FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

DECEMBER 1975

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Volume 57 **No. 12**

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The Dilemmas of Monetary Policy

by PAUL A. VOLCKER
President, Federal Reserve Bank of New York

Remarks delivered to the Economic Club of New York in New York City on Wednesday, November 12, 1975

Fellow New Yorkers:

I am emboldened to use that simple salutation tonight for more than one reason.

At the most personal level, I was reminded the other day where my own roots lay. I heard a tape recording of some remarks I had made. After spending three quarters of the past sixteen years in Washington, I confess to being startled by what I heard—the full, rounded tones of a homegrown New York accent.

Perhaps it is just that I am a bit more conscious of that fact today than I would have been in other circumstances. I have returned to this great city just in time to see it struggling with its greatest challenge. That challenge comes packaged in financial wrappings. But there can no longer be any doubt that, underneath the wrappings, there are issues that run deep into the economic and social fabric of the city and its relationships to the state, the nation, and even the world.

My intent tonight is not to dwell at length on the problems of the city. After all we have read and heard, to try to describe the current situation would risk tedium and being dated by tomorrow's papers at the same time—no mean trick. What I hope we have learned is that financial acrobatics cannot ultimately substitute for hard, definitive decisions and actions on the substance of the problem. That illusion has brought us to the edge of an abyss, the nature of which none of us can clearly foresee.

What does strike me, as I have observed the debate on New York, is that we are seeing here in sharpened and exaggerated form, issues closely relevant to the broader debate on national monetary and economic policy.

It would be easy to generalize too far. Our local problems have been aggravated by the particular pressures endemic to older urban centers. They have been thrown into sharp focus by the special history and traditions of this proud place, seeking to maintain itself in the forefront of social progress, even while its enormous commercial advantages and base of wealth have, in relative terms, been eroded. After allowing for all those special circumstances, the competing cries that we hear for "more financing", on the one hand, and for "more adjustment" in services and in budgets, on the other, seem to me to parallel some larger dilemmas in national policy. In the country as in the city, there are, in my judgment, no purely financial solutions to those dilemmas.

Quite obviously, economic performance in recent years—not just in the United States, but in other countries as well—has fallen far short of the standards we set for ourselves. We have seen at the same time in this country, the highest levels of unemployment and the highest levels of inflation of the postwar period. While the seventies have seen boom as well as recession, real growth has slowed to 2 percent in the past five years as a whole, and productivity growth has sagged. Real take-home pay of the average man and woman at work and real profits have both declined over the past two years, a most unusual combination of circumstances.

I have not described a pretty picture.

Measured against the exuberant hopes of a decade ago, it seems even more disquieting.

The mid-1960's, you will recall, seemed the golden age of economics. Leading practitioners—particularly as they left government service—could lecture with apparent justice about how we had destroyed the old mythology and had finally learned to apply the lessons of modern economics to practical policy. Growth would be assured; we

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could extend all those trend lines showing a rise of about 4 percent a year in the real gross national product almost indefinitely. Deviations around the trend would be contained. We could calculate, if we wished, a "trade-off" of a little more inflation for a little more employment, or vice versa, depending on our social preferences.

It was almost as if, after proving we could go to the moon, we could somehow run the economy at the console of a computer as well. The new challenges were said to be income distribution and social justice—not macroeconomic policy.

Well, it did not take long to shatter those visions. Today, we make more forecasts; we wrap them up in more mathematics; we use more complicated "models"; and we use up much more computer time. Yet somehow we have much less confidence in the results. In frustration, we are tempted to ask if the textbooks have relevance and whether our economic theories are in need of wholesale revamping.

Why have events diverged so much from the expectation?

One approach to the answer seems clear enough. We have permitted ourselves to get caught up in an inflationary process.

Some of the ways inflation has impaired our economic performance and prospects, particularly by distortions in financial markets, can be measured more or less directly. As prices have risen, businesses and financial institutions have found their balance-sheet totals expanding at a rapid pace. In the process, liquidity was impaired as lenders shied away from longer term commitments. Even more strikingly, the base of equity capital has not kept up. Strong wage and cost pressures—particularly when they collided with a weakening in real demand—squeezed profits and profit margins, making it harder to raise equity and to justify new investment at inflated prices. As inflation became imbedded in market thinking, long-term interest rates became "sticky" at historically high levels, even when the supply of financial capital improved during recession.

Less measurable, but perhaps more insidious, a pervasive air of uncertainty came to surround longer term commitments. As consumers and businessmen began to feel that their economic well-being and the results of their investment decisions were as dependent upon the trend of prices as upon their own productivity and business judgment, we began to see reactions that seem perverse by accepted axioms of economic behavior. Policymakers have been faced with the possibility that monetary and fiscal actions intended to stimulate may be interpreted as aggravating inflation. The result may be to push up interest rates or encourage precautionary savings, undercutting the purpose of the actions.

A central banker citing the evils of inflation hardly provides a fresh perspective, nor does deploring inflation seem to me to provide an adequate answer to the question I have posed. We have to push the matter further. We have to ask ourselves why the inflation arose in the form that it did, and whether the distortions in financial markets are not symptomatic of some broader currents in our economic life.

When I was in college, some older economists were still fond of talking about a "long cycle" in economic affairs with protracted periods of buoyancy and exuberance eventually giving way to periods of uncertainty, slow growth, and outright contraction. When these long cycles were mechanically related to such esoterica as the appearance of sun spots, debunking was easy. But I wonder if there is not more than a germ of truth, in terms of human behavior, in some of their observations.

It took a long time after World War II to convince ourselves that prosperity was really here, that a relapse into a great depression was not a significant probability. By the mid-1960's, confidence had replaced these doubts —and, as it did, the very serenity we felt about our economic future led us into patterns of behavior that have now turned out to be unsustainable. None of us individually would want to plead guilty. But we have to ask ourselves whether, collectively, we did not permit the general feeling of economic security and even euphoria to divert us from norms of prudent conduct—from a sense of limitation and restraint on risk taking—essential to ordered growth and stability.

In raising this question of attitude and psychology, I do not want to ignore some obvious concrete facts of the history of this period. Our failure to face up to the financing of the Vietnam war in a timely way—against the preponderance of economic advice—has often been rightly cited as one key factor in setting off the subsequent inflation. Much more recently, we have had the shock of increased energy prices. But even in those decisions, where political considerations plainly intruded heavily on economic judgment, the latter may have been weighed too lightly, partly just because there has been a sense that the future was assured and that we had the tools and the knowledge to repair any temporary damage.

With the benefit of hindsight, the evidence of overreaching—of putting aside traditional cautions and taking new risks—is now clear in the financial markets themselves. For instance, as the cult of performance took hold, active trading of securities replaced a sense of long-term investment commitment. We lost sight of the fact that

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"performance" was always dependent on access to highly liquid markets and on being among the first in and the first out. The glow of success could last only as long as most, in fact, did not want out. As the game broke down, the actual result was more instability and less perceived liquidity in many investment markets. Those facing the need to raise new capital found their task greatly complicated.

Even when market conditions were highly favorable, however, many business managers seemed to attach less importance to raising equity capital. Whether in financial institutions or elsewhere, they began to rationalize departures from old standards of capital adequacy and liquidity. In a world where "downside risk" seemed diminished, the attractions of high leverage were natural. We began to hear the theory that the only thing that mattered is that you were no worse off than your competitors; after all, in the last analysis, the government would need to step in to prevent catastrophe anyway.

In such a climate, regulatory restraints chafed even harder. With considerable justification, there was concerted effort to eliminate outmoded, archaic, and anticompetitive rules and regulations. In the banking world, in particular, relaxation of interest rate ceilings and the vogue for liability management seemed to open new vistas for expansion without clear limitation. Freed from old restraints, loan officers could move more aggressively at home and abroad, and their activity often seemed to support the objectives of national policy as well. But it is possible to question whether the enthusiasm for eliminating the old and outmoded was matched, by the regulated or by the regulators, with recognition of the need to retain or shape safeguards suited to today's conditions.

Similar psychological processes were at work elsewhere. In a world in which workers are told an average rise in real income of about 3 percent a year is virtually assured, few will be satisfied to remain below the average and many will find easy justification to exceed it. We seized opportunities to take giant steps forward on behalf of the old, the infirm, and the unemployed. Altogether, the new demands exceeded the capacity of the economy. We were hardly prepared for a situation in which external forces, whether because of poor crops or an oligopoly-imposed increase in oil prices, inexorably squeezed the living standards of most workers.

