FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

NOVEMBER 1974

Contents

Maintaining the Soundness of Our Banking System: An Address by Arthur F. Burns 263

The Business Situation 268

Monetary and Financial Developments in the Third Quarter 273

The Money and Bond Markets in October 278

Volume 56 No. 11

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Maintaining the Soundness of Our Banking System

By ARTHUR F. BURNS
Chairman, Board of Governors of the Federal Reserve System

An address before the 1974 American Bankers Association Convention, Honolulu, Hawaii, on October 21, 1974

This year, for the first time in decades, questions have been raised about the strength of our nation's, and indeed the world's, banking system. It is profoundly disturbing to me, as indeed it must be to all of you, that such questions should be raised.

Over the past century or longer, the American people have repeatedly demonstrated their determination to have a sound system of banking, and they have been willing to take whatever steps are necessary to assure it. The central role now played by American banks in international trade and finance imparts a new and global dimension to the need for confidence in our banking system. This international responsibility is made all the more compelling by the sudden and massive flows of funds to and from the oil-exporting countries. It is clearly of vital importance for the United States and the rest of the world that our commercial banks continue to measure up to the heavy obligation of financial stewardship now placed upon them.

In the past year, we have had the two largest bank failures in the nation's history. This fact has been widely noticed, as it deserves to be. But it is equally important to recognize that these failures did not cause any loss to depositors. Nor did they have serious repercussions on other banks or businesses. The ability of our financial system to absorb such shocks reflects credit on the safeguards that the Congress has developed in response to past experience.

One crucial element of our banking strength is Federal insurance of deposits. Another major source of banking strength is the Federal Reserve System's ability and willingness to come promptly to the assistance of banks facing a temporary liquidity squeeze. The financial world understands that our banking system can be and will be supplied with funds in whatever amount is necessary to forestall a credit crunch.

Nonetheless, it is important to ask why, for the first time since the Great Depression, the availability of liquidity from the central bank has become such an essential ingredient in maintaining confidence in the commercial banking system. The economy is operating at a reduced, but still very high, level. Bank profits are generally satisfactory. There is no danger of withdrawal of deposits for purposes of hoarding. Very few of our banks should need to count on Federal support in circumstances such as these. It is in order, therefore, to take a close look at recent trends in banking.

Commercial banking has been undergoing a profound evolution for well over a decade. The focus of bank management still embraces the traditional fiduciary responsibilities, but goals of profitability and growth have been receiving more and more attention. The recruitment and promotion policies of many banks nowadays emphasize entrepreneurial talent. Their internal controls are elaborately designed to weed out inefficient operations, and to stress the profits being generated by individual departments. Innovation has become one of the prime attributes of the pace-setting banks, and competition has sharpened appreciably in the process.

In seeking growth and profitability in an increasingly competitive environment, banks have generally succeeded in meeting the needs of their business customers more effectively. Deposit instruments have been tailored to meet the special needs of customers. New types of lending arrangements to serve business and institutional borrowers have proliferated. The capability of banks to assist their customers in financial management has also come to include "off balance-sheet" activities, such as bookkeeping,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

data processing, and financial advisory services. And as regional banks have entered national markets for loans and deposits, while local banks kept entering regional markets, the banking alternatives available to business firms have multiplied and the nation's money and credit markets have become more closely integrated.

For many years now, banks have been cultivating aggressively the area of consumer finance. Besides competing intensively for consumer deposits, they have been promoting instalment credit and increasing home mortgage lending. Where possible, banks have expanded their branch networks to facilitate the quest for consumer business, and the result has been a dramatic increase in the number of banking offices relative to the nation's population.

The larger banking organizations have also been driving hard to acquire foreign business—by soliciting deposits, making loans, and conducting other financial activities through their foreign branches or subsidiaries. Foreign exchange operations have assumed a larger dimension in the workaday world of banking, and this activity accelerated once exchange rates were allowed to float and forward markets became essential for the conduct of international business.

The quest for profits and growth has led, moreover, to substantial changes in the structure of the banking system. Bank mergers and acquisitions of individual banks by multibank holding companies have resulted in consolidation of small units into larger organizations, which have often added financial strength to individual banks and enabled them to provide a broader range of services.

Nor is that all. One of the most notable manifestations of the drive for profits and growth has been the development of diversified bank holding companies. These organizations now extend substantial amounts of credit through subsidiaries engaged in mortgage banking, factoring, consumer finance, leasing, and other specialized activities. Many smaller firms in these lines of activity have been rejuvenated through acquisition by bank holding companies. *De novo* entry into these lines of activity has also been widespread, thereby leading to more vigorous competition. And since the nonbank subsidiaries of bank holding companies enjoy the privilege of multistate operation, the growth of their activities has played an important role in the process of knitting together the nation's credit markets.

Clearly, the far-flung changes I have been describing have served the public in many ways. There is, however, another side of the ledger. The very forces that have produced innovative, highly competitive banking have also led to some trends that go far to explain the uneasiness that so concerns us in 1974. The most significant of these trends are, first, the attenuation of the banking system's base of equity capital; second, greater reliance on funds of a potentially volatile character; third, heavy loan commitments in relation to resources; fourth, some deterioration in the quality of assets; and, fifth, increased exposure of the larger banks to risks entailed in foreign exchange transactions and other foreign operations. These developments have increased the vulnerability of individual banks.

The first of these trends—the attenuation of the equity capital base—is directly traceable to the recent rapid expansion of the banking system. In the years immediately following World War II, commercial banks were able to accommodate increases in loan demand mainly by reducing the portfolios of government securities accumulated during the war. Commercial bank deposits therefore failed to keep pace with the growth of the national economy. But by the early 1960's, as loan-deposit ratios kept rising and competition became keener, a faster rate of growth became necessary to enable banks to expand further their lending activities. Thus, during the decade ended in 1970, total assets of commercial banks increased at an average annual rate of 9 percent, in contrast to a 7 percent rate of growth in the dollar value of our gross national product (GNP).

Then, during 1971-73, banking assets grew more than 15 percent per year. To some extent this faster growth was linked to the pace of inflation. But banking assets increased more than three times as fast as the price level, and about half again as fast as nominal GNP, which itself reflects the impact of inflation. To a large extent, therefore, the phenomenal pace of recent bank expansion reflects neither price level changes nor real economic growth, but an expansion of banking's share of total financing business, both at home and abroad.

Banks provided over half of total new financing during 1971-73 in several key domestic areas, including the markets for consumer instalment debt, corporate debt other than mortgages, and debt of state and local governments. Expansion in foreign markets has been even more dramatic. During these three years the assets of foreign branches and subsidiaries of American banks nearly tripled, reaching $117 billion. In fact, expansion abroad accounted for more than one fifth of the growth in total assets of the United States commercial banking system during this period.

The diversified bank holding company has also become an important instrument of growth for a relatively small number of banking organizations. Major banks or bank holding companies now account for over half of the factoring business, a major portion of mortgage banking, and a significant part of consumer finance and leasing.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

And so I now come to my point, namely, that this enormous upsurge in banking assets has far outstripped the growth of bank capital. At the end of 1960, equity capital plus loan loss and valuation reserves amounted to almost 9 percent of total bank assets. By the end of 1973, this equity capital ratio had fallen to about 6½ percent. Furthermore, the equity capital of banks has been leveraged in some cases at the holding company level, as parent holding companies have increased their equity investments in subsidiary banks by using funds raised in the debt markets. Thus, the capital cushion that plays such a large role in maintaining confidence in banks has become thinner, particularly in some of our largest banking organizations.

It has been no simple feat for banks to grow so rapidly. A key tool of management in the drive for expansion has been a shift in emphasis from managing assets to managing liabilities. This is the second of the recent trends that I mentioned earlier.

Liability management requires tapping of external sources for liquidity—that is, borrowing funds as needed to meet the demand for loans from present customers, to accommodate new borrowers, or to adjust to reserve drains. Asset management, by way of contrast, involves adjusting liquid assets in response to changes in the volume of deposits or loan demand.

The development of liability management has led the larger banks to operate on the premise that, within wide limits, additional funds can be acquired at any time as long as the market rate of interest is met. The presumed ability to acquire whatever funds might be needed has encouraged banks to seek new channels for profitable investment; it has also reduced incentives to maintain the liquidity of their assets. Recent experience has demonstrated, however, what banking prudence itself should have dictated; namely, that the funds on which liability management depends can be quite volatile, especially if the maturities are short, and that banks may therefore have to wrestle with uncomfortable—even though they be temporary—liquidity problems.

The shift to liability management has occurred on a vast scale. During the 1950's, commercial banks obtained the major portion of their new funds from increases in demand deposits or equity capital. In more recent years, on the other hand, about two thirds of the new money raised by domestic offices of our banks has come from interest-bearing time accounts or nondeposit liabilities. Once the concept of liability management took hold, banks developed great ingenuity in tapping the markets for interest-sensitive funds.

Although the beginnings of modern liability management can be traced to the rejuvenation of the Federal funds market in the 1950's, the major breakthrough came with the introduction of large negotiable certificates of deposit (CDs) in early 1961. Private holdings of negotiable CDs now exceed those of any other money market instrument, including Treasury bills. Large, but nonnegotiable, time deposits have also figured significantly in liability management. Commercial paper has become another vehicle of liability management; some bank holding companies rely on it heavily to finance their nonbank subsidiaries. Still another method by which banks have attracted interest-sensitive funds is by borrowing Euro-dollars from their foreign branches for use in domestic banking.

Taken together, these several types of interest-sensitive funds have assumed huge proportions. Not only have they become the principal means of financing expansion at many of our larger banking organizations, but the apparent efficiency of liability management has tempted banks to make advance commitments of funds on a generous scale. This is the third of the recent trends in banking that I previously mentioned.

Beyond question, loan commitments have a legitimate place in the array of services offered by banks. But they should be made with caution, since they constitute a call on bank resources that can be exercised at an awkward time. This fact has been driven home in recent months as banks were being called upon with increasing frequency to meet their commitments. Excessive commitments have raised problems for some thoroughly sound banks, and they also have complicated the Federal Reserve's efforts to bring aggregate demand for goods and services under control.

