

# FEDERAL RESERVE BANK OF NEW YORK



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## On Fed Watching

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*An address before the Bond Club of Buffalo,  
Buffalo, New York, on September 12, 1974*

Over the years, participants in the financial markets have avidly sought the touchstone of Federal Reserve policy: some single, simple, and instant financial indicator that could serve as an unfailing guide to the course of monetary policy in general, and interest rates in particular.

In the 1960's, the markets looked to the Fed's figures on net free or net borrowed reserves of commercial banks as the crucial indicator. It took some time before there was an understanding that changes in this measure, though important, could not be relied upon exclusively as the one unerring guide to monetary policy movements.

In the early years of the 1970's, the market shifted attention to the money supply, especially after the Federal Reserve made it clear that greater emphasis would be placed on the monetary aggregates as targets of policy. When the System announced in 1972 that it would experiment with the use of "reserves against private deposits", or "RPD", to guide open market operations, market observers found themselves a new favored indicator. And during all of these years, one or another interest rate came into—or receded from—popularity as the special key to credit conditions or Fed policy.

Fed watchers have been particularly interested in measures whose daily or weekly changes might yield fresh evidence on a continuing basis. Indeed, as the markets came under increasing strain this year, the search for clues became more intense—and more uncritical. During the summer, for example, the market became highly sensitive to the weekly business loan figures of New York banks reported by the Federal Reserve Bank of New York each Thursday.

During June the New York banks registered four straight large increases in commercial and industrial loans, the last of which was over \$1 billion. In the following week, when any further substantial increase in loans might

well have been grounds for stock market pessimism, a small gain—because it was small—was viewed so optimistically by the market that it was credited, in large part, with sending the Dow Jones up nearly 30 points. It might be useful to look more closely at this recent experience; in a sense it underscores the hazards that can befall Fed watchers.

Commercial and industrial loan demand during the first half of 1974 increased substantially, but by June it had slowed somewhat from the growth earlier in the year. At the same time, there was a more than proportionate increase in such loans at New York banks. In the first four months of 1974, almost 30 percent of the nationwide increase in commercial and industrial loans at large commercial banks occurred at the twelve weekly reporting New York banks, the balance in regional banks. From the end of April until July, there was a shift away from the regional banks to New York and Chicago banks—a shift that may have reflected uncertainties that had developed in the CD market in late spring and early summer, leading investors to seek top-quality instruments from the large money-center banks. New York's share of business loans sharply increased to 60 percent of the total. What the market did was to draw misleading conclusions by focusing on what New York banks were doing, and assuming that what happened in New York was happening nationwide.

The Fed has indeed been concerned with the rapid growth of business and other lending in 1974, but was well aware of the structural shift in lending away from regional banks to New York and Chicago. It was also cognizant that much of the lending represented a switch of borrowers from the commercial paper and bond markets to the banks, and some short-term financing of "petro" payments by oil companies. In other words, the behavior

of business loans represented some special factors superimposed on the reactions of borrowers as they came under increasing monetary restraint. We did not expect—and did not seek—signs of policy success in a three- or four-week period; and we certainly would not reconsider a policy posture on the basis of one week, or one month even, of comprehensive data, to say nothing of a single indicator for a single week. If one is going to focus on business loans (and I am not counseling that this be done to the exclusion of other factors) a Fed watcher would much better serve his interest if he focused more carefully on the Federal Reserve's weekly report covering the 330 large commercial banks around the country, which account for over 70 percent of all business loans. Even though these figures are reported one week later than those of New York, their comprehensive coverage makes them a superior indicator of trends in business lending than the New York figures.

Clearly, the market has often misread the System's response to unfolding developments and often has overreacted to its own convictions. The Federal Reserve response is, of course, dictated by its public responsibility for monetary policy and for helping to promote a healthy economy. If Fed watching is to be successful from your point of view, you should have a good understanding of our motives and methods, and of the linkage between central bank actions and the credit markets. Let me, then, turn to what the Federal Reserve does respond to, and how it responds, as it carries out monetary policy.

As you undoubtedly know, the Federal Reserve Bank of New York carries out on behalf of the System the directives issued monthly by the Federal Open Market Committee (FOMC), the key policy-making group in the System. The Committee, chaired by Arthur Burns, is composed of the seven Governors of the Federal Reserve Board and five Reserve Bank presidents, four of whom serve for only one year and then rotate with the other Reserve Bank presidents. Alfred Hayes, President of the New York Reserve Bank, is Vice Chairman and a permanent member. As First Vice President of the New York Fed, I serve as an alternate member. Alan Holmes, Senior Vice President of the New York Fed, is the Manager of the System Open Market Account and runs the Trading Desk at the New York Bank.

The FOMC sets goals for monetary and bank credit conditions a number of months ahead and indicates how the Trading Desk should respond to new information on such conditions in the period between meetings. Typically, the FOMC specifies its monetary aggregate targets as ranges of tolerance covering rates of growth for a two-month period. These ranges of tolerance are selected to be

consistent with longer run financial objectives expressed as growth rates for a period of six months or so. The Committee also specifies a range for the Federal funds rate (the day-to-day interest cost of reserves borrowed by banks from each other) until the next meeting.

The two-month targets and guidelines decided at each FOMC meeting are published, together with the general policy directive to the New York Federal Reserve Bank, with a three-month lag. Despite the lag, every serious Fed watcher reads these records carefully because they provide insight into how the FOMC views the economy and clues to how the Committee may respond to economic developments.

Greater emphasis has been placed in recent years by the Committee on the monetary aggregates—principally  $M_1$ , which is currency and demand deposits in public hands. Nevertheless, the Federal Reserve continues to be vitally interested in how interest rates and credit markets behave, especially when coping with domestic and international financial difficulties.

The central bank cannot hit the monetary aggregate targets directly. The direct influence we have is on the cost and availability of bank reserves to commercial banks. Through purchases and sales of securities in the open market, the Federal Reserve can add to or subtract from the level of bank reserves, and thus the base supporting member bank deposits which constitute the major portion of  $M_1$  and the other monetary aggregates.

However, even while pursuing longer run policy targets, the System must also cope with strong and often unpredictable short-run influences on reserves. These include Federal Reserve credit advanced in the check collection process, called "float", currency in circulation, and the Treasury balance at the Federal Reserve, all of which can vary substantially from week to week. And because of changes in these market factors, the underlying trend of financial developments may be obscured in the short run. Another problem for the Account Manager is that the information on credit outstanding and money supply at nonmember banks is not as comprehensive or as timely as it should be.

In order to implement the FOMC's instructions on a day-to-day basis, the Trading Desk at the Federal Reserve Bank of New York provides reserves which will keep the Federal funds rate, member bank borrowings, and net borrowed reserves within general objectives. Over the interval of several weeks between meetings of the Federal Open Market Committee, new data each week on reserve and money aggregates permit new estimates to be made of monthly growth rates. These are compared with the ranges set by the Committee. If we are coming out within

the desired ranges, then there is no reason to change the day-to-day reserve conditions that we had been aiming for previously. But if the estimated growth rates in the aggregates push up to, or beyond, the outer limits set by the Committee, then the Desk will make some adjustments in its attitude toward reserve provision. Typically, the Desk will provide nonborrowed reserves grudgingly if the reserve and money aggregates are growing more rapidly than desired, or more willingly if the aggregates are growing too slowly. The Desk effectively monitors any such short-term adjustments by shading the funds rates, bank borrowings, and net borrowed reserve measures. These adjustments are not entirely mechanical, however, and can be and have been modified by interim Committee reviews between regular meetings of the Committee.