To return to home, some of this same psychology must have accounted for the willingness of the city and its citizens to seek ever higher levels of services, despite a weakening economic base, without the alarm bells ringing at a much earlier time. Against a background of prolonged prosperity and high priority for social objectives, what could be more natural than to make full use of welcoming bond markets? If such resort involved some abrogation of irritating budgetary and financing conventions, could this not be accepted in an era of "creative" and "innovative" finance? In the long run, after all, growth and inflation would smooth over any difficulty.

I recognize the danger of abstract theorizing about human psychology. Nevertheless, in retrospect, attitudes developing over the past decade do help to explain some of the dislocations and difficulties today.

It was not so much a conscious willingness to take large new risks, but that the consciousness of risk was itself reduced. It was not so much that we saw ourselves acting without a sense of prudence, but that the definition of prudence was itself changed. It was not so much that we thought the laws of economics had been repealed, but that we could manipulate them to our will.

I recognize there is a school of thought that would lay the blame much more directly at the feet of monetary policy. According to this thesis, "inflation is always and everywhere a monetary phenomenon". There is no need to look further for culprits or to seek explanation in changes in economic structure or attitude.

Now I am not about to deny the correlation between growth in the money supply and the price level; over a long enough period of time, excessive growth in the money supply is bound to bring higher prices.

Taken alone, the monetary explanation seems to me seriously incomplete. For one thing, the correlation between money and prices is far from perfect. There is no way that even the relatively rapid monetary expansion of 1972 and 1973—averaging 7½ percent—can by itself explain double-digit increases in consumer prices and the much stronger surge in wholesale prices last year. Clearly, nonmonetary factors can have an important impact on inflation—and an impact that is "temporary" only from a more Olympian time perspective than most of us can afford to assume.

Monetary policy does not work in a vacuum, political or economic. Inflation, once started, can become embedded in the fabric of expectations. Whether the initial impetus is monetary or nonmonetary, the expectations vastly complicate the job of bringing inflation under control.

It seems to me unrealistic to the point of being meaningless to say, for instance, that monetary policy can always press to whatever point may be required to bring price stability. We have to consider whether the result of that action would be consistently higher unemployment, prolonged inability to finance the investment needed to support a growing economy, or even dislocations in

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our basic financial structure. If monetary policy has to bear the load alone, cutting across the grain of other deep-seated elements of economic behavior, those consequences cannot be ruled out.

To take the other side of the coin, neither can the monetary authorities reasonably accept whatever they find in the way of price expectations and other economic pressures and proceed within that context to provide the money and credit to finance ever higher levels of business activity. Such an approach can only reinforce inflation and require that we validate every excess in the behavior of large economic units. The result, it seems clear, might be to postpone the day of reckoning, but not to avoid it.

In important respects, the problem from a national perspective is not all that different from the problem of how best to deal with the situation facing New York. At one extreme, to ask for and to receive financing *without* real adjustments in the underlying economic and budgetary situation would merely pave the way to a larger crisis in the future. To expect adjustment so quick and draconian that new financing will not be required over a transition period may be equally shortsighted.

Faced with such dilemmas, there is a natural longing to look toward new avenues for easing the "adjustment problem". On a national scale, the list of proposals is a long one: (1) Removal of the evident and numerous obstacles to efficiency and productivity would obviously help; we all can make a list as long as our arm. (2) Improved competition in labor and product markets could reduce rigidities in costs. (3) We can and should review regulatory practices—not only those lingering from an earlier era, but those growing out of more recent environmental and consumer concerns—to see if they are achieving worthwhile objectives at acceptable cost. (4) I suspect we have too long neglected exploring techniques—some long established in other countries—that might improve the atmosphere at the bargaining table. For instance, as we look with admiration at the postwar German economic performance, can we dismiss entirely the ideas of "codetermination" and "concerted action" developed in that country as methods of achieving more understanding among business and labor? (5) Potentially most important in my view, those elements of our tax structure that serve as a drag on investment activity, and particularly penalize equity financing, need review and reform. But citing these five areas suggests their limitations for resolving our current dilemmas. However attractive in the abstract, in their specifics they will be fiercely debated. Whatever their future potential, they must be longer range measures.

In the here and now, the chances for improved performance in the nation and in the city seem to me to rest on changes in attitudes that have been nurtured over a long period of prosperity and stability. The harsh reality is that such changes seldom take place except under the pressure of events.

In our market system, these pressures for change—the signals for action—typically come in financial form. A business or a government exhausts its credit resources; individuals cannot spend beyond their income for very long; the unprofitable and undercapitalized firm eventually capsizes in an economic squall.

In theory, we could, of course, organize our economy differently, so that financial pressures did not play so prominent a role. Carried to one extreme, direct pressure and force can be applied by a government, as they are in a communist society. All of us would reject that.

Western governments, including our own, have more pragmatically experimented with "incomes policy"—guidelines or controls of varying degrees of severity over prices and wages. I am hardly in a position to be doctrinaire on that subject, having in 1971 advocated the freeze precisely to help change inflationary expectations. Whatever the merits of that experiment, I see no credibility in a renewed attempt now or in the foreseeable future in this country. Moreover, experience here and abroad in peacetime suggests strongly that milder controls cannot be effective for long when inconsistent with market pressures and when they too easily can be invoked as a substitute for other essential action.

So, it seems to me an illusion that we can find the path to renewed stability other than through the disciplines inherent in the market. We cannot expect the process to be smooth and steady. But we can be sure that it will be speeded and eased to the extent individuals, businesses, and governments recognize the need for changes in behavior and attitudes that rest on conditions that no longer exist. Our success will depend as well on the skill and wisdom we can marshal in shaping our monetary and fiscal policies.

The setting in some respects is propitious. We can shape our policies against the background of a rapid rebound in business activity. Despite some nasty surprises, the overall picture on inflation this year is at least better than last. Moreover, the improvements in productivity that should accompany expansion offer some prospect that the rise in labor costs per unit of output could moderate for a period, even as business improves.

Nevertheless, both in production and prices, the outlook for 1976 and beyond seems to me hardly assured. The vigor of business recovery so far has been heavily dependent on the cessation of heavy inventory liquidation.

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Consumer spending, spurred in part by the tax cut, has helped, but sustained growth will depend on incomes generated by other sectors of the economy.

A "normal" sequence for sustained business recovery would look to housing and later business investment to become driving forces. It can happen that way again, but we would be blind to ignore factors that could interrupt the sequence. The renewed sharp pace of wholesale price advances in October is warning enough—if any is needed—that cost and price pressures are still strong and could undermine prospects for continuing strong recovery. Backwash from the financial difficulties of New York City and of New York State and its agencies could complicate the job of financing expansion in markets already suffering from inflation and past excesses.

All of this points up critical questions for the Federal Reserve—questions that deserve answers. To me, the answers to those questions become a good deal clearer—and perhaps not even very controversial—if examined from the longer perspective of the basic functions of the Federal Reserve System. The first of those functions—and the one that attracts so much comment year in and year out—is to maintain overall supplies of money and credit at levels conducive to growth and stability. The second—sometimes almost forgotten except in times of strain—is to ensure the orderly functioning of the credit and payments system through thick and thin and to guard the stability of the banking structure.

Dilemmas or even conflicts can arise in discharging these functions. Today, in providing money and credit we do not face the textbook alternatives of dealing with unemployment *or* with inflation, but we have to face them both at the same time. But, I would suggest, there is a reasonable approach to that dilemma.

I must confess to a certain natural past (and I suspect future) skepticism about announcing money supply "targets" or ranges over a substantial period of time ahead. Set too narrowly and followed slavishly, they may imply too little operational flexibility to meet changing circumstances. As a matter of concept, they may imply a degree of faith in the crudest forms of monetarism—that policy can be set and judged in terms of the money supply alone—that I do not share.

Nevertheless, in the situation we face today, I believe it is distinctly helpful to set out the general dimensions of our intended policies in such quantitative and relatively unambiguous terms. Those making economic decisions—whether businessmen, governments, consumers, or those in financial markets—can then shape their decisions in a context of fuller knowledge about the intentions of the policymakers.

I will not attempt to debate here the appropriateness of the precise numerical ranges, such as the 5-7½ percent growth target range currently in effect for the narrowly defined money supply—whether it could be a bit higher or lower, or whether the range itself is too narrow or broad. But I will defend strongly the general implications of these numbers: The Federal Reserve will not willingly finance new excesses and increases in the rate of inflation; nor will it insist immediately on limiting money growth to rates fully in line with growth of our real productive potential in circumstances where the strong forward momentum of price increases in "the pipeline" must be given some weight.

Over time, a return to price stability necessarily implies a slower growth of money and credit than our present objective. But our present policy of steering between the extremes—a policy that has perhaps inadequately been described as "moderation"—seems to me both clear in intent and fully defensible. And I believe the numerical ranges help provide the longer perspective needed for those of you who try to interpret, literally from day to day or week to week, the significance of the gyrations in reported money and credit data.