A fourth disturbing trend has been a deterioration, albeit moderate as a rule, in the quality of bank assets. During recent years, as the role of credit in financing private spending increased and as interest rates rose, the debt service requirements of business borrowers have generally grown more rapidly than their incomes, and the additional debt has resulted in a rise of debt-equity ratios. These changes accompanied the efforts of commercial banks to assume a higher proportion of the lending done in the country. It should not be surprising, therefore, to find some tendency toward deterioration in the quality of bank assets.

Finally, both in this country and abroad, the freeing-up of exchange rates has made dealings in foreign currencies both tempting and risky. Not a few conservative bankers who previously had a strong preference for stable exchange rates suddenly discovered that floating exchange rates offered a new opportunity for profit, and some went at it with more enthusiasm than awareness of the risks involved. The large losses that a number of banks in Europe and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the United States have experienced as a result of excessive trading or unauthorized speculation in foreign currencies have not only caused embarrassment to these banks; they also have tarnished the reputation of the banking profession.

The confluence of the closely related trends I have just discussed—declining capital ratios, aggressive liability management, generous commitment policies, deterioration of asset quality, and excessive foreign exchange operations by some banks—explains much of the recent uneasiness about banking. Clear understanding of the current situation requires recognition of the interrelated effects of these banking practices on the state of confidence. An increase in doubtful loans is of consequence because it raises questions about bank solvency. Maintenance of solvency is closely linked, of course, to the adequacy of capital and reserves for losses. Similarly, heavy reliance on potentially volatile funds is not dangerous *per se;* it is dangerous only in proportion to doubts about ability to repay the borrowed money. Such doubts can undercut the basic premise of liability management—that needed funds can be raised as required from short-term sources. Extensive loan commitments are dangerous only when too many takedowns occur at the wrong time. And losses on foreign currency transactions have serious implications for the public only to the extent that they bulk large relative to the basic strength of the banks that experience them.

The developments I have sketched are in large part an outgrowth of the overheating experienced by our economy since the midsixties. This was also a period in which corporate profits failed to keep pace with expanding business activities. During the past year, in particular, the demand for business loans grew with extraordinary rapidity, as more and more corporations found it necessary to borrow heavily and to do so increasingly through the banking system. To a significant degree, many banks—especially the larger banks—have met the recent credit needs of hard-pressed sectors of the business community with a fine sense of public responsibility. But that is by no means the full story. Some carelessness also crept into our banking system, as usually happens in a time of rapid inflation, and that is why I have commented at such length on several disturbing trends in modern banking.

Even so, only a very small number of banks can be justly described as being in trouble. Despite all the strains recently experienced in credit markets, the banking system remains strong and sound. There is no reason to doubt the ability of our banks to meet their commitments, even in these trying times. But, while faith in our banks is fully justified, it now rests unduly on the fact that troubled banks can turn to a governmental lender of last resort.

It goes without saying that the discount facility is available for use and that it should be used when necessary, but the banking system's strength should not depend heavily on it. In our free enterprise system, the basic strength of the banking system should rest on the resources of individual banks. I believe that bankers generally support this principle, and that their policies are already reflecting renewed respect for it.

It is not sufficient, however, to rely on a rethinking by bankers of their goals and responsibilities. This country, like others, depends on public regulation as well as private vigilance to assure the soundness of its banking system. While the profound changes that I have described were taking place, our bank regulatory system failed to keep pace with the need. To be sure, there has been a great deal of activity among the regulators. Examinations of America's 14,000 banks have continued to be made methodically by the Federal supervisory agencies and the state banking authorities. And hundreds of regulatory decisions concerning bank mergers, holding company acquisitions, and the like, have been handed down each year by hard-working regulators under Federal and state statutes.

But the public attention devoted to adequacy of the safeguards provided by the regulatory system has waned appreciably since World War II. The traditionally interested parties—legislators, bankers, financial analysts, economists, and the bank regulators themselves—tacitly assumed that the sweeping financial reforms of the 1930's had laid the problem of soundness and stability to rest, once and for all. They have therefore concentrated on other matters, such as improving bank competition and adapting the banking system to changing needs for credit.

The stresses and doubts that have characterized recent financial experience are, however, bringing sharply back into focus the essential role of regulation and supervision in maintaining a sound system of banking. The regulatory agencies are responding to this need. At the Federal Reserve Board, concern about the adequacy of bank capital has been increasing. Recent decisions have also reflected a determination to slow down the expansion of bank holding companies. As one recent ruling stated, "the Board believes that these are times when it would be desirable for bank holding companies generally to slow their present rate of expansion and to direct their energies principally toward strong and efficient operations within their existing modes, rather than toward expansion into new activities". The purpose of this pause is not only to encourage—and where necessary enforce—a husbanding of resources, but also to provide a breathing spell during which both the Board and the banking industry can give the most serious thought to ways in which commercial banks and bank holding companies should develop in the future.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In this connection, it is well to note the favorable action by the Congress on the legislation requested by the Federal Reserve for authority to prevent, through cease and desist orders, unsound practices by bank holding companies and their nonbank subsidiaries. I am glad to say that the banking industry supported this needed legislation.

A number of specific projects designed to strengthen the regulatory system are under way at the Board, including establishment of a new program of reporting and financial analysis for bank holding companies, a critical appraisal of the current approach to bank examination, and concerted efforts to deal with problems relating to bank capital, bank liquidity, and foreign exchange operations. Similar projects, I understand, are under way at the other Federal bank supervisory agencies.

I must say to you, however, that I am inclined to think that the most serious obstacle to improving the regulation and supervision of banking is the structure of the regulatory apparatus. That structure is exceedingly complex. The widely used term "dual banking system" is misleading.

As you know, each of the fifty states has at least one agency with responsibilities for supervising and regulating banks. Some states also have statutes relating to bank holding companies. At the Federal level, every bank whose deposits are insured is subject to supervision and regulation, but authority is fragmented. The Comptroller of the Currency charters and supervises national banks. The Federal Reserve System supervises state-chartered member banks, regulates activities of Edge Act corporations, regulates all bank holding companies, and controls the reserves and other operating features of all its member banks. The Federal Deposit Insurance Corporation (FDIC) insures nearly all banks, but supervises only state-chartered banks that are not members of the Federal Reserve. The FDIC also has certain regulatory powers that apply to insured nonmember banks.

Those of you who have been intimately concerned with regulatory matters will realize that I have oversimplified, that our system of parallel and sometimes overlapping regulatory powers is indeed a jurisdictional tangle that boggles the mind.

There is, however, a still more serious problem. The present regulatory system fosters what has sometimes been called "competition in laxity". Even viewed in the most favorable light, the present system is conducive to subtle competition among regulatory authorities, sometimes to relax constraints, sometimes to delay corrective measures. I need not explain to bankers the well-understood fact that regulatory agencies are sometimes played off against one another. Practically speaking, this sort of competition may have served a useful purpose for a time in loosening overly cautious banking restrictions imposed in the wake of the Great Depression. But, at this point, the danger of continuing as we have in the past should be apparent to all objective observers.

I recognize that there is apprehension among bankers and students of regulation concerning overcentralized authority. Providing for some system of checks and balances is the traditional way of guarding against arbitrary or capricious exercise of authority. But this principle need not mean that banks should continue to be free to choose their regulators. And it certainly does not mean that we should fail to face up to the difficulties created by the diffusion of authority and accountability that characterizes the present regulatory system. On the contrary, it is incumbent on each of us to address these problems with the utmost care. For its part, the Federal Reserve is now pushing forward with its inquiries.

The range of possible solutions is broad. Some will doubtless conclude that the proper approach lies in improved coordination among the multiple bank regulatory agencies, together with harmonization of divergent banking laws. My own present thinking, however, is that building upon the existing machinery may not be sufficient, and that a substantial reorganization will be required to overcome the problems inherent in the existing structural arrangement. I have no illusion that reaching agreement on these matters will be easy. But I have found much wisdom and a strong sense of responsibility among this nation's bankers. I therefore earnestly solicit your views. They will receive full attention as the Board searches for the best path to progressive but still prudent bank regulation.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Business Situation

Economic activity dropped somewhat further in the third quarter. The gross national product (GNP) declined, after allowing for price changes, for the third consecutive quarter according to the preliminary estimate. Since its peak in the final three months of last year, real GNP has dropped about 3 percent, comparable to declines recorded during postwar recessionary periods. Other major indicators have shown somewhat less weakness this year, however. Thus, industrial production was about unchanged in the third quarter and is, so far, down only about 1.6 percent from its November 1973 peak. Employment actually rose a bit in the third quarter and in the year to date as a whole. While the third-quarter decline in overall real GNP apparently reflected mainly a rather sharp downward adjustment of inventories, there are few, if any, real signs of increased strength in the major demand sectors. Residential construction continues at depressed levels, and consumer confidence is apparently at a very low ebb. The continued sluggishness in the economy is being reflected, as had been widely expected, in rising unemployment, with the overall rate reaching 6 percent in October.

