SDRs;

Eighth, a better international consensus than exists at present about the proper role of reserve currencies in the new system;

Ninth, reestablishment of some form of dollar convertibility in the future;

And finally, tenth, a significant lessening of restrictive trading practices as the result of negotiations complementing the negotiations on monetary reform.

I firmly believe that a new and stronger international monetary system can and must be built. Indeed, I feel it is an urgent necessity to start the rebuilding process quite promptly. It is not pleasant to contemplate the kind of world that may evolve if cooperative efforts to rebuild the monetary system are long postponed. We might then find the world economy divided into restrictive and inward-looking blocs, with rules of international conduct concerning exchange rates and monetary reserves altogether absent.

As we learned last fall, a world of financial manipulations, economic restrictions, and political frictions bears no promise for the future. It is the responsibility of financial leaders to make sure that such a world will never come to pass.

## The Changing Banking Scene

By WILLIAM F. TREIBER

*First Vice President, Federal Reserve Bank of New York*

*Editor's Note: These remarks were delivered before the sixty-ninth annual convention of the New Jersey Bankers Association, Atlantic City, New Jersey, on May 18, 1972.*

It is always a pleasure for us in the Federal Reserve System to meet with you, the members of the New Jersey Bankers Association, and to share our thoughts on matters of mutual concern.

When I spoke with you here ten years ago, I pointed out that the systems that men create, whether they be economic, social, or political, are designed to meet the needs and aspirations of men. And those needs and aspirations are ever changing.

It is not enough that an institution or system serve those who have a proprietary interest in it. Over the long run a particular institution or system must serve society and meet its changing needs; if the institution or system does not do so, it will perish. History is full of evidence of economic systems, of governmental systems, of social systems that failed in this respect and therefore vanished from the earth. There is nothing sacred about the economic system or the banking system that we know today. Unless they serve society and keep up with its needs they, too, will pass away. Thus, as commercial bankers and as central bankers, we are under continuing pressure to improve the ways in which our organizations serve the people.

In my discussion with you today I propose to comment on two subjects: first, the structure of the banking system, with special reference to New Jersey, and, second, recent Federal Reserve proposals to improve the nation's payments mechanism by speeding up the collection of checks.

### BANKING STRUCTURE

Society wants a banking system that provides banking services of wide scope and high quality at reasonable cost,

available to all persons who have need for these services. History has demonstrated that competition fosters efficiency by assuring the broad availability of such services at low cost. History, on the other hand, has also taught that unrestrained competition can destroy. Thus, society seeks to promote efficiency and healthy competition.

Much has happened since I commented here a decade ago upon the report of a Branch Banking Study Committee appointed by the Commissioner of Banking and Insurance, and chaired by Professor Chandler of Princeton. The reaction of bankers to the Committee's modest suggestions was cautious—like walking on eggs. But a lot of eggs have been broken since then. Over the last ten years the New Jersey Banking Law has been changed bit by bit.

The most comprehensive changes were made in 1969. The amending statute made three principal changes in the New Jersey Banking Law.

- (1) It created three banking districts, and within any district permitted branching and merging by commercial banks and by savings banks,
- (2) It eliminated branch-office protection for commercial banks and savings banks in communities having a population of 7,500 or more, and
- (3) It authorized the creation of bank holding companies which could operate throughout the state.

Many of the banks in New Jersey responded enthusiastically to the new legislation.

Multibank holding companies were formed to do business throughout the state. Six companies with subsidiaries



in more than one district are now in operation. These companies control over three dozen banks<sup>1</sup> with about one third of the commercial bank deposits in the state. In addition, there are at least four or five other banks or one-bank holding companies that appear likely to embark on statewide expansion programs. In the next several years there may be as many as ten or twelve major statewide banking organizations, each having representation in most of the important markets in the state.

At the same time that bank holding companies were establishing their networks across district lines, branching activity within banking districts proceeded at a lively pace. Over two hundred fifty new commercial bank branches and savings bank branches<sup>2</sup> were established between the middle of 1969<sup>3</sup> and the end of 1971.<sup>4</sup> Two thirds of the new branches were established in communities that could not have had such branches under the old law.

In addition to the *de novo* branches, more than forty mergers<sup>5</sup> were consummated during the same period. Much of the branching and merger activity within districts involved subsidiaries of the holding companies that were expanding statewide.

At the Federal Reserve Bank of New York we followed closely the effects of the broadened expansion powers on the competitive banking environment in New Jersey. Last summer we interviewed officers of eighteen commercial banks in northern New Jersey to obtain a better understanding of the ways in which banks initially responded to the 1969 amendments dealing with branch offices.

Many of the bankers with whom we talked criticized the supervisory authorities for permitting too many banking offices, but none of them indicated that their profits had suffered appreciably. We think that in general the expansion of banking offices between mid-1969 and the end of 1971 was orderly. Most of the new offices were established in fast-growing communities capable of supporting additional facilities.

**NEW COMPETITION.** Bankers establishing branches in previously protected communities made strong efforts to obtain accounts. They spoke personally with potential customers and sought aggressively to obtain the accounts of newcomers to the community. They were eager to serve their new customers well and to provide services that previously had been unavailable in the community. Many provided expanded evening banking hours. Most changes, of course, were subtle and difficult to evaluate.

We found that bankers in communities that lost protection soon became keenly aware of the presence of the new banking offices. They took affirmative steps to improve their services and to establish a closer identity with their communities. They made a conscious effort to develop a more personal rapport with their customers and to speed up the execution of services. They sought to modernize and expand their banking offices, as, for example, by installing drive-in windows and providing parking space for customers. A few banks raised the rates of interest paid on savings deposits to be more competitive with new banking offices in the area.

It is not clear, of course, that every new service will be continued indefinitely. Nevertheless, we concluded from our discussion with the bankers that many of these new developments probably would not have occurred if there had not been a change in the banking law. The public has benefited from the new banking competition introduced into many communities for the first time. Both consumers and business concerns in those communities now have a wider choice of banking options and a broader range of banking services than were ever available to them in the past. Vigorous competition is the best safeguard the public has that it will receive high-quality service at the lowest cost.

As you know, the Banking Committee of the New Jersey General Assembly recently reported out a bill<sup>6</sup> that would permit statewide branching, eliminate branch-office protection, and reduce home-office protection. The key feature of this bill is the removal of banking-office protection from cities and important suburban growth areas. For a long time, banks in these communities have been insulated from competitive forces. Lifting protection can be expected to promote significant new branching activity along the lines observed following the 1969 amendments.

In considering this proposal and, indeed, any other

<sup>1</sup> Thirty-nine banks.

<sup>2</sup> Two hundred thirty-two new commercial bank branches and twenty savings bank branches.

<sup>3</sup> The change in the law regarding branches became effective July 17, 1969.

<sup>4</sup> During the period the number of banking offices in the state increased by 25 percent.

<sup>5</sup> Forty mergers of commercial banks and one savings bank merger.

<sup>6</sup> Assembly, No. 706 Committee Substitute. On May 18, 1972 the bill was passed by the General Assembly and transmitted to the Senate.

proposals to amend the banking laws, it is well to bear in mind that the public is best served by well-managed banking organizations offering diverse services, provided there are sufficient alternatives in each banking market to assure a healthy competitive environment. In my view, statewide branching and further curtailment of home- and branch-office protection would promote this goal. I do not suggest that large banking organizations should, or will, come to dominate the state and swamp local institutions. Indeed, recent experience in New Jersey and in other states has shown that competently managed and conveniently located small, independent banks can thrive alongside branch banks.