Thus, sophisticated market observers have watched carefully the growth rates of the reserve and money supply aggregates, the Desk's management of the Federal funds rates, the level of member bank borrowings, and net borrowed positions. An increase in money growth above longer term trends has been interpreted as a harbinger of even higher interest rates. In the first place, careful observers have understood that a rapid growth of money and credit implies inflation; in such circumstances, lenders demand and get higher interest rates—the so-called inflationary premium—in order to protect themselves against having to lend expensive dollars and be repaid in cheap ones. Second, as the Fed has adopted a more resolute stance against inflation, an increase in money growth over an extended period, above what was deemed to be the money supply target, has also raised the expectation that the Federal Reserve would act to offset such growth, inducing—at least in the short run—a rise in interest rates. In such circumstances, astute observers have looked for a rise in the Federal funds rate as one sign confirming that the FOMC has directed the Desk to manage bank reserves more strictly.

The day-to-day management of bank reserves must take into account that there is a long and variable lag from policy actions on bank reserves to the monetary aggregates. While the Federal Reserve can directly control the reserve base with some accuracy, it cannot exert direct control over the use of reserves by banks and the public's preferences for different types of deposits. Thus when banks vary the amount of their excess reserves, or the public shifts its deposit preferences in response to such things as the interest rate structure or transactions needs, the money supply can be subject to considerable variation on a week-to-week, month-to-month, and even quarter-to-quarter basis.

Because the demand for money can be highly volatile

in the short run, it is neither desirable nor possible to plot a predetermined short-term course for money supply growth. For if we did try to control rigidly the growth of the reserve base—say on a week-to-week or even a month-to-month basis—shifting demand for money would produce excessive interest rate fluctuations which would have highly destabilizing effects on financial markets.

In addition, short-run fluctuations in the money supply have little or no significant impact on the economy. Fluctuations within a half-year period seem to have little or no discernible effect, and our research suggests that, even if  $M_1$  growth somewhat overshoot the desired growth path for as long as six months, the ultimate economic effects would be minor if money growth during the following six months slowed enough to compensate.

These factors suggest the appropriateness of a longer time frame for the execution of Federal Reserve policy. In some ways, the nation's economy can be viewed as a giant ocean liner and its policy instruments as the controls. The controls are set broadly to bring the ship to its destination, and though there may be adjustments for currents or storms, the course is not changed from hour to hour. Nor is any captain foolish enough to think that he can turn the ship around sharply, as if it were a speedboat.

The credit and stock markets, by contrast, change their courses frequently. The day-to-day volatility of interest rates and share prices reflect primarily the volatility of the markets' expectations about profits, interest rates, and the prices of the securities themselves. At times as monetary policy is perceived as leaning toward a different posture—let us say toward ease—the markets may respond, sometimes with great exaggeration. Market participants, perhaps misreading a shading of policy for a major shift, rush to capitalize on what they fear may be only a fleeting opportunity for profit. The initial rise in prices may stimulate bullish expectations on the part of market bystanders who join in, reinforcing the buying pressure. Lord Keynes has pungently described the psychology of the financial speculator as one “who tries to guess better than the crowd how the crowd will behave”.

Thus, I warn you to be careful not to read Fed intentions into short-run changes in securities prices and interest rates; you may be staring into the mirror of your own expectations. Even in the Fed funds and Treasury bill markets, in which the Federal Reserve does indeed have substantial influence, the volatile expectations of participants at times play a substantial role in determining the level of rates.

Against this background, it might be useful to turn for a few minutes to the current economic situation.

Needless to say, the most overriding factor in today's

economic environment is inflation. Indeed, inflation isn't limited to our shores, it's worldwide. In the past year, United States consumer prices have risen nearly 12 percent. The take-home pay of the typical worker has declined over 5 percent in real terms during the same period. And wholesale prices have gone up over 20 percent.

A major reason for its current virulence was the dovetailing of very high levels of demand among the major industrial nations during 1972 and 1973, especially for industrial materials.

The decline in the value of the dollar in foreign exchange markets made our own situation acute because the prices we pay for imported materials, as well as for finished goods, rose. And a cheaper dollar made our exports increase sharply, which put further pressure on our already strained industrial capacity.

Aggravating the price structure were worldwide shortfalls in agricultural production in 1972, which caused food prices to rise in 1973. In addition, since last fall there has been the staggering rise in the price of all petroleum products, as oil-producing countries restricted their shipments and boosted prices. And last spring, many wages and prices rose as direct controls were phased out. More recently, there has been a further upward push in agricultural prices due to drought conditions in our Midwest.

I don't have to tell this group about what inflation has done to financial markets. Interest rates have increased sharply in 1974 and some firms have had difficulty raising funds—to put it mildly. The equity markets have been buffeted, with stock prices reaching a twelve-year low. And high market rates caused net deposit outflows from thrift institutions, with the result that residential building starts are now averaging more than one-third below what they were last year.

The distorting effects of inflation have complicated business-investment decision making, as profit figures have not reflected the fact that inventories and plant and equipment must be replenished at substantially higher cost. Consumer reaction to inflation has manifested itself in lowered confidence and, in turn, in sluggish spending. The result has been a diminution of overall economic activity, although there are still shortages in key areas such as steel, aluminum, fertilizers, and other petrochemicals.

The gross national product (GNP) in real terms declined in the first half of this year. This decline cannot be attributed entirely to a weakening in demand. There were supply and technical factors at work as well.

In the first quarter, the energy shortage acted as a drag on GNP. And the change in real GNP in the second quarter would have been positive, instead of negative,

had it not been for the partial take-over of Aramco by the Saudis. The resultant decline in Aramco's profits is recorded as a decline in net exports and thus a decline in GNP.

Economic activity in the third quarter is sluggish, judging from the evidence. For example, industrial production, a broad-gauge indicator, has stayed about unchanged in recent months.

Yet, despite the slackening of real economic activity, the number one problem facing us today is inflation, not unemployment. Fortunately, the level of unemployment so far has not risen significantly.

The Federal Reserve has had to bear the brunt of the battle against inflation. Unfortunately, the Federal budget remains in deficit. The nine-year inflation we have undergone can in no small measure be ascribed to a highly expansive fiscal policy, which occurred during a period when the economy's resources were being used rather intensively. And I have to add that monetary policy was by no means faultless during this period.

Last fiscal year's \$3.5 billion deficit seemed modest. But if the spending of Government-sponsored agencies and other outlays that did not show up in the regular budget were included, that deficit was over \$20 billion, exactly the opposite of what was fiscally required. Needless to say, the budget for fiscal 1975, with an expected deficit of over \$11 billion, is unsatisfactory. President Ford's dedication to greater fiscal discipline is most welcome news, as was his initiative in organizing and participating in a series of conferences focusing on inflation. It is heartening to see a spreading conviction on the part of the American public that the taming of inflation is an objective of the highest priority, that requires a determined commitment by us all.

