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FEDERAL RESERVE BANK OF ST. LOUIS

Review

CONTENTS




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FEDERAL RESERVE BANK OF ST. LOUIS

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# *Total Demand, Credit Flows, and Money*

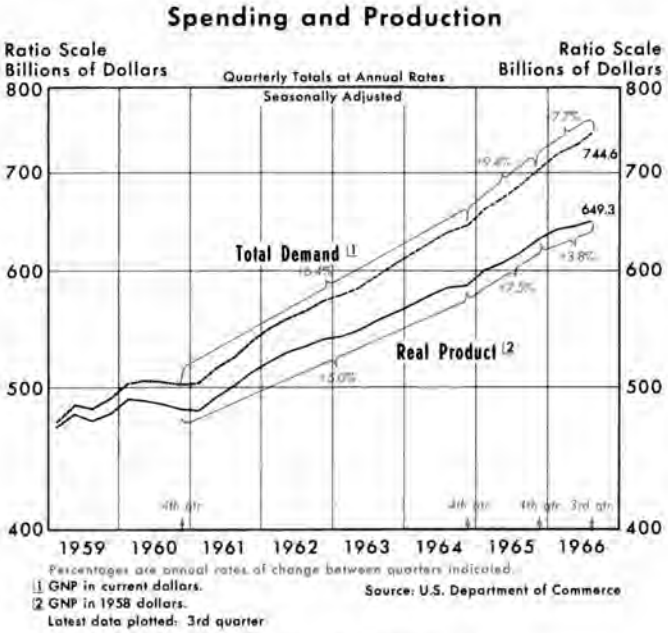
MEASURED IN CURRENT DOLLARS, the national economy has continued to expand at a rapid rate. Measured in real terms, advance has been at a reduced rate, largely due to capacity limitations. With total demand increasing more rapidly than real product, prices have risen rapidly, although very recently they have shown some evidence of greater stability.

The recent mix of stabilization policies may be described as a combination of fiscal ease and monetary restraint. Government spending has continued to rise, while key monetary variables have contracted. This policy mix led to an acceleration in the rise of interest rates from April to September.

## *Total Demand and Prices*

Total demand rose at a 7 per cent annual rate from the second to the third quarter, about the same as the rate of advance from the fourth quarter of last year. Real product increased at a 4 per cent rate from the fourth quarter of 1965 to the third quarter of 1966. With the economy operating near capacity, about half of the increase in total demand spilled over into price increases.

Increases in total demand have been broadly based as the major components, consumer, business, and government demand, have all advanced rapidly in 1966. Increases to the third quarter from the fourth quarter of last year were at a 14 per cent annual rate for government purchases of goods and services, a 4 per cent rate for private investment (including residential construction), and a 7.5 per cent rate for consumer spending.




### SPENDING BY SECTORS

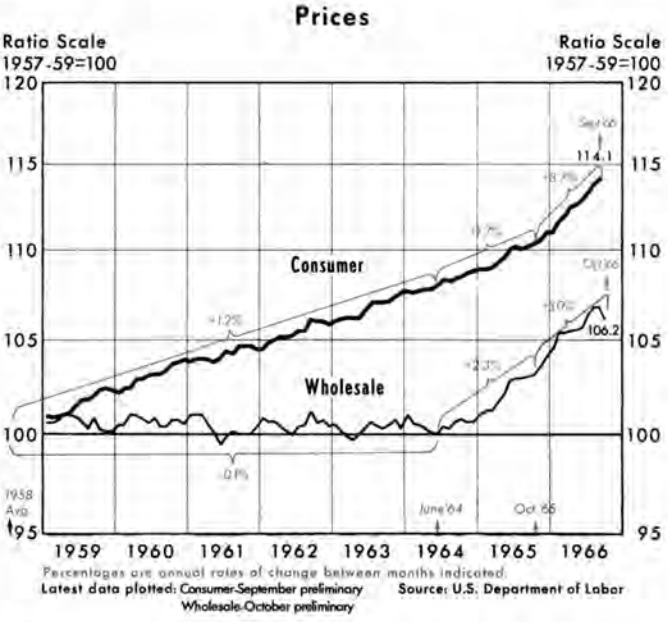
Annual Rates of Change

| | 1960 to 1965 | 4th Quarter 1965 to 3rd Quarter 1966 |
|---|---|---|
| Total spending (GNP in current dollars) | 6.2 | 7.7 |
| Consumption | 5.8 | 7.5 |
| Investment | 7.3 | 3.7 |
| Government | 6.5 | 13.7 |

Business investment is of primary concern because of its dynamic role in cyclical developments. Plant and equipment spending advanced sharply during the two-and-one-half year period ending in the second quarter. Third quarter estimates and surveys for the fourth quarter indicate some slowing in the rate of increase. Such a slowdown, if properly moderated, is to be welcomed when total demand is excessive. A moderation in plant and equipment spending would help to free resources for other sectors of the economy and relieve some upward pressures on prices by bringing planned investment in line with planned saving.

