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Statement by Alfred Hayes To the House Banking and Currency Committee

Editor's Note: *This statement on current economic problems as they relate to monetary policy and the Federal Reserve System was presented in testimony to the Committee on Banking and Currency of the House of Representatives on July 17, 1974 by Alfred Hayes, President of the Federal Reserve Bank of New York.*

Mr. Chairman and members of the Committee, I am happy to have this opportunity to express my views on some of our current economic problems, especially as they relate to monetary policy and the Federal Reserve System.

I would like at the outset to add my voice to those who believe that our most serious current economic problem is inflation. Indeed, the solution to many of our other difficulties, including high interest rates, the slump in housing, the liquidity problems of business and financial institutions, as well as many of our problems in the international financial sphere, depends importantly on our ability to get inflation under control. I believe that control of inflation clearly should be the main objective of monetary policy for the present and probably for quite some time to come.

Our current inflationary situation has had a long evolution, dating back to the mid-1960's. It began with our unwillingness, for a long period, to provide increased taxes to finance the Vietnam war and expanded social programs. The result was an excessively stimulative fiscal policy and pressures on aggregate demand. The ensuing demand inflation led, in due course, to cost pressures and to steadily mounting inflationary expectations. These secondary, but apparently inevitable, consequences of prolonged demand pressures made inflation progressively more deep-rooted and difficult to cure. The recession of 1970 removed demand pressures for a time. While it went too far in generating idle resources, the rate of inflation did begin to come down. Unfortunately, the gains in this respect were disappointingly slow and modest to an understandably frustrated public. I believe the program of price and wage controls begun in mid-1971 made a significant contribution to reducing inflation as long as demand pressures remained under control. By late 1972, however, the economy was again expanding too rapidly. Demand pressures reasserted themselves, making controls of little use and even counterproductive over the last portion of their life.

Over a long period of nearly ten years, we have paid an increasingly heavy price, in terms of irregularly accelerating inflation, for giving insufficient attention to the limits on our capacity to meet ever-growing demands at stable prices. Over most of this period the Federal budget has been in significant deficit, and fiscal policies have certainly been too expansionary during the period as a whole. Nor would I argue that monetary policy has been immune over this long period to the national tendency to try to expand demand at a rate in excess of what can be produced at stable prices. Indeed, I think there have clearly been times, particularly in 1968 and in 1972, when monetary policy has been rather too expansionary.

In any case, I think we have learned that the virus of inflation becomes progessively more difficult to cure as its treatment is postponed or neglected. The prospect of an ever-accelerating inflation is truly frightening in its implications for the stability of our economic and social system. The point has now been reached where we must direct our attention to solving this problem even though the cure may have painful side effects in the short run. As I will later indicate in more detail, I do not believe that our present inflationary problems stem solely from demand conditions. Nor do I necessarily believe that monetary and fiscal policies, our main tools of demand management, are the only ones we should use in bringing inflation under control. Nevertheless, I think it is clear that prudent moderation in aggregrate demand is an absolute precondition to the restoration of price stability. And monetary policy certainly has a very large role to play in this development.

Against this general background, I would like to address myself now to some issues in which the Chairman indicated a particular interest in his letter inviting me to testify. One of these issues is the so-called "trade-off" between inflation and unemployment and its implications for formulating monetary policy. In my view, the notion that unemployment can be permanently reduced below some specified minimum simply by pumping up aggregate demand—and without any improvement in the structural characteristics of our labor markets—is quite misleading. Indeed, the notion that low levels of unemployment can be achieved by monetary policy alone—provided only that a little more inflation be tolerated—has probably caused a good deal of mischief.

To be sure, if unemployment is abnormally high, the judicious application of monetary stimulus can help reduce unemployment to more moderate levels with little adverse effects on inflation. Beyond a certain point, however, one that seems to be dictated largely by the structural characteristics of labor markets, attempts to reduce unemployment in this way require progressively larger doses of stimulus. The resulting inflation which may be moderate at first, tends to accelerate progressively. In time, inflation comes to be built into the structure of costs and expectations and its stimulative effects wear out. Thus, a progressively more rapid inflation is required to achieve given effects on unemployment. Certainly, our present situation of unemployment in excess of 5 percent, coupled with the escalation of inflation rates that we have witnessed, strongly suggests that this process has been at work over the past decade.

I do not pretend to know just what rate of unemployment might be a sustainable minimum for price stability under the conditions of the 1970's. I do feel sure, however, that it is something materially above the 4 percent figure that was often cited in the past as an appropriate full employment goal.

At the same time, I do not want to suggest that an unemployment rate such as 5 percent need be accepted for all time as the best we can do under conditions of sustained price stability. What I think has to be recognized is that the only way permanently to reduce the levels of unemployment compatible with price stability lies in measures that will increase the qualifications of the labor force that are in demand and that will produce a more efficient and speedy matching of willing workers and available jobs. Attempts to solve the problem by pumping up aggregate demand can, in the end, have only devastating inflationary consequences with the accompanying risk of leading ultimately to really serious slumps in the economy and in employment.

Even if we could be sure we could trade a higher level of employment for an additional measure of inflation, this would seem to be a very bad bargain for the American people under the present circumstances. The longer inflation is allowed to run unchecked, the larger will be the distortions built into the economy and the more difficult and painful will it be to bring inflation under control. Thus, even though unemployment is not as low at present as most of us would like to see it, I think we have no real alternative to a policy of moderate but continuing monetary restraint. The short-term costs of restraint at this juncture will be less than would ultimately have to be paid if we were to allow inflation to gain even further headway before acting decisively to bring it under control.

A somewhat special problem for monetary policy in combatting inflation can arise, as the Chairman suggested in his letter, when nonrecurring price increases stemming from supply shortfalls arise. The increase in petroleum prices associated with the Middle Eastern oil boycott last winter is the most conspicuous recent example. I think it is difficult to generalize about the possible implications for monetary policy of such developments. Much depends upon circumstances.

In some cases, I would think such developments need not require any change in the thrust of monetary policy. In principle, the rise in prices in one sector of the economy may set in motion compensating price changes in other sectors as available funds are diverted to the sectors where prices have risen. Thus there may be, especially in the longer run, little net change in inflationary pressures, and no reason to change the thrust of policy. In particular instances, however, much depends upon the flexible and timely reaction of prices in the sectors not directly affected by the special development. In the shorter run, such developments clearly can add to the overall rate of inflation.

Of course, shortages of oil or other essential commodities can have a magnified depressing effect on total real output since they are needed to produce other goods and services. This was a matter of considerable concern during the recent oil embargo. While we in the Federal Reserve were under no illusions that we could increase the supply of oil by increasing the supply of money, we were also alert to the danger that the shortage-induced downturn in the economy could cumulate into a general recession. We were prepared to ease monetary policy if such a process seemed to be getting under way. This did not develop, however, and policy was not changed in any major way in response to the effects of the embargo.

I would now like to turn to the relationship between monetary and fiscal policies and the problems posed for monetary policy by fiscal stimulus in an inflationary environment. Monetary and fiscal policies are most effective when they are used in tandem, rather than working at cross purposes. While monetary policy can offset some of the effects of an excessively expansive Federal budget, it cannot compensate for all of the shortcomings of fiscal policy. Our experience over the past several years bears testimony to this truth. While a combination of factors has exacerbated our inflationary problem, Federal budgetary deficits have played a significant underlying role.

When productive facilities are strained by excessive demands for goods and services, Federal deficits tend to exert upward pressure on prices, as the Government competes with the private sector for scarce resources. At the same time, deficit financing also puts upward pressure on interest rates as the Government bids for credit to cover its deficits. This situation creates a dilemma for monetary policy. To underwrite the deficit by monetizing the Federal debt would, of course, tend to be inflationary. And inflation tends in the longer run to become imbedded in the credit markets in the form of higher interest rates, as I shall indicate more fully in a moment. On the other hand, preventing credit from expanding to accommodate a Federal deficit would tend to put immediate upward market pressures on interest rates. Such developments are, of course, unpopular and it is all too easy, almost without realizing it, to accommodate the pressures generated by fiscal deficits.

Reliance on monetary policy alone to restrain inflation in the face of overly expansive fiscal policy therefore does entail risks. Rising market rates of interest induce savers to withdraw funds from thrift institutions, thereby drying up the major source of private financing of residential construction. Extremely tight money, moreover, can imperil the liquidity and even the solvency of credit-dependent firms. The Federal Reserve cannot be oblivious to the risks of pushing monetary restraint too far. We must bear in mind our essential role as lender of last resort to the economy. If liquidity pressures mounted to the point that a breakdown of the credit system appeared to be a serious threat, the Federal Reserve would have to take steps to forestall it. This might entail some temporary deviation from the monetary growth rates that would be consistent with long-run price stability.

In practice, monetary policy must weigh the dangers of accommodation against those of resistance to excessive fiscal stimulus. The results are unlikely to be entirely satisfactory as long as excessively expansive fiscal policy is tolerated. I am encouraged by Congressional steps to gain better control over fiscal policy. I hope a more active and concerted role by the Congress in framing fiscal policy will significantly diminish the risk that monetary policy will have to select among bad choices in the face of inappropriate fiscal policy.