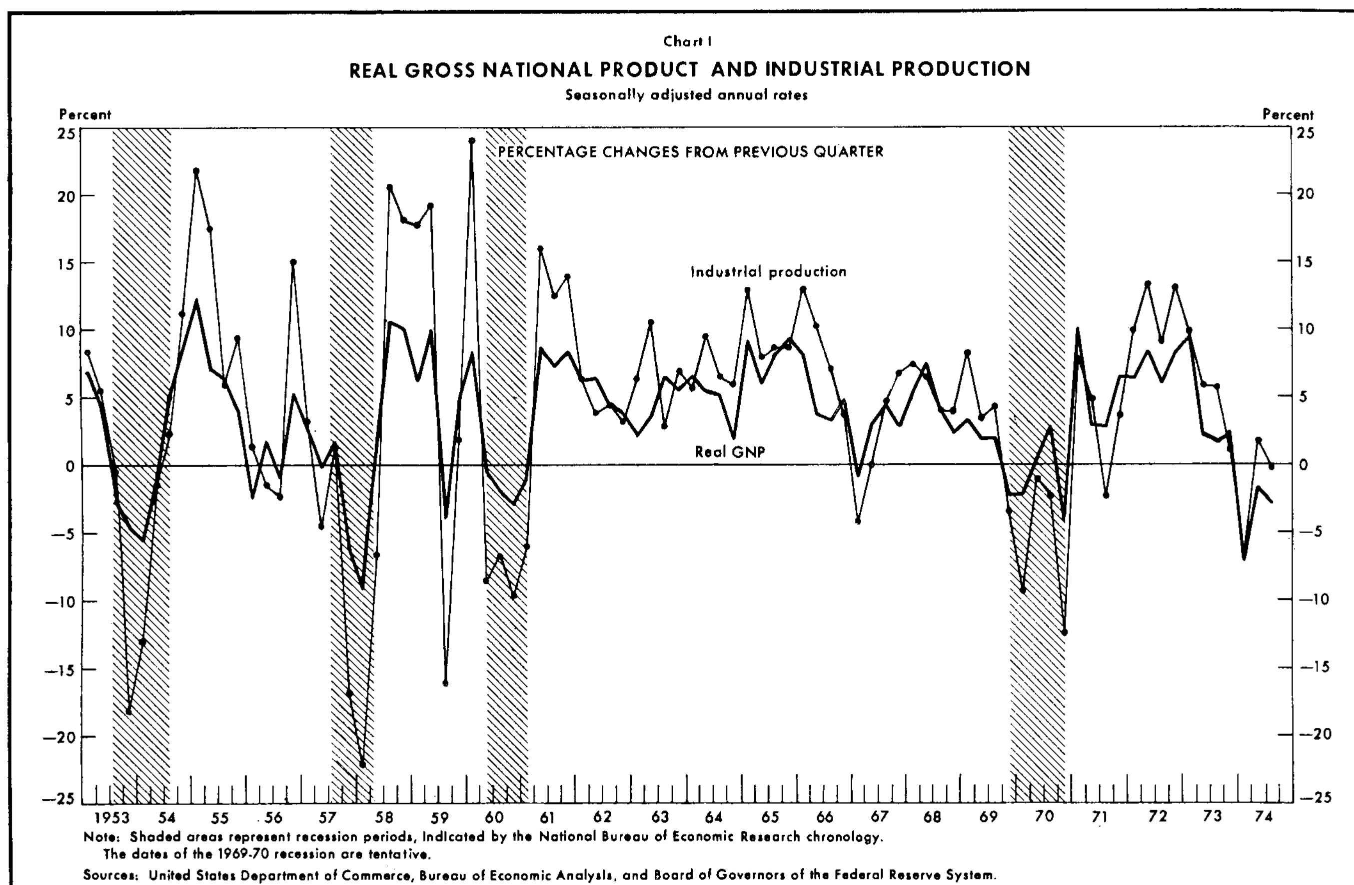
In the meanwhile, inflation remains exceptionally severe, although there are perhaps a few straws in the wind to suggest that some relief may be forthcoming. The GNP implicit price deflator, one of the broadest measures of prices, rose at an 11.5 percent annual rate in the third quarter. Except for the first three months of this year, this was the most rapid increase since the Korean war period. The fixed-weight deflator, which is unaffected by changes in the composition of output, rose at an even more rapid 12.8 percent annual rate over the July-September interval. However, as the quarter closed, there were signs of some easing of price pressures at the wholesale level. After registering the largest increase of the year in the previous month, wholesale prices in September rose only 1.1 percent at a seasonally adjusted annual rate. While the marked deceleration resulted mainly from a decline in farm and food product prices, the 12.4 percent annual rate of increase in wholesale prices of industrial commodities was the smallest since last October. Prices of a number of raw industrial commodities have continued their generally downward trend as a result of receding demand pressures in this country and abroad. However, such prices are only a small part of the costs of finished goods, which reflect accelerating wage costs as well. Hence, at the retail level prices have continued to surge, rising at a 15 percent annual rate in September.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary Department of Commerce estimates, the market value of the nation's output of goods and services rose by $27.8 billion in the third quarter of 1974, an 8.3 percent annual-rate increase. All of this rise, however, reflected higher prices, as real GNP declined at a 2.9 percent annual rate. Combined with the decrease of the two previous quarters, real GNP in the third quarter was down almost 3 percent from the peak attained at the end of last year. Thus far, the 1974 contraction in economic activity has deviated somewhat from the pattern of previous slowdowns, in which the decreases in real GNP were accompanied by even greater drops in industrial production (see Chart I). This time, the decrease in industrial production has been modest in comparison with that in real GNP and with its own behavior in previous cyclical declines. Industrial output in September was only 1.6 percent below its November 1973 peak, and this amounted to between one eighth and one fifth of the peak-to-trough contractions that occurred in 1969-70, 1960-61, 1957-58, and 1953-54.

Several factors have contributed to the recent atypical behavior of real GNP and industrial production. First, much of the decline in real GNP this year has reflected the very sharp contraction in residential housing activity. While home construction has typically fallen during cyclical declines, the recent drop has been unusually severe. This drop has had little effect on overall industrial production, with the exception of the decline in the output of construction materials and, perhaps, of the related dip

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



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

Sources: United States Department of Commerce, Bureau of Economic Analysis, and Board of Governors of the Federal Reserve System.

in the production of household appliances and furniture. Second, substantial buildups occurred in 1973 in the stocks of unfilled orders for durable manufactured goods and in unspent capital appropriations. No doubt these enlarged backlogs have cushioned production in recent months.

One of the major factors retarding the economy in the third quarter was the diminished rate of business inventory accumulation (see Chart II). Preliminary estimates based on partial data for the quarter indicate that investment in inventories amounted to only $5.8 billion in nominal terms in the July-September period, down from the $13.5 billion rate of accumulation of the previous quarter. In real terms, only durable manufacturing and farm stocks increased significantly in the third quarter. At the same time, the increase in current-dollar final expenditures—GNP excluding inventory investment—accelerated a bit to $35.5 billion, the biggest gain since the first quarter of last year.

Over the first nine months of this year, the pace of inventory investment has fallen off sharply from the unsustainable rate of accumulation recorded in the closing three months of 1973. In real terms, the decline in inventory spending in the first three quarters of the year has accounted for slightly more than two thirds of the total drop in aggregate demand. Businesses have continued to add to their stocks, however, and this has led to a steep runup in the ratio of real inventories to real final sales (see Chart III). In contrast, over this period, the ratio of book value inventories to total manufacturing and trade sales has remained fairly constant. To a large extent, the rapid rate of inflation has been the main factor behind the disparate behavior of these two indicators of inventory conditions, although there are other measurement and coverage differences. Much of the book value of inventories is valued in terms of past prices. Hence, in a period of rapid inflation, the book value of inventories will only incompletely reflect the higher market prices of inventoried

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

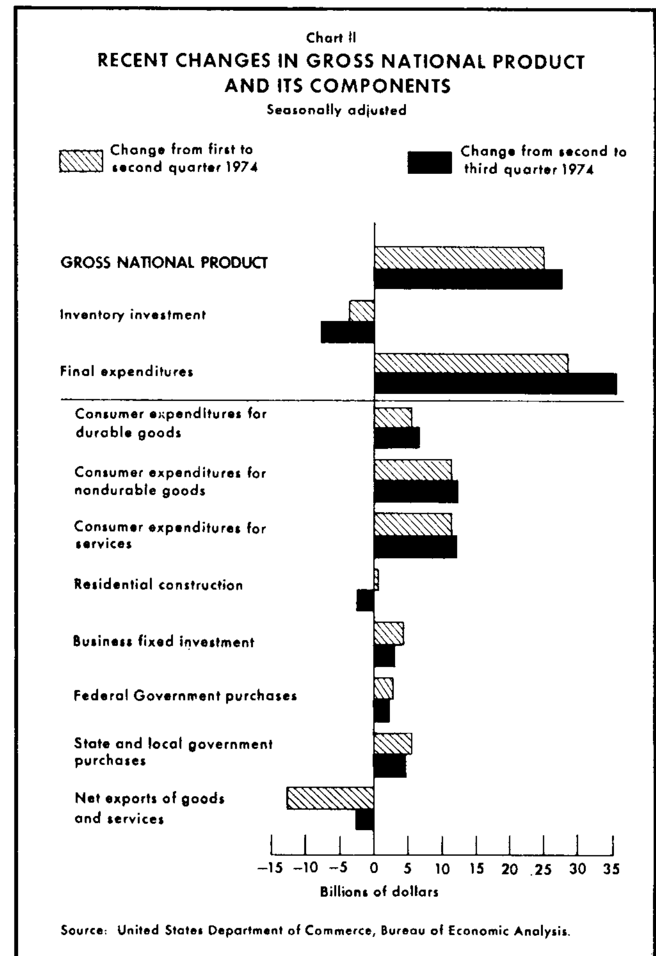
goods. This imparts a downward bias to the ratio of book-value inventories to manufacturing and trade sales during inflationary periods, since the latter are valued more nearly in terms of current market prices.

In view of the rising ratio of real GNP inventories to sales, the decreased rate of inventory spending may well represent a more or less orderly adjustment to rates of inventory accumulation consistent with present sluggish economic conditions. On the other hand, the recent switch by many businesses from first in-first out (FIFO) accounting to last in-first out (LIFO) may have artificially depressed the preliminary estimate of inventory accumulation in the third quarter. Other things being equal, an increase in the percentage of firms using LIFO implies a slower rate of gain in book value inventories. This effect should be offset by the inventory valuation adjustment (IVA) that is applied to the book value of inventories, measured partly in current prices and partly in terms of past prices, in order to obtain GNP business inventories, measured in current costs. However, the IVA is based on the mix of firms using LIFO and FIFO in the 1960's. An increase in the use of LIFO would lower the estimate of the IVA and thereby raise GNP inventory accumulation.

