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Open Market Operations in 1973

Editor's Note: *The following is adapted from a report submitted to the Federal Open Market Committee by Alan R. Holmes, Senior Vice President of the Federal Reserve Bank of New York and Manager of the System Open Market Account. Sheila Tschinkel, Manager, Securities Department, was primarily responsible for preparation of the report.*

The Federal Reserve implemented an active policy of restraint during 1973 to counter the powerful resurgence of inflationary pressures in the economy. The System moved forcefully to limit monetary growth through the conduct of open market operations and through several regulatory changes, bringing short-term rates of interest to unprecedented levels by the summer. The Federal Open Market Committee (FOMC) continued to express its policy intent in terms of quantitative objectives for the deposit and reserve aggregates, although these targets were frequently qualified by concern for domestic financial markets and the international financial situation. The M_1 definition of the money supply—demand deposits and currency in the hands of the public—remained the central focus of policy formulation and implementation. The Committee lowered its longer run objective for M_1 a number of times during the year in response to the acceleration of demands on the limited capacity of the economy.

The Committee's quantitative objectives for the aggregates continued to be framed with a view to the long-range economic outlook. They are changed relatively infrequently, and reflect the leverage the Committee seeks to exert on underlying economic forces. The FOMC's operational instructions to the Manager convey the thrust of its policy intent and specify a response to emerging patterns of monetary growth. In 1973, the Committee continued its practice of using two-month tolerance ranges[1] for the deposit and reserve aggregates to generate modifications in the Manager's weekly nonborrowed reserve targets. The tolerance range for growth in reserves to support private deposits (RPD) was designed to foster the desired growth of M_1 and M_2—M_1 plus time and savings deposits other than large negotiable certificates of deposit (CDs.) In practice, the relation between RPD and these two aggregates often proved hard to predict, leading to somewhat more emphasis on the underlying behavior of the aggregates themselves.

The Committee's instructions to the Manager involved (1) specifying his response to incoming information on the aggregates and (2) specifying a range within which the Federal funds rate was allowed to move in the period between meetings. When the aggregates were strong relative to their prescribed ranges, the Manager was to restrain nonborrowed reserves so that the Federal funds rate would rise, and conversely when the aggregates were weak. Unduly sharp fluctuations in money market conditions were to be avoided.

The Committee's operational strategy, as implemented by the Manager, initiates a series of reactions in the banking system and in the financial markets. Market participants' assessments of the economic outlook interact with anticipations of monetary policy's likely response to these prospects. Participants have developed a heightened awareness of the System's use of quantitative targets in recent years. They seek to anticipate System-engineered changes in reserve availability and in the Federal funds rate in making trading decisions and portfolio adjustments. These expectations and reactions, together with the institutional setting and underlying economic forces, act as major determinants of monetary and credit flows.

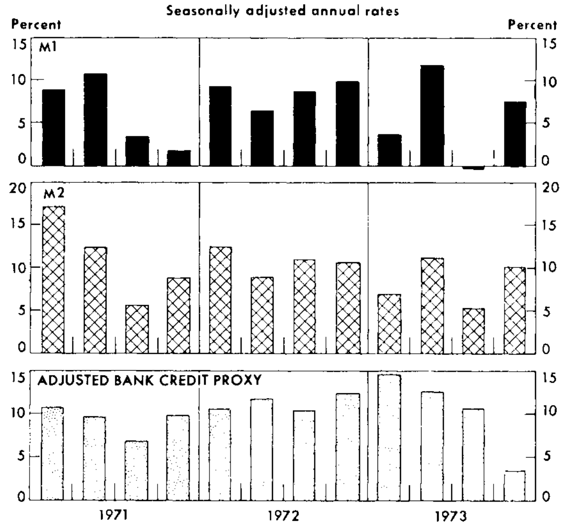
The interplay between the various factors in the monetary process rarely results in smooth growth of the aggregates. In 1973, the narrow money supply (M_1)

[1] Alan R. Holmes, "Open Market Operations in 1972", *Federal Reserve Bulletin* (June 1973), pages 405-16.

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.

increased by 5.7 percent (see Chart I).[2] While this reflects a moderation from growth in 1972, the quarterly changes were remarkably diverse and often not indicative of underlying economic trends. M_2 expanded at an 8.6 percent rate. The slower growth compared with the previous year was mainly related to the deceleration in M_1; an upward revision of Regulation Q ceilings in early summer and a temporary suspension of the interest rate constraint on four-year or longer time deposits in denominations of more than $1,000 sustained the inflow of such deposits at commercial banks.

Of far greater import for both the pattern of interest rates and credit flows was the absence of interest rate ceilings on large CDs during a period of monetary stringency. Demands on the banking system were bolstered during part of the year by the feverish speculative activity in the foreign exchange markets and shifts of borrowers out of the commercial paper market. The adjusted credit proxy, a more inclusive measure of member bank deposit liabilities, registered a 10.6 percent gain as banks accommodated enormous loan demands over the first two thirds of the year. Partly for this reason, RPD increased by 9.2 percent over the year, well above the growth in M_1. Total loans and investments at all commercial banks rose by 12.6 percent, just a bit below the 14.6 percent expansion in 1972 (see Chart II).

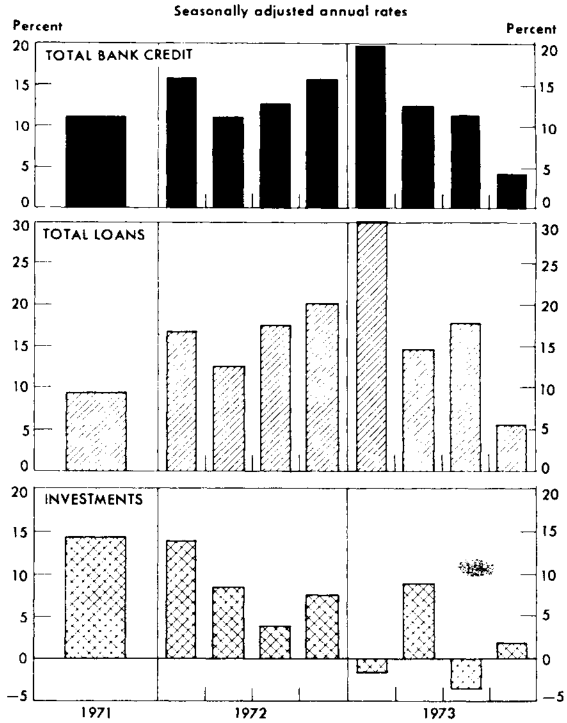
1973—AN OVERVIEW

THE FOMC'S POLICY OVER THE YEAR. In setting its long-run goals for the aggregates, the Committee initially sought to offset the overly rapid monetary expansion of 1972. The surge in spending and the bleak outlook for prices encouraged it to emphasize monetary restraint. At its March meeting, the FOMC lowered its longer run objective for

Chart II

CHANGES IN BANK CREDIT

Seasonally adjusted annual rates



Source: Board of Governors of the Federal Reserve System.

[2] The data on the aggregates in this introductory section reflect the annual revision of the series published in early 1974. The data used subsequently in describing operations during the year are those available at the time.

growth in M_1, and it retained an objective of moderate growth over the remainder of the year.

The Committee's reaction to deviations in money supply growth from the longer run path was influenced by its consideration of shifts in the underlying economic situation. Given continuing indications of a booming economy and the strength shown by the broad measures of the aggregates, it avoided a significant easing of money market conditions after M_1 decelerated in the first quarter. In the spring, the FOMC moved promptly to resist the renewal of rapid monetary growth, which brought expansion in M_1 to an unexpectedly strong 11.9 percent growth rate in the second quarter from 3.8 percent in the first. The Committee resisted accommodating the cumulation of bank demands for reserves in the spring and summer by permitting the Federal funds rate to rise more rapidly and even further than originally contemplated at its meetings. It maintained this posture and accepted an emerging shortfall of M_1 growth toward the end of the summer as inflationary pressures persisted.

The Committee began to temper its approach as the cumulative impact of increasing restraint, including sharply higher interest rates, was expected to keep monetary growth weak. It appeared toward the end of the third quarter that the "no growth" quarter just ended would be followed by further sluggishness in the final quarter. The staff suggested that delays in responding to this weakness could require increasingly sharp short-run adjustments to return M_1 to a longer run path of moderate expansion. The Committee's desire to get back on this moderate growth path was also a response to signs that expansion in real output would slow slightly in the fourth quarter and slacken further in the first half of 1974. Concern that the Mideast oil embargo would significantly worsen these prospects mounted as the year drew to a close. At the same time, growth in the money stock rebounded to a 7.5 percent rate in the final quarter of the year and the Committee moved cautiously in light of these contrary forces.

THE FOMC'S OPERATIONAL INSTRUCTIONS TO THE MANAGER OVER THE YEAR. The FOMC stipulated explicit responses to the behavior of the aggregates during the year, underscoring its basic policy intent by adjusting its tolerance ranges for RPD and the aggregates. At its first three meetings of the year and again in June, the Committee reduced the lower ends of the ranges suggested by the staff as consistent with longer run objectives. In this way, the FOMC indicated its tolerance of relatively slow growth in the near term and forestalled the possibility of a reduction in the prevailing restraint on bank reserve growth. In August, the Committee reduced the entire suggested range for RPD to indicate its concern over the rapid pace at which this measure had expanded in previous months. Thereafter, given indications of rather weak money supply growth in the months ahead, the FOMC generally raised the upper ends of the tolerance ranges by modest amounts. This increased the potential for some easing of reserve pressures, an intention that the Committee made explicit at its final meeting of the year.

In its instructions to the Manager, the Committee usually indicated that potential divergence between growth in RPD and the deposit measures be resolved to reflect the higher priority given to the latter, particularly M_1. In the event, a number of factors weakened the correlation between these measures during the year. Since RPD incorporates a weighting of the different types of private deposits by their respective percentage reserve requirements, it is particularly sensitive to changes in the composition of deposits and to bank liability management. RPD growth was stimulated relative to M_1 over the first two thirds of the year by the rapid rise in CDs which, in turn, reflected the sharp rise in bank loans and the suspension of Regulation Q ceilings in mid-May. The System acted to curtail bank credit and monetary expansion by raising reserve requirements on most demand deposits in early July. It imposed marginal reserve requirements on large CDs to take effect in June and increased them in September, before reducing them to their initial level in early December. However, the momentum of bank credit expansion was strong and this increase in reserve ratios bolstered RPD growth in the summer. When monetary expansion subsequently decelerated, RPD growth slowed. The regulatory amendments were thus a further source of variation in the reserve-deposit multiplier over the year, adding to the fluctuations which typically arose from shifts in the distribution of deposits among the different categories of member banks and changes in bank holdings of excess reserves. In view of the FOMC's concern with attaining its objectives for the deposit measures, the Manager found RPD of lesser importance in the determination of his response to the emerging patterns of monetary growth.

THE MANAGER'S IMPLEMENTATION OF THE FOMC'S INSTRUCTIONS. Open market operations in the first three months of the year increased the pressure on bank reserves and money market conditions in a continuation of the response to overly rapid money supply growth in late 1972. In establishing weekly targets for nonborrowed reserves, the Manager was mindful of the Committee's desire to see an orderly movement in the Federal funds rate. The Federal funds rate rose to 7 percent by mid-March, an increase of about 150 basis points from the start of the year. The Trading Desk acted to reduce nonborrowed reserve targets in relation to reserve requirements during this period. Member bank use of the discount window climbed by \$800 million to \$1.9 billion, on average, from December to March. For a time, in March and early April, the aggregates, and M_1 in particular, began to weaken relative to their tolerance ranges, leading to a pause in the move toward restraint.

Shortly after the April FOMC meeting, growth in the deposit measures appeared to be accelerating and open market operations brought additional pressure on bank reserve positions. Member bank borrowings changed relatively little, on average, but the Federal funds rate responded sharply.[3] The funds rate had reached 8½ percent by the end of June, when another wave of excessive monetary growth emerged and the Manager moved more aggressively to curtail the expansion of nonborrowed reserves. Enlarged bank demands for reserves, combined with some reluctance to increase use of the discount window, caused the Federal funds rate to rise abruptly to over 10 percent at the beginning of July, a larger increase than had been anticipated at the time. Actions to restrain the availability of nonborrowed reserves continued with little interruption over the summer, although the increase in the average Federal funds rate slowed somewhat, bringing it to 10½ percent during most of August and 10¾ percent near the end of that month. The aggregates moved down within their tolerance ranges by early September, and the Manager held his reserve objectives steady until after the September FOMC meeting. While average member bank borrowings rose by an additional \$300 million between June and August, it dropped back shortly after the beginning of September, leading to fairly persistent upward pressure on the Federal funds rate.

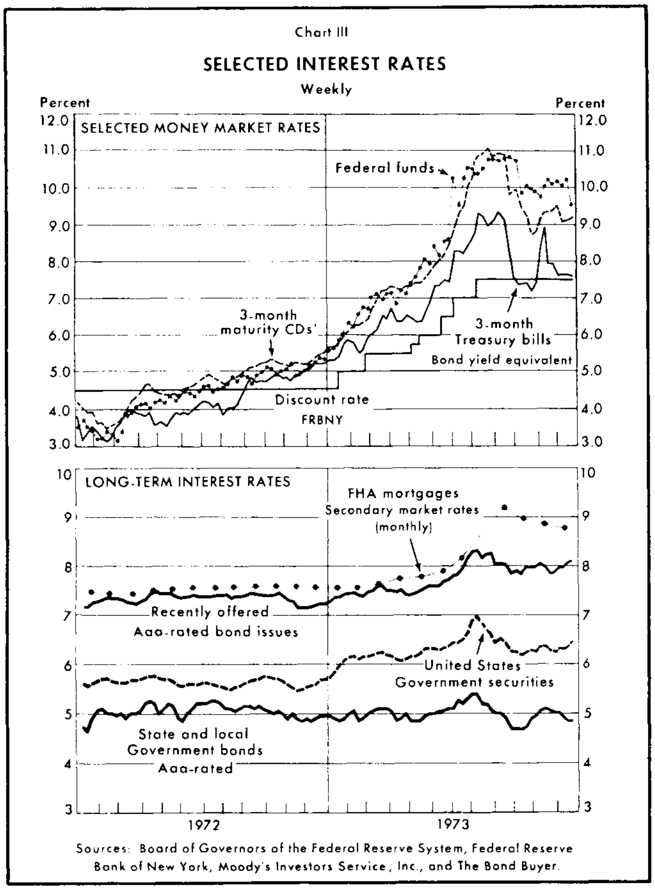
In response to the FOMC's instructions and weakness in the aggregates, the Manager adopted a more generous approach to the provision of nonborrowed reserves toward the end of September. The Desk provided reserves at a growing pace, and the Federal funds rate, after showing little tendency to decline, moved down to 10 percent in mid-October. The funds rate rose a bit above 10 percent in November as M_1 strengthened. But in December the FOMC again voted for more generous reserve provision, and the rate was just over 9½ percent at the year-end. While the decline in the Federal funds rate after September was rather modest, the Desk's increased provision of nonborrowed reserves enabled banks to reduce their borrowing to an average of \$1.3 billion in the last month of the year from the peak level of \$2.1 billion in August.