In commenting on the role of fiscal policy, I do not want to imply that monetary policy has not played a role in the evolution of our present situation. Indeed, as I indicated earlier, I think monetary policy has clearly been somewhat too expansionist at times over the past decade.

I would now like to turn to the relationship among the monetary aggregates, inflation, and interest rates. Certainly, there has been, historically, a broad long-run relationship between trends in monetary expansion and the behavior of prices. Over long periods of time, price stability depends upon a rate of money and credit growth commensurate with the economy's capacity to produce. Ultimately, therefore, the return to an era of price stability will require the restoration of the monetary aggregates to moderate rates of growth. And I should perhaps add that some of our current notions of what constitutes "moderate" growth would have seemed rather rapid in an earlier period of relative price stability.

It would, however, be a gross oversimplification to attribute all fluctuations in the pattern of inflation to the behavior of the monetary aggregates. There may be many nonmonetary developments that can have powerful influences on the behavior of prices for periods as long as one, two, or more years. The special case of supply shortages, as in the recent fuel and food cases, has already been touched on. As I noted earlier, such supply developments need influence only relative prices in the longer run, with spending being diverted from other sectors whose prices should in principle fall, or at least rise less rapidly, leaving the overall rate of inflation unaffected. But in the shorter run, the prices of goods in sectors not directly affected by such special developments may be rather unresponsive to demand conditions. Under these circumstances, there may be, and I believe have been, significant, if temporary, effects on the overall price level.

There are, moreover, many other factors that may have an important influence over prices quite independent of the behavior of the monetary aggregates. One of the most conspicuous of these in recent years has been behavior of foreign exchange rates. I think there is little question that the overall depreciation of the dollar since early 1971 has been a significant inflationary force in this country. The depreciation of the dollar has raised the dollar prices of goods we import. It has also tended to raise the prices of goods produced in the United States and sold in both domestic and foreign markets.

Among other influences on inflation apart from the behavior of the monetary aggregates, I have already noted the role of excessively stimulative fiscal policy. More broadly, I think the rough long-run statistical parallelism between price and monetary behavior conceals important social and political factors that partly account for this statistical relationship. The well-known association between wars and inflation, for example, has often reflected the unwillingness of governments to finance military spending through adequate taxation. This has often led to pressures on central banks to accommodate government borrowing through excessive monetary and credit expansion. And wars have not provided the only instances of governmental failure to face up to the costs of spending programs with consequent pressures, direct or indirect, on central banks to make up the difference by monetary expansion.

With regard to the relationship between inflation and interest rates, the trend to high levels of interest rates that has developed over the past several years has clearly reflected in major part the behavior of prices. In a situation where rising prices have steadily eroded the real value over time of debt instruments, lenders have come to demand an inflationary rate premium, and borrowers have felt justified in providing it. It is hard to persuade savers to lend their savings at interest rates lower than the rate of inflation, especially when real estate and other commodity investments exist as alternatives to fixed dollar instruments. In this setting, an attempt to bring down interest rates by rapid expansion in money and credit would be self-defeating, except perhaps in the short run. I am convinced that the only way to restore more normal levels of interest rates is to restore price stability—and this will require restraint in monetary expansion, not extravagance.

The problem for monetary policy in bringing inflation under control and interest rates down to more normal levels is indeed essentially a single problem. The solution requires a degree of monetary restraint over a period sufficiently long to wring inflation out of the economy. This will mean gradually reducing the growth of the monetary aggregates to a trend compatible with long-run price stability.

The task of restoring price stability is likely to be protracted. The experience of recent years indicates that our price system reacts only gradually to changes in demand conditions, owing to the long-lasting secondary effects of demand pressures on costs and expectations. In view of these factors, I do not expect price behavior to react quickly to monetary restraint. The length of time that will be required to bring the long-run trend of monetary expansion, aggregate demand, and price behavior to a satisfactory point will depend upon a number of factors. The ability of our financial markets to withstand restraint and the impact of restraint on unemployment and on particularly sensitive areas of the economy, such as the savings institutions and the housing industry, will affect the feasible path of monetary policy.

On a number of occasions in recent years during periods of monetary restraint, tight money conditions have resulted in sharp liquidity pressures on particular institutions or particular segments of the markets. In some instances these have been so acute, or threatened to become so acute, as to create risks for the financial system as a whole. In such instances, the Federal Reserve has recognized and accepted its responsibilities, particularly in its role as lender of last resort, and has taken action designed to cushion the impact of such pressures.

There are a number of things that might be done to make the task of monetary policy easier. Fiscal restraint is certainly one of these. A budget surplus would be very helpful in relieving strains on financial markets. Programs to aid housing, such as those recently announced by the Administration, are another example. A third would be efforts to improve the functioning of our labor markets, perhaps including, if needed, Federal job programs for the unemployed.

An important factor that I hope will make our job easier this time is the widespread conviction on the part of the American public that inflation is public enemy number one. I am hopeful that this will be reflected in a healthy measure of self-restraint by all of us in our common fight against inflation—including restraint by labor in wage settlements and by industry in the setting of prices.

In any case, I think a path of prudent monetary restraint for however long is needed to restore price stability is the only responsible course of action. A premature easing would lead to a resurgence of demand pressures and a renewed and even more virulent acceleration of inflation. This would, I am convinced, pose serious dangers for our economic and social fabric. Price stability is the key to many things, to low interest rates, to a smoothly functioning financial system, to a healthy housing industry, to a strengthened international economy, and to the opportunity for sustainable economic growth. All of these things can be achieved through responsible policies, including monetary policy—not without temporary costs, to be sure, but at costs that will be far outweighed by the benefits accrued.

The Business Situation

Economic activity was sluggish in the second quarter, and uncertainties over the possible implications of inflation, high interest rates, and liquidity problems remain. Real gross national product (GNP) declined at a 1.2 percent seasonally adjusted annual rate, following the sharp 7 percent decline registered in the first quarter. After allowing for the effect of higher prices, disposable income declined further in the second quarter but real personal consumption expenditures increased slightly, led by the rebound in spending on services and durable goods. At the same time, however, consumer confidence apparently remained weak and purchases of nondurables slowed. Plagued by tight mortgage markets and high interest rates, real spending on new housing continued to decline, but at a significantly slower rate than in the previous six months. In constant-dollar terms, business fixed investment was roughly unchanged in the April-June period. However, the backlog of unfilled orders of durable goods manufacturers grew substantially. One of the most important factors retarding real growth in the second quarter as relates to GNP accounting was the oil-related deterioration of net exports. In July, the labor market was essentially unchanged, although the unemployment rate edged up to 5.3 percent from the 5.2 percent rate of the previous two months.

Inflation continued at a dismaying rate in the second quarter, although the rate of increase slowed somewhat. According to preliminary Commerce Department estimates, the implicit GNP price deflator surged at an 8.8 percent annual rate in the second quarter, following the 12.3 percent advance of the first quarter of the year. The rate of increase in the fixed-weight price index—which, unlike the implicit deflator, is unaffected by changes in the composition of output—also slowed, but nevertheless the fixed-weight index climbed at an 11.2 percent annual rate in the second quarter, compared with a first-quarter advance of 12.7 percent. Over the past four quarters, the implicit deflator has increased 9.5 percent, the highest rate of increase in over twenty-five years. With at least part of this price explosion attributable to the dismantling of price controls, there is hope that the rate of inflation may moderate in coming months. However, much of the most recent slowing in the rate of increase has resulted from declines in prices of agricultural commodities—declines that now may be reversed as a result of reduced forecasts of future crop harvests. Furthermore, cost pressures on prices are not likely to ease in the near term in view of the recent huge expansion in the prices of wholesale industrial commodities and the strong demand for higher wages as workers attempt to regain their loss in purchasing power.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

Preliminary data released by the Commerce Department indicate that, measured in current dollars, the market value of the nation's output of goods and services rose at a 7.5 percent seasonally adjusted annual rate in the second quarter. After adjustment for price increases, however, real GNP declined slightly, falling at a 1.2 percent annual rate in the April-June period. At this time, the Commerce Department released its annual bench-mark revisions of GNP data going back to 1971. According to revised estimates, growth in the last quarter of 1973 was somewhat stronger than in the second or third quarters of that year, whereas earlier data had indicated some weakening. In addition, the decline in real GNP in the first quarter of this year is now estimated at a 7 percent rate (see Chart I), somewhat more than was first reported.

