by the headlong expansion of 1965-66, and the market indexes surged strongly upward — in the case of the comprehensive New York Stock Exchange index, to a new record high.

Some observers, more attuned to the real world of corporate stockpiles than to the financial world of corporate stocks, had a less exuberant answer. They argued that a quasi-recession, a mini-recession — call it what you will — had already begun amid an atmosphere of unwanted inventories, reduced investment plans, and falling profit margins. Others, looking at the underlying strengths of consumer and defense demand, agreed with Walter Heller: "There never was a recession."

—*William Burke*

Early Thaw

MONETARY and fiscal policy actions in early 1967 were undertaken in the context of an economy which was at a standstill in terms of real growth. There was no longer any need to restrain the demand for credit, since the demands upon the physical resources of the economy were obviously easing. Thus, the first quarter continued the period of transition initiated last fall, when public policy makers first shifted from a restrictive policy designed to contain inflation to an easy policy designed to promote expansion. Fiscal policy, already expansive in later 1966, became increasingly so in first quarter 1967 when the Federal budget showed a $10-billion annual deficit (national-accounts basis). Monetary policy meanwhile became progressively easier during the first quarter.

Monetary policy shifts

In the six-month period encompassing November through April, the Federal Reserve System made use of all of its general monetary controls. The shift from the earlier policy of firm restraint dates from the November 22 meeting of the Federal Open Market Committee. In its directive of that date to the Manager of the System Open Market Account, the Committee instructed that ". . . System open market operations, until the next meeting of the Committee, shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be resuming a rapid rate of expansion . . ." In late December the Federal Reserve rescinded the September 1 letter which had urged member banks to hold down the extension of new loans, particularly business loans. With this as a background, monetary policy moved increasingly toward the position of fairly generous ease evident in April.

Most of the first-quarter increase in member bank reserves was provided through open-market operations. In mid-March an additional $850 million of reserves was released when the reserve requirement against savings deposits and time deposits of less than $5 million was reduced from 4 percent to 3 percent. Finally, on April 6, the discount rate — the cost to member banks of borrowing from the Reserve Banks — was cut from 4½ percent to 4 percent, following a rapid decline in money market rates during the preceding weeks.

The net effect of these monetary policy actions was to change the member banks' reserve position from an average level of $165 million of net borrowed reserves in

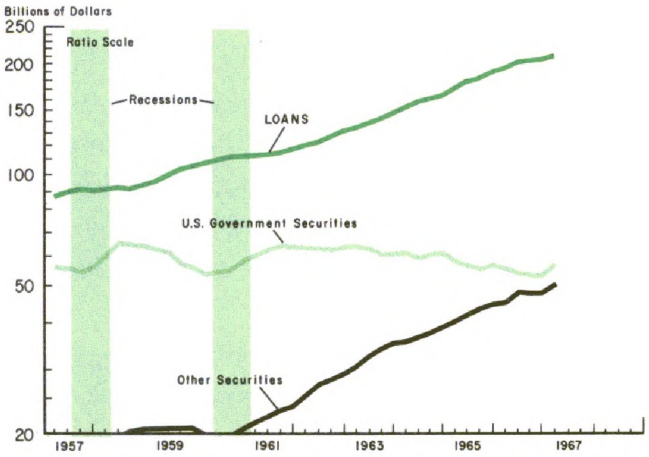
December to net free reserves of $233 million in March. Member bank borrowings fell from an average of $557 million in December to $199 million in March. In the first three months of the year, total reserves of the member banks increased at an average annual rate of 17½ percent.

Of course, not all of this increase in member-bank reserves may be attributed directly to open-market operations and reduced reserve requirements. The inflow of time-and-savings deposits to commercial banks rose sharply in the first quarter, increasing at an annual rate of nearly 18 percent. This represents a process of "reintermediation"; for as yields on money-market instruments fell (reflecting both easier monetary policy and a decline in loan demand at commercial banks), the rate of return on time-and-savings deposits again became attractive. The rates offered by commercial banks on time-and-savings deposits of individuals changed hardly at all in the first quarter, although reductions were reported in various parts of the country in late April. However, the rate on large-denomination negotiable certificates of deposit (30-day maturities) fell from the ceiling rate of 5½ percent at the end of December to as low as 4 percent in mid-April.