Business investment in inventory has continued to rise, but generally in pace with final sales. So long as inventories remain in line with sales, pressures will not develop to cut back orders, and production, employment, and income will be maintained. Key factors underlying decisions to accumulate inventory are sales expectations, interest rates, and price expectations. The temptation to build inventories because of expectations of higher prices may be held in check by the relatively high costs of credit. To the extent that inflationary fears are arrested, inventory investment tends to increase less rapidly. Consequently, a decline in the rate of inventory accumulation need not necessarily be interpreted as portending a downturn in business activity. Rather, such a development might indicate anticipations of a sustainable advance in production without excessive price increases.

Prices, responding to total demand increases in excess of resource growth, have risen rapidly. As measured by the GNP price index, prices increased 3.7 per cent from the fourth quarter of last year. Wholesale prices in October were up 3 per cent over a year earlier, with some hesitation in the rise in September and October. Consumer prices have continued their upward surge, rising at about a 4 per cent annual rate since early this year. Prices for food and services have gone up about 5 per cent, and prices for commodities other than food have increased about 2 per cent.




## *Total Demand and Fiscal Stimulus*

Federal fiscal policy is imparting a substantial stimulus to the economy in the last half of this year. Fiscal actions were more stimulative in the year ending in the second quarter (fiscal year 1966) than in any previous year in over a decade. The high-employment budget showed a $1.1 billion surplus compared with an average surplus of $7.2 billion from 1955 to mid-1965. During times of high employment and rising prices, the high-employment budget probably understates the extent of fiscal stimulus. The estimate of surplus is overstated at these times because of the progressiveness of the tax structure relative to money incomes and because the share of national income going to profits is probably rising. The high-employment surplus thus tends to rise in response to


inflationary forces rather than because of restrictive fiscal actions.[1]

The Viet Nam conflict is probably boosting defense expenditures even more rapidly in the last half than in the first half of this year. Defense expenditures in the third quarter were up $4.2 billion (annual rate) from the second quarter, and medicare payments were also up sharply. The medicare program will show less quarter-to-quarter change subsequently, but increases in defense spending are expected to continue.

The Federal Government is not instituting any major changes in tax rates during the remainder of 1966. Suspension of the investment tax credit and the less liberal depreciation procedures for tax purposes, as enacted into law, are not expected to produce much additional tax revenue in calendar 1966. These programs, however, may increase Federal revenues somewhat in early 1967. Social security tax rates are scheduled to increase from 8.4 per cent to 8.8 per cent on January 1, 1967, and the last phase of the corporate tax speed-up program will take place in the first half of 1967. Taken all together, however, these measures seem likely to have little effect in restraining the stimulative impact of the Federal budget.

## *Credit Demand and Monetary Restraint*

The rapid expansion in total spending on goods and services has contributed to marked increases in credit demands. Businesses have sought credit to finance inventories and large capital expenditures. Outstanding business loans made by commercial banks in August were up 18 per cent from a year earlier. From early August to late October such loans at weekly reporting banks grew no further. Recent moderation of borrowing from commercial banks may have resulted primarily from cessation of growth of bank deposits. This in turn follows in considerable measure from Regulation Q ceilings. Corporate securities offerings for new capital were 26 per cent greater in the first three quarters of this year than in the same period of 1965. State and local government issues for new capital through the third quarter of 1966 were 9 per cent above the total for the same period a year earlier.

Federal Government borrowing during the first three quarters of 1966 was up significantly despite programs to bring individual and corporate tax payers closer to a pay-as-you-go basis. Gross proceeds from new issues of U.S. Government securities, including agency issues, in the first three quarters of 1966 exceeded those for the corresponding period of 1965 by about 25 per cent.

The quickened pace of Government borrowing is expected to continue throughout the remainder of 1966, as the cash deficit will be at an annual rate of about $12 billion. The postponement of the issue of agency participation securities will tend to expand direct Treasury borrowing further, placing upward pressure on the short end of the maturity spectrum, where this borrowing will be concentrated because of the 4.25 per cent interest rate ceiling on long-term Government securities.