According to the preliminary estimates, business inventories rose $15.1 billion in the second quarter, slightly less than the $16.9 billion increase registered in the first three months of 1974. This slight decline in the rate of inventory accumulation followed a much sharper drop-off in the preceding quarter (see Chart II). For the last half of 1973 and the first quarter of 1974, Commerce Department revised estimates, which have on average doubled the original estimates of inventory spending, indicate that, measured in current dollars, inventory accumulation amounted to an average of $19.2 billion at an annual rate over these three quarters. Although a small part of the most recent buildup has been in farm inventories, the bulk of the accumulation has been in stocks of nonfarm nondurable goods. The rate of increase in nondurable goods inventories doubled in the second quarter, rising to $16.5 billion at a seasonally adjusted annual rate from $8.2 billion in the first quarter. On the other hand, durable goods inventories fell $1.4 billion in the second quarter following an $8.7 billion dollar increase in the first quarter.

The growth of final expenditures—GNP net of inventory accumulation—remained essentially steady in the second quarter, as outlays climbed at a $26.5 billion rate compared with a $26.8 billion gain in the first quarter. After allowing for the impact of inflation, real final expenditures declined $1 billion in the April-June interval. Nevertheless, this was an improvement over the declines of $5.8 billion and $7 billion during the previous two quarters.

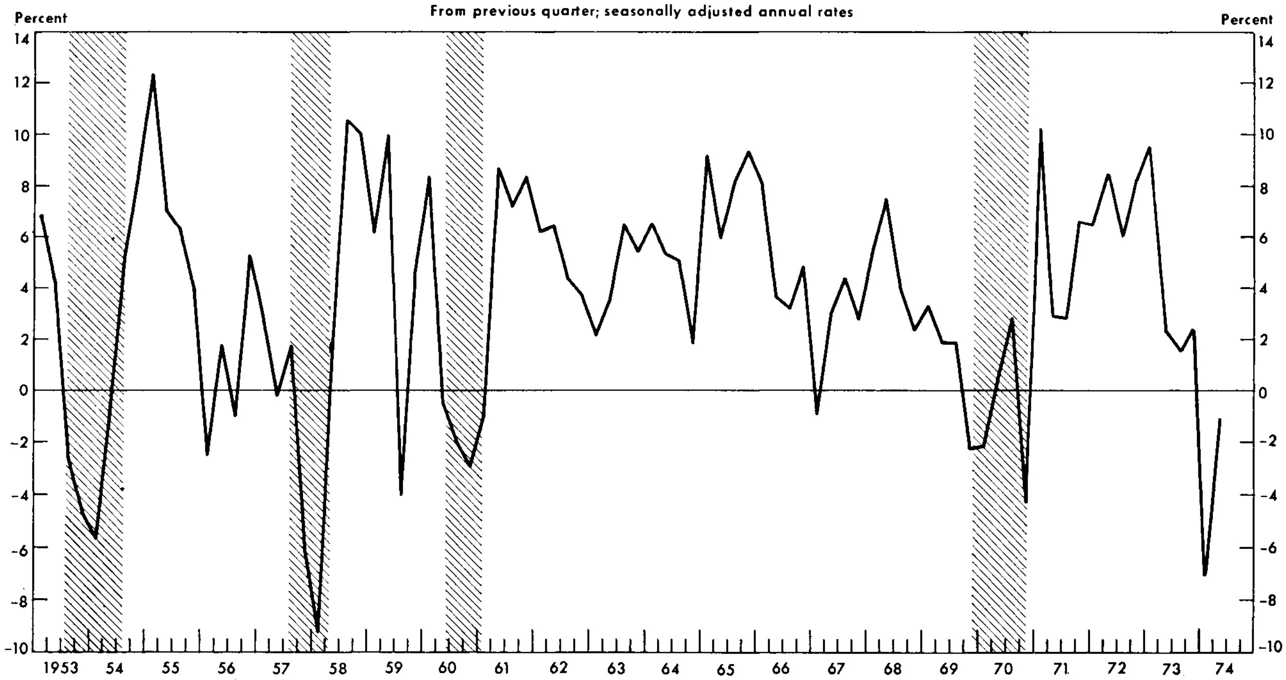
Personal consumption expenditures in current-dollar terms increased by $26.2 billion in the April-June period, well above the $16.7 billion increase posted in the first quarter and the $7.6 billion rise in the final quarter of 1973. Following two quarters of decline, real consumer spending registered its largest advance in over a year in the second quarter, paced by a rise in durable goods purchases. The outlook for consumer spending, however, continues to be complicated by the erosion of consumer confidence and purchasing power by inflation. The latest reading of the University of Michigan's index of consumer sentiment suggests little improvement in consumer confidence, although the index did edge up from the all-time low reached in February during the worst of the oil embargo. This survey indicated that an increasing number of consumers had become concerned over the pervasiveness of inflation.

Reversing the $0.4 billion decline in purchases of durables in the first quarter, consumer spending on durables increased $6.3 billion in the second quarter. After balking at purchasing automobiles in the January-March quarter, consumers renewed their purchases of autos, which accounted for more than one third of the increase in durables purchases. New automobile sales have gradually edged up from the 7.5 million units (seasonally adjusted annual rate) averaged in the first three months of the year to 7.9 million units in the second quarter, with 8 million units sold in

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From previous quarter; seasonally adjusted annual rates



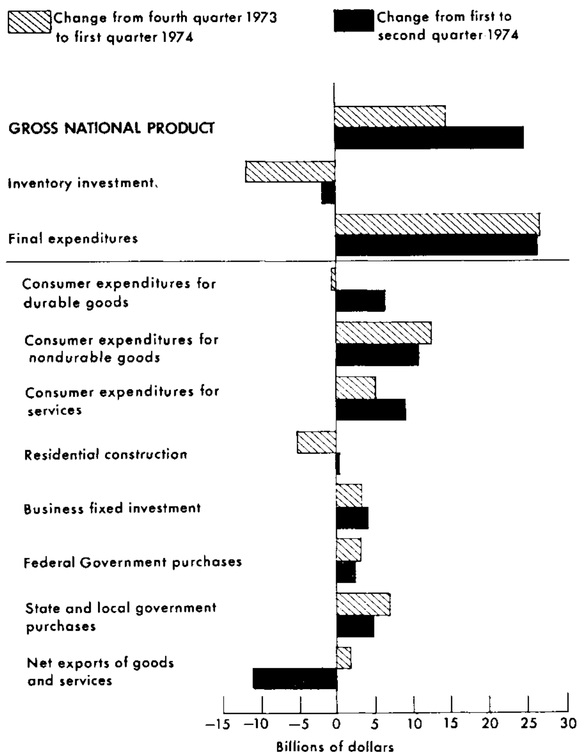
Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology.
The dates of the 1969-70 recession are tentative.

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

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

June. While part of the increase in automobile sales reflects the improved availability of gasoline, sales may also have been bolstered in the second quarter by expectations of still higher auto prices in the future. The latest Conference Board survey of consumers indicated a pickup in automobile buying plans.

The growth in consumer purchases of nondurable goods slowed in current-dollar terms in the second quarter, rising by $10.8 billion following a $12.3 billion increase in the first quarter. The increase in spending on food and beverages, clothing, and shoes all were smaller than in the January-March interval. After adjustment for price increases, real nondurables expenditures declined slightly in the second quarter.

The decline in the rate of personal saving out of disposable income accelerated in the second quarter. After climbing almost continuously from mid-1972, the saving rate dropped from an exceptionally high 9.5 percent in the fourth quarter of 1973 to 8.9 percent in the first quarter and to 7.6 percent in the second quarter. It appears that consumers are attempting to maintain their consumption levels despite a continuing decline in real disposable income. Real disposable income fell in the second quarter, but the decline was less than that posted in the first three months of the year.

Business fixed investment rose $4 billion in nominal terms in the second quarter, only modestly above the upward revised $3.3 billion gain recorded over the previous three months. While this sector has been counted on to provide a good portion of the upward thrust to the economy in 1974, some firms may be delaying or reducing capital spending projects in light of financial market conditions. Most notably, some public utility offerings have faced relatively poor receptions in the bond market and, as a result, this industry has pared planned capital expenditures. The latest Department of Commerce survey of planned expenditures indicated a 12.2 percent rise in outlays in 1974; however, since these outlays are in nominal terms, they reflect the rapid inflation rate and therefore overstate the level of real business spending. On the other hand, the persistent rise in the backlog of unfilled orders of durable goods manufacturers continues to suggest that gains in capital spending may be in the offing.

After declining for three consecutive quarters, residential construction spending rose modestly in nominal terms in the second quarter of 1974. Outlays increased by a slight $0.3 billion, a considerable improvement over the $5.2 billion decline in the first quarter of this year. As a result of the decline of its relative importance, residential construction outlays now account for only 3.1 percent of real GNP, the lowest percentage since 1970. Moreover, caught in the web of high mortgage rates and unavailability of mortgage money, the outlook for residential construction remains dim. The 8.1 percent annual rate increase in housing starts in June still leaves starts one-fourth below their level of a year ago. Multifamily starts have been particularly hard hit and now stand at 43 percent below the level of such starts a year ago. Part of this decline may be because of adverse publicity concerning condominium apartments and the recently announced Government investigation of possible unfair or deceptive industry practices. Another factor depressing multifamily starts has been the rise in the rental vacancy rate to 6.3 percent, the highest level since 1967. In contrast to the jump in starts, permits for new construction were unchanged in June and remain depressed compared with a year ago.