Fiscal policy expands

Early-1967 changes in fiscal policy were much less dramatic than the monetary measures effected during the same period, but they too weighed in on the expansion side of the scales. In three separate actions, the Administration released a total of more than $2.1 billion of funds for highways, public construction and mortgage assistance that had been frozen last October. The Administration also requested the restoration of the 7-percent investment-tax credit that had been suspended last September for a fifteen-month period. In a variety of related actions,

Banks restore liquidity
by increasing security purchases



funds also became more readily available for residential construction: the Federal Home Loan Bank Board eased the terms upon which savings-and-loan associations might obtain advances, and the Federal National Mortgage Association increased its purchases of home mortgages. Altogether, the Federal budget during this period stimulated the economy with a deficit more than twice the size of what had been anticipated in January.

On the other hand, the 6-percent surcharge on personal and corporation income-tax liabilities that was requested in the President's January budget message remained in the forefront of discussion in early spring. The economy's lackluster performance did not create any particular pressure for enactment of this measure by July 1, the date on which it was originally scheduled to become effective. But in view of the recovery in the growth rate projected for the second half of the year, the Administration contends that this tax increase will then be needed to contain inflationary pressures.

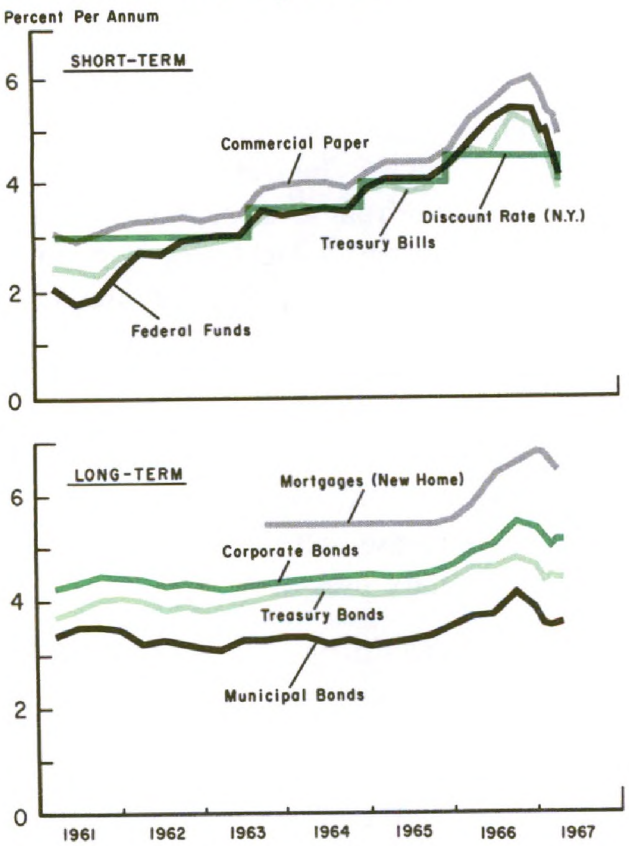
Banks rebuild liquidity

The banking system took advantage of the relaxed climate of monetary policy to improve its liquidity position during the first quarter. Total bank credit increased at a 14-

percent annual rate (seasonally adjusted), mostly because of very large acquisitions of securities. For the quarter as a whole, banks purchased about $3.6 billion of state-local securities, and they added about $3.3 billion of U.S. Government obligations despite substantial sales of such issues during January. Most of the first-quarter acquisitions were in short-term maturities, which suggests that liquidity was a major motive in the selection of securities acquired.

Total commercial-bank loans increased by about $4 billion during the quarter — roughly in line with the 1966 average pace. Business loans accounted for the largest part of the gain, as real-estate loans and consumer loans showed rather modest increases. The 13-percent annual rate of gain in business loans was well below the early-1966 pace but substantially ahead of the rate of growth in the second half of last year. Corporations met an increasing part of their credit needs in the capital market in the first quarter, using receipts from this source to reduce their indebtedness to the banking system and to meet their tax liabilities.

Interest rate decline
continues in early 1967



Time-and-savings deposits at commercial banks grew at an 18-percent annual rate in the first quarter. Large-denomination negotiable certificates of deposit increased by $3.6 billion in the January-March quarter despite a steady decline in rates on these instruments during the second half of the period. The money supply meanwhile grew at an average annual rate of almost 6 percent — a sharp turnaround from the slight decline which took place in the second half of last year.

Interest rates drop . . . mostly

In late 1966, interest rates had already started to decline from their record third-quarter levels. Then, in the first three months of 1967, this downward trend was sharply accentuated, particularly in money-market rates, which fell off by more than a full percentage point. The yield on 91-day U.S. Treasury bills dipped below 4 percent prior to the April reduction in the discount rate, and was down below 3.70 percent within a month. The Federal-funds rate — the rate on overnight purchases and sales of claims to balances at the Reserve Banks — also declined, pointing up the growing ease in member banks' reserve positions.

