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Priorities for the International Monetary System

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*Remarks before the National Foreign Trade Council
in New York City on Monday, November 17, 1975*

It was three years ago when, in a different capacity, I last spoke before this forum. My purpose then was to explain and defend the official United States proposals for reform of the international monetary system that had been presented shortly before to the annual meeting of the International Monetary Fund.

The United States and other countries then looked toward an ambitious restructuring of the IMF articles, resolving in one set of comprehensive negotiations an outline for a monetary system suitable for today's world. Events have forced a different and less sweeping approach. Some major issues have been settled, at least temporarily, by markets and governments responding to the pressures of new events. Others have been left partly or wholly unresolved. Today, speaking not for the United States Government or for the Federal Reserve System as a whole, I would like to address a few of these problems again, in the light of what has happened in the intervening period.

In approaching the job of rebuilding the international monetary system, perhaps the first thing that strikes a "reformer" is the number, severity, and essential unpredictability of the shocks that have struck the world economy in these past four years. Since the Bretton Woods system broke down and the Committee of Twenty launched its efforts, there has been a worldwide boom, an outburst of two-digit inflation, enormous fluctuations in basic agricultural prices, the oil crisis, and then sharp recession. Meanwhile, the process of negotiation had clearly reflected marked differences in perspective among countries about the priorities for a new monetary system, and these dif-

ferences could not be quickly resolved.

In the circumstances, it is not surprising—and perhaps more realistic—that we have adopted a more piecemeal approach toward change and reform. Notably, while specific exchange rate practices vary widely among countries, the floating of major currencies has become a dominant fact of life. Questions of international control of reserve creation and of reserve "consolidation", which had earlier been a preoccupation of many reformers, have been for the time put aside.

This is not a neat, intellectually satisfying picture. Many feared that resort to floating without clearly defined rules of behavior would undermine international economic integration and interfere with trade and investment. Some went further. They felt that what they saw as a total breakdown of the monetary order was responsible for much of the instability in the world economy and carried the seeds of political and economic chaos.

But the worst has plainly not happened. Flows of international trade and investment—while recently affected by recession—have been well maintained. Controls on trade and payments have not proliferated. Resort to "beggar my neighbor" policies—one source of concern to those pushing comprehensive reform—is so far notable mostly by its absence.

Have the fears been unjustified, or have we simply been lucky—at least in this area?

I don't want to discount entirely the possible role of good fortune in human affairs. But I suspect it has been three other, more identifiable, factors that have made the

major contribution to the reasonably effective functioning of the system.

Private market mechanisms have proved to be much more resilient than the pessimists feared, or perhaps even than the optimists hoped. Both business firms and financial institutions have demonstrated remarkable ability to adapt to the new circumstances.

For their part, the national governments of the industrialized world, influenced by the habits of decades of successful international economic cooperation, have not retreated into overtly nationalistic and autarchic policies. To be sure, negotiations on trade, money, energy, and development have been proceeding at a frustratingly slow pace. But, the framework and platform for forward-looking negotiations have been maintained.

Not least, the new flexibility of exchange rates—introduced not by agreed design but under the force of events—has helped us cushion and absorb the successive blows to economic stability while facilitating some longer run balance-of-payments adjustments that had eluded us so long.

There is room for satisfaction in this experience. But it would, in my judgment, be a mistake to conclude all is well—that the essential job of reform has been done in, as it were, a fit of absentmindedness.

Exchange rates have at times been highly volatile. Practices with respect to reserve creation and composition have become more diverse and less predictable. More broadly, the international monetary system has been functioning with only rather vaguely understood “rules of good behavior” and guidelines of uncertain status.

In a period of radical change and transition, the absence of a well-defined structure and agreed rules has perhaps been inevitable and even useful in helping us to break out from outmoded patterns. Certainly, to accommodate to the turmoil surrounding us, a larger degree of flexibility has been essential.

Nevertheless, there are, in my view, dangers and difficulties in this situation—in continuing indefinitely without a greater sense of structure or an identifiable set of codes of conduct in international monetary affairs. Volatile exchange markets feed uncertainty. Diversity in management of official reserves, while undoubtedly welcome from the point of view of some individual countries, could degenerate into a lack of consistency and predictability contributing to further instability. A sense of drift, or worse, potential conflict, in the policies and purposes of major countries could arise, eroding instincts for co-operative policies and mutual confidence. All of this supports the thesis that monetary reform should remain high on the international agenda.

THE AMERICAN INTEREST IN REFORM

No reform effort will be successful that does not take into account some simple truths of international economic and political life. Among these is the fact that the United States is still by all counts the largest single economic force in the world. Foreign concern with, and sensitivity to, our economic health remains high. Our financial markets are unmatched in their breadth and strength. The dollar is still by far the world's leading currency.

However, the United States is not nearly so predominant in the world economy as it was in the heyday of Bretton Woods. The economic and political strength of our trading partners has grown, in relative as well as absolute terms. They are bound to look at some issues from a different perspective, and their differing views will need to be blended into a coherent whole.

It is not just that economic situations of individual countries differ—for instance, their relative dependence on external trade and capital markets and their degree of development. Intangible, but strongly felt, matters of national prestige sometimes develop, and there is a strong desire for the form and substance of symmetry and equality.

Faced with these complications and difficulties, the temptation can always arise for a large continental power like the United States to retreat from the process of negotiation and reform and to limit involvement in the world economy. But that is not today, if it ever was, a realistic course. The objective circumstances point in quite the other direction.

The growing strength of your organization reflects the fact that, even as the relative size and dominance of the United States in the world economy has been reduced, our economy has also become much more open. Our exports, in little more than a decade, have increased from 8 percent of the output of domestic mines and factories to 15½ percent. We are dependent on imported energy and other materials for a large fraction of our needs and on foreign markets for similarly large fractions of our agricultural output. Our major financial institutions have increasing proportions of their assets and liabilities overseas; some of our leading banks, generating half or more of their profits from international business, illustrate the point dramatically.

Inevitably, with few sectors of the United States economy insulated from external influence, our approach to monetary reform, as that of other countries, has to take account of our immediate economic interests. But the broader goals must remain as well, the larger vision of a

developing world order, in which all countries—large and small, rich and poor—can prosper. The essential requirement is that we find ways to safeguard our legitimate interests in a framework that reconciles those interests with those of others.

The Committee of Twenty faced that issue on a large scale in attempting to deal with all aspects of the monetary system simultaneously. Perhaps it tried too much too soon. Now, we have a chance to proceed in a more evolutionary way, testing the results as we go and learning from the turbulent experience of recent years.

In this process, two priorities suggest themselves. For the longer run, we will need to take up again the old issue of how to achieve some control over international liquidity and to develop a stable and acceptable world reserve asset. More immediately, we need to see how, within the broad framework of the more flexible exchange rate practices achieved in recent years, we can achieve greater stability in market performance.

INTERNATIONAL LIQUIDITY

On the face of it, arrangements for international liquidity—its creation and composition—appear more haphazard today than ever. In the context of Bretton Woods, it was already complicated enough; the balance-of-payments positions of the reserve currency countries, the balance between the production of gold and private demands and official convertibility policies all played a part. Today, gold neither flows into nor out of reserves in substantial volume, but its price fluctuates widely in the market. Intervention practices, leading to the creation or destruction of reserves, vary greatly among countries, and there has been more desire for currency diversification in reserve holdings. The attraction of Euro-currency markets, whether for the placement of reserve assets or for official borrowings, has added to the avenues of reserve creation and opened new options for reserve holdings.

With other reserve components expanding so rapidly, the SDR—the chosen instrument for “rational” international reserve management—has understandably been held at a fixed and relatively small total. The revised valuation and interest rate formulas have made the SDR a usable asset once more in the context of a floating system, and it has received more attention as a unit of account. But, as matters stand, SDR creation is not a significant factor in determining the supply or composition of reserves. Gold is still important for some countries as a kind of residual national asset. But it stands, convicted by its own price instability, as an inactive component of international reserves.

All of this has raised two important questions. The first concerns the aggregate volume of reserves. The observable statistic is that a massive volume of new reserves has been generated by the present system—or more accurately out of the breakdown of the old. There is concern that this creation of international liquidity has contributed to strong inflationary forces in the past, and the process may be repeated.

The second question grows out of the possibility of sizable shifts in the composition of reserves among particular currencies. If such shifts developed on an important scale, they would add to exchange market instability in general and, in the view of some, to systematic undervaluation of the dollar should “diversification” out of dollars prove a lasting phenomenon.

Before approaching possible solutions to these problems, it is important to keep them in perspective. In the four and one-half years since the end of 1970, world reserves, as usually calculated keeping gold at the official price, have more than doubled in dollar terms, rising from \$94 billion to over \$225 billion this summer. The most rapid growth took place during the earlier part of the period, before floating exchange rates were generalized, and therefore should not be associated with that system. In fact, in 1971-72, the ratio of reserves to trade, one simple though incomplete measure of reserve adequacy, sharply reversed the long decline that had persisted over the postwar period. But the ratio of reserves to world imports then dropped again in the two years after 1972. For a sample of sixty countries, that ratio at the end of 1974 stood at 24 percent. That was the lowest point ever recorded since the series started in 1954, when the ratio stood at just over 70 percent.

The oil-related payments imbalances have, of course, affected the distribution of reserves. In fact, over the past two years, holdings of reserves by other than OPEC countries have experienced virtually no growth.

It is questionable in my mind whether the \$40 billion of “reserves” accumulated by OPEC nations during that period should be considered, without qualification, as a part of the world total. Those OPEC reserves by and large are not considered by their holders as balances held against short- or medium-term contingencies—the usual function of reserves—but rather as an important element of longer term national savings, whatever the precise nature of the investment media used. Over a more distant time horizon, as their surplus oil income is curtailed, the funds may be spent. But it does not necessarily follow that reserves of other countries will then increase, since their surpluses might be used for the repayment of debt. To put the point another way, if the objective were to

hold the recorded total of world reserves unchanged, the accumulation and subsequent liquidation of OPEC reserves would force sharp contraction and then rebuilding on other countries. For oil-importing countries, their willingness in many cases to engage in substantial official borrowing to maintain reserve holdings does not support the idea of an enormous surfeit of world reserves.

The parallel concern, about the possible instability of reserve currency holdings, seems to wax or wane with the performance of the exchange markets and particularly confidence in the dollar. While the statistics are not really adequate, the central banks of the leading industrial countries have not shifted any significant amounts of funds. Practices of countries that have been accumulating new reserves are more varied, however, and some have made placements in a number of different currencies.

Altogether, I do not see here cause for great immediate alarm. Nevertheless, the degree of remaining uncertainty about reserve creation and composition makes it appropriate to study techniques designed to deal with the problem. In particular, a number of proposals have been made for "consolidation" of holdings of dollars and other reserve currencies, a technique which contemplates individual countries depositing currencies with the IMF in return for an equivalent amount of SDRs. To achieve control over future reserve additions, further acquisitions of currency balances would presumably need to be limited.

In approaching these questions, I see no issue of national pride. Nor do I see any overwhelming national purpose or commercial advantage served by clinging to an exclusive reserve currency role for the dollar—a role that developed originally not out of deliberate national choice but out of a long evolution of market and reserve practices.