Federal Government purchases of goods and services rose by $2.4 billion in the second quarter, primarily as a result of an increase in nondefense expenditures. Defense spending was virtually unchanged, as it rose only $0.3 billion. State and local government outlays jointly climbed $4.8 billion, a somewhat smaller gain than in the previous quarter.

Largely reflecting the impact of the oil situation, the value of net exports during the second quarter dropped to $0.2 billion, $11.1 billion below the first-quarter level. The decline in net exports was in part a consequence of the post-embargo rise in the importation of higher priced oil. Also important was the decline in the receipts of American oil companies on their investments abroad as a result of the increased participation of the Saudi Arabian government in the Arabian American Oil Company. Such receipts are included as a plus element in the net export figures, and when they decline their effect is to reduce this component.

PRICE DEVELOPMENTS

Serious inflation persisted in the second quarter. The Commerce Department estimates that the implicit GNP price deflator climbed at an 8.8 percent annual rate in the April-June period, following an upward revised 12.3 percent rise in the first quarter of 1974. Over the four quarters ended in June, the deflator increased at a 9.5 percent annual rate, the highest rate of increase recorded in over twenty-five years. Since changes in the implicit deflator reflect shifts in the composition of spending as well as price changes, the Commerce Department also calculates a fixed-weight price index based on an unchanging composition of spending. In the second quarter, the fixed-weight GNP price index, which is based on the composition of 1967 spending, rose at an 11.2 percent annual rate, slightly less than the increase of 12.7 percent recorded in the first quarter.

Consumer prices continued to increase at a very rapid rate in June, rising at an 11.5 percent seasonally adjusted annual rate. Over the twelve months ended in June, consumer prices spurted 11.1 percent, the largest increase in twenty-seven years. The broadly based June increase underscores the degree to which inflation has spread throughout the economy. While there was a marked slowdown in the increase in the prices of food and consumer power and fuel, large price increases were recorded for medical services, new and used automobiles, and household durables. Responding to some extent to the recent reductions of food prices at the wholesale level, retail food prices rose at a 3.8 percent annual rate in June, well below the 15.7 percent increase averaged over the previous twelve months. Prices of consumer power and fuel increased at a 14.9 percent annual rate in June, a substantially slower advance than the explosive 40.2 percent rise averaged over the previous six months. At least part of the bulge in prices of nonfood items in June is attributable to price increases instituted following the termination of the price controls program on May 1. Hence, current advances are to some extent only reflecting increases that were postponed by controls, and there is some hope that price gains may moderate in the future. On the other hand, cost pressures are not likely to ease in the near term in light of the recent upsurge in wage settlements.

Wholesale prices rose at a seasonally adjusted annual rate of 5.7 percent in June, well below the 14.4 percent annual rate advance averaged over the previous three months. This slowing was the result of the further fall in wholesale prices of farm products and processed foods. In posting their fourth consecutive decline, wholesale agricultural prices fell at an annual rate of 47.6 percent. It appears, however, that these declines may give way to increases in the near term. Forecasts of future crop harvests in the Midwest have been reduced, as unfavorable climatic conditions, first rain and then drought, have held down production. As a result, prices of agricultural commodities are rising once again. Continuing to reflect the end of the price controls and higher material costs, prices of wholesale industrial commodities rose at a 26.9 percent rate in June, compared with the 33.6 percent rate of increase averaged over the previous three months.

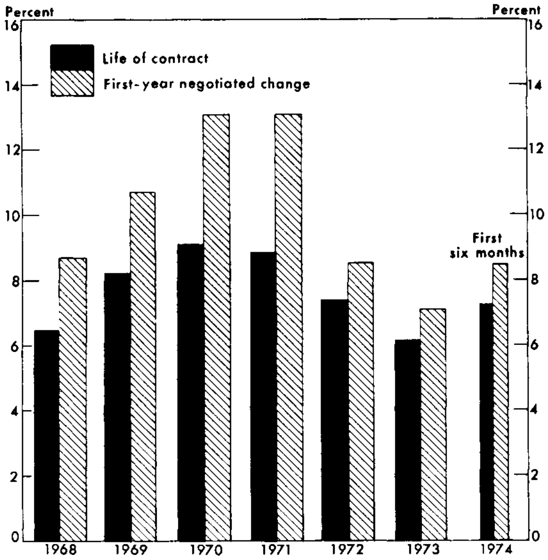
WAGES, PRODUCTIVITY, COLLECTIVE BARGAINING, AND EMPLOYMENT

Cost pressures continued strong in the second quarter as productivity remained relatively unchanged and as labor, in the face of continuing inflation and the end of wage controls, pressed for higher wage and benefit gains. Compensation per hour of work in the private sector rose at a 13.9 percent seasonally adjusted annual rate in the second quarter, the highest rate of increase in over twenty years and well above the 6.6 percent increase averaged over the previous four quarters. However, much of the second-quarter increase was attributable to a decline in hours worked in farming. In the nonfarm private sector, compensation rose at a 10.2 percent annual rate, compared with a rise of 8.5 percent in the first quarter. This advance resulted from an increase in hourly earnings and fringe benefits relative to hours of work.

As measured by real output per hour of work, second-quarter productivity in the private economy increased slightly at a 0.7 percent seasonally adjusted annual rate. This

Chart III

WAGE AND BENEFIT CHANGES NEGOTIATED IN MAJOR COLLECTIVE BARGAINING AGREEMENTS



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

increase was primarily the result of the precipitous decline in hours worked in the farm sector. It appears that the first-quarter farm hours worked were inflated as farmers rushed to bring additional land under cultivation but, with this accomplished, farm employment and hours have now fallen to levels comparable to a year ago. Excluding the variable farm sector, productivity in the private economy declined 2.8 percent. With productivity failing to record any significant rise and compensation rising sharply, unit labor costs during the second quarter rose at a 13.5 percent annual rate.

The recent declines in real wages have caused an upsurge in union demands and strike activity. The number of man-days lost because of strikes has jumped, with the second-quarter average the highest in over three years. During the past six months, first-year wage and benefit gains in collective bargaining settlements covering 5,000 or more workers aggregated 8.5 percent, a marked increase from last year's average first-year gain of 7.1 percent but well below the explosive advances recorded in early 1970 and 1971 (see Chart III). Over the life of the contract, wages and benefits rose 7.2 percent in the first half of 1974, rebounding from the six-year low of 6.1 percent recorded last year. Thus, although front loading—that is, providing a disproportionate share of the total increase in the first year of the contract—is on the upswing, the differential of first-year gains over life-of-contract advances has not approached the differential reached in 1970 and 1971 when labor last attempted to make up for lost purchasing power. Instead, it appears that a number of unions are focusing on protecting real wage gains by negotiating or liberalizing cost-of-living escalator clauses. In fact, over 10 percent of the collective bargaining settlements reached thus far in 1974 have adopted escalator provisions. Approximately 45 percent of all workers under major bargaining units are now covered by cost-of-living escalators. As a result of the growing importance of these escalators, the Bureau of Labor Statistics has initiated a new statistical series that includes the gains in cost-of-living escalators in contracts of 1,000 or more workers. These data indicate that first-year wages negotiated in the second quarter rose 10 percent, the highest quarterly advance in the six-quarter history of the new series. The escalator adjustments accounted for only 0.8 percentage point of this advance.

According to the monthly survey of households, conditions in the labor market changed little from June to July. As the growth in the civilian labor force outpaced the rise in employment, the unemployment rate edged up to 5.3 percent from the rate of 5.2 percent sustained over May and June. During July, the unemployment rate for most major labor force groups was unchanged, including the closely watched rate for married men that held at 2.6 percent. Among the labor force groups registering increases in jobless rates were white collar workers, adult women, nonwhites, and teen-agers. The 0.2 percentage point increase in the jobless rate for white collar workers increased their level of unemployment to 3.3 percent in July. The unemployment rate for adult women edged up 0.1 percentage point in July to 5.2 percent, and the volatile teen-age jobless rate rose from 15.6 percent to 16.2 percent. The nonwhite unemployment rate rose to 9.4 percent from 8.8 percent, compared with the 9.2 percent rate averaged over the first six months of 1974.

The July payroll survey of establishments diverged from the household survey, as seasonally adjusted nonfarm payroll employment declined 122,000, led by declines in employment in the construction and manufacturing industries. The two surveys often differ in a particular month because of sampling and coverage differences; however, over longer periods of time they tend to show comparable changes. While the number of production workers on factory payrolls declined, the average workweek in manufacturing rose 0.2 hours in July to 40.3 hours, despite a 0.1-hour drop in overtime. In the private nonfarm sector as a whole, the average workweek increased by 0.2 hours to 36.9 hours.

