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Central Banking in the Economy Today

By ALFRED HAYES
President, Federal Reserve Bank of New York

An address before the forty-sixth annual midwinter meeting of the New York State Bankers Association in New York City on January 21, 1974

I would like to talk today about the central bank and the environment in which it must operate to affect the course of the economy. While I will naturally focus on the Federal Reserve, central banks in other countries face similar challenges and are subject to similar constraints. It may be particularly timely to review these matters in view of the very uncertain economic outlook for 1974, and the problems that this uncertainty poses for monetary policy.

Painted with very broad strokes, the economic picture of the last quarter century or so is quite satisfactory. Never before had this country or other developed economies escaped serious depression for so long. The recessions that were experienced were, historically, mild and short in duration. Until the past few years, our record of inflation was also encouraging; from 1951 to 1965, for example, consumer prices rose less than 1½ percent a year on average. For the past eight years, however, we have been grappling with a stubborn and distressing rate of inflation; averaging over 4 percent a year and exceeding 8 percent last year, it has distorted spending and investing, borrowing and lending, decisions. This inflation is not easily stopped, as we have learned from a mini-recession in 1967 and a year's recession in 1970.

Just as the record of expansion since World War II may point up the capability of the Federal Reserve to contribute to satisfactory economic performance, the experience with inflation since 1965 illustrates some of the limitations of monetary policy. First, throughout most of this period, private demand was strong and fiscal policy, stimulative. In the fiscal years 1971 to 1973, for example, the Federal budget deficit totaled $60.5 billion. As the credit crunch of 1966 illustrated, in the absence of fiscal restraint a restrictive monetary policy can be pushed only so far before the financial system becomes seriously strained. Second, once wages and prices rose, they were validated by contract and price practices, and they resisted decline, even when total demand slackened. Third, in 1973, the second of the dollar devaluations resulted in increased foreign demand for our goods just as bottlenecks in the expanding economy began to appear. Finally, incomes policy, which had contributed to stabilizing prices in 1971 and 1972, became ineffective in the overheated environment of 1973. Thus, appropriate fiscal and incomes policies are important conditions for monetary policy to be effective.

Now, I do not want you to think that I am commenting on the difficulties that confront the Federal Reserve in dealing with economic problems as a defense against criticism of our mistakes, or to seek sympathy for those of us with the responsibility for making policy. It is rather that I believe that a better understanding of what a central bank can and cannot do will guard against unrealistic expectations—and consequent disappointment. Moreover, better understanding may well produce more useful criticism that could help the Federal Reserve to improve its performance.

To begin with, it's obvious that any group—whether in the Congress, the Administration, or the Federal Reserve—required to make decisions that will affect the economy in the future must formulate some idea of how the economy is going to evolve in the months ahead. For the Federal Government's budget, that time period is a year and a half ahead or more. We have just had a timely reminder

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—at a recent meeting in this city, attended by some of the country's foremost economists—that the art of forecasting is still an extremely difficult one and that nobody is willing or able to claim adequate foresight. Although the art has certainly made progress in recent decades as our economic understanding has been enhanced, as strides have been made in quantifying variables and constructing econometric models, and as judgment has improved, it still has far to go.

Nevertheless, economic policy makers must do their best to forecast the conditions they hope to affect. At this point, then, we can say that a central bank must make a forecast taking into account all other government policies, and of course it must review this forecast frequently and adjust its policies as that may become desirable. The central bank must then decide how to exert its influence on money and credit, and how vigorously. For some students of central banking policy this task does not seem to pose any problem: just increase the money supply by, say, 6 percent a year or ½ percent a month. This seems to be an appealingly simple solution. But, in my view, an effective monetary policy cannot be achieved by such a simple—and simplistic—formula. As you probably know, a large majority in the Federal Reserve is very reluctant to accept the notion that the rate of growth in bank credit, and total credit, or volatile fluctuations in interest rates, or in velocity, can be safely disregarded in such a narrow focus on any monetary aggregate. And, even if such an approach were desirable, it presumes a much greater degree of statistical knowledge, and a greater ability to control the monetary aggregates in the short run, than exists.

In this regard, I am very much concerned about the adverse impact of the present system of reserve requirements on our ability to control money and credit. In today's environment, effective monetary control requires that the reserves of all institutions offering payments services come under the direct influence of the Federal Reserve. Until this is accomplished, our monetary and credit control efforts will be less precise than they can, or should, be. Moreover, the present system imposes a heavier reserve burden on Federal Reserve member banks than on nonmembers, and fear of aggravating member banks' competitive disadvantage can inhibit the use of reserve requirement changes for control purposes. Thus, I am convinced that we face a continuing gradual weakening of our ability to control money and bank credit so long as some banks have the option of not holding their reserves in a form that comes under the direct influence of the Federal Reserve. These considerations have led me to the firm conclusion that reserve requirements on demand deposits should be similar for both member and nonmember banks. Indeed, it is anomalous that the United States is the only major country in which banks enjoy the option of choosing *not* to adhere to the central bank's reserve regulations.

With respect to nonmember banks, I should also note that we need more comprehensive and timely deposit data from these banks for monetary control purposes. Normally we have gotten deposit figures from nonmember banks for only two days a year; that is, for the June and December call dates. In addition, these figures are available only with a very long lag. Thus, we have no current information on nonmember bank deposits to feed into the monetary-policy process. This has been a serious limitation in recent years when nonmember bank deposits have been growing more rapidly than expected. The June 1972 call report, for example, indicated that nonmember bank demand deposits were $1.8 billion higher than expected, which was the largest such revision on record. Unfortunately, we were not aware of the size of this revision until the end of the year. We are still not sure what changes will be made in 1973's numbers, but, in any case, it seems clear that better nonmember-bank deposit data are needed to enhance overall monetary control.

Apart from the statistical and other limits on our ability to control the monetary aggregates within narrow limits of tolerance in short periods of time, the very attempt to do so would in all likelihood result in wide fluctuations in interest rates. Gyrations in interest rates and in prices of fixed-income securities disrupt financial markets and the decision-making process of market participants. Yet it is in and through these financial markets that the central bank must carry out policy decisions. The basic operating premise of the central bank's open market operations is that they must be conducted in effective, viable financial markets. The need for vigorous markets, capable of absorbing and transmitting the effects of expected and unexpected developments, does not mean the central bank must protect, much less promote the interest of, the participating institutions. It does, however, mean that those committing their capital in the market must be confident that they will not be exposed to unduly violent fluctuations caused by actions of the central bank. Moreover, any suspicion of erratic conduct by the monetary authorities would cause an apprehensive withdrawal of savers and investors that would make it difficult for private and governmental borrowers to conduct financing operations.

Any such interruption of financial flows to the business or consumer sectors would have an adverse impact on production and employment. But over and above such financial effects, uncertainty about the central bank's operations and intentions, resulting from wide short-run

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fluctuations in interest rates, may well have a negative effect on business confidence and spending. There is, in short, a real cost to interest rate instability that we cannot ignore in formulating and implementing policy.

Please do not misunderstand me; I am referring here only to the wide gyrations in interest rates that are likely to result from any attempt to maintain steady short-run growth of the monetary aggregates. Longer run movements in interest rates in response to policy changes and developments in the private sector have, of course, important equilibrating and allocative effects on the economy. Such rate movements are obviously meaningful, and are part of the process of transmitting monetary policy changes to the economy. It would be just as bad to try to pursue policies that avoid significant movements in interest rates as to follow policies that lead to very sharp short-term fluctuations in rates. In this respect, I am in full accord with the Federal Reserve move toward greater reliance on interest rates in free markets than on direct controls, such as certificate of deposit (CD) ceiling rates, in the monetary-control process.

Just as the central bank must earn and keep the confidence of financial markets and institutions in its integrity, its competence, and its awareness of present and impending developments, so it must also earn the confidence of the Government, in our case principally the Treasury and the Congressional committees concerned with banking and with the economy. A former Governor of the Bank of England, Lord Cobbold, reflecting on his service in that position, concluded that "After its relationship with Government, which is fundamental," the central bank's "most important concern" is with the banking and financial systems. "One of its first duties", he said, "is to interpret Government thinking to the financial markets and market thinking to the Government. A central bank which is out of touch with its own financial community and does not enjoy their confidence can never be doing its job properly." He then noted that "confidence and praise are two quite different things".

There are clearly major differences between the role in Government of the Federal Reserve and the Bank of England. However, the Federal Reserve Bank of New York —as the operating arm of the System in the domestic money market and of the System and the Treasury in the foreign exchange market—is, I believe, well situated to serve as such an intermediary between the Government and the financial community. We have sought to fulfill this role, always recognizing, of course, that the independence of the Federal Reserve within the Government and from the financial community must not be compromised.

As for "confidence and praise", I am certainly not going to argue that central banks should get heaping portions of praise at frequent intervals, any more than Lord Cobbold would. But a goodly measure of confidence is necessary. Perhaps the chief reason for this is the authority entrusted to the central bank to create and issue money, including the high-powered variety called bank reserves that provide the base for a multiple expansion of bank credit and deposits. It is self-evident that the Congress, the Treasury, and all participants in financial markets have a crucial interest in how well the central bank exercises this great authority. By the same token, all of them will review most carefully the monetary authorities' actions and the results, since those actions will affect incomes and market values. For all these reasons, a central bank must always stand ready to explain its objectives and reasoning, and the use it has made of its instruments. This is particularly true in our country with respect to the Congress, which has delegated its constitutional monetary power to the Federal Reserve.