THE SECURITIES MARKETS OVER THE YEAR. The intensification of pressures on bank reserve positions in the early part of the year quickly spilled over into the short-term credit markets. Borrowers had strong inducement to switch from open market paper to taking down bank loan commitments as the rise in the bank prime rate was slowed by the activities of the Committee on Interest and Dividends (CID). To help finance loan demand, banks aggressively issued a large volume of CDs.

The rise in CD rates often outdistanced the Federal funds rate, and many banks were reportedly paying 11 percent for 60- to 89-day prime CDs over most of August and September, more than double the rates offered at the start of the year (see Chart III). Rates on longer CDs adjusted upward after the remaining applicable Regulation Q ceilings were suspended in May, although banks rarely showed inclination to commit themselves to pay high rates for long periods of time. The introduction of a dual prime rate structure in late April prompted a steady rise in the prime loan rate charged large businesses in the months that followed, bringing it to a record 10 percent by September. Commercial paper rates were also pushed higher, but activity in this market receded sharply over the first eight months of the year. Treasury bill rate increases were damped until June by demand from foreign central banks, which periodically depleted dealer inventories. Thereafter, bill rates rose sharply in response to the accelerated rise in the Federal funds rate. The rate on the three-month issue stood at 9.05 percent in mid-September, an increase of almost 4 percentage points from the beginning of the year. A series of increases in the Federal Reserve discount rate, which brought this rate to an unprecedented 7½ percent by mid-August, confirmed the shift to a higher rate structure.

Near the end of September, the Committee's adoption of a less reluctant approach to reserve provision was followed by a precipitous drop in short-term interest rates. Thereafter, rates fluctuated dramatically in response to conflicting economic developments and changing market assessments of the outlook for System policy. The initial

[3] In April, the Federal Reserve began to permit member banks with particularly heavy seasonal reserve outflows to borrow a portion of their reserve needs at the discount window. Since this borrowing privilege is prearranged, it is not included with regular borrowing in this report. Seasonal use of the discount window rose from \$5 million to \$163 million in August and then declined steadily to \$41 million in December.



declines were partly eroded by the year-end as the System's moves toward a less restrictive policy stance proved more measured than participants anticipated. Bank offering rates on large CDs fell to as low as 8½ percent for three-month maturities by the end of October, but they subsequently moved back to close the year at 9½ percent. Bank willingness to permit CDs to run off toward the end of the year, in anticipation of further interest rate declines, was facilitated by a shift of borrowers back to the use of commercial paper. Banks reduced the prime rate only marginally, and it thus remained above commercial paper rates in the last four months of 1973. Treasury bill rates became particularly volatile, reflecting sensitivity to developments in the foreign exchange markets as well as to domestic monetary influences. The bid rate on the three-month issue dropped by nearly 200 basis points between early September and early October. Thereafter it rose as high as 8.62 percent but closed the year at 7.45 percent.

The long-term debt markets were partly insulated from money market pressures, and yields never reached the levels observed in late 1969 and 1970. The funneling of business credit demands into the banks and sizable internal cash flows, aided by dividend restrictions, kept public offerings of corporate bonds at a modest $13.6 billion in 1973, down $5 billion from the previous year. Bond yields rose moderately through June and then climbed sharply, paralleling the escalation in short-term rates. Yields peaked for the year in early August and then fell sharply, as the view that monetary restraint had reached a plateau set off an anticipatory buying spree. The impact of the Mideast oil embargo on fuel costs and inflation worries generally had stronger impact on long-term bonds as the year drew to a close and yields rose again. The yield on recent Aaa-utility issues was at 8.10 percent near the end of December, around ⅞ percentage point higher than one year earlier. Trends in the municipal bond market were similar, but yields rose somewhat less toward the year-end as bank interest in tax-exempt securities reemerged. The Bond Buyer's municipal index rose only 5 basis points over 1973 to 5.16 percent. Government coupon yields generally moved in concert with corporate issues although some additional upward adjustments were related to the Treasury's refinancing of a relatively larger share of 1973 maturities in the long-term bond market. The Treasury's expanded use of long-term borrowing was part of an overall plan to increase the viability of the long-term Government market by increasing supplies. Over the year, an improvement in the tradability of such issues was apparent.

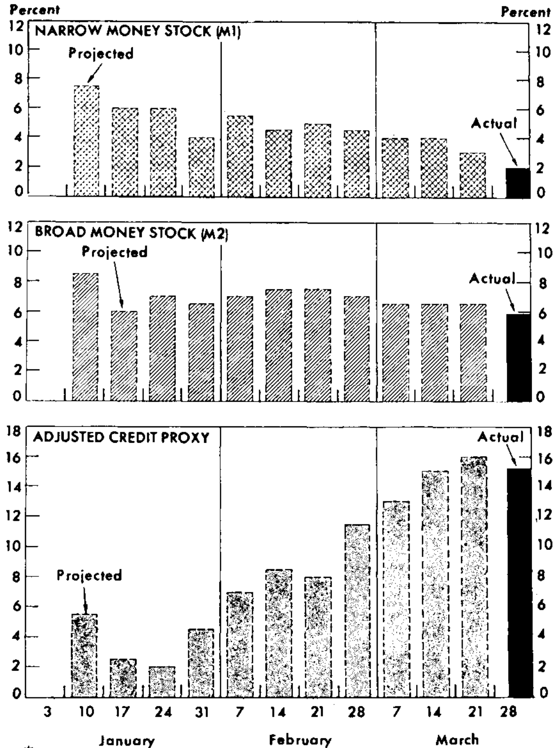
Treasury cash borrowing fell sharply from $15.3 billion to $7.7 billion during 1973, but sales of Federally sponsored agencies rose by over $10 billion to $14.4 billion. The housing-related agencies became particularly heavy borrowers as the climb in short-term rates eroded deposit flows at the thrift institutions. The steep rise in mortgage commitments from 1970 to early 1973 led to a continued expansion in mortgage lending over the first half of the year. Mortgage rates rose steadily during most of 1973, and rate limitations in a number of states, as well as a drop in thrift institution commitments, limited the growth in mortgage credit toward the end of the year.

JANUARY—MID-APRIL

THE COMMITTEE'S INSTRUCTIONS. At its first three meetings of the year, the Committee voted for slower growth in the aggregates over the months ahead than had occurred in the previous six months. When the Committee met on January 16, the staff's analysis indicated that it would take time for additional pressure on bank reserve positions

Chart IV

WEEKLY FORECASTS OF QUARTERLY GROWTH IN THE MONETARY AGGREGATES, 1973*



* As of two days after end-of-statement week shown.
Source: Board of Governors of the Federal Reserve System.

to reduce money supply growth from the excessive pace of late 1972. While it was expected that intensified reserve pressures would achieve the moderate expansion in M_1 desired over the months ahead, growth in the near term was expected to remain rapid in view of the accelerated pace of economic activity. The Committee chose tolerance ranges for M_1, M_2, and RPD that were at least as restrictive as the alternatives presented by the staff and reduced the lower ends of these ranges to indicate its willingness to accept substantially slower growth in the near term. The Committee agreed that open market operations should be directed at restraining reserve growth and anticipated that the Manager would achieve the attendant firming in the money market in advance of the Treasury's February refunding operation.

Money supply growth decelerated sharply in January, but the outlook presented at the February 13 meeting continued to indicate considerable growth in the aggregates over the months ahead. The FOMC again chose more restrictive two-month tolerance ranges for the aggregates than presented by the staff and anticipated that some additional firming of money market conditions would ensue. Estimates made soon after the meeting indicated that M_1 growth would remain strong while RPD was beginning to accelerate and moved above its specified range. In view of this, the Committee agreed on March 1 that the Federal funds rate should be permitted to rise somewhat further than had been contemplated earlier.

By the time of the March 19-20 FOMC meeting, growth in M_1 and M_2 had moderated, although RPD and credit proxy growth were well above levels previously indicated. In view of recent sharp price increases and evidence suggesting a continuation of overly rapid economic growth, the Committee reduced its longer run objective for M_1. While RPD growth was expected to remain rapid, the FOMC chose the lowest two-month ranges suggested for the money supply measures and reduced the bottom ends of the tolerance ranges for all measures. When M_1 and RPD growth decelerated even more because of weaker than expected expansion in private demand deposits, a majority of the Committee agreed, on April 11, to avoid an easing of money market conditions in the days before its April meeting.

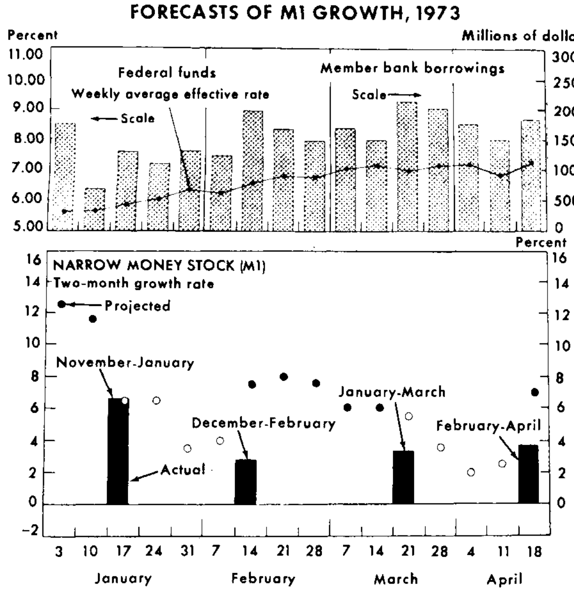
THE MANAGER'S RESPONSE. The Manager moved promptly after the January FOMC meeting to limit nonborrowed reserve availability. By the end of January, the Federal funds rate had risen to 6⅜ percent from 5⅞ percent two weeks earlier (see Chart V). Estimates of M_1 growth steadily moved lower, while RPD was within the range specified for the two months ended February, and the Desk acted to stabilize conditions in the money market during the refunding operation. The Desk adopted a more reluctant approach to reserve provision soon after the Committee's February meeting, when estimates of M_1 over February and March indicated that growth would remain strong while larger than anticipated time deposit expansion was adding to M_2. At the same time, extraordinarily large gains in negotiable CDs brought credit proxy growth well above earlier expectations and pushed RPD up to a 5 percent rate, well above the 2.5 percent top of the range specified for February and March combined. Accordingly, the Manager continued to hold back on the provision of nonborrowed reserves, anticipating that trading in Federal funds would average around 7 percent in the weeks leading up to the Committee's meeting in March.

The Manager initially continued with the same reserve strategy after the March meeting, expecting the Federal funds rate to remain around 7 percent. While record expansion in large CDs boosted credit proxy growth above earlier expectations, a weakness in demand deposits began to moderate growth in the money supply measures and in RPD. As a result, these measures began to move below their tolerance ranges toward the end of March. In response, Desk operations were directed at encouraging less money market tautness. While the Manager would have ordinarily continued with this shading of reserve objectives, the Committee decided on April 11 to avoid further modifications until the next meeting.

The Account Management encountered difficulty over much of this period in avoiding unduly sharp fluctuations in money market conditions. While member bank borrowings rose considerably, on average, they sometimes varied by as much as $700 million from week to week. Bank response to anticipations of further increases in the Federal funds rate caused them to build up excess reserves early in a statement week, bidding aggressively for Federal funds and using the discount window heavily over the weekend. Substantially easier money market conditions would then emerge when the hoarded reserves were pressed on the market. The Desk often adapted its operations to this pattern, supplying some reserves early in the week and, on occasion, withdrawing them at the end of the statement period.

Chart V

MONEY MARKET CONDITIONS AND WEEKLY FORECASTS OF M1 GROWTH, 1973



Note: Solid bars are actual growth rates for each two-month period and are placed at the time of FOMC meetings. Dots preceding each bar represent weekly projections of these growth rates.

THE SECURITIES MARKETS. Developments in the credit markets in the opening months of the year reflected awareness that the System would respond to the persistence of inflation and the strong pace of money supply growth, leading to higher interest rates. Market participants were quick to note the Desk's reluctance to supply reserves as the Federal funds rate rose above previous levels. Two ½ percentage point increases in the Federal Reserve discount rate, bringing it to 5½ percent by the beginning of March, underscored the System's intent.

The emergence of strong loan demand at banks, bolstered by the low level of the prime rate in relation to rising market rates, and the resulting pressures in the CD market also had an impact on the structure of rates. By mid-March rates paid by major banks on CDs maturing in up to 89 days had risen by around 150 basis points to 7⅛ percent and Regulation Q ceilings constrained the availability of funds with a longer maturity. Treasury bill rate increases were tempered by the strength of foreign central bank demand, but still rates on most issues rose by well over 100 basis points. The rate on the three-month issue reached 6.55 percent in early April but then moved back down to 6.19 percent when an easier climate emerged in the money market.