Monetary and Financial Developments in the Second Quarter

Interest rates on all forms of private debt instruments moved substantially higher during the second quarter. Yields on short-term Government securities declined, however, and the rates on intermediate- and long-term Government obligations changed very little. Firm monetary policy, together with inflationary expectations and a continuing high demand for business loans, pressed most interest rates upward throughout the quarter. Yields received an added boost during the second half of the period from the successive announcements that a large commercial bank had sustained heavy financial losses and that a major utility company was experiencing liquidity difficulties and was omitting a dividend payment. For the period as a whole, the yield on four- to six-month commercial paper rose 2½ percentage points, and the prime rate at most commercial banks reached 11¾ percent by the end of June. In contrast, the return on three-month Treasury bills registered a moderate decline, as investors appeared willing to surrender a substantial yield advantage for the added safety of Government obligations. During the last week of April, the twelve Federal Reserve Banks increased the discount rate on member bank borrowings by ½ percentage point to a record 8 percent.

Despite rising interest rates, the monetary aggregates continued to expand rapidly during the April-June period. The narrowly defined money stock (M_1) grew at a seasonally adjusted annual rate of 7 percent, only slightly below the gain experienced in the first quarter but still excessive. The more broadly defined money stock (M_2) grew at a 7.8 percent annual rate during the second quarter, off somewhat from the pace of the first quarter. The volume of large certificates of deposit (CDs) expanded very rapidly, and consequently the growth rate of the bank credit proxy accelerated.

Commercial banks continued to extend huge amounts of credit to their corporate customers during the second quarter, as business loan demand showed persistent strength. The volume of business loans outstanding advanced at a 23 percent annual rate over the period, while total bank credit grew at a rate of 11.5 percent. Deposits at thrift institutions expanded at a very modest rate during the quarter. Mortgage loans, however, continued expanding at nearly their first-quarter rate, but new loan commitments, in reaction to the weaker deposit inflows and record high interest rates, were off sharply from their level at the end of March.

THE MONETARY AGGREGATES

M_1—private demand deposits adjusted plus currency outside commercial banks—grew at a 7 percent seasonally adjusted annual rate during the second quarter (see Chart I). This pace was slightly slower than during the first quarter* and brought monetary growth for the first half of 1974 to a 7.1 percent rate. Some of the expansion of M_1 in the second quarter was provided by currency, which increased at an 8.8 percent annual rate. Increases in currency often reflect a larger dollar value of ordinary household expenditures on nondurable goods and services, which typically are paid for with cash. These expenditures have been increasing rapidly for the past several quarters, in part because of rising food prices.

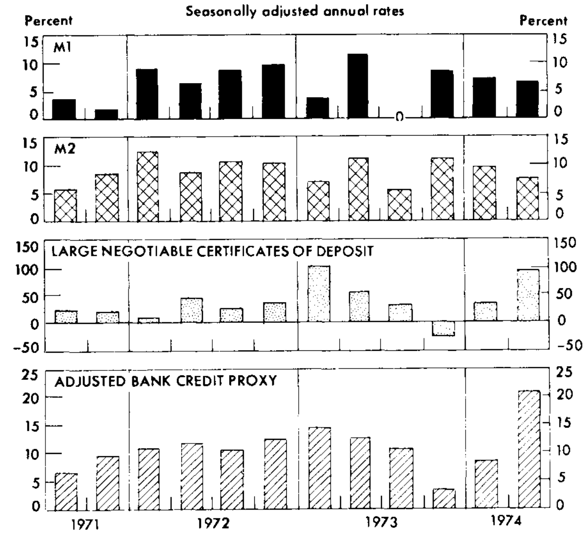
During the quarter, the Board of Governors began to publish the short-run numerical specifications that guide open market operations in the period between Federal Open Market Committee (FOMC) meetings, along with the policy records of the meetings. The policy records continue to be published with a three-month lag, and hence publication of the numerical specifications involves a similar lag. At the FOMC meeting of April 15-16, the most recent meeting for which notes are publicly available, the Committee concluded that the economic situation and

*In May, the Board of Governors of the Federal Reserve System announced revisions of the money stock measures to incorporate data on nonmember bank deposits obtained from the December call reports and recent data on deposits of domestic agencies and branches of foreign banks. The revisions boosted the growth of seasonally adjusted M_1 over that previously reported by 0.4 percentage point in the first quarter to 7.1 percent at an annual rate and 1.4 percentage points in the fourth quarter of 1973 to 8.9 percent. Similar upward adjustments were announced for the growth of M_2.

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.

outlook continued to call for moderate growth in monetary and credit aggregates over the long run. However, the desired long-run growth rate of M_1 was revised upward slightly since staff analysis suggested that attainment of the previous goal would likely involve sizable declines in net inflows of deposits to banks and nonbank thrift institutions. Staff analysis also indicated that progress toward achieving the Committee's long-run objectives could be achieved even if rates of expansion of M_1 in the short run were temporarily high, and it was decided to aim for a 3 percent to 7 percent growth of M_1 during the April-May period.

M_2—defined as M_1 plus time and savings deposits other than large CDs at commercial banks—grew at a fairly rapid 7.8 percent seasonally adjusted annual rate during the quarter. This was 2.1 percentage points slower than it grew during the first quarter of this year and 3.3 percent off the pace of the second quarter of 1973. The time and savings component of M_2 advanced at an 8.5 percent rate, which—while below the 12.5 percent pace of the first quarter—was still quite rapid for a period of high market interest rates. The continued rapid growth of the time deposit component of M_2 may reflect increases in nonnegotiable large CDs at weekly reporting banks and large negotiable and nonnegotiable CDs at other banks which are currently included in M_2.

The adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit liabilities—rose at approximately a 21 percent annual rate during the April-June period. This rapid advance resulted from a very large increase in the volume of CDs outstanding; CDs grew at nearly a 92 percent annual rate in the second quarter. Attempting to satisfy the expanding demand for loans, commercial banks competed actively for CDs and, except for a short period in early June, they succeeded in attracting sizable amounts of funds. These funds came at the price of a higher interest rate, however, and by the end of June the yield on CDs in the secondary market increased to over 12 percent.

Total bank reserves rose at a 20.3 percent annual rate during the second quarter. Member bank borrowings from the Federal Reserve reached a record high of $2.4 billion; however, much of this increase was the result of loans to Franklin National Bank. RPD—reserves available to support private deposits—increased at a 20.3 percent rate, substantially above the 6.2 percent rate of the first quarter.

INTEREST RATES, BANK CREDIT, AND THE CAPITAL MARKETS

Interest rate movements throughout the second quarter were largely dominated by a combination of inflationary expectations, restrictive monetary policy, and continued strong demand for business loans. Under these influences, most short-term interest rates rose steadily until the second week of May, at which time they leveled off somewhat. However, late in May the cumulative effects of the omission of a dividend payment by Consolidated Edison Company, the announcement of financial losses at Franklin National Bank, and reports that several foreign commercial banks were also experiencing financial difficulties added a strong note of uncertainty. The influence of these events, in conjunction with already existing market pressures, forced interest rates on most private debt instruments sharply upward, and by the end of the quarter many rates reached record levels (see Chart II). Among them was the effective rate on Federal funds which averaged 11.97 percent in the final week of June, up 236 basis points from its average in the final week of March. Secondary rates on CDs with three months' maturity and offering rates on 90- to 119-day commercial paper also rose to record highs, increasing over the quarter by about 2.5 percentage points. At the same time, commercial banks raised their prime lending rates for large business borrowers in ten ¼ percentage point steps to a record level of 11¾ percent.

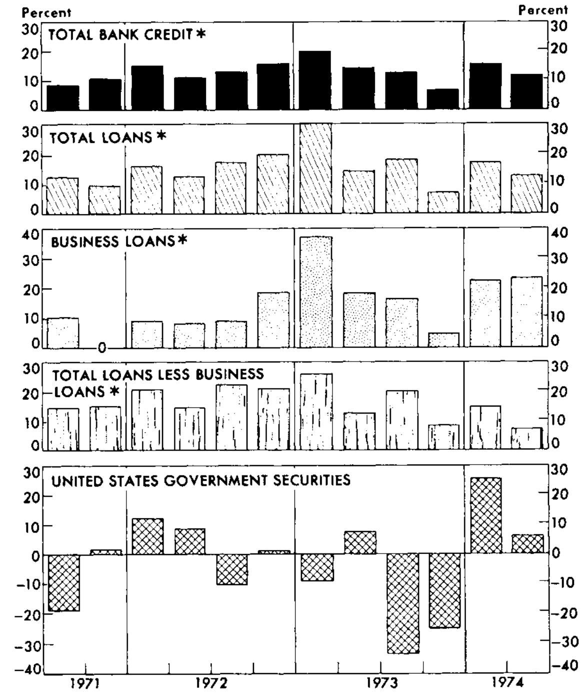
In the capital markets, yields on corporate bonds rose fairly steadily throughout April and May and then the advance accelerated in June. The volume of new issues was quite heavy, but in the early weeks of the quarter investor demand was forthcoming as yields increased. The situation changed noticeably after the middle of May, however, and the market became appreciably tighter. The announcement of Consolidated Edison's dividend cancellation sharply intensified the concern over the financial health of many firms in the utility industry. The pessimistic tone spread to other industries, as rising short-term interest rates led some market observers to question the liquidity of many firms. Consequently, as the period drew to a close, investors resisted long-term commitments to all but the highest quality borrowers. The rates on lower quality issues rose to the point where, in several instances, borrowers found them unacceptable and sales were either postponed or canceled. By the end of the quarter, rates on recently offered utility bonds—as measured by the Federal Reserve Board's index—had risen 115 basis points to a record 9.82 percent and the increases were somewhat larger on intermediate quality issues. New offerings in the tax-exempt sector met good receptions throughout most of the quarter, albeit at rising interest rates. However, by mid-June the effects of general market uncertainty and the large volume of new offerings had raised rates to levels at which some offerings were canceled because the available terms exceeded legal interest rate ceilings. Over the period as a whole, The Bond Buyer index rose 76 basis points to 6.33 percent.