The real issue is whether so heavy a use of national currencies as at present contributes to the stability and adaptability of the monetary system as a whole. Consolidation of reserve currencies in concept would remove one source of instability in exchange rates and, if in fact the alternative would be some diversification out of dollars, the performance of the dollar in the exchange market might be strengthened. However, the case can easily be overstated in both respects.

Markets are affected by transactions at the margin. No consolidation plan in any relevant time horizon will dispense with a sizable volume of reserve currency holdings. Such holdings are necessary, apart from all other attractions, for intervention purposes and to provide some margin of elasticity for reserve creation or destruction. So long as a substantial volume of reserve currencies remains in the system, marginal shifts in these balances could still

be a potential market factor. Moreover, continued use of the dollar as an intervention currency by others would mean that its value at times will be affected by changes in the payments position of other countries, just as at present.

More broadly, even complete elimination of reserve currencies would not insulate us or others from flows of funds in private markets inspired by swings in confidence, by differentials in interest rates, or by other factors. Private holdings of dollars—whether in the United States or abroad—are, after all, both larger in the aggregate and potentially more sensitive than official holdings.

Consolidation of reserve currencies can at best be only a step toward the further objective of regaining control over the growth of international liquidity. That objective could indeed be facilitated by wider use of a common international reserve asset on the SDR prototype. A few contingencies—such as a drain on world reserves from a persistent United States surplus sometime in the future—would then be dealt with directly. But consolidation would not by itself help with the larger problem of controlling future growth in reserves. Nor can it resolve the interesting question of just how many reserves we need or want in a new world monetary order.

Finally, a host of practical problems would need to be handled in any consolidation proposal, problems no less difficult because they are sometimes termed technical. For instance, what specific obligations would the United States or others assume if dollar balances were to be taken over by the IMF and SDRs emitted as a substitute? If SDRs are to become a much larger proportion of reserve assets, what new undertakings and obligations might be required to ensure their usability on a large scale on short notice?

In raising these questions, I want only to emphasize that the problem of controlling the size and composition of reserves will not yield to quick and easy answers. I do not mean to suggest that these issues should be removed from the agenda for reform. Indeed, the incentive for giving more concentrated attention to the problem is not entirely economic. Suspicion and concern that the United States, despite a decline in its relative economic strength, wants to maintain special and inequitable advantages for itself through a dominant role for the dollar continue to lurk in the background of monetary negotiations. That suspicion will be removed only by dispassionate study of the real issues.

THE EXCHANGE RATE SYSTEM

There is one further, and fundamental, reason why the proper approach to the problem of international liquidity

will take time to resolve: the answer, in important respects, will be dependent on the kind of exchange rate system we want. Exchange rate practices are much more directly relevant to the world's business—and in the past have been a matter of high controversy. Fortunately, there are signs that a broad consensus may be coming within reach.

I have already alluded to the constructive role of flexible exchange rates in dealing with some of the chronic payments imbalances of earlier years and in coping with other strains on the world economy. But along with the good, the degree of turbulence in exchange markets from time to time has been a cause for concern. A large measure of responsibility must be assigned to the violent shocks to the system, and to the weakening of confidence in currency values generally during a period of inflation. As economies stabilize, exchange rates may as well.

Nevertheless, there is room for questioning whether a system of completely free floating rates—if individual countries are led to believe such a system permits full autonomy in national policy—will continue to be prone to sizable fluctuations in currency values, with adverse consequences for trade and investment over time.

Analytically, floating rate theorists have typically emphasized the benign role that “stabilizing” speculators should play in maintaining the stability of floating exchange rates. As exchange rates begin for whatever reason to deviate substantially from some anticipated longer term equilibrium, theory suggests the speculator will step in and contain the movement.

But observation shows the opposite sometimes happens; a kind of bandwagon psychology can develop as an exchange rate begins to move, say, because of a change in relative interest rates or other factors. When there is considerable uncertainty in the market about what exchange rate is broadly appropriate in the future, market pressures can cumulate and for a time feed upon themselves. The friendly “stabilizing” speculator is reluctant to step in.

Looking back, we have avoided the atmosphere of crisis and the sharp discontinuities in exchange rates that characterized the later years of the Bretton Woods system. However, with floating rates, actual exchange rate swings among some leading currencies have been very sizable. The typical daily fluctuation is much larger than before and, more important, changes have cumulated to as much as 15 to 20 percent over a relatively short period of time only to be largely or entirely reversed in ensuing months.

The evidence is not yet all in as to the consequences. Banks and traders have by and large coped well—sub-

stantially better than if widespread controls had been introduced in a probably futile effort to promote greater stability. However, speculative excesses have also produced some strains, and surely swings so large as we have seen in key exchange rates can have little to do with comparative advantage and the efficient allocation of real resources. In the background, the larger danger remains that fear of overvalued or undervalued exchange rates, combined with the absence of more clearly defined rules of good behavior, may tempt one country or another to take refuge in trade and payments restrictions.

Different countries will naturally attach different weight to these problems, depending on their degree of dependence on foreign trade and the structure of their trade and other payments flows. The United States, which still has a relatively smaller foreign trade sector than most other industrialized countries, will naturally weigh the gains from domestic autonomy more heavily when a choice exists. But we have had ample reason to learn in recent years that exchange rate changes are not an insignificant matter to our own economy.

TOWARD GREATER STABILITY

The exchange rate issue has long been approached as a matter of doctrine. It is somehow more satisfying to argue for the extremes of fixed and freely floating rates—both have a long intellectual history and lend themselves to rather clear rules of conduct. The trouble is neither, pressed to an extreme, fits the reality of the world we have. Maintenance of fixed rates implies a degree of international economic integration we do not have and most governments do not want or, alternatively, heavy use of controls that would themselves damage trade and capital movements. Completely free floating by all important currencies, *when* combined with the exercise of complete autonomy in economic policymaking, could risk over time a degree of economic disintegration we cannot afford. The ground in between—while perhaps less satisfying intellectually—does not seem to me a vacuous compromise. It fits the world we have.

There is some evidence that is the way the debate is moving. Some countries—as in the Common Market—will seek a large degree of “fixity” among themselves but appear willing to float *vis-à-vis* others. Other important countries—including the United States—seem likely to retain floating rates for as long ahead as we can see. There is recognition, within the context of a system in which major currencies will remain floating, of the desirability of greater stability. But stability cannot be artificially imposed. The aim must be to achieve a stability

consistent with market forces, not a rigidity imposed by official action.

There are also signs, as yet inconclusive, that the markets themselves are moving toward more stability. After all, exchange rate flexibility is a very new element in post-World War II monetary arrangements, and the market and the authorities have benefited from a learning period. I am optimistic that the extreme instability of recent years will prove to have been—in retrospect—just a historical episode.

But I don't want to sit back and rely on hope alone. The chances for stability will improve as market expectations about an appropriate range of equilibrium exchange rates are more firmly established. And I believe the authorities have a role to play in the process.

Questions of confidence are paramount. Confidence in currency values is inexorably linked to confidence in the soundness of our economies, our institutions, and in the policies followed by governments to assure domestic stability.

At a much more technical level, official intervention is sometimes useful in smoothing disturbed markets. Indeed we have seen periods when the mere knowledge that the authorities were ready to move in steadied the market. When markets move to extremes clearly out of keeping with more fundamental factors, more forceful approaches have at times been helpful.

Conversely, any favorable effects will soon be dissipated if there is disarray in tactics or purposes among the principal trading nations. Moreover, no amount of intervention will be useful if it runs against fundamental market forces or if it is viewed as a substitute for other action to bring monetary and other economic conditions into closer alignment.

In other words, intervention is a tactic—sometimes useful, sometimes not. By itself, it will accomplish little if not accompanied by appropriate domestic policies, by internal stability, and by some willingness to take account of international considerations in policymaking. Floating rates are attractive precisely because they give us a beneficial new degree of freedom in reconciling our domestic policies with open international markets. But to act as though nations can have complete independence in national policy in an interdependent world would be to abuse the system. The result would be to diminish the chances for greater stability in exchange markets.

These are obvious points, and so are the difficulties in approaching better coordination of policies. All those old dilemmas and conflicts in domestic and external policy rear their heads. The United States and other nations will often find it difficult to give international considerations

heavy weight. And because the exchange market is multi-sided, the difficulties are increased when several countries are involved.

Nevertheless, there is ground on which to build. The central problem primarily concerns a small number of major countries—if their currencies are reasonably stable, the rest can fall in place. Indeed, there is room in practice for a considerable variety of specific exchange rate practices; these can be managed without great difficulty so long as the exchange rate relationships between the United States, its European Common Market trading partners, and Japan provide a reasonably stable focus.

We have already gone a long way in developing informal consultative arrangements among these countries, and I hope an atmosphere of mutual trust and respect. Gradually, at least around the edges of economic policy, decisions can take into account the mutual desirability of relatively stable exchange markets. This seems to me possible, for instance, in shaping the precise mix of fiscal and monetary policies and their timing. Eventually, a common view can emerge as to an acceptable broad range of exchange rates—possibly deliberately fuzzy around the edges—consistent with mutual balance-of-payments equilibrium and adjustment.

That view cannot be static and rigid if we are to retain the flexibility afforded by floating rates. Over time, it is the market that has to tell us what is realistic and what is not. But we also have seen the market move to extremes, and it is those extremes that could usefully be dampened.

That will happen when expectations in the marketplace about an appropriate range of exchange rates become firmer. In the end, those expectations will need to find support and justification in the stability and predictability of our economic policies.

CONCLUSION

We have come through these turbulent years, not unscathed, but with our monetary system operating and trade strongly flowing. In the process, we have all learned a good deal about markets, about the limits on official action, and about ourselves.

We have learned again that no international system will work well except on the bedrock of strong internal economic policies and domestic stability.

We have learned, too, that policies that may be fully responsible and adequate in a purely domestic context are not enough. We need to see how those policies fit and mesh with those abroad to assure the stability of any monetary system.

We have learned that large elements of flexibility in the international system are essential in today's world.

We have developed new habits and machinery for consultation, building on the old.

What remains is to distill from this experience the new codes of conduct necessary to strengthen the system and to assure its durability, to fill in the obvious gaps, and to bring the whole more clearly within the orbit of the International Monetary Fund.

By definition the international monetary system has to serve the needs of all nations. Success is dependent on the reconciliation of national views and mutual adjustment.

In the end, those qualities can only be maintained by understanding and impetus from the highest levels of government. That is one reason—without personally having been engaged in the planning or privy to its results—why I can see an extremely useful purpose in the Summit Conference now ending. Perhaps my view is parochial, but it seems to me a good thing for heads of government of the principal trading nations to get together and discuss economic issues, and to understand each other's problems in a way that only face-to-face discussion can achieve. Economics after all is going to have a lot to do with how well we get along on this increasingly small planet.