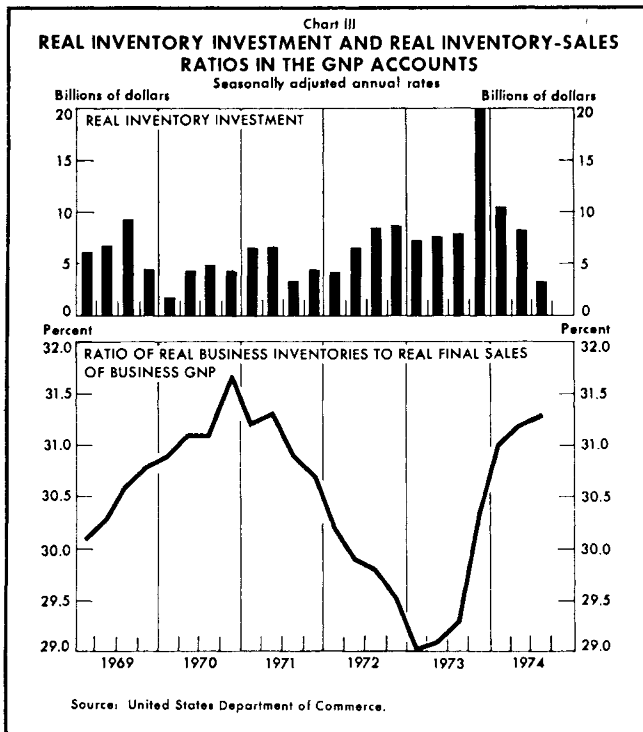
During the July-September period, personal consumption expenditures rose in both nominal and real terms. Following three consecutive quarterly declines, real outlays on consumer nondurable goods posted an increase in the most recent quarter. Likewise, consumers stepped up their spending on new automobiles. Domestic automobile sales climbed to an annual rate of 9.1 million units during the middle of the quarter, up from an average of 7.9 million units in the second quarter of the year. Much of this increase, however, appears to have resulted from the efforts of consumers to avoid the price hikes on the new 1975 models. Indeed, unit automobile sales fell sharply to 6.4 million units at an annual rate in October.

Personal consumption expenditures have contributed to the recent weakness in real GNP to a larger extent than in previous periods of economic downturn. In constant dollars, personal outlays on goods and services in the third quarter were $8.7 billion below the peak level of a year ago. The decline in real disposable income, as a result of the 12 percent hike in the prices of consumer goods and services and of the rise in unemployment, has been even more dramatic. The $21 billion drop in real spendable income over the last three quarters has been three to five times greater than declines experienced in the four post-Korean war recessions. Moreover, as consumer buying power continues to fall, an increasing proportion of consumer expenditures has been financed at the expense of personal savings; the personal saving rate declined to 6.5 percent in the third quarter, down from the 9.5 percent rate prevailing a year earlier.

Residential construction spending declined further in the third quarter. Following the modest $0.4 billion rise in the preceding period, outlays on residential structures dropped at a $2.5 billion seasonally adjusted annual rate in the July-September period. Because of the lag between the time when new housing units are started and the time of completion, the third-quarter decline in construction spending in part reflected the fall in starts in earlier months of the year. In addition, housing starts in the third quarter averaged about 25 percent below the rate of the first six months of the year and permits for new units dropped in September to the lowest level in nearly eight years. While the housing sector may be helped in the future by the decline in interest rates and by the Administration's new program wherein some $3 billion will be channeled



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



to the mortgage market, the most recent statistics afford little encouragement about the near-term outlook.

In nominal terms, business spending on plant and equipment increased $3.1 billion during the July-September period, somewhat below the increase of the second quarter. A drop in expenditures on business structures was responsible for the slowing. Capacity utilization in manufacturing has fallen off in recent quarters, perhaps relieving pressure for immediate investment in buildings and equipment. In the third quarter, factories operated at 79.2 percent of capacity, down from 80.1 percent in the prior three months and the lowest level of utilization in two years. However, an early survey of planned plant and equipment spending in 1975 seems somewhat more encouraging. Outlays are expected to increase by 10 percent in that year, according to the survey prepared by Lionel D. Edie & Company Incorporated. This is close to the 12.5 percent increase expected this year. Of course, if the economy weakens significantly further, these plans may be pared back.

Government purchases of goods and services rose by $6.8 billion in the most recent quarter, compared with $8.1 billion in the previous three months. The $2.1 billion increase in Federal Government outlays centered in national defense spending. State and local government expenditures rose by $4.7 billion at a seasonally adjusted annual rate over the third quarter, down from the $5.3 billion increase in the second quarter of the year.

PRICE DEVELOPMENTS

Inflation remains a severe problem. The advance of the GNP implicit price deflator accelerated to an 11.5 percent annual rate in the third quarter. This was above the 9.4 percent rate of the second quarter and close to the first quarter's 12.3 percent annual-rate increase, the most rapid since the Korean war period. Farm prices declined slightly on balance over the period, but the implicit price deflator for the private nonfarm economy as a whole jumped 12.8 percent at an annual rate. The fixed-weight GNP price index, which is unaffected by changes in the composition of output, surged at a 12.8 percent rate in the July-September period.

At the wholesale level, price increases moderated a bit toward the end of the quarter. Following very rapid increases in July and August, seasonally adjusted wholesale prices registered a modest 1.1 percent annual-rate advance in September, the slowest climb in nearly a year. The index of wholesale agricultural prices declined 21 percent at an annual rate in that month, as the prices of animal feeds, grains, and livestock moved lower. However, since September, there have been signs of renewed pressure on wholesale food prices. Between mid-September and mid-October, prices received by the nation's farmers climbed at an annual rate of 47 percent, after falling by half that amount over the previous monthly period.

Some slowing was evident in the advance of wholesale industrial prices in September. Whereas these prices had risen at almost a 33 percent annual rate during the first eight months of the year, they increased at a 12.4 percent pace in September, with higher prices for machinery, chemicals, metals, and furniture and household durables accounting for most of the advance. By stage of fabrication, most of the September deceleration in industrial wholesale prices occurred at the crude and intermediate stages; the wholesale prices of consumer and producer finished goods continued to rise at fairly rapid rates.

Further easing in price increases at the wholesale level was evident in the latest survey conducted by the National Association of Purchasing Management, Inc. In October, 61 percent of the purchasing agents reported higher prices, down from 68 percent in September. Moreover, 12 percent of those reporting said they paid lower prices, up from 7 percent in September and only 2 percent in August. Hence, there are now fewer reports of higher prices than at any

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

time since July 1973, a period when prices were frozen, and the percentage of reports of lower prices is the largest in twelve years.

At the consumer level, prices continued to surge ahead in September, rising at a 15 percent annual rate to a level 12.1 percent above that of a year earlier. This constituted the largest yearly increase since 1947. Food prices led the September spurt, rising at a 22.3 percent annual rate, but the increases in prices of other consumer commodities and in services were not far behind. Prices of nonfood commodities rose at a seasonally adjusted annual rate of 12 percent during the month, primarily as a result of sizable increases in the prices of used cars and household durables. About one fourth of the 13.2 percent rise in prices of services was attributable to an increase in mortgage interest rates.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Cost pressures accelerated in the third quarter, as labor pressed for higher wage and benefit gains in the face of continuing inflation. Compensation per hour worked, which includes wages and fringe benefits, rose in the private economy at a seasonally adjusted annual rate of 10.6 percent, up from the average increase of 8.6 percent in the previous four quarters. However, the strong rise in compensation failed to offset recent consumer price increases. Measured in real terms, hourly compensation in the private sector declined by 2.4 percent at an annual rate.

According to a separate survey of collective bargaining agreements covering 5,000 or more workers, contracts settled in the third quarter provided for an 11.9 percent annual rise in wages and benefits over the first year of the contract and 7.9 percent annually over the contract life. In contrast, the second-quarter increases averaged 9 percent and 7.5 percent, respectively. For wages alone, first-year increases in contracts containing escalator clauses averaged 10.1 percent in the third quarter but actually yielded 10.4 percent before the end of the quarter because of the immediate effects of some escalator provisions. Since the beginning of the year, wage gains from escalator clauses have been substantial. New contracts with clauses signed during the first quarter of 1974 contained a fixed first-year wage boost of 6.4 percent. Through September, these contracts have yielded an average increase of 10.4 percent as a result of escalator payments.

Despite the larger initial wage increases, contracts settled during the third quarter provided for smaller average annual-wage increases over the life of the contract than those negotiated in the second quarter. The rise in escalator coverage, which included 49 percent of the workers involved in major settlements in the third quarter versus 44 percent in the April-June period, might account for the slight drop in wage increases over the life of the contract. Escalator pacts generally call for smaller fixed raises in expectation of larger increases through the escalator adjustment.

Output per hour worked in the private economy fell 2.8 percent at an annual rate in the third quarter. The decline in productivity, coupled with the sharp increase in hourly compensation, pushed unit labor costs ahead at a 13.9 percent annual rate during the third quarter, similar to the rise over the preceding three-month period.

The rise in the seasonally adjusted unemployment rate from 5.8 percent in September to 6 percent in October reflected the continued sluggish pace of the economy. In October, as in the previous month, about one half of the increase in unemployment resulted from job layoffs. The layoffs occurred primarily in the automotive industry and related sectors. Since mid-October, when the employment statistics were collected, automotive manufacturers have announced additional cutbacks in employment. Among age groups, the jump from 3.9 percent to 4.3 percent in the jobless rate of adult men accounted for most of the latest rise in the unemployment rate. The jobless rates for teen-agers and women were little changed from their September levels. Total employment was virtually unchanged in October, while the civilian labor force increased by 174,000 persons. Despite the slow pace of economic activity, employment has expanded by 842,000 workers since December 1973. Over the same period, the labor force increased by a substantial 2 million persons.

In the separate October survey of nonfarm establishments, the labor picture was much the same. Total payroll employment was basically unchanged over the month. However, manufacturing employment fell by 84,000 persons largely as a result of the automotive industry layoffs, and employment in the construction industry fell by 30,000 persons. In October, as in the previous nine months, the weakness in both construction and manufacturing employment was offset by increases in employment in the trade and services industries.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Monetary and Financial Developments in the Third Quarter

Long-term yields rose on balance over the third quarter, but most short-term interest rates closed lower after increasing in the early part of the interval. As the quarter began, rates moved up in response to Federal Reserve pressure on bank reserve positions, continued strong demand for funds, inflationary anticipations, and expectations that the Federal Reserve System would continue to pursue a restrictive policy. Private short-term rates rose to record peaks, before stabilizing in mid-July and August. Yields in the Treasury bill market did not rise immediately, as participants in that market awaited foreign demand. When such demand did not materialize and the supply of bills increased in August, Treasury bill yields also increased to record highs.