In addition to fiscal restraint, there will have to be, of course, a sustained period of monetary restraint to reduce inflationary pressure and wring out inflationary expectations. Such a policy will contribute to a slowing in the rate of economic growth for a while and undoubtedly cause some hardships, such as rising unemployment, a weak housing sector, and continued pressures in financial markets. In the interest of social equity, we cannot let any one group or economic sector suffer disproportionately in the anti-inflationary battle. For example, it would be desirable, as Chairman Burns has suggested, to be prepared to limit the extent of unemployment by establishing a Government program of public-service employment should the unemployment rate rise above 6 percent.

With respect to financial pressures, the Federal Reserve is keenly aware of its responsibilities as lender of last resort. We are prepared to meet those responsibilities as



we have done in the past, whether difficulties arise in the banking system, as they did this year in the case of Franklin National Bank, or in the commercial paper market, as in 1970. Also, as you may know, the Fed has the authority to lend directly to institutions other than banks, including thrift institutions, and for a number of years has had contingency arrangements for supporting member banks which might extend credit to a thrift institution suffering unusual liquidity pressures.

At the present time, other financial intermediaries serving real estate markets, as well as corporations—such as utilities—heavily dependent on capital market financing, have also come under great pressure. In the present period, for example, the cash flow of utilities has been squeezed between rising costs, especially for fuel, and controlled prices.

We in the System have been very much concerned with the effects of these liquidity strains, and have kept ourselves closely informed of developing problems. In particular, we have been in close touch with the banking community regarding potential problem areas. In this connection, I might say that the commercial banking system has been fulfilling its responsibilities in these circumstances, and has been extending credit to firms subject to such liquidity strains, particularly in those cases where the failure to obtain the necessary financing could have adverse repercussions in the financial markets. In this respect, the banking system has been playing an important role in helping to avert potentially serious problems in the financial sector of the economy.

In general, I believe that a course of fiscal and monetary restraint is the necessary precondition to achieving price stability. Such policies, however, are not sufficient in themselves in our present circumstances. They would be aided, for example, if we could eliminate institutional rigidities, some of which have been built in by government, that shackle competitive price and wage determination. Re-examination of antitrust laws and building codes to encourage more competition, and the modification of mini-

mum wage laws as they affect teen-agers are a few examples that come to mind.

Restraint by business and labor in setting prices and bargaining for wages would also help importantly. While wage and price controls would be counterproductive, it would be useful to reestablish guideposts, to give publicity to fair standards, that might help end the self-defeating alternation of wages-pushing-prices-pushing-wages.

I know the markets would welcome some masterstroke of policy, and each statement by a policy maker that fails to suggest a fresh new initiative has been met with visible disappointment. However, it is unrealistic to expect a rapid resolution of a problem that has been rooted so deeply for so long.

A protracted period of moderate fiscal and monetary restraint should not be considered bearish for the credit and equity markets. As I suggested earlier, one of the major factors contributing to high interest rates is the expectation that inflation will continue. Once the markets are convinced of the long-range commitment of policy makers to responsible restraint, and once the markets see hard evidence of fiscal resolve to support monetary policy, inflationary expectations should recede and set the stage for a decline in interest rates and the recovery of financial markets. I might add that, while realities of the 1975 Federal budget may well preclude large spending cuts, expectations in the markets should respond favorably even to moderate reductions if they testify to the dedication of the Congress and the Administration.

The abatement of inflationary expectations would be most welcome—not only for this group as participants in the business and financial community, but for us all, and our families, as citizens. It would mark meaningful progress in our long struggle to arrest what is now recognized as public enemy number one—a deeply entrenched and recalcitrant inflation which, if not brought under control, can cause serious damage to the fabric of our society. Let's hope that we will see such progress over the coming year.

## The Business Situation

The latest business statistics indicate little change in the recent lackluster pace of economic activity. In September, domestic automobile sales declined, as the August spurt attributed to consumers' attempts to avoid the announced higher prices on 1975 models apparently ended. Also in September, the labor market weakened as the unemployment rate rose from 5.4 percent to 5.8 percent. In August, the dollar value of new orders at durable goods manufacturers rose sharply, and manufacturers' shipments and inventories continued to advance. Industrial production declined that month, however, and nonauto retail sales were unchanged. Construction continued depressed as housing starts and permits fell further.

The most recent price statistics confirm a continuation of steep inflation. Moreover, a widespread feeling that a rollback in oil prices has become increasingly unlikely has been a source of additional concern. Wholesale prices exploded in August, and consumer prices posted their largest increase in a year. The pervasiveness of inflation was evident in price advances in all sectors of economic activity. The prices of services, foods, and nonfood commodities skyrocketed. Furthermore, concern over frost damage to the already weather-beaten Midwest corn and soybean crops has reversed the recent declines in spot prices of agricultural commodities.

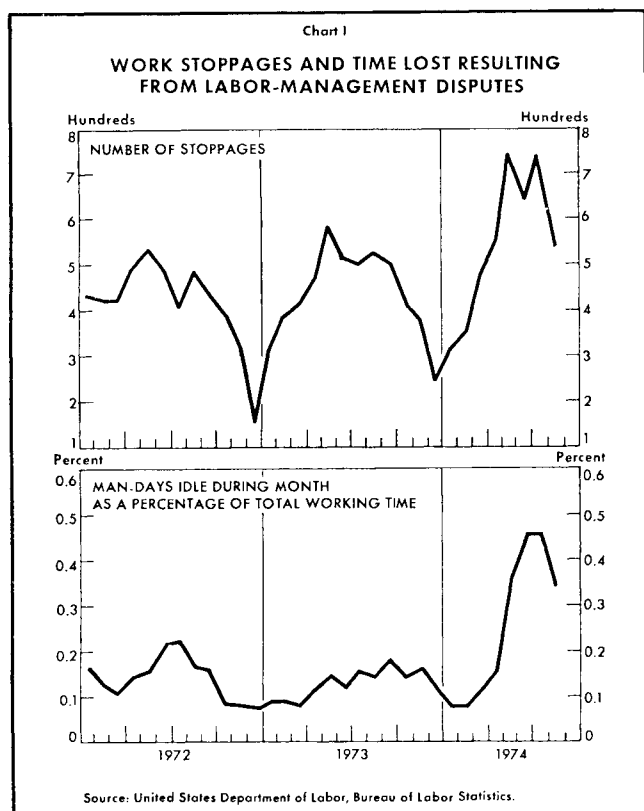
### INDUSTRIAL PRODUCTION AND WORK STOPPAGES

The Federal Reserve Board's index of industrial production fell at a seasonally adjusted annual rate of 4.8 percent in August. This was the sharpest decline in industrial output since last winter's energy-related contraction, leaving output 1 percent below the level of a year earlier. Although the size of the August decline was magnified by labor disputes in numerous industries, the pervasive sluggishness of economic activity suggested that production would have edged downward even in the absence of these disputes. Production of defense and space equipment, construction materials, and durable consumer goods all fell, in addition to the strike-related cutbacks in the production

of business equipment, coal, and iron mining. The housing slump no doubt accounts for the decline in the output of construction materials. Also, since the reduction in consumer durable goods production was centered in household appliances and furniture, it too may reflect the depressed state of housing activity. As fewer new housing units are completed, correspondingly fewer new appliances are needed. In contrast to most major market groups, production of nondurable consumer goods and materials rose in August.