In the past year we have been confronted with a new problem for monetary policy as the shortages associated with a cyclical peak have been aggravated by a worldwide boom and the reduction in oil supplies. Even before the cutback of oil output and the embargo on shipments to the United States by several large producers in the Middle East, it was becoming apparent that our economy faced a year of much less growth than in 1972 or 1973, when real output rose about 6 percent a year. During 1973 it became increasingly clear—as has often been the case in the past—that we had reached effective capacity for many materials; there were more and more widespread shortages and delays in delivery, larger and larger backlogs of unfilled orders. It was also clear that a good deal of time was going to be required to develop additional capacity.

This cyclical-capacity problem was exacerbated in 1973 by worldwide boom conditions. During most of the period from the end of World War II to last year, the makers of economic policy for the nation had to focus on how fiscal and monetary policies should affect aggregate demand. They could generally assume that an adequate supply of goods and services would be forthcoming, perhaps in response to a higher price, if not at home then from abroad. But one can no longer make that assumption, either knowingly or unconsciously. The coincidence of excess demand, both at home and abroad, in 1973 was unique in the postwar period and meant that we could no longer rely on the rest of the world to fill the gap between supply and demand in this country. In this setting, the devaluation of the dollar, and the encouragement it gave to exports from this country, added to our supply

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problem. More recently, this problem has been further aggravated by the oil embargo. Thus, we are facing conditions today quite unlike any of the past quarter century, not merely because of a shortage of petroleum whose extent we cannot even now determine with any precision. There is, in fact, little the central bank can do to ease such supply problems in the short run; as Chairman Burns pointed out, the problem is a shortage of oil, not of money. The central bank can, however, seek to forestall any cumulative downswing in the economy that might result from the oil shortage.

To this point, I have tried to sketch what seem to me some of the major elements shaping the capabilities and limitations of central bank policy, drawing largely on our experiences in the United States, but implying that similar conditions exist in other developed countries. Clearly, I would not wish to conclude without some reference to the world monetary system and the flows of trade, investment, and other international transactions that affect all central banks.

On the international financial side, we have witnessed over the last several years a breakdown of the Bretton Woods system. World trade and investment have nevertheless continued to expand, and some would construe this experience as a vindication of those who have long advocated floating exchange rates and as a repudiation of earlier fears by central bankers, such as myself, that floating rates would not work. I would view the recent experience quite differently.

During the past year it has become evident that no large country is prepared to allow the external value of its currency to fluctuate without limit in response to market forces. To do so is to invite speculative aberrations which may carry exchange rates to levels that are inconsistent with balance-of-payments equilibrium. Moreover, undue variations in exchange rates can have harmful domestic effects on the economic life of every country, large and small. As we have seen in the United States this past year, such rate changes unnecessarily exacerbate inflationary pressures in countries whose currencies depreciate well beyond longer run equilibrium levels. They can also distort the allocation of real resources into a pattern not warranted by underlying economic forces. Thus, for both domestic and international reasons most governments have found it desirable to limit exchange rate fluctuations through periodic official intervention or through controls on trade or payments.

In fact, we have not really had freely floating rates; the world financial system has developed into a mixed arrangement of fixed and managed rates, involving exchange-market intervention by the major central banks of about $30 billion equivalent since last March when the markets were reopened. In this connection, I believe that the resumption of Federal Reserve operations in the foreign exchange markets since last July helped to create conditions in which the improvement in our balance of payments was able to be reflected in the subsequent recovery of the dollar. Such operations will provide an essential safeguard against unwarranted speculation in the future.

It is also evident that exchange rate changes are a matter of international concern, since any exchange rate change inevitably entails variations in the exchange rates of other countries and may introduce new problems in the management of other economies. Thus, the determination of exchange rates under virtually any regime involves a process of international negotiation and conciliation. The Bretton Woods system provided a solution to this problem for many years, but one that placed the United States in a passive role. That role is no longer appropriate, and the need for agreed-upon rules of international conduct is all the more urgent.

The urgent need for close international cooperation is underlined by all of the ramifications of the oil crisis. The impact of the staggering increase in crude oil prices on world trade and payments is of particular concern to central bankers. The resulting jump in payments to the oil-producing countries by the rest of the world will be enormous—some estimates place it in excess of $50 billion this year alone. The readjustment of the world economy to such a major shift can properly take place only on a cooperative basis. If we don't work together we shall all be the losers, the developed and developing countries alike.

In conclusion, I am sure you understand that, despite what I have said about the limits or constraints confronting monetary policy, there is no doubt in my mind of the important influence exerted on the economy by the central bank. It's just that I don't think money is the only thing that matters. You will probably agree that the problems confronting central banks are unusually difficult today. While, in our policy formulation, we can't disregard the possibility of a cumulative downturn that would increase unemployment substantially, inflation has been, and continues to be, the major problem for policy makers. It is difficult to remember a time when the economic outlook was as uncertain as it is today. Supply constraints, not only in petroleum but also in a wide range of basic industrial materials, pose novel and, in the short run at least, largely intractable problems for policy makers. However, I am confident that in time these difficulties will be surmounted, with your cooperation and with that of all of the American people.

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The Business Situation

The most recent business statistics provide further evidence of a slowing in the economy. During the past quarter, real gross national product (GNP) edged up at a seasonally adjusted annual rate of 1.3 percent, the slowest pace in three years. In the last month of the quarter, industrial production actually declined, following three months of very small gains. Some of this recent braking clearly reflects the impact of the embargo on oil shipments from the Arab oil-producing nations, announced late last October, with all of the December decline in industrial production traceable to reductions in the output of "energy" and automotive assemblies. Actual and anticipated fuel shortages contributed to a fairly broad-based rise in unemployment from 4.8 percent in December to 5.2 percent in January.

Some slowing in the economy was generally expected even before the petroleum situation moved to center stage, and would almost certainly have taken place even if ample supplies of oil had continued to be available. Shortages were an important factor; these were widespread up to and including the final quarter. Indicative of this was the extraordinarily high level of capacity utilization in the major materials industries during the last quarter. Despite a slight decline from the third-quarter rate, the October-December figure was the second highest quarterly utilization rate on record. Price controls contributed to the shortages, since they led to changes in output patterns and also induced producers to expand exports, which are not subject to domestic price controls.

The price situation has gone from bad to worse in recent months, with prices of fuel and power skyrocketing. The rise in the GNP deflator continued to accelerate during the fourth quarter and reached an annual rate of 7.9 percent, the fastest climb since the Korean war. Wholesale prices soared at a 26 percent annual rate in December, after registering a 21 percent increase in November. A broad-based advance in all the components was evident, even though fuel and power prices, which increased at the phenomenal annual rate of 146 percent in December and 157 percent over the last three months, had an overwhelming effect on the index. For the entire year, wholesale prices rose by 18.2 percent, the highest rate since the end of World War II. Although the upward march in consumer prices "slowed" to an annual rate of 6½ percent in December, the rapid run-up in wholesale prices has not yet been fully felt at the retail level. During the past year, consumer prices climbed 8.8 percent, the fastest advance since price controls were terminated after World War II.

Cost pressures during the final quarter of 1973 intensified, as rapidly rising wages and declining productivity generated the largest unit labor cost increase in four years. Prospects for a moderating of the pace of wage changes are diminished by the fact that real wages declined over much of 1973. Moreover, a heavy collective bargaining schedule is anticipated for 1974.

GNP AND RELATED DEVELOPMENTS

The market value of the nation's output of goods and services rose $29.5 billion during the fourth quarter to a seasonally adjusted annual rate of $1,334 billion, according to the preliminary Commerce Department estimates. Measured in current dollars, GNP climbed at a 9.4 percent annual rate, but nearly all of this advance reflected higher prices; after adjustment for changes in the price level, GNP expanded at a 1.3 percent rate, the slowest pace in three years (see Chart I).

Although the Arab oil embargo had some impact on real growth during the fourth quarter, a slowing had become apparent earlier in the year. During the two middle quarters of 1973, real growth averaged about 3 percent per year, after having risen 8 percent during the twelve months ended March. A comparable deceleration in the growth of the Federal Reserve Board's index of industrial production, which measures the physical output of the nation's factories, mines, and utilities, has also occurred. Over the four quarters ended last March, the expansion in industrial production averaged close to 12 percent. It then slowed to about 6 percent in each of the next two quarters and to less than 1 percent in the final quarter. In December, industrial production registered its sharpest decline in more than two years. However, excluding the energy component,

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which encompasses such activities as the extraction and processing of fuels as well as the generation of power, and the motor vehicles and parts component, which has also been strongly affected by the oil situation, industrial production rose in December.

Inventory investment added $11.2 billion to the growth of GNP during the fourth quarter (see Chart II). According to estimates based on incomplete data, the change in business inventories soared from the small $4½ billion annual rate of accumulation averaged during the preceding three quarters to a huge $15.9 billion climb in the October-December period. Final expenditures—GNP net of inventory accumulation—rose only about half as fast as in the earlier quarters of 1973, as spending on consumer durables and residential construction declined sharply.