In September, several developments caused a turnaround in rates. Market participants interpreted declines in the Federal funds rate as indicative that an easing of monetary policy was in progress. A reduction in the marginal reserve requirement on large-denomination certificates of deposit (CDs) having maturity of more than four months was taken also as a sign that policy was becoming less stringent. Expectations that such an easing would continue emerged in light of reports that industrial production was sluggish and the growth of the monetary aggregates had decelerated sharply. In addition, business loan demand for short-term funds was modest in September, after having been exceptionally strong over the first eight months of the year. In the Treasury bill market, strong demand from foreign sources and individual investors emerged and the supply of bills was curtailed by the Treasury. As a result, rates in the short-term debt markets plummeted to close below their end-of-June levels. The overall decline of rates extended to the intermediate portion of the Government securities market. Interest rates on long-term Government securities also dropped significantly from the peaks attained in August, although they closed above their end-of-June levels.

In the corporate and municipal bond markets, yields generally rose over the quarter, with peaks being established in late August and early September. Investors continued to prefer high-quality debt issues and those with shorter maturities. Equity values were buffeted during the quarter by concern over inflation and by investor pessimism and uncertainty regarding the future course of the economy. Measured by the major indexes, stock prices fell about 25 percent during the quarter in moderate trading. Margin credit outstanding fell to its lowest level since early 1971.

Partially in response to the increase in money market rates in preceding months, the growth of the monetary aggregates slowed considerably. The narrow money stock (M_1) grew about 2 percent in the third quarter, after having grown at a rate of 6.4 percent over the preceding three-month period. As a result of the deceleration of M_1 growth, the growth of the broad money stock (M_2) slowed considerably despite only a slight reduction in the rate of advance of its time deposit component. High interest rates and a moderation of the demand for loans caused banks to compete less aggressively for funds in the market for large-denomination CDs. As a result, the growth of CDs slowed sharply from the explosive rate of expansion of the second quarter, thereby prompting a pronounced decline in the growth of the adjusted bank credit proxy. The rate of advance of bank credit dropped substantially in the second quarter, largely as a result of the absence of any increase in bank loans during September and substantial liquidations throughout the quarter of United States Treasury obligations.

Thrift institution deposit growth decelerated further in the third quarter from the already slow pace established in the first half of the year. Deposit flows were adversely affected by keen interest in the Treasury's August refunding operation and the attractiveness of floating-rate securities offered during the quarter. As deposit flows slowed, thrift institutions reduced the volume of their outstanding mortgage commitments to its lowest seasonally adjusted level since June 1971. Actual mortgage disbursements fell sharply, reflecting earlier declines in mortgage commitments.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

MONETARY AGGREGATES

Growth in the money stock measures decelerated sharply during the July-September period. M_1—private demand deposits adjusted plus currency outside commercial banks—advanced at a seasonally adjusted annual rate of 2.1 percent, down from the 6 percent rate of increase experienced during the first half of the year (see Chart I). This brought the growth of M_1 in the nine-month interval ended September to a 4.8 percent annual rate, in contrast to gains in 1973 and 1972 as a whole of 6.1 percent and 8.7 percent, respectively. The growth of M_2—which adds to M_1 time deposits at commercial banks less large negotiable CDs—also slowed in the third quarter to a 4.9 percent seasonally adjusted rate. Over the first nine months of this year, M_2 rose at an annual rate of 7.3 percent, compared with 8.9 percent in all of 1973.

The slowdown in the growth of the money stock measures during the third quarter resulted, in part, from a lagged response to the sharp increase in interest rates in preceding months. This, in turn, partly reflected System efforts to moderate the growth of the monetary aggregates in view of the fairly rapid expansion experienced during the first half of the year. The slowdown, however, was evidently sharper than desired. For example, at the Federal Open Market Committee meeting of July 16, the most recent meeting for which policy records are publicly available, the Committee adopted a range of tolerance for the growth of M_1 over the July-August period of 2 to 6 percent at a seasonally adjusted annual rate.* The actual M_1 growth rate of 2.1 percent during this period was thus at the bottom end of the tolerance range, and growth remained quite slow in September.

Banks competed less aggressively for funds in the market for large negotiable CDs during the third quarter. Seasonally adjusted, the volume of outstanding CDs rose \$2.7 billion, compared with an increase of \$15.6 billion in the second quarter. This development notwithstanding, on a seasonally adjusted basis the dollar volume of CDs outstanding rose more in the first nine months of 1974 than in any preceding entire year.

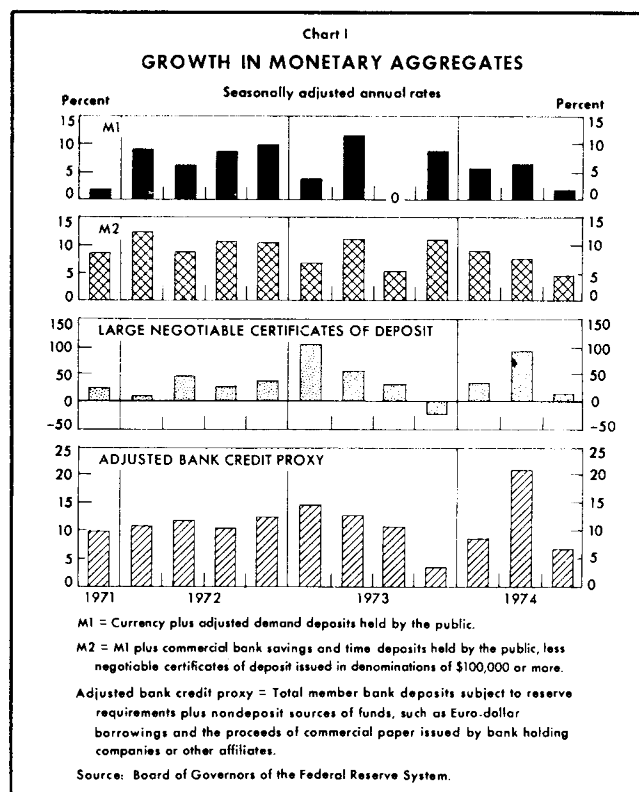
On September 4, Regulation D was amended by the Federal Reserve Board to remove the prevailing 3 percent marginal reserve requirement on CDs having a maturity of more than four months. The action was taken in an effort to encourage banks to lengthen the maturity of their liabilities. The regular 5 percent reserve requirement now applies to all CDs, with the marginal 3 percent reserve requirement applying only to CDs having a maturity of less than four months in excess of the amount outstanding in May 1973. The 3 percent marginal reserve requirement does not apply to banks with a combined total of less than \$10 million of CDs and bank-related commercial paper outstanding in May 1973.

The slowing of CD growth in the third quarter, coupled with slower demand deposit growth, caused the rate of advance of the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—to slow to a 6.6 percent seasonally adjusted annual rate. It had grown at a rate of 20.9 percent in the second quarter and 8.5 percent in the first quarter. Reserves available to support private nonbank deposits grew at a rate of 8.2 percent during the July-September period, down from 20.3 percent in the second quarter. Member bank borrowings averaged a record \$3.3

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.

*At the time of the meeting, M_1 was estimated to have increased over the first half of the year at a seasonally adjusted annual rate of close to 7 percent. A subsequent revision, to reflect new benchmark data for nonmember banks available from the April 1974 call report, reduced the growth of M_1 over this period by almost 1 percentage point.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

billion in the third quarter, reflecting a large volume of lending to the now defunct Franklin National Bank. The operations of this bank have been taken over by the European-American Bank & Trust Company, and its indebtedness to the Federal Reserve System has been assumed by the Federal Deposit Insurance Corporation in its role as receiver for the parent Franklin New York Corporation.

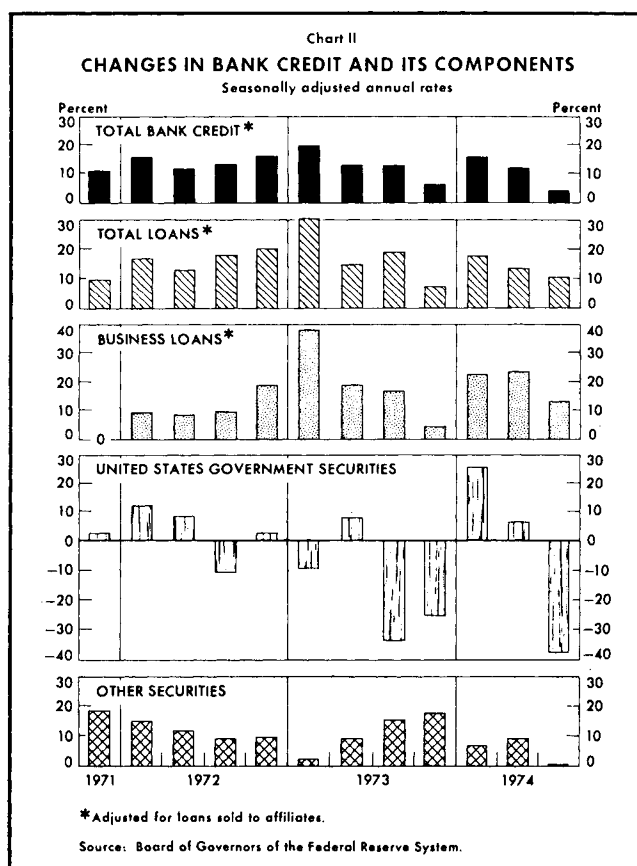
BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Bank credit grew at a seasonally adjusted annual rate of 4.2 percent during the third quarter, 7½ percentage points below its rate of advance in the quarter ended in June (see Chart II). Throughout the quarter, banks liquidated considerable amounts of United States Treasury obligations while their holdings of other securities remained virtually unchanged. In September the volume of outstanding business loans rose less than 1 percent on a seasonally adjusted annual-rate basis, after having grown 19 percent in July and August. This reflected an overall slowing of loan demand. Some shifting of borrowers to the commercial paper market apparently also took place, as commercial paper rates late in September fell significantly below the 12 percent prime rate which prevailed over almost the entire quarter. Because of these developments, business loans grew at a seasonally adjusted annual rate of 12.9 percent in the quarter, high by broad historical standards but more than 10 percentage points below the rate of advance in the first six months of the year.

