CURRENT ECONOMIC PROSPECTS

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Let me single out a few specific elements of the next six or nine months in which you may be particularly interested:

1) Interest rates

2) Prices

3) The flow of commercial bank funds

A sound way to approach a discussion of these matters is to try to understand where we are at present and how we got there: Why did interest rates rise as they did in the past 18 months? What has happened to the supply of commercial bank funds during this period? Why did prices of goods and services rise? And how did increases in total demand for goods and services contribute to rises in interest rates and prices?

In order that we may agree on the facts and have some background for analysis, I shall review the recent behavior of a number of economic indicators.

Interest Rates

Interest rates generally trend upward in periods of economic expansion. This usual behavior of rising rates occurred from 1961 to 1965. In 1965, however, rates began to spurt upward much more rapidly than they had at any time during the 1961-65 period (Chart 1). From April 1965 to April 1966, rates on both highest-grade corporate bonds and highest-grade state and local bonds increased 12 per cent. Then from April to September 1966, interest rates on corporate bonds rose 28 per cent, while rates on state and local bonds jumped 36 per cent. In recent weeks there has been some tendency for interest rates to decline, as shown by the chart.

What brought about these marked rises in interest rates? First, let us examine the demand for loan funds.

Demand for Loan Funds

Rising demand for loan funds has been brought about primarily by rising demand for goods and services on the part of both the private and Government sectors.

Consumer spending for goods and services, which had been rising at rates of about 9 per cent in 1965 and the first quarter of 1966, rose less rapidly in the second quarter, but resumed its high rate of expansion in the third quarter. Retail sales, a major part of consumer spending, were up about 8 per cent in September over a year earlier.

Business demands for plant and equipment have risen sharply in 1966, with outlays for the year now expected to surpass those in 1965 by about 17 per cent. Plant and equipment spending during the first half of this year was up at an annual rate of 18 per cent over the second half of 1965. Government surveys of investment anticipations for the second half indicate continued advance but at a somewhat slower rate.

The major upward thrust to total demand has come from Governments. Demands for goods and services by Federal, state, and local Governments, which accelerated in the second half of 1965, continued to advance in the first half of 1966. Available evidence indicates that these demands are intensifying in the second half of 1966. 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. In addition, the Federal Government has continued to expand its welfare programs; the growth of Medicare payments is an example of this expansion. The Medicare Program will show less quarter-to-quarter change subsequently, but increases in defense spending are expected to continue.

Supply of Funds

The increase in interest rates has probably come from the jump in demand for loan funds, not from a restriction on supply. At least it did not result from any Federal Reserve restriction of money and credit before last April. From June 1964 to April 1966, Federal Reserve credit grew at an annual rate of 10.3 per cent, bank reserves 5.4 per cent, bank credit 9.7 per cent, and the money supply 5.2 per cent. These do not appear to be restrictive rates of growth.

It was said that the Federal Reserve was a major factor causing higher interest rates when the discount rate and the Regulation Q ceiling were raised in early December 1965. However, interest rates had already been moving up strongly for several months prior to these actions. In the last half of 1965 Treasury bill yields had moved above the discount rate. Also, practically every other market interest rate had trended strongly upward. The discount rate and the Regulation Q ceiling were adjusted upward only after market rates had moved.

We find then that monetary restraint was not a factor in the tightness of credit markets and that interest rates moved up because of the great demand for loan funds.

It is true that this picture has changed since April. Monetary developments since then 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 (adjusted for reserve requirement changes), reflecting the reduced rate of net Federal open market purchases and other factors, have declined at a 2.2 per cent rate since April, compared with a 5 per cent increase in the year ending in April and a 4 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 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 (Chart 10).

Reflecting the course of bank reserves, the money supply, as measured by checking accounts plus currency, declined at a 1.5 per cent annual rate from April to October.

The combination of fiscal ease and monetary restraint, with Government spending and borrowing continuing to rise while key monetary variables contracted, led to the acceleration in the rise of interest rates from April to September.

The Behavior of Prices

Total demand has been expanding more rapidly than the ability of the economy to produce. Total demand for goods and services rose 9.4 per cent for the year ending in the fourth quarter of 1965, while the rate of growth of real product was only 7.5 per cent. From the fourth quarter of 1965 to the third quarter of 1966, total demand rose 7.7 per cent, while the rate of growth in real product was only 3.8 per cent (Chart 3).

As the economy approaches full utilization of its resources, its ability to expand real output is limited to growth in labor, capital, and technology. This growth rate is currently estimated to be about the same as the 3.8 per cent rate of growth in production experienced this year. Hence, the rate of growth of industrial production and employment fell from 1965, when producers were able to draw upon unemployed resources. In 1966, virtually all factors of production were being utilized. Industrial production grew 9 per cent in the year ending in March 1966, and at a 6.4 per cent rate from March 1966 to September 1966. The rate of growth of total employment has fallen from 3.4 per cent for the year ending in December 1965 to 1.2 per cent from December 1965 to October 1966.

Increases in total demand beyond the capacity of the economy to increase real product lead to increases in prices. From October 1965 to September 1966, consumer prices rose at an annual rate of 3.7 per cent, compared with a rate of 1.7 per cent for the period June 1964 to October 1965 and only 1.2 per cent for the period 1958 to June 1964 (Chart 2). The increase in wholesale prices has been even more pronounced. In the year ending in October 1966, wholesale prices increased 3 per cent, compared with a rate of 2.3 per cent for the period June 1964 to October 1965 and virtual stability from 1958 to 1964

Prospects for Interest Rates and Prices

On the basis of information that we have now, what may we expect the course of interest rates and prices to be over the next few months?

So long as the basic supply and demand situation with respect to loan and investment funds produces high general interest rates, it is necessary for the commercial banks to go along with these trends. Banks must both pay high rates and charge high rates if they are to perform their function in the economy. Interest rates serve the function of allocating a limited supply of investable funds among competing uses. When demand rises faster than supply, interest rates go up and some projects must be postponed. In some ways the high and increasing general level of interest rates is disruptive and undesirable, but the alternative of creating enough funds to hold interest rates low would be even more disruptive and undesirable, as other prices would be forced up.

Since last fall, commercial banks and other financial intermediaries have had difficulty attracting time and savings deposits. Limitations on the interest rates paid or charged by these institutions mean that funds will flow through other avenues, notably the open market. Big borrowers and big savers have better access to the open market than small borrowers and savers, and thus the allocation of funds has been affected by interest rate limitations.

In summation, total demand for goods and services expanded during the past year at a faster rate than the ability of the economy to produce them. This rapid increase in total demand was imparted primarily by a stimulative Federal fiscal policy. Fiscal actions were more stimulative in the year ending in the second quarter 1966 than in any year in over a decade.

Prices have increased rapidly in response to total demand expansion beyond the capacity of the economy to produce. Wholesale prices in October were up 3 per cent over a year earlier. Consumer prices rose at more than double their rate of increase in previous years.

Interest rates rose as demand for loan funds jumped in response to the rapid expansion in total spending on goods and services. Prior to April of this year, the increase in rates does not appear to have been due to restrictive monetary policies. Since April, however, monetary developments have helped restrain inflationary pressures by limiting the ability of banks to extend credit. These restrictive actions on the supply of loanable funds have placed further upward pressure on interest rates.

If the level of interest rates is to be kept down, total demand for loanable funds must also be reduced. Public policy can reduce demand for loanable funds by reducing demand for total product in the economy. This can be accomplished by a more restrictive Federal budget. Such a policy would permit greater monetary expansion and reduced interest rates.