Petro-Dollars, LDCs, and International Banks

By RICHARD A. DEBS

*First Vice President and Chief Administrative Officer
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*An address before a meeting of
The FOREX Association of North America
in New York City on Friday, January 9, 1976*

FOREX and the Federal Reserve Bank of New York have a great many common interests—a healthy world economy, a well-functioning international financial mechanism, a sound international banking system, and a smoothly operating foreign exchange market. In view of this, I am pleased to have this opportunity to be with you to review some of the major developments that have a bearing on those interests and to look ahead at problems and prospects for the future. As you well know, one of the most significant developments of the past couple of years has been the advent of the “petro-dollar”—a recent and most significant addition to the vocabulary of international finance. Today I would like to focus in particular on some of the issues arising in connection with the accumulation and disposition of petro-dollar balances and their impact on international financial developments. I would also like to have a look at the position of the less developed countries (LDCs) and the role of the international banking system in dealing with these matters. These issues are timely today as we begin the new year, particularly in the light of the agreements reached in Jamaica yesterday. They are also timely for me personally since I have just returned from a trip to the Middle East, visiting central banks and monetary authorities there, and have some fresh impressions of the area that I would like to share with you.

As a very general observation, I will start by saying that my recent visit confirmed impressions of earlier trips—and impressions of other travelers to that area—that the monetary authorities of the oil-exporting countries are contin-

uing to follow a responsible and constructive course in the handling of the massive amounts of petro-dollar balances accumulated by their respective countries. However disruptive the oil price increases have been for the world economy in general, the monetary authorities of the OPEC countries, in managing the flows of funds through their central banks, have been most careful to avoid disruptive actions that, merely because of the huge amounts involved, could have unsettling effects on the international financial markets. The magnitude of that task can best be illustrated by the fact that these authorities have to invest—and reinvest—at a rate of several hundred million dollars each week, every week of the year.

In carrying out their responsibilities, the monetary authorities in the oil-exporting countries have also recognized the desirability of cooperation with the central banks of other countries of the world. The need for central bank cooperation has been recognized, notwithstanding the basic disagreement on the question of oil prices between the oil-exporting and oil-importing countries. I am pleased to report in this regard that close cooperation has been developed between the Federal Reserve and the central banks of the OPEC countries aimed at avoiding disruptive flows of funds within our own markets, and ensuring that market mechanisms continue to function efficiently in handling such flows. The lines of communication and coordination that we have established for these purposes have been most effective and mutually beneficial.

Another general observation worth making is that the investment strategies of the various oil-exporting countries

vary greatly. As a general rule, the OPEC countries have as a common objective the development of their internal economies as rapidly as possible, recognizing the finite nature of their petroleum resources and the necessity to build a broad economic base for future development. They also have as a common objective the preservation of their financial assets, pending the time when they will be needed for purposes of internal economic development. In this sense, they look upon their financial assets as savings, to be used at a later date—some sooner than later. Here, however, the similarity among the countries ends, and there are great differences among them in their investment strategies in attempting to achieve these common objectives. These differences reflect in large part the differences among them with respect to their internal development needs and absorptive capacities, as well as their gross oil receipts. Obviously, a country like Saudi Arabia, with a relatively low population density, low absorptive capacity, and relatively high oil production, will have a larger surplus than a country with a lower level of oil production or a higher absorptive capacity. Perhaps not so obvious, but just as important, is the fact that the investment strategies of these two countries will differ greatly in the light of those factors.

PETRO-DOLLAR SURPLUSES

Turning now for a look at the figures, as we all know, the overall payments surplus of the oil exporters fell sharply in 1975. Some observers now believe that the overall surplus is likely to disappear completely in a few years. In any event, it is quite clear that the magnitude of the surplus—and the magnitude of the problems arising from the surplus—are much smaller than predicted earlier. Whatever the case, I don't think we should devote too much time attempting to predict with any precision the eventual size of the cumulative surplus and the time of its peaking. There are too many imponderables to rely heavily on such long-range forecasts. The future course of oil prices, of oil production, of oil demand, as well as the level of OPEC imports, all of which are crucial elements in the equation, will be influenced by many factors, each of which can be perceived only dimly at this time. To emphasize too heavily that the total OPEC surplus is likely to disappear in the not-too-distant future may divert attention from the problems that we still face. In the same vein, the earlier forecasts of huge and never-ending surpluses may well have weakened efforts to tackle the immediate issues by making the problems seem unmanageable.

In 1975, the sharp reduction of the OPEC surplus re-

flected a number of factors. First of all, on the demand side, the steep recession in the industrial countries reduced industrial use of all forms of energy.¹ In addition, the relatively warm 1974-75 winter helped reduce fuel consumption for heating. At the same time, the natural market demand response to higher prices finally began to appear in significant degree. Both industrial users and individuals particularly the former, made serious efforts to economize in their energy consumption. The price elasticity of demand for oil is no doubt considerably larger in the longer run than we at first surmised, or than we have seen so far. Thus we should have some further effects along this line. Beyond the market reaction, government-led energy conservation programs have also begun to dampen oil demands. So far, these have been more effective abroad, especially in Europe and Japan, than in this country.

As a result of all these factors, OPEC oil production in 1975 fell to 70 percent of capacity,² the volume of OPEC oil exports declined by more than 10 percent from 1974, and the value of oil shipments fell by about 5 percent, even in the face of increased oil prices in the course of the year.³

On the other side of the ledger, the surge of OPEC imports was also a major factor in diminishing the surplus. Last year OPEC merchandise imports probably exceeded \$60 billion, compared with some \$37 billion in 1974 and \$20 billion in 1973. A rise in import prices contributed to this increase in dollar amount, although the rate of price increases appears to have slowed down last year. The rate of increase in the volume of OPEC imports, on the other hand, continued unabated; in 1975 the volume of imports was more than double that of two years previously.

Given the limited port facilities of the OPEC countries, this jump in their imports has been rather remarkable. Headlines emphasize the port congestion in these countries, and a visitor can indeed see the long lines of freight-

¹ The extent of the recession is illustrated by the fact that the volume of world trade in 1975 showed the first significant drop (estimated at 6-7 percent) since the end of World War II.

² OPEC oil production apparently amounted to a little more than 26 million barrels per day, as against the 1973 peak of more than 30 million barrels per day.

³ The 1975 figure for oil shipments is estimated at about \$100 billion on a transactions basis. This estimate differs from estimated cash revenues because oil payments lag shipments. This difference, which appears to have been more than \$10 billion in 1974 because of the large price increase at the end of 1973, was substantially smaller last year.

ers in the harbors waiting to unload. But a visitor to some of the OPEC countries also becomes aware of the ingenuity beginning to be shown in speeding the unloading of shipments from abroad. The use of containerized barges, floating docks, and other similar devices is spreading, although serious problems of congestion remain.

American inventiveness is playing an important role in resolving many of these problems, just as American industry is contributing to the upsurge in OPEC imports in general. On my latest visit, I was a little disappointed to observe scattered indications that United States manufacturers may not be holding their own against those of other industrial countries. Until recently at least (current figures are hard to come by), the already large United States share in OPEC imports had risen somewhat further. But I wonder whether we are making as much of an effort to participate in these rapidly growing markets as we could. A visitor to these countries is struck by the growing inroads made there by Japanese and European products and services.

With the continuing rapid growth of OPEC imports and the decline in their oil exports in 1975, the OPEC current-account surplus—on a transactions as distinct from a cash basis—appears to have been almost halved in 1975, perhaps to \$35 billion from the almost \$70 billion level of 1974.⁴ For 1976, the prospect would seem to be for little change in this net surplus. Unless the recovery in the industrial countries gathers speed considerably faster than is now generally anticipated, OPEC oil income is likely to grow no more than some 15-20 percent (about \$15-20 billion), assuming the present level of oil prices.

At the same time, it would be surprising if total OPEC imports in 1976 increase significantly more than the increase in their oil income. Even though it seems clear that the long-run import capacity of these countries is substantial,⁵ a slowdown in the growth of OPEC imports is likely. Worldwide inflation has lessened, and this will keep down the rise in OPEC import prices and thus in import values. More fundamentally, a number of the "high absorber" countries are close to balance in their

external accounts and are already taking steps to moderate their import expansion. Furthermore, all OPEC countries are finding that their internal development efforts are creating domestic inflationary strains that will probably cause them to slow down their development plans.

Looking at last year's surplus on a cash basis (rather than a transactions basis), the total for 1975 came in at about \$30 billion. This compares with \$55 billion in 1974.⁶ This is the amount of the "investable surplus"—the amount that OPEC countries actually have available to make new investments abroad. For obvious reasons, it is a figure of great interest to all of us involved in the international financial markets.

The disposition of the OPEC investable surplus—or the composition of OPEC investments—has now changed greatly, both in geographic terms and in the types of assets utilized. In the first place, the accrual of the surplus itself has become much more concentrated. Saudi Arabia, Kuwait, and the United Arab Emirates accounted for the bulk of the OPEC cash surplus in 1975. Several of the OPEC countries—Algeria, Ecuador, Indonesia—swung into deficit. A few others, including Iran and Venezuela, were coming close to balance. A number of OPEC countries have in fact already entered the international financial markets as borrowers rather than investors—Algeria, Ecuador, Indonesia, Iraq, and Iran. The desire to solidify their credit standing at this early stage has been an important reason behind these moves.

As for the area distribution of OPEC investment funds, new sterling investments in the United Kingdom—as opposed to the Euro-sterling markets—appear to have stopped, although apparently there has not been any substantial disinvestment. According to the Bank of England,⁷ OPEC sterling investments in the United Kingdom are estimated to have actually declined by \$0.8 billion in the second and third quarters of 1975, after having risen the same amount in the first quarter. In 1974 such investments had risen by \$6 billion.

OPEC placements in the Euro-currency markets have continued, but at a slower pace. For 1975 they may be roughly estimated at less than \$10 billion, or about 30 percent of the investment total. In 1974, in contrast, the Euro-currency markets had received the prime share of

⁴ Current account defined to include transactions in goods and services and private transfers.

⁵ On this point, we should be paying more attention to the ability of the industrial countries to satisfy the growing demands for imports by these countries and to the possible strains on capacity in the industrial countries that could well develop as time goes on.

⁶ OPEC grants to the LDCs are not included as part of this investable surplus; that is, they are counted as an outflow before the line is drawn to calculate the size of the surplus. Grants and other aid to the LDCs are discussed below.

⁷ *Quarterly Bulletin* (December 1975).

OPEC investments, estimated at \$23 billion or over 40 percent of the total.

The United States share in the placement of OPEC funds in 1975 appears to have stayed close to the 20 percent of 1974; in absolute terms such placements may be put at about \$6 billion in 1975, as against \$11¼ billion in 1974. At the same time, there have been significant changes in the portfolio distribution of OPEC placements in the United States, in the share of individual OPEC countries in aggregate investments, and in the maturity pattern of OPEC holdings here.