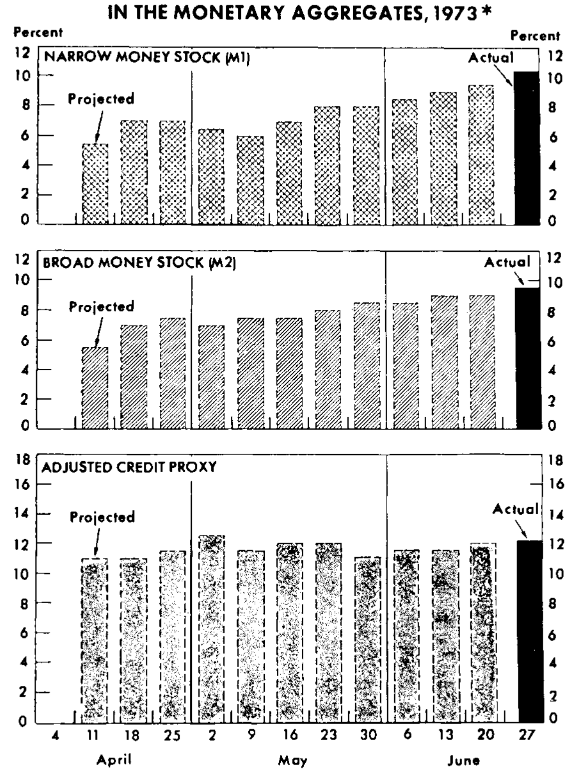
In the long-term debt markets, the pull of short-term interest rates and concern over inflation generated an upward adjustment in yields. But expectations of light corporate and Government borrowing demands kept the rise in yields to modest proportions in the first few months of the year. In its February refunding, the Treasury sold a 3½-year 6½ percent note priced to yield 6.60 percent and auctioned $1 billion of a 6¾-year 6⅝ percent note which was awarded at an average yield of 6.74 percent. Interest in the new issues was initially restrained as dealers were anxious about burdensome financing costs. However, demand from foreign central banks soon spilled over into the Treasury coupon sector, and the market improved in the weeks that followed.

Published data showing a deceleration in money supply growth over the first quarter began to outweigh evidence of continued rapid economic expansion in the formulation of interest rate expectations. The less-than-2 percent growth first reported in M_1 over the three months ended March, generated the view that the System could soon move to stimulate more rapid expansion. The stability of the funds rate around the 7 percent level was interpreted as an encouraging sign and when the Desk entered the market to make outright purchases of Treasury bills on April 6 when Federal funds were trading at 7⅛ percent—a rate previously thought to be acceptable—a major rally ensued in the securities markets.

The change in attitudes had the most impact on longer term securities amid dealer efforts to cover short positions. Expectations of continued modest calendars of bond offerings also helped yields retrace earlier increases. The yield on recently offered Aaa-utility issues was 7.47 percent in mid-April, around 20 basis points above its level at the start of the year. The Bond Buyer's index, at 5.07 percent, was around its early-January average and down 27 basis points from the level of one month earlier. At the same time, the confluence of business demands for short-term credit kept money market rates under some pressure. Rates on large CDs and commercial paper thus increased by another 25 to 35 basis points between the March and April meetings. The three-month Treasury bill rate rose but then fell back to 6.20 percent, while rates on longer issues began to experience modest declines.

Chart VI

WEEKLY FORECASTS OF QUARTERLY GROWTH IN THE MONETARY AGGREGATES, 1973*



* As of two days after end-of-statement week shown.

Source: Board of Governors of the Federal Reserve System.

MID-APRIL TO JUNE

THE COMMITTEE'S INSTRUCTIONS. At the Committee's April 17 meeting, demands for money were expected to strengthen in the near term, given the transactions needs of a booming economy. At the same time, the staff thought that the previous rise in interest rates would continue to limit money growth so that the reserve conditions consistent in the near term with the FOMC's longer run objective for M_1 could be achieved without further money market pressure. The broad money supply (M_2) and RPD were anticipated to slow, and the extraordinarily rapid bank credit expansion of previous months also seemed likely to taper off. Against this background, the Committee voted to seek moderate growth in the aggregates over the months ahead, anticipating that the two-month expansion rates indicated for the reserve and deposit measures would be associated with little change in the Federal funds rate.

In the months that followed, most aggregates measures exhibited excessive strength. The Committee voted in May to seek slower growth in the aggregates over the months ahead than had occurred in the previous half year. It responded to signs of further acceleration by raising the upper limit of its constraint on the Federal funds rate at its May meeting and twice in the weeks that followed.

THE MANAGER'S RESPONSE. The Manager moved almost immediately after the April FOMC meeting to adopt a more reluctant approach to reserve provision when it was projected that M_1 and M_2 growth over April and May would move above acceptable ranges. RPD growth, however, fell below its tolerance range, given a shift in the multiplier. The Desk was soon anticipating that the Federal funds rate would rise to around 7½ percent, compared with about 7 percent prevailing just prior to the meeting (see Chart VII). The success of the Treasury refunding in early May gave no cause for modifying this approach, although the Committee had provided for this possibility in its directive.

At its May 15 meeting, the Committee retained close to the same two-month acceptable range for M_1 but the range for RPD was lowered somewhat from the interval specified the month before, given recent experience and the expectation that higher interest rates would soon curb deposit growth. The upper limit placed on the Federal funds rate was raised.

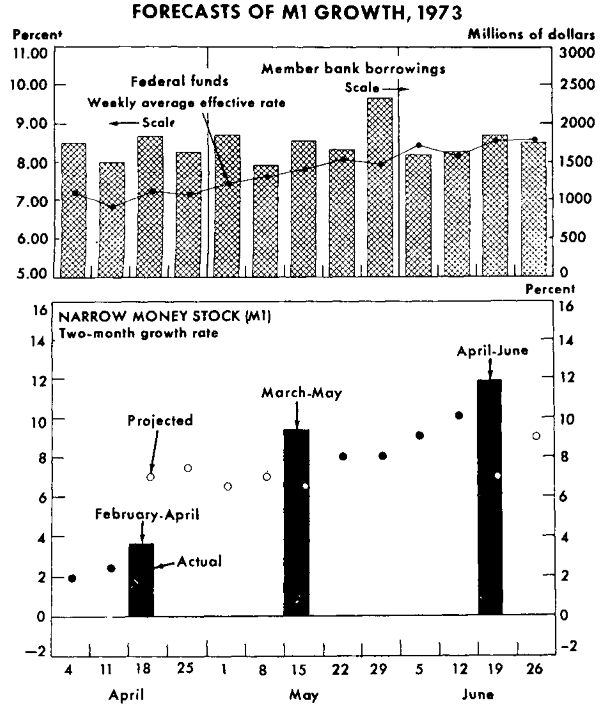
The Account Manager soon found himself pressing against the Federal funds rate constraint as projected M_1 growth accelerated to a 10 percent rate over May and June. The expansion in M_2 was well above acceptable growth, although shifts in the distribution of deposits worked to keep RPD just a bit above the 11 percent upper end of the range established for this measure. In view of these developments, the Committee decided on May 24 and again on June 8 to raise the upper limitation on the Federal funds rate. By the June 18 Committee meeting, the Manager was anticipating reserve conditions consistent with a funds rate of around 8½ percent.

The Manager's growing reluctance to supply nonborrowed reserves over the period starting with the April meeting became readily apparent in the money market. Member banks became less willing to increase borrowing much above the $1,850 million level reached in March. In this situation, and with deposit levels rising steadily, enlarged demands for reserves pushed the Federal funds rate progressively higher over the two months with little interruption.

THE SECURITIES MARKETS. The emergence of more rapid money supply growth during April quickly generated bond market expectations of increased monetary restraint. These were confirmed by the rise in the Federal funds rate and three rounds of increases in the Federal Reserve discount

Chart VII

MONEY MARKET CONDITIONS AND WEEKLY FORECASTS OF M1 GROWTH, 1973



rate, which brought the rate to 6½ percent at all Reserve Banks by June 15. Rates in the CD market, spurred by bank demands, led rate increases on other instruments, even though the cost of increasing such liabilities had been stepped up by the Board's action on May 16 to subject them to marginal reserve requirements, a move taken to brake the rapid expansion in bank loans. Although the outlook in the bill market had been improved by substantial Treasury redemptions of maturing issues, it was outweighed by the spreading impact of monetary restraint, and the rate on the three-month issue rose another 100 basis points to 7.20 percent by mid-June.

Interest rate expectations began to be affected in June by the belief that the pace of economic activity would soon begin to moderate. In fact, many observers began to suggest that a recession would emerge by the year-end and that the System would move to counter such a development. The response to the growing monetary stringency was thus tempered by some feeling that it could well turn out to be of fairly short duration. For a while, anticipations of stronger Administration wage-price control measures also convinced many that the need for prolonged monetary restraint would be reduced. Although the System had suspended the remaining Regulation Q ceilings on large CDs, as part of the broad regulatory package adopted on May 16, banks showed little interest in extending the maturity of these liabilities. Rates on longer term Treasury bills were still below 7 percent by mid-June and price declines in the long-term bond markets were moderate despite the further tightening of money market conditions.

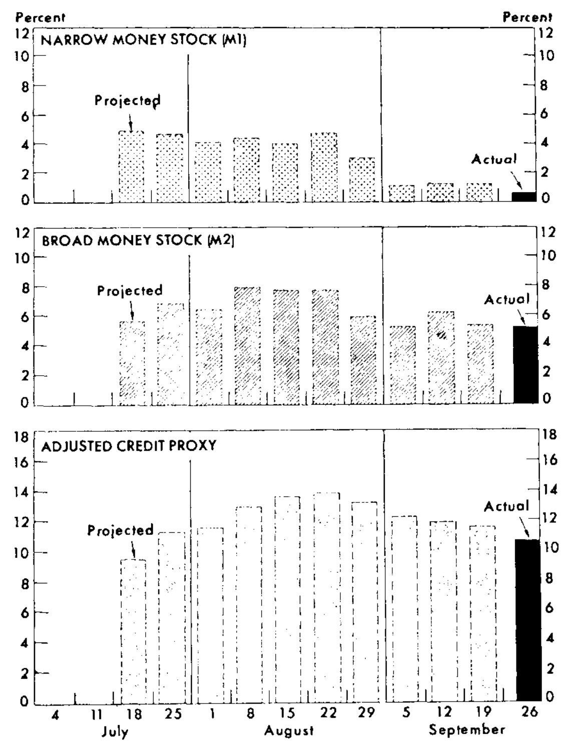
Yields on intermediate-term Treasury issues rose prior to the May refunding operation but declined afterward as dealers made good progress in distributing the new issues. The Treasury redeemed $1.65 billion of maturing issues for cash, auctioned $2 billion of 6⅞ percent seven-year notes at 7.01 percent, and $650 million of 7 percent 25-year bonds at 7.11 percent. The bonds were sold at the lowest accepted bid price, the second time that the Treasury had utilized this technique. (In early January, $625 million of a twenty-year bond had been sold at a price to yield 6.79 percent.) Subsequent yield increases were modest, as banks remained generally unwilling to reduce holdings of coupon issues. Over the two-month period ended in mid-June, the yield on United States Government securities maturing in ten years rose from around 6.70 percent to 6.90 percent. The returns on recently offered Aaa-rated corporate utility issues increased by a similar amount to around the 7.60 percent level reached in mid-March. Reflecting hopes that banks might again become more active participants in the tax-exempt market, the Bond Buyer's index, at 5.13 percent over the first two weeks of June, was essentially unchanged from its average in the first half of April. Mortgage yields continued to creep up, and the rates established in the biweekly Federal National Mortgage Association auction rose 15 basis points to 8.04 percent.

JULY—MID-SEPTEMBER

THE COMMITTEE'S INSTRUCTIONS. When the Committee met on June 18-19, money supply growth estimated for the second quarter was rapid. The Committee voted to seek somewhat slower growth in the aggregates over the months ahead and underscored the need for monetary restraint by adopting a range for M_1 growth in June and July with a midpoint that was below the expansion then projected. The ranges adopted for M_2 and RPD implied similar restraint. New estimates soon indicated another wave of excessive M_1 growth. On July 6, the Committee agreed to raise the upper constraint on the Federal funds rate from the limit adopted at the June meeting.

Chart VIII

WEEKLY FORECASTS OF QUARTERLY GROWTH IN THE MONETARY AGGREGATES, 1973*



*As of two days after end-of-statement week shown.

Source: Board of Governors of the Federal Reserve System.

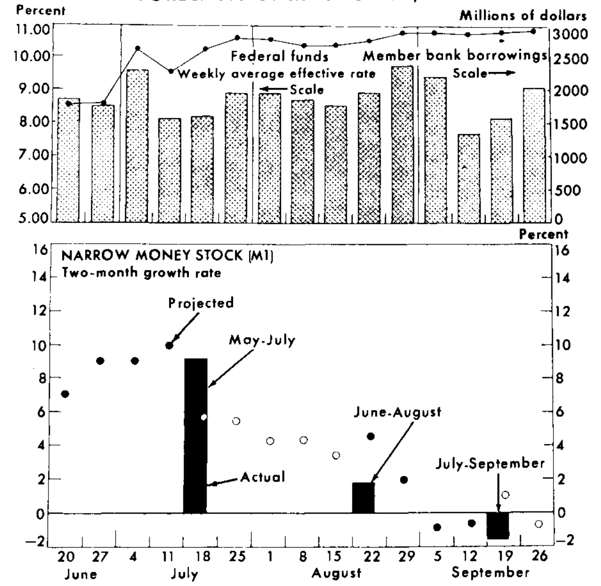
The FOMC was willing to see a further intensification of reserve pressures as the summer progressed. At its July 17 meeting, the Committee again voted for slower growth in the aggregates and raised the upper constraint on the Federal funds rate from the limit agreed upon earlier that month. The members agreed on August 3 that the funds rate could rise even further if necessary. By the time of the August 21 meeting it was expected that the prior rise in short-term rates would continue to limit money demand in the months ahead following a marked deceleration in July. The Committee became willing to accept slow growth for a while, especially because RPD showed no such tendency and even strengthened. At its August meeting, the Committee placed emphasis on bringing expansion in this measure below the range thought consistent with its near-term objectives for the money supply measures.

THE MANAGER'S RESPONSE. The System moved to adopt a substantially more restrictive posture at the end of June when incoming data showed more rapid than acceptable growth in the aggregates. It was expected that this shift in reserve strategy would raise the Federal funds rate to 9¼ percent from the 8½ percent average then prevailing, although a much larger increase developed. After the July 17 meeting, M_1 moved within an acceptable range, but M_2 and RPD continued to increase at overly rapid rates following enlarged inflows of time deposits to commercial banks. Actions to restrain the availability of nonborrowed reserves thus continued without interruption until early August, although the anticipated weekly rise in the Federal funds rate became more gradual. The weekly average Federal funds rate had risen to about 10½ percent by late July (see Chart IX). Subsequently, data indicated a further slowing in monetary growth and RPD moved within its specified range. The Desk sought no further intensification of pressures in the weeks leading up to the August 21 meeting. Shortly after this meeting, the Manager raised his sights for the Federal funds rate a shade in view of the emphasis placed by the Committee on limiting the rapid growth in RPD. A further deceleration of demand deposit growth helped bring RPD within its 11 to 13 percent range for August and September combined, and the Desk sought no additional pressure on bank reserve positions. The Federal funds rate stabilized at around 10¾ percent in the weeks leading up to the September 18 meeting.