In present circumstances, it is worth remembering that it is the second of our functions—to protect the payments system—that was enshrined in the original Federal Reserve Act, adopted after a series of banking crises had disrupted the economy. Essentially, the broad economic policy responsibilities, so much debated in its specifics today, were grafted onto this original function over the years, rather than the reverse. But I assure you this basic statutory function, which demands special concern for the functioning and health of the banking system, is not forgotten.

That continuing concern finds its reflection in part in the day-to-day—sometimes dull but never forgotten—discharge of our responsibilities for the supervision and regulation of banks. The more dramatic, but seldom required, role is sometimes described as the "lender of last resort". Because in recent years recourse to the Fed for credit has so rarely been required on any scale, clarity in our approach in that respect would be useful too.

The law provides the Federal Reserve with only very limited emergency powers to lend to *nonbank* borrowers for rather closely defined short-term liquidity needs. In a sense, the presumption is against such assistance. Consequently, short-term credit for liquidity purposes has not, for instance, fit the particular circumstances of New York City, where the credit need has been for a substantial period, where the budgetary problem has been central, and where the difficulties have not arisen as a result of

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market disturbances elsewhere but from basic problems of the city itself.

By statute and policy, the presumption is quite the reverse should the stability of the payments and banking system be questioned; indeed, it is a central legal and policy duty of the Federal Reserve to assist banks in coping with pressures created by extraordinary economic strains and, particularly, to maintain the depository function unimpeded. I emphasize this side of our responsibilities in recognition of the concern that some have expressed about the impact of a default of New York City on the local money market banks. It would, of course, be more accurate to describe those banks as national and international institutions that happen to have their home offices in the city. They hold city securities—slightly over $1 billion in the aggregate. But that amounts to less than ¾ of a percent of their earning assets and to little more than 9 percent of their total capital and reserves.

Should these securities be substantially impaired in value over a long period, there are some obvious implications for future profits. But it is by no means obvious—or perhaps even likely—that serious impairment will last. Doubts on that score have led the supervisory authorities to decide to defer for up to six months following any default a mandatory write-down of the value of those securities. Even then, an unavoidable impact on profits—which have generally risen in recent years—is quite a different thing from the default of New York City affecting the basic stability of the banks; the holdings are simply not that large. The problem, if it exists, would lie in psychological apprehensions, and the classic response of the Federal Reserve would be to act—forcefully and freely—to provide an alternative source of liquidity.

All of this falls in the category of contingency planning.

As matters stand, I have been encouraged in recent days that the state and the city are coming to grips more directly with the budgetary problems that underlie the financial crisis in their affairs. In my judgment, questions about the financial health of the state can be resolved, and the marketability of its securities can be restored in a reasonable time frame. Even now, with the clock running all too fast, the needed combination of stern budgeting and residual financing for the city should not be wholly beyond the reach of those interested in solving the problem and in limiting and containing its repercussions.

Indeed, I would go further. The kind of agonizing adjustments in practices and attitudes the city and state are facing in the most acute form find their counterparts in other areas of our national economic life. While the problems differ in detail and scope, the process will never be quick and painless. But our collective response can lay—is laying—the basis for a return to stability and prosperity.

In business and public life, most of the men and women in this room—and I do not exclude myself—have for a long time seen their horizons and preoccupations extend to the nation and the world. For too long, those few laboring for the financial and economic strength of this city—away from the spotlight and amid the frustrations—have had too little support. Today, we begin to realize a simple truth—that honor and fortune alike rest ultimately on the good health and prosperity of our city.

Out of this travail, I for one believe we can help make New York an example, not of default and decay, but of how to learn from experience, respond to adversity, and restore stability. Call it whether in irony or praise Fun City, the Big Apple, or the Capital of the World, we can be sure that whatever we do here will be more than a symbol. It can be a real turning point, not just for New York, but for the nation as a whole.

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The Business Situation

Economic activity is continuing to expand, but the upward impetus is narrowly based and has slackened somewhat in recent months. In October, there was a discernible slowdown in the pace of the recovery from that recorded for the third quarter.* While industrial production rose for the sixth consecutive month, the October advance was less than half as large as the average of the earlier months and was also not so broadly diffused. Similarly, there was an appreciable slowing in the growth of nonagricultural employment in November. Yet, because of a large drop in the civilian labor force in that month, the unemployment rate declined to 8.3 percent, the same level that had prevailed in September.

The latest readings of the other monthly business statistics also point to a temporary lull in the economic recovery. Retail sales have been relatively sluggish since July, following several months of very large increases. Consumption spending may be buoyed in months to come, however, by continued advances in personal income. Single-family housing starts have recovered substantially during the past six months, but construction of apartment buildings remains slow. Capital spending has also remained weak. There are increasing signs that inventory liquidation is drawing to a close. Businesses have clearly gone a long way toward paring their excess inventories and have succeeded in establishing a much better balance between sales and inventories.

Despite the occasional monthly flare-ups, the inflation rate appears still to be hovering around the 7 to 8 percent range. While this is unusually rapid by historical standards, it still represents a major improvement over the prolonged double-digit increases recorded last year. Consumer prices, led by a fairly stiff increase in retail food prices, accelerated a bit in October. Excluding food, however, the October rise in consumer prices was actually below the average for the previous six months. Wholesale prices were unchanged in November, as the large drop in agricultural prices offset the moderate advance in the prices of industrial commodities. Looking ahead, there appears to be little reason to anticipate a fresh burst in the rate of inflation in the coming months. There has, in fact, been some easing in the rate of increase in nonfood consumer commodity prices in recent months, and retail food price increases are currently expected to slow considerably as the record 1975 crops come to market. Also, the large gains in productivity typically associated with the early phases of economic recovery may help to blunt some of the inflationary pressures arising from the sizable increases in wages. Moreover, the substantial slack in the labor market is likely to exert a restraining influence on wage increases for some time to come, particularly in less organized sectors of the economy. However, there are major questions surrounding the large number of major collective bargaining agreements scheduled for 1976.

INVENTORIES AND INDUSTRIAL PRODUCTION

It appears that most of the once massive inventory overhang has largely been eliminated, and some businesses have begun to replenish their depleted stockpiles. Measured on a GNP basis, the real inventory-sales ratio for the business sector declined further in the third quarter to the lowest level since the opening quarter of 1974 (see Chart I). This level, it may be noted, is in line with past experience at similar stages of cyclical recoveries. At the same time, the rate of inventory liquidation was much reduced from what it had been earlier in the year. Within the trade sector, while wholesalers were still reducing their real inventory stocks during the third quarter, retailers had actually begun to add to theirs. However, the book value data suggest that a turnabout in inventory investment may have occurred in the wholesale trade

* According to revised estimates, the increase in real gross national product (GNP) amounted to a 13.2 percent annual rate in the third quarter, up 2 percentage points from the preliminary estimate. The rate of inventory liquidation was revised downward, while the advance in real final sales was revised upward. The rate of growth of the implicit price deflator for GNP was also adjusted downward slightly to a 4.7 percent annual rate. Released along with the GNP revisions were preliminary estimates of corporate profits in the third quarter. Pretax corporate profits, expressed at an annual rate and adjusted for changes in inventory valuation, increased an estimated $17.6 billion to $122.5 billion.

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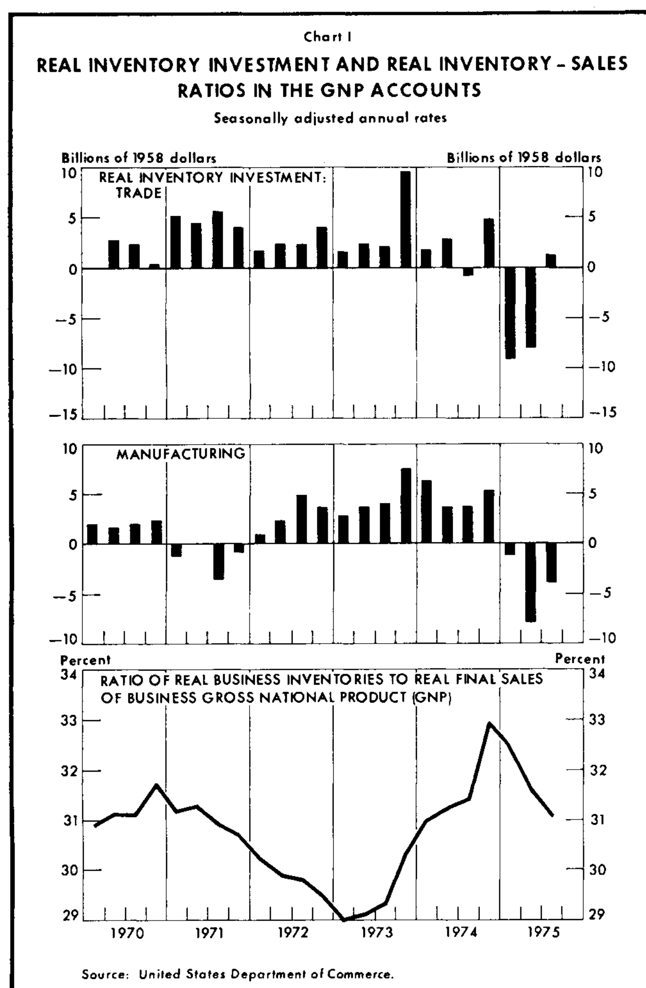

sector as well at the end of the third quarter. Within the manufacturing sector, the liquidation of real inventories continued in the third quarter but at about half of the pace of the preceding quarter. In October, nondurables manufacturers posted their third consecutive monthly gain in the book value of inventories. The book value of durables manufacturers' inventories, however, registered another decline. This drop more than offset the gain for nondurables manufacturers, but the net decline for the total manufacturing sector was the smallest this year.

