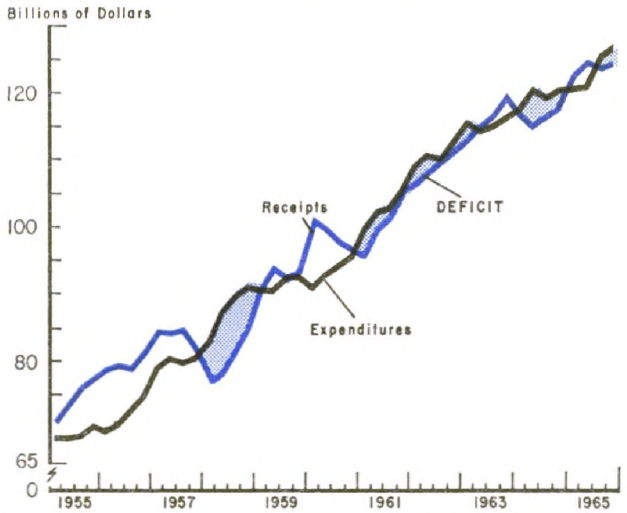
Excise-tax cuts, social-security gains presage late-1965 fiscal stimulus



Source: Bureau of the Budget (national-income accounts basis)

an indirect stimulus of several times that magnitude. Even apart from the relative size of the recent as against the earlier fiscal stimulus, doubts have arisen concerning the effectiveness of these recent fiscal measures as opposed to an across-the-board tax reduction—doubts, for example, concerning whether excise-tax cuts would be passed along to consumers in the form of lower prices.

The preliminary report of an inter-agency Administration committee, released in late July, showed that tax savings on autos and air-conditioners generally were being passed on to consumers. But early returns were mixed regarding the effectiveness of tax-*cum*-price reductions in spurring the perhaps-jaded appetites of those consumers. Not everyone agreed with the comment of one culture-conscious retailer who delightedly reported that "pianos are going like crazy."

William Burke

In the Markets

ACTIVITY in the financial markets continued at a vigorous pace during the second quarter, as businesses, consumers, and governments (particularly at the state and local level) again increased their gross borrowings. Overall, the volume of credit demands increased during the quarter, although some shifts again occurred in the pattern of credit and financial flows. Many observers especially noted the stepped-up financing by businesses in the bond and equity markets, and the still substantial, albeit somewhat slower, increase in business borrowing from the commercial banks.

Wall Streeters in particular noted the shift in the investing public's attitude toward the stock market, where frenetic activity accompanied a 10-percent decline in the Standard and Poor index between mid-May and late June. Though much less spectacular than 1962's sharp break, the market decline, like that of three years ago, ran counter to the generally rising trend of economic activity and, not surprisingly, generated a considerable amount of comment as to its causes. One suggested factor was the June 1 speech of Federal Reserve Chairman Martin dealing with certain "disquieting similarities" between the present economic situation and that of the 1920's. Almost unnoticed by the press were those passages in the speech dealing with the many, and important, dissimilarities with the 1920's. The fact too, that the advent of the market decline preceded Chairman Martin's comments by two weeks also appeared to have escaped general notice.

Turn of the screw

Meanwhile, monetary policy assumed a somewhat firmer tone during the spring months. The level of member bank free re-

serves—a very frequently consulted barometer of the climate of policy—moved from an average of $60 million of net free reserves to an average level of $155 million of net borrowed reserves between the first and second quarters. The change in policy came against the backdrop of a strong demand for bank accommodation and a somewhat paradoxical decline of about 25 basis points between late-February and late-June in the market yield on 91-day Treasury bills. The policy shift, of course, actually began in February, when a package program was developed to correct the nation's balance-of-payments difficulties.