The move toward further restraint initiated at the end

Chart IX

MONEY MARKET CONDITIONS AND WEEKLY FORECASTS OF M1 GROWTH, 1973



of June attracted widespread attention. Bank avoidance of both Federal funds and discount window borrowings over the quarterly statement publishing date led to a sharp convergence of reserve demands in the two days before the July 4 holiday on Wednesday. The Desk pumped in \$3,314 million of reserves in the two days, but the cumulative deficiencies of the banks proved too large to head off the extraordinary strain. The average Federal funds rate climbed sharply to 10.21 percent from 8.59 percent the week before, and trading took place at rates as high as 15 percent for the first time.

This episode complicated operations for a number of weeks. Expectations that the System would continue and possibly intensify restraint led to a concentration of demands for funds at the start of a statement week. This reflected a continuation of the pattern that had emerged with the onset of restraint; only the pressures in the money market were often more difficult to temper given the enlarged demands for nonborrowed reserves.

THE SECURITIES MARKETS. There was a sharp and dramatic response in the securities markets to the implementation of a clearly more restrictive monetary policy. The Board reaffirmed the System's intent on July 2 by approving requests by all Federal Reserve Banks to raise their discount rates to 7 percent and by announcing the adoption of a ½ percent increase in reserve requirements on the bulk of demand deposits at member banks. Market participants soon began to project that tightening would continue indefinitely. The upward pressure spread quickly from the Federal funds rate to dealer financing costs and Treasury bill rates. The rate on the three-month issue rose from about 7¼ percent to a high of 9.05 percent on August 14, the day that another ½ point increase in the discount rate, to a record 7½ percent, was announced. The bill rate subsequently fell by 60 basis points but rose again to around the same peak after the Board's announcement in early September of an increase in the marginal reserve requirement on large CDs to 11 percent. Aggressive competition continued in the CD market, raising yields on ninety-day CDs by 63 basis points to around 11 percent over the same interval.

The influence of higher short-term rates spilled over to the markets for long-term debt, given expectations that banks would abstain from buying new issues and/or liquidate holdings as monetary restraint persisted. The climb in long-term rates intensified with the approach of the August refunding. The Treasury announced on July 25 that it would auction \$2 billion of additional 7¾ percent four-year notes and \$500 million of 7½ percent twenty-year bonds, the latter using the uniform-price technique adopted at the start of the year. The remaining \$2 billion financing need would be met through an auction of 35-day tax anticipation bills.

Dealers soon became concerned that investor demand would be insufficient to permit them to distribute issues before they had to be financed at burdensome costs. Enlarged demands by Federal agencies, as they moved to preserve mortgage flows, added to the gloomy outlook. A precipitous drop in note and bond prices emerged prior to the auctions, which were scheduled for July 31 and August 1, amid large-scale short selling. Desk purchases of intermediate-term coupon issues on behalf of Government investment accounts helped impart some stability to the market. Even so, only \$2.1 billion of acceptable bids were received for the \$2 billion of 7¾ percent notes, and these came under heavy selling pressure shortly thereafter. Public bids for the twenty-year bonds at the lowest acceptable price amounted to only \$260 million. The tax anticipation bills sold on August 8 were issued at a substantial average rate of 10.03 percent—on a bond equivalent basis—even though banks were permitted to pay for 50 percent of subscription by crediting Treasury Tax and Loan Accounts.

The decline in bond prices ended quite suddenly. Evidence of a deceleration in money supply growth during

July and August convinced many participants that the next move in System policy would be in the direction of less restraint. Thus, despite the slight edging up of the daily level of Federal funds trading after the August FOMC meeting, securities dealers began to cover some short positions in notes and bonds. An explosive rally emerged in the debt markets as it became apparent how short aggregate trading positions had become and as investors sought to capture the prevailing yields on securities rather than risk missing a turn in rates. Prices rose sharply over the rest of August and in September so that, by the time of the September FOMC meeting, the increase in yields on notes and bonds that had occurred over the summer had been largely eradicated. The index of Government securities maturing in ten years averaged 7.09 percent, close to its level of mid-July and well below its August 8 peak of 7.54 percent. Recently offered Aaa-rated utility issues were yielding 8.03 percent, reflecting a decline of around 27 basis points in six weeks. The Bond Buyer's index of yields on twenty-year municipal bonds had fallen over 50 basis points to 5.05 percent, merely 5 basis points above its lowest level of the year.

MID-SEPTEMBER—DECEMBER

THE COMMITTEE'S INSTRUCTIONS. Starting with its September 18 meeting, the FOMC voted to seek moderate growth in the aggregates over the months ahead. The cumulative increases in interest rates over the year and the sharp deceleration of money supply growth in the late summer led the staff to reduce its estimates of the demands for money that were likely to emerge in the months ahead. It appeared that a delay in a move toward easing could require a much more substantial move at a later time to achieve moderate M_1 growth. At its September 18 and October 16 meetings, the FOMC raised the upper ends of the two-month tolerance ranges for the aggregates a bit above those suggested by the staff, expecting that reserves would be provided more readily as the period unfolded and that the Federal funds rate could decline.

In fact, M_1 became considerably stronger in the closing months of the year, and it appeared that growth in previous months would be revised upward. While inflation remained a disturbing problem, the pace of real economic activity decelerated and it appeared that the curtailment of oil supplies from abroad could have significantly adverse effects. The Committee at its November 20 meeting retained the objective of moderate growth in the long run. M_1 growth continued to strengthen, and by the end of November appeared to be moving above an acceptable range for the last two months of the year. On November 30, however, the Committee agreed to forestall a tightening of money market conditions because of current uncertainties with respect to the economic outlook and the sensitive state of market psychology. At its final meeting of the year, on December 17-18, the FOMC moved further in the direction of less restraint and decided to seek some easing of bank reserve and money market conditions, provided that the aggregates did not appear to be growing excessively.

THE MANAGER'S RESPONSE. After the September meeting, estimated money supply growth over the two months ended October fell below an acceptable range and the Manager moved to provide reserves more readily. While the Manager was careful in light of the FOMC's desire to avoid generating market impressions that monetary restraint was being relaxed significantly, the securities markets responded dramatically to the first sign that the System was changing its reserve and money market objectives.

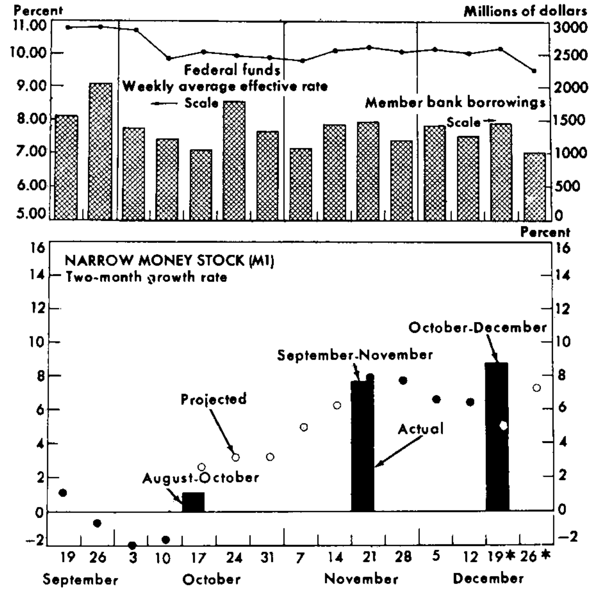
Three-month bill rates plummeted from 8.68 percent on the day of the meeting to 6.96 percent by September 27. At the same time, a downward shift in member bank borrowings and enlarged demands for Federal funds by major banks seeking to avoid issuing CDs until rates fell further kept the money market under constant pressure. The Manager asked for guidance in resolving the inconsistency between the indicated response to the aggregates, which were expected to fall below the FOMC's objectives for the September and October period, and the state of the credit markets. The Committee agreed at a telephone meeting on October 2 that money market conditions should be allowed to ease somewhat if this easing did not threaten to reinvigorate the sharp rally in the markets for short-term securities. While the Manager became more aggressive in his efforts to supply nonborrowed reserves, the money market remained under pressure and the Federal funds rate showed no tendency to move below 10¾ percent. At the same time, M_1 growth weakened further and the other measures moved well below their specified ranges. On October 10, the Committee held a second telephone meeting and directed the Manager to supply reserves consistent with some easing of money market conditions beyond that indicated eight days earlier. The Desk redoubled its efforts to achieve this and, following substantial additions to nonborrowed reserves, the funds rate had declined to 10 percent by the October FOMC meeting.

In the weeks after the October 16 meeting, estimates of money supply growth initially remained within the range indicated as acceptable for the two months ended November while bank willingness to permit CDs to run down pulled RPD below its range. The Account Manager retained a somewhat more generous approach to the provision of nonborrowed reserves and began permitting doubts about reserve availability to be resolved on the side of a bit less tautness, with the Federal funds rate settling a shade under 10 percent (see Chart XI). This process was halted shortly thereafter when estimates of M_1 growth strengthened, reaching 8 percent over the two months. While the Desk adopted a more grudging approach and the Federal funds rate rose to around 10¾ percent, efforts to restrict reserve supplies more noticeably were tempered by the Treasury refunding that was in process and by the unsettled conditions that developed in the securities markets.

The surge in M_1 growth during November and the uncertainties attributable to the oil shortage led the staff to conclude that demands for M_1 in the near term could increase, while the economic outlook became more uncertain. The Committee established tolerance ranges for the aggregates over the two months ended December that were

Chart XI

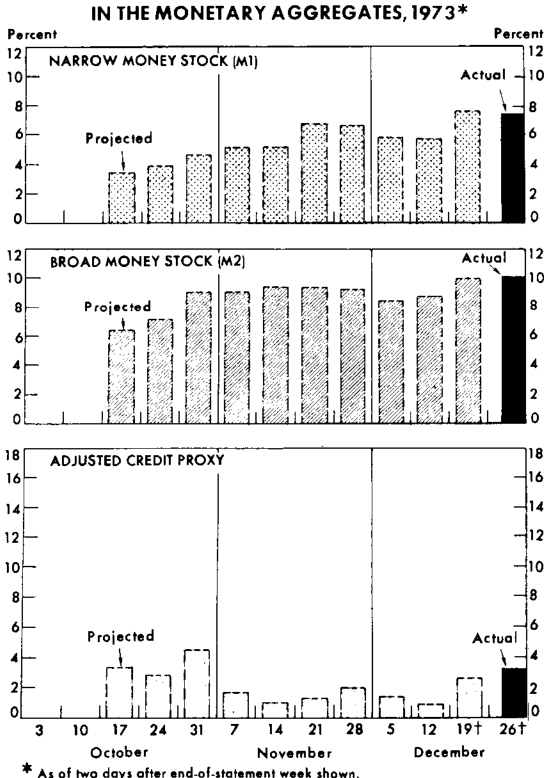
MONEY MARKET CONDITIONS AND WEEKLY FORECASTS OF M1 GROWTH, 1973



*Reflects annual bench-mark revisions.

Chart X

WEEKLY FORECASTS OF QUARTERLY GROWTH IN THE MONETARY AGGREGATES, 1973*



* As of two days after end-of-statement week shown.

† Reflects annual bench mark revisions.

Source: Board of Governors of the Federal Reserve System.

likely to be consistent with little change in money market conditions. Soon after the meeting, however, incoming data suggested that growth in M_1 and also M_2 might be stronger than acceptable over the two months. While these conditions ordinarily would have called for limiting reserve availability and thus generating a rise in the Federal funds rate, the Manager sought to maintain prevailing money market conditions until the December meeting following the Committee's concurrence on November 30 with the Chairman's recommendation of this course of action.

At its December 17-18 meeting, the Committee concluded that the economic situation and outlook called for a modest easing of monetary policy. The FOMC also decided to place somewhat more emphasis on money market conditions until its next meeting and directed the Manager to seek some easing of these conditions provided that the aggregates did not appear to be growing excessively. Accordingly, the Desk moved promptly after the meeting to provide nonborrowed reserves at a more generous pace. But the process was delayed again just before the year-end when estimates of the aggregates turned out stronger than anticipated and it appeared that M_1 was moving above an acceptable range for December and January combined. The Manager was providing reserves consistent with Federal funds trading in a 9¾ to 10 percent range as the year drew to a close. While this was below the level in November, the faster growth in the aggregates, with M_1 increasing at a 7½ percent rate over the fourth quarter, had forestalled the emergence of a more significant easing in conditions of reserve availability.

THE SECURITIES MARKETS. There was an ebullient reaction in the securities markets in late September when participants sensed the System's response to the deceleration of money supply growth to a 0.3 percent rate over the third quarter. A spectacular decline in short-term rates occurred shortly after the September meeting when the Desk purchased a small volume of Treasury bills at a time when the money market was not particularly firm in comparison with previous weeks. Banks reduced offering rates on CDs by over 2 percentage points to around 8½ percent between September and the end of October. Dealers in prime commercial paper reacted similarly, with rates on 90- to 119-day paper falling to 8⅜ percent from close to 11 percent. Treasury bill rates plummeted, with the three-month issue dropping by about 2 percentage points to around 7 percent. Later, when M_1 growth accelerated and the funds rate failed to decline significantly, the reaction was almost as sharp.

The Treasury bill market was especially volatile toward the end of the year. Expectations that the System would ease to ward off an economic slowdown generated by fuel scarcities were dampened by signs of accelerated M_1 growth. Increased bill sales by foreign central banks, due to the improved international position of the dollar, added to market caution. A significant increase in rates occurred after the Treasury announced, in early November, the sale of bills to raise new cash. In all, the Treasury raised an additional $8 billion of cash in the bill market in the last three months of the year, as its needs were enlarged by redemptions of nonmarketable issues held by foreign central banks. The central banks also liquidated a substantial volume of marketable coupon issues toward the end of the year as the dollar improved against other currencies. By the year end, bill rates were still 40 to 50 basis points above the low points reached in late September and early October. Short-term bill rates remained above rates on longer maturities, with the three-month issue bid at 7.45 percent and the one-year issue at 6.86 percent. The continued moderation of business credit demands at banks, reflecting in part a shift of borrowers to the commercial paper market, led to modest CD growth in the final months of the year. Offering rates retraced part of the earlier declines, with the ninety-day maturity closing the year at 9½ percent.

