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CONFIDENTIAL (FR)

CURRENT ECONOMIC and FINANCIAL CONDITIONS

**Prepared for the
Federal Open Market Committee**

By the Staff

**BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM**

October 27, 1965

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SUMMARY AND OUTLOOK

Outlook for demands and output

Prospects are good for a continuing expansion in final demands in the current quarter -- at a rate which is likely to boost GNP by around \$10 billion, despite a considerable drop in the rate of inventory accumulation. Sharp curtailment of steel output may be causing industrial production to show little change in this quarter even though total GNP is continuing to rise. The production index dropped by one per cent in September and is unlikely to recover this month. However, divergence between GNP and industrial production is not unexpected, given the special circumstances affecting the steel industry on the one hand and the sharp rise in income payments and consumer spending on the other.

A further large increase is in prospect for consumer buying this quarter. Much of the large retroactive increase in social security benefits in September is likely to be spent by recipients in the current quarter. Also, a military pay raise, effective in September, is being followed by a Federal civilian pay raise effective this month, and current incomes of social security beneficiaries are at the higher level established in September. These special factors are accompanying the on-going rise in incomes being generated by expanding private economic activity and by rising government employment -- civilian and military.

The additional spending generated by this increase in incomes is expected to be almost entirely in nondurables and services. An

uncertainty in the near-term consumption outlook is the rate of auto sales, but current new model sales and fourth quarter output schedules of producers suggest consumer purchases will continue at the very high rate prevailing thus far in 1965.

Federal outlays are being further increased by additional defense expenditures to support the war in Vietnam. New orders for defense products have been increasing steadily, and the defense order backlog is up substantially from the beginning of the year. State and local government purchases are continuing their steady growth.

Business fixed investment outlays are slated for a large further rise in the current quarter while residential construction activity and net exports are expected to change little. Apart from steel, there is no evidence that inventory accumulation is changing much from the third quarter rate.

Prospective developments in resource utilization, costs and prices

Heavy spending for plant and equipment is yielding widespread and substantial increases in capacity; the estimated gain in manufacturing capacity is 6 per cent for this year and at least as much for next year. Recently, the utilization rate in steel has dropped sharply while that in the rest of manufacturing has apparently shown little change. Nor is any significant change in capacity utilization expected through the remainder of the year.

Employment continued to expand through the summer but some slackening in the advance occurred in September in part because of slowdowns in manufacturing output and construction activity. The

unemployment rate -- 4.4 per cent in September -- is unlikely to show much change for the balance of the year.

Because of the decrease in steel production since the labor settlement, output per manhour is lower and unit labor costs higher in that and closely related industries. The pace of wage increases in industries other than steel has shown no acceleration and output is rising further. Consequently, measures of labor costs per unit of output in these lines are likely to show little increase during the current quarter.

The industrial commodity price index has been virtually stable since mid-August, following a rise of about 1.5 per cent over the preceding year. Nevertheless, further price increases among materials are likely, especially in view of the recent rise for primary copper. Selective increases in list prices for steel also are taking place, although it is uncertain to what extent average prices will rise until demands for steel strengthen again.

With increases in labor costs and materials prices neither large nor widespread, price increases among finished products also are likely to be selective and some decreases may continue to be announced. Moreover, current and prospective rates of capacity utilization are high in most lines, and the outlook is for a continued upward creep in industrial prices without any appreciable acceleration.

Bank credit and money

Demand for bank loans from nonfinancial customers has continued strong in recent weeks, and is expected to remain vigorous over

the final months of 1965, although somewhat less so than in the third quarter. Expansion in business loans will be moderated by the reduced needs of firms which previously had been stockpiling steel. On the other hand, demands for funds for more general working and fixed capital purposes should continue very strong, and prevailing interest rate relationships are tending to channel a large part of such demands into the banking system. Consumer and real estate loan demands are expected to continue at about the same rate as shown in recent months.

Bank security portfolios have increased sharply so far this month, as banks absorbed the Treasury's tax bill offering. The resulting bulge in bank investments is likely to be temporary, but over the remainder of the year will likely be followed by other bulges, mainly as a result of additional financing by the Treasury. Total Treasury financing this quarter is expected to add about \$7 billion to the market supply of Government securities (including the tax bills already offered), and this will be only partly offset by about \$2 billion of official purchases to meet seasonal reserve needs. Much of this increased supply will be absorbed initially by the banking system, and redistribution to the nonbank public may be relatively slow at current rate levels. Meanwhile, banks are curtailing their acquisitions of municipal and agency securities.