As to changes in OPEC portfolio preferences, last year there was a pronounced shift from time deposits in United States banks to investments in Government and Federal agency securities. In 1974, as much as 40 percent of OPEC placements in the United States took the form of time deposits. In 1975, such holdings appear to have remained about stationary. Aggregate holdings of Government and Federal agency securities, on the other hand, increased by more than \$4 billion in 1975. The great bulk of these securities are held by the Federal Reserve Bank of New York. The Bank, as you know, maintains accounts for all of its foreign central bank correspondents and provides investment facilities for them in United States Treasury and agency securities.⁸

An even more significant change in OPEC investment patterns is reflected in the dramatic surge of equity purchases by a small number of OPEC countries in the Middle East. During the first ten months of 1975, reported purchases of equities by residents of OPEC countries exceeded \$1 billion, and no doubt additional amounts were indirectly acquired through European banks.⁹ I have the general impression—which cannot be substantiated by reported statistics—that for 1975 as a whole total OPEC equity investments in the United States may well be double that figure. While our statistics do not give any indication as to whether these securities have been acquired by official agencies or private investors, it is likely that the bulk of these purchases were for official accounts. These are portfolio investments and have not been made for the purpose of acquiring control of individual companies. They appear to be spread among a range of securities, and aggregate holdings of the shares

of individual corporations appear to account for only a negligible proportion of their outstanding stock. I should add that these official equity purchases in the market on this scale are without precedent in the administration of the financial reserves of central banks and governments. They would appear to be a not inappropriate innovation on the part of countries such as these, who wish to find a profitable outlet for their national savings which they do not plan to draw on for many years to come. Such investments, moreover, also contribute to the basic strength of our stock market.

Another significant aspect of OPEC investments in the United States during 1975 is the increasing concentration of placements here by a relatively few countries in the Gulf area. Actually, the acquisition of securities by these countries—as reflected in holdings at the Federal Reserve Bank of New York—exceeded by a substantial margin the aggregate increase in OPEC holdings in this country. In other words, during 1975 several OPEC countries in areas outside the Middle East drew down their holdings as one would have expected in the light of well-publicized changes in their financial position.

The composition of securities held in custody for OPEC countries at the Federal Reserve Bank of New York also indicates a substantial lengthening of maturities. This is in line with an apparent lengthening of maturities of OPEC investments generally. Of the total OPEC investment portfolio in the United States at the end of 1975, long-term Treasury, Federal agency, and private securities accounted for more than one third. At the end of 1974, the comparable proportion was a little more than 10 percent.

OPEC investments in the United States, the United Kingdom, and Euro-currency markets combined thus came to about one half of the total OPEC surplus in 1975. Of the remaining \$15 billion—the other half—an estimated \$2 billion was “diversified” as investments in the domestic markets of countries other than the United Kingdom or the United States, such as Germany or Switzerland. The amounts of these placements are rough approximations because we have no detailed statistics on such figures.

The remainder—approximately \$13 billion—was placed with international institutions, such as the IBRD and the IMF, and as financial assistance in the form of loans to other countries.¹⁰

⁸ At the end of 1975, securities held in custody for about 130 foreign and international accounts held at the Federal Reserve Bank of New York totaled \$68 billion.

⁹ In 1974 the reported purchases amounted to only a few hundred million dollars.

¹⁰ Details of financial assistance to the LDCs are discussed below.

THE PROBLEMS OF THE LDCs

As the payments surplus of the OPEC countries fell sharply, its counterpart—the overall payments position of all of the oil-importing countries—changed substantially. The current-account balance of the industrial countries as a group swung abruptly from a deficit of about \$11 billion in 1974 to a surplus estimated at more than \$15 billion in 1975.¹¹ This change reflected the rise in the industrial countries' exports to OPEC and the influence of recession in keeping down their overall imports. A second group of relatively well-off countries, the so-called more developed primary-producing countries ranging from Australia to Yugoslavia, apparently saw little change in their large current-account deficit, which in 1974 had approached \$15 billion.

In contrast, the poorest group of the world's countries, the oil-importing LDCs, suffered yet another deterioration in their already large balance-of-payments deficit. In 1975 their deficit approached about \$35 billion, compared with \$28 billion in 1974 and \$9 billion in 1973. This serious deterioration of these countries' external position reflects a combination of adverse developments—the rise in oil prices and worldwide inflation raised the price of their imports, and the recession weakened the markets for their exports, with exports falling both in value and volume terms.

The quintupling of oil prices since 1973 added an estimated \$12 billion to these countries' annual oil import costs. The higher prices of their other imports, whether essential raw materials like fertilizer, or food or manufactures, added some further \$25 billion to the cost of their imports. In 1974 the LDCs had been able to more than offset the higher costs of their imports from the developed oil-importing countries through higher prices of their exports, as they reaped the benefits of the 1973-74 commodity boom. But in 1975, as the commodity boom collapsed, their export prices fell. The prices of their imports, however, continued to rise. As a result, their terms of trade—the change in export prices relative to the change in import prices—deteriorated sharply in 1975 by more than 10 percent. This deterioration followed a 4 percent deterioration in 1974 that stemmed from the jump

in oil import prices. The worldwide inflation also eroded the real value of the economic aid they received and reduced the purchasing power of their external reserves. This cost to them was only partly offset by the reduction in the real costs of their debt burden that inflation brings about.

The situation of the LDCs is serious, but one can no longer regard them uniformly. Within this group, a significant number of countries—ranging from Brazil to Taiwan—have been able, through a combination of circumstances since the 1960's, to make significant breakthroughs in their economic development. Their industrialization and export diversification has brought them to the point where their annual rates of growth in real incomes approach or even surpass 10 percent. The oil crisis and the recession sharply slowed their growth in 1974 and 1975. But they have a cushion of external reserves and have retained their internal momentum. As the world economy recovers, it is a reasonable expectation that these so-called middle-income LDCs will be able to resume their relatively rapid growth.

The situation is quite different for the low-income LDCs that have per capita incomes of less than \$200 per annum. These countries, ranging from Bangladesh to Zaire, have a total population of one billion. Unlike the middle-income countries, most of them did not benefit from the 1973-74 commodity boom, and their growth, slow as it had been previously, came to a complete stop in 1974 and 1975. Their prospects, internal and external, are critical. According to World Bank estimates, even if total economic aid to these countries increases in money terms sufficiently to maintain its real value, the real per capita annual income growth will hardly exceed 1 percent in the remainder of this decade. This is indeed a grim outlook. The longer term outlook is particularly problematical, given the immediate difficulties these countries face in the financing of their swollen external deficits.

In 1975 the oil-importing LDCs as a whole managed to finance their deficits with only a moderate drawing-down of their external reserves, an estimated \$3 billion out of a total of some \$30 billion at the beginning of the year. They had to cut back the volume of their imports, apparently by more than 5 percent, but they obtained larger amounts of international assistance which may be estimated at about \$17 billion, and were able greatly to increase their borrowing from private lenders, possibly to as much as \$14 billion. As the recovery in the industrial countries takes hold and they increase their imports, the general expectation is that the overall deficit of the LDCs will decline. This is a reasonably safe assumption, but it is unlikely that this decline will be very great. Despite the

¹¹ The current account is defined to include goods and service transactions and private transfers. The current-account positions of all the major industrial countries, except Canada and Germany, strengthened in 1975. The United States experienced the largest change, as its surplus rose from \$2 billion to an estimated \$15 billion.

hazards of forecasting, one can estimate that LDCs will face a current-account deficit in 1976 of around \$30 billion, as against an estimated \$35 billion in 1975.

What are the prospects for the two main sources of financing the LDCs' deficits: official assistance and private lending?

Official financing, as I indicated, may have reached \$17 billion last year, and of this IMF financing came to about \$2 billion. This took place partly through the special oil facility, to which both OPEC and OECD countries contributed,¹² and partly through regular IMF channels. The oil facility is due to be phased out, and therefore primary reliance will have to be placed on the basic IMF quota facilities—which were expanded by the Jamaica agreement yesterday—and the new plans for an IMF trust fund and an expanded compensatory financing facility. It seems clear that IMF financing will have to play an important role, as was recognized at the Jamaica meetings.

The prospects for further growth in total assistance provided by both the OECD and the OPEC countries, bilaterally or multilaterally, are not very bright. The OECD countries as a whole appear to have somewhat increased their total aid in monetary terms, although as a proportion of their GNP their aid remains substantially below the target agreed upon for the 1970's.¹³ Little change appears on the immediate horizon.

The OPEC countries expanded their total assistance to over \$9 billion in 1975 from \$7 billion in 1974, including their actual contribution (\$2.6 billion in 1975 and \$1.8 billion in 1974)¹⁴ to the IMF oil facility, which is utilized by developed as well as developing countries. This total assistance in 1975 came to about 5 percent of their GNP and 9 percent of their oil exports. About a third of this aid total was in the form of grants and loans at concessionary interest rates. Bilateral aid appears to

be an increasing proportion of the total, accounting for about one third. With respect to multilateral aid, not counting the IMF oil facility, OPEC resources appear to be increasingly channeled through special institutions set up and administered by OPEC countries.¹⁵ While the bulk of total concessionary aid by OPEC countries continues to be given to a few Arab countries, the proportion directed to non-Arab low-income developing countries is rising.

As OPEC surpluses diminish, only a few OPEC countries will be in the position of being able to provide assistance out of external revenues that are not immediately needed domestically. In 1975 the larger part of OPEC concessionary aid was provided by three countries, Saudi Arabia, Kuwait, and the United Arab Emirates. The concentration is less if loans at market rates are included. Several OPEC countries, including Iran, have now scaled down their external assistance. While the OPEC countries by and large recognize their international responsibilities in this regard, their foreign-aid programs will undoubtedly come under increasing pressure from competing domestic needs. In 1976 their total aid disbursements are likely to rise somewhat further, simply because their aid commitments continued to rise through the first part of last year. But beyond that, it would hardly be realistic to expect further substantial growth.

THE ROLE OF THE INTERNATIONAL BANKING SYSTEM

The other main source of financing the LDCs deficits is the private sector. When the world community first faced the problem of financing the greatly enlarged payments deficits of the oil-importing countries in early 1974, there were serious questions of how large a role the private markets could play. Areas of concern included the possible instability of the new OPEC deposits, the restraints on banks of declining capital-deposit ratios, the creditworthiness of borrowers, and the advisability of private lenders engaging in large balance-of-payments

¹² For 1974 and 1975 total contributions, not all drawn down, to the IMF oil facility totaled \$7¼ billion, of which almost \$6 billion came from OPEC countries.

¹³ Grants and concessionary loans, so-called official development assistance, appear to be about ⅓ percent of GNP for the OECD countries as a whole, as against the 0.7 percent target.

¹⁴ These figures are based on estimates of actual disbursements; total commitments for financial assistance are considerably greater. Total commitments by the OPEC countries to provide financial assistance of all forms—concessional and nonconcessional—to the nonoil LDCs, according to a report by UNCTAD, amounted to \$14.9 billion in 1974 and \$10.7 billion in the first six months of 1975. ("Financial Cooperation between OPEC and Other Developing Countries", October 29, 1975.)

¹⁵ By latest count the following official institutions have been established: Arab Bank for Economic Development in Africa, Arab Bank for Investment and Foreign Trade, Arab Fund for Economic and Social Development, Arab Fund for the Provision of Loans to African Countries, Arab Investment Company, Arab Fund for Technical Assistance to Arab and African Countries, Arab Petroleum Investment Company, Inter-Arab Investment Guarantee Corporation, Islamic Development Bank, Islamic Solidarity Fund, League of Arab States Emergency Fund.

financing.¹⁶ The international banking system did indeed experience some serious strains in the middle months of 1974, but these stemmed largely from the turmoil and excesses in the foreign exchange markets at that time. In any case, the shock of a few bank failures (Franklin, Herstatt) led to an improvement in market practices in general. Margins in the Euro-currency markets, which competition had reduced to abnormally low levels, were widened and lending terms were tightened generally. The role of some marginal lenders was reduced and a more careful appraisal of credit risks became a general practice. At the same time OPEC countries' deposits did not turn out to be volatile and the creditworthiness of many borrowers was strengthened by enlarged official financing facilities and by their constructive domestic policies.