In contrast to the movement of rates on private debt instruments, rates on short-term Treasury securities declined during the quarter while yields on longer term issues changed little. As a consequence, an unusually wide spread developed between rates on Treasury obligations, particularly bills, and other market instruments. In the last half of June, for example, the rate on three-month bills averaged more than 4 percentage points below rates available on CDs and commercial paper with the same maturity. By comparison, the spread between rates on these instruments averaged less than 1½ percentage points

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS

Seasonally adjusted annual rates

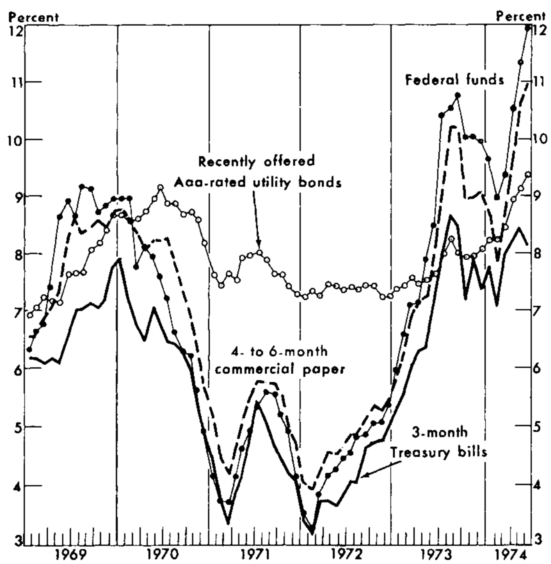


* Adjusted for loans sold to affiliates.

Source: Board of Governors of the Federal Reserve System.

Chart II

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 four- to six-month commercial paper are monthly averages of weekly figures.

Source: Board of Governors of the Federal Reserve System.

in 1973. In part, this wide spread in rates was attributable to heavy foreign central bank purchases of bills during the quarter, but it also reflected increased investor preference for the additional security of Government obligations in response to the liquidity problems that had come to light.

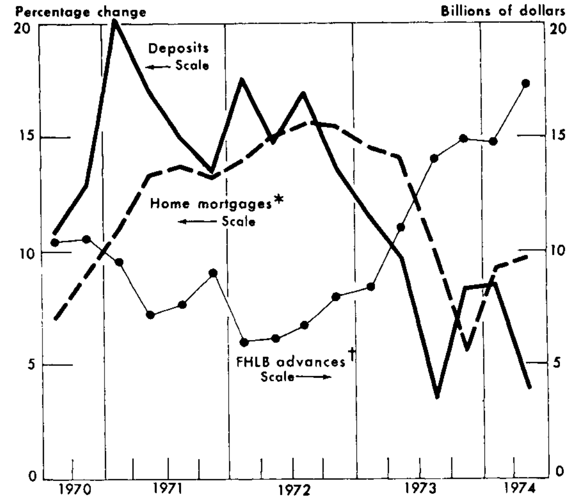
The pace of bank credit expansion moderated somewhat during the second quarter to a still strong 11.5 percent annual rate, down from the 15.9 percent rate of advance of the first quarter. The business loan component of bank credit, adjusted for loan sales to bank affiliates and seasonal variation, continued to advance at a very brisk 23 percent rate, however. The more moderate growth of total bank credit reflected mostly the easing of loans other than business loans (see Chart III).

The April-June period marked the second consecutive quarter of extremely rapid expansion of business loans, after the relatively sluggish experience of the fourth quarter of 1973. Inflation and inventory accumulation were again strong motivating forces behind the demand for loans. However, loan demand reflected also the financing needs of utility companies that experienced imbalances in their flows of funds, as revenues lagged behind rising operating costs. Some loan demand also came from firms in the resource industries that acquired leases on oil-producing properties late in May. Since resource firms and utility companies tend to borrow from money center banks in New York and Chicago, loans were concentrated at banks in these areas. In addition, there were reports that regional banks experienced difficulty in acquiring funds through CDs, and this may have contributed further to a concentration of business loans at money center banks.

Nonfinancial corporations tapped the commercial paper market for substantial amounts of funds during most of the second quarter. Market participants frequently expressed concern over the general state of corporate liquidity, and there was added emphasis on quality paper. For the quarter as a whole, the outstanding volume of nonbank-related, dealer-placed commercial paper increased by approximately $385 million.

Chart IV

DEPOSITS AND MORTGAGES AT THRIFT INSTITUTIONS AND ADVANCES TO SAVINGS AND LOAN ASSOCIATIONS



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

* Mutual savings bank mortgages for the second quarter of 1974 are based on April and May data.

† Advances represent short-term loans from the Federal Home Loan Banks to savings and loan associations.

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

THRIFT INSTITUTIONS

Reflecting the rise in interest rates on most competing market instruments, deposit growth at thrift institutions was sharply reduced during the second quarter. For the April-June period, the rate of expansion of combined deposits at savings and loan associations and mutual savings banks fell to a 4 percent seasonally adjusted annual rate from an average of 8.5 percent during the two immediately preceding quarters. Mutual savings banks were hit harder than savings and loan associations, experiencing deposit growth at only a 1 percent rate over the quarter and net deposit outflows during the month of May. The volume of mortgages at thrift institutions, however, did not show the effects of the decline in deposit growth (see Chart IV). Mortgage expansion at savings and loan associations proceeded at a 9.9 percent annual rate, compared with 10.6 percent during the first quarter. At mutual savings banks, mortgages grew at a 5.4 percent rate during April and May, only slightly below the 5.5 percent pace of the first quarter.

As a means of financing mortgage demand, thrift institutions reduced their liquid asset holdings, and savings and loan associations increased their borrowing from the Federal Home Loan Banks to $17.5 billion. The mortgage advance was accompanied by rising interest rates; by the end of June, the average effective rate on conventional mortgages, as measured by the Federal Home Loan Bank Board, had reached a record level of 8.84 percent. In reaction to the high interest rates and the reduced deposit inflows, mortgage commitments at thrift institutions declined sharply during the quarter.

The Money and Bond Markets in July

After rising rather steadily over the preceding four months, interest rates were mixed in July. In the money market, enlarged credit demands over the quarter-end statement date and turbulence in the foreign exchange and Euro-dollar markets pushed rates up to record levels early in the month. The pressures on the short end of the market abated as the month progressed, and by the end of the period most short-term rates had receded substantially from the highs recorded early in July. Some rates, notably those on commercial paper, finished July below the levels posted at the end of June.

In contrast, yields on Government securities, while highly volatile, generally rose over the month. Thin supplies of issues interacted with shifting market assessments to produce marked price changes. Yields moved up early in the month, and then dipped during a midmonth rally in response to optimistic interpretations of banking and monetary data. However, upward pressure on yields resumed when the optimistic expectations were discouraged by several developments, including the failure of Mideast money to help reduce the size of the Treasury's refunding operation. By the end of the month, yields were rising sharply.

In the corporate and municipal bond markets, unseasonally heavy supplies of new issues exerted downward pressure on prices at the same time that record-high interest rates provoked cancellations of issues and rejections of bids. Investors continued to show preference for high-quality issues, and the interest rate spread between medium-grade bonds and high-grade bonds was far larger than usual. Underwriters were also cautious about bidding on competitive offerings, while negotiated offerings fared better in an unsettled market. At midmonth, the decline in money market rates contributed to the emergence of a better atmosphere in the bond markets and a number of new issues were successfully sold. Yields were again rising sharply as the month drew to a close.