Despite the relative calm in most major collective bargaining negotiations, the number of work stoppages and working time lost from labor disputes have jumped since the end of wage controls in April. Thus, it appears that the attempts by unions to recoup lost purchasing power through wage increases and cost-of-living protection may be meeting stiff management resistance at smaller concerns. In the four months since wages were decontrolled in April, the number of stoppages have spurted sharply, averaging more than 660, compared with the 425 stoppages averaged in the first four months of 1974. In August, however, labor disputes moderated, declining to 540 from over 700 in July (see Chart I). The percentage of total working time lost by employees directly involved in these stoppages fell to 0.34 percent in August from the three-year high of 0.46 percent reached in June and July. This measure, which allows for the growth of the labor force, neglects the indirect or secondary effects on other establishments or industries where employees are idle as a result of material or service shortages. Despite this recent decline in strike activity, it is likely these strikes may have had greater direct impact on industrial production, as it appears that these disputes have shifted from construction to the manufacturing sector.

Nevertheless, the bulk of this year's heavy calendar of major collective bargaining agreements (defined by the Bureau of Labor Statistics as agreements covering 1,000 workers or more) that expire or contain wage reopening provisions have been peacefully settled. Major accords have been reached in the steel, telephone, aluminum, and can industries, with few or no labor-management disputes.



Even the volatile construction industry has had only relatively minor labor stoppages. However, one major industry settlement that could bear heavily on economic activity—coal—has not yet come up for renegotiation. Coal is an important energy source for the steel and electric utility industries. Indeed, it accounts for almost half of all the electricity produced in the United States. Coupled with the prospective shortages of natural gas this winter, a sustained nationwide strike by the United Mine Workers in November could have a seriously deleterious impact on the economy. Utilities' inventories of coal, which were already low in July, have been reduced further by August's "memorial" work stoppages. At least one major utility, the Tennessee Valley Authority, has already requested its users to reduce voluntarily electricity consumption in an attempt to maintain its dwindling stock of coal.

#### RETAIL SALES, NEW ORDERS, AND INVENTORIES

According to the advance report, retail sales in August rose at a 6.8 percent annual rate. However, the bulk of this increase was the result of the continued improvement

in sales of new domestic automobiles, which in large part probably reflected the attempt by consumers to avoid the announced higher prices on the forthcoming 1975 models. Sales of nondurable goods rose in August but, excluding the automotive sector, durable goods sales slipped slightly. In September, sales of new cars weakened, although they remained ahead of the pace of early summer. New car inventories are down sharply from the peaks recorded in the gasoline-short winter months.

Allowing for the impact of surging prices, both durable and nondurable retail sales have shown little improvement in recent months, after recovering from last winter's lows. Slackening retail sales to some extent reflect the continued deterioration in real personal income that has characterized the twelve-month period ended in August. The most recent survey of consumer sentiment and spending plans suggests that little improvement is in the offing for real retail sales. The Conference Board's index of consumer confidence in August was close to a four-year low.

New orders received by durable goods manufacturers rose \$1.73 billion, or 3.6 percent, in August. A sharp spurt in defense equipment orders, especially for aircraft, and a pickup in primary metals orders accounted for all of the advance. Excluding the defense sector, new orders registered a slight decline in August. Although new orders have risen almost continuously in 1974, these data are expressed in nominal terms and thus reflect the rapid rate of inflation. Allowing for the effect of higher wholesale prices of manufacturers' durable goods, it appears that the physical volume of new orders has advanced only slightly in the past few months.

As measured by their book value, manufacturers' inventories rose by \$31 billion at an annual rate in August, the fourth consecutive month that the rate of inventory accumulation equaled or exceeded \$30 billion. The August growth in manufacturers' shipments equaled that of inventories, leaving the inventory-sales ratio unchanged at 1.63 months of shipments. This apparent stability in the inventory-sales ratio, however, tends to disguise real accumulation since the value of sales reflects the rapid rate of inflation more fully than the book value of inventories. Despite this limitation, these inventory-sales ratios can indicate relative accumulation in particular sectors. Examination of these ratios by market groups indicates marked accumulation in the household durable and capital goods industries, where inventories have jumped over the past few months even though shipments have declined. Unlike recent months, in which finished goods accounted for a rising portion of the buildup in manufacturers' inventories, more than 80 percent of the August increase was in inventories of materials and supplies and work in process. At



the trade level, inventories at both wholesale and retail rose sharply in July, with nondurables inventories accounting for the bulk of the increase.

### CONSTRUCTION

Residential construction activity deteriorated further in August, as mortgage market conditions became even more stringent. Housing starts dropped to an annual rate of 1.13 million units in August, down 44 percent from a year earlier and the lowest level in more than four years. While single-family starts were 26 percent below the level of a year ago, multifamily starts, which have been especially hard hit, stood at a seven-year low of 302,000 units in August. Building permits fell 10 percent in August to an annual rate of 912,000, the first time since early 1967 that newly issued permits have fallen below the million mark. Sales of single-family homes fell 15 percent at an annual rate in July to a level of 518,000 units. The inventory of unsold homes remained virtually unchanged and,

at the current sales rate, represents a large ten months' supply.

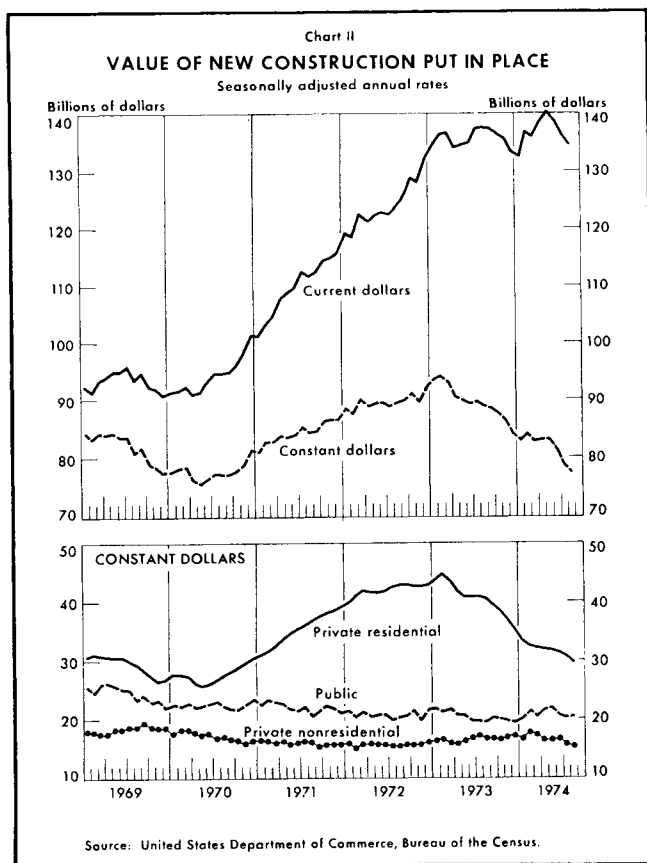
The mortgage market tightened further in August. Despite a slight pickup in the growth of thrift deposits, which was concentrated at savings and loan associations, deposit growth remained near July's four-year low. In August, mutual savings banks, which have been hard hit by deposit outflows, suffered their fourth deposit loss in the past five months. As a result of these deposit flows, thrift institutions continued to curtail both their mortgage lending and their commitments to lend in the future. Interest rates on both new mortgage commitments and mortgage closings recently have climbed, with mortgage rates reportedly exceeding 10 percent in many areas of the nation in September.