International bank credit expansion in the Euro-currency markets and by banks in the United States slowed down markedly in 1975. The total of publicly announced new Euro-currency credits came to some \$20 billion in 1975 (as against \$29 billion in 1974), and loans extended to foreigners by United States banks totaled some \$3 billion (as against almost \$12 billion in 1974). In contrast, activity in the international bond markets accelerated to some \$18 billion in 1975, from only \$7 billion in the preceding year.

Within the reduced total of international bank credit in 1975 the oil-importing LDCs were able to expand their international borrowings quite substantially. They obtained over \$8 billion in publicly announced Euro-currency credits, as against some \$4½ billion in 1974. From banks in the United States these countries borrowed some \$5 billion, about the same as in the preceding year. The oil-importing LDCs also marketed about \$½ billion in international bonds in 1975.

From now on private lending to the LDCs will come under increasing restraints, and it appears doubtful that they will be able to raise anywhere near the same record amounts in 1976. The restraints are likely to come both from the position of the borrowing countries and from the side of the lenders. The current debt service payments of the LDCs are already very high; they may be estimated at over \$10 billion a year on public and publicly guaranteed debt alone. The indebtedness of some of these countries is now so large that their interest and debt

repayments exceed 20 percent of their total foreign exchange receipts. In some cases there is a clear need for debt restructuring and, as you know, discussions along these lines have in a few cases been under way for some time. A large number of these countries undoubtedly can now expect little if any help from private lenders. They are entirely dependent on official financing.

Some of the middle-income LDCs retain their relatively good credit ratings and will in all probability want to continue to raise funds from private lenders. In 1976, however, they may face increasing competition from other borrowers. These will include private borrowers in the industrial countries as the recovery proceeds, some of the OPEC countries that are returning to the borrowing side, the various communist countries that entered the market in large volume last year, and finally some of the OECD countries themselves.

The international banking system can thus expect a growing demand for loans from various types of borrowers this year. And the question has been raised as to the extent to which it will be able to accommodate these demands. As far as the Euro-currency markets are concerned, it would seem that a loan expansion of about the same magnitude as in 1975 is entirely possible. Because of increased domestic demands in the United States, banks may not wish to channel as much of their funds to the Euro-markets through their branches. But as happened so often before, a reduction in the flow from the United States is likely to be replaced by other inflows. All in all, despite some continuing problems, the Euro-banks should be able to continue to accommodate good borrowers. The maturity of deposits has lengthened, equity positions have strengthened, and earnings remain in general reasonably healthy, notwithstanding increased provisions for loan losses. Data for some of the major United States banks illustrate this position. Thus for the New York money market banks the capital-funds-to-deposits ratio, which turned up in 1975 after having declined sharply in the two preceeding years, reached 6.6 percent at the end of September 1975, as against 5.9 percent at the end of 1974. Moreover, the net income of these banks for the first nine months of 1975 increased by a remarkable 18.2 percent, notwithstanding record charges against income to provide for possible loan losses. The earnings picture for the fourth quarter has, of course, been much weaker as actual loan charge-offs and loan loss provisions have increased sharply. Nevertheless, most of the major United States banks have recorded substantial earnings gains for 1975 as a whole, and have entered 1976 with stronger loan loss reserves than a year earlier.

¹⁶ I reviewed these in an address on "International Banking" before the Banking Law Institute in New York City on May 8, 1975. See *Monthly Review* (June 1975), pages 122-29.

THE SOUNDNESS OF BANKING SYSTEMS

Banking systems throughout the world have remained sound despite the recent tests to their resilience and the possibility that lending problems may arise in the future, whether with respect to the LDCs or to some other source in this uncertain world. These tests have spurred bank managements and national supervisory authorities to take actions to ensure that operating procedures will provide for adequate liquidity and solvency in the face of a constantly changing banking environment. A number of countries are revising their banking laws or otherwise modernizing their supervisory apparatus in the light of the increasing importance that international transactions have assumed in the banking business. In this country, for example, our examiners' training now gives added emphasis to the international aspects of bank operations, and our supervisory authorities have been working with banks to develop minimum standards for operational safeguards in foreign exchange trading.

Central banks of the Group of Ten countries, along with other supervisory authorities from these countries, have also been working as a committee to provide more

secure banking systems. The committee, in meetings at the Bank for International Settlements, has agreed on the need for international cooperation in the supervisory field; representatives have exchanged and discussed information on national supervisory developments and have agreed to cooperate in an "early warning system" to heighten official awareness of banking difficulties.

I think we can all agree that the health of the international banking system is vital for the health of the world economy as a whole. We have managed to overcome some difficult obstacles in the last few years. With the newly developed cooperation of the monetary authorities in the oil-producing countries, we have been able to cope with the financial problems of petro-dollar accumulations and flows. So far, we have managed also to cope with the problems of financing the LDCs; while we may be approaching the limits of these efforts by the private sector for some of the LDCs, the Jamaica agreements provide for further official financing possibilities for these countries. All of us involved, private and central bankers alike, and whether in OECD, OPEC, or LDC areas, must strive to ensure that the international banking system retains its basic strength and soundness, while adapting to the changing needs of changing times.

The Business Situation

The pace of the economic recovery apparently picked up toward the year-end, following a marked slowdown in the fall. In December, there were sizable gains reported in nonagricultural employment, the average workweek, and overtime hours. To be sure, the unemployment rate held steady at 8.3 percent, but this reflected an outsized December increase in the civilian labor force. At the same time, retail sales surged ahead on a wide front, including an advance in domestic car sales. Retail sales had exhibited only modest increases between July and November, while automotive sales were virtually flat. In coming months, continued growth in consumption spending seems likely now that a compromise has been reached on tax legislation between President Ford and the Congress. Under this agreement, the 1975 tax cuts will be extended to the end of June of this year, and the Congress issued a promise to consider limits on Federal Government spending in fiscal 1977.

In the price area, a major source of near-term uncertainty was also cleared up when the President signed the Energy Policy and Conservation Act into law on December 22. The new legislation establishes an upper limit on the average price of domestically produced oil which is more than \$1 per barrel lower than the average price prevailing at the end of 1975. It also provides for some rather modest increases in domestic oil prices over the longer term. At the same time, the Administration has removed the \$2 per barrel duty on imported oil. The near-term impact of these actions will probably be a reduction in crude oil prices; in the absence of the new legislation, there would have been a major inflationary shock as a result of immediate decontrol.

The recent price news has been reasonably favorable on balance. In December, wholesale farm and food prices fell substantially for the second consecutive month; industrial wholesale prices continued to rise more rapidly than earlier in the year but sharply below 1974 rates of advance. In November, retail prices of commodities other than food continued their recent, quite moderate performance. Retail food prices, however, while rising less

than in October, still showed a somewhat disappointingly rapid advance. Looking ahead, the current projections of the Department of Agriculture indicate a relatively modest 4 to 5 percent annual rate of increase in retail food prices in the first half of 1976, less than half the rise recorded in the second half of 1975. Of course, these estimates are subject to substantial change because of weather conditions and other unforeseen developments.

CONSUMER SPENDING AND RESIDENTIAL CONSTRUCTION

After a brief respite in the fall, consumption spending has lately shown renewed signs of vigor. Indeed, seasonally adjusted retail sales spurted 3.5 percent in December, the sharpest monthly advance since July 1973. By comparison, from July to November the rate of growth in consumption spending had amounted to a sluggish 1.4 percent, virtually all of which was attributable to higher retail prices. The December surge in retail sales was paced by the huge 11.3 percent increase in the automotive sector. Sales of domestic automobiles in December totaled 8.2 million units at a seasonally adjusted annual rate, up 7.9 percent from the preceding month and the highest rate since August 1974. Sizable gains were also recorded in December in sales of both department stores and furniture and home-furnishings stores.

Consumers can now look forward to a continuation of the 1975 tax cut, at least for a while, as a result of the recent compromise worked out between the Congress and the President. Under the compromise, President Ford agreed to extend the tax cut through June 30, 1976. In return, the Congress promised that, should it continue the tax cut beyond this date, it would consider reducing expenditures by an equal amount. Had this agreement not been reached, consumers' tax liability for the first half of 1976 would have jumped by approximately \$7 billion. Also scheduled for this year is another increase in social security taxes under legislation that was passed at the end of 1973. In 1975 social security taxes were collected

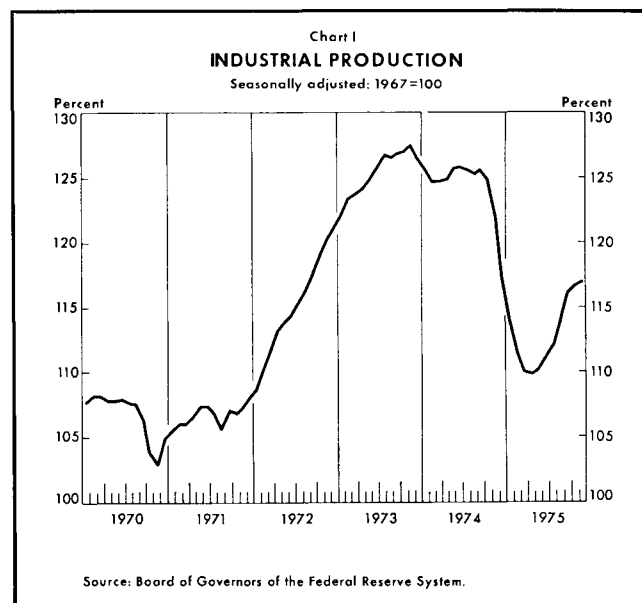
on only the first \$14,100 of wages and salaries, but in 1976 these taxes will be collected on the first \$15,300. The higher ceiling will lower spendable income in 1976 by about \$1 billion, most of which will take effect in the second half of the year.

Residential construction seems to be gradually recovering from the battered condition it was in at the end of 1974. In November, housing starts slipped by 82,000 units to a seasonally adjusted annual rate of 1.38 million units, but this was greatly overshadowed by the increase of almost 200,000 units in the previous month. Indeed, despite the November decline, the level of starts in that month remained significantly above the average level for the third quarter. Building permits rose in November, reaching their highest level in eighteen months. While housing starts rose substantially in the third quarter, the increase proceeded from a very low level, and the industry remains in a depressed state. The very high levels of mortgage interest rates currently prevailing may continue to exert a considerably dampening influence on the near-term housing recovery.

INDUSTRIAL PRODUCTION AND INVENTORIES

The Federal Reserve Board's index of industrial production posted a modest increase in November. Although production was up for the seventh consecutive month, the November advance amounted to a mere 0.2 percent, only one-fifth as large as the average gain of the previous six months (see Chart I). At this point, the pace of the current recovery is comparable to that of most previous postwar recoveries. However, while industrial production has risen 6.3 percent above the trough of April 1975, it still remains 8.4 percent below the November 1973 peak. Thus, if production were to continue to expand at the average rate of the past seven months, it would take an additional nine months before the previous peak would again be attained. Output of consumer durables, which has been a bulwark of the recovery, continued to climb in November despite a drop in the output of automobiles. At the same time, production of consumer nondurables was marginally higher. The output of business equipment rose slightly in November following a decline in the previous month. While equipment production has edged up from its July trough, it currently remains well below the peak levels of late 1974. The output of materials rose in November for the sixth consecutive month but by the smallest amount in this period.