Preliminary data indicate that the growth of the money supply measures slowed in July after the acceleration of June. M_1—private demand deposits adjusted plus currency outside commercial banks—and M_2—which also includes time deposits other than large negotiable certificates of deposit (CDs)—both showed much slower growth in the four weeks ended July 24 in comparison with the four weeks ended June 26. CD growth, however, remained very rapid.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

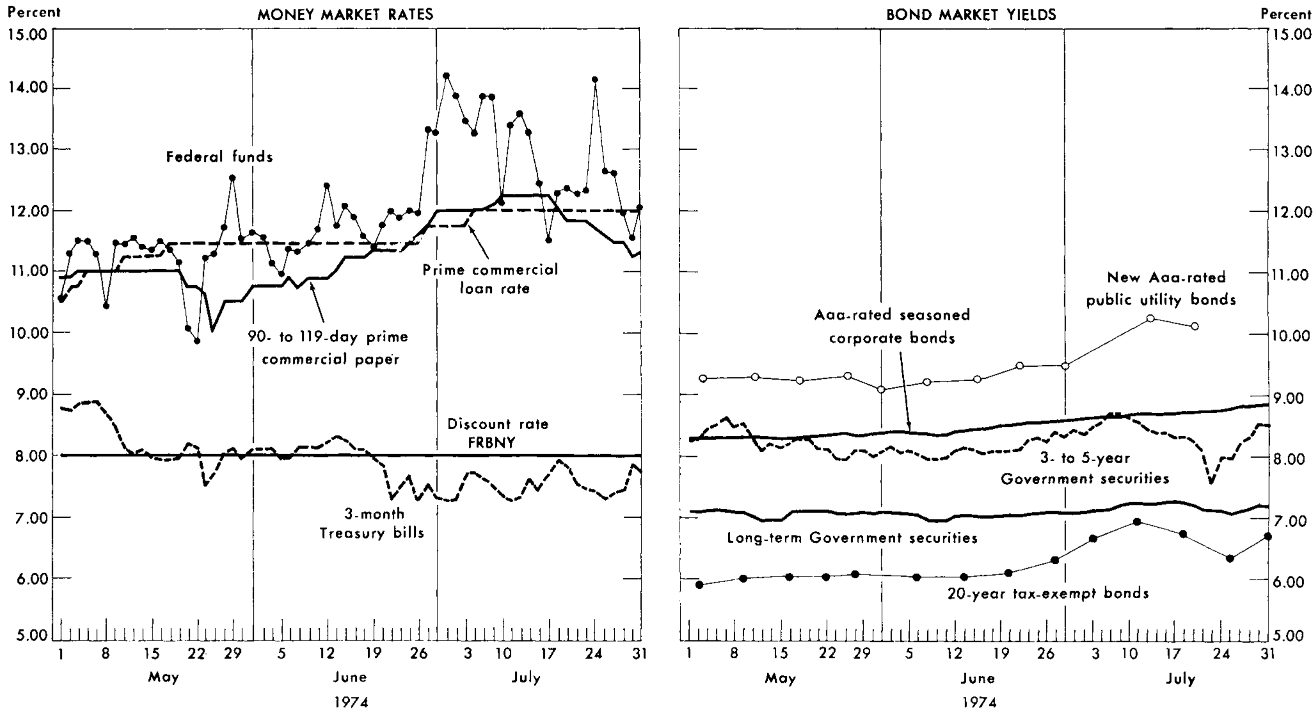
The money market was extremely tight at the beginning of the month, but conditions relaxed by midmonth and most short-term interest rates began to decline. Subsequently, some rates backed up but remained well below the record levels observed earlier in the period. The effective rate on Federal funds fell from the highs reached early in July (see Chart I), although for the month as a whole it averaged a record 12.92 percent, 99 basis points above the previous record of 11.93 percent in June. Rates on three-month CDs in the secondary market moved as high as 12.80 percent by midmonth before falling back to about 12 percent. Similarly, offering rates on dealer-placed 90- to 119-day prime commercial paper moved up early in the month by ¼ percentage point to 12¼ percent and then dropped to 11⅜ percent by the close of the period. Rates on bankers' acceptances generally followed the pattern of other short-term rates and were among those that moved back up at the month end. Dealers in bankers' acceptances seemed to prefer setting rates on a negotiated basis, and one dealer announced it was terminating operations, putting considerable pressure on the acceptance market. In contrast to the movement in other money market rates, the prime lending rate for large business borrowers at most commercial banks remained at 12 percent, after increasing from 11¾ percent very early in July. Several banks which tie their lending rates directly to past market rates also held their prime rates at 12 percent, even though their formula guidelines called for rates in the range of 12¾ to 13 percent at midmonth.

One of the factors responsible for the turnaround in most short-term rates was a moderation in the growth of business loans as the month progressed. During the first six months of the year, business loans at commercial banks increased by a seasonally adjusted $18.4 billion, only slightly less than the extraordinary $19 billion gain in the

Chart I

SELECTED INTEREST RATES

May - July 1974



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Prime commercial loan rate at most major banks; 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.

first half of 1973 and more than three times the growth experienced in the corresponding period in 1972. In July, business loans at all weekly reporting banks in the first statement week alone spurted by $1.9 billion, seasonally adjusted, but then registered more modest gains during the remainder of the period.

At the July 16 meeting, the Federal Open Market Committee raised the maximum amount of bankers' acceptances that can be held outright by the System. The ceiling was increased to $500 million from the $125 million maximum which had been in effect for the last ten years. In explaining its decision, the Committee noted that the volume of bankers' acceptances outstanding has grown sharply from $3.25 billion in 1964 to nearly $12 billion at present. Earlier in the month, dealers were notified that the Federal Reserve Bank of New York would no longer require dealers to endorse acceptances sold outright to the System and its customer accounts.

According to preliminary data, the growth of most monetary aggregates slowed appreciably in July relative to the gains experienced in June. M_1 advanced at only a 1.4 percent seasonally adjusted annual rate for the four weeks ended July 24 from its average level over the four weeks ended June 26. The growth of M_1 from the corresponding period thirteen weeks earlier to the four weeks ended July 24 was 4.2 percent—the lowest quarterly growth rate this year (see Chart II). The growth of M_2 decelerated to a seasonally adjusted annual rate of 4.6 percent in the four weeks ended July 24 over the first four statement weeks in June, while the growth of the adjusted bank credit proxy fell to 11 percent. However, banks continued to support their loan expansion with rapid increases in large negotiable CDs, which advanced at a 34.5 percent annual rate during the same period. Most of the CD growth was concentrated in the banks in New York City and Chicago. Member bank borrowings from the Federal Reserve averaged \$3.3 billion during the month (see Table I), well above the record level set in June. Tight money market conditions and continued reliance by Franklin National Bank on the discount window were prime factors behind the high level of borrowings.

THE GOVERNMENT SECURITIES MARKET

An uneasy atmosphere prevailed in the market for longer term Treasury securities as the month began. The market was weighed down by concerns about the high level of short-term rates, bulging business loan demand, and deteriorating conditions in the corporate and tax-exempt bond markets. By midmonth, however, intermediate-term Treasury issues rallied briefly in response to the improved sentiment in the money and bond markets and the month's initial price declines were reversed. The market for long-term Treasury issues did not respond so quickly as the market for the intermediate-term issues, mainly because of the lingering weakness in the corporate bond market where investors remained unwilling to commit funds to longer maturities, given increased uncertainty over the future course of inflation. Toward the end of the month, prices of Treasury coupon securities began to fall again, owing in part to the anticipation of the August Treasury refunding. For the month as a whole, yields on three- to five-year securities were 12 to 20 basis points higher and yields on long-term Treasury securities were 7 to 28 basis points higher.

In contrast to the early-month rise and subsequent decline in most money market rates, Treasury bill rates did not display a pronounced pattern. Investor preference for securities with no default risk served to insulate the bill sector from pressures felt in other securities markets and also kept bill rates in July relatively low, compared with rates on other short-term securities. In the middle of the month, for example, the spread between three-month bill rates and rates on CDs in the secondary market with the same maturity exceeded 5 percentage points, far wider than the more usual 1 to 2 percentage points experienced in recent years. For the month as a whole, Treasury bill rates were 30 basis points lower to 37 basis points higher.

In most weekly bill auctions held during the month, deal-

Table I

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

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

Factors	Changes in daily averages— week ended					Net changes
	July 3	July 10	July 17	July 24	July 31	
"Market" factors						
Member bank required reserves	— 468	+ 315	—1,259	+ 535	+ 279	— 598
Operating transactions (subtotal)	— 197	+ 338	— 404	— 447	— 182	— 892
Federal Reserve float	+ 135	+ 761	— 516	— 320	+ 365	— 305
Treasury operations*	— 110	— 158	+ 605	— 355	— 500	— 518
Gold and foreign account	— 7	+ 61	— 14	+ 20	— 10	+ 50
Currency outside banks	— 94	— 538	— 309	+ 257	+ 808	+ 124
Other Federal Reserve liabilities and capital	— 121	+ 212	— 170	— 48	— 114	— 241
Total "market" factors	— 665	+ 653	—1,663	+ 88	+ 97	—1,490
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 197	+ 45	+ 811	— 462	— 202	+ 389
Outright holdings:						
Treasury securities	+ 307	+ 91	+ 274	+ 403	— 630	+ 445
Bankers' acceptances	+ 3	+ 4	+ 16	+ 50	+ 44	+ 117
Federal agency obligations	+ 307	+ 253	+ 333	+ 136	+ 8	+1,037
Repurchase agreements:						
Treasury securities	— 442	— 222	+ 160	— 589	+ 248	— 845
Bankers' acceptances	+ 76	— 16	+ 67	— 223	+ 71	— 25
Federal agency obligations	— 54	— 65	— 39	— 239	+ 57	— 340
Member bank borrowings	+ 647	— 795	+ 534	+ 465	+ 48	+ 899
Seasonal borrowings†	— 7	+ 11	+ 15	+ 3	+ 8	+ 30
Other Federal Reserve assets‡	+ 92	+ 6	+ 61	+ 76	+ 37	+ 272
Total	+ 935	— 744	+1,406	+ 80	— 118	+1,559
Excess reserves†	+ 270	— 91	— 257	+ 168	— 21	+ 69