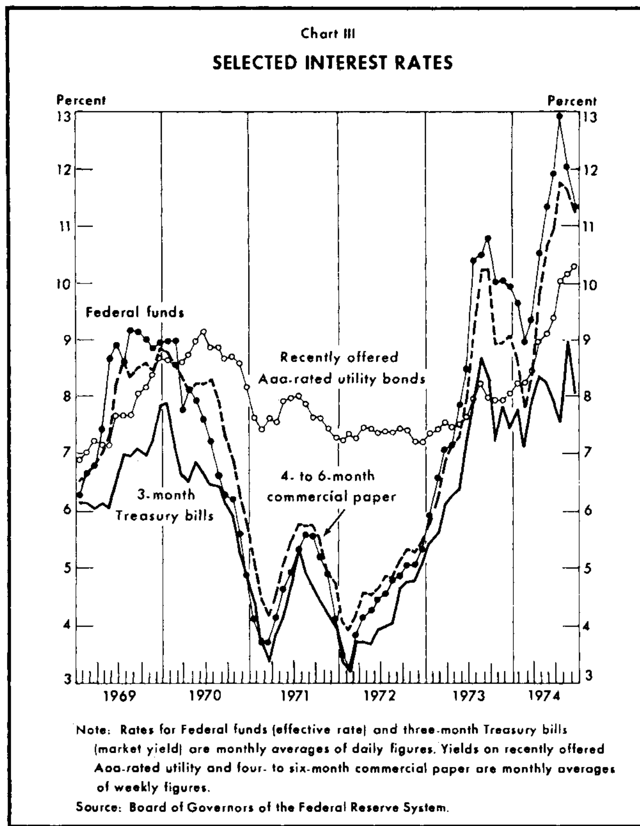
The growth in several other categories of commercial bank loans also decelerated in the third quarter. Notably, real estate loans grew at less than half the pace of the second quarter, as housing activity weakened perceptibly in the July-September period. Starts dropped to an average of 1.2 million units during the period on a seasonally adjusted basis, down from 2 million units in 1973. The growth in agricultural loans also slowed considerably. In contrast, consumer loans at banks advanced sharply, since consumers stepped up their borrowings to finance accelerated acquisitions of 1974 automobiles in anticipation of price rises on 1975 models.

Interest rates on private short-term debt instruments rose sharply at the beginning of the quarter (see Chart III), reflecting investor concern regarding inflation, a highly restrictive monetary posture, and continued strong demand for funds. The historically high prime commercial loan rate of 12 percent became widespread early in July. By the middle of that month, respective record yields of 12.66 percent and 11.95 percent were reached on three-month CDs in the secondary market and prime four- to six-month dealer-placed commercial paper. These latter two rates declined somewhat in late July but rose again in August. In September, the CD rate dropped 1½ percentage points and the four- to six-month commercial paper rate fell 138 basis points from the respective highs reached in July, as the demand for funds receded and investors began to anticipate an easing of monetary policy. The effective rate on Federal funds averaged 11.12 percent in the final statement week of the quarter, 85 basis points below the average effective Federal funds rate in the last statement week of June. Three major banks lowered their prime rate to 11¾ percent by the close of the quarter. Subsequently, a prime rate of 11¼ percent became widespread in late October, with three major banks lowering their prime rate to 11 percent by the end of that month.

In contrast to rates on private short-term credit market instruments, Treasury bill yields displayed no clear pattern in July. They moved sharply upward in August, in part because market participants were disappointed over



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



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.

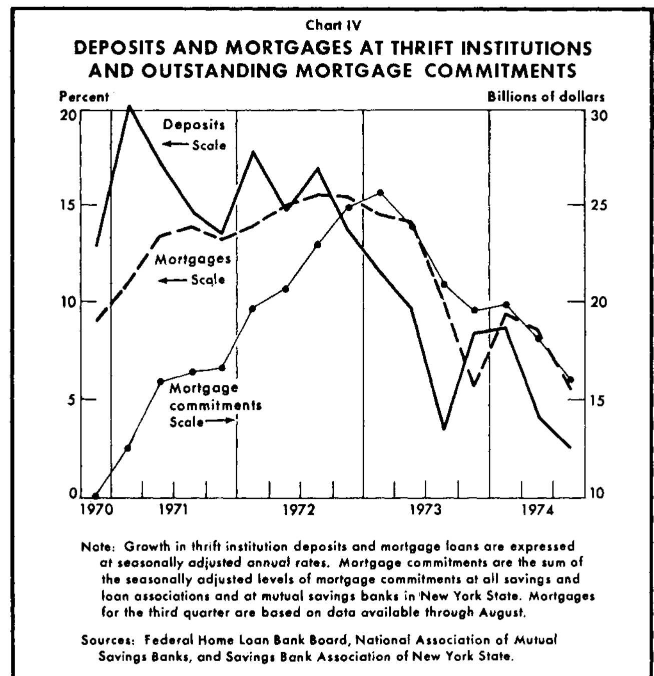
Source: Board of Governors of the Federal Reserve System.

the absence of foreign demand for Treasury obligations and in part because the Treasury borrowed an additional $5.5 billion in the bill market. As a result, the yields on three- and six-month bills rose about 2 percentage points to record highs. Since other money market rates were relatively steady in August, this development narrowed the unusually wide spread between bill yields and other money market yields that had emerged in July. In September, however, bill rates plunged further than other market rates, as the Treasury reduced the supply of bills outstanding by $400 million, a record volume of noncompetitive bids was received at the regular weekly bill auctions, and foreign demand for bills emerged.

Yields in the intermediate portion of the market for Treasury obligations moved in about the same pattern as bill rates. After touching a record peak in late August, the index of yields on three- to five-year Government securities closed the quarter at 8.14 percent, down almost 20 basis points from the end-of-June level. Yields on long-term Government securities, though considerably lower than their August peaks, were up 20 basis points over the quarter as uncertainty regarding inflation inhibited the downward drift of long-term rates.

Interest rates in the tax-exempt and corporate bond markets also rose on balance during the third quarter. Measured by The Bond Buyer twenty-bond index, yields on state and local government obligations rose about 30 basis points over the quarter to 6.62 percent, after touching 6.91 percent in late August. The volume of new tax-exempt offerings was light. A large number of issues were postponed because of statutory interest rate ceilings which precluded the acceptance of any bids received. Many municipalities also postponed issues in anticipation of better market conditions. Reflecting these postponements, the municipal calendar for October and November built up considerably.

In the corporate bond market, concern about the forward calendar worked against any significant decline of rates in September. The yield on recently offered Aaa-rated utility bonds closed the quarter at 10.27 percent, up 45 basis points from the end of June and only 3 basis points below the peak reached in early September. The volume of corporate bond offerings was only slightly lower than during the preceding quarter, as postponements of many utility offerings were largely offset by the addition to the calendar of ten floating-rate note issues. Seven of these issues were offered by bank holding companies. These



Note: Growth in thrift institution deposits and mortgage loans are expressed at seasonally adjusted annual rates. Mortgage commitments are the sum of the seasonally adjusted levels of mortgage commitments at all savings and loan associations and at mutual savings banks in New York State. Mortgages for the third quarter are based on data available through August.

Sources: Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and Savings Bank Association of New York State.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

floating-rate notes generally promised a fixed return for a specified period of time and later a return equal to the three-month Treasury bill rate plus a premium, considerable call protection, and periodic redemption opportunities at par after a specified period of time. The notes gained considerable attention when initially offered, but interest seemed to wane following the success of the first two offerings.

THRIFT INSTITUTIONS AND THE MORTGAGE MARKET

Thrift institution deposit growth slowed to a seasonally adjusted annual rate of 2.6 percent in the third quarter, down 1½ percentage points from the rate of deposit expansion in the second quarter (see Chart IV). The adverse effect of high interest rates upon deposit growth was aggravated by small investor interest in floating-rate notes. Deposit growth was also inhibited by the decline of personal savings in the quarter. Mutual savings bank deposits continued to grow more slowly than savings and loan association deposits. In the nine-month period ended September, mutual savings bank deposits grew at a seasonally adjusted annual rate of 2.2 percent, while savings and loan association deposits grew at a seasonally adjusted annual rate of 6.4 percent. These rates of growth are below those experienced in the latter half of 1973. However, total thrift institution deposits have grown more rapidly this year than during the periods of slow deposit growth in 1966 and 1969.

With deposit flows slowing further, the seasonally adjusted volume of outstanding mortgage commitments at thrift institutions was reduced from $18.1 billion at the end of June to $16 billion at the end of September. The growth of mortgage holdings decelerated substantially during the quarter but still exceeded the growth of deposits. To finance their lending, thrift institutions decreased their liquid asset holdings and increased their borrowings. Savings and loan associations increased their borrowings from the Federal Home Loan Bank (FHLB) system to $20.5 billion, up $3.1 billion from the end of June. The constricting effect of slower deposit flows upon mortgage credit availability forced mortgage interest rates to record highs. In September the FHLB Board series on effective rates on new-home conventional mortgages stood at 9.20 percent, up 35 basis points from June.

NEW PUBLICATION

The Federal Reserve Bank of New York has just published a collection of eleven essays, entitled *Monetary Aggregates and Monetary Policy*. It is the latest in a series of books on economic and financial matters prepared by members of the Bank's staff. The focus of the present volume is on the role of monetary aggregates in the formulation and execution of monetary policy. In his foreword, Alfred Hayes, President of the Bank, states that "the subject is a timely one in view of the increased emphasis placed on these aggregates by the Federal Reserve in its policy deliberations over the past few years".