The Federal Reserve Board's index of industrial production posted a moderate 0.4 percent gain in October. While this marked the sixth consecutive monthly rise, the October advance was less than half as large as the average of the earlier months and was also not so broadly distributed. Consumer goods output continued to climb in that month, but the output of capital goods and defense equipment slipped back after previous advances. Symptomatic of the more sluggish growth in the production pipeline, the increase in output of materials in October was less than one fourth as large as the average gain for the previous four months. Iron and steel have once again resumed the declining pattern evidenced throughout most of 1975 and interrupted only briefly in August when there was a bunching of purchases by steel mill customers, an effort apparently aimed at stocking up before the announced price increase took effect on October 1. If output were to continue to grow at the markedly slower October pace, it would take quite a while before production recovered the ground lost during the recently ended recession. As of October, industrial production was still 8.6 percent below the November 1973 peak. Furthermore, the Wharton index of capacity utilization for the industrial sector stood at 80.3 percent in the third quarter, 16 percentage points below the peak recorded two years earlier.

PERSONAL INCOME, CONSUMER SPENDING, AND RESIDENTIAL CONSTRUCTION

Personal income posted another solid gain in October, amounting to $12.7 billion at a seasonally adjusted annual rate. Wage and salary disbursements rose by $8.7 billion, and this marked the eighth consecutive month of growth. About $2 billion of the October increase in wages and salaries was attributable to a pay raise for Federal Government employees. The rest of the increase in wage and salary disbursements was widespread across payroll categories.

After fairly rapid growth earlier in the year, consumption spending has been flat in recent months. Retail sales in October were only slightly above the level of July, and this sluggish pattern for the monthly sales figures has characterized both durables and nondurables sales categories. Domestic automobile sales also exhibited little buoyancy over the July-November period. To be sure, the succession of sizable monthly advances in personal income continues to provide the wherewithal for further gains in coming months. Perhaps, though, consumers' lingering uncertainties about employment prospects and inflation may be tempering the strength of the recovery in consumer spending. For example, while the index of consumer sentiment, as measured by the Survey Research Center at the University of Michigan, rebounded in the second quarter from the all-time low recorded in the first quarter, it showed little further progress in the third quarter and remained at a low level by historical standards.

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Thus, the relatively flatter pattern for retail sales since midsummer may be an indication that consumers have taken cautious wait-and-see attitudes at this early point in the recovery.

Residential construction appears to be showing some tentative signs of improvement. To date, the recovery in housing starts compares rather favorably with the upswings in past housing cycles, although the current recovery has proceeded from a very depressed level. In October, housing starts were running at a 1.46 million unit annual rate, up slightly more than 200,000 units from the third-quarter rate. Almost all of the increase was in single-family starts. Building permits, which had risen about 10 percent in September to their highest level since June 1974, were essentially unchanged. Yet, despite the rebound in housing starts, a number of factors suggest that the rate of recovery in housing in the near term will be more sluggish. Although the overhang of unsold new single-family homes has been reduced considerably, the backlog nevertheless remains high. Even more importantly, mortgage terms have remained tight despite large savings inflows. Lenders seem hesitant to issue new mortgages, perhaps because of fears of rising interest rates and induced outflows. At the same time, demand remains weak as buyers face large uncertainties over the economic outlook and high home prices, and the run-up in energy costs probably continues to discourage prospective buyers.

NEW ORDERS, CAPITAL SPENDING, AND LEADING INDICATORS

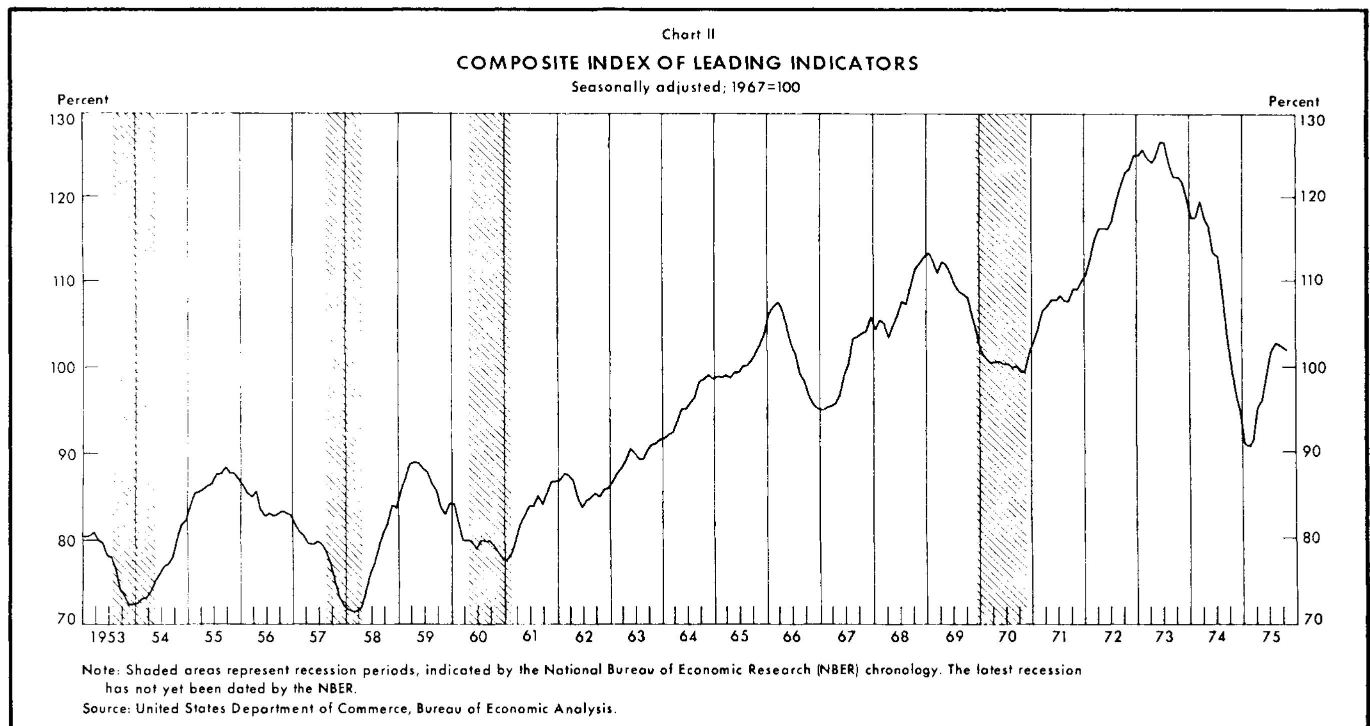
After dropping in the previous month, the flow of new orders received by durable goods manufacturers advanced in October. Actually, the October gain would have been bigger but for a fairly large decline in the bookings for defense goods, a development unrelated to the current state of business conditions. Excluding new defense bookings, the increase in new durables orders amounted to $0.9 billion in October, which more than erased the dip of the preceding month and which was a bit above the average monthly gain recorded over the March-August period. As shipments of durable manufactured goods also rose in October and exceeded new orders, the backlog of unfilled orders edged down further, continuing the pattern of the past year. In contrast, at this stage of the recovery during previous postwar upturns, the backlog of unfilled durables orders had usually begun to rise.

While real business capital spending leveled off in the

Chart II

COMPOSITE INDEX OF LEADING INDICATORS

Seasonally adjusted; 1967=100



Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research (NBER) chronology. The latest recession has not yet been dated by the NBER.