**BANKING EXPANSION IN THE NATION.** The 1969 amendments to the New Jersey Banking Law and the proposed legislation now being considered by the Legislature are not isolated developments, nor are they events unique to New Jersey. Indeed, these changes may be viewed as part of a movement in many parts of the nation to permit the expansion by banks into wider geographic areas.

In recent years, a number of states have liberalized their traditional branching restrictions; New York is an example.

At the same time there has been a rapid expansion of multibank holding companies in many states across the nation. Much of the expansion has been spurred by the 1970 amendments to the Federal Bank Holding Company Act of 1956. The amendments called for equal regulatory treatment for all bank holding companies, whether one-bank or multibank. As a result, many one-bank holding companies which might have been reluctant to become multibank holding companies prior to the 1970 amendments have recently established new banks or acquired existing banks.

The amended Bank Holding Company Act permits bank holding companies to expand the nature of their operations as well as their geographic coverage; bank holding companies are permitted to enter into bank-related activities anywhere. Bank holding companies have acquired mortgage companies and other financial concerns in distant places. Thus, interstate expansion by bank holding companies has already gathered considerable momentum. As these organizations continue to establish or acquire non-banking subsidiaries across state lines and serve customers in distant localities, as I expect they will, state lines will have less significance in the banking industry.

I do not intend to suggest, however, that the bank expansion movement has been greeted with enthusiasm in all parts of the country. To the contrary: several states have imposed new restrictions on the entry into those states by bank holding companies organized elsewhere.

On balance, however, I believe that most changes at the state level have been in the direction of more liberalized rather than more restricted expansion powers. There is little doubt that the nation's banking institutions have been eager to expand their frontiers, not only geographically but also functionally.

The expansion of banking institutions into new geographic areas and into new bank-related activities has, of course, increased the burden on the bank supervisory authorities, both state and Federal. As individual banking organizations continue to test and probe their new freedoms, they will be entering markets heretofore protected from entry. While such expansion will indeed create new possibilities for a more vigorous competitive environment, the need to protect the public interest will become increasingly crucial. Perhaps more than ever before, it will be incumbent upon the supervisory agencies to prevent the elimination of significant and viable competitive alternatives, to ensure that the largest banking organizations do not attain a position of dominance in local markets, and to preserve opportunities for new entry.

The Federal Reserve System has been and will continue to be responsive to, and mindful of, these considerations. What then can I offer in the way of advice to New Jersey bankers who are contemplating taking advantage of the new branching, merging, and holding company powers? I would make two suggestions. First, I think you would benefit by reviewing the antitrust decisions of the courts, the opinions of the Justice Department, and recent rulings of the Federal Reserve Board regarding bank mergers and the acquisition by holding companies of bank and nonbank subsidiaries. Second, I recommend that you come into the Reserve Bank and discuss your expansion plans with the Reserve Bank officers.

#### **IMPROVEMENTS IN PAYMENTS MECHANISM**

On March 28, 1972, the Federal Reserve Board published for comment proposed changes in its Regulations D and J to make reserve requirements of member banks and Federal Reserve check-collection procedures more equitable and more efficient. I want to talk about the proposed changes in Regulation J, especially the requirement that a commercial bank pay in immediately available funds on the day of presentment for the cash letters it receives from a Reserve Bank. But first, a bit of background.

In the first decade of this century, before the enactment of the Federal Reserve Act, checks were collected in far too many instances by elaborately circuitous routing in attempts to avoid or reduce so-called exchange charges.



There were inordinate delays before the payee of a check received good payment; and long delays in the return of unpaid items made the circuitous routing even worse. In establishing the Federal Reserve System, the Congress expected that it would serve to improve the check-collection system; such improvement would be facilitated because many banks would have balances at the Reserve Banks to which payments could be readily debited and credited. The newly created Federal Reserve Banks soon established an Interdistrict Settlement Fund so that they could make payments on behalf of member banks through other Federal Reserve Banks to the banks in their Districts.

With advancing technology in air transportation and electronic communications, the Federal Reserve Banks have been able to reduce markedly the time required for the collection of checks and to expand their capabilities for wire transfer of bank balances and Government securities.

Last year the Federal Reserve Banks collected more than eight billion checks worth almost \$4 trillion, and transferred by wire more than \$13 trillion. In short, a great deal has been done, but it is also clear that much remains to be done.

In 1969, the Federal Reserve System established a Steering Committee on Improving the Payments Mechanism; its membership is drawn from members of the Board and representatives of the Reserve Banks. I am a member of that committee, whose studies, plans, and policy decisions have been supported by a broad range of communications specialists, economists, lawyers, and check-collection officers. The committee has sought, in cooperation with the commercial banks, to improve the payments mechanism in various ways, e.g., by expanding same-day payment arrangements in large metropolitan areas, by liberalizing access to the Federal Reserve wire network for the transfer of funds, and by improving transportation facilities for the movement of checks. At the same time the commercial banks have been involved in a number of projects having similar goals.

**DIRECTION OF IMPROVEMENTS.** Indications of the direction in which the payments services of banks should move have come from the MAPS study<sup>7</sup> of the American Bankers Association; the six-volume report of the so-called Atlanta

study<sup>8</sup> (another cooperative endeavor of commercial banks and the Federal Reserve); the research of the SCOPE committees<sup>9</sup> around the country; the experiments with point-of-sale terminals linked to bank computers now going on in Columbus, Ohio, and Hempstead, New York; the development of the CHIPS and PEPS arrangements<sup>10</sup> in New York City; and the establishment of regional check processing centers. This list is by no means a complete catalog of recent studies and accomplishments.

What the list does make clear, however, is the direction in which the banking system is moving, and that it is now moving at an accelerating pace. All bankers will have to give increasing attention to how their banks can best accommodate themselves to the changing procedures and technology in order to meet the needs and desires of their customers in a competitive market. The direction we're going, it seems to me, is toward greater use of electronic means of payment, including, among other methods, the Federal Reserve wire network, the Bank Wire, card-activated terminals, exchange of magnetic tape (with or without checks), and magnetic tape input for the deposit of large payrolls.

Despite the numerous studies and experiments now under way with electronic means of payment, however, we are not on the threshold of a checkless era. The Atlanta study, the most exhaustive yet made, suggests that, even if payroll deposits, payments of recurring bills, and point-of-sale terminals are successfully introduced in the next few years, all that will have been done by 1980 is to hold the volume of checks at about its present level. So, we're going to have to handle a large number of checks for quite a while.

**PROPOSED REVISION OF REGULATION J.** Now, let's return to the proposed revision of Regulation J to require payment in immediately available funds on the day of presentment. This proposal is another step in the continuing process of improving the country's payments mechanism. An estimated 85 percent of the dollar value of all checks is in fact now paid on the day of presentment.

<sup>8</sup> *Research on Improvements of the Payments Mechanism: Phase III General Systems Design and Analysis of an Electronic Funds Transfer System*, Prepared for the Federal Reserve Bank of Atlanta by Atlanta Payments Project (Atlanta, Georgia: Georgia Institute of Technology, March 1972).

<sup>9</sup> Special Committee on Paperless Entries.

<sup>10</sup> Clearing House Interbank Payments System and Payment Exchange Paper System.

<sup>7</sup> Executive Report of the Monetary and Payments System Planning Committee published by the American Bankers Association, April 1971.

The remaining 15 percent represents largely items drawn on "country" banks not participating in any clearing house or similar arrangement for exchange of items.

It is estimated that the proposal, when effective, would reduce Federal Reserve float by about \$2 billion, thus cutting banks' reserves by the same amount. It is for this reason that the proposed change in Regulation J is coupled with a proposal to revise Regulation D, governing member bank reserve requirements, which would lower the presently required reserves by almost \$3 billion.