After climbing to a peak in May, the value of new construction has begun to decline in recent months. Thus, it appears that the protracted decline in construction activity not only has spread beyond the residential building sector, but also has more than offset the effect of higher prices. Real construction outlays have been falling over the past eighteen months and dropped to a four-year low in August (see Chart II). In constant-dollar terms, private residential construction outlays have declined almost \$17 billion from their peak in February 1973. Furthermore, spending on public construction, even though it has risen in current dollars over the past year and a half, has shown little real growth. Finally, private nonresidential construction activity, which edged upward in 1973 and early 1974, has recently been declining under the weight of high interest rates and construction costs.

### PRICE DEVELOPMENTS

Inflationary pressures remain intense. According to the latest price statistics, almost all sectors of the economy continue to be gripped by accelerating inflation. In August, wholesale prices surged at a seasonally adjusted annual rate of more than 45 percent for the second consecutive month. As these wholesale price increases are likely to work their way through the economy, there can be little hope for near-term improvement in inflation at the retail level. The August advance in consumer food prices was the sharpest in six months, and the full impact of the drought-related runup in farm product prices has yet to be felt by the consumer. Moreover, the edging-down of agricultural spot prices following their earlier sharp advance has recently been reversed by concern over frost damage.

Consumer prices advanced at a 16 percent seasonally adjusted annual rate in August, the largest increase in one year. Also discouraging was the pervasiveness of the price



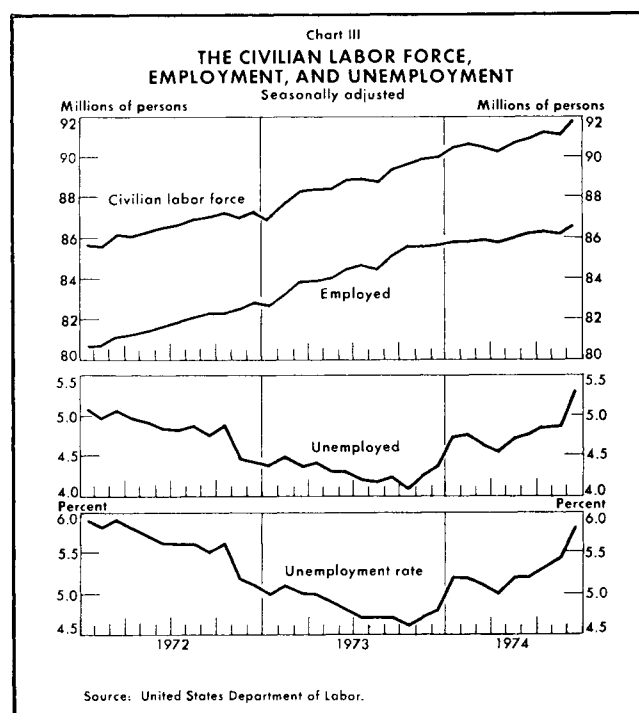
rise. The prices of both food and nonfood commodities rose at slightly more than a 17 percent annual rate, and prices of services increased at an annual rate of more than 13 percent. Gasoline prices were one of the few consumer prices that declined. Higher prices of meats, apparel, and medical care services led the consumer price advance.

Propelled by continuing increases in industrial prices and a large advance in the price of farm and food products, wholesale prices rose at a seasonally adjusted annual rate of 46.4 percent in August. Wholesale industrial prices rose 30.3 percent at an annual rate in the month and have advanced at a sizzling 32.9 percent annual rate thus far this year. Even after allowance for the expected price bulge due to the termination of controls, the magnitude and duration of the upsurge in wholesale industrial prices has sharply dimmed prospects of a near-term slowdown in the rate of inflation. Among the many products for which prices were higher in August, the increases in the prices of chemicals and paper and pulp products were especially large. In addition to the industrial price advance, prices of farm products and processed foods and feeds, led by increases in the prices of livestock and feed grains, skyrocketed for the second consecutive month, jumping at an 88.9 percent seasonally adjusted annual rate in August. However, agricultural prices have moved erratically, and earlier in the year wholesale farm and food prices declined for four consecutive months.

Concern over recent frost damage to Midwest crops has reversed earlier declines in spot prices of several agricultural commodities. Most notably, the prices of corn, soybeans, and other grains, which had begun to retreat from their drought-related peak in mid-August, have spurted in recent trading. For example, the spot price of corn, after falling more than 30 cents per bushel in the weeks following mid-August, has recently jumped above its earlier peak. Soybeans, which because of their longer growing period have been particularly hard hit by the frost, have jumped about \$1.20 per bushel in the last two weeks of September.

#### LABOR MARKET DEVELOPMENTS

The sluggish pace of economic activity has resulted in weakness in the labor market (see Chart III). The seasonally adjusted unemployment rate rose 0.4 percentage point to 5.8 percent in September, the highest level in more than two years. Although the September jump in the jobless rate was widespread among most major age-sex groups, the burden fell more heavily on teen-agers, especially men, and women 25 years of age and over. The unemployment rate for male teen-agers jumped almost



2 percentage points to 17.1 percent in September, and the rate for women 25 years of age and over climbed a substantial 0.6 percentage point to 4.8 percent. The rate for married men rose to 2.8 percent, the highest for that group since October 1972. Most major industry groupings registered large increases in jobless rates; the 12.4 percent rate for construction workers was the highest in four years.

Despite the sluggishness of economic activity following the Arab oil embargo, the household survey indicates that civilian employment has risen by about 870,000 over the first nine months of this year. Employment increased by a substantial 351,000 workers in September. However, most of the September growth was the result of persons who, although seeking full-time employment, were forced to accept part-time employment. The number of these involuntary part-time workers jumped 310,000 in September, accounting for almost nine tenths of the growth of total employment. At the same time, the rise in the number of unemployed workers—948,000 over the first nine months of this year—has been primarily the result of growth in the labor force rather than increased layoffs. The civilian labor force rose sharply in September, continuing the growth that began in May. The bulk of the recent expansion in the labor force has stemmed from a pronounced

rise in the number of women and teen-agers seeking employment. Over the May-September period the number of adult women in the labor force has risen at a 4 percent annual rate and that of teen-agers surged at a 14.2 percent annual rate.

The separate payroll survey, which differs from the household survey in definition, coverage, and other factors, indicates that employment has grown by 520,000 workers over the first nine months of 1974, with most of the gain in the service-producing sector of the economy. In contrast to the similar employment growth recorded by these surveys over extended periods, payroll employment in September was considerably weaker than indicated by the household survey. Payroll employment remained relatively flat in that month, rising only 33,000 workers. This gain

was particularly small in light of the large number of employees returning from strikes who did not appear on company payrolls in August.

