June 1966

FEDERAL RESERVE BANK OF ST. LOUIS

Review

CONTENTS

Volume 48 • Number 6

FEDERAL RESERVE BANK OF ST. LOUIS

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

Total Demand, Prices, and Real Growth

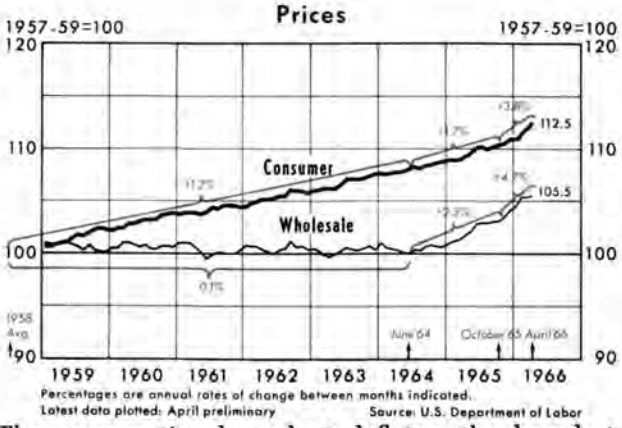
PRICES CONTINUED TO RISE in April and early May, while growth of real product apparently slowed. Total demand for goods and services continued to be stimulated by Government expenditures relative to the tax rate structure and by monetary expansion.

Prices

Most price movements have been upward in recent months. From March to April the consumer price index rose at a 5.5 per cent annual rate, the same as for the past three months. This index rose at a 3.8 per cent rate from October to April, after rising at a 1.7 per cent rate from mid-1964 to late 1965 and at a 1.2 per cent rate from 1958 to 1964.

The wholesale industrial price index increased at a 3.5 per cent annual rate from March to April and has risen at a 2.9 per cent rate since last October. This compares with a 1.4 per cent rate from June 1964 to October 1965 and a 0.3 per cent rate for the period 1958-64.

The overall wholesale price index rose at a 4.7 per cent annual rate from October to April and according to preliminary data remained high in May. This index increased at a 2.3 per cent rate from mid-1964 to October 1965 and was virtually unchanged from 1958 to 1964. The rate of increase in the overall index has slowed since February, as declines in prices of farm products and processed foods have partially offset rising industrial prices.



The gross national product deflator, the broadest of the price indexes, rose at a 3.6 per cent rate from the fourth quarter of 1965 to the first quarter of this year. This price measure rose 1.9 per cent during 1965 and at a 1.4 per cent rate from 1958 to 1964.

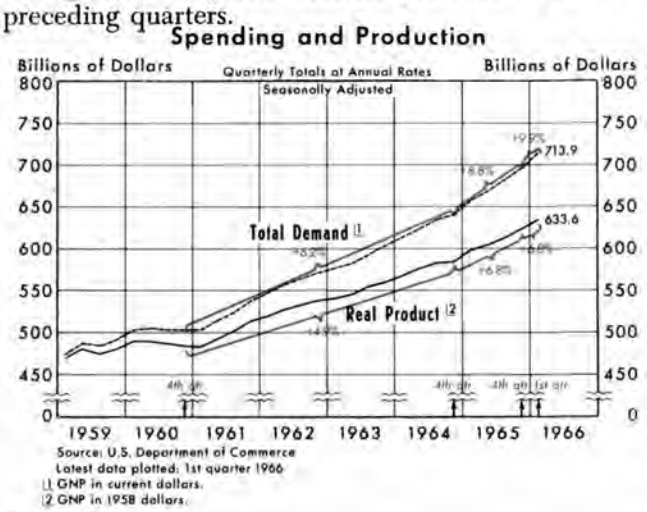
The average price of farm land in the United States rose 8 per cent from March 1965 to March 1966, according to the Department of Agriculture. In comparison, farm land prices increased at an average annual rate of 5.6 per cent during the past decade.

Real Product

Output of goods and services has been rising rapidly, but recent data indicate that the pace of the rise may be slowing, perhaps in response to capacity limitations. Industrial production rose at a 3 per cent annual rate from March to April and, according to initial reports, changed little from April to May. This moderate growth compares with an extremely rapid 14 per cent rate from last September to March and 8.9 per cent over the past year. Payroll employment has risen only moderately since March, after rising rapidly earlier this year. Estimates of total civilian employment indicate a decline during the January-May period. These figures may give some evidence of a lack of employable manpower.

These recent data, indicating reduced rates of increases in real product and employment, cover a very short period and are highly tentative. Current data are frequently revised, but even in final form most economic time series are very irregular over a short time span. Also, various sectors of the economy may be expected to perform differently in any short period of strong demand. Nevertheless, the recent data may indicate that use of productive resources is becoming so complete that the rapid expansion of total demand is resulting less in increases in real product and more in price rises.