The abrupt rise in inventory investment represents the outcome of a diverse set of factors. As in the preceding quarter, there was a run-up of farm inventories ($1 billion, annual rate), with farmers probably increasing their holdings in anticipation of higher prices. Many other businessmen were undoubtedly attempting to build up inventories from the very low levels to which they had been pushed by the exceptionally rapid growth of final demand and the widespread supply shortages that have characterized much of the recent past. However, the most dramatic development was the $4.5 billion surge in passenger car inventories held by auto dealers (see table), while some of this buildup was voluntary, in response to the depletion of dealer stocks during the earlier part of the year, most of it reflects the marked weakening toward the end of 1973 in the demand for standard-size cars. As sales dropped, dealer stocks of domestic-type cars went from the equivalent of forty-two days of sales in September to sixty-nine days in December. The present imbalance of auto inventories is underscored by industry reports that supplies of certain slow-selling large vehicles currently are equal to several months of sales while for some of the much-sought-after subcompacts supplies are extremely short.

The pace of overall consumer spending slowed dramatically during the fourth quarter. Current-dollar outlays expanded by only $13 billion, compared with the $20.4 billion advance registered in the previous quarter and an

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From previous quarter; seasonally adjusted annual rates

Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.

Source United States Department of Commerce, Bureau of Economic Analysis.

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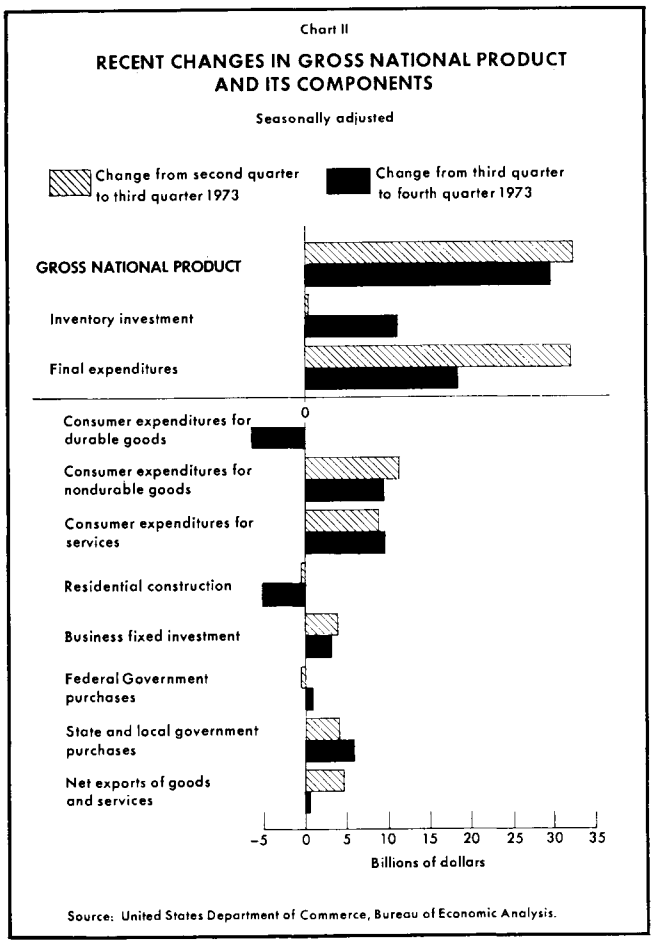
average increase of $19.1 billion per quarter over the year ended in June. When stripped of the sharp price increases, the recent sluggishness of consumer spending emerges even more clearly, showing an actual decline in the fourth quarter at a 2.6 percent annual rate. This was the first decline since the final quarter of 1970, when the recession and a lengthy strike at General Motors had combined to produce an even larger drop.

Current-dollar spending on consumer durables, which had shown a very sizable increase in the first quarter of 1973 and had remained essentially flat for the next six months, declined in the fourth quarter by $6 billion. Expenditures on passenger cars plummeted $7.1 billion (see table), a decline comparable in both current dollar and real terms to the drop that occurred during the auto strike of three years ago. Although some slowing in the pace of new car sales was widely anticipated well in advance of the launching of the 1974 models, the magnitude of the decline has surpassed most expectations. The Arab oil embargo and accompanying uncertainties as to the availability and cost of gasoline have taken their toll on the auto industry. They have not only weakened the demand for new cars beyond the amount of slippage that might otherwise have occurred, but have also precipitated a strong shift toward smaller vehicles. However, parts shortages and capacity limitations have constrained the production of smaller cars both at home and abroad and lengthened delivery times. Consequently, sales of new passenger cars—domestic types and imports combined—dropped from the record annual rate of 12.6 million units reached this past March to a seasonally adjusted annual rate of 9.6 million units in December. In January, sales of new domestic cars, which had been at a seasonally adjusted annual rate of 7.9 million units in December, slipped to 7.7 million units. This compares with a fourth-quarter average of 8.4 million, and a peak rate of over 10 million reached during the first quarter of the year.

Spending on nondurable goods also weakened during the fourth quarter, with real outlays showing a decline. Although current-dollar outlays for both food and gasoline rose appreciably in the face of rapid price increases, real consumption fell in both categories. The decline was especially acute with respect to gasoline and motor oil. Expenditures for services, on the other hand, continued quite strong—both before and after adjustment for price increases.

Business fixed investment advanced by a comparatively modest $3.1 billion. This was somewhat slower than in the preceding two quarters and only about half as fast as the rapid growth during the final quarter of 1972 and the opening quarter of 1973. During October-December, business purchases of passenger cars dropped by $1.2 billion to the slowest pace in almost two years (see "producers' durable equipment" in the table). The petroleum outlook, including its implications for the resale price of larger-size cars, was at least partly responsible for this decline.



The important role of automotive developments in the evolution of fourth-quarter GNP is summarized in the table. These data show those portions of GNP that arise from expenditures on passenger cars. They comprise consumer spending on passenger cars, the part of business fixed investment that takes the form of passenger car purchases by business, and the portion of the change in business inventories that is accounted for by dealer holdings of cars. The difference between auto exports and auto imports (the latter including passenger cars assembled in Canada for sale in the United States) also enters into the calculation of gross auto product.

As the table shows, following the big drop in auto pro-

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duction during the General Motors strike near the end of 1970 and the sizable rebound immediately thereafter, auto product remained virtually flat through the first half of 1972. This was followed by a period of dramatic growth, with real auto product rising at an annual rate of more than 32 percent over the three quarters ended March 1973. This compared with a rise of less than 8 percent in total real GNP (see last line of table) over the same period. Thus, the increase in gross auto product accounted for fully 20 percent of the increase in real GNP. As 1973 wore on, however, gross auto product began to decline, contributing significantly to the slowing in overall economic activity. During the middle two quarters of the year, auto product growth was restrained by the fact that the industry was operating at or close to maximum capacity, and the third quarter was additionally plagued by a variety of supply problems. The fourth-quarter decline, as indicated above, was clearly related to the weakening in demand for the larger new cars. Although a sharp rise in dealers' inventories offset much of this decline in final demand, it is unlikely that this will continue, given the substantial downward adjustment of domestic auto production that is currently under way.

The demand for fixed investment goods as a whole still appears quite strong. The latest Commerce Department survey, which was conducted during November and December—after the announcement of the Arab oil embargo—indicated that businessmen are planning to increase their capital spending 12 percent above 1973 levels. Of course, when adjusted for anticipated price changes, the implied increase is substantially less. Nonetheless, it is interesting that the planned rise showed no significant decrease from projections made on the basis of information gathered somewhat before the oil embargo was instituted—namely, 12 percent in the Lionel D. Edie survey and 14 percent in the McGraw-Hill survey. However, many of these intentions are still tentative and may involve no firm commitment on the part of business firms.

Residential construction spending during October-December dropped $5 billion. This had been foreshadowed by monthly data showing a decline in private housing starts, which moved down from an average in the first quarter of 1973 of 2.4 million units, seasonally adjusted annual rate, to 1.6 million in the final quarter. The high cost and limited availability of mortgage financing have played an important role in reducing the volume of housing activity. However, other forces have also contributed to the decline. Some slowing was inevitable from the fever-

GROSS AUTO PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rates

Groups	1970		1971				1972				1973			
	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
	In billions of current dollars													
Gross auto product	**34.2**	**22.5**	**42.4**	**40.1**	**42.4**	**38.8**	**40.1**	**42.1**	**46.5**	**45.6**	**51.5**	**51.2**	**49.6**	**45.7**
Personal consumption expenditures	29.7	23.4	34.3	34.3	37.1	35.9	36.6	38.1	41.8	41.2	45.1	44.6	44.5	37.4
Producers' durable equipment	5.2	4.1	6.1	6.1	6.5	6.3	6.5	6.7	7.4	7.3	8.0	7.9	7.8	6.6
Change in dealers' auto inventories	0.3	—3.3	4.0	1.6	1.2	—1.2	—0.4	—0.4	—0.8	—0.4	0.9	1.2	—0.5	4.5
Net exports	—1.5	—2.1	—2.3	—2.3	—2.9	—2.8	—2.9	—2.8	—2.3	—2.9	—2.8	—2.9	—2.7	—3.3
	In billions of 1958 dollars													
Gross auto product	**31.6**	**20.0**	**37.1**	**34.8**	**37.8**	**35.8**	**36.1**	**37.7**	**41.0**	**41.4**	**46.4**	**45.5**	**43.6**	**40.6**
Addendum:														
Gross national product	**726.8**	**718.0**	**731.9**	**737.9**	**742.5**	**754.5**	**768.0**	**785.6**	**796.7**	**812.3**	**829.3**	**834.3**	**841.3**	**844.1**

Note: The gross auto product totals include government purchases, which amounted to $1¼ billion annually during the periods shown. Because of rounding, figures do not necessarily add to totals.
Source: United States Department of Commerce, Bureau of Economic Analysis.