However, the effects of these two changes would not be the same for all banks, since banks differ widely both in net demand deposits subject to reserve requirements and in size of cash letters received each day. In order for you—and for us at the Fed—to reach a better estimate of just how the proposed change in Regulation J would affect individual banks, we have asked you to complete a one-page form. An analysis of the responses, which I am gratified to report have already been filed by more than half of the banks, shows wide variations from net gains in lendable or investable funds to several fairly significant reductions. The information provided in your responses will, of course, be studied carefully by the Federal Reserve as it gives further consideration to the proposed amendments of the Regulations.

**RCPCs.** Another important step in improving the payments mechanism is the establishment of what are called Regional Check Processing Centers, or RCPCs. Here in New Jersey, as many of you know, the Federal Reserve Bank of Philadelphia is planning to establish such a center at its premises in Philadelphia to speed up the collection of checks which are drawn on a bank in the Third Federal Reserve District and which are deposited in another bank in the same area. The Philadelphia Reserve Bank will receive such checks from the depositing bank late in the day, sort the checks during the night, and deliver them in the

morning to the drawee bank for provisional payment that day in immediately available funds.

The Federal Reserve Bank of New York has been having discussions with the banks in that part of New Jersey which is included in the Second Federal Reserve District about the expansion of the Bergen County Clearing Bureau that now serves banks in six counties. The Bureau, which has been in existence for the last thirteen years, is to be converted into a Federal Reserve facility to speed up the collection of checks in northern New Jersey, as the Philadelphia Reserve Bank will do in the southern counties.

Once again, as you know, we have sought your help, which has been given freely, in analyzing the contents of your cash letters. From an analysis of the flows of checks we are now trying to establish the best location for the Northern New Jersey Regional Check Processing Center, a site that will serve you and us most efficiently in terms of transportation times and costs, and the latest possible hour for depositing work. Incidentally, you may be interested to know that our preliminary estimate is that the Center will process a million or more checks a night when it is fully operational, we hope, in a year or so. That volume would be exceeded by only eight or nine Federal Reserve offices so that, you see, it will not only be a considerable undertaking, but one that will benefit a great many checking account holders in this state.

#### CONCLUSION

In conclusion, I believe that the developments that I have been discussing with you demonstrate the dynamic nature of banking. Improved service to the public has been the goal. Competition has an important role in implementing that goal. As the banking system improves its service to the public, its importance will increase, and well-run banks concerned with serving society should prosper.

## The Business Situation

Recent data confirm that an impressive expansion in economic activity is under way. In April, industrial production registered its strongest overall advance in sixteen months, with particularly sharp increases in the consumer durables and business equipment categories. Personal income posted a healthy advance during the month, and retail sales rose sizably on balance over the March-April period. Further, sales of domestic automobiles in May were at the fastest pace since last October, when sales were boosted by the price freeze. Labor market conditions have also continued to improve, as evidenced by the sizable increase in payroll employment in May, almost half of which was in manufacturing. On the other hand, the unemployment rate has continued high, inventory spending has remained quite modest, and the rate of residential housing starts, which had been exceptionally strong, has slackened a bit.

Price and wage data still provide no firm basis on which to judge the success of the Phase Two programs to combat inflation. Consumer prices rose at a modest seasonally adjusted annual rate of 2 percent in April after showing little change in the previous month. Thus far in Phase Two, consumer prices have increased at a 3.3 percent annual rate, somewhat below the pace of the first eight months of 1971 and considerably below that of 1970 and 1969. However, industrial wholesale prices continued to climb rapidly in May, and wholesale prices of farm products and processed foods and feeds rose sharply. There is some evidence that wage gains have moderated recently, following the post-freeze bunching of increases.

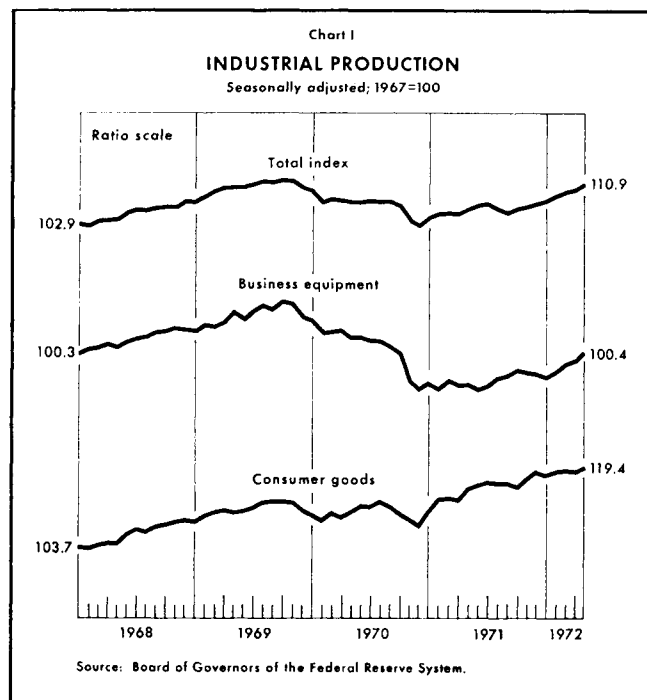
### PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose by a large 1 percent in April, when especially sharp gains in the production of business equipment, materials, and consumer durables occurred. Over the first four months of 1972, industrial production advanced at a rapid 9 percent seasonally adjusted annual rate, in contrast to an increase of only 3 percent over 1971 as a whole. By April, the index was 4.4 percent above the level of a year earlier and about 8 percent above the recession low

of November 1970, but nevertheless was still almost 1 percent below its peak attained in the fall of 1969.

Sharply higher levels of business equipment output have been one of the major elements contributing to the overall rise in industrial production so far this year (see Chart 1). The April gain of 1.3 percent brought the advance in the production of business equipment since December 1971 to a seasonally adjusted annual rate of nearly 12 percent, well above the sluggish performance of 1971. Materials production also climbed 1.3 percent, in part reflecting an increase in steel ingot production. The production of consumer goods rose 0.9 percent in April, with gains in the output of furniture, carpeting, and some other home goods. Automobile assemblies were up substantially in April as well.

According to preliminary data, orders placed with manufacturers of durable goods rose \$0.4 billion, or 1.2 percent, in April to a level 17½ percent above that of a year earlier. This gain was concentrated in bookings for transportation equipment, as orders for aircraft and parts increased sharply. The rise in shipments of automobiles and trucks, which are counted as orders, also contributed to the advance in bookings for transportation equipment. New orders for producers' capital goods edged above their already high March level. In somewhat longer run perspective, bookings in almost all major market groups have exhibited healthy growth thus far in 1972. For example, in April orders for machinery and for producers' capital goods were 10 percent and 6½ percent, respectively, above their December 1971 levels. These increases tend to corroborate the acceleration in plant and equipment spending which has been indicated by several recent surveys. During the first quarter, net new capital appropriations of the 1,000 largest manufacturing firms rose sharply to their highest level in more than two years, according to the Conference Board survey. The May Department of Commerce survey of capital spending plans revealed that such investment was expected to increase by nearly 10½ percent in 1972. This was about in line with the results of their previous survey but below those of the most recent McGraw-Hill survey. Virtually all of the growth indicated by the latest Commerce De-



partment survey was expected in the first half of the year, with capital spending expected to level off, on balance, during the final two quarters.