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

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third quarter following four quarters of declines, there are no signs of any exuberance in this sector, where recovery typically lags behind that in other sectors. The recent McGraw-Hill survey of planned capital outlays points to a 9 percent rise for 1976 with an equal increase in capital goods prices, thus implying no gain in real spending levels. A similar projection was obtained by the Commerce Department in its October-November survey of planned plant and equipment spending; it was reported that businesses expect to step up their capital outlays in the first half of 1976 at a 10.6 percent annual rate, compared with what they were planning to spend during the second half of 1975. While the various surveys have generally tended to underestimate capital outlays in the first years of recoveries, the lackluster outlook evidenced by the surveys is corroborated by recent monthly data on new orders for nondefense capital goods. Although new orders rose in October, the most recent month for which data are available, they were slightly below their July level.

An interesting barometer of economic activity is the composite index of leading indicators, which is assembled and published each month by the United States Department of Commerce. The index is made up of a dozen individual data series and is designed to provide an advance reading on the direction of economic activity. Several of the data series, such as net business formation, building permits, new orders for consumer goods and materials, and contracts and orders for plant and equipment, represent early indications of spending intentions. After a while, these decisions show up as actual expenditures. Other data series, such as the average workweek, the layoff rates, changes in the wholesale prices of crude materials, and vendor performance, reflect the decision of managements in reaction to the perceived strength of prospective demand. Also included in this index, but harder to characterize, are common stock prices, the real money stock, and changes in total liquid assets.

The revised composite index of leading indicators has fallen in each of the past two months from 102.6 in August to 102.0 in October (see Chart II). The question arises whether this drop points to a downturn in economic activity or to a slowdown in the rate of growth. An examination of past episodes where the index declined in two successive months after increasing in previous months reveals that the most recent two-month decline is the smallest in the postwar period. The two components that declined for two straight months and accounted for most of the drop in the index were the real money supply and liquid assets. However, it appears that the real money supply expanded strongly in November following contractions in the two previous months. In addition, the rebound of the composite index of leading indicators prior to the declines in the past two months had been quite strong, compared with the upturn pattern in past early recoveries. It should be noted that, as a recession predictor, the composite leading indicators series has exhibited a number of false signals. For example, downturns in 1962, 1963, and 1968 were not followed by major downturns in economic activity. However, the sluggish pattern of the index in the past two months is consistent with the pattern of slower growth exhibited by a number of other monthly series and may be an indicator that the pace of the recovery in the near term will remain considerably below the extremely rapid third-quarter rate.

LABOR MARKET DEVELOPMENTS

The slackening pace of the economic recovery has carried over to the labor market. In November, nonfarm employment was essentially unchanged in both the household and payroll surveys. According to the payroll survey of establishments, seasonally adjusted payroll employment edged up by a scant 41,000 workers following four months of very hefty gains. Indeed, from June to October, the increment in payroll employment amounted to more than 1.2 million workers. In the separate survey of households, nonagricultural employment dipped by 33,000 workers and agricultural employment fell by 130,000 workers subsequent to a similar decline in the previous month. However, the civilian labor force, which often exhibits volatile movements on a monthly basis, fell by a substantial 464,000 workers. Because of the proportionately greater decline in the labor force, the seasonally adjusted civilian unemployment rate fell 0.3 percentage point to 8.3 percent of the labor force, bringing it back to its September level.

While the average number of unemployed workers has been substantially higher in 1975 than in the previous year, there has also occurred a sharp increase in the proportion of unemployed workers who are eligible for unemployment insurance benefits (see Chart III). For those who are eligible, these benefits act partially to replace the income lost due to unemployment. By acting as a cushion for lost wage and salary income, unemployment insurance benefits also tend to stabilize aggregate consumer outlays on goods and services. These benefits are a particularly potent stabilizer since they are not subject to the personal income tax or social security payments. Typically, the fraction of unemployed workers eligible for benefits rises during recessions. This partly reflects the greater numbers of adult men and job losers among the ranks of the unemployed; these groups have larger fractions who qualify

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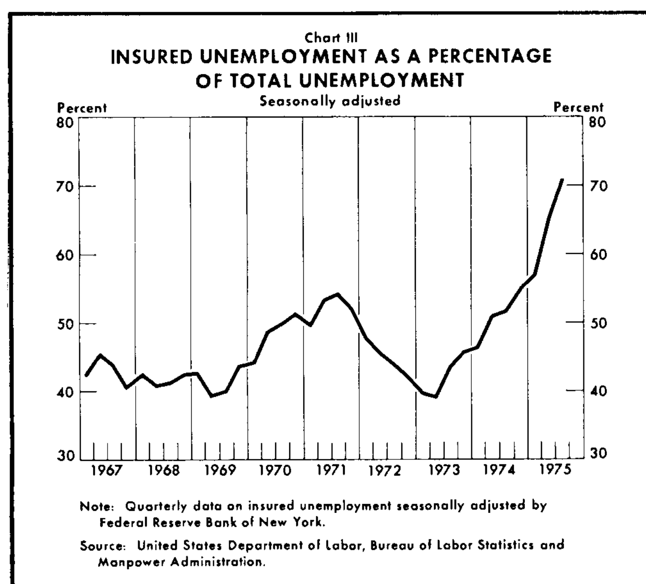

Note: Quarterly data on insured unemployment seasonally adjusted by Federal Reserve Bank of New York.

Source: United States Department of Labor, Bureau of Labor Statistics and Manpower Administration.

to receive unemployment insurance benefits. In the most recent recession, new legislation which temporarily extended the benefit period has also had an impact in raising the proportion of unemployed workers who receive benefits. This proportion has in fact risen throughout 1975 to 70.9 percent in the third quarter, by comparison with a figure of 51 percent for all of 1974.

Although the tempo of wage rate increases appears to have picked up in the two most recent months, the monthly wage data typically exhibit considerable variability, and the overall rate of wage inflation seems to be about in line with that registered in the third quarter. In the July-September interval, average hourly earnings in the private nonfarm economy, adjusted for interindustry shifts and overtime in manufacturing, advanced at an 8.4 percent seasonally adjusted annual rate. This was identical to the gain in the first quarter of this year but slightly above the second-quarter rate of advance. The advances in adjusted average hourly earnings in October and November brought the three-month growth in the adjusted index to a seasonally adjusted annual rate of 8 percent.

PRICES

Although there have been a number of flare-ups in both wholesale and retail prices in recent months, it appears that the typical pattern of moderating price increases in early recovery phases is continuing in the current recovery. The twelve-month growth rate in the consumer price index, which smooths out much of the monthly volatility of retail prices, has fallen steadily over 1975. In October, the twelve-month growth rate in consumer prices stood at 7.6 percent, down substantially from a figure of almost 12 percent with which the year began. This slowdown reflects continuing moderation in recent months in consumer nonfood commodity prices and services prices (apart from higher New York City subway fares in September). In addition, there is the encouraging prospect that food price increases are likely to slow considerably as the record 1975 crop comes to market.

On a seasonally adjusted basis, the wholesale price index in November was virtually unchanged from the level of the previous month. This development reflected a substantial drop in the index for farm products and processed foods and feeds, combined with a moderate increase in wholesale prices of industrial commodities. Wholesale prices of farm products and processed foods and feeds fell at a seasonally adjusted rate of 1.2 percent (not annualized) following very rapid gains in the previous two months. While these prices have been advancing fairly rapidly in the past six months, as of November they actually stood slightly below the level of a year ago. Prices of industrial commodities rose at a 0.6 percent seasonally adjusted rate in November, marking the first month since April that the rate of increase in these prices did not accelerate further. It should be pointed out, however, that prices of nonagricultural intermediate materials and supplies, which are an important input for nonfood commodities at the retail level, have advanced at a 7.5 percent seasonally adjusted annual rate over the past three months. In November, these prices stood 5.2 percent above the year-ago level.

Consumer prices climbed at a 0.7 percent seasonally adjusted rate in October, a somewhat faster rate of increase than the moderate gains of the two previous months. All the acceleration, however, was attributable to the run-up in the volatile food prices component. According to the Department of Agriculture, however, the growth of retail food prices should moderate to a 4-5 percent annual-rate range in the first half of 1976. Consumer prices of nonfood commodities, which had risen at an average annual rate of about 7 percent in the first three quarters of the year, have averaged about a 5 percent annual rate over the three most recent months. Increases in the prices of services have remained moderate in recent months, apart from the September spurt which largely reflected higher subway fares in New York City.

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The Money and Bond Markets in November

Interest rates in the money and bond markets stabilized in November after dropping sharply in the previous month. Although slightly easier conditions prevailed in the Federal funds market, reports of very large weekly increases in the money stock produced doubts that the monetary authorities would promote further declines in interest rates in the near term. As a result, rate declines early in the month were generally offset by subsequent increases.