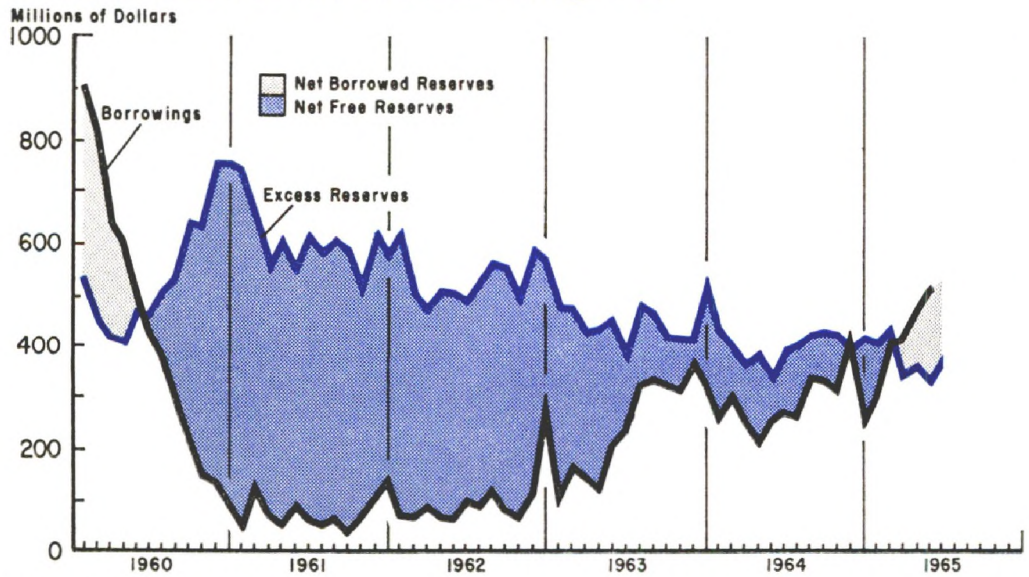
To meet the burgeoning demand for credit, member banks substantially reduced their holdings of U. S. Government securities, largely bills. Borrowings from the Reserve Banks rose by $130 million in the second quarter, to an average level of about $500 million; in contrast, excess reserves fell only $40 million in the quarter, to a level of $350 million. Thus, the member banks supported the increase in bank credit through a sell-off of Governments and through a greater recourse to the discount window.

The fall in Treasury bill yields did not extend to the remainder of the Treasury list, since the market return on coupon issues remained essentially unchanged from the beginning of the year. Long-term rates on corporate and municipal bonds came under pressure in June as the volume of new issues, together with competing Federal agency issues, coming onto the market approached record proportions. The corporate and agency issues moved into investor hands after some initial congestion, and by early July this sector of the long-term market showed increasing strength. However, the municipal market continued weaker into July, as prices were depressed by large inventories of unsold issues.

Money in the till

The modest dimensions of Treasury activity in the capital markets during the second quarter contributed substantially to the overall stability of interest rates. Although the Treasury ended fiscal 1965 with a deficit, it had reason to be pleased with its financial position. On a cash-budget basis the deficit was roughly about $2.7 billion — a little more than half the cash deficit for fiscal year 1964, and $1.3 billion less than had been projected as recently as last January. A $2-billion reduction in defense outlays, which offset most of the increased expenditures in other areas, and a larger than expected volume of revenues from individual income taxes, were the principal factors contributing to the improvement — an improvement which enabled the Treas-

Banks shift to net borrowed-reserve position as excess reserves fall and borrowings soar