The improvement in durables orders in recent months tends to support the view that a more expansionary pace of inventory spending should materialize. As yet, however, there is little evidence of a quickening in the demand for inventories. For example, in the first quarter, the rise in inventory spending in the gross national product (GNP) accounts was a minuscule \$0.6 billion.<sup>1</sup> Furthermore, preliminary data indicate a decline in the book value of total

<sup>1</sup> The first-quarter estimate of GNP has been revised, indicating that GNP increased by \$30.7 billion to a seasonally adjusted annual rate of \$1,103.6 billion. The rate of increase in the implicit GNP price deflator was revised downward slightly to an annual rate of 6 percent. The revised estimates reveal somewhat greater growth in real output—5.6 percent, compared with the 5.3 percent originally reported. Among the contributors to the upward revision in current-dollar GNP were business fixed investment and personal consumption expenditures. At the same time, the savings rate was revised down considerably to 7 percent. The preliminary estimates of corporate profits, released along with the GNP revisions, indicate that before-tax corporate profits rose \$5.6 billion during the first quarter to \$91.6 billion at a seasonally adjusted annual rate.

manufacturers' inventories in April, although the increase estimated for March was raised slightly. For all manufacturers, the ratio of inventories to sales slipped further in April to 1.59, as manufacturers' shipments increased moderately. This gain was concentrated in the durables sector, where shipments in almost all product groupings advanced. Despite the rise in durables shipments during April, the unfilled orders backlog climbed for the sixth consecutive month.

#### RESIDENTIAL CONSTRUCTION, PERSONAL INCOME, AND RETAIL SALES

Following the very strong performance of the December-February period, private housing starts declined in both March and April. The April decline of 242,000 units, about equally divided between single and multiunit construction, brought total starts to a volume of 2.1 million units at a seasonally adjusted annual rate. The April reduction may have been the result, in part, of an unusually small number of working days in the month relative to earlier years. In any event, April marked the twelfth consecutive month in which starts had exceeded 2 million units at an annual rate. Moreover, newly issued building permits halted a three-month slide in April and rose 3 percent to a seasonally adjusted annual rate of almost 2 million units.

Personal income increased by \$4 billion in April to a seasonally adjusted annual rate of \$910 billion, after rising by a similar amount in March and by \$9 billion in February. The recent behavior of personal income has been affected by a variety of special factors, including retroactive payments of wage increases approved by the Pay Board, the Federal pay raise, and the increase in the social security tax base. Adjusting for the influence of these factors, personal income advanced by a fairly steady \$5.5 billion per month over the February-April period. By comparison, the average monthly gain in personal income over the corresponding three months of 1971 was about \$4.4 billion. Wage and salary disbursements accounted for most of the April gain, with a particularly significant advance occurring in manufacturing disbursements. Within manufacturing the durable goods sector provided much of the advance in payrolls, as gains were recorded in transportation equipment, machinery, electrical equipment, and fabricated metals.

Although April retail sales dropped below the record March level, the overall picture still looks strong. Estimates for both February and March have been revised up rather substantially. Furthermore, the average level of sales for the March-April period was about \$1 billion, or nearly 3 percent, above that of the preceding two

months. Sales of both durables and nondurables have shared in the gain. May sales of new domestic-type automobiles accelerated to a 9½ million unit seasonally adjusted annual rate, the fastest pace since last October when sales were stimulated by the price freeze. At the same time, sales of imported cars were at a 1.5 million unit annual rate, about the same rate that prevailed during most of 1971. Thus, for the month of May, total sales of new passenger cars were at a substantial 11 million unit annual rate—again, the highest monthly total since October 1971. The 13½ percent of the total that was accounted for by imports was somewhat below the 15 percent share they averaged during 1971.

### LABOR MARKET DEVELOPMENTS

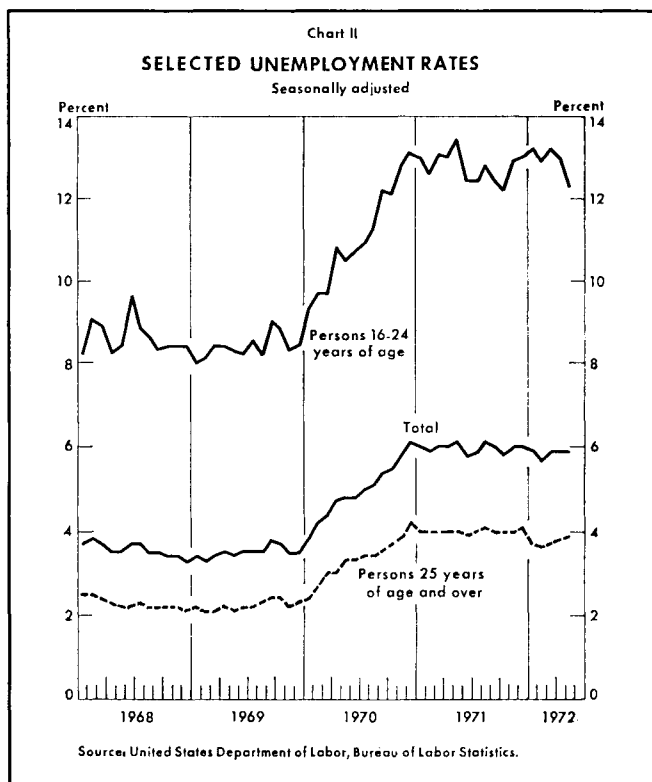
Thus far in 1972, there has been a marked improvement in underlying labor market conditions. According to the Bureau of Labor Statistics survey of employers, nonfarm payroll employment rose by a seasonally adjusted 206,000 workers in May, bringing the gain in nonfarm payrolls since the beginning of the year to almost 1.3 million workers. Significantly, manufacturing em-

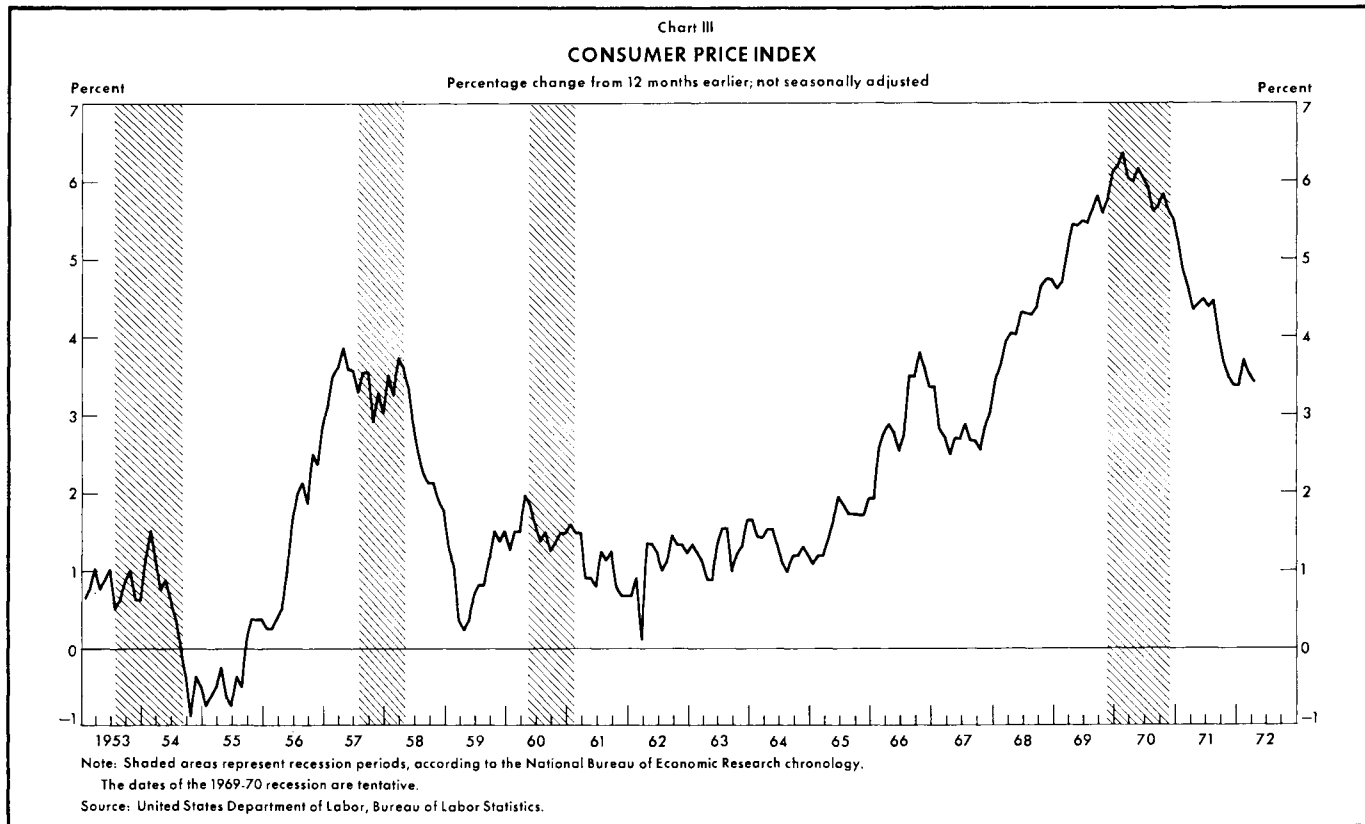
ployment—which was relatively hard hit by the recession and was slow to recover—has advanced considerably in 1972. After rising by an average of about 75,000 workers per month during the first four months of the year, manufacturing payrolls increased by an additional 92,000 workers in May. Moreover, these gains in manufacturing employment have been accompanied by significant increases in both the average factory workweek and hours of overtime since late last year.