Gross national product estimates for the first quarter of 1966 also provide evidence of real product growing less rapidly despite an acceleration in the demand for goods and services. Real product increased at a 6.0 per cent rate from the fourth to the first quarter compared with 6.8 per cent in the four preceding quarters.



Total Demand

The rise in prices and some continued expansion of real product have occurred in response to strong demands for goods and services. Although the latest figures indicate a decline in spending, the trend has been strongly upward. Retail sales, according to preliminary figures, totaled $25.2 billion in April, down from $25.6 billion in March. Retail sales figures are subject to large revisions. For example, the January retail sales figure, originally reported at $24.8 billion, was later revised to $25.0 billion. A larger revision was made for February when the original $24.6 billion estimate was revised to $25.3 billion. In the first quarter of the year retail sales were up at a 10 per cent annual rate from the third quarter of last year.

Taking a broader view of the economy, the strengthening of demand has been quite clear. Total spending for goods and services rose at a 9.9 per cent annual rate from the fourth quarter of last year to the first quarter of this year. In the preceding year these outlays increased at an 8.8 per cent rate. From 1960 to 1964 the average growth in aggregate demand was at a 5.7 per cent rate.

Consumer purchasing power has been growing at a rapid rate in recent months. Personal income has risen at an 8.9 per cent annual rate since late last summer compared with a 6.5 per cent gain in the previous 12 months and a 5.4 per cent average rate of increase from 1960 to 1964.

Fiscal Actions

Total demand has continued to be stimulated by Government actions. The economic impact of the

Federal Government's taxing and spending actions, as indicated by the high-employment budget, are currently the most expansionary in many years. The level of this budget declined from a $7.2 billion surplus at an annual rate in the first half of 1965 to a $0.3 billion surplus in the second half of 1965 and is estimated to be at about the same level in the first half of 1966. Barring unanticipated departures from the January budget plan for expenditures and taxes, this budget is expected to remain at about the first-half level in the last half of this year. However, there seems to be considerable likelihood that defense spending in the second half will exceed the forecasts in the January budget plan.

Sources: Council of Economic Advisers, Board of Governors of the Federal Reserve System, and Federal Reserve Bank of St. Louis
Latest data plotted: 1st quarter 1966 preliminary. 2nd quarter and last half 1966 estimated by Federal Reserve Bank of St. Louis.

The smaller the surplus (or larger the deficit) in the high-employment budget, the less is the amount that the Government withdraws from the income stream at high employment relative to what it spends and the greater is the stimulus of fiscal actions. A common opinion holds that the level of the high-employment surplus should be low when aggregate demand is inadequate to maintain high employment. A shift from surplus to deficit in this budget is appropriate if planned private saving tends to exceed planned investment. A deficit in the high-employment budget stimulates total demand and thus propels the economy toward greater production as long as there are unused resources. If private demand gains sufficient momentum, the high-employment budget should assume a less stimulative position by means of a reduction of government expenditures or an increase of tax rates. If demand becomes excessive, the high-employment budget should run whatever surplus is necessary to hold total demand within appropriate limits.

The above discussion assumes a neutral or unchanging monetary policy. When monetary policy is considered flexible, there is accordingly a range of appropriate fiscal actions. It then becomes possible for the high-employment surplus to be at a low level during a period of excessive demand, provided the fiscal stimulus is accompanied by sufficient monetary restraint. Such a policy mix results in higher interest rates than would a mix of policies including greater fiscal restraint.

Monetary Developments

The money supply, seasonally adjusted, declined from April to May. It has declined or increased relatively little in the middle month of each quarter for the past two years. This situation should be considered when evaluating data regarding money supply over a period of less than three months. In view of this problem the money supply should probably not be considered to have increased so rapidly as the indicated 14 per cent annual rate from March to April nor to have declined as indicated in May.

The money stock has increased about 6 per cent in the past year. The general upward trend of money seems to be continuing when full account is taken of seasonal adjustment difficulties. Growth has not been so rapid for any other 12-month period since World War II. The next highest rate was 5.6 per cent during the Korean War. The money supply increased at a 2.6 per cent rate from 1960 to 1964 and at a 1.4 per cent rate from 1953 to 1960.

Rapid increase in the money supply might be justified if the velocity of money were declining, that is, if spending were declining and the demand for money to hold, increasing. However, the increase in money has been accompanied by a continuing rise in the turnover of money. Income velocity of money, which is the ratio of gross national product to the money supply, rose to 4.24 in the first quarter of 1966 from 4.18 in the third quarter of 1965 or at about a 3 per cent annual rate. Velocity has risen at a 3 per cent average rate since the last peak in business activity in the spring of 1960. The ratio of GNP to the money supply plus bank time deposits was 2.25 in the first quarter of 1966, the same as in the third quarter of 1965.