Although in real terms workers' wages are probably continuing to decline, it does appear that unions have been successful to some extent in arresting the erosion in purchasing power that has resulted from inflation. The adjusted index of average hourly earnings for production workers on private nonagricultural payrolls increased at an 11.2 percent seasonally adjusted annual rate in September. Manufacturing earnings alone rose at a 12.9 percent rate in that month. Manufacturing wage gains adjusted for interindustry shifts and overtime have proceeded at a double-digit pace over the past six months, considerably above the pace of the earlier part of the year.

#### NEW PUBLICATION

The second booklet entitled *Glossary: Weekly Federal Reserve Statements* completes a pair of glossaries describing five weekly banking statistical reports published by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

The 32-page, annotated booklet defines, line-by-line, the meaning of, and relationships among, the terms used in the weekly condition report of large commercial banks, the weekly summary of banking and credit measures, and the report covering the basic reserve position, Federal funds, and related transactions of eight major reserve city banks in New York City.

Both glossaries are available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

## The Money and Bond Markets in September

Pressures in the financial markets, particularly in the short-term sectors, eased in September after a summer of record-high interest rates. Market sentiment was buoyed by a drop in the Federal funds rate, a temporary reduction in the Treasury's bill sales, and the elimination of the marginal reserve requirement on large certificates of deposit (CDs) with maturities of four months or more. At the same time, the decline reported in industrial production for August reinforced judgments that the economy had cooled and that rapid growth would not resume quickly. This prospect promoted expectations that credit demands would moderate further and that the Federal Reserve might adopt a somewhat less restrictive monetary policy in the months ahead. As a result, most short-term rates fell sharply in September while yields on long-term securities edged modestly lower.

The most dramatic decline in short-term rates occurred in the Treasury securities market, where rates on Treasury bills dropped by about 135 to 325 basis points over the month. Contributing to these declines were a reduction in the supply of new bills, coupled with a high volume of noncompetitive tenders at the weekly auctions, and large purchases of marketable Treasury debt by foreign official institutions. Improvement in the long-term Treasury securities market was tempered, however, by investor hesitancy about committing funds to long-term investments as several rallies faltered for lack of investor enthusiasm.

In the corporate and municipal bond markets, the gloom of August diminished somewhat, though the long-term markets were still beset with the problem of rapid inflation. Several new issues moved to substantial premiums in trading in the secondary markets. Also, electric utility offerings improved, as two Aa-rated companies were able to sell thirty-year bonds at rates slightly below those on a similar issue in August.

According to preliminary data, the sluggish growth of most of the monetary aggregates of the last few months continued in September.  $M_1$ —private demand deposits adjusted plus currency outside banks—actually declined in the four-week period ended September 25. The growth of

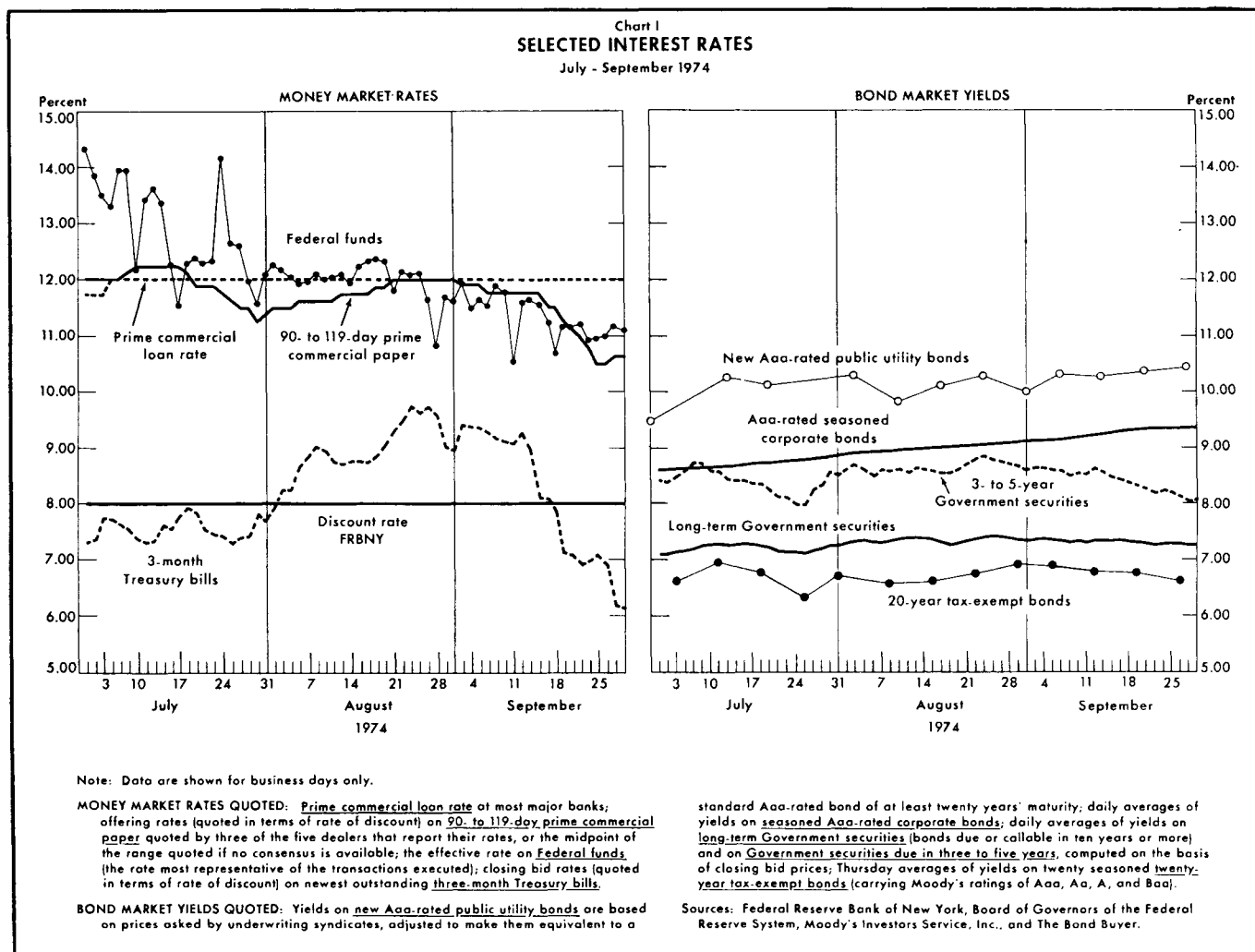
$M_2$ — $M_1$  plus commercial banks' time deposits other than large CDs—decelerated sharply in the same period. In contrast, the volume of CDs outstanding increased after falling in August.

### THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Short-term interest rates declined across a wide front in September (see Chart I). The effective rate on Federal funds averaged 11.34 percent, 67 basis points below the August level and substantially below the record high of 12.92 percent reached in July. In the secondary market, the rate on three-month CDs fell during the month by about 1 percentage point to the 10¾ to 11 percent range. Similarly, rates on 90- to 119-day commercial paper declined from 12 percent at the end of August to 10⅝ percent at the end of September. At the same time, dealers' offering rates on bankers' acceptances showed a drop of 2 percentage points to the 9½ to 10½ percent range in generally heavy trading.