The unemployment rate remained at a seasonally adjusted 5.9 percent in May, essentially unchanged from its average of the past year and a half (see Chart II). To a considerable extent, however, the small fluctuations exhibited by this statistic have obscured recent, fundamental improvement in the labor market. The failure of the unemployment rate to show a larger decline, given the increase in employment, is attributable to a combination of factors that have resulted in very rapid labor force growth thus far in 1972. For example, over the six-month interval ended in May, civilian labor force growth amounted to a seasonally adjusted annual rate of 3.2 percent, whereas the long-term rate of increase in the labor force has been about 1.7 percent. In part, the rapid labor force growth is due to the larger than average expansion currently occurring in the population of labor force age. Beyond this, the continued reduction in the size of the armed forces has further swollen the ranks of the civilian labor force. At the same time, the increased availability of jobs has apparently stimulated a fairly sizable influx of new labor force entrants and reentrants.

As noted above, one reason for the rapid growth of the civilian labor force has been the reduction in the armed forces. By May 1972, armed forces employment had declined by almost 240,000 from its level of December 1971. The influx of veterans, many of whom are less than twenty-five years of age, has also contributed to the growing concentration of unemployment among younger workers. Data on the age composition of the unemployed reveal that, on balance, teen-agers and young adults (workers of sixteen to twenty-four years of age) have comprised a greater percentage of total unemployment in 1972 than they did over most of last year, while adults (twenty-five years of age and older) have made up a smaller proportion of the unemployed. This suggests that a relatively higher proportion of adult workers has been absorbed by the expansion in employment.

Further along these lines, data published by the Bureau of Labor Statistics on the distribution of the unemployed by reason of joblessness indicate a similar shift in the composition of unemployment. Thus far in 1972, a noticeably greater proportion of total civilian unemployment





has stemmed from new labor force entrants—and to some extent reentrants—than was the case during 1971; concomitantly, the proportion of those unemployed because of loss of previous job has fallen below 1971 levels. For example, in December 1971 new entrants and reentrants together accounted for 41½ percent, on a seasonally adjusted basis, of total unemployment, while persons who had lost their jobs comprised 45½ percent. The corresponding figures for May of this year were 44 percent and 43 percent, respectively, indicating that the relative contribution of these groupings was reversed. In combination, these compositional shifts suggest that new, young entrants into the labor force, rather than job losers, have played an increasingly important role in sustaining the relatively high unemployment rates recently prevailing. Additional evidence of this is provided by the behavior of the state-insured unemployment rate which, unlike the total unemployment rate, has fallen well below 1971 levels in recent months. The performance of the state-insured rate largely reflects the reduction in the percentage of job

losers among the unemployed for, in most instances, only persons who have lost their jobs are eligible for state unemployment insurance benefits. However, it should be noted that the decline in the insured unemployment rate may also reflect the exhaustion of benefits by some of the unemployed, as suggested by the recent increase in the ranks of those unemployed for twenty-seven weeks or longer.

Average hourly earnings of production and nonsupervisory workers in the private nonfarm economy, adjusted for overtime hours in manufacturing and for shifts in the composition of employment among industries, rose at a 3.5 percent seasonally adjusted annual rate in May, down from the 6.2 percent rate of increase in earnings in the previous month. Since the end of the wage freeze, this index, boosted by exceptionally large gains in December and January, has climbed rapidly at an annual rate of 7½ percent. However, over the four months since January, the increase in average hourly earnings has been at a more moderate 4.7 percent annual rate, whereas, during 1970

and the first eight months of 1971, earnings rose at about a 7 percent annual rate. While these recent data suggest some diminution in wage pressures, following the initial post-freeze bunching of increases, it is still too early to conclude that a fundamental and significant slowing in wage gains is under way.

#### RECENT PRICE DEVELOPMENTS

The most recent readings on consumer and wholesale prices remain mixed. The pace of advance in consumer prices appears to have slowed considerably, as the index, seasonally adjusted, climbed at a relatively modest 2 percent annual rate in April, after displaying little change in March. With the exception of the months covered by the price freeze, this marked the slowest increase in consumer prices over two consecutive months since early 1967. Overall, in Phase Two thus far, consumer prices have climbed at an annual rate of 3.3 percent, somewhat below the pace of the first eight months of 1971 and strikingly below the advances registered in each of the preceding three years, when consumer prices rose annually between 4.7 percent and 6.1 percent (see Chart III).

The April rise in the consumer price index resulted from relatively moderate increases in prices of nonfood commodities and services; on the other hand, retail food prices declined. Among the nonfood commodity groups, some individual product prices—such as prices of used

cars and men's clothing—moved up appreciably, as did service charges for electricity and property taxes. The latter two groups of prices have been a significant source of upward pressure on the overall consumer price index for many months. Food prices, which had surged sharply in several recent months, decreased at a 1 percent seasonally adjusted annual rate after holding steady in March. Moreover, the decline in food prices was rather broadly based, with prices of beef and veal falling for the first time since November. On the other hand, in light of the sharp increase in May in prices of farm products and processed foods and feeds at the wholesale level, it is likely that renewed upward pressures on consumer food prices will emerge in coming months.

The advance of overall wholesale prices accelerated in May to a seasonally adjusted annual rate of 5.4 percent, up from the 2.4 percent rate of increase experienced on average during the previous two months. Since the termination of the price freeze last November, wholesale prices have climbed at a 5.1 percent annual rate, or at about the same pace as during the first eight months of 1971. Industrial wholesale prices increased at a 4.2 percent annual rate in May, about the same disappointingly rapid pace of the previous five months. Prices of hides, skins, leather, and related products and prices of lumber and wood products continued to advance sharply in May, contributing significantly to the persistent rise in industrial wholesale prices.