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ish and unsustainable pace hit during 1972 and early last year. In addition, rapid increases in housing prices have probably reduced demand somewhat below where it might otherwise be. More recently, the restricted availability and increased cost of gasoline and other fuels, as well as the general uncertainties associated with the Arab oil embargo, have probably been further factors dampening housing activity. On the other hand, recent Government steps, such as that providing for expanded use of the "tandem plan", could favorably affect the near-term outlook for housing. The tandem plan allows the Government National Mortgage Association to purchase at below market interest rates up to $6.6 billion in unsubsidized Federal Housing Administration and Veterans Administration mortgages.

Spending by state and local governments rose $5.8 billion during the fourth quarter, up from the $4.7 billion growth averaged during the earlier quarters of the year. Federal spending increased $1 billion, compared with the decline of $0.4 billion in the previous quarter and the large gain of $2.3 billion averaged during the first half of the year. A Federal pay raise that took effect on October 1 led to a $1.7 billion increase in fourth-quarter Federal expenditures on wages and salaries. Excluding the pay raise, nondefense spending was up $0.7 billion and defense spending was down $1.5 billion. However, defense spending was reduced $2.5 billion by the sale of arms to Israel out of Government stocks, and net exports were raised by the same amount. Excluding both the pay raise and the arms shipment, defense spending was up $1 billion.

PRICE DEVELOPMENTS

Prices took a decided turn for the worse during the fourth quarter. According to preliminary data, the implicit GNP deflator rose at a 7.9 percent annual rate, almost a full point above that recorded in the previous quarter. For the entire year, the deflator climbed 7 percent. This was more than twice the rate of increase experienced during 1972, 1½ percentage points faster than the 1969-70 period of rapid price inflation, and the strongest spurt since the Korean war.

Partly as a result of numerous changes in the price controls program, the month-to-month behavior of wholesale prices has been exceedingly erratic. On balance, the movement has been very sharply upward. Seasonally adjusted prices of farm products, processed foods, and feeds rose at a 17 percent annual rate in December, following the astronomical leap of 232 percent, annual rate, in August and large declines in each of the next three months. By December, this component had risen 27 percent above year-ago levels. The fuel and power component of the wholesale price index soared in the final three months of the year, rising at a 157 percent annual rate after climbing at a 25 percent rate during the first nine months of the year and 6 percent during 1972. Even excluding the two foregoing index components, wholesale prices have risen extremely rapidly—at a 12.3 percent rate during the last three months of 1973, compared with an 8 percent rate during the first nine months of 1973 and a total of 3½ percent in 1972.

Consumer price increases "slowed" to a seasonally adjusted annual rate of 6½ percent in December, compared with the 9½ to 10 percent range of the October and November advances. For the entire year, prices soared 8.8 percent, more than twice as fast as during 1972 and the highest annual burst in a quarter century. Food price increases tapered off sharply during the final quarter of the year, compared with the advance during January-September; in those first nine months prices soared at a 23 percent rate, and in the last three months rose at a 9 percent rate. This deceleration, however, was dwarfed by the explosion of energy prices that accompanied the Arab embargo on petroleum shipments to the United States. Prices for consumer power and fuel, i.e., gasoline, home-heating oil, and gas and electricity, which have a total weight of about 6½ percent in the consumer price index, rose at over 40 percent, annual rate, in the final three months of 1973, compared with a rise of about 8 percent, annual rate, during the first three quarters of the year.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate a substantial intensification of inflationary pressures during the fourth quarter, with wages rising rapidly and productivity registering an outright decline. Hourly compensation in the private economy increased at a seasonally adjusted annual rate of 8 percent, bringing the rise over the entire year to a very substantial 8.2 percent. The 1973 increase in this broad measure of wage and fringe benefits was a full point higher than the advance in 1972, and the largest since 1968. However, because of the very rapid advance in the consumer price index, real private compensation declined for the third consecutive quarter. This erosion is almost certain to put added pressure on wage demands during 1974.

Productivity, as measured by output per hour of work in the private economy, fell at an annual rate of 1.3 percent in the October-December period. Over the preceding two quarters, productivity growth had been essentially unchanged after having risen very rapidly during the previous twelve months or so. The combination of rising hourly

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compensation and declining productivity caused private sector unit labor costs to soar 9.3 percent in the fourth quarter, the largest increase since 1969. For the entire year, unit labor costs rose 7.2 percent or nearly three times the 2.7 percent rise averaged over 1972.

According to the Bureau of Labor Statistics survey of major collective bargaining agreements, contracts negotiated during 1973 provided, on average, first-year wage increases of 5.8 percent and life-of-contract gains of 5.2 percent. However, for wages and fringe benefits combined, first-year settlements averaged 7.1 percent and life-of-contract gains came to 6.1 percent. Moreover, the growth in compensation that will finally emerge under many of these contracts will undoubtedly be larger, since the Labor Department data do not include payments made under escalator-clause provisions that are contingent on movements in the consumer price index. Forty percent of the workers under major contracts concluded in 1973 were covered by cost-of-living escalator clauses.

A very heavy collective bargaining schedule is unfolding for 1974. During the year, 5.2 million workers, representing about half the working population covered by major collective bargaining agreements, will be involved in negotiations. Bargaining activity will be concentrated in the steel, canning, aluminum, construction, communications, electrical machinery, aerospace, longshore, railroad, and mining industries. More than a million additional workers come under contracts that, although not scheduled for negotiations this year, could be reopened in the event of a "national emergency".

The unemployment rate registered its third consecutive monthly increase in January, according to the household survey, rising to 5.2 percent on a seasonally adjusted basis. This compared with the 3½-year low of 4.6 percent reached this past October and the 4.8 percent level registered in December. A sharp January rise of 370,000 in the number of unemployed persons was the net result of a very large growth of more than 500,000 persons in the size of the civilian labor force and a very small increase of 142,000 persons in the volume of employment as measured by the household survey. Although month-to-month changes in the size of the labor force tend to be quite volatile, the growth in the labor force has, on balance, been rather vigorous. Over the year ended January, the civilian labor force increased by 3.5 million persons or close to 4 percent.

The January payroll survey recorded a second straight monthly decline in the number of persons employed by nonagricultural establishments. Seasonally adjusted payroll employment dropped by 260,000 persons to about the level reached this past October, with the decline concentrated in construction and manufacturing. At the same time, the average workweek for production and nonsupervisory workers dropped sharply. The abrupt decline of 0.8 hours brought the seasonally adjusted factory workweek to 39.9 hours, its lowest level in slightly more than two years.

Although the household and payroll surveys tend to give rather comparable employment readings over long-enough time spans, they often diverge on a month-to-month basis for a variety of reasons, including coverage, sampling techniques, and seasonal adjustments. A substantial portion of the January discrepancy between the household and payroll survey measures of employment is removed when the two surveys are examined from the vantage point of more comparable coverage. If the 150,000-person increase in agricultural employment is excluded, the January household survey shows a small employment decline.

Taken together, the direct and indirect effects of the Arab oil embargo have undoubtedly accounted for a considerable part of the January rise in unemployment, but it is impossible to tell how much. About half of the large January decline of 125,000 persons in manufacturing employment was centered in transportation equipment, where sizable layoffs have occurred among workers producing passenger automobiles. Although the evidence is preliminary, Labor Department analysts feel that actual or anticipated fuel shortages have been responsible for reducing employment in a variety of other areas also, such as gasoline stations, air transportation, automobile selling, and hotels and motels.

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Monetary and Financial Developments in the Fourth Quarter

During the fourth quarter of 1973, growth in the money supply measures accelerated substantially. The narrowly defined money supply (M_1)—as recently revised to reflect new bench-mark data for nonmember bank deposits—expanded at a seasonally adjusted annual rate of 7.5 percent, after showing virtually no change in the third quarter. The more broadly defined money supply (M_2) also rose more rapidly than in the previous quarter, although the time deposit component advanced at only a slightly faster pace. The outstanding volume of large negotiable certificates of deposit (CDs) fell appreciably, on balance, over the quarter. Consequently, growth in the bank credit proxy was much lower than the gains experienced in the first three quarters of the year.