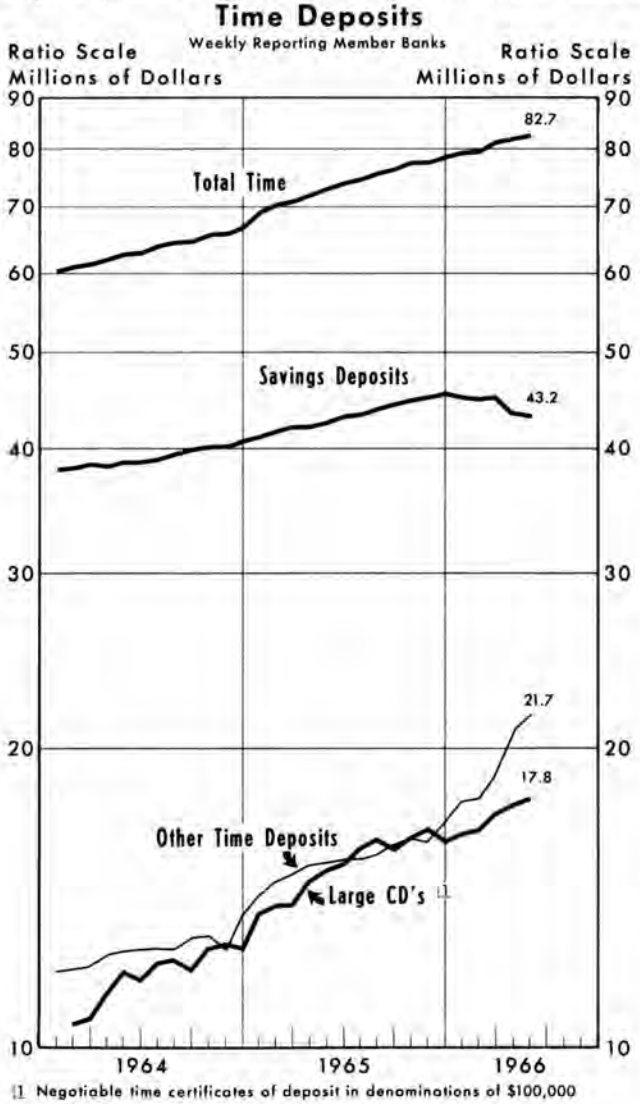
Time Deposits

Time and savings deposits at commercial banks increased at about a 14 per cent annual rate from March to May. However, since November the growth of these funds at commercial banks has generally been more moderate than previously. During the past six

months these deposits have grown at about a 10 per cent annual rate compared with 16 per cent in the previous year. Time deposits rose at a 15 per cent rate from 1960 to 1964 and at a 7 per cent rate from 1953 to 1960.

The decline in the rate of growth of time deposits at commercial banks has been one aspect of a general decline of the rate of net flow of funds into and through almost all financial intermediaries. The decline of the role of financial intermediaries has been accompanied by more direct investment in the capital and money markets and by a greater use by corporations of their own liquid funds.

Time deposits at the weekly reporting banks have risen at about a 13 per cent rate since November compared with the 10 per cent rate at all commercial banks. Weekly reporting banks, which are primarily large banks, provide condition statements more frequently and in greater detail than other banks.



[1] Negotiable time certificates of deposit in denominations of $100,000 or more.
Latest data plotted: May

They hold about 55 per cent of total commercial bank time and savings deposits.

Large negotiable and smaller certificates of deposit have both risen rapidly at these banks, while saving deposits have declined. Large negotiable certificates of deposits have increased at a 15 per cent annual rate since November compared with a 30 per cent jump in the year ended in November. Savings deposits have declined at a 7.6 per cent rate since November, with the drop particularly sharp since February. These deposits grew 12 per cent in the year ending in November. Other time deposits have risen at a 67 per cent rate since November compared with 27 per cent in the previous year. This category includes small denomination certificates of deposit.

Growth in Time Deposits

Annual Rates of Change

	Weekly Reporting Banks				All Commercial Banks
	Large CD's	Savings	Other Time	Total	Total
Feb. 1966-May 1966	30.1	—16.2	85.0	16.0	11.5
Nov. 1965-May 1966	15.1	— 7.6	66.7	12.6	10.4
Nov. 1964-Nov. 1965	29.5	11.8	27.0	18.1	16.3
Nov. 1961-Nov. 1964	N.A.	11.7	40.5[1]	19.7	17.4

[1] Includes some large CD's.
N.A.—Not available.