The inventory adjustment process appears to be now largely completed, and some businesses have even begun to rebuild their inventory stocks, albeit at a fairly cau-



tious pace. In the retail trade sector, wherein the inventory liquidation had commenced at the beginning of 1975, physical stocks actually rose in the third quarter. Moreover, in October, the most recent month for which data are available, book value accumulation was about double the average gain in the three previous months. In fact, the ratio of retailers' book value inventories to retail sales has risen three months in a row. While there are conceptual problems in interpreting book value data (and book value to sales ratios) in inflationary periods, the most recent figures suggest a pickup in inventory investment in the retail sector. In the wholesale trade sector, the aggregate book value of inventories has risen in the past three months following declines in all but one of the previous seven months. Book value inventories for manufacturing inched up for the second month in a row in November after seven months of decline. Although inventories in the durable goods sector continued to slide, there seems to be an easing in the rate of liquidation. The November drop was the smallest in seven months and was more than offset by the buildup in nondurable goods manufacturing.

NEW ORDERS AND CAPITAL SPENDING

The flow of new orders received by durable goods manufacturers declined in November, after rising in the previous month. To a large extent, this seesaw pattern has reflected the monthly movements in export orders for

nonautomotive durable goods. Excluding new defense bookings, durable goods orders fell \$1.4 billion in November, which was more than enough to offset the \$1 billion increase in the preceding month. Looking at the record of the current recovery, total durables orders bottomed out last March, spurted \$6.7 billion from then until August, and declined \$1.4 billion from then until November. This pattern is not at all unusual inasmuch as similar ones occurred in the 1955, 1961, and 1971 recoveries. Since shipments in November exceeded new orders, the backlog of unfilled orders edged downward, further continuing the pattern evidenced throughout most of 1975.

Capital spending remains weak, and there are no signs of any exuberance in this sector. According to a recent survey conducted by The Conference Board, net new appropriations for new plant and equipment by the nation's 1,000 largest manufacturers continued to fall in the third quarter, although the decline was the smallest of four consecutive drops beginning in the fourth quarter of 1974 (see Chart II). Actual capital outlays by large manufacturers were up slightly and exceeded net new appropriations, so that the backlog of unspent appropriations declined for the fourth consecutive quarter. Despite these declines, the backlog remains at a relatively high level, suggesting

that many projects might have been postponed rather than canceled. For the economy as a whole, real capital spending leveled off in the third quarter, and the October-November Department of Commerce survey points to at least some real growth in capital spending over the first two quarters of the year. On the other hand, a more recent Commerce Department survey indicates a modest decline in real spending for the year as a whole, a development which would be highly unusual at this stage in the recovery.

LABOR MARKET

Labor market conditions strengthened appreciably in December, thus ending the year on a positive note. According to the establishments survey, about 240,000 workers were added to the payrolls of businesses in the private nonfarm sector in December. This advance was fairly widely based, and was about one-third larger than the average monthly increment recorded in earlier months of the recovery. Besides hiring more workers, businesses also extended working hours. The average workweek for the private nonfarm economy lengthened in December for the third consecutive month. Within the key manufacturing sector, the average workweek increased 0.4 hour to 40.3 hours, an unusually large monthly advance. In the separate survey of households, the gain in employment amounted to about 230,000 workers, following the slight decline of the previous month. Nevertheless, because of the proportionately equal increase in the civilian labor force, the overall unemployment rate held steady at 8.3 percent. Since peaking at 9.2 percent in May, the unemployment rate has varied between 8.3 percent and 8.6 percent in subsequent months. For the year as a whole, the unemployment rate averaged 8.5 percent, up 2.9 percentage points from the previous year.

Although unemployment certainly remains high by historical standards, the overall unemployment rate appears to overstate to some extent the current degree of labor market slack, compared with earlier years in the postwar period. Over the past two decades, women and teen-agers have constituted an increasing proportion of the labor force. These workers change jobs more frequently than adult males do and also tend to enter and leave the labor force more often. Because an unemployed person is defined as one who is jobless but is looking for work, the relatively frequent spells of looking for new jobs result in higher unemployment rates for women and teen-agers. As the labor force share of these groups rises, so too does the overall unemployment rate. Chart III compares the official unemployment rate with a fixed-weight measure which weights the unemployment rates of the major age-sex

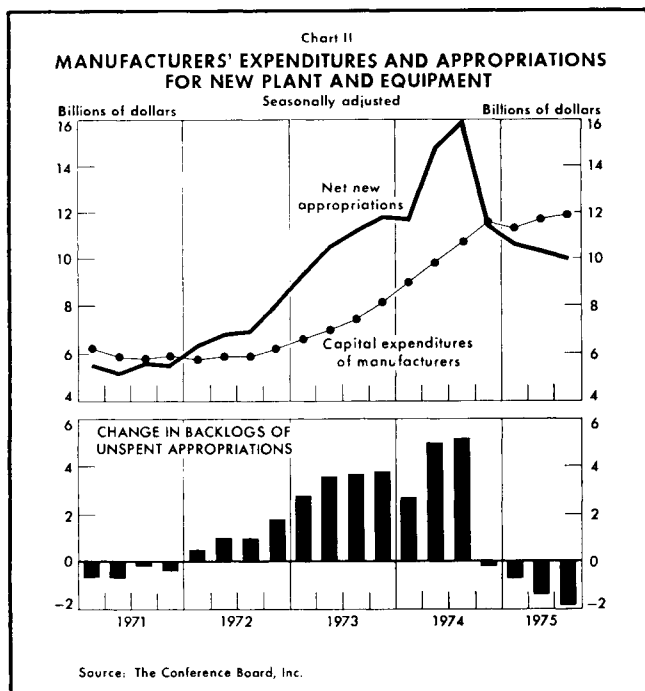
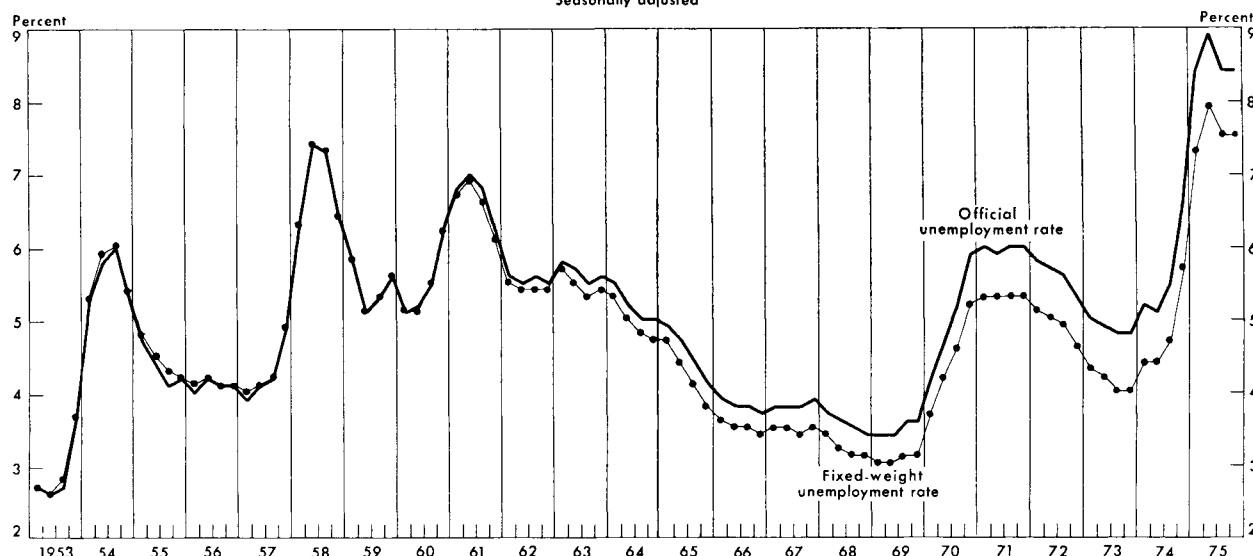


Chart III
A COMPARISON OF OFFICIAL AND FIXED-WEIGHT RATES OF UNEMPLOYMENT
Seasonally adjusted



Note: The fixed-weight unemployment rate was calculated by the staff of the Federal Reserve Bank of New York, using as relative weights the 1956 age-sex composition of the labor force.

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

groups by their relative importance in the labor force in 1956. This latter measure provides a comparison over time, which abstracts from those changes in the overall unemployment rate that arise from relative shifts in the labor force. Based on the age-sex composition of the labor force in 1956, the peak unemployment rate in 1975 was not very much higher than the maximum rates in 1958 and 1961. At the same time, the jobless rate for men aged twenty-five and older has been about equal to the peak rate in 1961 but below the 1958 rate. At least in some respects then, the current degree of labor market slack is roughly comparable to the 1958 and 1961 experiences.

PRICES

The latest readings on inflation are moderately encouraging on balance. At the wholesale level, prices declined 0.6 percent in December. This decline entirely reflected the large drop in the prices of farm products and of processed foods and feeds. At the same time, the rate of growth of industrial wholesale prices stood at 0.6 percent. This was essentially unchanged from the November advance but remained below the increases recorded in the

preceding three months. Among industrial commodities, the largest price increases were posted for lumber and wood products, pulp, paper, and allied products, and cigarettes. The growth in prices of fuel and power continued to be moderate after their sharp midyear flare-up.

Consumer prices rose at a 0.7 percent seasonally adjusted rate in November, a rate of gain about the same as the October advance but somewhat faster than the two previous months. Prices of consumer services rose 1.1 percent in the month, reflecting higher prices for automobile insurance, telephone service, parking, and hospital care as well as higher mortgage interest rates and property taxes. While the pervasiveness of these increases is somewhat disturbing, services prices had been rising at more moderate rates in recent months—apart from the September spurt which largely reflected the New York City subway fare increase. Nonfood commodity prices continued the very modest pattern of increases exhibited in recent months. The November monthly increase of 0.3 percent brought the three-month growth rate of these prices to a seasonally adjusted annual rate of 3.7 percent. Food price increases moderated to a 0.6 percent seasonally adjusted rate after increasing more rapidly in the

previous month. According to the Department of Agriculture, retail food price gains are expected to slow to a 4 to 5 percent annual-rate range in the first half of 1976. This would be about half as fast as the rate of growth recorded for the second half of 1975, compared with the first six months of the year.