Source: Federal Reserve Board

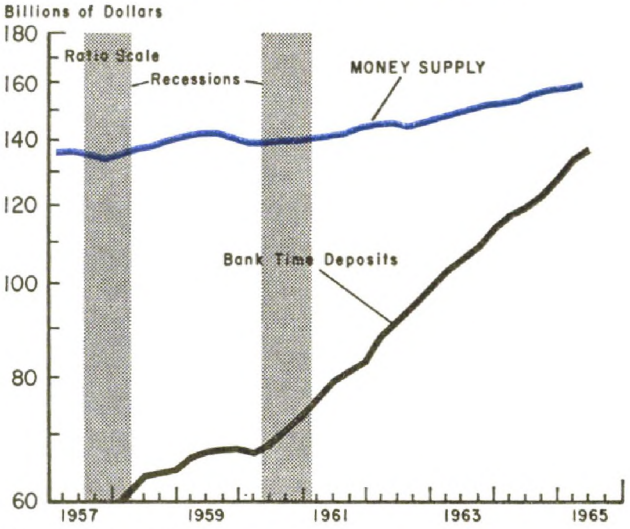
ury to start fiscal 1966 with a cash balance of nearly $11.5 billion. This was the highest level attained by the general fund since 1946, and represented a gain of about $1.3 billion over the Treasury's cash position at the end of June a year ago. Furthermore, the improvement was accompanied, during the first half of 1965, by a reduction of $0.8 billion in the public debt, in contrast to a $2.4-billion debt increase during the corresponding period a year ago. During both periods, the volume of special securities issued to Government trust accounts increased. On the other hand, public-held marketable debt declined far more rapidly this year than last, and thereby contributed to the general steadiness in yields on Treasury coupon issues and to the decline in the bill rate.

In the state and local government sector, a further rise in spending during the second quarter was again accompanied by an increase in debt offerings. Prices softened under the impact of the new issues and rising inventories in the hands of dealers. However, by cutting prices on older issues in their inventories, dealers during June made considerable headway in reducing their holdings of unsold securities (from about $900 to $750 million), thereby minimizing upward pressures on yields on the new issues coming onto the market. Consequently, yields on top-quality general-obligation bonds only rose a few basis points above the level prevailing throughout most of the quarter.

Private sector growth

For their part, consumers increased their borrowings to help finance a rising level of purchases, but they also increased, albeit modestly, their personal saving. Part of the saving increase took the form of increased holdings of liquid assets, although these rose at a much slower pace than during the first quarter. Part of the saving gain also took the form of stepped-up debt repayments. But in

Money supply increases slowly
while time deposits grow rapidly



Source: Federal Reserve Board

this connection, a strong rise in credit extensions, bolstered by an exceptionally large increase in personal loans during April (apparently for tax purposes) and by a continued vigorous expansion in automobile credit, raised instalment debt outstanding by a solid $2.3 billion (seasonally adjusted) during the quarter.

But it was the business sector which again accounted for the lion's share of activity in the nation's credit markets. Business demands were reflected in a continued vigorous pace of borrowing from banks, as loans rose by $2.8 billion (seasonally adjusted), or at an 18-percent annual rate. Business demands were also reflected in a sharp rise in financing in the bond and equity markets; at $4.5 billion, offerings for new capital, which included issues totalling somewhat over $500 million by two New York banks, far exceeded their first-quarter volume. This development contributed to a slight increase in yields on top-quality corporate bonds, from 4.42 percent in March to 4.47 percent in June. On the other hand, the rise in business borrowings from banks was accommodated at a slightly lower average-interest cost, at least on short-term

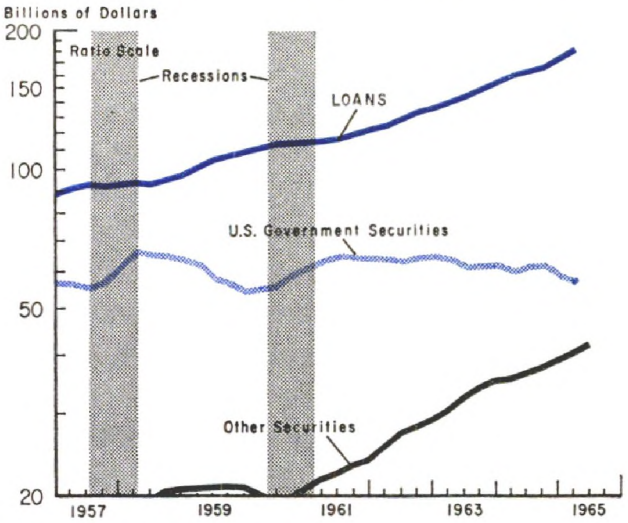
loans, although non-price terms of borrowing apparently firmed during the quarter.