Monetary developments in recent months have helped restrain inflationary pressures by limiting the ability of banks to extend credit. The Federal Reserve influences the banking system's ability to expand credit by altering total reserves through purchases or sales of Government securities in the open market. Federal Reserve purchases of securities expand member bank reserves, while sales contract reserves.

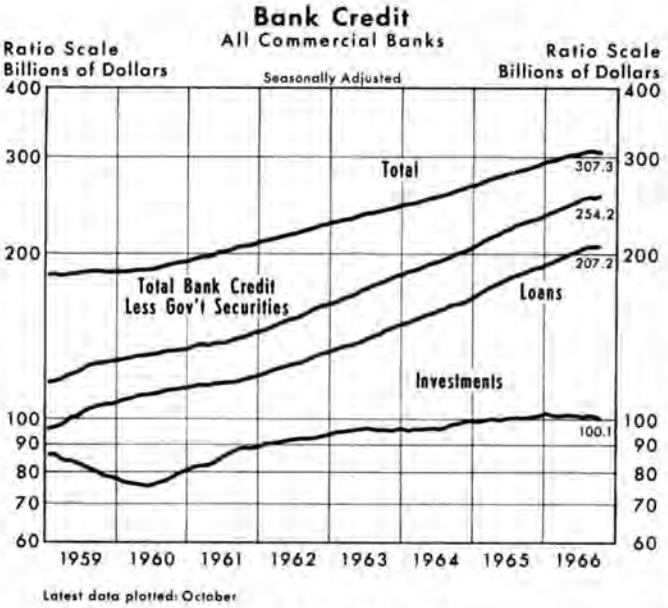
Federal Reserve holdings of U.S. Government securities have expanded at a 4 per cent annual rate since April compared with an increase of 8 per cent from April 1965 to April 1966 and a 10 per cent average annual increase from 1961 through 1965.

Total member bank reserves, reflecting the reduced rate of net Federal open market purchases and other factors, including reserve requirement changes, have declined at a 2.2 per cent rate since April compared with a 4.8 per cent increase in the year ending in April and a 3.9 per cent average rate of increase from 1961 through 1965. Reserves available for private demand deposits have declined at a 4 per cent annual rate

[1]This point was brought out in correspondence with Herbert Stein of the Committee for Economic Development.

since April compared with an increase of 5 per cent in the preceding year and an average rate of 1.4 per cent from 1961 to 1965.

In line with these monetary developments tending to limit the ability of banks to expand credit, bank credit outstanding increased only slightly from July to October. Growth in total loans has moderated since July; business loans have risen at a much slower pace than earlier in the year.




## *Interest Rates and Changing Sources of Credit*

The continued strong credit demands coupled with more restrictive monetary actions resulted in an acceleration in the rise of interest rates from April to September. Increases were most rapid for securities with shorter maturities, as is usually the case when rates rise substantially. From April to September the three-month Treasury bill rate and the four- to six-month commercial paper rate rose from 4.61 per cent to 5.36 per cent and from 5.38 per cent to 5.89 per cent, respectively. These rates compare with 3.93 per cent and 4.38 per cent in April 1965. Discounted at higher interest rates, the present value of anticipated future earnings and dividends on common stock decreased during this period. This may be one factor determining the net declines in the stock market. The earnings-price ratio on common stock rose 1.7 percentage points from April to September compared with an increase of 0.6 percentage points in the preceding year.

In recent weeks there has been some tendency for interest rates to decline. During October the rate on three- to five-year Government bonds declined to 5.36 per cent from 5.49 per cent, while the bill rate declined from 5.39 per cent to 5.22 per cent.

### CHANGES IN INTEREST RATES

Percentage Points

| | April 1965 to April 1966 | April 1966 to Sept. 1966 | Sept. 1966 to Oct. 1966 |
|---|---|---|---|
| 4- to 6-month commercial paper | 1.00 | 0.51 | 0.11 |
| 3-month Treasury bills | 0.68 | 0.75 | 0.03 |
| 3- to 5-year Government bonds | 0.74 | 0.76 | —0.22 |
| Long-term Government bonds | 0.40 | 0.24 | —0.04 |
| Corporate Aaa bonds | 0.53 | 0.53 | —0.06 |
| Municipal Aaa bonds | 0.37 | 0.47 | —0.08 |
| Conventional first mortgages (including fees & charges) | 0.31 | 0.51 | N.A. |
| Dividend/price ratio | 0.20 | 0.60 | 0.01 |
| Earnings/price ratio | 0.55 | 1.73 | 0.02 |

N.A. — Not available.