Long-term interest rates presented a somewhat different pattern. After falling about 40 basis points from the end of December to mid-February, the yield on high-quality corporate bonds regained about half of this decline by early May, reaching a level of 5.19 percent. A similar reaction developed also in the long-term Treasury bond and municipal bond markets.

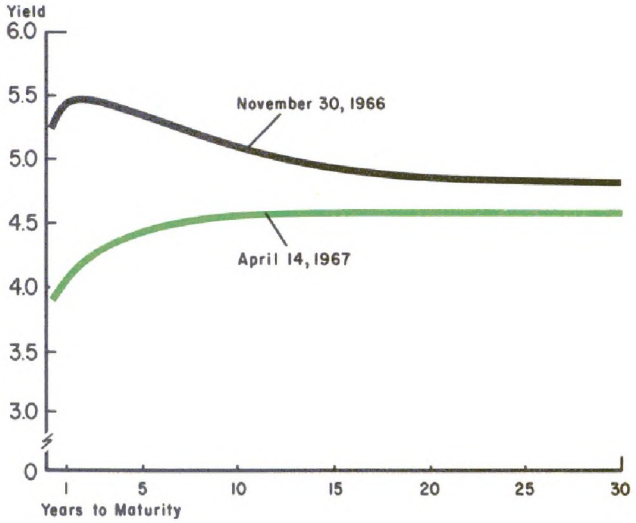
The recent increase in long-term yields reflected the very large volume of publicly

offered issues which came to market during the first quarter. About $5.8 billion of corporate securities and $3.7 billion of state-local securities reached the market — about 15 percent and 25 percent, respectively, above the peak figures recorded in first-quarter 1966.

March was a particularly heavy month, since offerings of participation certificates in pools of Federal loans and foreign and World Bank securities swelled the total for that month to around $4 billion. The fact that the capital market was able to absorb this volume of securities without a substantial run-up in interest rates gives further testimony to the increasingly easy tone of the credit markets.

The structure of interest rates now has changed considerably from what it was in November, when monetary policy first turned in the direction of ease. The yield curves for U.S. Government obligations show that while interest rates on outstanding issues have

Humpbacked yield curve
disappears as short-term rates drop



fallen absolutely for the entire spectrum of maturities, the drop has been much more pronounced in the one-to-five-year maturity range than further out on the time scale. Consequently, the "humpbacked" contour of last fall's yield curve has now disappeared.

—Herbert Runyon

TWELFTH DISTRICT BUSINESS

Year and Month	Condition items of all member banks (millions of dollars, seasonally adjusted)				Bank debits 22 SMSA's (billions $)	Bank rates: short-term business loans	Total nonfarm employment (1957-59 = 100)	Industrial production (1957-59 = 100)		
	Loans and discounts	U.S. Gov't. securities	Demand deposits adjusted	Total time deposits				Lumber	Refined Petroleum	Steel
1959	15,908	6,514	12,799	12,502		5.36	104	109	101	92
1960	16,612	6,755	12,498	13,113		5.62	106	98	104	102
1961	17,839	7,997	13,527	15,207		5.46	108	95	108	111
1962	20,344	7,299	13,783	17,248		5.50	113	98	111	100
1963	22,915	6,622	14,125	19,057		5.48	117	98	112	115
1964	25,561	6,492	14,450	21,300	501	5.48	120	107	115	130
1965	28,115	5,842	14,663	24,012	535	5.52	125	107	120	138
1966	29,858	5,444	14,341	25,900	618	6.32	132	103	123	140
1966: Mar.	28,897	5,589	15,006	24,169	605	5.89	130	108	117	143
Apr.	29,267	5,309	14,924	24,579	617	. . .	131	113	122	147
May	29,157	5,128	14,812	24,735	618	. . .	131	107	125	145
June	29,688	4,919	14,780	25,001	622	6.18	131	105	128	144
July	29,791	5,071	14,753	25,265	628	. . .	131	104	130	143
August	29,764	5,473	15,120	25,271	622	. . .	131	95	119	136
Sept.	29,532	5,190	14,819	25,159	629	6.58	132	93	123	140
Oct.	29,583	4,987	14,719	25,085	645	. . .	133	96	121	142
Nov.	29,538	5,267	14,800	25,318	642	. . .	135	89	125	142
Dec.	29,858	5,444	14,341	25,900	634	6.62	135	97	120	141
1967: Jan.	30,274	5,468	14,437	26,134	638	. . .	136	98	123	142
Feb.	29,923	5,889	14,376	26,425	644	6.28	137	96	119	135
Mar.	29,980	6,483	14,855	26,892	645	. . .	136			123