For most of September, the commercial bank prime lending rate remained at the record-high level of 12 percent reached in July. At the end of the month, however, two money market banks lowered their prime rate to 11¾ percent, owing in part to the declines in most short-term rates and the relatively modest business loan demand during the midmonth tax and international oil payment dates. Although many banks did not reduce their prime rate immediately, the 11¾ percent prime rate spread through much of the banking system in early October.

Member bank borrowings from the Federal Reserve continued relatively high in September, averaging \$3.4 billion (see Table I). Late in the month, the Board of Governors of the Federal Reserve System announced that it had amended Regulation A which governs member bank borrowings. The amendment will allow Federal Reserve Banks to impose a special discount rate (higher than the regular discount rate) on member banks requiring exceptionally large, long-term assistance. The special rate



will not exceed the rate established for emergency loans to nonmember banks (currently 10 percent). The special discount rate, which can be waived in individual cases, may be applied to a bank borrowing exceptionally large amounts (such as more than the bank's average required reserves) for prolonged periods (such as more than eight weeks).

According to preliminary estimates, most monetary aggregates displayed little, if any, growth in September.  $M_1$  declined at a 1.4 percent seasonally adjusted annual rate from its average level over the four weeks ended August 28 to the average level for the four weeks ended September 25. With the growth of other time deposits advancing at a 3.6 percent rate over the same period,  $M_2$

grew at a 1.3 percent rate. The growth of  $M_2$  from the corresponding period ended thirteen weeks earlier to the four weeks ended September 25 fell to a 4.6 percent rate, the lowest such growth rate thus far this year (see Chart II). The adjusted bank credit proxy increased at a 4.3 percent annual rate in the four weeks ended September 25 over the four statement weeks in August, with CDs advancing at an 18.4 percent rate over the same period.

On September 4, the Federal Reserve Board revised Regulation D to remove the 3 percent marginal reserve requirement on large-denomination CDs with maturities of four months or longer. The action lowered the effective cost to the banks of the longer CDs by about 40 basis points and was designed primarily to encourage member

banks to lengthen the maturities of their CDs. The removal applied to roughly one sixth of the large CDs outstanding and reduced required reserves by about \$400 million in the statement week ended September 25. The regular 5 percent time deposit reserve requirement will still be placed on all CDs, while the marginal 3 percent will now apply to the shorter CDs in excess of the amount held in May 1973. In addition to CDs, Regulation D also covers bank-related commercial paper and finance bills.

### THE GOVERNMENT SECURITIES MARKET

Yields on all maturities of Treasury securities fell during the month, with the largest declines occurring in the shortest maturities. Long-term interest rates edged down only slightly. Early in the month, Treasury bill rates declined moderately before dropping sharply at midmonth. Market participants concluded that the removal of the marginal reserve requirement on CDs with more than four months' maturity, together with the decline in the Federal funds rate, indicated that monetary policy was becoming less restrictive. In addition, the slow growth of  $M_1$  prompted the hope that further easing of monetary policy would be possible. Also contributing to the midmonth decline in bill rates was the purchase of a sizable volume of Treasury securities in one week by the Federal Reserve for its customer accounts. By the month end, the drop in the three-month bill rate had exceeded by far the declines in rates on commercial paper and CDs with the same maturity.

The rates at the weekly auctions of Treasury bills fell in September by about 3 percentage points from the record-high rates set in late August. Contributing to this decline was the reduction in the Treasury's bill sales in September. At each of the last two weekly auctions in August, the Treasury raised an additional \$400 million in new cash. In September, the Treasury merely refunded the maturing bills at the first and last weekly auctions and paid down \$200 million in each of the two weekly auctions in the middle of the month. While the Treasury was reducing its demands, noncompetitive tenders from the public at the weekly auctions early in the month were unusually high. In addition, after allowing for the rolling-over of bills by the Federal Reserve for its own and its customer accounts, the supply of new bills for competitive bidding in September was only about half the amount available in August. At the first auction on September 9, noncompetitive bids from the public reached a total of \$1 billion of the \$4.4 billion of three- and six-month bills sold; these issues were auctioned at rates of 9.10 and 8.98 percent, respectively (see Table II). Demand was also high at the next weekly auction, when noncompetitive tenders

**Table I**  
**FACTORS TENDING TO INCREASE OR DECREASE**  
**MEMBER BANK RESERVES, SEPTEMBER 1974**

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

Factors	Changes in daily averages— week ended				Net changes
	Sept. 4	Sept. 11	Sept. 18	Sept. 25	
<b>"Market" factors</b>					
Member bank required reserves .....	— 26	+ 287	— 378	+ 126	+ 9
Operating transactions (subtotal) .....	— 336	+2,518	— 221	—2,121	— 160
Federal Reserve float .....	— 62	+1,007	— 213	— 363	+ 369
Treasury operations* .....	+ 64	+1,263	+ 422	—1,674	+ 75
Gold and foreign account .....	— 64	+ 9	— 163	— 87	— 305
Currency outside banks .....	— 142	— 203	— 125	+ 351	— 119
Other Federal Reserve liabilities and capital .....	— 132	+ 442	— 142	— 348	— 180
Total "market" factors .....	— 362	+2,805	— 599	—1,995	— 151
<b>Direct Federal Reserve credit transactions</b>					
Open market operations (subtotal) .....	+ 57	—2,223	+ 702	+1,273	— 191
Outright holdings:					
Treasury securities .....	+ 181	—1,923	+ 96	+1,335	— 311
Bankers' acceptances .....	+ 7	— 8	— 18	+ 35	+ 16
Federal agency obligations .....	+ 234	— 12	—	+ 59	+ 281
Repurchase agreements:					
Treasury securities .....	— 116	— 186	+ 434	— 174	— 42
Bankers' acceptances .....	— 78	— 37	+ 55	+ 47	— 13
Federal agency obligations .....	— 171	— 57	+ 135	— 29	— 122
Member bank borrowings .....	+ 373	— 821	— 164	+ 610	— 2
Seasonal borrowings† .....	— 9	— 20	+ 2	+ 7	— 20
Other Federal Reserve assets‡ .....	+ 92	+ 40	+ 33	+ 90	+ 255
Total .....	+ 522	—3,004	+ 571	+1,974	+ 63
Excess reserves‡ .....	+ 160	— 199	— 28	— 21	— 88
	Daily average levels				Monthly averages\$
<b>Member bank:</b>					
Total reserves, including vault cash† .....	37,255	36,769	37,119	36,972	37,029
Required reserves .....	36,919	36,632	37,010	36,884	36,861
Excess reserves .....	336	137	109	88	168
Total borrowings .....	3,906	3,085	2,921	3,531	3,361
Seasonal borrowings† .....	152	132	134	141	140
Nonborrowed reserves .....	33,349	33,684	34,198	33,441	33,668
Net carry-over, excess or deficit (—)¶ .....	155	144	102	55	114

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 four weeks ended September 25, 1974.