Total bank credit advanced very slowly over the October-December period as loan demand, particularly from businesses, slackened. The weak demand for business loans stemmed, in part, from a shift of corporate borrowings to open market instruments, especially commercial paper. This, in turn, reflected a lagged response to the sharp declines in late September in short-term interest rates relative to banks' prime lending rates. During the fourth quarter, most short-term interest rates fluctuated over a broad range but showed no discernible trend. In contrast, movements in intermediate-term and long-term interest rates were mild. New corporate bond offerings, however, were significantly higher in the fourth quarter than in the first nine months of the year, and new issue activity is increasing further in the early months of 1974.

Following a three-month period of restrained growth, deposits at thrift institutions increased at a moderate rate in the fourth quarter. Deposit inflows were stimulated by the sharp September declines in rates on several competitive market instruments as well as by changes in regulations which allowed these institutions to increase their issuance of long-term consumer-type certificates of deposit.

THE MONETARY AGGREGATES

M_1—private demand deposits adjusted plus currency outside commercial banks—advanced in the fourth quarter at a seasonally adjusted annual rate of 7.5 percent, following a decline of 0.2 percent in the preceding three-month period (see Chart I). Some of the fourth-quarter gain can be explained by policy actions taken during the early part of the period that were designed to step up the growth in the money stock to a moderate pace. The strenghtening of the dollar in foreign exchange markets contributed to the advance, since it led to higher foreign central bank balances at the Federal Reserve Banks and expanded foreign bank demand deposit holdings at commercial banks. An increase in precautionary demand for cash balances, stimulated by uncertainties concerning the energy situation and employment, may also have played a role.

For 1973 as a whole, M_1 is now estimated to have grown by 5.7 percent, compared with an increase of 8.7 percent in 1972. These data reflect the latest annual revisions of the money stock figures, which boosted the growth in M_1 over what was previously reported by 0.4 percentage point in 1972 and 0.7 percentage point in 1973. The revisions included the annual reestimates of seasonal adjustment factors and also incorporated data from new monthly reports filed by internationally oriented banking institutions. The principal changes, however, resulted from upward adjustments of the estimates of demand deposits at nonmember domestic banks. Because deposits at such institutions are not available on a current basis, they are estimated initially from data for "country" member banks. Estimates are adjusted annually to incorporate figures reported by nonmember banks on call dates. In the current revision, nonmember domestic bank estimates were "benchmarked" to the March and October 1973 call reports in addition to the usual June and December calls. This was the first year since the early 1960's that call report data appropriate for money supply bench marks were available for the spring and fall call dates. The Board of Governors of the Federal Reserve System noted that the current revisions incorporating the largest nonmember bench-mark adjustments in the history of the series point up the serious need for more timely and more complete nonmember bank data.

M_2—defined as M_1 plus time deposits other than large CDs—expanded in the fourth quarter at a seasonally adjusted annual rate of 10.1 percent, substantially higher

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than the 5.2 percent rate of increase experienced in the previous quarter. The acceleration was primarily attributable to the sharp rise in currency and demand deposits; the time deposit component advanced at only a slightly faster pace than in the preceding three-month period. According to the revised data, M_2 is estimated to have increased 8.6 percent in 1973, up 0.7 percentage point from the figure previously reported. New bench-mark levels for nonmember banks led to upward revisions of the time deposit component similar in magnitude to the corresponding adjustments of the demand deposit component.

Contrary to the behavior of the money supply measures, the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—rose at a relatively slow pace in the fourth quarter. After adjustments for seasonal variations, the proxy grew at an annual rate of only 3.3 percent. For the year as a whole, however, it increased 10.6 percent, 1 percentage point below the growth experienced in 1972.

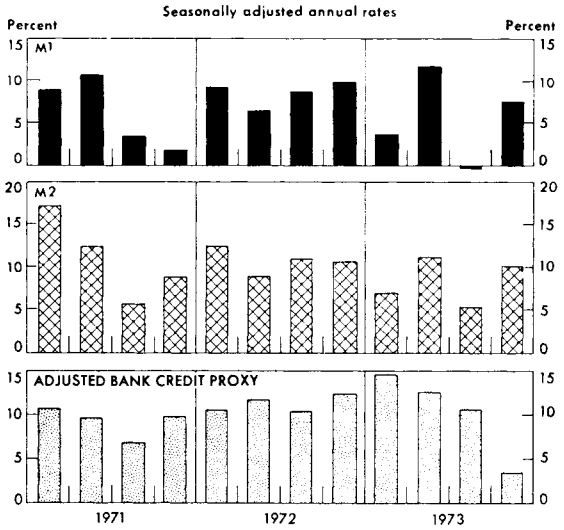
The slow growth of the proxy during the fourth quarter reflected primarily a sharp decline in CDs. Earlier in the year, CDs had risen very rapidly as banks aggressively sought funds to finance a strong demand for business loans. During the fourth quarter, however, business loan demand was weak and banks tempered their CD sales efforts. Moreover, CDs had become an increasingly expensive source of bank funds. Effective early in June, the Board of Governors had imposed a supplemental reserve requirement of 3 percent, in addition to the existing 5 percent requirement, on CDs and certain other bank liabilities above their mid-May base levels, and subsequently had raised the new requirement an additional 3 percentage points effective mid-September. These moves were intended to help curb the rapid expansion of bank credit. During the fourth quarter, the growth of bank credit turned very sluggish and, effective December 13, the supplemental reserve requirement was lowered back to 3 percent.

Reserves available to support private nonbank deposits (RPD) grew very slowly in the fourth quarter in conformity with the behavior of the credit proxy. After adjustments for normal seasonal variations and the effects of changes in reserve requirements, the annual rate of increase amounted to only 1.4 percent. The volume of borrowed reserves declined by $563 million over the quarter, as the Federal Reserve supplied nonborrowed reserves more readily in relation to deposit growth.

Chart I

GROWTH IN MONETARY AGGREGATES

Seasonally adjusted annual rates



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.

BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

The rate of growth in total bank credit fell sharply during the October-December period. When adjusted for net loan sales to affiliates, bank credit increased at only a 4.4 percent seasonally adjusted annual rate, compared with a 15.2 percent annual rate in the first nine months of the year. Banks continued to make only modest additions to their securities holdings. Total loans, however, which had expanded rapidly during the first nine months of 1973, advanced at the slowest rate in three years. Virtually all the major loan components registered somewhat smaller gains, or larger declines, than earlier in the year, but business loans were particularly sluggish.

During the first three quarters of 1973, business loans had increased very rapidly (see Chart II). In part, this reflected strong demands for funds brought on by the heady economic expansion and the acceleration in the rate of inflation. To some extent, however, the increase represented merely a redirection of business borrowings to banks from other credit sources, particularly the commercial paper market. Interest rates on commercial paper rose sharply from January through August, along with other short-term market rates. However, because banks were restricted by the Committee on Interest and Dividends

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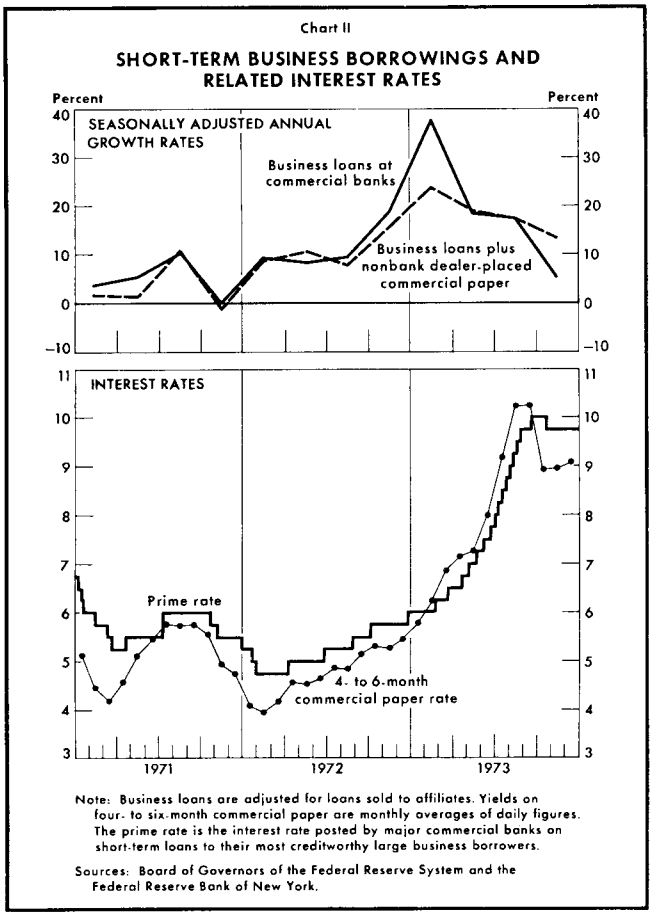

from raising their lending rates to large business borrowers too rapidly, the prime rate did not keep pace. For example, the rate on four- to six-month prime dealer-placed commercial paper averaged about 30 basis points above the prime rate during the February-August period (see Chart II). This contrasted with the usual relationship during recent years when the commercial paper rate had averaged about 50 basis points below the prime rate. Consequently, the volume of nonbank dealer-placed commercial paper fell by $3.9 billion over the first quarter, and then remained essentially flat through August. Meanwhile, the volume of business loans at commercial banks surged, spurting during the first quarter and continuing to rise rapidly for the next five months. Over the January-August period as a whole, business loans adjusted for loan sales to affiliates rose at a seasonally adjusted annual rate of 28.7 percent.