Accommodation of private loan demands and the Treasury's financing plans will likely result in a faster growth rate for total bank credit over the fourth quarter of the year. However, this does not necessarily imply an acceleration in the rate of private deposit expansion.

Private deposit expansion was already at an advanced rate in the third quarter, but Treasury deposits declined sharply. As a result, growth in total deposits was held down. In the fourth quarter, Treasury deposits are expected to remain basically unchanged. Thus, while private deposits are not likely to increase as rapidly as in the third quarter, total deposits are expected to grow more rapidly. This growth in total deposits throughout the rest of the year will require renewed expansion in total reserves.

Securities market prospects

Long-term interest rates have edged up again since mid-October, reflecting active and anticipated demands for funds by businesses and Government. Whether or not long-term interest rates will continue to rise over the rest of 1965 will depend in large measure on whether business demands for financing continue to press actively on available supplies of funds. The pace of mortgage financing and State and local government security flotations is not expected to change appreciably. Nor is the impact of expected Treasury cash borrowing likely to fall directly on long-term markets.

During October the volume of publicly-offered corporate bonds was less than half that of September, and the calendar of offerings presently scheduled for the weeks immediately ahead is also on the light side. However, underwriters report a very large volume of new corporate borrowing currently being arranged, some of which may represent an effort to anticipate early 1966 needs ahead of possible interest rate increases. A larger than usual proportion of this financing may take the form of private placements, thus minimizing the upward pressure on market yields.

In the municipal bond market, yield increases very recently have reflected a concentration of new offerings, along with an unexpected and large issue of FNMA participation certificates. But over the longer period, yield changes on municipals will continue to be highly sensitive to bank demand, which in turn will depend importantly on the strength of loan demands and continuing bank ability to attract funds.

The U.S. Government bond market continues to be cautious, with investor demand largely absent in recent weeks. Upward rate pressures may be minimized by keeping the mid-November Treasury re-funding in the 18-month area. Nevertheless, the long end of the market is still vulnerable and could be pushed up by a rise in short- or intermediate-term rates, or a change in expectations.

Balance of payments

Prospects for the fourth-quarter balance of payments now appear more uncertain than they did before the receipt last week of semifinal data on settlements in September (and the third quarter), described and discussed in the main body of this report. The latest data show a third-quarter deficit of \$700 million on regular transactions and a small surplus on the official settlements basis, both figures less favorable than had been anticipated earlier.

Despite these developments, it is still possible on optimistic assumptions to visualize a regular transactions deficit considerably smaller in the fourth quarter than in the third, and perhaps no larger than the average for the first three quarters (\$450 million). The merchandise trade surplus, which is likely to continue higher than it

was in the first half-year, would contribute toward improvement, and outflows of direct investment capital may be down substantially from the very high levels of the first two quarters.

A more pessimistic prognosis would take into account not only the possibility that seasonally adjusted outflows of bank credit and movements of U.S. liquid funds may be less favorable than earlier, and the probability that the United Kingdom will again exercise its option to postpone year-end debt service payments to this country of about \$140 million, but also a newly emerging possibility that direct investment outflows may not fall off as much as previously was supposed likely. It seems possible that recent talk about the possibility of new measures for dealing with direct investment outflows may be stimulating anticipatory flows.

The deficit settled by official transactions in the fourth quarter may be about as large as the deficit on regular transactions, whatever the size of the latter, as inflows of foreign private liquid funds seem likely to be small. Efforts by U.S. banks to attract funds through their foreign branches may be less successful because foreigners may be shifting out of dollars into sterling and because the Italian banks may not be putting as large sums into the Euro-dollar market as in the third quarter.

SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest Period	Amount			Per cent change	
		Latest Period	Preced'g Period	Year Ago	Year Ago*	2 Yrs. Ago*
Civilian labor force (mil.)	Sept '65	75.5	75.8	74.3	1.6	3.2
Unemployment (mil.)	"	3.3	3.4	3.8	-13.5	-18.4
Unemployment (per cent)	"	4.4	4.5	5.1	-	-
Nonfarm employment, payroll (mil.)	"	60.8	60.7	58.5	4.0	6.9
Manufacturing	"	18.2	18.2	17.4	4.3	6.9
Other industrial	"	7.9	7.9	7.7	2.6	4.2
Nonindustrial	"	34.7	34.6	33.3	4.2	7.6
Industrial production (57-59=100)	"	142.8	144.3	134.0	6.6	13.6
Final products	"	142.6	142.3	132.8	7.4	12.9
Materials	"	142.8	145.9	135.6	5.3	14.2
Wholesale prices (57-59=100) <u>1/</u>	"	103.0	102.9	100.7	2.3	2.7
Industrial commodities	"	102.3	102.3	100.7	1.6	1.9
Sensitive materials	"	102.9	103.1	99.5	3.4	6.1
Farm products and foods	"	103.5	103.3	99.3	4.2	5.1
Consumer prices (57-59=100) <u>1/</u>	Aug '65	110.0	110.2	108.2	1.7	2.7
Commodities except food	"	104.7	104.7	104.2	0.5	1.1
Food	"	110.1	110.9	106.9	3.0	3.9
Services	"	117.9	117.8	115.4	2.2	4.1
Hourly earnings, mfg. (\$)	Sept '65	2.64	2.63	2.58	2.3	6.9
Weekly earnings, mfg. (\$)	"	107.66	107.46	104.18	3.3	7.5
Personal income (\$ bil.) <u>2/</u>	"	545.3	532.0	501.7	8.7	16.2
Retail sales, total (\$ bil.)	"	23.3	23.7	22.3	4.9	14.3
Autos (million units) <u>2/</u>	"	8.9	8.9	8.8	0.5	24.1
GAF (\$ bil.)	"	5.4	5.3	4.9	8.2	16.3
Selected leading indicators:						
Housing starts, pvt. (thous.) <u>2/</u>	"	1,424	1,422	1,445	-1.5	-16.9
Factory workweek (hours)	"	40.9	40.9	40.5	1.0	1.0
New orders, dur. goods (\$ bil.)	"	21.8	21.5	19.9	9.3	19.2
New orders, nonel. mach. (\$ bil.)	"	3.2	3.3	2.9	10.4	23.7
Common stock prices (1941-43=10) <u>1/</u>	"	89.38	86.49	83.41	7.2	22.7
Inventories, book val. (\$ bil.)	Aug '65	116.7	116.0	107.6	8.4	13.6
Gross national product (\$ bil.) <u>2/</u>	QIII '65	676.9	665.9	634.8	6.6	14.1
Real GNP (\$ bil. 1958 prices) <u>2/</u>	"	609.1	601.4	582.6	4.5	10.0

*Based on unrounded data. 1/ Not seasonally adjusted 2/ Annual rates.

SELECTED DOMESTIC FINANCIAL SERIES

	Week ended	Four-Week	Last six months	
	Oct. 22	Average	High	Low
<u>Money Market</u> ^{1/} (N.S.A.)				
Federal funds rate (per cent)	4.05	3.92	4.25	1.00
U.S. Treas. bills, 3-mo., yield (per cent)	4.03	4.01	4.05	3.77
Net free reserves ^{2/} (mil. \$)	-97	-152	-91	-233
Member bank borrowings ^{2/} (mil. \$)	591	544	627	345
<u>Security Markets</u> (N.S.A.)				
Market yields ^{1/} (per cent)				
5-year U.S. Treas. bonds	4.35	4.32	4.35	4.13
20-year U.S. Treas. bonds	4.32	4.32	4.34	4.20
Corporate new bond issues, Aaa	--	4.68	4.71	4.37
Corporate seasoned bonds, Aaa	4.57	4.56	4.57	4.41
Municipal seasoned bonds, Aaa	3.31	3.31	3.31	3.09
FHA home mortgages, 30-year ^{3/}	5.46	5.46	5.46	5.44
Common stocks S&P composite index ^{4/}				
Prices, closing (1941-43=10)	91.84	90.97	91.98	81.60
Dividend yield (per cent)	2.90	2.93	3.11	2.90
	Change in	Average	Annual rate of	
	Sept.	last 3 mos.	3 mos.	1 year
<u>Banking</u> (S.A., mil. \$)				
Total reserves	0	-8	-0.4	3.8
Bank loans and investments:				
Total	100	1,300	5.5	9.3
Business loans	700	700	13.6	19.4
Other loans	-300	500	4.8	11.5
U.S. Government securities	-500	-500	-9.7	-8.2
Other securities	200	600	16.2	16.5
Money and liquid assets:				
Demand dep. & currency	1,600	800	6.2	3.9
Time and savings dep.	1,500	1,900	16.8	16.0
Nonbank liquid assets	1,500	1,800	8.7	6.3

N.S.A.--not seasonally adjusted. S.A.--seasonally adjusted.