## The Money and Bond Markets in May

On the whole, interest rates declined during May as estimates of near-term demands on the capital markets were revised downward. There was a tendency for rates to rise early in the month, as market participants became concerned over the intensification of military activity by the North Vietnamese. Additional indications of domestic economic expansion also contributed to investor caution. The announcement by President Nixon of the mining of North Vietnamese harbors brought some temporary price declines. Following news of the relatively small rise in consumer prices during April and the carrying forward of plans for President Nixon's trip to Russia, however, the markets developed a firmer tone and rates moved lower during the last two weeks in May. The major exception was the bill market where rates moved back into closer alignment with the Federal funds rate.

In contrast to the bill sector, prices of Treasury coupon issues rose on balance during May. Some reinvestment demand for coupon issues arose from holders of the maturing May notes.<sup>1</sup> More importantly, banks and others were also encouraged by continuing evidence that the Treasury's strong cash position would reduce near-term borrowing. (On May 31, the Treasury confirmed that it would pay off in cash, rather than refund, the \$1.23 billion of its bonds maturing June 15.) Trading activity in the corporate and tax-exempt market was rather dull during much of May. The relatively small volume of new issues prompted strong underwriter bidding, but investor resistance developed to the pricing on some of those bonds. In the final part of the month, however, investor demand picked up and interest rates declined. The Bond Buyer index of yields on twenty municipal bonds closed at 5.15 percent on June 1, down 5 basis points since April 27 and 24 basis points below its high for the month of 5.39 percent.

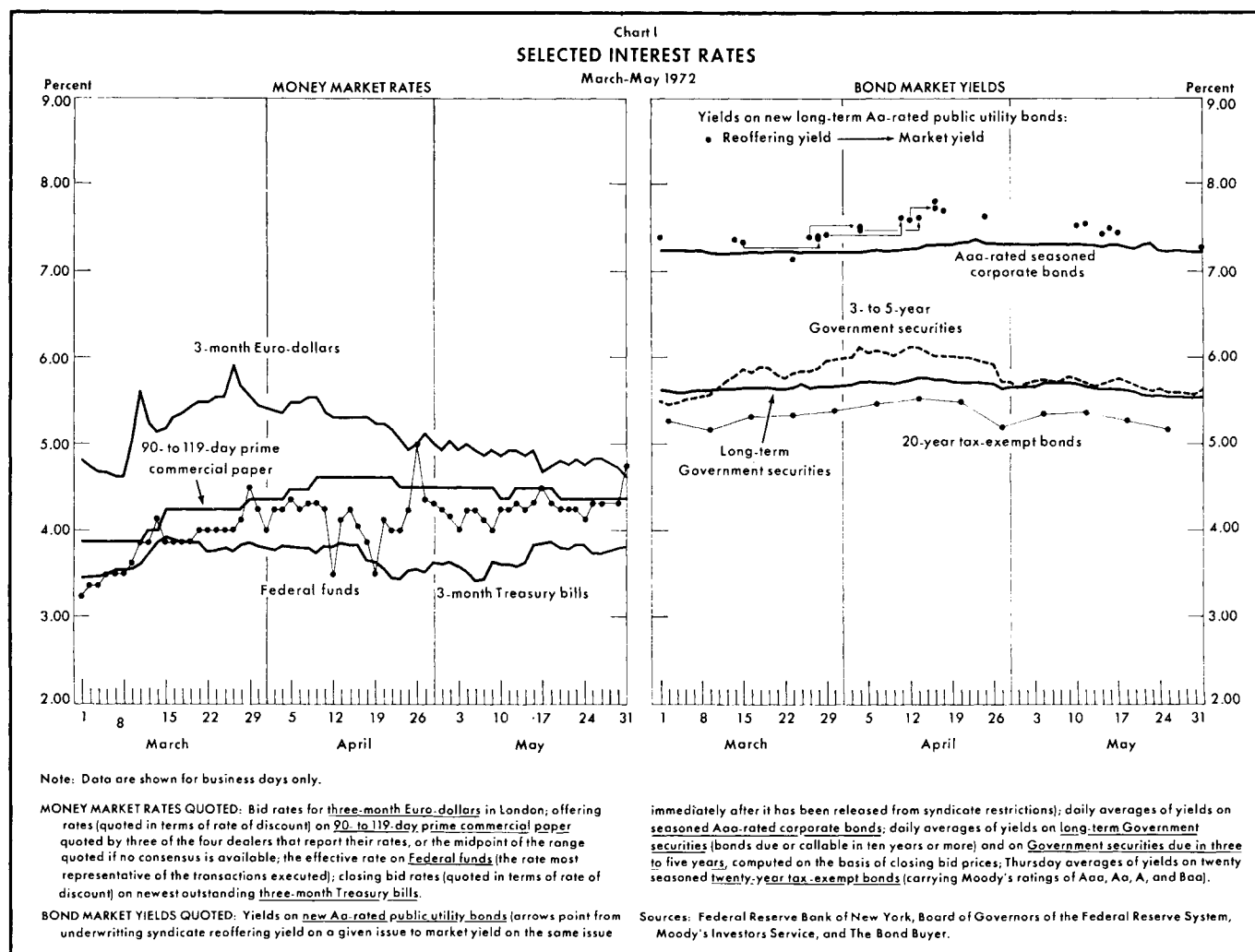
### THE MONEY MARKET

Rates on most short-term instruments were either unchanged or declined slightly during May (see Chart I). The return on various maturities of directly placed prime commercial paper was unchanged to  $\frac{1}{8}$  percentage point lower, while yields on dealer-placed paper were  $\frac{1}{8}$  to  $\frac{1}{4}$  percentage point lower for the month. Offering rates on new negotiable certificates of deposit (CDs) declined by about  $\frac{1}{8}$  percentage point. In addition, several banks lowered their prime rate early in the month, and two of the banks with "floating" rates lowered them to the generally prevailing 5 percent level at the end of the period.

Federal funds traded generally within the same range of rates which had prevailed in April, closing the month on a firm note. The effective rate averaged 4.27 percent in May, 10 basis points higher than a month earlier. Member bank borrowings at the Federal Reserve averaged \$112 million in the five weeks ended May 31 (see Table I), little changed from the average borrowings in April. Banks typically borrowed very little on the first six days of each week in May, but then resorted to the window to cover reserve requirements on each settlement day. By far the bulk of these borrowings was concentrated at the major New York City banks until May 31, when other reserve city banks borrowed heavily. According to preliminary data, total member bank reserves grew at a seasonally adjusted annual rate of about 8 percent in May, while "reserves available to support private nonbank deposits" (RPD) grew at about a  $7\frac{1}{2}$  percent annual rate. RPD consists of total member bank reserves except those required to support United States Government and interbank deposits. At its January 11 meeting the Federal Open Market Committee,<sup>2</sup> noting that the fourth-quarter

<sup>1</sup> For details of the Treasury's refinancing, which partially refunded the notes maturing May 15, see this *Review* (May 1972), page 124.

<sup>2</sup> For a more detailed discussion of the January 11 meeting, see "Record of Policy Actions of the Federal Open Market Committee", *Federal Reserve Bulletin* (April 1972), pages 390-97.



sluggishness in the growth of the money supply had been accompanied by little growth in total member bank reserves, decided that more attention should be given to the provision of sufficient reserves to support a more rapid rate of monetary growth. Initially, the Committee decided that open market operations, while continuing to take appropriate account of money market conditions, should be guided more by the course of total bank reserves than had been customary previously. At its February 15 meeting,<sup>3</sup> the Committee decided to express its reserve objec-

tives in terms of reserves available to support private nonbank deposits (see Chart II). This measure was considered preferable to total reserves because the latter aggregate is affected by short-run fluctuations in Government and interbank deposits which are sometimes large and difficult to predict. In effect, it was deemed appropriate for System open market operations normally to provide or absorb the reserves needed to accommodate changes in Government and interbank deposits without disturbing reserves available to support private nonbank deposits. The Committee decided, however, that in pursuing the reserve target the System should avoid both sharp short-run fluctuations and undesirably large cumulative changes in money market conditions in either direction

<sup>3</sup> *Federal Reserve Bulletin* (May 1972), pages 455-63.

between Committee meetings, which are usually held at four-week intervals.