In September, credit markets began to ease. Late that month, rates on commercial paper started to fall, moving below the prime rate for the first time since February. In mid-October, most major banks reduced their prime lending rates from 10 percent to 9¾ percent, retaining that rate for the remainder of the quarter, although several boosted their rates back to 10 percent early in December. Over most of the period from late September through December, the more usual relationship between the prime rate and commercial paper rate prevailed, and corporations returned to the commercial paper market to finance their short-term borrowing needs. Reflecting these developments, the volume of commercial paper rose $4.6 billion from the end of August to the end of November. In December, however, there was a small decline, presumably indicating that most of the switch back to commercial paper had been completed in the prior month. During these last four months of the year, business loans at commercial banks increased at a seasonally adjusted annual rate of only 4.6 percent.

Several other major loan components of bank credit, including consumer loans and real estate loans, also grew less rapidly in the fourth quarter than earlier in the year. Securities loans fell sharply, continuing the trend set in the preceding three quarters. Decreased loans to brokers, reflecting the rundown in their margin stock accounts, undoubtedly played a major part in the year-long slump in securities loans. Total margin credit to customers, which is financed in part by bank loans to brokers, declined about 30 percent in 1973. In recognition of the sharp reduction in stock market credit, the Board of Governors lowered its margin requirements for purchasing or carrying stocks from 65 percent to 50 percent, effective January 3, 1974.

Most short-term interest rates moved irregularly over the fourth quarter, after falling dramatically in the last half of September. The Federal funds rate, however, declined about 75 basis points to 10 percent in mid-October, and then hovered around that level for the remainder of the period (see Chart III). Intermediate-term and long-term interest rates fluctuated in a very narrow range throughout the quarter, despite a sharp increase in new bond offerings. In the corporate market, public and private placements, seasonally adjusted, totaled $7.1 billion, considerably above the January-September quarterly average of $5.1 billion. New corporate bond issues in January amounted to one of the largest monthly totals in nearly three years, and the calendar of issues scheduled for February is about as heavy. State and local government bond issues also increased in the fourth quarter of 1973, to $6.2 billion, seasonally adjusted, up from an average volume of $5.6 billion during the first three quarters. Federal agency offerings, on the other hand, declined slightly over the quarter, reflecting the improved financial position of thrift

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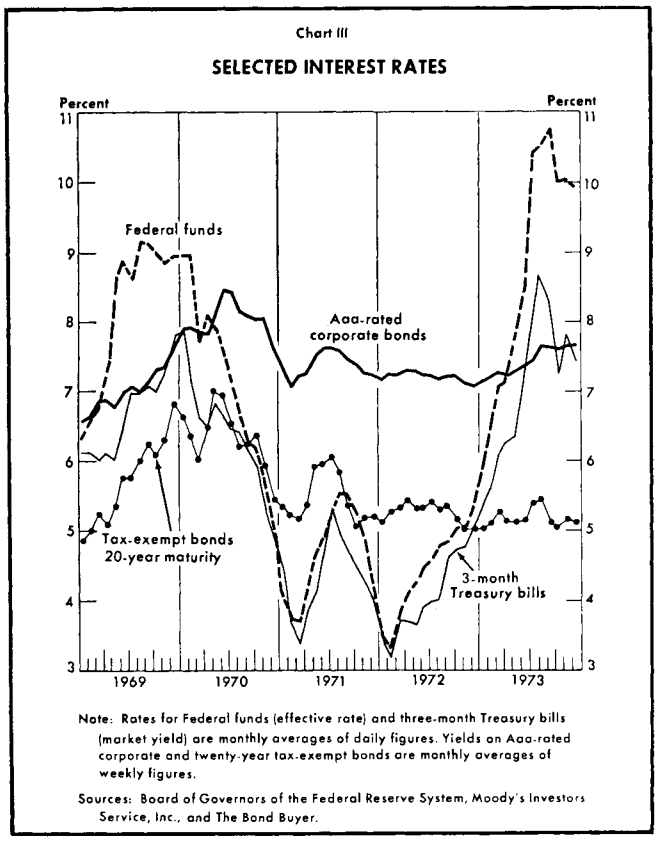


Note: Rates for Federal funds (effective rate) and three-month Treasury bills (market yield) are monthly averages of daily figures. Yields on Aaa-rated corporate and twenty-year tax-exempt bonds are monthly averages of weekly figures.

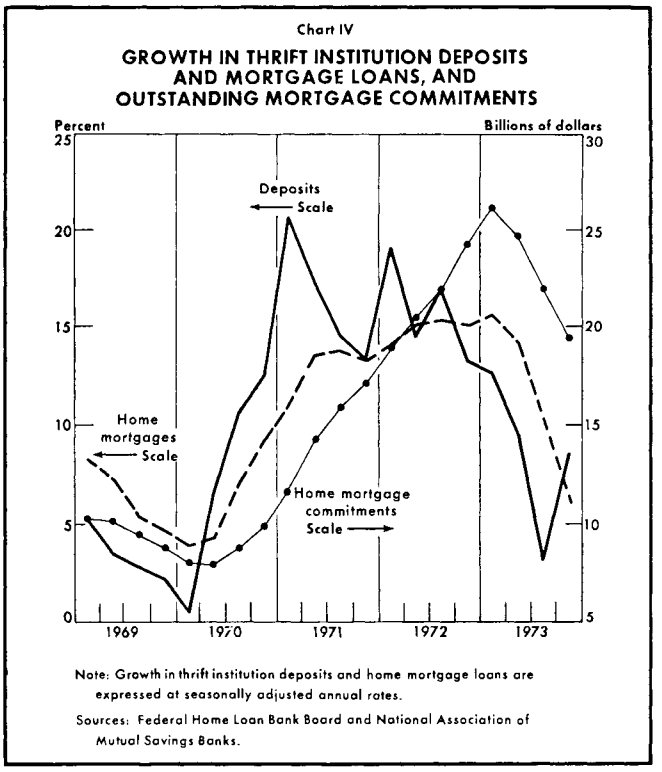
Sources: Board of Governors of the Federal Reserve System, Moody's Investors Service, Inc., and The Bond Buyer.

institutions. Nevertheless, the $5.9 billion total of new Federal agency issues was about $2½ billion greater than in the final quarter of 1972.

THRIFT INSTITUTIONS

Deposit flows into thrift institutions showed a marked recovery in the fourth quarter of 1973 (see Chart IV). Combined deposits at savings and loan associations and mutual savings banks advanced at a seasonally adjusted annual rate of 8 percent, following a gain of only 3 percent during the preceding three-month period. The increased thrift deposit inflows reflected, in part, a delayed response to the declines in late September in interest rates on competing market instruments, particularly Treasury bills. Moreover, thrift institutions benefited from changes in the regulations on consumer-type certificates of deposit with maturities of four years or more. The previous modification of regulations in July 1973, which had permitted the introduction of no-interest-rate-ceiling "wild card" deposits by banks and thrift institutions, had resulted in intense competition. The situation became acute in September when many thrift institutions—particularly mutual savings banks—reached the legal limits on the amounts of these deposits that they could offer (5 percent of total deposit liabilities at insured commercial banks, savings banks, and savings and loan associations, with an additional 5 percent allowed at savings and loan associations for certificates issued by September 7 and subsequently renewed). New regulations, effective November 1, removed all restrictions on the volume of these consumer-type certificates that may be issued and imposed interest rate ceilings on such certificates of 7.50 percent for thrift institutions and 7.25 percent for commercial banks.

Reflecting the improved performance of deposit flows in the fourth quarter, thrift institutions increased their liquid asset holdings and sharply reduced their rate of borrowing. Net Federal Home Loan Bank Board advances to savings and loan associations, for example, rose $841 million during the October-December period as compared with an increase of about $3 billion in the preceding quarter. The growth in mortgages held by thrift institutions, however, as well as commitments by these institutions to make new mortgage loans, continued to slacken.



Note: Growth in thrift institution deposits and home mortgage loans are expressed at seasonally adjusted annual rates.

Sources: Federal Home Loan Bank Board and National Association of Mutual Savings Banks.

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The Money and Bond Markets in January

A rally late in January pushed most interest rates down sharply from their midmonth levels. Treasury bill rates had backed up earlier in the month in response to a heavy volume of sales by foreign central banks. However, when the Federal funds market showed signs of easing in the final week of January, this was interpreted by participants as indicative of a less restrictive monetary policy and touched off the rally. Rates on money market instruments had begun to move downward early in the month, and the declines accelerated in the wake of the rally. By the end of the month, rates on commercial paper were as much as a full percentage point lower while other rates posted more modest declines. In addition, toward the end of the month, most major commercial banks reduced their prime lending rate to large borrowers by ¼ percentage point to 9½ percent.

End-of-the-month declines in yields on Treasury coupon issues were more modest than those on bills, and most rates closed above their levels at the end of December. The rising yields in the United States Government securities market resulted from a number of factors. The selling of foreign holdings occurred because of the strength of the dollar relative to certain other currencies and the consequent attempt of foreign central banks to support these currencies. Dealers were also concerned with the high cost of financing inventories in view of the relatively weak investor demand and prospects of additional supplies that would be forthcoming from the Treasury's February refunding. The termination on January 29 of United States restrictions on foreign investments by United States residents contributed to an improved tone in the securities market at the close, since the move was expected to reduce some of the pressure on foreign currencies.