^{1/} Average of daily figures. ^{2/} Averages for statement week ending October 20.

^{3/} Latest figure indicated is for month of September. ^{4/} Data are for weekly closing prices.

U. S. BALANCE OF PAYMENTS

	1965					1964		Year
	Sept.	Aug.	Jul.	QIII ^p /QII	QI	QIV		
Seasonally adjusted annual rates, in billions of dollars								
Balance on regular transactions				- 2.8 ^e /	0.5	- 3.1	- 6.2	- 3.1
Current account balance					6.9	5.2	8.1	7.7
Trade balance <u>1</u> /	6.0	7.3	6.9	6.7	5.2	3.7	7.2	6.7
Exports <u>1</u> /	27.2	27.8	26.7	27.2	27.1	22.3	26.8	25.3
Imports <u>1</u> /	-21.2	-20.5	-19.8	-20.5	-21.9	-18.6	-19.6	-18.6
Services, etc., net					1.7	1.5	0.9	1.0
Capital account balance					- 5.7	- 8.3	-12.5	- 9.7
Govt. grants & capital <u>2</u> /					- 3.8	- 3.2	- 4.1	- 3.6
U.S. private direct inv.					- 3.5	- 4.6	- 3.3	- 2.4
U.S. priv. long-term portfolio					0.5	- 2.8	- 3.3	- 2.0
U.S. priv. short-term					2.0	1.3	- 2.3	- 2.1
Foreign nonliquid					- 0.9	1.1	0.4	0.4
Errors and omissions					- 0.7	0	- 1.7	- 1.2

Monthly averages, in millions of dollars

Balance on regular transactions (seas. adjusted, - = deficit)					- 235 ^e /	40	- 260	- 517	- 259
Less: Net seas. adjustment					- 150 ^e /	16	- 174	1	
Balance before adjustment	- 465	- 425	- 265	- 385	24	- 86	- 518	- 259	
Financing (unadjusted)	465	425	265	385	- 24	86	518	259	
Adv. on military <u>3</u> /					42	23	50	19	
Advance debt repayment <u>3</u> /			179	60	2	3	2	10	
Liabilities increase									
Nonofficial <u>4</u> /	64	403	221	229	- 52	67	217	130	
Official <u>5</u> /	272	308	- 331	83	- 39	- 286	300	86	
Monetary reserves decrease	129	- 286	196	13	23	281	- 50	14	
of which: Gold sales	- 10	53	80	41	197	277	57	10	
<u>6</u> / Memo: Official financing	401	22	44	156	- 14	- 2	251	111	

1/ Balance of payments basis which differs a little from Census basis.

2/ Net of associated liabilities and of scheduled loan repayments.

3/ Assumed zero in absence of information.

4/ Includes international institutions (except IMF), commercial banks and private nonbanks.

5/ Includes nonmarketable bonds.

6/ Decrease in monetary reserves, increase in liabilities to foreign official institutions, and advance repayments on Government loans.

THE ECONOMIC PICTURE IN DETAIL

The Nonfinancial Scene

Gross national product. According to a staff projection, gross national product is expected to rise about as much in the current quarter as in the third. Fourth quarter GNP is now estimated at an annual rate of \$687 billion, up from \$677 billion (Commerce preliminary estimate) in the third quarter and from \$666 billion in the second.

Key factors in the projected rise in the fourth quarter are: (1) the anticipated increase of nearly \$2 billion (annual rate) in business fixed investment, which is in line with business plans reported in the latest Commerce-SEC survey; and (2) the projected rise of \$1.5 billion in Federal defense outlays, which is based partly on the build-up in defense orders and trends in defense expenditures accompanying the heightening of military activity in Vietnam. Also contributing to the fourth quarter rise in defense outlays is the military pay raise, which was effective for one month in the third quarter.

A Federal civilian pay raise is now slated to be effective October 1, and this accounts for the bulk of the step-up shown in other Federal outlays in the fourth quarter. Residential construction activity, which had declined somewhat in the third quarter, is now assumed to be stabilizing or perhaps increasing slightly. This is in line with general trade forecasts.

The steel wage settlement at the beginning of September marked the termination of the large steel stock build-up which had kept total business inventory accumulation at relatively high levels into the third quarter. Excessive steel stocks are now being liquidated, and the steel inventory adjustment is estimated to lower the rate of overall inventory accumulation by about \$2.5 billion, from an annual rate of \$6.1 billion to \$3.7 billion.