The long-term debt markets were also highly responsive to expectations of a change in System policy and to changing assessments about prospects for the economy. Yields declined in late September and early October. The terms of the Treasury's refunding, announced on October 24, were greeted favorably, but the emerging pressures on short-term rates soon began to dampen market sentiment. The Treasury auctioned $3.8 billion of issues to replace maturing securities, and the package included $1.5 billion of 25½-month notes, $2 billion of six-year notes, and $300 million of additional 7½ percent bonds due in 1993. Coupon rates of 7 percent were established for both notes. The October 30 auction of the six-year notes at an average yield of 6.82 percent was disappointing, and yields adjusted higher before the two auctions held on the next day. The 25½-month notes were sold at 6.91 percent, and the long-term bonds were awarded at 7.35 percent with all bonds awarded at the price of the lowest accepted tenders.

Dealers were unable to reduce inventories significantly in the weeks that followed, and coupon prices declined quite steadily. The rounds of price increases expected to result from potential fuel scarcities deepened concern over inflation and had particular impact in the long-term markets. By the last week in December, the yield on ten-year Government securities reached 6.87 percent, little changed from its early-October level. Corporate bond yields experienced more pronounced increases, reflecting expectations of enlarged financing demands in 1974. The yield on recently offered Aaa-rated utility issues rose to 8.10 percent, 20 basis points below its August high. Stronger bank interest in municipal issues benefited the tax-exempt market, and the Bond Buyer's index stood at 5.16 percent, 43 basis points below its August high.

The Business Situation

Economic activity posted a sizable decline during the first quarter of 1974, as real gross national product (GNP) fell at a 5.8 percent seasonally adjusted annual rate, the largest quarterly decline since 1958. However, it appears that practically all of this drop reflected the impact of the Arab oil embargo which ended in mid-March. Moreover, the data suggest that the weakness in business activity did not spread widely throughout the economy but was confined largely to the automotive sector, which bore the brunt of the embargo's direct and indirect effects. During the first quarter, the decline in real gross auto product accounted for 95 percent of the drop in total real GNP. Subsequently, auto sales have apparently bottomed out and may even be on an uptrend. In addition, automobile producers have revised upward, by better than 4 percent, their second-quarter production schedules in response to the improved outlook.

On the other hand, the price situation has deteriorated even further in recent months. During the first quarter, the GNP deflator, which is the broadest available measure of price movements, soared at a 10.8 percent annual rate, the fastest climb since the Korean war, and the fixed-weight price index for GNP increased at an even more rapid rate. While skyrocketing food and fuel prices have had a very substantial impact on price data, the upward march of prices is currently taking place along a very broad front. Consumer prices rose at nearly a 13 percent rate in March, the third consecutive month of inflation in excess of 10 percent at the retail level.

The first-quarter rise in compensation per hour of work was modest in comparison with the surge in consumer prices. As a result, real wages declined for the fourth consecutive quarter. Moreover, the decline in real wages experienced over the year ended in March is bound to escalate wage demands during the latter part of the year unless labor shows remarkable restraint.

GNP AND RELATED DEVELOPMENTS

Preliminary estimates indicate that the seasonally adjusted market value of the nation's output of goods and services rose only $14.3 billion at an annual rate during the first quarter of 1974. This constitutes a 4.4 percent annual rate of increase, the smallest percentage advance in nominal GNP in about three years. Moreover, when adjusted for the enormous rise in prices that occurred during the quarter, GNP actually declined at a 5.8 percent annual rate, the largest drop in real output since the first quarter of 1958. Reflecting the impact of pervasive shortages, the growth of real GNP had slowed noticeably during the two middle quarters of 1973, well in advance of the start of the Arab oil embargo (see Chart I). While the embargo had some effect on GNP during the fourth quarter of last year, its major impact was experienced during the first quarter of this year. The embargo weighed most heavily on the automotive sector. The reduction in gross auto product, which is the portion of GNP directly attributable to the production and sale of passenger cars, represented 95 percent of the overall decline in real GNP during the first quarter. Furthermore, real farm output decreased considerably during the first quarter after rising sharply in the October-December period. Excluding both the auto and farm sectors, real GNP edged down by less than 1 percent in the January-March interval.

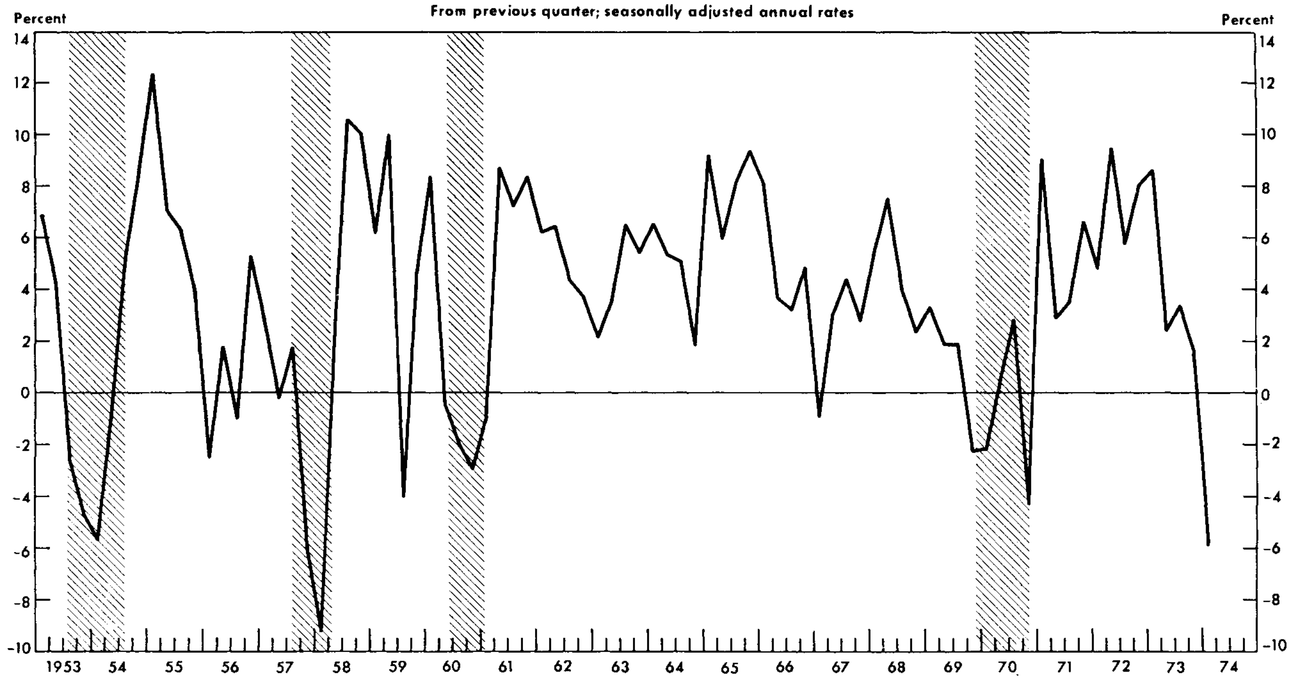
A number of factors have probably helped to keep the economic decline precipitated by the oil embargo from spreading widely throughout the economy. A sizable portion of the impact to date has fallen on the automotive sector, where many workers have had their spendable incomes protected to a degree by supplementary unemployment benefit programs. Payments from privately sponsored plans, which have been incorporated into the collective bargaining contracts covering the rank and file workers at the major auto-producing firms, are combined with state unemployment insurance benefits to maintain temporarily take-home pay for eligible workers close to that earned on the production lines. More broadly, the persistence of the shortages which developed during 1973 has probably meant that some of the easing in demand that became apparent in certain sectors toward the end of last year and early in 1974 had relatively little impact on output and income.

The modest growth of nominal GNP in the first quarter

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 Research chronology. The dates of the 1969-70 recession are tentative.

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

was accompanied by a sharp slowing in the rate of inventory accumulation (see Chart II). However, huge swings in dealer holdings of new passenger cars have obscured the extent to which inventory investment has strengthened in nonautomotive sectors. Excluding the change in dealer new car stocks, the rate of real inventory accumulation was actually somewhat stronger in the first quarter than during the previous three-month period. The change in overall business inventories, which dropped abruptly from the large $18 billion annual rate of accumulation registered during the fourth quarter to a $7.8 billion seasonally adjusted annual rate in the January-March 1974 period, does not of course reflect this. Further, while book value inventories posted very large gains during the first two months of the quarter, most of this was the result of price increases and is not included in the national income accounts estimate of inventory spending. The inventory valuation adjustment, which removes that part of the book value change due only to inflation, was huge in the first quarter.

The first-quarter increase in current-dollar final expenditures—that is, GNP net of inventory accumulation—amounted to a 7.7 percent increase at an annual rate, up from the pace of the previous quarter. In real terms, final sales actually declined at a 2.4 percent rate in the January-March period, a bit less than the 2.9 percent drop recorded over the preceding three-month interval.

Measured in current-dollar terms, consumer spending strengthened during the first quarter. Consumption rose $19.4 billion in the January-March interval, compared with the very small $9.2 billion increase of the preceding quarter. In real terms, however, consumer spending declined for the second successive quarter, although the decrease was noticeably smaller than that of the fourth quarter.

Current-dollar spending on consumer durables, which had declined by a sustantial $7.2 billion in the fourth quarter, fell an additional $1.1 billion in the first quarter of 1974. While this latest decrease continued to reflect weakness in spending on automobiles, there are tentative signs that the decline in auto sales may have bottomed out and perhaps even reversed itself. Sales of new domestic-type passenger cars reached a three-year low of 7.4 million units (seasonally adjusted annual rate) in February, remained at that pace in March, but rose to 7.8 million units in April. The more favorable automobile sales picture can be attributed, at least in part, to the increased availability of gasoline as well as to the general improvement in the fuel outlook that has accompanied the announced termination of the oil embargo.

Consumer spending on nondurable goods picked up in current-dollar terms during the first quarter, with large increases in outlays for food, beverages, clothing, and shoes. After adjustment for price increases, however, spending on nondurables edged down. At the same time, real expenditures for services showed no change, the first quarter in twenty years that spending for services failed to expand in real terms.

During the first quarter, the rate of personal saving out of disposable income dropped sharply to 6.5 percent, after climbing from 5.7 percent to 7.3 percent in the last half of 1973. This decline in the personal saving rate may reflect attempts on the part of consumers to preserve consumption levels in the face of the diminution in real personal disposable income. Real disposable income fell in the January-March quarter for the first time since the fourth quarter of 1970. With declines in payroll employment and the average workweek during the first quarter, wage and salary disbursements grew slowly in nominal terms and dropped considerably after adjustment for the upsurge in consumer prices. Higher social security taxes resulting from the increase in the taxable wage and salary base also contributed to the fall in after-tax personal income.

Business fixed investment, an area expected to contribute substantial strength to the economy in 1974, advanced only modestly in the first quarter. The gain of $2.6 billion was the smallest in more than a year and, in real terms, first-quarter fixed investment experienced a slight decline. All of the most recent rise in nominal outlays for fixed investment was in stuctures; the leveling-off of spending on durable equipment may reflect the impact of capacity constraints and shortages on the capital goods industries. Backlogs of unfilled orders on the books of nondefense capital goods producers have grown at about a 30 percent annual rate over the first three months of this year. Furthermore, the latest McGraw-Hill survey of capital spending intentions reveals that businesses are still planning a large increase in such spending in 1974. In addition, most of the first-quarter slowdown in business fixed investment reflects the decline in business purchases of passenger cars and trucks. This decline is at least partly in response to the energy situation.

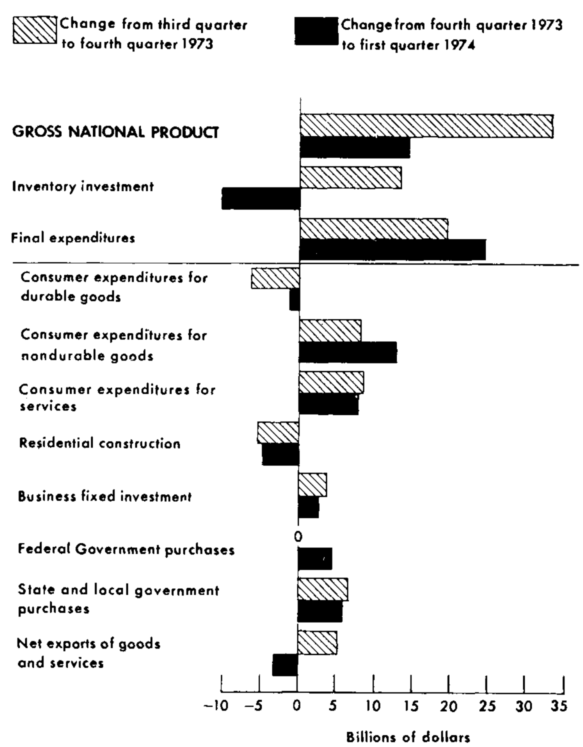
During the first quarter, residential construction spending dropped $4.5 billion. Since the peak reached in the January-March quarter of 1973, expenditures on residential structures have fallen almost $10 billion in current dollars and more than 20 percent in real terms. Seasonally adjusted housing starts dropped in March to 1.46 million units at an annual rate, the same as the January pace, suggesting that the sharp rise in starts in February was largely a statistical aberration. Permits for new construction, on the other hand, rose smoothly during the first quarter and, by March, had climbed 15 percent above the 3½-year low reached last December. However, the recent upswing in market interest rates and signs of renewed disintermediation at thrift institutions make the housing outlook highly uncertain.

Federal Government purchases of goods and services increased by $4.5 billion in the first quarter, reflecting gains

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

of $3.2 billion in defense spending and $1.3 billion in nondefense outlays. At the same time, state and local government outlays rose $5.8 billion. During the January-March period, spending by all levels of government expanded to $296 billion, approximately 22 percent of total GNP.