Faced with the largest monthly calendar in two and one-half years, the corporate bond market posted rates on new issues in January at the highest levels since last summer. The yield on new Aaa-rated utility bonds, as measured by the Board of Governors of the Federal Reserve System, climbed to 8.27 percent from the 7.98 percent registered late in December, before declining to 8.13 percent at the close of January. (On one utility issue the yield dropped back to 7.98 percent.) Rates on municipal bonds also rose, as dealers began the period with heavy inventories and the prospects of a sizable supply of new issues.

Preliminary data indicate that the narrow money supply (M_1)—private demand deposits adjusted plus currency outside banks—declined on average for the four weeks ended January 23, following a large increase during the preceding four-week period. There was further expansion both in M_2, which includes time and savings deposits other than large negotiable certificates of deposit (CDs), and in the adjusted bank credit proxy, which consists of daily average member bank deposits subject to reserve requirements plus certain nondeposit liabilities.

On January 25, the Board of Governors of the Federal Reserve System sent to the Congress draft legislation to implement its recommendations for uniform reserve requirements. The proposals were drawn in such a way as to achieve more precision in monetary control and more equity in competition without altering the diversified banking and financial structure that now serves the country. The basic underlying principle is that equivalent cash reserve requirements should apply to all deposits that effectively serve as a part of the public's money balances, regardless of the type of institution in which the balances are held. Thus, there would be reserve requirements against demand deposits at nonmember commercial banks and at foreign-owned banking institutions located in the United States as well as against those interest-bearing deposits at savings and loan associations and mutual savings banks from which withdrawals by negotiable instrument are permitted in some states. The proposal would provide a four-year transition period and no reserves would be required against the first $2 million of deposits.

BANK RESERVES AND THE MONEY MARKET

Interest rates on most money market instruments declined in January and by larger amounts than had occurred in the preceding month (see chart). All categories of dealer-placed commercial paper registered decreases;

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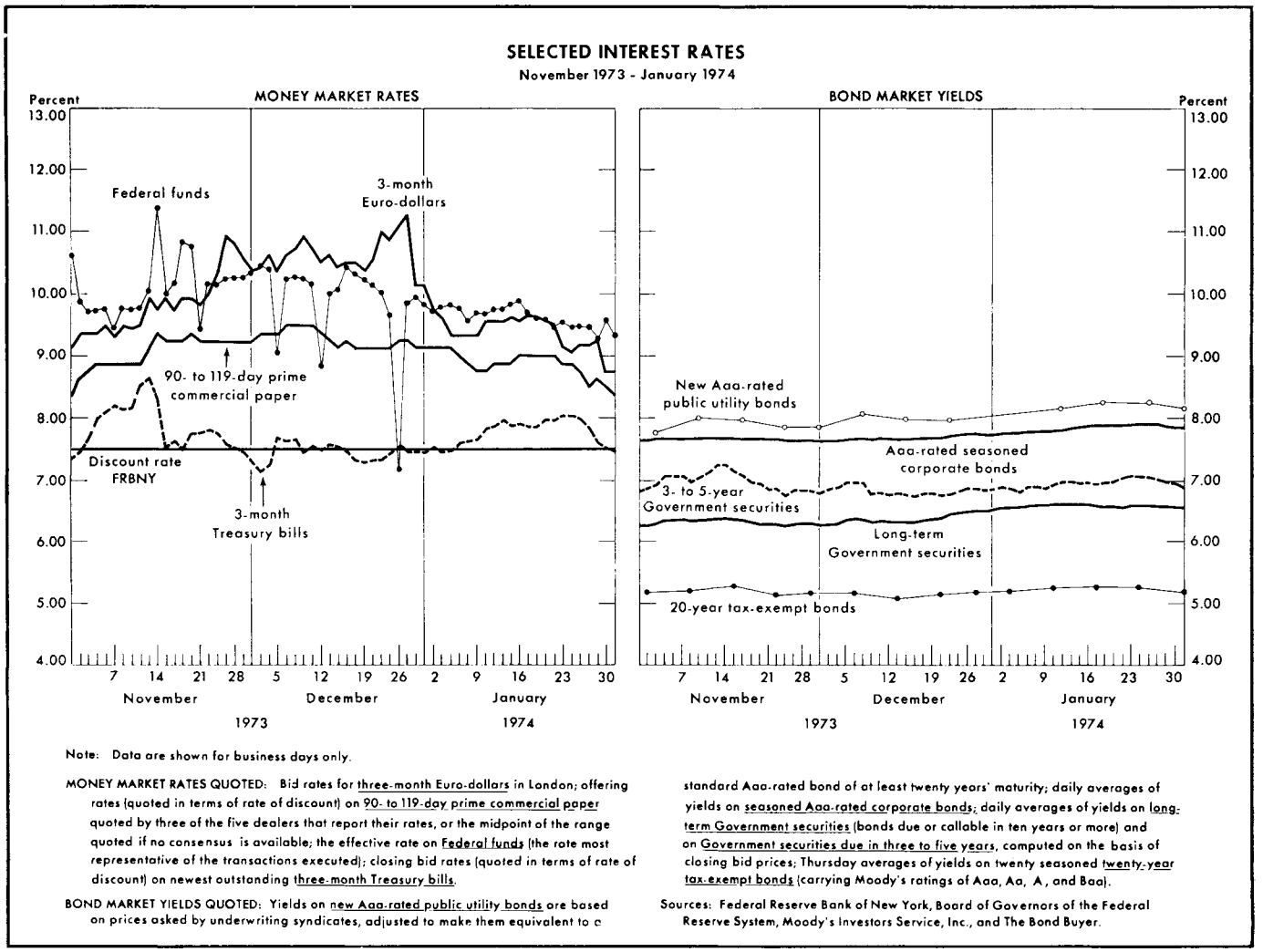

Note: Data are shown for business days only.

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 five 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 Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa-rated bond of at least twenty years' maturity; 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, Inc., and The Bond Buyer.

these ranged from ¾ percentage point on paper maturing in ninety days or more to 1 percentage point on paper due in less than ninety days. Bid rates on bankers' acceptances were lowered by ⅜ percentage point. The effective rate on Federal funds averaged 9.65 percent in January, 30 basis points less than in December when the rate also fell. For the fifth consecutive month, member banks reduced their reliance on the discount window. Consequently, the average level of borrowings fell $251 million in January to $1,076 million (see Table I).

The secondary market yield on large negotiable CDs also moved lower in January. The rate on CDs of three months' maturity closed the month at 8.87 percent, down 36 basis points over the period. At the same time, the volume of CDs outstanding increased by about $2.5 billion in this, the first month following the reduction in the marginal reserve requirement on large CDs and certain other commercial bank liabilities.* The reduction had been made in recognition of the slowing of bank credit growth during October and November, a pattern which had continued in December. In line with the deceleration of credit growth and the decline in short-term rates, several commercial banks reduced their prime lending rate ¼ per-

* For details concerning this change in reserve requirements, see this *Review* (January 1974), pages 7-8.

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centage point to 9½ percent effective late in January.

Following the pattern of the last several years, M_1 appears to have been weak in January after rapid growth in December. Preliminary data indicate a decline in seasonally adjusted M_1 for the four weeks ended January 23. (The money supply series have been revised to reflect bench-mark adjustments for nonmember banks and new seasonal adjustment factors.) From its average for the four weeks ended thirteen weeks earlier to its average for the four weeks ended January 23, M_1 rose at a seasonally adjusted annual rate of 5.1 percent. The increase from the average for the four weeks ended fifty-two weeks earlier was also at a 5.1 percent rate.

The growth of commercial bank time and savings deposits other than large CDs remained strong in January, and as a result the advance in the broad money supply (M_2) slowed very little from its December pace. M_2 expanded at an 8.5 percent annual rate between its four-week average thirteen weeks earlier and its average for the four weeks ended January 23.

The adjusted bank credit proxy grew strongly during the four weeks ended January 23, continuing the pickup which had begun in December. The rise in the proxy during this most recent period was at a seasonally adjusted annual rate of 6 percent, compared with the four-week average ended thirteen weeks earlier. Substantial growth in CDs, as well as in other time and savings deposits, and a large increase in United States Government deposits were the major factors in the proxy's expansion following two months of contraction. Reserves available to support private nonbank deposits also increased in January, though more moderately than their average growth in 1973.

THE GOVERNMENT SECURITIES MARKET

Rates on Treasury bills were pushed steadily higher during the first half of January, when this sector of the market experienced heavy sales by foreign central banks. Investor demand was modest, and Government securities dealers were generally reluctant to incur the high cost of financing inventories in the absence of signs of a Federal Reserve move to a less restrictive monetary policy. Rates began to drift lower in the third week, and sentiment improved dramatically as the month closed. A decline in the Federal funds rate during the final week was interpreted as a sign of a relaxed policy stance, and rates fell sharply. By the end of the month, shorter rates were only a touch above their end-of-December levels while rates on bills maturing in more than three months were 6 to 24 basis points lower on balance.