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	37,274	36,868	37,870	37,503	37,203	37,344
Required reserves	36,905	36,590	37,849	37,314	37,035	37,139
Excess reserves	369	278	21	189	168	205
Total borrowings	3,433	2,640	3,176	3,641	3,689	3,316
Seasonal borrowings†	126	137	152	155	163	147
Nonborrowed reserves	33,841	34,228	34,694	33,862	33,514	34,028
Net carry-over, excess or deficit (—)‖	88	140	200	23	104	111

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Average for five weeks ended July 31, 1974.
‖ Not reflected in data above.

ers showed concern about rising interest rates and were reluctant to build inventories because of the large cost of carrying securities. On July 1, the average issuing rates were 7.81 percent for the three-month bill and 8.06 percent for the six-month bill, rates which were well above those on outstanding comparable issues. The cautious bidding continued, for the most part, at the other weekly auctions. In the monthly auction of 52-week bills on July 24, the average issuing rate was 7.84 percent (see Table II).

On July 18, the Treasury announced that it would auction $1.5 billion of tax anticipation bills on August 1 for payment on August 7. The bills will be due on September 20, and commercial banks may make payments for their own and their customers' accepted tenders by crediting Treasury Tax and Loan Accounts. On July 31, the Treasury announced the terms for refunding the $4.3 billion of notes held by the public, maturing on August 15. The Treasury will auction $2.25 billion of 9 percent 33-month notes, $1.75 billion of 9 percent six-year notes, and $400 million of 8½ percent bonds due in 1999. In addition to refunding maturing issues, the operation will provide $100 million to cover a portion of the Treasury's short-term cash needs. The Treasury also announced that it would increase the size of the weekly bill auction on August 5 by $200 million to a total of $4.7 billion.

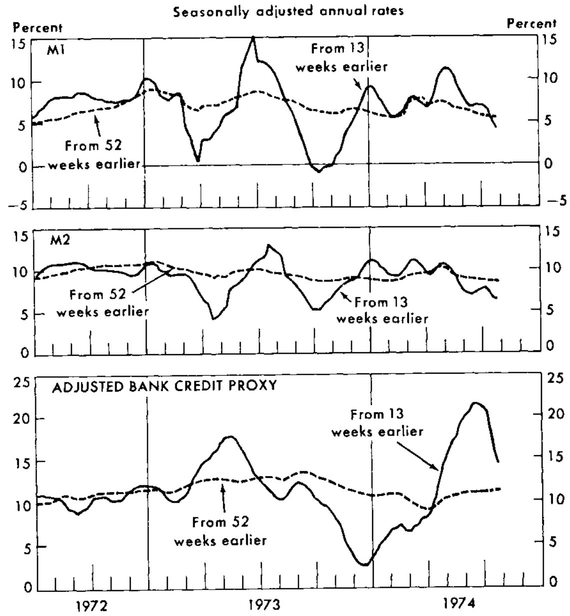
On July 23, the Federal Financing Bank held its first auction and sold $1.5 billion of eight-month bills priced to yield 8.05 percent. The bills, which have the same characteristics as Treasury bills, were auctioned with full commercial bank Tax and Loan Account privileges. The Financing Bank, which began operations this year, will coordinate the borrowing activities of several Federal agencies that provide loan and loan-guarantee programs, thereby reducing their financing costs. The proceeds of this offering will be used to pay back the $1.4 billion already borrowed by the Financing Bank from the Treasury and advanced to some of the agencies.

In the market for Federal agency issues, the Federal Land Banks borrowed $1.3 billion in the first week of July, paying rates of 9.20 percent on eighteen-month bonds, 9.15 percent on four-year bonds, and 9.10 percent on seven-year bonds. In the following two weeks, the Federal Home Loan Banks and two farm credit agencies marketed over $2 billion in securities, with yields in the 9.45 to 9.55 percent range. During this period, the Tennessee Valley Authority (TVA) canceled its sale of $100 million power bonds and its regular monthly auction of short-term notes because of high interest rates and weak market conditions. This was the first time in eight years that the TVA failed to hold a monthly auction.

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 July 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.

THE OTHER SECURITIES MARKETS

As July began, a very heavy prospective calendar of over $4 billion in offerings—coupled with investor concerns over double-digit inflation and a preference for quality debt issues—exerted extreme pressures on the corporate and municipal bond markets. Even record rates on some issues were not sufficient to attract investors. Issuers moved toward shorter maturities and longer call protection in their efforts to sell bonds, but still many offerings were postponed, canceled, or reduced in size.

A substantial portion of the corporate bond calendar was comprised of a $650 million issue of floating-rate notes by Citicorp, the holding company of the First National City Bank. Several features of the fifteen-year notes, such as the $5,000 minimum purchase after which the notes may be traded in $1,000 denominations, periodic redemption opportunities, and a listing on the New York Stock Exchange, seemed designed to appeal to relatively small investors. After some modifications and a reduction in the size of the offering from $850 million to $650 million, the Citicorp notes were issued on July 24. The notes, which will be redeemable semiannually beginning in 1976, will pay an initial interest rate of 9.70 percent for the first year and then will pay an interest rate 1 percentage point above the average yield on three-month Treasury bills. Several other bank holding companies, a savings bank, and a large oil company have announced plans to sell over $500 million floating-rate notes in August.

Investor preference for high-quality corporate debt was evident throughout the month. Consequently, the spread between the interest rates on new issues of Aaa-rated bonds and A-rated bonds was far wider than the usual spread of roughly ½ percentage point. In the industrial sector, a very large spread was evident on securities issued two days apart. On July 16, Ford Motor Company sold twenty-year Aaa-rated debentures with an interest rate of 9.25 percent. On July 18, the International Telephone and Telegraph Company issued eight-year notes with an A-rating which carried an interest rate of 11 percent. Although some portion of the 175 basis point spread is attributable to the difference in maturities, both issues carried similar call protections. As in June, new medium-grade electric utility bonds carried substantially higher interest rates than high-grade telephone debt. An Aaa-rated forty-year debenture offering of the Bell Telephone Company of Pennsylvania priced to yield 9.65 percent was sold on July 15. Two days later, an A-rated Consumers Power Company first-mortgage bond was sold with an interest rate of 11.38 percent, over 170 basis points higher than the telephone issue even though its maturity was only twenty years and the call protection was ten years, or twice as long as the telephone bond.

The terms of the Consumers Power Company's offering were typical of the electric utilities' attempts to make their debt issues more attractive to investors. The power companies have paid record-high interest rates, shortened maturities to twenty years from thirty years, and increased the call protection to ten years from five years to overcome the depressing impact of higher fuel prices on their ability to raise capital. Even these new features did not guarantee success. A $130 million A-rated offering of the Georgia Power Company did not receive any valid bids in a competitive auction despite provisions for a coupon rate as high as 11⅝ percent. However, other companies were more fortunate in negotiated offers. The Virginia Electric and Power Company sold $100 million of A-rated bonds priced to yield 11 percent.

In the tax-exempt market, many new issues were postponed and bids on over $600 million in offerings were rejected in the first half of July, in reaction to the high interest rates and because of statutory interest limitations. The only sizable offering awarded early in the month was the $125 million issue of the state of Oregon, which was divided into $100 million five- to fifteen-year veterans welfare bonds, priced to yield 5.90 to 6.40 percent, and $25 million six- to thirty-year highway bonds, priced to yield 6 to 6.80 percent. In the latter half of the month, several previously postponed or rejected offerings returned to the market. For the month as a whole, the total volume of municipal bond awards fell slightly short of the nearly $1.4 billion in offerings projected for July. One of the largest issues to return was the $325 million New York City offering on July 30 (scaled down from the $438 million issue on which the City had earlier rejected the sole bid submitted). The net interest cost of the two- to forty-year bonds was 7.69 percent, 23 basis points below the 7.92 percent rate rejected on July 9 but still above the previous high of 7.57 percent for New York City. On August 1, The Bond Buyer index of municipal yields was 6.70 percent, 37 basis points above the level on June 27. It had reached as high as 6.94 percent on July 11. The Blue List of dealers' advertised inventories fell $125 million to $455 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—July 1974				
	July 1	July 8	July 15	July 22	July 29
Three-month	7.808	7.892	7.702	7.604	7.698
Six-month	8.055	8.480	7.876	7.700	8.055

Maturity	Monthly auction dates—May-July 1974		
	May 29	June 26	July 24
Fifty-two weeks	8.248	8.256	7.836

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