In December, the Congress passed the new Energy Policy and Conservation Act, and the measure was signed into law at the end of the month. Many of the provisions of the new law will have a direct bearing on the cost of crude oil to domestic refiners. First, the bill imposes a ceiling on the average price of domestically produced crude oil of \$7.66 per barrel, which is more than \$1 below the average price prevailing at the end of last year. Under the Emergency Petroleum Allocation Act, there had been a price ceiling of \$5.25 per barrel on domestically produced "old" oil—i.e., oil produced from domestic wells but not exceeding the 1972 rate of output from these wells. If President Ford retains this ceiling, then the ceiling price for "new" oil would have to be set at about \$11 per barrel. Second, subsequent to the initial rollback, the legislation provides for modest increases in the average price of domestically produced oil. The new law allows the President to raise the ceiling on domestic crude oil prices by at most 10 percent per year until February 1977. From then on, the President can propose increases in the ceiling of

up to 10 percent per year, but the Congress has the power to limit the hikes to the overall rate of inflation. Third, to prevent domestic oil producers from taking advantage of the currently higher world price of oil, the new legislation directs the President to establish export restrictions on oil. At the same time the President signed the legislation, he also removed the \$2 per barrel duty on imported oil. In the very near term, it is clearly this latter action that will have the dominant impact on the price and quantity of imported crude oil. The physical volume of imported crude oil is likely to rise, and the cost to refiners should fall but perhaps by an amount less than the \$2 per barrel import fee. Thus, the immediate impact on the new energy bill will be a reduction in the average price of oil as a result of both the imposition of a ceiling price on new domestic oil and the removal of the import duty on imported oil. Over the longer haul, however, the supply of domestic oil might be reduced in response to additional domestic controls. For one thing, domestic oil suppliers might well expect higher oil prices at some future point when controls would be ended. In this case, there might be some implicit capital gain earned by merely "sitting" on the oil. Hence, domestic oil refiners would have to import additional oil from abroad, and the attendant increase in the effective price of crude oil would no doubt be passed on to consumers.

The Money and Bond Markets in December

Interest rates rose at the beginning of December, but declines later in the month more than offset earlier increases. Upward pressure on rates emerged early in December, when market participants became concerned that the Federal Reserve might tighten money market conditions if November's rapid growth of the monetary aggregates continued. At the same time, a large volume of new corporate and United States Government issues also contributed to these increases. Adding to supplies, several New York City pension funds sold corporate and agency securities in the secondary markets to raise money to invest in Municipal Assistance Corporation (MAC) bonds. The markets rallied around the middle of December when reports of weakness in the growth of the monetary aggregates, coupled with private forecasts that new corporate borrowing would be lower in 1976, fostered the belief that interest rates could well decline in the near term. As a result, yields on corporate and Treasury issues fell over the balance of December, closing the month below their end-of-November levels.

Yields on highly rated tax-exempt issues also moved downward on balance in December, but yields on lower rated issues continued to advance. Investors remained concerned about the financial backing of issues offered by municipalities and continued to show unusually strong preference for safer, highly rated issues. A New York State court upheld the deferral of principal and reduction of interest payments to holders of certain New York City notes. This decision is to be appealed, but it cleared the way by December 29 for an exchange of these notes for MAC bonds. In other developments, a package of business and bank taxes designed to help balance the state budget was passed by the New York State legislature and enacted into law.

According to preliminary estimates, the narrowly defined money stock (M_1) fell in December after advancing rapidly in November. Growth of the more broadly defined money stock (M_2) was modest, since consumer-type time and savings deposits expanded moderately. The bank credit proxy also grew at a modest pace.

THE MONEY MARKET AND THE MONETARY AGGREGATES

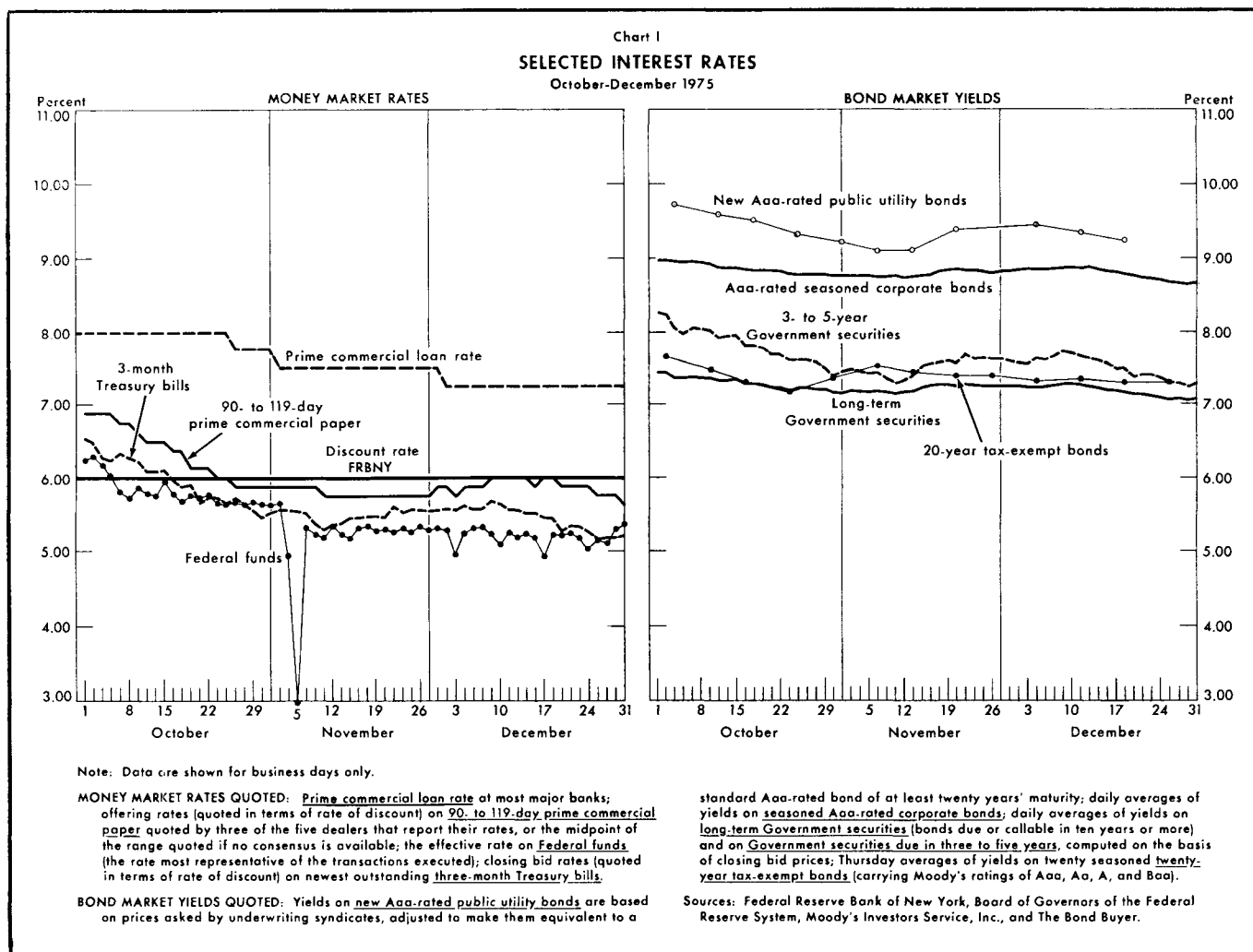
Interest rates on most money market instruments declined in December after rising in the early part of the month (see Chart I). The rate on 90- to 119-day dealer-placed commercial paper dropped about $\frac{1}{8}$ percentage point to 5.63 percent. Rates on bankers' acceptances fell $\frac{1}{4}$ percentage point over the month, while the average yield in the secondary market on ninety-day large negotiable certificates of deposit (CDs) declined $\frac{1}{2}$ percentage point to 5.68 percent. In comparison, the effective rate on Federal funds was relatively stable during the month and averaged 5.20 percent, compared with a 5.22 percent average in November. Federal funds continued to trade at rates substantially below the discount rate, and thus member bank borrowings from the discount window remained modest, although borrowings rose on Christmas eve in response to settlement day pressures (see Table I).

The demand for bank loans by businesses remained weak in December. Commercial and industrial loans at large commercial banks rose by \$1.1 billion in the four statement weeks ended December 31. A portion of this, however, reflected a rise in holdings of bankers' acceptances. Business loans excluding bankers' acceptances increased by \$0.5 billion. Over comparable periods in the preceding two years, these loans excluding bankers' acceptances showed an average increase of \$2 billion. At the beginning of the month, a number of large banks lowered their prime lending rates $\frac{1}{4}$ percentage point to $7\frac{1}{4}$ percent after a few money center banks had reduced their prime rates to this level at the end of November. Following midmonth, one large bank that had been quoting 7 percent raised its prime rate $\frac{1}{4}$ percentage point to the prevailing $7\frac{1}{4}$ percent. The volume of nonfinancial commercial paper outstanding fell by \$1.4 billion in the four weeks ended December 31. Year-end declines are normal in this series, which showed an average decrease of \$471 million over the similar period in the preceding two years.

Preliminary data suggest that M_1 declined in December, while the broader monetary aggregates advanced at a modest pace. M_1 —private demand deposits adjusted plus currency outside commercial banks—fell at an annual rate of 3.2 percent in December, after rising by 12.2 percent in the previous month. This brought the growth in M_1 in the four-week period ended December 31 from its average level in the four weeks ended thirteen weeks earlier to 1.6 percent at an annual rate (see Chart II). Consumer-type time and savings deposits at commercial banks grew at a moderate rate in December. Consequently, M_2 — M_1 plus time deposits other than large negotiable CDs—registered a modest gain of 3.2 percent. The average level of CDs also rose moderately in December,

and the adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain non-deposit sources of funds—increased at a 4.2 percent annual rate.

On December 24, the Board of Governors of the Federal Reserve System announced a reduction from 3 percent to 2.5 percent of reserve requirements on time deposits maturing in 180 days to four years. The new reserve requirement ratio is subject to the condition that in no case may the average of reserves on the total of time and savings deposits at any member bank be less than 3 percent, the minimum level specified by law. The action, which initially affected required reserves of member banks in the week that began January 8, 1976, lowered required reserves by



about \$340 million. In commenting on its move, the Board noted that the decision was in line with previous actions encouraging member banks to lengthen the structure of their time deposit liabilities. Since the last half of 1974, reserve requirements on time deposits have been changed on two previous occasions. These changes involved an increase in reserve requirements on time deposits with a maturity of less than six months and a reduction of reserve requirements on time deposits of various maturities of six months or longer.

THE GOVERNMENT SECURITIES MARKET

Yields on United States Government securities moved upward early in December, but subsequent declines more than offset earlier increases. At the beginning of the month, demand by investors was restrained, as they awaited announcements regarding the Treasury's borrowing plans and noted the sizable volume of planned corporate financing. On December 9, the Treasury announced that \$3 billion of new cash would be raised through coupon-bearing obligations during December. This financing involved an auction of \$2.5 billion of two-year notes on December 16—to replace \$1.5 billion of publicly held maturing notes and to raise \$1 billion in new cash—and an auction of \$2 billion of four-year notes on December 22. The offerings were larger than some participants had expected, and yields edged upward in the wake of the announcement. Toward midmonth, sentiment was buoyed by private forecasts that interest rates would decline early in 1976. Market participants were also encouraged by a large unexpected drop in M_1 . Yields of securities throughout the maturity spectrum adjusted downward, retracing earlier rises and ending the month generally 5 to 55 basis points lower.

Rates on Treasury coupon issues inched upward through mid-December, as dealers reduced their inventories of securities in preparation for the auctions of two- and four-year notes. Response to the \$2.5 billion of two-year notes sold at midmonth was favorable, with tenders from the public totaling \$4.3 billion. The notes were offered at an average yield of 7.28 percent, 27 basis points below the yield on a similar issue auctioned in mid-October. Demand by investors strengthened in mid-December and, reflecting this, the average issuing yield on the four-year notes was 7.50 percent. Over the month as a whole, the index of yields on intermediate-term Government securities fell 34 basis points to 7.28 percent. The index of long-term bond yields declined 19 basis points to 7.05 percent.