PRICES

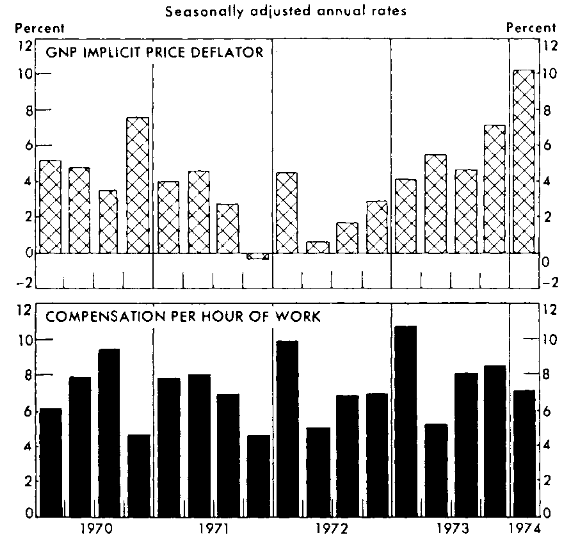
The price situation deteriorated further during the first quarter. According to preliminary data, the implicit GNP deflator rose at a 10.8 percent annual rate, 2 percentage points faster than in the fourth quarter of 1973 and the most rapid quarterly price increase in over two decades. Over the four quarters ended March 1974, the deflator climbed by an extraordinary 8½ percent. The severity of the acceleration in the rate of inflation is underscored by the fact that, during each of the preceding two years, the GNP deflator rose only about 3½ percent. A number of factors have contributed to the recent, sustained explosion in prices. Food prices continued to rise at extremely rapid rates through the first quarter. Nevertheless, the private nonfarm deflator still rose at a rate in excess of 10 percent in the same interval (see Chart III). The Arab oil embargo put very substantial upward pressure on prices of domestic energy supplies since they can serve, in varying degrees, as substitutes for imported fuels. Moreover, there is some indication that the process of gradually eliminating wage and price controls, which gathered momentum in recent months, may have contributed to the first quarter's distressing rate of inflation.

Consumer prices rose at a 12.9 percent seasonally adjusted annual rate in March, marking the third consecutive month of inflation in excess of 10 percent at the consumer level. During the three months ended in March, consumer prices increased at a spectacular 13.8 percent annual rate, on top of the already very rapid 9.4 percent increase during the last half of 1973. The March increase brought the consumer price index to a level of 10.2 percent above that of a year earlier, the largest yearly surge since 1948. Almost half of the February leap in consumer prices reflected steep increases in food prices, but the March jump was more broadly based. In March, consumer food prices increased at a 9.1 percent rate, substantially slower than the February climb of 30 percent. Skyrocketing energy prices have contributed heavily to the current bout of inflation. In March, consumer power and fuel prices rose at a 47 percent annual rate, bringing the climb during the first quarter to a 57 percent pace. Nevertheless, surging prices of food and energy-related items have obscured in recent months the inflationary pressures in other areas of the economy. For example, excluding food and consumer power and fuel, consumer prices still advanced at a 7.4 percent rate during the three months ended in March, compared with a 4.6 percent rise in 1973.

Chart III

INCREASES IN PRIVATE NONFARM PRICES AND WAGES

Seasonally adjusted annual rates



Sources: United States Department of Commerce, Bureau of Economic Analysis and the United States Department of Labor, Bureau of Labor Statistics.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Although recent information indicates a moderate increase in wages in the first quarter, cost pressures nevertheless intensified. Compensation per hour of work—the broadest available measure of wages and benefits—rose at a 7.1 percent seasonally adjusted annual rate in the private nonfarm sector of the economy during the opening quarter of this year. Including the farm sector, the advance in compensation was somewhat slower. In any event, because of the rapid escalation in the rate of consumer price increases, real hourly compensation declined in the January-March period for the fourth consecutive quarter to reach a level 2½ percent below that of a year earlier. According to the separate survey of collective bargaining agreements covering 1,000 or more workers, contracts settled during the first quarter of the year provided, on average, for first-year wage and benefit gains of 6.9 percent and for improvements over the life of the contract of 5.9 percent. While seemingly on the modest side, it should be noted that these figures do not include those payments made under escalator clauses contingent on movements in the consumer price index. About half the workers for whom major agreements were concluded during the first quarter had such clauses in their contracts. Moreover, the collective bargaining data for the first three months of the year encompassed only 466,000 of the more than 5 million workers covered by major contracts for which wages can be negotiated this year.

As measured by real output per hour of work, private nonfarm productivity declined at a 3.4 percent annual rate in the first quarter. This dip in productivity, coupled with the rise in compensation, resulted in an increase in private nonfarm unit labor costs during the period of 11.1 percent at an annual rate. Short-term movements in output per hour of work typically reflect variations in the rate of real economic growth. For example, over the four quarters ended in March 1973, real private nonfarm output rose a substantial 9 percent and productivity grew by a healthy 5.3 percent. During the next three quarters, when real output increased at a much slower 2.7 percent pace, output per hour of work actually edged down. The sharp productivity drop in the first quarter of this year, doubtless related to the Arab oil embargo, stems from the fact that the decrease in real output was considerably larger than the decline in hours worked. One possible reason for the disparity between the declines in output and hours is that firms were reluctant to make commensurate reductions in employment and hours in the face of what was viewed as a largely temporary situation.

After climbing from 4.6 percent last October to 5.2 percent in January, the unemployment rate subsequently steadied in February and then edged lower in the two succeeding months. The seasonally adjusted unemployment rate dropped to 5 percent in April, the same level that prevailed in the corresponding month last year. The recent declines in unemployment occurred largely as a result of contractions in the labor force amounting to 60,000 persons in March and a further 180,000 in April. It is important to note, however, that these reductions were preceded by sizable increases, so that the labor force was 2.3 percent larger in April 1974 than it was twelve months earlier. Over the two months ended in April, the teen-age labor force fell by 280,000 and the adult male work force by 247,000, but the adult female labor force jumped by 283,000 persons. While the modest decline in the unemployment rate was unexpected in light of the slowdown in business activity, it should be noted that the cyclically more meaningful unemployment rate for married men edged up in April, reaching a level last recorded in March 1970. Since November, the unemployment rate for married men has inched slowly upward.

In the April payroll survey of nonfarm establishments, seasonally adjusted employment increased by 126,000, bringing the rise since the end of 1973 to a total of 285,000. Manufacturing employment, which had fallen steadily since November, rose significantly and accounted for 75,000 of the April advance. About two thirds of the rise in manufacturing employment was centered in the transportation equipment sector, where recalls of automotive workers boosted employment during the month. Although there was a sharp drop in the average workweek and, particularly, in manufacturing overtime hours in April, this may largely reflect the fact that the Friday and Saturday preceding Easter, when many employees traditionally work reduced hours, were included in the survey week.

Monetary and Financial Developments in the First Quarter

Business demand for short-term financing continued strong during the first quarter of 1974. At commercial banks, the growth of business loans surged at a 23.2 percent seasonally adjusted annual rate. The rise in business loans at commercial banks did not appear to come at the expense of other short-term business borrowings since the volume of dealer-placed commercial paper also increased substantially. Along with the burgeoning demand for short-term funds, the growth of the money supply measures remained excessive in the first quarter. The narrowly defined money supply (M_1) expanded at a seasonally adjusted annual rate of 6.7 percent over the January-March interval, an acceleration over the pace of 1973. The more broadly defined money supply (M_2) rose almost as rapidly in the first quarter as in the fourth quarter of 1973. The outstanding volume of large negotiable certificates of deposit (CDs) at weekly reporting banks increased sharply, after declining on balance over the preceding three-month period. Consequently, the growth in the bank credit proxy accelerated in the January-March quarter.

The huge demand for short-term credit, along with a change in market participants' expectations of the future course of monetary policy, prompted a turnaround in short-term interest rates during the quarter. After falling through mid-February, most short-term rates rose over the remainder of the period, experiencing little net change over the quarter as a whole. Short-term interest rates subsequently rose sharply in April.* Meanwhile, long-term bond yields increased rather steadily throughout the quarter. By the end of March, yields in the corporate sector were at their highest levels in more than three years.

Deposits at thrift institutions continued to expand at a moderate pace over the quarter, but inflows appeared to slacken considerably early in April. The slowing of deposit growth at thrift institutions appeared to reflect the rise in short-term rates on competing market instruments, as evidenced by the sharp increase in the volume of noncompetitive tenders at the weekly Treasury bill auctions. Thrift institutions increased their mortgage holdings considerably over the quarter, but their commitments to make new mortgages showed virtually no change.

* Interest rate developments in April are discussed in "The Money and Bond Markets in April", this *Review*, pages 127-31.

THE MONETARY AGGREGATES

M_1—private demand deposits adjusted plus currency outside commercial banks—expanded in the first quarter at a 6.7 percent seasonally adjusted annual rate (see Chart I). This represents a 1 percentage point increase in growth from that experienced in all of 1973. As usual, the individual monthly growth rates of M_1 exhibited wide fluctuations. In January, M_1 actually declined at an annual rate of about 3½ percent, and then it increased sharply at annual rates of about 13 percent in February and 10½ percent in March. Some of the pronounced increase in M_1 in February can be attributed to relatively large refunds of individual income taxes, which served to reduce United States Government balances and increase private demand deposits. Since Government deposits are not included in M_1 while private deposits are, this transfer works to increase the money stock.

Over the January-March period, the currency component of M_1 rose at a seasonally adjusted annual rate of 11 percent, more than double the rate of increase in demand deposits. Since mid-1972, the expansion of currency has been rapid relative to both its own historical trend and to the growth of demand deposits. Much of the substantial advance of currency during recent months probably reflects large increases in expenditures on items that are exchanged for currency rather than demand deposits. Typically, these items include nondurable goods and services purchased by consumers. These expenditures in the gross national product (GNP) accounts grew sharply in the first quarter, rising by 12 percent as compared with a gain of only 4½ percent in total GNP.

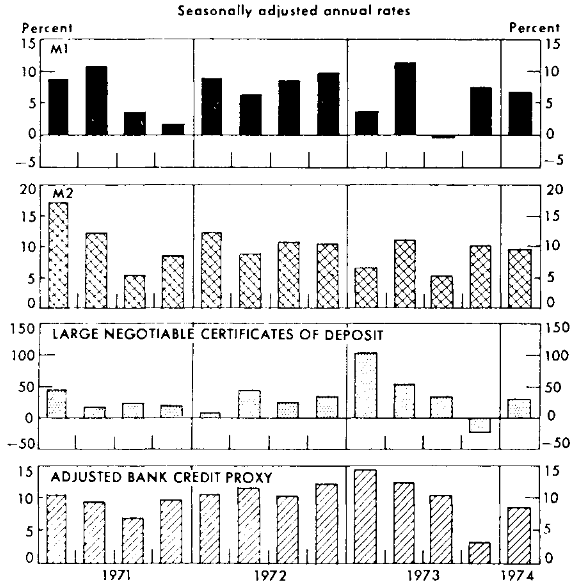
M_2—defined as M_1 plus time deposits other than large CDs—advanced in the first quarter at a seasonally adjusted annual rate of 9.4 percent, compared with a gain of 10.1 percent in the preceding quarter. Over the quarter as a whole, the time deposit component of M_2 continued to rise rapidly—although not quite by so much as in the previous quarter—but its rate of growth decelerated in each succeeding month. In part, the slowdown in the expansion of time deposits less large CDs over the quarter may have reflected the rise in market rates on instruments that compete for consumer funds. It should also be recognized that the time deposit component of M_2 includes some corporate deposit holdings as well. In deriving M_2, only negotiable CDs issued in amounts of $100,000 or more at weekly reporting banks are subtracted from total time deposits. Thus, the time deposit component of M_2, as it is currently measured, includes nonnegotiable CDs in amounts of $100,000 or more at large weekly reporting banks as well as large negotiable and nonnegotiable CDs at other banks.

In contrast to the behavior of the time deposit component of M_2, the growth in large CDs accelerated sharply in the first quarter to a seasonally adjusted annual rate of 31.2 percent, after declining at a 23 percent annual rate in the fourth quarter of 1973. With short-term interest rates generally falling early in the quarter, banks were able to reduce their offering rates and still attract a large volume of funds with this instrument. Moreover, CDs became a less expensive source of bank funds after the Board of Governors of the Federal Reserve System lowered its marginal reserve requirement on CDs and certain other bank liabilities from 11 percent to 8 percent in December. As the quarter progressed, CD rates rose substantially, since banks were marketing such instruments aggressively in an effort to attract sufficient funds to accommodate the tremendous demands for credit and to roll over the large volume of CDs maturing in March.

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.

The rapid growth of large CDs during the first quarter contributed to the expansion of the bank credit proxy. The adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—advanced at a seasonally adjusted annual rate of 8.5 percent during the January-March period, a substantial acceleration over the pace of the previous quarter. Aside from the decline in Government deposits, all components of the proxy added to its growth. Reserves available to support private nonbank deposits (RPD) exhibited some renewed vigor in the first quarter; after adjustment for seasonal variation, RPD expanded at an annual rate of 6.2 percent over the period, still not so rapid as the growth experienced overall in 1973.

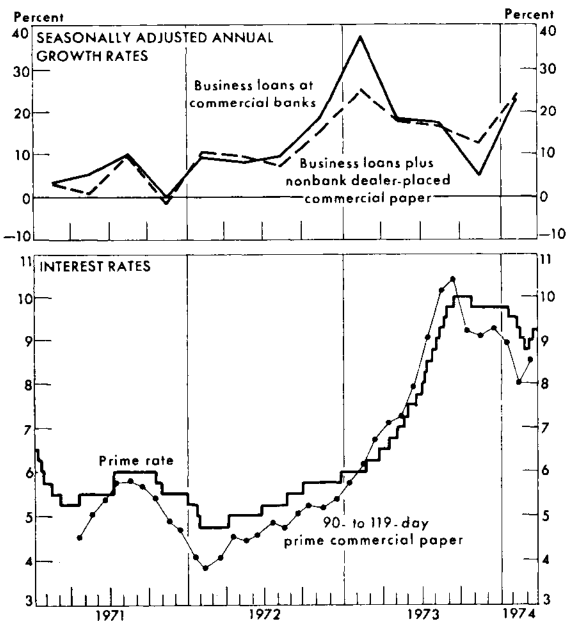
BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Following four consecutive months of sluggish growth, bank credit expanded sharply over the January-March period. Total bank credit, adjusted for net loan sales to affiliates, rose at a seasonally adjusted annual rate of 16.2 percent in the first quarter of 1974, nearly matching the extraordinary gain experienced over the first eight months of 1973.