¶ Not reflected in data above.



amounted to nearly \$900 million and the rates on the auctioned bills were well below those on outstanding issues of comparable maturity. By the last auction of the month, the rate for three-month bills had dropped to the lowest level since May 1973. In the auction of the 52-week bill on September 18, the average issuing rate was set at 8.34 percent, 122 basis points below the record rate established at the preceding monthly auction.

Yields on Treasury coupon securities also fell over the month in response to the sharp rate declines in the short end of the market. However, the market for Treasury notes and bonds continued to be somewhat depressed by the high rate of inflation, and the market sagged after the report of the surge in wholesale prices in August. By the end of the month, most other developments had strengthened the market, and yields on intermediate-term securities were 31 to 62 basis points lower, while yields on longer term securities declined by about 7 to 33 basis points. On September 24, the Treasury auctioned \$2 billion of two-year notes to replace a like amount maturing at the end of the month. The bidding was on a yield basis and the minimum denomination on the notes was increased to \$10,000 from the usual \$1,000 to reduce the likelihood of a shift of funds from the nation's thrift institutions. The auction attracted good interest from both dealers and investors, and the average yield was set at 8.34 percent.

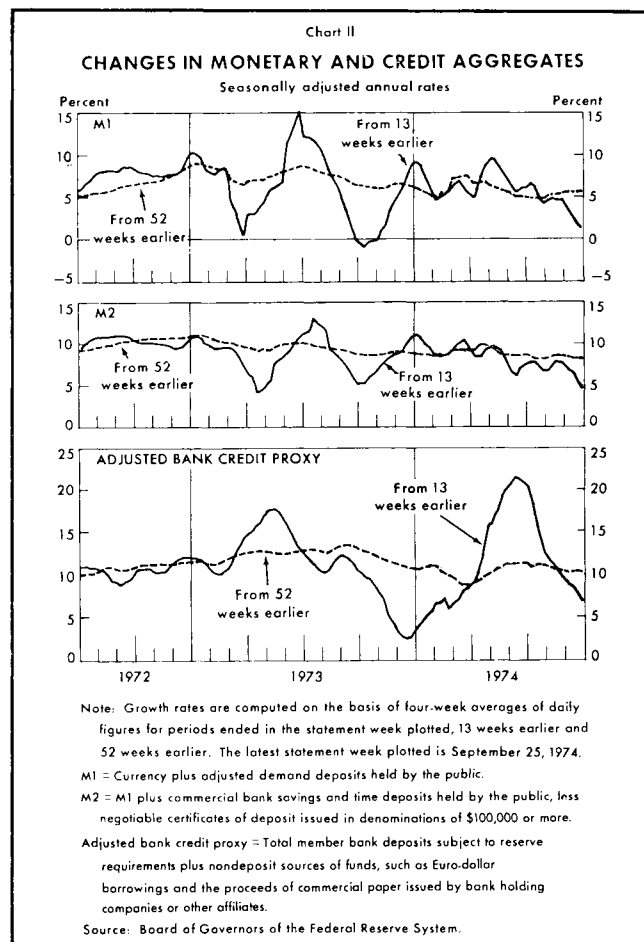
Prices of United States Government agency securities moved up during the month, and new issues were generally well received. In the first offering of the month, the Federal Home Loan Banks raised \$1.7 billion of new capital. The bonds due in August 1976 carried a yield of 9.55 percent, the bonds maturing in February 1978 returned 9.38 percent, and the February 1979 bonds paid 9.45 percent. The monthly offering of Banks for Cooperatives six-month and the Federal Intermediate Credit Bank nine-month issues produced rates that were 30 and 20 basis points lower, respectively, than those on comparable issues sold in August. At the end of the month, the Tennessee Valley Authority (TVA) resumed its monthly note auction after a two-month absence because of high interest rates. The TVA sold \$50 million of four-month notes at an average interest cost of 9.07 percent, about 1 percentage point below the rate paid on similar notes in June.

#### THE OTHER SECURITIES MARKETS

The atmosphere in the corporate and municipal bond markets improved somewhat in September in response to the sharp drop in short-term interest rates. A relatively modest volume of new issue activity during the month

also served to bolster the market. However, the continuing high rate of inflation as well as an unusually heavy calendar of new offerings scheduled for October provided a sobering influence.

Early in the month, the corporate calendar was dominated by electric utility issues. During the first two weeks, two electric utilities each marketed \$50 million of thirty-year Aa-rated first-mortgage bonds. Both issues were well received; one issue was priced to yield 10½ percent, and the other was priced to yield 10.40 percent. These yields were 25 to 35 basis points lower, respectively, than on a similar long-term Aa-rated utility issue sold in August. In the middle of the month, Duke Power Company marketed \$100 million of Baa-rated five-year notes, which were priced to yield a very high 13 percent and proved attractive to individual investors. The issue sold out on the first day and traded at a premium in the secondary market.



The largest corporate bond issue of the month was the \$225 million of South Central Bell Telephone Company debentures. In a negotiated sale in mid-September, the Aaa-rated forty-year debentures were priced to yield 10.05 percent, 5 basis points above a Bell issue in August and a new record-high interest rate for Bell System debt. The issue sold only moderately well at first, but was down to tag ends at the end of the second day. Three non-Bell telephone-utility issues, all of which were A-rated thirty-year first-mortgage bonds, were also sold at midmonth. The range of yields on these securities was 10.82 to 11.25 percent, and the issues generally received only fair receptions. The yield spread of roughly 100 basis points between the Aaa-rated and the A-rated utility issues was still wider than usual—although the spreads were far wider this summer—reflecting investors' lingering preference for high-quality debt.

In the tax-exempt sector, the bulk of new financing was concentrated in the short-term area, with two of the largest short-term offerings being sold by New York City. On September 9, New York City awarded \$600 million of revenue anticipation notes at a net interest cost of 8.43 percent. Near the end of the month, after short-term rates had dropped sharply, a second note issue of \$800 million sold at a net interest cost of 7.31 percent, more than 100 basis points lower than the earlier issue.

The volume of long-term tax-exempt securities was rather light early in the month, but became heavier as the month progressed. Toward the end of the month a sharp drop in the net interest costs of some new issues prompted apprehension that the heavy fourth-quarter calendar might become even larger. Consequently, the aggressively priced issues of the states of Oregon and California sold fairly

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

In percent

Maturity	Weekly auction dates—September 1974			
	Sept. 9	Sept. 16	Sept. 23	Sept. 30
Three-month .....	9.099	8.185	7.002	6.385
Six-month .....	8.980	8.203	7.928	7.430
	Monthly auction dates—July-September 1974			
	July 24	Aug. 21	Sept. 18	
Fifty-two weeks .....	7.836	9.564	8.341	

\* 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.

slowly during the last week of the month. The Oregon bonds, rated Aaa by Moody's and AA by Standard and Poor's, were reoffered at yields of 5.25 percent for the five-year bonds to 5.95 percent for the sixteen-year bonds. The Aaa-rated California issue was reoffered at yields of 5.10 percent for bonds due in 1975-76 to 6.10 percent for bonds due in 1993-94. On September 26, The Bond Buyer index of twenty municipal bond yields stood at 6.62 percent, 29 basis points below the level at the end of August. The Blue List of dealers' advertised inventories rose by \$221 million to \$580 million.