Based on preliminary data, there was some further deceleration in the growth of  $M_1$ —demand deposits adjusted and currency held by the public—during May when the demand deposit component grew less rapidly than it had in April. It is now estimated that  $M_1$  grew at a seasonally adjusted annual rate of 2.2 percent over the four weeks ended May 24<sup>1</sup> and at a 7.6 percent rate during the thirteen weeks ended then. For the twenty-six weeks ended May 24, a somewhat more useful period since the monetary aggregates exhibit a good deal of short-run volatility,  $M_1$  has grown at a seasonally adjusted annual rate of 6.9 percent, up from the 6.2 percent rate of growth for all of 1971.

Data for the four weeks ended May 24 indicate that  $M_2$ , which is composed of  $M_1$  plus commercial bank time and savings deposits other than large negotiable CDs, grew at a seasonally adjusted annual rate of 7.8 percent. These consumer-type time and savings deposits make up almost one half of the broader money supply total, and their rapid increase of some 13 percent to a large extent offset the slower pace at which  $M_1$  grew during the month. It is estimated that  $M_2$  increased at annual rates of 9.4 percent over the thirteen weeks ended May 24 and 11.1 percent over the twenty-six weeks ended then.

In contrast to the money supply measures, the adjusted bank credit proxy experienced some quickening in its rate of growth during May to a seasonally adjusted annual pace of 15.2 percent over the first four statement weeks, compared with 13.3 percent over the preceding four. While the substantial increase in time deposits was the primary factor in the accelerated growth of the proxy in May, an additional element of strength in recent months has been the relatively strong performance of United States Government deposits, compared with earlier years. As the Treasury confirmed when announcing the terms of the May refinancing, its cash position has been extremely strong as a result of higher revenues and lower expenditures than had been anticipated, and this has been reflected in the unusually large Government deposit balances at member banks. In large part, because of the substantial gains in total time and Government deposits in recent months, the

adjusted credit proxy grew by a seasonally adjusted annual rate of 15.4 percent over the thirteen weeks ended May 24, a decidedly more rapid pace than that of  $M_1$  or  $M_2$ . Proxy

**Table I**  
**FACTORS TENDING TO INCREASE OR DECREASE**  
**MEMBER BANK RESERVES, MAY 1972**

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

Factors	Changes in daily averages— week ended					Net changes
	May 3	May 10	May 17	May 24	May 31	
<b>"Market" factors</b>						
Member bank required reserves .....	- 259	+ 58	- 347	+ 438	- 173	- 283
Operating transactions (subtotal) .....	+ 287	- 293	+ 847	- 260	- 321	+ 260
Federal Reserve float .....	- 110	+ 192	+ 27	+ 187	- 405	- 109
Treasury operations* .....	+ 336	- 756	+ 763	- 105	+ 95	+ 333
Gold and foreign account .....	- 39	+ 407	+ 466	- 9	- 174	+ 651
Currency outside banks .....	+ 188	- 219	- 501	- 291	+ 250	- 573
Other Federal Reserve liabilities and capital .....	- 88	+ 82	+ 93	- 42	- 86	- 41
Total "market" factors .....	+ 28	- 235	+ 500	+ 178	- 494	- 23
<b>Direct Federal Reserve credit transactions</b>						
Open market operations (subtotal) .....	+ 3	+ 192	- 184	- 44	+ 234	+ 201
Outright holdings:						
Treasury securities .....	+ 182	+ 187	- 176	- 45	+ 64	+ 212
Bankers' acceptances .....	-	+ 5	- 8	+ 1	- 2	- 4
Federal agency obligations .....	+ 25	-	-	-	-	+ 25
Repurchase agreements:						
Treasury securities .....	- 184	-	-	-	+ 159	- 25
Bankers' acceptances .....	- 17	-	-	-	+ 9	- 8
Federal agency obligations .....	- 3	-	-	-	+ 4	+ 1
Member bank borrowings .....	- 162	- 30	- 48	+ 24	+ 191	- 25
Other Federal Reserve assets† .....	+ 49	+ 41	- 167	- 216	+ 55	- 238
Total .....	- 110	+ 203	- 399	- 235	+ 478	- 63
Excess reserves .....	- 87	- 27	+ 101	- 56	- 16	- 85

	Daily average levels					Monthly averages
<b>Member bank:</b>						
Total reserves, including vault cash .....	32,838	32,753	33,201	32,707	32,864	32,872‡
Required reserves .....	32,707	32,649	32,996	32,558	32,731	32,728‡
Excess reserves .....	131	104	205	149	133	144‡
Borrowings .....	117	87	39	63	254	112‡
Free, or net borrowed (-), reserves .....	14	17	166	86	- 121	32‡
Nonborrowed reserves .....	32,721	32,666	33,162	32,644	32,610	32,761‡
Net carry-over, excess or deficit (-)§ .....	85	72	111	95	79	88‡

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

\* Includes changes in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Average for five weeks ended May 31.

§ Not reflected in data above.

<sup>1</sup> The growth rate cited is the annualized percentage change of the average level of  $M_1$  in the four weeks ended May 24 from the average of the four weeks ended April 26. Similarly, the growth rates cited for longer periods are based on the average levels in the four weeks ended thirteen, twenty-six, and fifty-two weeks, respectively, prior to the four-week period ended May 24.

growth in the twenty-six weeks ended May 24 was at a 12.6 percent seasonally adjusted annual rate and at a 10.5 percent rate during the fifty-two weeks ended then.