The continued strength of business credit demands was understandable, in view of the continuation of inventory accumulation, the financing of current and prospective increases in fixed-investment outlays, and a growing need for working capital to support expanded operations. Some squeeze on liquidity may also have been involved, although conclusive evidence on that point is still lacking. The very sharp rise in business borrowings over the June tax date reflected the speed-up in corporate tax payments required under the terms of the Revenue Act of 1964. The second-quarter rise in borrowings was accompanied by another increase in negotiable certificates of deposit; in fact, the $1.3-billion increase in these high-yielding certificates (most of which are held by businesses) almost equalled the first quarter's very strong gain.

Busy bankers

The nation's commercial banks again occupied a pivotal position in accommodating the nation's credit demands, as a $6.7-billion gain in bank credit (seasonally adjusted) fell only slightly short of the first quarter's record $8.3-billion increase. Business loans, as noted previously, again experienced a vigorous advance, despite the reduced importance of several special factors which contributed to the particularly strong first-quarter gain—factors such as the financing of goods held up in transit during the dock strike, and the financing of inventory accumulation in anticipation of a steel strike. Similarly, net disbursements under long-term bank loans to foreigners, which exceeded $450 million during the first quarter, shifted to net repayments of over $130 million in April and May, as the credit-restraint program adopted to cope with the balance-of-payments problem began to take hold. Nevertheless, 16 of 18 major industry groups increased their bank borrowings during the second quarter, amply testifying to the breadth as well as to the depth of business loan demand.

Banks support boom by expanding loan and municipal security portfolios



Source: Federal Reserve Board

Demands for bank credit from other sectors of the economy also continued strong. Real estate loans, with an increase of $1 billion, maintained their strong pace of the past year, and thereby indicated a continued willingness on the part of the banks to compete aggressively with other lending institutions for a larger share of a more slowly growing supply of mortgages. Consumer loans, with a gain of over $1 billion, slightly exceeded their first-quarter increase and considerably surpassed their average quarterly gain of the 1962-64 period.

Portfolios of "other securities" (including tax-exempt issues) recorded a particularly sharp $2-billion rise, and gave further evidence of the banks' desire to place a substantial portion of their loanable funds in state- and local-government debt issues. But in the second as in the first quarter, the banks helped finance the growth in their loans and other securities by a fairly substantial $2-billion liquidation of U. S. Government securities. This action reduced one traditional measure

of liquidity, the ratio of portfolios of U. S. Government securities maturing within one year to deposits, to a cyclical low. Similarly, another (inverse) measure of bank liquidity, the ratio of bank loans to deposits, reached its highest level of the post-war era.

Total bank deposits, with a $7.3-billion increase, grew more slowly than in the first quarter, and the deposit mix also shifted somewhat. U. S. Government deposits rose by $2.6 billion as a reflection of the rising levels of tax revenues. But a $3.1-billion growth in time and saving deposits was only about half the size of the first-quarter gain. (On the other hand, commercial banks—unlike their principal competitors—recorded a larger gain than in the year-ago period.) Private demand deposits at the commercial banks meanwhile increased $1.6 billion, although the increase was centered in June.

Verle Johnston and Herbert Runyon

Foreign Investment

Copies are again available of the article, "Can We Afford to Invest Abroad?", which appeared in the September 1964 *Monthly Review*.

The article provides a background analysis of the role of private capital flows in the U. S. payments picture. The discussion includes definitions of different types of private capital investments, the location of our investments abroad, the short- and long-run impact of private capital outflows on the balance of payments deficit, and the implications of private capital exports.

Copies of the article are available on request from the Administrative Service Department, Federal Reserve Bank of San Francisco, 400 Sansome Street, San Francisco, California 94120.