An exceptionally large increase in business loans over the quarter provided the major thrust to the rapid expansion in bank credit. When adjusted for net loan sales to affiliates and normal seasonal variation, the growth of business loans spurted at a 23.2 percent annual rate in the January-March period (see Chart II). Business loan demand was broadly based among the manufacturing, wholesale, and retail sectors, although metal firms and commodity dealers were especially heavy borrowers. The huge first-quarter bulge in business loans was probably due in part to the need to finance larger inventories at higher prices. In turn, the inventory building may have reflected fears of rising material prices, raw material shortages, and expectations of future inflation.

The rapid expansion in business loans at commercial banks during the first quarter did not reflect a pronounced slowing in other short-term business borrowing. The volume of nonbank dealer-placed commercial paper outstanding expanded substantially in the first two months of the period, although it declined in March. For the quarter as a whole, business loans plus nonbank dealer-placed commercial paper grew at about the same pace as business loans alone. In contrast, during 1973 the growth in these two series differed substantially. Business loans at commercial banks surged over the first eight months of that year, when pressure from the Committee on Interest and Dividends kept the bank prime lending rate to large business borrowers artificially low relative to other short-term interest rates. The prime rate averaged about 20 basis points below the rate on 90- to 119-day commercial paper over the January-August period. This contrasted with the usual relationship during recent years, when the prime rate had averaged about 50 basis points above the commercial paper rate. With the prime rate relatively low over the first two thirds of 1973, businesses switched some of their borrowing from the commercial paper market to commercial banks. During the last four months of 1973, when commercial paper rates dropped below the prime rate, by about 35 basis points, on average, businesses rechanneled their borrowings to the commercial paper market and business loans at banks grew sluggishly.

Chart II
SHORT-TERM BUSINESS BORROWINGS AND RELATED INTEREST RATES



Note: Business loans are adjusted for loans sold to affiliates. Yields on 90- to 119-day prime commercial paper are monthly averages of daily figures. The prime rate is the interest rate posted by major commercial banks on short-term loans to their most creditworthy large business borrowers.

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

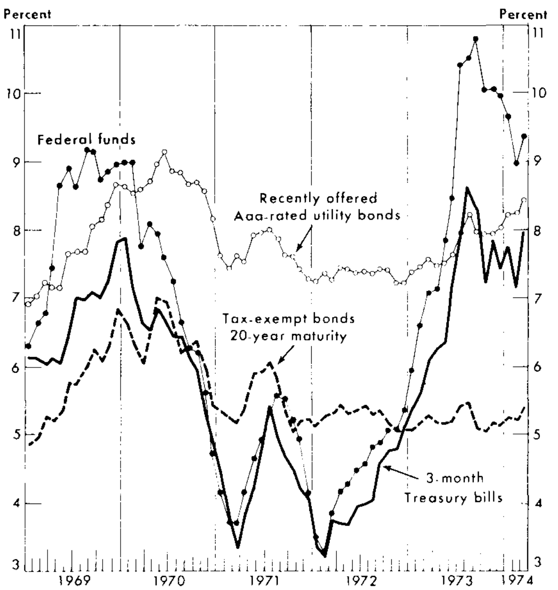
Not all components of bank loans advanced at an accelerated pace in the first quarter, however. Notably, the growth of consumer loans and real estate loans slackened, while securities loans continued to decline. At the same time, banks increased their securities holdings substantially. Total investments rose at a seasonally adjusted annual rate of nearly 12 percent, after showing virtually no change in all of 1973.

During the first quarter, most short-term interest rates moved in a seesaw pattern, declining in the first half of the period and then rising in the latter half, with little net change over the period as a whole. The Federal funds rate, for example, fell in late January through early February and then began rising around mid-March. By the end of the quarter, the effective rate on Federal funds stood at about 10 percent, almost the same level that prevailed in late December. Subsequently, the Federal funds rate advanced in April well above the levels of December. Offering rates on 90- to 119-day dealer-placed commercial paper dropped 125 basis points from the end of December to mid-February and then rose 163 basis points over the remainder of the quarter. The commercial bank prime lending rate for large business borrowers followed the same general pattern but with a lag. The tendency for changes in the prime rate to lag behind movements in other short-term rates is not a new phenomenon. Since early 1973, however, several banks have tied their lending rates directly to past market rates, thus reinforcing this tendency.

Movements in short-term rates during the quarter were especially sensitive to market participants' perceptions of apparent changes in monetary policy. The decline in the Federal funds rate late in January was perceived as a sign of some relaxation in monetary restraint, and market rates dropped sharply. The rally halted in mid-February in the wake of Chairman Burns's Congressional testimony emphasizing the System's concern with the ongoing rate of inflation. Then in March, when available data suggested that inflation was continuing unabated, M_1 was rising rapidly, and economic indicators were pointing to underlying strength in the economy, many market participants

Chart III

SELECTED INTEREST RATES



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

Sources: Board of Governors of the Federal Reserve System and The Bond Buyer.

apparently reasoned that some tightening of policy was likely. The higher levels at which the Federal funds rate traded in mid-March seemed to confirm these expectations, and market rates increased substantially.

In contrast to the behavior of short-term interest rates, yields on long-term bonds increased rather steadily throughout the quarter (see Chart III). Rates on recently offered corporate bonds—as measured by the Federal Reserve Board index—ended the first quarter 57 basis points above their 1973 year-end levels, while rates in the municipal bond market—according to The Bond Buyer index of twenty municipal bond yields—advanced 41 basis points over the period. Since early 1973, corporate bond rates have increased substantially, and by the end of March 1974 they were at the highest levels in over three years. By comparison, rates on municipal bonds have not risen so noticeably. One of the factors contributing to the divergent behavior between corporate and municipal bond rates over this period has been the sharp rise in the price level. This has pushed individuals into higher marginal tax brackets, thus making tax-exempt securities relatively more attractive.

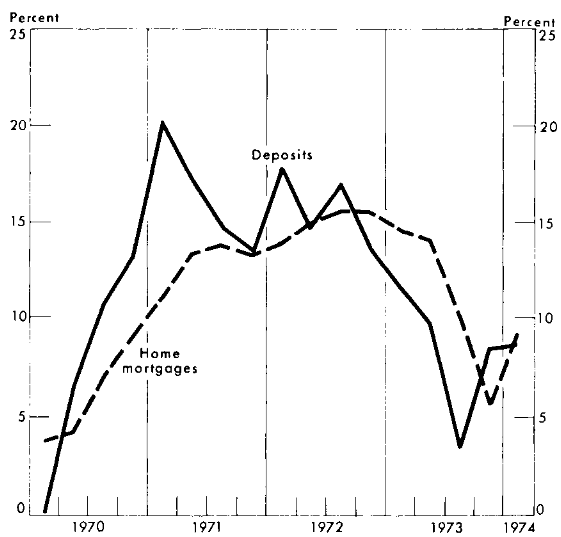
THRIFT INSTITUTIONS

Over the first quarter as a whole, deposits at thrift institutions continued to grow at a moderate pace (see Chart IV). Combined deposits at savings and loan associations and mutual savings banks advanced at a seasonally adjusted annual rate of 8½ percent, the same as the percentage gain experienced in the preceding quarter. However, with the sharp rise of market interest rates experienced in the latter half of March and in April, deposit flows to thrift institutions apparently weakened substantially in April. There was some indication of this in the magnitude of deposit outflows experienced at New York State mutual savings banks in early April. The attraction of market rates to individual savers was also illustrated by the expansion in the noncompetitive tenders at the weekly Treasury bill auctions. In the April 1 auction, the volume of noncompetitive tenders rose to its highest level since July 1970.

Thrift institutions maintained a relatively high volume of borrowings during the first quarter. Net Federal Home Loan Bank Board (FHLBB) advances to savings and loan associations, for example, rose $100 million on average over the January-March interval from the average

Chart IV

GROWTH IN THRIFT INSTITUTION DEPOSITS AND MORTGAGE LOANS



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

Mutual savings bank mortgages for the first quarter of 1974 are based on January and February data.

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

level sustained in the previous quarter, although borrowings from other sources decreased somewhat. Savings and loan associations seemed to be taking advantage of the relatively low rate on FHLBB advances to pay down their more costly indebtedness. On April 19, the FHLBB announced an increase in the ceiling rate that applies to advances to bring it in closer alignment with other interest rates.

Thrift institutions increased their mortgage holdings considerably over the first quarter, reflecting the heavy volume of commitments made during the first half of 1973, when housing demand was very strong. Thrift institution commitments to make new mortgages, however, remained at virtually the same level as in the final quarter of 1973. After declining for five consecutive months, rates on mortgage commitments for conventional homes in the primary market and insured new homes in the secondary market, as measured by the United States Department of Housing and Urban Development survey, edged upward in March by 5 and 12 basis points, respectively. The final March Federal National Mortgage Association (FNMA) auction of four-month commitments on insured mortgages provided additional evidence of firming in the mortgage market. Moreover, the volume of offerings to FNMA in the final March auction exploded to $1.2 billion, compared with $351 million in the previous auction and an average of $36 million offered in the auctions held in the past five months.

The Money and Bond Markets in April

Interest rates continued to move higher during April. The firm stance of monetary policy, coupled with exceptionally rapid inflation and substantial credit demands, exerted upward pressure on a broad spectrum of rates and led to expectations that rates might climb even further over the near term. In the money market, the rate on four- to six-month commercial paper rose about 1½ percentage points, and the rate on bankers' acceptances also increased. The average effective rate on Federal funds rose to 10.51 percent from its average of 9.35 percent in March, and most commercial banks raised their prime lending rates on loans to large business borrowers to a record 10½ percent during the month. Early in May, most major banks boosted their prime rates further in two ¼ percentage point steps to 11 percent. In recognition of the increases that had already occurred in other short-term rates and in light of a recent rapid rise in money and bank credit, the Board of Governors of the Federal Reserve System approved an increase in the discount rate at seven Federal Reserve Banks, including New York. Effective April 25, the rate at these banks rose to 8 percent from its previous record high of 7½ percent. By April 30, all twelve Reserve Banks had established an 8 percent discount rate.

Bond yields also increased over the month in the face of heavy corporate and municipal calendars and an approaching Treasury refunding. In addition, since the latest economic data showed no letup in inflation and no widespread softening in the economy, hopes for a near-term easing of monetary policy faded. Two statements by Federal Reserve Board Chairman Burns emphasizing the System's determination to curb inflation by moderating the growth of money and credit served to confirm this view. Over the month, the yield on three- to five-year Treasury coupon issues registered about a 50 basis point increase while the increase in the yield on long-term Government issues was somewhat smaller. Rates on Treasury bills were mixed during much of April, but yields on all maturities rose sharply in the final week. In the corporate market, yields on newly issued Aaa-rated utility bonds climbed above 9 percent, reaching their highest level since June 1970. By the end of April, The Bond Buyer index of municipal bond yields stood at its highest level since August 1971.

Preliminary data indicate that the seasonally adjusted narrow money stock (M_1)—private demand deposits adjusted plus currency outside commercial banks—grew at a rapid rate in the four statement weeks ended April 24 following very large increases in both February and March. However, the growth of time and savings deposits at commercial banks, other than large negotiable certificates of deposit (CDs), was more moderate, and the broad money stock (M_2)—M_1 plus consumer-type time and savings deposits at commercial banks—rose less rapidly than M_1 in April. Primarily as a result of a substantial increase in CDs, the adjusted bank credit proxy, which includes deposits of member banks plus certain nondeposit liabilities, rose sharply in the four-week period ended April 24. On April 22, Chairman Burns announced that the Board of Governors would begin to publish, together with the policy record of the Federal Open Market Committee, the numerical specifications that guide open market operations in the period between Committee meetings. (The policy record continues to be published with a three-month lag, and hence publication of the numerical specifications involves a similar lag.) The data cover specifications for M_1, M_2, reserves available to support private nonbank deposits (RPD), and the Federal funds rate. Earlier records had contained specifications only for RPD. In an accompanying staff paper, it was pointed out that, while these short-run specifications are guides in the conduct of open market operations between Committee meetings, they in turn are determined in the context of the Committee's longer run objectives for monetary aggregates and credit conditions generally.