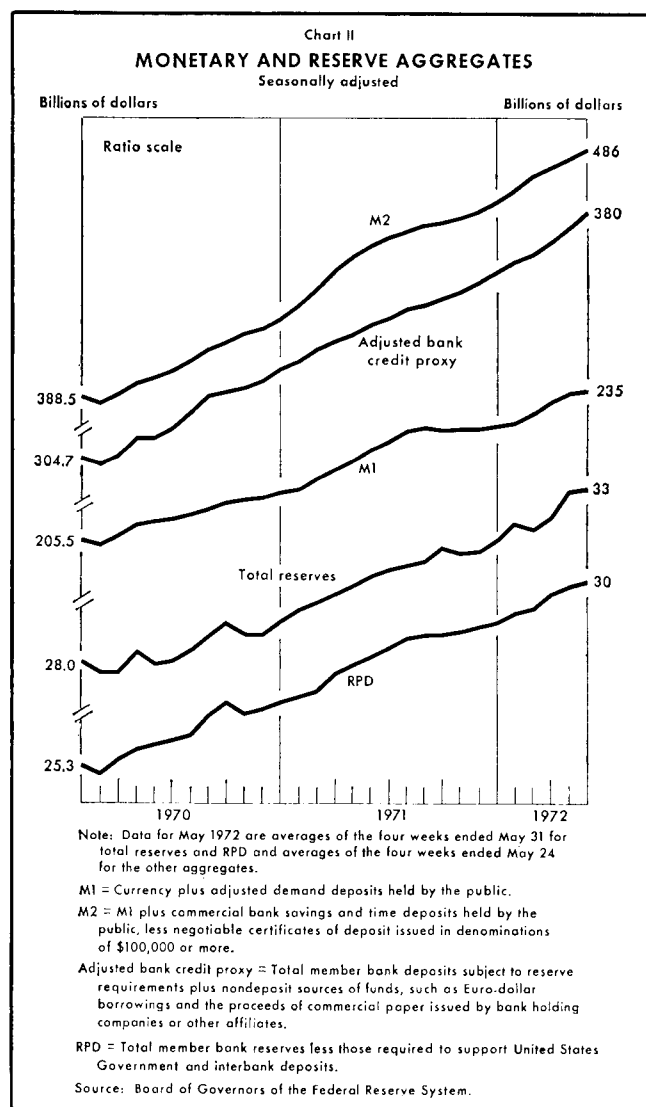
### THE GOVERNMENT SECURITIES MARKET

Rates on Treasury bills, unlike those on most other instruments, rose on balance during May. At the beginning of the month, however, a firm tone was evident in the bill market as participants continued to respond favorably to the Treasury's statements concerning the May refinancing which were made at the end of April. The Treasury's very strong cash position indicated that no additional funds would be raised in the bill market over the near term, and its planned redemption of \$700 million of the notes maturing in May fostered the expectation of a sizable amount of reinvestment demand for bills. There was good investor interest in the bill market at the start of May, and fairly persistent demand emerged for the rather thin floating supply of bills. Rates on most bills declined by 1 to 19 basis points during the first week of May and, with their inventories relatively depleted, dealers were fairly aggressive bidders in the weekly auction on May 8. The average issuing rates on the new three- and six-month bills at that auction were 14 and 9 basis points lower, respectively, than a week earlier (see Table II).

Following President Nixon's speech regarding the mining of North Vietnamese harbors and the interdiction of their supply routes, rates moved higher when the market opened on May 9 but then began to stabilize as no substantial investor selling developed. Over the next several days, the bill market deteriorated further in quiet, largely professional trading and an air of caution emerged in response to sales of bills on several days by the Trading Desk of the Federal Reserve Bank of New York. The reinvestment demand from the Treasury notes which matured at midmonth proved considerably less than had been anticipated, and bill rates continued on an upward path. Already uncomfortable in the face of the abundant supply of bills for which there was little demand, dealers became apprehensive about the final full week of the month when three auctions were scheduled because of the holiday on Monday, May 29. Reflecting this atmosphere, average issuing rates on the new three- and six-month bills moved higher in the weekly auction on Monday, May 22, by 13 and 12 basis points, respectively, while the rates set on the new nine- and twelve-month bills the next day rose 13 and 10 basis points from their April levels. The tone of the market began to firm, however, in response to some renewed demand from both investors and dealers, and rates moved lower over the remainder of the month. In the

final weekly auction on Friday, May 26, the average issuing rates on the new three- and six-month bills declined by 6 and 13 basis points, respectively, from those of the preceding Monday. Rates on outstanding bills maturing within three months were generally 15 to 25 basis points higher over the month as a whole, while rates on longer maturities were generally 1 to 15 basis points higher.

Yields on most Treasury coupon issues moved in the opposite pattern from those on Treasury bills during much of May, rising early in the month and then falling steadily over the rest of the period. Interest in the May 2 auction of notes and bonds proved less aggressive than had been expected as a result of concern over the possibility of



increased demands on the capital markets which could result from the economic expansion and reports of a substantial buildup in Vietnamese military activity. Prices of outstanding issues edged downward over the next few days and then fell in initial reaction to President Nixon's May 8 speech.

In the absence of investor selling, however, the market soon stabilized and then prices began to rise as the reaction from other nations to the Vietnam initiatives proved less negative than many had feared. The atmosphere was also buoyed by the strong technical position of the market and by some reinvestment demand on the part of holders of the maturing May notes. The announcement of the relatively modest rise in consumer prices again in April helped to strengthen the market by dampening inflationary expectations. Market reports of an increasingly strong Treasury cash position were also a favorable influence. Although activity was largely professional after midmonth, the market maintained a firm tone and prices continued to rise. For the month as a whole, most Treasury coupon issues registered declines in yields of 3 to 22 basis points.

#### OTHER SECURITIES MARKETS

The month's principal corporate flotation—\$250 million of Aaa-rated Bell Telephone System debt—was made on May 2. Considered by many as a key test of the viability of the current interest rate levels, the offering consisted of \$175 million of forty-year debentures yielding 7.40 percent and \$75 million of seven-year notes priced to yield 6.60 percent. Neither part of the offering was particularly successful, though the notes were somewhat more in demand, and the cool reception to the offering signaled a pause in the rally which had begun in mid-April. The lack of institutional investor interest in the offering was interpreted by some participants as an indication that lower bond prices were expected in the immediate future. This dampened the market tone further, and rates on seasoned corporate bonds also moved higher over the next few days amid concern over the stepped-up level of military activity in Vietnam. Then prices fell sharply in response to the President's television address on the evening of May 8 but quickly rebounded.

In contrast to the fate of the Bell System offering, a \$100 million issue of Aaa-rated industrial bonds was enthusiastically received on May 11. The fact that very few industrial corporations enjoy such a high rating gave the bonds substantial scarcity value, and investors were eager to buy them despite their relatively low yield of 7.08 percent. During the following week, several medium-

**Table II**  
**AVERAGE ISSUING RATES\***  
**AT REGULAR TREASURY BILL AUCTIONS**

In percent					
Maturities	Weekly auction dates—May 1972				
	May 1	May 8	May 15	May 22	May 26
Three-month .....	3.604	3.462	3.699	3.825	3.762
Six-month .....	3.998	3.907	4.118	4.233	4.106
	Monthly auction dates—March-May 1972				
	March 24	April 25	May 23		
Nine-month .....	4.511	4.234	4.367		
One-year .....	4.661	4.362	4.465		

\* 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.

sized Aa-rated utility issues were marketed with mixed receptions at yields ranging from 7.43 percent to 7.55 percent. Another pair of Aaa-rated telephone issues was brought to market on May 22. The \$50 million issue of forty-year debentures was priced to yield 7.34 percent, 6 basis points less than the yield offered on the earlier Bell System issue on May 2 and the lowest yield placed on such an issue since mid-February. The companion offering of six-year notes was priced to yield 6.50 percent. This aggressive pricing resulted in rather slow initial sales of these issues, but prompted swift sales of older securities still in syndicate hands and in the secondary market where yields looked attractive in comparison. As prices of issues in the secondary market were bid up, in turn, sales of the new telephone issues improved. Corporate bond prices closed higher for the month, although some investor resistance developed on May 31 to an offering of thirty-year Aa-rated utility bonds priced to yield 7.29 percent, the lowest yield offered on such an issue since mid-January.

In the tax-exempt bond market, a \$100 million offering of Pennsylvania bonds was marketed on May 2. Providing yields that were described as somewhat less attractive than had been anticipated, the bonds were only about 20 percent sold at the close of the first day. When the remaining balance was released from price restrictions two days later, yields adjusted upward by as much as 20 basis points. This cleared the atmosphere in the market, and a number of new issues—including a \$200 million offer-

ing of Battery Park City Authority (New York) bonds—were well received by investors during the next few days at somewhat higher yields than those prevailing at the beginning of the month.

A cautious tone developed on the day following the President's speech, and an issue of New Jersey bonds was postponed because of the uncertain market conditions. Other scheduled offerings were marketed that day, though at somewhat lower prices than originally intended, and investor reaction was generally quite favorable. Prices

rose over the next several days, and the postponed New Jersey bonds were almost a first day sellout at the price set on them a week earlier. Prices continued to rise as the month progressed, and The Bond Buyer index of yields on twenty municipal bonds fell by 10 basis points to 5.29 percent in the week ended May 18 after increasing by 19 basis points over the two preceding weeks. The index fell further to 5.19 percent on May 25 and to 5.15 percent on June 1. This was the lowest level since January 13, 1972.

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