Single copies of this book are available, without charge, on request, from the Public Information Department of the Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. Additional free copies are sent for educational purposes to official addresses of United States schools and certain business and government organizations. If charges apply, multiple copies are available at $4 each. Checks and money orders must be made payable to the Federal Reserve Bank of New York. Foreign residents must pay in United States dollars with a check or money order drawn on a United States bank or its foreign branch.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Money and Bond Markets in October

Virtually all interest rates fell in October, as the modest easing in the financial markets that began in September prevailed for most of the month. The declines were generally largest on short-term money market instruments. Notably, the average effective rate on Federal funds dropped 128 basis points from its September level, while the rate on most maturities of dealer-placed commercial paper fell 1⅝ percentage points. The decline in interest rates came amid signs of a weakening economy which fostered expectations of a diminution in credit demands. In addition, market participants concluded that the continued drop in the Federal funds rate in October indicated some relaxation in Federal Reserve policy. The statement by Federal Reserve Board Chairman Arthur F. Burns on October 10, indicating that he desired moderate growth in the money supply, provided some confirmation of this view. However, the persistence of inflationary expectations served to temper the improvement.

Developments in the United States Government securities market paralleled for the most part those in other markets, although rates on short-term Treasury bills experienced large increases. In a reversal of the situation in September, rates on three-month bills moved up by about 170 basis points. The volume of noncompetitive tenders at the weekly bill auctions diminished in October, while at the same time the supply of new bills was increased. Investor interest was light in the market for longer term Treasury obligations, but yields dropped somewhat in response to falling money market rates and the sluggish economy.

The corporate and municipal bond markets were also aided by falling short-term rates and, despite one of the heaviest corporate calendars in recent years, the markets rallied at midmonth. Subsequently, more large offerings were announced, including several by industrial corporations, and the rally halted temporarily but resumed around month end. High inflation rates continued to weigh on the capital markets, and investors displayed a preference for shorter term issues.

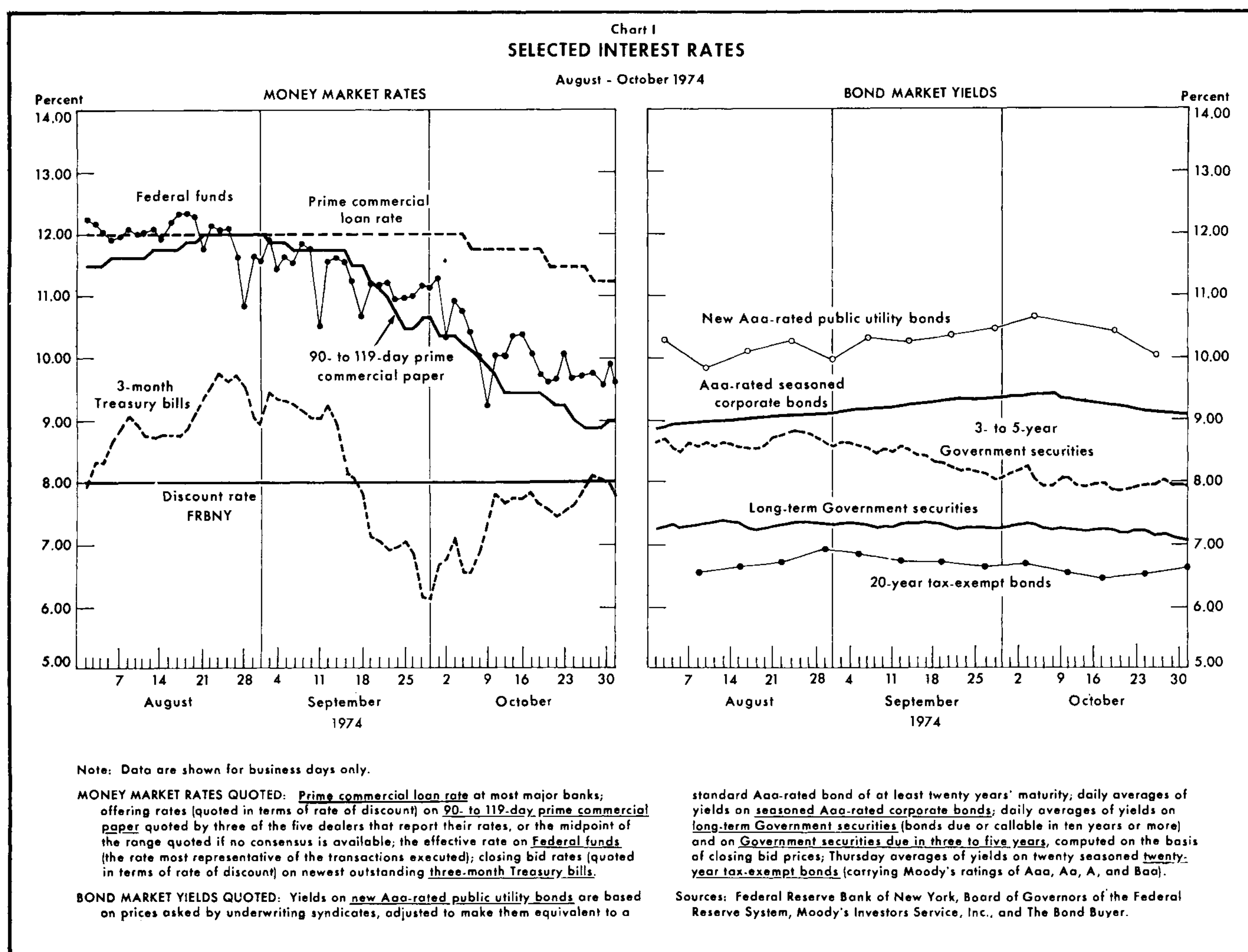
According to preliminary estimates, the growth of the monetary aggregates picked up substantially in the first several weeks of October, lifting the growth rate of M_1 over the most recent thirteen-week period to 2.7 percent at an annual rate. The growth of M_2 also accelerated. However, the volume of large negotiable certificates of deposit (CDs) dropped in October after rising sharply in September.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Most short-term interest rates dropped in October, continuing the experience of September (see Chart I). The average effective rate on Federal funds was 10.06 percent, the lowest average rate since last March. Rates on 90- to 119-day dealer-placed commercial paper fell by about 1⅝ percentage points during the month to close at 9 percent. The rates on three-month CDs in the secondary market showed a similar decline, falling from the 10.60 to 10.90 percent range at the beginning of the month to around 9.15 to 9.30 percent at the end of the interval. Heavy trading continued in the market for bankers' acceptances, where dealers' offering rates declined by about 1 to 1¼ percentage points to the 8.60 to 9.25 percent range at the close of the month.

The commercial banks' prime lending rate, which had remained at a record-high 12 percent from early in July until late in September, worked its way down from a split 11¾ to 12 percent rate at the beginning of October to the 11 to 11¼ percent range by the end of the month. Business loans at large banks in New York City were exceptionally volatile in October, increasing sharply early in the month and then dropping late in the period. Outside New York City, business loan growth was generally sluggish throughout the month. At the same time, the volume of nonfinancial commercial paper outstanding showed some large increases in October, probably reflecting the efforts of borrowers to switch from bank borrowing to the commercial paper market where rates had dropped more sharply. During the four weeks ended October 23, non-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



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.

financial commercial paper outstanding increased by \$1,280 million.

Preliminary data indicate that the money stock measures advanced at a fairly rapid pace in the first several weeks of October, after growing slowly during the previous three months. M_1—demand deposits adjusted plus currency outside banks—advanced at a 6.5 percent seasonally adjusted annual rate in the four-week period ended October 23 over the average of the four weeks ended September 25. The growth rate of time deposits other than CDs was 12.1 percent for the same period, thus boosting the growth of M_2—which includes these time deposits plus M_1—to a 9.5 percent rate. Taking a somewhat longer term perspective, the growth rate of M_2 from the corresponding period thirteen-weeks earlier to the four weeks ended October 23 was 5.8 percent (see Chart II). CDs declined at a 3 percent rate from the four weeks ended September 25 to the four weeks ended October 23, reflecting the subdued growth of business loans.

The failure of Franklin National Bank, at one time the nation's twentieth largest bank, distorted several monetary aggregates and bank reserves series in October, in particular the adjusted bank credit proxy and member bank borrowings. On October 8, Franklin National Bank, a member bank, was declared insolvent and a substantial portion of its assets and liabilities was assumed by European-American Bank & Trust Company, at the time a nonmember bank. The credit proxy is a series based upon

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table I

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

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

Factors	Changes in daily averages— week ended					Net changes
	Oct. 2	Oct. 9	Oct. 16	Oct. 23	Oct. 30	
"Market" factors						
Member bank required reserves	— 197	+ 415	— 430	+ 492	+ 25	+ 305
Operating transactions (subtotal)	+ 106	+1,007	+ 844	— 535	— 71	+1,351
Federal Reserve float	— 275	+ 249	— 274	+ 656	— 615	— 259
Treasury operations*	— 121	+ 572	+1,866	— 356	— 124	+1,837
Gold and foreign account	+ 256	+ 68	+ 17	—	— 41	+ 300
Currency outside banks	+ 349	— 402	— 726	— 679	+ 787	— 671
Other Federal Reserve liabilities and capital	— 103	+ 521	— 39	— 156	— 78	+ 145
Total "market" factors	— 91	+1,422	+ 414	— 43	— 46	+1,656
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 563	—1,357	— 767	— 122	+ 160	—1,523
Outright holdings:						
Treasury securities	+ 140	—1,424	— 882	+ 874	— 254	—1,546
Bankers' acceptances	+ 22	+ 3	+ 16	— 115	+ 1	— 73
Federal agency obligations	+ 148	—	—	—	—	+ 148
Repurchase agreements:						
Treasury securities	+ 87	+ 32	+ 138	— 517	+ 209	— 51
Bankers' acceptances	+ 143	— 21	— 109	— 112	+ 50	— 49
Federal agency obligations	+ 23	+ 53	+ 70	— 252	+ 154	+ 48
Member bank borrowings	— 313	— 973	— 501	— 422	+ 316	—1,893
Seasonal borrowings†	+ 1	— 8	— 12	— 15	— 3	— 37
Other Federal Reserve assets‡	+ 232	+ 398	+1,234	+ 108	— 12	+1,960
Total	+ 482	—1,932	— 34	— 436	+ 465	—1,455
Excess reserves‡	+ 391	— 510	+ 380	— 479	+ 419	+ 201

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	37,560	36,635	37,445	36,474	36,868	36,996
Required reserves	37,081	36,666	37,096	36,604	36,579	36,805
Excess reserves	479	— 31	349	— 130	289	191
Total borrowings	3,218	2,245	1,744	1,322	1,638	2,033
Seasonal borrowings†	142	134	122	107	104	122
Nonborrowed reserves	34,342	34,390	35,701	35,152	35,230	34,963
Net carry-over, excess or deficit (—)‖	48	177	56	188	— 46	85

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 October 30, 1974.
‖ Not reflected in data above.

member bank liabilities, and consequently the absence of Franklin National's data contributed to the large decline in the week ended October 9. This decline is reflected in the slow growth of the credit proxy in Chart II. On October 31, the European-American Bank & Trust Company became a member of the Federal Reserve System, and its liabilities will be included in the credit proxy beginning in the week ended November 6. In addition, the large volume of lending by the Federal Reserve to Franklin National Bank (which had reached approximately $1.75 billion early in October) was assumed by the Federal Deposit Insurance Corporation. This arrangement produced a large decline in member bank borrowings for the month of October to an average of $2 billion (see Table I).