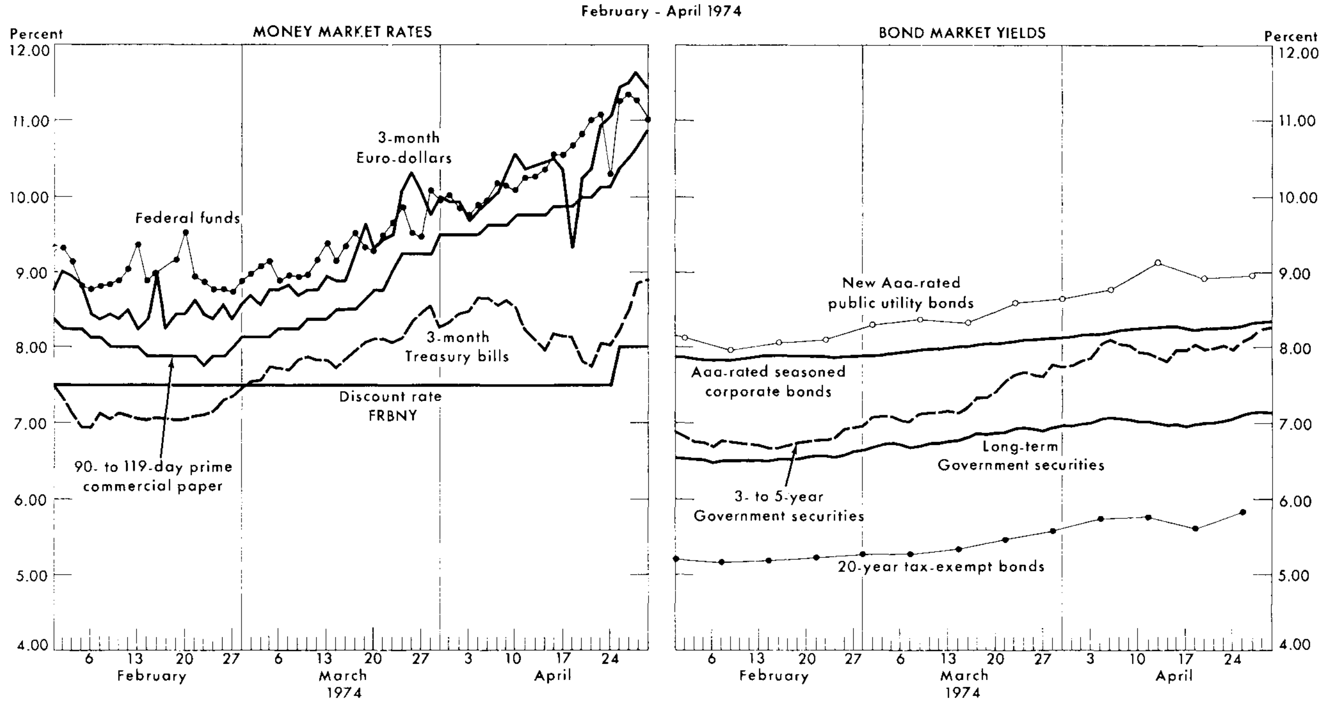
THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Rates on most money market instruments rose further during April, as the firm stance of monetary policy contributed upward pressure on most short-term interest rates (see Chart I). The effective rate on Federal funds

Chart I

SELECTED INTEREST RATES

February - April 1974



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.

climbed to an average of 10.51 percent in April, 116 basis points higher than in March and 154 basis points above the February level. Commercial paper rates registered increases during the month ranging from ⅝ to 1½ percentage points, while rates on bankers' acceptances rose 1¼ percentage points. In line with the rise in other money market rates, most major commercial banks raised their prime lending rate for large business borrowers in several steps during April to a record 10½ percent, up from 9¼ percent at the end of March. As in the preceding two months, commercial banks also increased their reliance on the discount window in April. The average level of borrowings rose $333 million during the month to $1,611 million (see Table I). Effective April 25, the Board of Governors of the Federal Reserve System approved an increase in the discount rate at seven of the Federal Reserve Banks, including New York, from 7½ percent to 8 percent. This was the first increase in the discount rate since August 1973; the 8 percent rate became uniform throughout the Federal Reserve System by the end of the month.

According to preliminary data, M_1 continued to expand rapidly in the four statement weeks of April. As a result, seasonally adjusted daily average M_1 rose at a substantial 10½ percent annual rate in the four weeks ended April 24 relative to its average of the four weeks ended thirteen weeks earlier (see Chart II). From its four-week average of a year earlier, M_1 grew a sizable 6.9 percent. The growth of commercial bank time and savings deposits other than large CDs was moderate in April, and the advance of M_2 was less rapid than that of M_1. However, growth of M_2 in the four weeks ended April 24 relative to its average of the four-week period ended a year earlier was in excess of 9 percent.

Faced with heavy loan demand and rising rates on other short-term instruments, commercial banks raised their offering rates on large negotiable CDs and attracted a substantial volume of funds through this instrument in April. At the end of the month, the secondary market rate on CDs of three months' maturity was 11.03 percent, a rise of 143 basis points over the period. Over the four statement weeks in April, the volume of CDs outstanding increased by about $7 billion. Primarily as a result of this large expansion in CDs, the adjusted bank credit proxy also rose sharply over the four statement weeks in April. Relative to its four-week average level in the period ended thirteen weeks earlier, the proxy grew at a seasonally adjusted annual rate of 14.4 percent in the four-week interval ended April 24. The proxy advanced 10.2 percent from its average level a year earlier.

THE GOVERNMENT SECURITIES MARKET

Yields on Treasury securities increased during April. There was a cautious atmosphere prevailing in the coupon market at the beginning of the month, as a result of the relatively firm conditions in the money market and the announcement of a fairly sizable Federal agency offering. Prices initially drifted lower in light activity, but then the decline accelerated in response to several factors which seemed to preclude any near-term easing of monetary policy. The release of economic data revealed a further rapid rise in wholesale prices and a slight decline in the unemployment rate during March. In addition, Chairman Burns stated that the Federal Reserve System was determined to permit only moderate growth of money and credit in view of the high domestic rate of inflation. Prices subsequently improved briefly, as participants became hopeful that the 10 percent prime rate established by most major commercial banks would reduce credit demands and help to slow the upward spiral of interest rates.

Prices on Government notes and bonds resumed their downtrend after midmonth in the face of only modest investor demand and rising costs of financing inventories. An increasingly cautious tone developed as the month progressed, in part because of the proximity of the May Treasury refunding. Further statements by Chairman Burns to the effect that the System was determined to subdue inflation reinforced concern, since such a course for monetary policy was seen as resulting in higher inter-

Table I

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

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

Factors	Changes in daily averages— week ended				Net changes
	April 3	April 10	April 17	April 24	
"Market" factors					
Member bank required reserves	− 612	+ 277	− 974	− 5	−1,314
Operating transactions (subtotal)	+ 338	+ 607	− 309	− 524	+ 112
Federal Reserve float	+ 35	+ 233	+ 660	− 198	+ 730
Treasury operations*	+ 435	+ 565	+ 81	− 343	+ 738
Gold and foreign account	− 65	+ 72	− 139	+ 170	+ 38
Currency outside banks	− 23	− 494	− 787	− 158	−1,462
Other Federal Reserve liabilities and capital	− 44	+ 232	− 126	+ 5	+ 67
Total "market" factors	− 274	+ 884	−1,283	− 529	−1,202
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 495	− 785	+ 962	+ 158	+ 830
Outright holdings:					
Treasury securities	+ 157	+ 2	+ 166	+ 198	+ 523
Bankers' acceptances	− 1	+ 1	− 1	+ 5	+ 4
Federal agency obligations	+ 24	—	—	+ 147	+ 171
Repurchase agreements:					
Treasury securities	+ 146	− 558	+ 674	− 247	+ 15
Bankers' acceptances	+ 86	− 131	+ 32	+ 70	+ 57
Federal agency obligations	+ 83	− 99	+ 91	− 15	+ 60
Member bank borrowings	− 210	− 309	+ 622	+ 111	+ 214
Seasonal borrowings†	+ 4	− 7	+ 6	+ 7	+ 10
Other Federal Reserve assets‡	+ 56	+ 46	+ 31	+ 56	+ 189
Total§	+ 331	−1,048	+1,615	+ 325	+1,223
Excess reserves‡	+ 57	− 164	+ 332	− 204	+ 21

	Daily average levels				Monthly averages‖
Member bank:					
Total reserves, including vault cash‡	35,443	35,002	36,308	36,109	35,716
Required reserves	35,217	34,940	35,914	35,919	35,498
Excess reserves§	226	62	394	190	218
Total borrowings	1,503	1,194	1,817	1,928	1,611
Seasonal borrowings†	48	41	47	54	48
Nonborrowed reserves	33,940	33,808	34,491	34,181	34,105
Net carry-over, excess or deficit (−)♯	105	143	38	173	115

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.

§ Adjusted to include $58 million of certain reserve deficiencies on which penalties can be waived for a transition period in connection with bank adaptation to Regulation J as amended effective November 9, 1972. The adjustment amounted to $67 million from January 2 to March 27, 1974.

‖ Average for four weeks ended April 24, 1974.

♯ Not reflected in data above

est rates and heavy borrowing by Federal agencies to support housing. Over the month as a whole, yields on securities maturing within five years were generally 40 to 88 basis points higher, while those on most longer term issues rose 5 to 59 basis points.

After the close of business on May 1, the Treasury announced the terms of its refinancing of the $5.6 billion of publicly held securities which mature May 15. The Treasury will provide funds for retiring some $4.1 billion of the maturing notes and bonds by auctioning three issues to the public. These consist of up to $2 billion of 25 ½-month notes, up to $1¾ billion of 4 ¼-year notes, and up to $300 million of 25-year bonds. The coupon rate on the notes was set at 8¾ percent, while the rate on the bonds was placed at 8½ percent. The Treasury will use available cash to handle the balance of the maturing issues.

Rates on Treasury bills also rose early in April. Investor demand was light, and the market reacted unfavorably to news of underlying strength in the economy and burgeoning growth in money and credit. A limited supply of bills in the six-month maturity range resulted in strong bidding for such bills in the first two weekly auctions of the month, however (see Table II). Rates subsequently fluctuated in a narrow range until shortly after midmonth. Substantial demand, particularly for shorter term bills, emerged when a sizable volume of Treasury tax anticipation bills matured on April 19, and a sharp drop in rates ensued. However, following the increase in the discount rate on April 25, bill rates began moving higher. Rates continued rising over the remainder of the month in response to lackluster demand and concern on the part of some participants that the Treasury would offer additional bills either as part of the May refunding or shortly after the conclusion of that operation. For the month as a whole, bill rates rose 25 to 70 basis points.

On April 23, the Treasury announced that, beginning with the regular weekly auction the following Monday, the Federal Reserve System may exchange the maturing bills it holds for System and official customer accounts for new issues at the average issuing price rather than having to bid competitively for the bills. The amount of maturing bills held in such accounts and eligible for exchange on a noncompetitive basis will also be disclosed each week in the regular auction announcements. On May 1, the Treasury announced that from May 16 through June 13 it will increase the amount of the regular weekly offering of Treasury bills by $200 million each week.

Yields on Federal agency issues moved higher in April, in concert with yields in the Treasury coupon and corporate bond markets. Early in the period, the Federal Land Banks issued three bonds totaling about $1.3 billion. Offered at par, these included $300 million of 8.30 percent fifteen-month bonds, $400 million of 8.25 percent two-year bonds, and $565 million of 8.25 percent three-year bonds. Demand for the two shorter maturities was good, but there was less enthusiasm for the three-year bonds. Around the middle of April, the two other major farm credit agencies marketed new issues which encountered mixed receptions. Specifically, the Banks for Cooperatives offered $211.7 million of six-month 8.65 percent bonds which sold quite well. The initial response was somewhat less favorable to $674 million of 8.80 percent nine-month bonds offered by the Federal Intermediate Credit Banks.

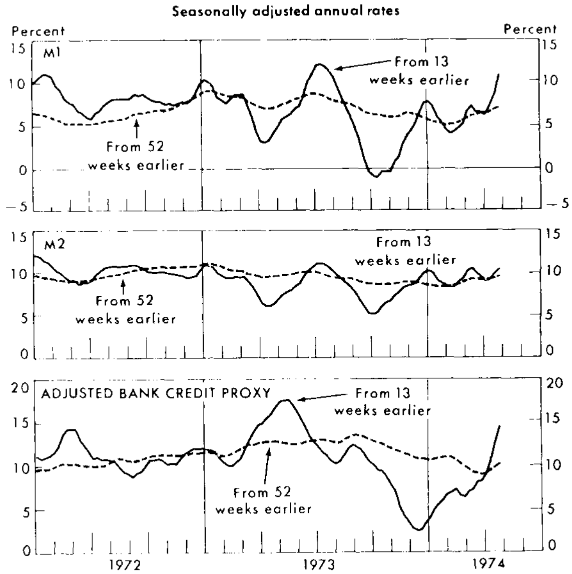
THE OTHER SECURITIES MARKETS

Yields on corporate and municipal bonds rose substantially during the first two weeks of April, as both markets were confronted with the largest calendars in recent

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier, and 52 weeks earlier. The latest statement week plotted is April 24, 1974.

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.

months. Investor response to the higher rate levels was generally favorable, particularly in the tax-exempt sector, and the markets steadied somewhat until the final week of the period when prices weakened again. On April 25 the Federal Reserve Board's series on recently offered Aaa-rated utility bond yields reached 9.08 percent, its highest level since June 1970, and The Bond Buyer index of twenty municipal bond yields climbed to a 2¾-year high of 5.82 percent.

As the month began, investors showed little interest in the first large corporate offering, $100 million of Bell System debentures. Despite the fact that this Aaa-rated issue maturing in thirty-five years carried a yield of 8.65 percent, the bonds sold slowly and, when freed from syndicate price restrictions, the yield adjusted upward by some 10 basis points. A much more enthusiastic reception was afforded to the next large taxable issue, $150 million of A-rated debentures. This issue was priced to yield 9.20 percent in thirty years and also had a provision for deferred payment for large investors and an unusually long call protection period. Shortly after this issue was sold, investors evidenced some indifference to an Aa-rated utility company offering yielding 9 percent. However, the following day, in the wake of the successful sales of several new issues which were very attractively priced, additional demand developed for these thirty-year utility bonds, and they also moved well.

The tone in the corporate bond market remained good following the Easter weekend, and three large issues totaling $300 million were first-day sellouts. These included $100 million of debentures of one of the few industrial corporations with an Aaa rating; the debentures provide a yield of 8.44 percent in thirty years. In addition, $125 million of Aa-rated industrial bonds yielding 8.57 percent in twenty-five years sold quickly, as did $75 million of Aa-rated utility bonds paying 8.90 percent in thirty years. Several large corporate issues were marketed during the last week in April and encountered favorable receptions. The largest of these—$300 million of Aaa-rated industrial bonds—was priced to yield 8½ percent in thirty years, an exceptionally high return for such an issue.

There was good demand for most of the new tax-exempt issues which were marketed during April. Yields on the first two large offerings of the month were some 20 to 35 basis points higher than on preceding comparable issues, and investors responded well. On April 10, New York City sold a $436.6 million issue, reportedly the largest offering ever marketed by a local government. The bonds attracted sizable interest, particularly from small investors. The average cost to the city of 6.18 percent was 1 percentage point higher than at its previous sale in January. The A-rated bonds, which are exempt from New York City, New York State, and Federal taxes, were successfully marketed at yields ranging from 5.5 percent in 1975 to 6.5 percent in 2003-14. Their warm reception buoyed the market generally, and several large issues sold well the following week. One of these was a $110 million offering of Aaa-rated tax-exempt securities scaled to return about 25 basis points less than a comparable issue sold eight days earlier. Over the remainder of the period, however, rates on municipal bonds resumed their rise and closed the month some 25 basis points higher, on balance. The Blue List of dealer inventories fell $183 million to a level of $474 million in April.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—April 1974				
	April 1	April 8	April 12	April 22	April 29
Three-month	8.358	8.648	8.051	7.857	8.909
Six-month	8.211	8.393	8.084	7.995	8.796

Maturity	Monthly auction dates—February-April 1974		
	February 6	March 6	April 3
Fifty-two weeks	6.342	6.897	7.886

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return of the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.