Early in the period, the market had responded favor-

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JANUARY 1974

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

Factors	Changes in daily averages—week ended					Net changes
	Jan. 2	Jan. 9	Jan. 16	Jan. 23	Jan. 30	
"Market" factors						
Member bank required reserves	— 316	— 924	—1,129	+ 646	+ 800	— 923
Operating transactions (subtotal)	— 741	+ 983	+1,418	— 859	—1,330	— 529
Federal Reserve float	— 723	+ 202	— 674	— 418	—1,028	—2,641
Treasury operations*	— 27	— 73	+ 161	— 162	— 741	— 842
Gold and foreign account	+ 200	— 213	+ 226	— 80	— 96	+ 37
Currency outside banks	+ 4	+ 571	+1,786	— 94	+ 571	+2,838
Other Federal Reserve liabilities and capital	— 196	+ 496	— 81	— 105	— 37	+ 77
Total "market" factors	—1,057	+ 59	+ 289	— 213	— 530	—1,452
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 705	— 23	— 158	— 458	+ 803	+ 869
Outright holdings:						
Treasury securities	+ 879	+ 428	+ 21	— 486	+ 498	+1,340
Bankers' acceptances	+ 9	— 4	— 1	—	+ 3	+ 7
Federal agency obligations	+ 117	+ 5	— 2	— 2	+ 13	+ 131
Repurchase agreements:						
Treasury securities	— 195	— 338	— 95	+ 28	+ 226	— 374
Bankers' acceptances	— 68	— 48	— 39	— 5	+ 21	— 139
Federal agency obligations	— 37	— 66	— 42	+ 7	+ 42	— 96
Member bank borrowings	+ 172	— 434	+ 213	+193	+ 39	+ 183
Seasonal borrowings†	— 4	— 12	+ 1	— 7	+ 4	— 18
Other Federal Reserve assets‡	+ 92	+ 7	— 21	+ 62	+ 58	+ 198
Total	+ 969	— 449	+ 34	— 202	+ 900	+1,252
Excess reserves‡	— 88	— 390	+ 323	— 415	+ 370	— 200

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	35,656	36,190	37,642	36,581	36,151	36,444
Required reserves	35,268	36,192	37,321	36,675	35,875	36,266
Excess reserves	388	— 2	321	— 94	276	178
Total borrowings	1,210	776	989	1,182	1,221	1,076
Seasonal borrowings†	31	19	20	13	17	20
Nonborrowed reserves	34,446	35,414	36,653	35,399	34,930	35,368
Net carry-over, excess or deficit (—)‖	229	152	64	171	— 31	117

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Average for five weeks ended January 30, 1974.
‖ Not reflected in data above.

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ably to a move by several major banks to reduce the prime rate to 9¾ percent. However, in the cautious atmosphere that prevailed at that time, the improvement was short-lived. When rates approached the 8 percent level around midmonth, some participants felt investors would be attracted, and bidding at the regular auction on January 14 was stronger than anticipated. Investor demand did emerge and rates moved lower over the rest of the week. At the auction on January 21, bidding was once again strong; the rate on the new six-month bill was down 5 basis points from the week before, while the three-month bill was only 1 basis point higher (see Table II). Sales by the Federal Reserve for customer accounts depressed the market soon after that, but a firm tone developed during the final week of January in response to the additional ¼ percentage point reduction in the prime rate to 9½ percent by most major banks. When the Federal Reserve executed repurchase agreements shortly before the weekly auction on January 28, bill rates plummeted and the average issuing rates were down about ¼ percentage point from the previous week's auction rates. The removal of restrictions on investments abroad helped buoy sentiment causing rates to continue falling over the final days of the month.

Yields on Treasury coupon issues also rose over the first half of January, and the rate on long-term securities held steady at that level during the rest of the period. The rate on three- to five-year issues, however, continued its increase over the next week, and then declined. For the month as a whole, the rate on intermediate-term issues rose 7 basis points and that on long-term issues 5 basis points.

The coupon market was also influenced by many of the factors which operated in the bill market during the first half of the month. In addition, there was concern over continued inflation and the dim prospects for sustained long-term rate declines. In the face of relatively limited demand, dealers became increasingly anxious about the addition to supply that would result from the Treasury's February refunding, and a cautious tone prevailed as participants awaited the Treasury's January 30 announcement. At the beginning of the final week, the coupon market reacted favorably to the reductions in short-term rates and a firmer tone developed despite the impending Treasury sale.

In its February refunding, the Treasury will provide funds for retiring the $4.5 billion of publicly held notes and bonds maturing on February 15 by auctioning three issues to the public. These consist of up to $2¼ billion of 3¼-year notes, up to $1½ billion of seven-year notes, and up to $300 million of 19½-year bonds. The last is an addition to an issue of 7½ percent bonds initially offered last August. Coupon rates on the 3¼- and seven-year notes were set at 6⅞ percent and 7 percent, respectively. Market reaction to the terms of the refunding was generally quite favorable.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—January 1974			
	Jan. 7	Jan. 14	Jan. 21	Jan. 28
Three-month	7.615	7.983	7.995	7.778
Six-month	7.560	7.867	7.819	7.516
	Monthly auction dates—November 1973-January 1974			
	Nov. 14	Dec. 12	Jan. 9	
Fifty-two weeks	7.708	6.881	6.948	

* 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.

Yields on Federal agency securities also increased on balance. There were large offerings by each of the three major farm agencies during January. The first of these was a two-part sale by the Federal Land Banks that included $360 million of thirty-month bonds yielding 7.05 percent and $300 million of five-year bonds yielding 7.10 percent. Later in the month the Banks for Cooperatives and the Federal Intermediate Credit Banks also marketed two bond issues, both of which were priced at par. The former consisted of $556 million of 8.15 percent bonds due August 1, 1974, while the latter comprised $753.5 million of 8 percent bonds maturing November 4, 1974. All of these issues were well received.

OTHER SECURITIES MARKETS

Yields on corporate and municipal securities moved somewhat higher during January, when more than $3 billion in new securities was marketed. The corporate calendar of more than $2 billion represented the heaviest monthly volume in two and one-half years. In view of the large supply, investors were quite selective and rates moved steadily higher until late in the month, when they declined.

At the start of the month, prior to the marketing of any new offerings, syndicates were terminated on the unsold portions of several recent corporate issues, resulting in

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upward yield adjustments of as much as 21 basis points. Investors gave a rather cool reception to the year's first large new issue, $75 million of power company bonds offered on January 7. Utility bonds were in plentiful supply, and several offerings had recently encountered investor resistance. On the following day, however, investors responded with strong interest to two attractively priced offerings. The larger of these issues, $100 million of Singer Company A-rated debentures, was almost completely sold by the close of the first day, a result of its 8.1 percent yield and the relative scarcity of new industrial bonds. Although the smaller issue was again a utility issue (Oklahoma Gas and Electric Company), it was priced to yield 8¼ percent, the highest return on Aa-rated utility bonds in about six months, and sold rapidly.

Investor response to new offerings of bonds from industrial corporations remained favorable throughout the month. Shortly after the Singer Company sale, two other industrial issues totaling $150 million were successfully marketed in one day. The largest offering of the month, a $160 million package from Ford Motor Company on January 16, was also in good demand. This negotiated package included $100 million of six-year notes and $60 million of twenty-year debentures, yielding 7.40 percent and 7.85 percent, respectively. Investor response to new utility bonds, on the other hand, remained, as at the beginning of the month, quite mixed. The year's first Bell System issue, $100 million of Aaa-rated Wisconsin Telephone Company bonds priced to yield 8.05 percent, was given a good reception, and a $125 million Aa-rated offering by the Florida Power and Light Company was a first-day sellout on January 17 at a yield of 8.44 percent. Several other large issues, however, met with investor resistance, and one syndicate disbanded after two days. In addition to attractiveness of price, a factor cited by some observers in determining the reception to new utility issues was the impact that investors thought possible fuel shortages would have on the companies selling the bonds. At the close of the month, two issues—one of industrial debentures and the other of utility bonds—were successfully marketed at yields just under 8 percent.

While the January calendar of new state and local government bonds was somewhat smaller than the corporate calendar, dealers began the month with heavy inventories, and rates moved higher in this market as well. The Bond Buyer index of yields on twenty tax-exempt bonds climbed 10 basis points over the first three and one-half weeks to 5.26 percent and then eased back to 5.20 percent on January 31 for a net gain of 4 basis points over the month. The largest issue sold during the month was $349.1 million of New York City bonds, the city's first offering since being restored to an A rating by both bond-rating houses. The city was able to sell the bonds at an average interest cost several basis points below The Bond Buyer index, in contrast to its previous sale when the average cost was higher than the index. The bonds, which are exempt from New York City, New York State, and Federal taxes, were well received, with a balance of only $25 million remaining after the first day. Another large offering during the month was a $302 million package of New Jersey Sports and Exposition Authority Baa-rated bonds. This consisted of $218.2 million of term bonds yielding 7.5 percent and $83.8 million of serial bonds with rates from 5¼ percent to 7 percent. The term bonds sold well, but the others moved more slowly. By the end of the month, dealers had made some progress in reducing their inventories and the Blue List of stocks on hand had declined $97 million to $1,034 million.

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