Substantial new corporate borrowing weighed heavily on the bond market in November, as the calendar of new issues for December increased. The Treasury continued to borrow through large increases in the regular bill auctions but not through coupon issues during the month. Government agency financing activity was also heavy.

Yields on high-grade tax-exempt securities declined modestly in November, but lower rated issues continued to encounter market resistance. Throughout the period, uncertainty revolved around the prospect of finding a means of avoiding a New York City default. Optimism was revived in midmonth when a three-year moratorium on the payment of certain New York City notes, with the option of exchanging them into long-term Municipal Assistance Corporation (MAC) bonds, was passed by the New York State legislature and enacted into law. The moratorium, however, is being challenged in the courts. By the end of November, the legislature had passed a broad plan designed to help avert a default by New York City, which included the raising of certain taxes. Subsequently, President Ford indicated that he would propose Federal legislation to provide the city with up to $2.3 billion in short-term loans.

According to preliminary data, the narrowly defined money stock (M_1) rebounded strongly in November from its decline in October. With consumer-type time deposits continuing to advance, the more broadly defined money stock (M_2) expanded rapidly as well. The bank credit proxy also experienced relatively strong growth in comparison with previous months.

THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on most money market instruments fluctuated narrowly in November, after having fallen in the previous month (see Chart I). The effective rate on Federal funds averaged 5.22 percent during the month, down 60 basis points from October. With the rate of Federal funds averaging over ¾ percentage point below the discount rate, member banks continued to make little use of the discount window (see Table I). Rates on 90- to 119-day dealer-placed commercial paper closed the period at 5.75 percent, down ⅛ percentage point from the end of October, and rates on ninety-day bankers' acceptances fell 5 basis points to 5.75 percent. At the month end, large negotiable certificates of deposit (CDs) maturing in ninety days were trading in the secondary market at 6.30 percent, a decline of 10 basis points over the period.

Business demand for bank loans remained weak in November. Over the first four statement weeks of the month, business loans at large commercial banks rose by $642 million; however, a portion of this reflects a rise in holdings of bankers' acceptances. Business loans excluding bankers' acceptances declined by $519 million. Over comparable periods in the preceding three years, these loans showed an average increase of $877 million. One large bank lowered its prime lending rate ½ percentage point in two steps to 7 percent. A few other money center banks reduced their prime rates ¼ percentage point to 7¼ percent, and at the beginning of December this became the prevailing rate at most money center banks.

Preliminary data indicate that, after experiencing sluggish growth over the previous four months, the monetary aggregates grew at rapid rates in November. During the four-week period ended November 26, seasonally adjusted M_1—private demand deposits adjusted plus currency outside commercial banks—advanced at a 13.7 percent annual rate from its average level during the preceding four statement weeks. This rapid expansion raised the growth

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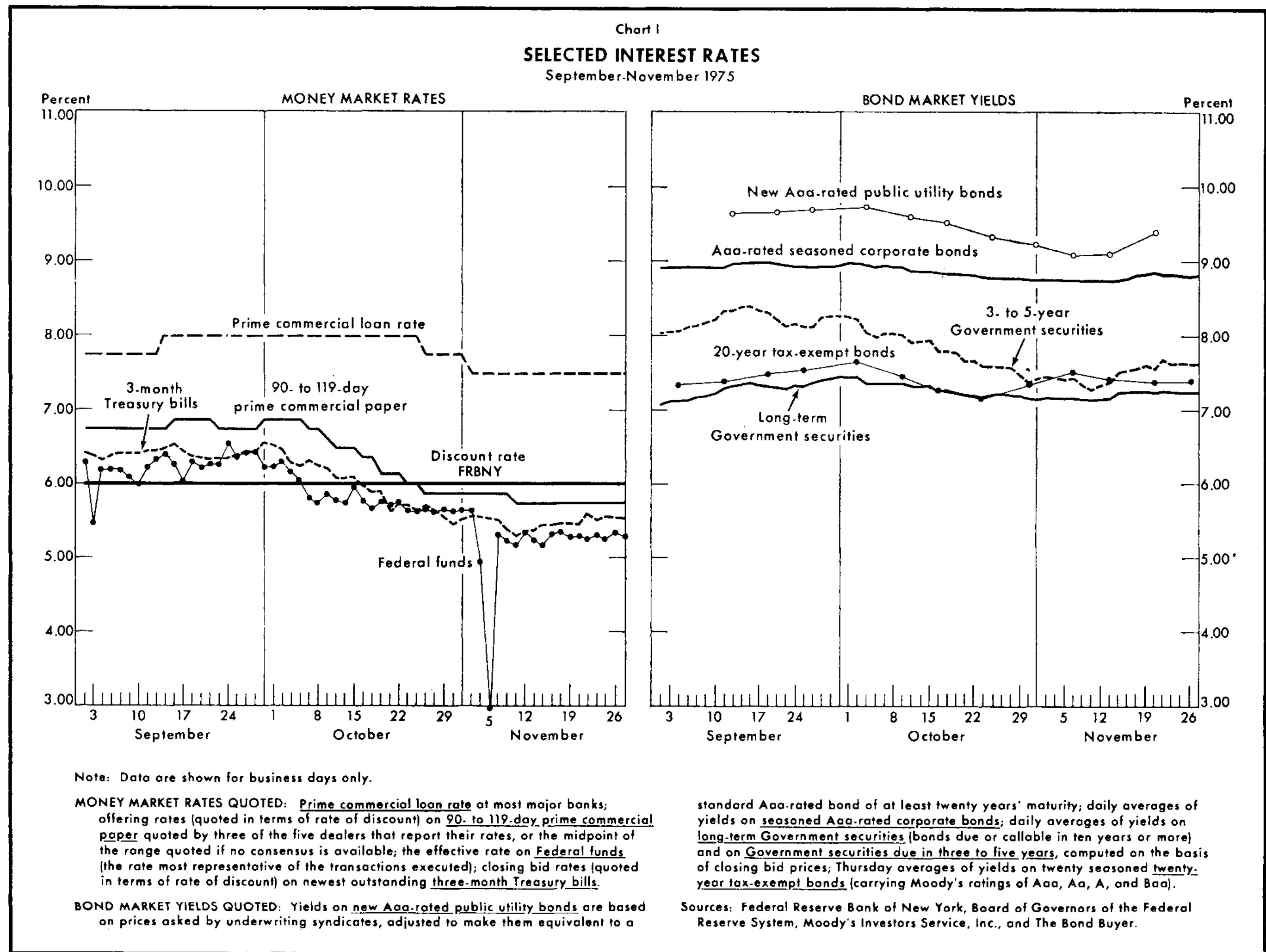
Chart I

SELECTED INTEREST RATES

September-November 1975



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.

rate of M_1 over the past thirteen weeks to 3.3 percent (see Chart II). Consumer-type time and savings deposits at commercial banks in November expanded at a relatively strong rate. Consequently, M_2—M_1 plus time deposits other than large negotiable CDs—also registered a sizable gain. During the first four statement weeks of the month, these deposits advanced at a 12.8 percent annual rate from their average during the four statement weeks ended October 29. Over this same period, M_2 increased at a 13.2 percent annual rate. After rising at a rapid rate in the preceding month, the average level of CDs declined slightly in November. The adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—rose at a 12.8 percent average rate.

THE GOVERNMENT SECURITIES MARKET

Yields on most Government securities ended higher on balance in November. The interest rate declines that typified the previous month continued during the first week of November. Easier conditions prevailed in the Federal funds market, and increased investor preference for safety supported demand. Toward the middle of the month, however, investor preference for safety eased somewhat with the appearance of progress in resolving New York City's fiscal crises. At the same time, published data indicating that the money stock measures had expanded sharply during the first two statement weeks of the month fostered market expectations that the recent easing in monetary policy could halt and possibly reverse.

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Sizable increases in the wholesale and consumer price index added to the concern of market participants, while supplies of fixed income investments grew through enlarged regular bill auctions and corporate debt financings. Against this background, yields in all maturity ranges moved higher.

Treasury bill rates declined modestly early in November in response to good investor demand and lower dealer financing costs. At the second weekly auction of the month on November 10, the average issuing rate on three-month bills was 5.28 percent (see Table II), 41 basis points below the average rate at the last weekly auction in October. At the same time, the average yield on six-month bills was 5.48 percent, 49 basis points lower than two auctions previous. In the auction of 52-week bills held on November 13, the average issuing rate was 6.01 percent, 59 basis points below the average yield in the corresponding monthly auction in mid-October. Around mid-November, however, considerable concern emerged about the future course of monetary policy. Dealer financing costs stabilized, and the substantial additions to the available supply of bills through increases in the bill auctions began to weigh on the market. The Treasury raised approximately $2.8 billion of new cash in the four regular weekly auctions in November and about $1 billion in the auction of 52-week bills. Following these developments, the average yields on three- and six-month bills at the weekly auction of November 24 rose to 5.52 percent and 5.93 percent, respectively.