A marked change in the sources of funds supplied to credit markets has accompanied the overall rise in interest rates. Financial intermediaries have been supplying a much smaller proportion of the total, while open market channels have been increasing their share. Direct financing accounted for approximately 12 per cent of total funds supplied to credit markets in 1965. Preliminary data indicate that during the first half of 1966 this proportion increased to approximately 36 per cent, and it appears that the share rose further in the third quarter. Total funds supplied increased from $73.5 billion in 1965 to an annual rate of $74.9 billion in the first half of 1966.

Most of the shift of funds into direct flow through the open market has been a movement away from the acquisition of liabilities of intermediaries, i. e., time deposits at commercial and mutual savings banks and shares of savings and loan associations. The growth of total time deposits at commercial banks fell from 15 per cent during 1965 to a 10 per cent annual rate in the first eight months of 1966. From mid-August to late October these deposits remained virtually stable. The change in the course of time deposits has been particularly affected by a decline in the amount of large certificates of deposit outstanding. Since about August 1965 growth of these deposits has been impeded at times by the limited rates banks have been permitted to pay compared with open market rates. After growing about one-third each year for several years, CD's grew at only a 14 per cent annual rate from August 1965 to May 1966. After May these deposits were about unchanged to late August. Subsequently, they have fallen about $2 billion or about 11 per cent as open market rates have been above the rates the banks were permitted to pay.

Effective September 26, the maximum rate payable on time deposits of less than $100,000 (primarily consumer-type CD's) was lowered from 5½ per cent to 5 per cent, while all other maximum rates remained unchanged. Prior to this action, the Federal Reserve had reduced the maximum rate that member banks may pay on new multiple-maturity deposits of 90 days or more from 5½ to 5 per cent and from 5½ to 4 per cent on those with a maturity of less than 90 days. This action became effective July 20, 1966. These actions, following the rapid rise during the summer in rates on market instruments which compete with large CD's, have made time deposits much less attractive to potential investors. Recent slowing in rates of increase of bank credit may reflect the declining role of banks as intermediaries as well as restrictive monetary actions.

Both savings and loan associations and mutual savings banks have experienced significant reductions in the rate of growth of their deposits. During the first half of this year savings and loan shares increased at an annual rate of 5 per cent compared with 9 per cent during the corresponding period of 1965. Mutual savings banks have had a similar experience with regard to new deposit inflow. Recent actions by the supervisory agencies in limiting rates paid on time deposits have been aimed at reducing competition between financial intermediaries and directing more funds into the mortgage market.

## *Money Stock and Money Demand*

Reflecting the course of bank reserves, the money stock, as measured by checking accounts plus currency, declined slightly from April to October. In contrast, money rose 6 per cent from April 1965 to April 1966 and at a 3 per cent rate from 1961 to 1965. The marked change in money growth centered in demand deposits (checking accounts), which fluctuate closely with the volume of reserves available to support them. From April through October this component of the money supply declined, after increasing about 6 per cent in the year ending in April. Currency, which usually expands or contracts in response to the volume of sales handled by currency, continued to rise at about the same rate as in the previous year.


Money supply defined to include time deposits at commercial banks has been about unchanged since mid-August. This measure of the money stock grew at a rate of 3 per cent a year from April to October, about 10 per cent from April 1965 to April 1966, and at a rate of 8 per cent from 1961 to 1965.

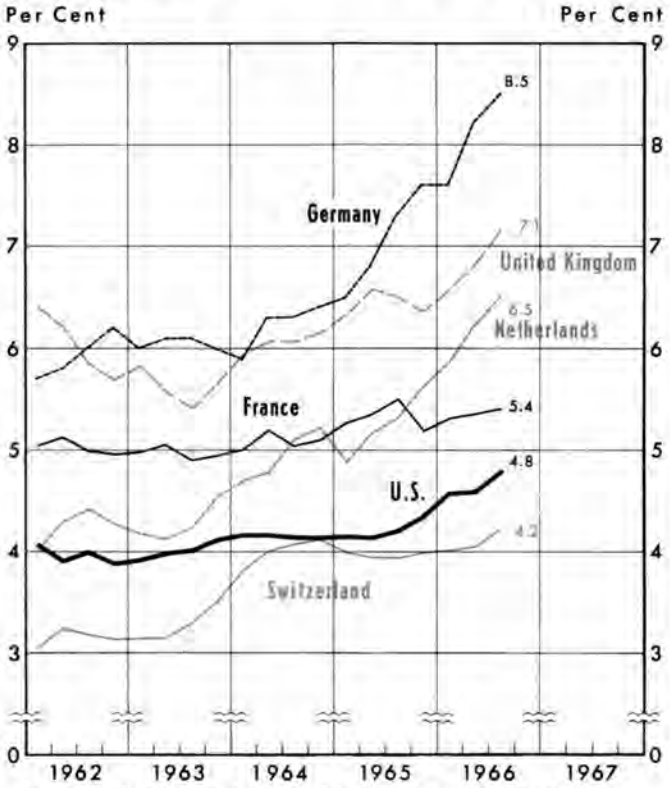
Demands for money stem primarily from transactions needs and store-of-value demand. Continued advances in economic activity since early summer indicate that the need for money balances for transactions purposes has probably increased despite declines in the supply of money. Increases in desired money balances for transactions purposes may have been offset by the sharply rising interest rates, making the alternative cost of holding idle money much greater. To the extent that the money stock has declined relative to the desire to hold it, the growth of total demand may be restrained in coming months as individuals and businesses attempt to build cash balances by spending less than their current incomes.