The steel adjustment is also causing industrial production to level off in the current quarter at about the third quarter average, following rapid gains earlier in the year. With industrial capacity continuing to rise as a result of record outlays for new plant and equipment, the rate of manufacturing capacity utilization is likely to recede slightly in the current quarter--from 90 to 89 per cent.

Leveling off of industrial production may also slow somewhat the rise in the flow of personal income from private economic activity. With the Federal pay boosts and the 7 per cent increase in current social security payments, supplementing the flow of income from expanding activity, total personal income is expected to show a sizable gain in the current quarter. The rise will be much smaller than in the third quarter, however, because of the special large retroactive social security payment late in that period. This large boost to incomes was not reflected immediately in consumer spending but it is assumed to affect such spending in the current quarter. Consumption expenditures, therefore, are expected to rise more than incomes in the fourth quarter, and the savings rate, which spurted in

the third quarter, should recede toward the low second quarter level.

Among the major categories of consumption expenditures, outlays for nondurable goods and services are expected to rise in the current quarter at about the third quarter annual rate of 7 per cent. Expansion in durable goods, on the other hand, is expected to be slower. Total new car sales including imports are estimated to hold at the advanced third quarter annual rate of about 9.5 million. Household durable expenditures are assumed to rise somewhat further.

Given this pattern and level of spending, price changes in private economic transactions are expected to be similar in the fourth quarter to those in the third. However, the Federal pay increases, which are treated as price increases in calculating GNP in constant prices, result in some step-up in the rate of increase of the implicit GNP deflator. Thus, although the increase in GNP in current prices is projected to be about the same as in the third quarter, real GNP is projected to rise somewhat less.

The leveling off in industrial production may contribute to a slower rise in productivity in that sector in the current quarter. It is expected that total nonagricultural employment will continue to rise at about the slackened third quarter pace. This suggests that the unemployment rate, which was reduced from 4.7 per cent in the second quarter to 4.5 per cent in the third, may decline slightly further in the current quarter.

GROSS NATIONAL PRODUCT
(Billions of dollars, seasonally adjusted annual rates)

	1965				
	IIQ	IIIQ ^{1/}	IVQ ^{2/}	IIIQ from IIQ	IVQ from IIIQ
Gross National Product	665.9	676.9	687.4	11.0	10.5
Personal consumption expend.	424.4	432.2	439.5	7.8	7.3
Durable goods	63.7	65.4	66.0	1.7	.6
Nondurable goods	187.6	191.0	194.5	3.4	3.5
Services	173.1	175.9	179.0	2.8	3.1
Gross private domestic invest.	101.1	101.8	101.4	.7	-.4
Business fixed invest.	66.4	68.1	69.9	1.7	1.8
Residential construc.	28.0	27.6	27.8	-.4	.2
Change in business invent.	6.7	6.1	3.7	-.6	-2.4
Net exports	7.5	7.8	8.0	.3	.2
Govt. purchases of goods and services	132.9	135.1	138.5	2.2	3.4
Federal	65.9	67.3	69.5	1.4	2.2
National defense	49.4	50.8	52.3	1.4	1.5
Other	16.5	16.5	17.2	0	.7
State and local	67.0	67.8	69.0	.8	1.2

^{1/} Commerce Dept. preliminary estimate

^{2/} Staff projection, October 26, 1965

Industrial production. The one per cent decline in industrial production in September, to 142.8 per cent from 144.3 in August, was due to the sharp decline in steel production, to reduction in aircraft, autos, coal, and newspapers because of strikes, and to a loss in crude oil caused by Hurricane Betsy. Output of business equipment and consumer staples increased, and output of home goods and apparel changed little.

In October, steel ingot production has continued to decline and for the month as a whole total steel output is likely to be down 10 per cent, amounting to a loss of .7 of one point in the total production index. However, with the strikes limiting production in September settled by early October, with recovery in crude oil, and with an expected further rise in business equipment production, output in these industries may rise enough to offset the loss in steel. Any change in the total index in October thus will depend on developments for consumer goods and/or materials other than steel, for which data are not yet available.

Consumer goods output in total has been relatively stable from January through September although with much diversity among major components. Apart from the influence of the strike at American Motors in September, auto assemblies have been steady since April. Output of home goods peaked last March, then declined gradually and in August (the latest month with solid figures) was down 4 per cent. Output of apparel and consumer staples changed little in the first half of the year and then edged up in the third quarter.