Movements in the yields of Treasury bills paralleled

Table I
FACTORS TENDING TO INCREASE OR DECREASE
MEMBER BANK RESERVES, DECEMBER 1975

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

Factors	Changes in daily averages—week ended					Net changes
	Dec. 3	Dec. 10	Dec. 17	Dec. 24	Dec. 31	
"Market" factors						
Member bank required reserves..	— 19	+ 267	— 631	+ 298	— 591	— 676
Operating transactions						
(subtotal)	+1,044	+1,936	— 423	—3,899	+ 195	—1,147
Federal Reserve float	+ 398	— 344	+ 275	+ 536	+1,516	+2,381
Treasury operations*	+ 901	+2,264	— 72	—3,603	—1,240	—1,750
Gold and foreign account	— 28	+ 62	— 1	— 10	— 39	— 16
Currency outside banks	— 71	— 256	— 452	— 740	+ 99	—1,420
Other Federal Reserve liabilities and capital	— 155	+ 209	— 172	— 82	— 141	— 341
Total "market" factors	+1,025	+2,203	—1,054	—3,601	— 396	—1,823
Direct Federal Reserve credit transactions						
Open market operations						
(subtotal)	—1,064	—2,536	+1,049	+3,643	+ 453	+1,545
Outright holdings:						
Treasury securities	— 105	—1,878	+1,616	+1,955	+ 398	+1,986
Bankers' acceptances	— 5	+ 2	+ 4	+ 3	+ 5	+ 9
Federal agency obligations	—	—	—	—	—	—
Repurchase agreements:						
Treasury securities	— 888	— 488	— 472	+1,446	— 77	— 479
Bankers' acceptances	— 28	— 108	— 49	+ 131	+ 114	+ 60
Federal agency obligations	— 38	— 64	— 50	+ 108	+ 13	— 31
Member bank borrowings	— 7	— 37	+ 15	+ 175	+ 37	+ 183
Seasonal borrowings†	— 4	— 7	— 1	— 2	—	— 14
Other Federal Reserve assets‡	+ 163	+ 207	+ 71	— 204	+ 115	+ 352
Total	— 908	—2,366	+1,135	+3,614	+ 606	+2,081
Excess reserves‡	+ 117	— 163	+ 81	+ 13	+ 210	+ 258
	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash‡	34,860	34,430	35,142	34,857	35,658	34,989
Required reserves	34,531	34,264	34,895	34,597	35,188	34,695
Excess reserves	329	166	247	260	470	294
Total borrowings	67	30	45	220	257	124
Seasonal borrowings†	22	15	14	12	12	15
Nonborrowed reserves	34,793	34,400	35,097	34,637	35,401	34,866
Net carry-over, excess or deficit (—)	117	195	140	148	119	144

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 December 21, 1975.

|| Not reflected in data above.

those of coupon obligations. In the second weekly bill auction held on December 8, the average issuing rate for three-month bills was set at 5.63 percent, about 10 basis points above the rate established in the last weekly auction in November. The shift to more optimistic market sentiment just before midmonth increased investor demand, and rates moved downward. At the weekly auction on December 29, the average yields on three- and six-month bills were 5.21 percent and 5.51 percent (see Table II), down 31 and 43 basis points, respectively, from the last auction in November. Over the month as a whole, yields on most bills fell 32 to 55 basis points.

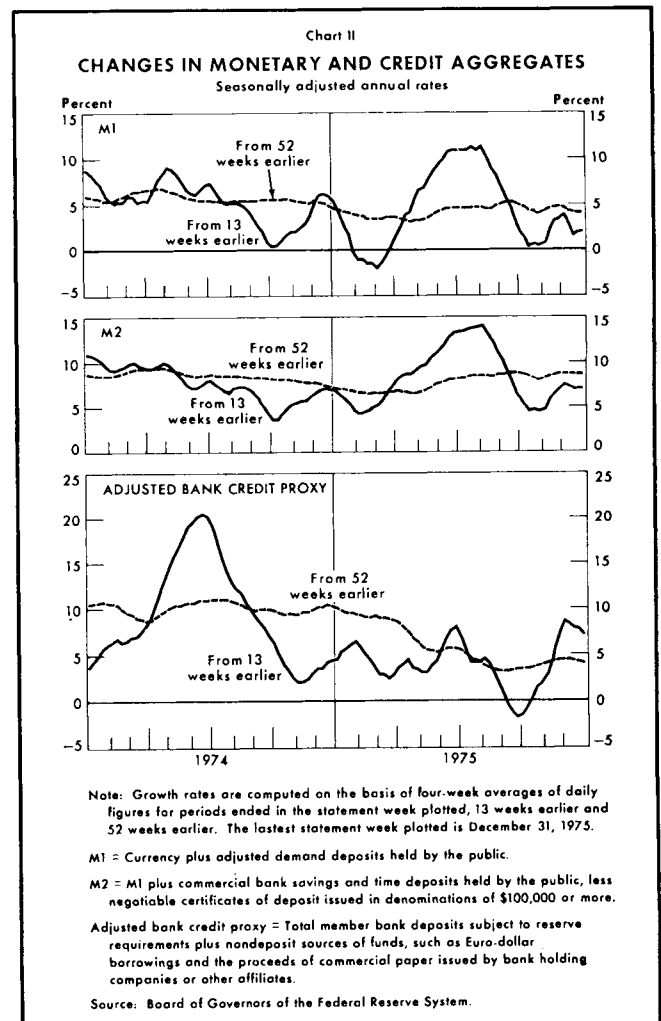
Yields on Federal Government agency securities responded in a similar manner to many of the factors which affected the market for Treasury obligations during December. Prices on Federal agency issues declined modestly in the first half of the month as the volume of borrowing rose. On December 11, the Government National Mortgage Association (GNMA) offered \$200 million of thirty-year modified pass-through securities, of which \$69 million was for new cash. These issues are backed by pools of Federal Housing Administration-insured or Veterans Administration-guaranteed mortgages. The principal and interest collected on the mortgages are transmitted to the holders of pass-through securities, and GNMA guarantees that these payments ultimately will be made. In modified pass-through securities, GNMA insures that these transmittals are made on normal payment dates, even when actual collections are late. The two-part offering consisted of \$131 million and \$69 million of securities bearing coupons of $7\frac{1}{4}$ percent and $7\frac{1}{2}$ percent, respectively. Both of these securities were priced to yield 8.70 percent, about 27 basis points above the yield on a similar offering sold in mid-November. Initial sales were slow, but market conditions improved during the week as demand strengthened and remaining issues were sold. On December 18, the Federal Intermediate Credit Banks, in a two-part offering, successfully sold \$1,330 million of bonds, redeeming \$10 million more of securities than was offered. Rates of return on this two-part financing were 6.55 percent on \$898 million of nine-month bonds and 7.90 percent on \$432 million of five-year bonds. At the same time, the Banks for Cooperatives successfully sold \$589 million of 6.25 percent six-month bonds, of which \$155 million was for new cash.

OTHER SECURITIES MARKETS

A large volume of borrowing weighed heavily on the market for corporate securities in the first half of December. A number of large issues were offered by industrial

firms and utility companies and, in addition, five New York City employee pension funds sold in the secondary market corporate and agency securities with face values of about \$340 million. Around \$280 million was raised to help meet the city's cash needs until Federal loans became available. Prices in the secondary market moved downward, and a number of offerings were postponed. However, at midmonth, investor demand was bolstered by the same factors that were supporting the Treasury market and by private forecasts of lower corporate bond flotations in 1976 than in 1975. Bond prices moved upward, offsetting earlier declines, while underwriting and trading activity tapered as is typical near the end of the year.

Rate movements on corporate securities were reflected



by the yields on several major issues sold during December. Early in the month a credit company offered \$225 million of notes and bonds, rated Aa by Moody's and A by Standard & Poor's. The 26-year bonds were priced to yield 9.82 percent, about $\frac{3}{4}$ percentage point above the yields on comparably rated industrial issues sold in mid-November. The major offering of the month was an Aaa-rated \$750 million three-part issue of an international organization, which consisted of equal dollar amounts of five-year notes, ten-year notes, and 25-year bonds. The bonds were priced to yield 9.35 percent, slightly above the rate on a similar issue offered by a foreign government in mid-November, and were favorably received. A number of issues, including a \$150 million Aa-rated offering by a finance company, were postponed until 1976 when the volume of new offerings was expected to be lighter. A Bell System member offered \$100 million of Aaa-rated forty-year debentures which sold quickly at a yield of 9.35 percent. Investor demand improved in mid-December, and a \$150 million offering of Aa-rated 25-year debentures by an industrial company was well received at a yield of 8.85 percent shortly after midmonth. By the end of the month the yield on the telephone debentures sold three weeks earlier had declined about 40 basis points.

The volume of new offerings was moderate in the market for tax-exempt securities in December. Investors continued to stress safety, and demand favored highly rated issues. Yields on these securities declined from their end-of-November levels, but yields on lower rated municipal securities moved upward, as demand for these obligations continued to be affected by the financial problems of New York City, New York State, and its agencies.

Three New York State agencies—Housing Finance Agency, Dormitory Authority, and Medical Care Facilities—narrowly avoided default at midmonth when the state legislature voted to liquidate about \$200 million in securities held by the State Insurance Fund, a special reserve set aside by the state to insure the payment of workmen's compensation claims to private employees in the state. Proceeds from the sales were then used to purchase securities issued by the three agencies. The New York State legislature passed, and Governor Carey signed into law, a package to raise \$600 million in new taxes to help reduce the state budget deficit. The measures provide for a permanent increase in the corporate franchise tax and

Table II
AVERAGE ISSUING RATES
AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—December 1975				
	Dec. 1	Dec. 8	Dec. 15	Dec. 19	Dec. 29
Three-month	5.550	5.633	5.491	5.340	5.208
Six-month	5.995	6.144	5.914	5.678	5.507
	Monthly auction dates—October-December 1975				
	Oct. 15	Nov. 13	Dec. 10		
Fifty-two weeks	6.601	6.010	6.439		

* 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.

bank tax, in addition to a one-year surcharge on income of corporations and banks. All taxes are retroactive to January 1, 1975. Also, the collection schedule for the state sales tax was changed from a quarterly to a monthly basis.

In mid-December, a New York State court ruled that the moratorium which permits New York City to defer for at least three years the payment of principal and to reduce the interest paid on notes maturing before June 30, 1976 does not violate either the state or national constitutions. The decision is being appealed. In the meantime, the decision permitted the optional exchange of these maturing New York City notes for ten-year 8 percent MAC bonds to occur as scheduled on December 29. About 30 percent of the eligible notes were exchanged. The prices of these bonds dropped sharply at the end of the month, when they began trading in very light volume. At the same time, prices of previously issued MAC bonds were generally unchanged.

The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds fell 10 basis points from the end of November to 7.29 percent on December 31. The Blue List of dealers' advertised inventories rose by \$4 million and closed the month at \$635 million.