At the end of the month, the Treasury announced plans to raise $3.2 billion of new money in the Treasury bill market. An auction of $2 billion of 139-day bills due April 22, 1976, representing an addition to the outstanding series, was scheduled for December 2. Auctions for $600 million of ten-day bills due December 18 and $600 million of eighteen-day bills due December 26, both of which represent additions to the outstanding series, were scheduled for December 5. The terms of the financing were generally in line with market expectations and had little effect on bill rates. The average yield on the 139-day bills auctioned on December 2 was 5.82 percent, and in the auctions held on December 5 the average yield was 5.22 percent on the ten-day bills and 5.14 percent on the eighteen-day bills. Over the month as a whole, bill rates were about 2 basis points lower to about 40 basis points higher.

Developments in the market for Government coupon issues followed a similar pattern. November was the first month in 1975 in which there was not an auction for new cash borrowing through coupon issues by the Treasury. While this was a positive factor, supply considerations

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, NOVEMBER 1975

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

Factors	Changes in daily averages— week ended				Net changes
	Nov. 5	Nov. 12	Nov. 19	Nov. 26	
"Market" factors					
Member bank required reserves	+ 303	+ 362	— 788	+ 54	— 69
Operating transactions (subtotal)	— 214	+3,419	—1,022	—2,680	— 497
Federal Reserve float	+ 457	+ 10	+ 587	— 577	+ 477
Treasury operations*	— 591	+3,933	— 389	—1,677	+1,276
Gold and foreign account	— 23	+ 15	— 42	+ 38	— 12
Currency outside banks	— 60	— 849	—1,104	— 215	—2,228
Other Federal Reserve liabilities and capital	+ 5	+ 310	— 76	— 250	— 11
Total "market" factors	+ 89	+3,781	—1,810	—2,626	— 566
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 408	—4,582	+2,242	+2,997	+1,065
Outright holdings:					
Treasury securities	— 962	—2,305	+2,016	+1,527	+ 276
Bankers' acceptances	+ 14	— 10	— 7	+ 3	—
Federal agency obligations	—	— 1	—	—	— 1
Repurchase agreements:					
Treasury securities	+1,104	—1,930	+ 184	+1,232	+ 590
Bankers' acceptances	+ 170	— 232	+ 44	+ 118	+ 100
Federal agency obligations	+ 82	— 104	+ 5	+ 117	+ 100
Member bank borrowings	— 28	— 27	+ 19	+ 15	— 21
Seasonal borrowings†	— 10	— 16	— 1	—	— 27
Other Federal Reserve assets‡	+ 48	+ 37	— 278	— 359	— 552
Total	+ 428	—4,572	+1,983	+2,653	+ 492
Excess reserves‡	+ 517	— 791	+ 173	+ 27	— 74
	Daily average levels				**Monthly averages§**
Member bank:					
Total reserves, including vault cash‡	34,943	33,790	34,751	34,724	34,552
Required reserves	34,140	33,778	34,566	34,512	34,249
Excess reserves	803	12	185	212	303
Total borrowings	67	40	59	74	60
Seasonal borrowings†	43	27	26	26	31
Nonborrowed reserves	34,876	33,750	34,692	34,650	34,492
Net carry-over, excess or deficit (—)‖	160	267	36	88	138

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 November 26, 1975.
‖ Not reflected in data above.

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continued to be an issue as corporate and agency financing was sizable. The uncertain outlook for interest rates and inflation encouraged trimming of dealer positions, and some profit taking followed October's rally. Over the month as a whole, the index of yields on intermediate-term Government securities rose 19 basis points to 7.62 percent. The index of long-term bond yields rose 9 basis points to 7.24 percent.

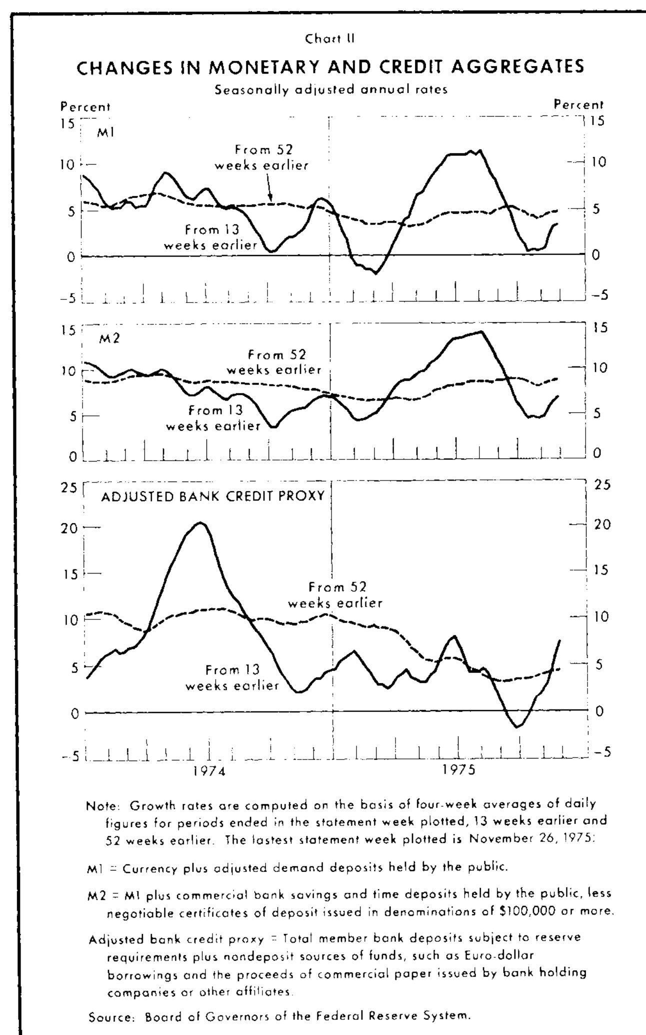
Yields on Government agency issues reflected the same influences during November. Early in the month, the Federal Home Loan Banks successfully sold $1.8 billion of bonds. Rates of return on this three-part financing were 7.25 percent on $800 million of 27-month bonds, 7.75 percent on $600 million of five-year bonds, and 8.10 percent on $400 million of ten-year bonds. In concurrent issues just before midmonth, refinancings by the Federal Intermediate Credit Banks (FICB) and the Banks for Cooperatives (BC) were well received, as the redeemed securities totaled $232 million more than the two new issues sold. The FICB sold $714 million of nine-month bonds yielding 6.20 percent, and the BC sold $449 million of six-month bonds yielding 6 percent. These returns were 70 and 75 basis points, respectively, below similar financings in October. In addition to the previously mentioned factors depressing the market later in the month, the Federal National Mortgage Association unexpectedly included $600 million of new cash borrowing in an auction on November 25. In that $1.4 billion financing, $450 million of 21-month debentures was sold at a 7⅜ percent yield, $650 million of five-year debentures was sold at an 8 percent yield, and $300 million of eight-year debentures was sold at an 8.4 percent yield.

OTHER SECURITIES MARKETS

Yields on corporate securities edged downward early in November, but they reversed course following increased concern about monetary policy, a very sizable influx of new issues, and a growing calendar of scheduled financings for December. Large price declines were recorded when dealers sought to reduce inventories by removing price restrictions on issues in syndicate, and a number of new offerings were postponed. In the market for state and municipal obligations, yields on high-quality issues outside New York State stabilized, while developments in Albany and Washington were the primary influence on the prices of debt instruments which carried low ratings or were located in New York State.

Following the improvement in market tone of the previous month and anticipating sizable demand on the credit markets by the United States Treasury in early 1976, underwriters brought a substantial amount of new corporate issues to market in November and added more to the schedule for December. This financing activity included an appreciable new supply of medium-term notes as well as long maturity issues.

Reflecting the improvement in market conditions, a $50 million A-rated utility offering of thirty-year bonds was priced in the first week of November to yield 9.75 percent, a full percentage point below a similar issue offered two months earlier. However, after the market retreated somewhat, a yield of 10 percent was set on $100 million of A-rated thirty-year utility bonds. In two 25-year industrial financings, $250 million of Aa-rated debentures was priced to yield 8⅞ percent and $100 million of



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 lastest statement week plotted is November 26, 1975.

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.

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Aa-rated debentures returned 9⅛ percent. Market sentiment shifted while the larger issue was still in syndicate, and the yield rose sharply when price restrictions on the undistributed portion were lifted.