THE GOVERNMENT SECURITIES MARKET

Interest rates on United States Government securities were mixed in October, with yields on notes and bonds falling while some Treasury bill rates increased. As the month began, rates on three-month bills were roughly 4 percentage points below the rates on large CDs and dealer-placed commercial paper of comparable maturity. Market participants questioned the viability of the relatively low bill rates and, by midmonth, rates had moved closer to the more normal spread of roughly 1½ percentage points. Bill rates moved up during the month partially in response to a diminution in the volume of noncompetitive tenders at the weekly auctions in comparison with the September level. At the same time, the Treasury raised a total of $1 billion in new cash in October at the regular weekly and monthly bill auctions. As a consequence of these developments, the average volume of three- and six-month bills available for competitive bidding at the October auctions was roughly double the amount in September. In addition, the supply of new bills was augmented by $1.5 billion of 7½-month bills auctioned on October 29 as part of the Treasury's $2.5 billion cash financing.

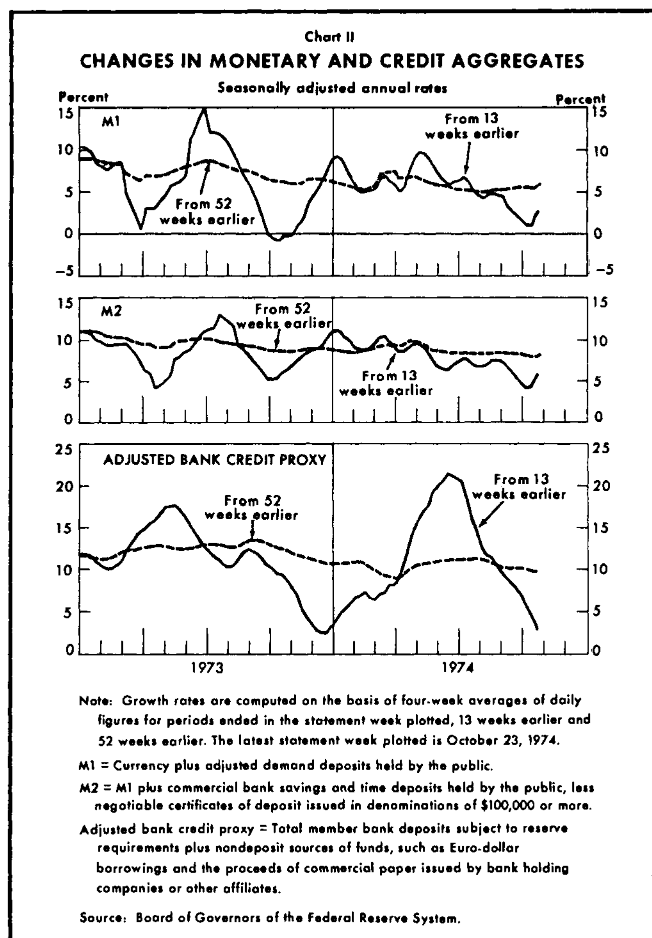
Moreover, a special demand factor impinged on the three-month bill rate. Throughout the month, the rate on the bill maturing December 26, 1974 was substantially below that on the bill maturing one week later, reflecting investors' end-of-year window-dressing practices. Thus, in moving from September to October, the three-month bill rates rose in part because of the shift from December to January maturities. However, even the rates on the December maturities rose in response to supply pressures.

At the first weekly bill auction on October 7, bidding favored the six-month bill, since rates on three-month bills had fallen far below dealers' financing costs. As a result, the rate on the three-month bill was set at 6.70 percent

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(see Table II), 31 basis points above the rate at the previous auction, while the six-month bill rate dropped slightly. At the next auction—advanced to Friday, October 11, because of the Columbus Day holiday—the three-month bill rate rose by over 100 basis points, owing largely to an overhang of unsold awards from the Monday auction. Bidding at the final two weekly auctions was routine and rates changed little. The average issuing rate at the special auction of 7½-month bills on October 29 was 7.93 percent, roughly in line with the prevailing rates on similar maturities.

Despite the upsurge in short-term bill rates, yields on Treasury coupon securities edged down in October. In a market that was dominated by professional trading, buying interest favored intermediate- rather than long-term issues. President Ford's anti-inflation program and Treasury Secretary Simon's statement that further reductions in short-term rates were likely promoted a constructive tone, but the distressingly high rate of inflation made investors wary of longer term securities. For the month as a whole, yields on intermediate-term Treasury securities fell by 6 to 39 basis points, while long-term yields declined by 1 to 44 basis points. A portion of the Treasury's cash needs was met by an auction of $1 billion of 4½-year notes on October 23. Bidding on the notes was on a yield basis, as was the case in the auction of two-year notes in September. However, the minimum denomination on the notes was lowered to $1,000 from the $10,000 minimum set in September's auction. The note issue drew good interest, with the average yield established at 7.89 percent.



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 October 23, 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.

On October 30, the Treasury announced its plans to refund $4.3 billion of publicly held notes and bonds maturing on November 15 as well as to raise $550 million in new cash. The Treasury will use the yield-auction method to sell $2.5 billion of three-year notes and $1.75 billion of seven-year notes, while $600 million of 8½ percent bonds due in 1999 will be auctioned on a price basis. The minimum denomination for the three-year notes will be $5,000 in order to reduce pressures on the nation's thrift institutions, and the minimum denomination for the other securities will be $1,000. The Treasury also indicated that it will need to raise an additional $4.5 billion of new cash by mid-December.

Prices of United States Government agency issues were buoyed by the improvement in the market for Treasury coupon issues. New issues were well received at rates significantly below those on comparable issues in September. On October 9, the Federal Home Loan Banks raised $1.5 billion of new capital by selling $600 million of 8.60 percent bonds maturing November 1976, $500 million of bonds due May 1979, and $400 million of November 1981 bonds yielding 8.65 percent. In the middle of the month, two farm credit agencies issued $1.4 billion of short-term securities at rates that were 100 to 115 basis points below those on similar issues in September. The offering raised about $340 million of new cash.

THE OTHER SECURITIES MARKETS

The corporate and municipal bond markets suffered from some congestion of new offerings early in the month before rallying at midmonth. Investors continued to show preference for short- and intermediate-term offerings. As recently issued bonds moved well above par, prices of older issues increased as well. Moody's index of Aaa-rated seasoned corporate bonds, which had risen rather steadily over most of the year, finished the month at 9.07

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

percent, 26 basis points below the level prevailing at the end of September.

The preference for shorter maturities was typified by the receptions afforded two Bell System offerings. An $80 million issue of forty-year Aaa-rated debentures priced to yield 10.03 percent met investor resistance on October 1 and was only 60 percent sold at the end of the second day. In contrast, at midmonth a $300 million issue consisting of seven- and ten-year notes, rated Aaa by Moody's and AA by Standard and Poor's, was quite attractive to small investors and sold out quickly when priced to return 9.05 percent and 9.10 percent, respectively. Investor reluctance to purchase longer term issues was also evident in the offering rates on two well-received Aa-rated utility bonds. A thirty-year $100 million bond issue sold early in the month was priced to yield 12 percent, while an eight-year $150 million issue was sold later in the month with a yield of 9.85 percent.

In a market where utility companies were generally marketing shorter maturities, several large industrial borrowers sold long-term debt that was well received. At midmonth, Abbott Laboratories issued $100 million of Aa-rated 25-year sinking-fund debentures priced to yield 9.20 percent. On the next day, Exxon Pipeline Company, a subsidiary of Exxon Corporation, sold $250 million of Aaa-rated thirty-year debentures. The securities were priced to yield 9.07 percent, well below the average rate for new Aaa-rated public utility bonds shown in Chart I. On the last day of the month, Weyerhaeuser Company sold $200 million of Aa-rated thirty-year debentures priced to yield 8.9 percent, the lowest such yield since last April.

The tax-exempt market was again dominated by New York City's offerings. At midmonth, New York City sold $476 million of A-rated various-purpose bonds. The bonds were priced to yield from 6.50 percent in 1976 to 7.90 percent in 2015. At a sale in July, New York City's bonds due in 1976 were priced to yield 7 percent, while the 2015 bonds were priced to yield 7.50 percent. The other major tax-exempt financing of the month was a $125 million competitive offering of Aa-rated bonds reoffered at yields of 4.80 percent in 1975 to 6.10 percent in 1994. The yields proved to be unattractive, and the bonds sold very slowly. The Bond Buyer index of twenty municipal bond yields rose by 3 basis points over the month to reach 6.65 percent on October 31. The Blue List of dealers' advertised inventories rose by $254 million to $834 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—October 1974			
	Oct. 7	Oct. 11	Oct. 21	Oct. 25
Three-month	6.698	7.722	7.524	7.892
Six-month	7.364	7.829	7.398	7.766

Maturity	Monthly auction dates—August-October 1974		
	Aug. 21	Sept. 18	Oct. 16
Fifty-two weeks	9.564	8.341	7.629

* 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis