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FEDERAL RESERVE BANK OF ST. LOUIS

Review

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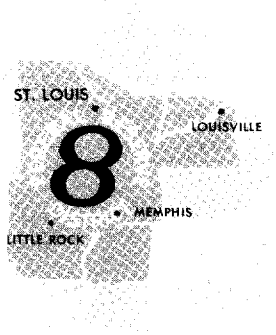

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FEDERAL RESERVE BANK OF ST. LOUIS

P.O. Box 442, St. Louis, Mo. 63166

Economic Expansion with Stable Interest Rates

THE CURRENT BUSINESS EXPANSION, now in its forty-third month, continues to make substantial progress. Spending on currently produced goods and services, the gross national product, reached an estimated $618.5 billion annual rate in the second quarter, nearly $10 billion above the rate three months earlier. Most economic indicators continued to show strength through July. At the same time, wholesale prices remain at about the same level that has prevailed since 1958, while the rate of increase of consumer prices is about the same as since mid-1963. The nation's money supply rose markedly from May to July. As has been the case throughout most of the period of recovery and expansion since 1961, however, interest rates continue to exhibit unusual stability.

Business Developments

Consumers were responsible for much of the gain in total spending from the first to the second quarter, as personal consumption expenditures rose $6 billion. Spending on nondurable goods and services increased about $5.4 billion and purchases of durables $0.7 billion. The winter tax cut has undoubtedly spurred consumer spending. Disposable personal income—i.e., personal income less personal taxes—increased at an annual rate of $12 billion from the first to the second quarter. This compares with gains of $8.3 billion and $6.8 billion in the two previous quarters.

Federal Government purchases of goods and services in the second quarter were up at an annual rate of $2.7 billion, while state and local government spending was up at a rate of $1.6 billion. Investment spending was $1.1 billion greater in the second than in the first quarter. Gains in investment in producers' durable equipment and inventories were partially offset by a decline in spending on new construction. Net exports of goods and services were at a $6 billion annual rate in the second quarter, down from the first quarter rate of $7.7 billion.

Most other economic indicators have also shown strength in recent months. Industrial production, employment, and retail sales all continued to grow substantially through July.

Financial Developments

The money supply rose markedly from May to July. The recent increase in money was primarily in demand deposits rather than in currency. For the entire period since last December money has risen at a 3.9 per cent annual rate, about the same as the 4.1 per cent rate from September 1962 to December 1963 and substantially greater than the 2 per cent average annual rate for the 1951-63 period. The 3.9 per cent rate of increase since December was quite high compared with rates which have characterized the advanced stage of other postwar business cycles.

Money plus time deposits also increased more rapidly from May to July than last winter and spring. Time deposits rose $2 billion compared with a $2.2 billion expansion in money. From December to July money plus time deposits rose at about a 7 per cent rate compared with an 8 per cent rate in the preceding year.

Member bank reserves rose from May to July at a 9 per cent annual rate. Since December, their increase has been at a 3.6 per cent rate. Reserves available for private demand deposits have also risen at a 9 per cent rate since May, but for the entire period since December have risen at only a 1.0 per cent rate, as increases in reserves required to support Government deposits and time deposits absorbed most of the expansion in total reserves.[1]

Recent Interest Rate Stability

Since last November, there has been little change in most interest rates. As shown in Table I, average yields on many securities in July were about unchanged from last November. Several rates have been stable for a much longer period. The prime bank rate, at 4.5 per cent, has not changed since August 1960, and bank rates on short-term business loans have been near 5 per cent since mid-1960. Yields on both new FHA residential mortgages and conventional mortgages have not changed appreciably since early 1963.

Table I

Market Yields on Selected Securities
Monthly Averages of Daily Figures

	November 1963	July 1964
U. S. Government Securities		
3-month Bills[1]	3.52	3.46
6-month Bills[1]	3.65	3.56
3- to 5-year Bonds[2]	3.97	3.99
Long-term Bonds	4.10	4.13
Commercial Paper	3.88	3.96
Finance Company Paper, 90-179 days	3.75	3.73
Bankers' Acceptances	3.71	3.75
Aaa Corporate Bonds	4.33	4.40
Baa Corporate Bonds	4.84	4.83

[1] Except for new bill issues, yields are averages computed from daily closing bid prices.
[2] Includes certificates of indebtedness and selected note and bond issues (fully taxable).
Sources: Board of Governors of the Federal Reserve System, Moody's Investors Service, Federal Housing Administration, and finance companies.

With output, employment, incomes, spending, and investment all showing strength in the first half of this year, it seems reasonable to have expected increases in credit demands accompanied by upward pressure on interest rates. Experience during previous post World War II periods of rapid economic expansion is consistent with such an expectation. During the 1949-53, 1954-57, and 1958-60 periods of expansion, interest rates showed strong increases (see Chart 1 on facing page). Possible explanations of this phenomenon are examined below.

The demand for loan funds on the part of the U. S. Treasury is a factor bearing on interest rate developments. A decline in the supply of outstanding Treasury securities tends to result in a bidding up of prices and a drop in yields. On the other hand, prices tend to fall and yields increase when the supply of outstanding securities is increased. The supply of marketable, interest-bearing public debt, at $206.5 billion in June, was about the same as in November 1963. This compares to a small reduction in the November 1962-June 1963 period and a slight increase in the November 1961-June 1962 period. On the basis of these data it appears that Treasury needs during the past eight months have probably been neutral with respect to interest rates.