New issues of Aaa-rated state bonds were distributed at lower interest rates in November. The State of Wisconsin sold $102 million of bonds yielding from 3.50 percent in 1976 to 6.50 percent in 2005, while returns on $100 million of State of Oregon bonds ranged from 5 percent in 1981 to 6.15 percent in 1990. A similar Oregon issue yielded 5.25 percent in 1981 to 6.70 percent in 1993 when offered at the beginning of October.

As in recent months, the financial problems of New York City continued to dominate the market for lower grade tax-exempt securities. Developments around mid-November rekindled optimism over the prospect of some form of Federal aid to New York City, and prices on MAC issues rose. Another municipality in New York State as well as certain state agencies, however, experienced financial difficulties. At midmonth the New York State legislature averted default by Yonkers, the fourth largest city in the state, and by the Housing Finance Agency (HFA). Yonkers was able to redeem $21 million of maturing notes on schedule through a plan passed by the legislature providing for the creation of an emergency control board to oversee the city, similar to the one for New York City. The legislature also appropriated $80 million as part of a package to prevent the HFA from defaulting on its maturing notes. Although rated Aaa by Moody's and Aa by Standard & Poor's, a $37 million issue of Westchester County bonds was offered at yields ranging from 4.5 percent in 1976 to 6.8 percent in 1990, between 50 and 90 basis points higher than on a similar issue of bonds by a municipality outside the state.

At the end of the month, prices of MAC issues rose following the passage by the New York State legislature of a plan designed to avoid a New York City default. The legislature voted a $200 million increase in New York City taxes, which includes increases in the personal income tax, the bank tax, and the cigarette tax. The city sales tax is to be extended to cover personal services, and the minimum corporation tax is to be raised. In addition, an estate tax is to be levied and a minimum personal income tax is to be imposed. In a subsequent speech, President Ford stated that he would propose legislation to provide short-term loans to New York City to allow for adjustments to the uneven cash flow pattern during the year. The direct Federal loans, to be available through June 30, 1978, would not exceed $2.3 billion at any one time. To qualify for new loans for the next fiscal year, the city would be required to pay back all outstanding loans by the end of each fiscal year. The loans would be administered by the Treasury and made at a rate of 1 percentage point above the Treasury borrowing rate. If the city failed to keep up its efforts to achieve a balanced budget, the loans could be discontinued.

The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds rose 3 basis points from the end of October to 7.39 percent on November 26. The Blue List of dealers' advertised inventories declined by $53 million and closed the month at $631 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—November 1975			
	Nov. 3	Nov. 10	Nov. 17	Nov. 24
Three-month	5.602	5.279	5.471	5.520
Six-month	5.792	5.483	5.796	5.933

Maturity	Monthly auction dates—September-November 1975		
	Sept. 17	Oct. 15	Nov. 13
Fifty-two weeks	7.338	6.601	6.010

* 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.

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Treasury and Federal Reserve Foreign Exchange Operations Interim Report: August-October 1975

By Alan R. Holmes and Scott E. Pardee*

Coming into August, the exchange markets were bullish for the dollar. By that time, the United States trade account had moved decisively into surplus. Growing signs of a United States economic recovery also helped bolster confidence in the dollar, while a firming of United States interest rates beginning in late June had added to interest differentials favoring short-term dollar placements. By contrast, economic recovery abroad was still lagging, and the market had come to expect additional stimulative measures, including lower interest rates, in several foreign countries. These considerations had gradually erased the market's previous extreme pessimism toward the dollar and had prompted a ground swell of demand for dollars in June and July, as earlier speculative positions against the dollar were unwound, adverse leads and lags were reversed, and arbitrage and investment funds were drawn into New York and the Euro-dollar market. By end-July, the dollar had climbed against the German mark by some 9¾ percent from mid-May and by almost 11½ percent from the lows of last February. As previously reported, the Federal Reserve had taken advantage of this recovery to acquire sufficient currencies to repay in full all remaining swap debt incurred in market operations in late 1974-early 1975.

During August the immediate optimism for the dollar waned somewhat, particularly after release of discouraging consumer and wholesale price figures for the United States. Following the previous sharp run-up, profit taking shaved some 1-2 percent from dollar exchange rates early in the month. The undertone was nevertheless firm, and over subsequent weeks the dollar continued to be bolstered by the sizable United States trade surplus and by favorable interest arbitrage differentials. In fact, the exchange markets remained in rough balance through the rest of August and early September.

Toward mid-September, bullish exchange market sentiment for the dollar resurfaced. While the economic picture remained little changed abroad, the United States recovery was, in the initial stages at least, progressing much more strongly than previously expected. Consequently, a renewed rise in some United States money market rates prompted expectations of even further increases in dollar interest rates. In response, traders resumed heavy bidding for dollars in the exchanges and dollar rates advanced across the board. To moderate the day-to-day rise, foreign central banks sold sizable amounts of dollars in their respective markets. The Federal Reserve bought modest amounts of German marks to add to working balances, accumulating $59.3 million equivalent since early August. Moreover, when the Belgian franc dropped particularly sharply, the System took the opportunity to purchase $6 million equivalent of francs to hold in balances. Demand for the dollar crested on September 22-23, when dollar rates reached some 4 to 5 percent above their late-July highs.

The mood of the market shifted abruptly in late September, however, as the long-brewing controversy over how to resolve New York City's fiscal difficulties began to influence the exchanges. By then, each new development was receiving widespread attention in the world press and, although very little of New York City debt is held abroad, an increasing number of foreign businessmen and officials were expressing concern over the broader implications of

* Mr. Holmes is the Executive Vice President in charge of the Foreign Function of the Federal Reserve Bank of New York and Manager, System Open Market Account. Mr. Pardee is Vice President in the Foreign Function and Deputy Manager for Foreign Operations of the System Open Market Account. The Bank acts as agent for both the Treasury and the Federal Reserve System in the conduct of foreign exchange operations.

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a possible default by the city. These concerns at first prompted precautionary selling of dollars by some traders, leading to a slippage of dollar rates. Then, in early October, United States interest rates turned down once again and, amidst scattered indications that the pace of the United States economic recovery might have slowed, some dealers shifted to expect further declines. Meanwhile, new forecasts of a near-term pickup of some European economies raised the prospect of a hardening of interest rates abroad. In this atmosphere of uncertainty, the dollar lost buoyancy and dollar rates were pushed sharply lower in sporadic bouts of selling pressure. In an effort to maintain order and resist the decline, foreign central banks entered the market as buyers of dollars, on some days in sizable amounts. The New York market also turned unsettled on several occasions in early October, and the Federal Reserve, operating on four days between October 1 through 15, sold a total of $50.1 million equivalent of marks from balances. Thereafter, the dollar leveled off around 4-5 percent below late-September highs. Exchange rates still fluctuated widely, however, as the market reacted to each new twist and turn in the New York City fiscal situation. On balance, foreign central banks continued to buy dollars through the month end. In New York, although the Federal Reserve remained prepared to intervene, the market was generally quiet and there was no further need for sales of foreign currencies. During periods of dollar buoyancy in October, the System purchased $36 million equivalent of marks for future contingencies.

In sum, during the period August-October the Federal Reserve purchased in the market and from correspondents a total of $95.3 million of German marks and $6 million of Belgian francs. Sales of currencies in the market which occurred in early October amounted to $50.1 million equivalent of marks. There were no new swap drawings by the Federal Reserve.

On August 29 the swap line between the Federal Reserve and the Bank of Mexico was increased by $180 million to $360 million. The full amount was subsequently drawn by the Bank of Mexico, in late September-early October, to meet temporary needs, and these drawings remained outstanding at the end of the period.

Table I

FEDERAL RESERVE SYSTEM DRAWINGS AND REPAYMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars equivalent

Transactions with	System swap commitments, July 31, 1975	Drawings (+) or repayments (—) August 1 through October 31, 1975	System swap commitments, October 31, 1975
National Bank of Belgium	261.8	-0-	261.8
Swiss National Bank	371.2	-0-	371.2
Bank for International Settlements (Swiss francs)	600.0	-0-	600.0
Total	1,232.9	-0-	1,232.9

Note: Discrepancies in totals are due to rounding.

Table II

DRAWINGS AND REPAYMENTS BY FOREIGN CENTRAL BANKS AND THE BANK FOR INTERNATIONAL SETTLEMENTS UNDER RECIPROCAL CURRENCY ARRANGEMENTS

In millions of dollars

Banks drawing on Federal Reserve System	Drawings on Federal Reserve System outstanding July 31, 1975	Drawings (+) or repayments (—) August 1 through October 31, 1975	Drawings on Federal Reserve System outstanding October 31, 1975
Bank of Mexico	-0-	+360.0	360.0
Bank for International Settlements (against German marks)	-0-	+ 58.0 — 58.0	-0-
Total	-0-	+418.0 — 58.0	360.0

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