## *Recent European Economic Developments*

In most European countries interest rates have risen substantially since mid-1963. Rates on long-term government bonds began rising in the second half of 1963 or early 1964 in France, Germany, the Netherlands, Switzerland, and the United Kingdom. The rise has been strongest in Germany, the Netherlands, and the United Kingdom.

An increase in interest rates could be due either to an increase in demand for credit (because of an expansion in total demand for goods and services possibly brought about by expansionary fiscal policy) or to a decrease in the supply of credit (because of a decline in planned saving or restrictive monetary policy). Rising interest rates in most European countries have, in considerable measure, been caused by increasing demand for loan funds promoted by growth in total demand for goods and services. In the period from 1963 to 1965 total demand increased at average annual rates of 8 per cent in Belgium and Germany, 12 per cent in the Netherlands, 9 per cent in Switzer-

## Long-Term Government Bond Yields




Latest data plotted: U.S.-3rd quarter; Others-3rd quarter estimated

Source: IMF

land, and 7 per cent in the United Kingdom. The recent increases in interest rates in the United Kingdom have also been due to monetary restraint as part of the comprehensive program to protect the balance of payments. The money supply in the United Kingdom changed little in the second quarter of 1966 compared with an annual rate of increase of 10 per cent over the previous five quarters. Germany, the Netherlands, and Switzerland increased their central bank discount rates in the early summer of 1966, but latest data show no significant changes in the rate of increase in the supply of money.

Monetary expansion has in general continued at rapid though somewhat reduced rates. Currently available data show money supply increasing over recent periods at annual rates of 7 per cent in Belgium, 10 per cent in France, 6 per cent in Germany, and 11 per cent in the Netherlands. In addition, most Western European governments have been spending more than they have been taking in from taxes. Thus, stimulative fiscal and monetary policies have contributed to the high total demand for goods and services, to the large demand for loan funds, and to high interest rates.

As demand has increased, limited availability of labor and other resources has led to rapidly increasing wages and prices. Since 1963 employment has been increasing at annual rates that average 1 per cent to 2 per cent in Belgium and Germany and less than 1 per cent in France, the Netherlands, and the United Kingdom. Over recent periods consumer prices have increased at annual rates of about 3 per cent in France and Germany, 4 per cent in the United Kingdom, 5 per cent in Switzerland, and 6 per cent in Belgium and the Netherlands.

With demand for output increasing rapidly and with wages in many cases rising faster than productivity, European firms have been provided with incentive to increase capital investment at a time when the squeeze on profits and thus on retained earnings has rendered them less capable of financing such investment internally. The decline in retained earnings and the increase in investment incentives have contributed to increased demands for investment funds.

The concurrence of restricted growth in real output, reflecting labor shortages, and continued growth in total demand has put unusual pressure on European capital markets. Most European rates have been pushed to such high levels that the spread between rates in the United States and Europe has actually widened in spite of the rise in U. S. rates. But because of the speculative movement out of sterling in July and the unusually sharp increases in short-term rates in the United States in the middle and late summer, there was substantial short-term capital movement from Europe to the United States. This resulted in a rapid increase in U. S. liabilities to private foreigners in the third quarter, which probably accounts for the apparent surplus in the U. S. balance of payments on the official settlements basis. Because an increase in U.S. liabilities to private foreigners is not considered a capital inflow on the liquidity basis, this measure of the balance of payments is estimated to have continued in deficit in the third quarter.[2]

[2] On the official settlements basis, only an increase in dollar assets held by foreign monetary authorities is treated as a means of financing, and thus as a measure of, the deficit. On the liquidity basis an increase in liquid dollar assets held by both public and private foreigners is treated as a means of financing the deficit.