While the growth of total time and savings deposits at commercial banks in the past six months has been at a slower rate than in the preceding five years, it has nonetheless remained rapid. The rise of time deposits over the past several years has resulted in large part from aggressive bidding for funds by banks as demands for bank credit have risen. The higher interest rates which banks have paid have enabled them to compete effectively for funds which have in turn been channeled primarily into bank loans.

Because of the higher rate of return on capital investment and great competition for lendable funds, savers are receiving higher interest rates. This encouragement to savers is highly desirable at a time when total demands for goods and services are tending to exceed our capacity to produce and demands for investment funds are exceeding saving. Despite the keen competition for funds, other financial institutions also have continued to grow. Preliminary data show that in the first four months of this year shares in savings and loan associations rose at a 4 per cent annual rate and deposits in mutual savings banks increased at a 3.5 per cent rate.

Bank Credit

The total of bank loans and investments grew from January to May at an 8.1 per cent rate, slightly

less than the 10 per cent rate of the previous 12 months. Total bank credit expanded at an 8.0 per cent rate from 1960 to 1964 and at a 4.3 per cent rate from 1953 to 1960.

Total bank credit has risen in response to huge credit demands, rapid growth in the reserve base, and bank acquisition of funds in competition with other financial intermediaries and other money market participants. Bank loans have risen even faster than total bank credit. Individual banks have accommodated strong loan demands by attracting funds, by reducing their holdings of Federal securities, and by adding to their holdings of municipal securities at a lesser rate. Total loans at commercial banks have increased at a 14 per cent annual rate since last fall, about the same rate as in the preceding 12 months, while total investments have risen slightly since fall. Bank holdings of Government securities have declined at a 9.7 per cent rate since December, while holdings of municipal securities have increased at about an 11 per cent rate, after rising 15 per cent in the previous 12 months. In May U. S. Government security holdings amounted to only 18.2 per cent of total credit at all commercial banks. Since Government securities are used as collateral for certain deposits, sale of these securities as a source of loan funds is limited.

Business loans at all commercial banks increased in the four months ending with May at an 18 per cent annual rate, about the same rate as during the past year. These rates of increase of commercial bank business loans compare with about a 6 per cent rate of increase of real product in the nation since early 1965 and an 8.4 per cent average rate of increase in business loans from 1953 to 1965.

Interest Rates

Despite the rapid monetary expansion over the past year, strong demand for loan funds pushed interest rates up. Key rates rose substantially after last July. The increase was especially rapid in December in spite of exceptionally rapid increases of total bank credit and the money supply. Some interest rates have hovered at or slightly below their peaks in recent months, while others have continued to rise. In May and early June many interest rates were rising.

Reflecting a recent decline in stock prices, yields on common stocks were higher in May than in February. Higher long-term interest rates used in capitalizing expected corporate earnings may have been a factor in the lower stock prices. From a longer view, yields on stocks have fluctuated in a relatively narrow range since 1958.

Even though they have risen substantially over the past year, interest rates in the United States on both short- and long-term securities are still below those in most other industrialized countries. For example, yields on U.S. Treasury bills increased from 3.89 per cent last May to 4.63 per cent this May, while yields on three-month Euro-dollar deposits in London rose from 4.99 per cent to 5.75 per cent.

Bank borrowing from the Federal Reserve has increased since February as money market interest rates have been high relative to the discount rate. At times in recent weeks, the interest rate on Federal funds, which are, in effect, overnight loans from one commercial bank to another, touched 5¼ per cent or three-quarters of a percentage point more than the basic Federal Reserve rate.

Conclusion

Prices continue to rise rapidly in response to a high and increasing total demand for goods and services. At the same time there are some indications that increasing employment of previously unused resources is resulting in a reduction of the rate of increase of real product. Government fiscal actions and monetary expansion continue to facilitate rapid expansion of total demand and have stimulated large credit demands. These credit demands have been so vigorous that relatively high interest rates have developed despite the record monetary expansion.

If the present level of total demand is too high, several alternatives are available for dampening it. The Government might reduce its expenditures or increase its taxes. These actions would reduce the demand for goods and services directly and take some of the pressure off credit markets, making control of monetary growth less difficult and limiting interest rate increases. Decisions on Government expenditures and tax rates, however, take into consideration factors other than economic stabilization.

Total demand might also be restrained by reduction of the rate of expansion of bank reserves, bank credit, and the money supply. Such restraint might initially cause a further rise in interest rates. However, after a period, lower rather than higher rates might result from less rapid monetary expansion. The rise in interest rates in the past year has resulted from increases in credit demands flowing from greater spending, optimistic expectations, and inflation fears. If total demand for goods and services were to be moderated by monetary restraint or other means, demand for credit might recede, causing lower interest rates despite more moderate growth in bank credit and money.[1]

[1] For further discussion bearing on this point, see "Interest Rates, 1914-1965," by Norman N. Bowsher in the October 1965 issue of this *Review*.