Although business investment in plant and equipment has been strong, inventory investment has been

[1] For charts and tables giving detail regarding money and reserves, see this bank's semi-monthly release on deposits and reserves.

only moderate since the first of the year. Since January, businesses have accumulated inventories at an annual rate of 2.4 per cent. This is substantially less than the 7.3 per cent rate during the 1954-57 expansion, the 4.5 per cent rate during the 1958-60 expansion, and the 3.9 per cent rate from February 1961 to January 1964. A rapid accumulation of inventories is typically accompanied by strong demands for credit, which in turn exert upward pressure on interest rates. Because inventory investment has been moderate since the first of the year, credit demands have been light, and little pressure has been put on rates.

One possible explanation of the recent stability of interest rates is that since about April the market has expected no change in rates. According to this view, the market would treat any movement in rates as only temporary, and adjustment would be immediate. Thus, whenever yields edged higher (and prices lower), this would induce purchases by those attempting to take advantage of the higher rates of return. These purchases would tend to exert upward pressure on security prices (and downward pressure on yields). By the same token, when rates moved lower, the market's reaction would tend to arrest the decline and reverse the movement.

Monetary developments have been intermittently expansive since the beginning of the year. While the rate of increase averaged only 2 per cent from December to May, it was 8.5 per cent from May to July, and for the entire period averaged about 4 per cent. Normally, such a rapid rate of growth in money tends to put some downward pressure on interest rates. The 4 per cent rate since December is in sharp contrast to rates of increase during comparable periods in

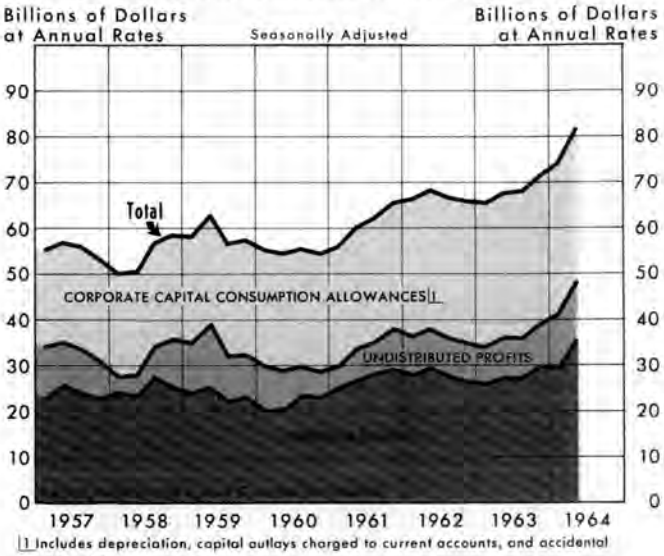
other expansions when interest rates were generally rising. During the final twelve months of the 1954-57 expansion the money supply increased at a rate of only 0.7 per cent. For the 1958-60 expansion the money supply actually declined at a 2 per cent rate during the final twelve months. On the basis of these comparisons, monetary developments from December to mid-1964 were very easy and therefore, other things equal, may have placed some downward pressure on rates.

A further explanation for the stability of interest rates is that savings have been increasing at a substantial rate for some six months, thereby expanding the supply of funds available for investment. An increase in the supply of investable funds puts downward pressure on rates. The major nonbank sources of investable funds – personal saving, undistributed corporate profits, and capital consumption allowances – have all increased substantially since the fourth quarter of 1963 (Chart 2). Since the fourth quarter, the total of these three sources has increased at an annual rate of about 30 per cent. This compares to a 10 per cent rate from the first quarter of 1961 to the fourth quarter of 1963 and a 6 per cent rate since 1951.

It is unusual for savings (both corporate and personal) to rise substantially at this phase of the cycle. The recent large tax cut may provide a partial explanation. This tax cut was unique in that it came at a time when spending and investment were both high. The tax cut may have served the dual role of stimulating spending and providing additional saving.

Chart 2

Major Nonbank Sources of Investable Funds



[1] Includes depreciation, capital outlays charged to current accounts, and accidental damages.

Source: U.S. Department of Commerce

Interest rate developments over the past nine months have been contrary to experience during comparable periods of previous cyclical upswings. The comparative stability of rates since November has probably been the result of several forces. The strong expansion of business has no doubt put some upward pressure on rates. But at the same time, it appears that the rapid increase in money, the high savings rate, and market expectations have combined to exert downward pressure on rates. The net result has been a stability of rates since November.

Economic Pause in Central Mississippi Valley

ECONOMIC ACTIVITY in major cities of the Central Mississippi Valley has shown little change so far this year.[1] This is in contrast with the strong expansion in the national economy. After expanding steadily through 1962 and 1963, total payroll employment has not increased since January. Neither manufacturing nor nonmanufacturing employment has increased. The index of industrial production[2] in the region has risen only slightly. Check payments have been unchanged since the first of the year, continuing at rates which have prevailed since August 1963. The relatively lackluster economic situation of the region as a whole was found locally in St. Louis, Louisville, and Memphis.

[1] Monthly data and charts for the individual cities may be obtained upon request to the Research Department of this bank.

[2] This *Review* for June presented a new "index of value added by manufacture" for each of the metropolitan areas in the Central Mississippi Valley and for the seven centers combined. Whether the index in question is best denominated an "index of value added" or an "index of industrial production" may depend on whether it is considered primarily as an historical series or as an indicator of current developments. As an historical series, it is a value added series in which known value added data are interpolated and extrapolated by use of industrial use of electric power figures. Over a period of time in which any significant price trends have occurred, any other interpretation would be improper. But, viewed as a current short-run indicator at a time when significant price trends are not in evidence the series may best be considered an "index of industrial production." Industrial use of electric power may then be used as a proxy for industrial production by weighting electric power use by value added by manufacture in the respective industries as estimated from time to time by the Census Bureau.