Orders for durable goods. New orders for durable goods rose a little in September and the third quarter average was moderately above the first half level as a sharp drop in steel orders was more than offset by gains for most other durable goods.

NEW ORDERS FOR DURABLE GOODS
(Monthly averages, in billions of dollars)

	1965			Per cent change 3rd quarter from 1st quarter
	3rd quarter	2nd quarter	1st quarter	
Total	21.8	21.4	21.4	2
Steel	1.5	1.8	2.2	-30
All other	<u>20.3</u>	<u>19.6</u>	<u>19.2</u>	<u>6</u>
Defense products	2.9	2.8	2.4	18
Machinery & equip.	4.2	4.1	3.9	7
Miscellaneous	13.2	12.8	12.8	3

New orders for steel in September were about as low as they were in mid-1963, when a steel settlement also precipitated a large inventory run off. New orders for defense products, on the other hand, rose sharply to nearly equal the high reached last April.

In September, as in earlier months this year, the new order level exceeded shipments and unfilled orders rose further. Unfilled orders at the end of September amounted to 2.8 months' sales, which was not much above the average over this past year.

Since February, when the steel backlog was at its peak for the inventory build-up period, unfilled orders for durable goods have increased 7 per cent further despite the decline of 42 per cent in the steel order backlog.

UNFILLED ORDERS FOR DURABLE GOODS
(Billions of dollars)

	1965		Per cent change Sept. from Feb.
	September	February	
Total	58.9	55.1	7
Steel	2.8	4.8	-42
All others	56.1	50.3	11
Defense products	23.2	20.3	15
Machinery & equip.	15.2	13.6	12
Miscellaneous	17.7	16.5	7

Prices. The industrial commodity price index was stable from mid-August to mid-September, and weekly estimates show little change to late October. Wholesale prices of foodstuffs, after edging down from advanced July levels, have generally been stable since mid-August, and the total wholesale price index has shown little change in the past three months.

The industrial index, while up 1.6 per cent from September 1964 when it began to move out of the narrow range in which it had fluctuated for five years, has risen only .2 per cent since mid-June. Increases in an index of metals and machinery, which from autumn 1964 to late spring accounted for much of the rise in the industrial index, have slowed appreciably in recent months, while an index of industrial commodities excluding metals and machinery has continued to edge up slowly.

Major copper producers abroad advanced prices 2 cents to 38 cents a pound, following the Chilean government's price-raising directive

to American owned companies. For the present, domestically-produced copper will remain at 36 cents, while imported copper, accounting for about one third of U.S. consumption, will sell at 38 cents -- over 20 per cent above levels of early 1964. With continuing shortages, and the crisis in Rhodesia threatening to reduce supplies from Africa, the price of copper in the London market has risen to around 64 cents a pound. Prices of domestic copper scrap have risen to around 44 cents a pound, and have created the anomaly of some finished products selling below the scrap price. Market analysts expect not only a rise in the domestic price to the foreign price of 38 cents, but also further increases in prices of fabricated copper products.

The President has abolished lead and zinc import quotas which have been in effect for seven years. With the increased availability of foreign lead and large increases in production from new mines, domestic lead supplies are expected to be adequate by early 1966. The abolition of the zinc quota, however, will have little effect in the near future, and stockpile releases will continue to be an important source of supply.

Steel producers raised prices of tin plate about 2-1/2 per cent, and, at the same time, reduced prices of "tinless" tinplate purportedly to recapture markets lost to other materials. Can producers do not expect volume production of "tinless" cans until late next summer, and following the tin plate rise, advanced prices of tin plated cans.

WHOLESALE PRICE INDEXES

Commodity group	Per cent increase		
	Feb. 1961 to Sept. 1964	Sept. 1964 to June 1965	June 1965 to Sept. 1965
Industrial commodities	-0.3	1.4	.2
Industrial materials	-0.4	1.7	.2
Industrial products	-0.2	1.0	.1
Consumer nonfoods	-1.1	1.0	.1
Producer goods	1.6	1.2	.1
Foodstuffs	-0.6	4.3	.1
Industrial commodities			
Less metals and machinery	-1.4	1.1	.2
Metals and machinery	1.3	1.7	.1

Employment. Nonfarm payroll employment continued to expand in September, but the increase at an annual rate of 1.5 million was somewhat slower than early this year. The lower rate of employment expansion now appears to be more in line with growth in the labor force and suggests little change in the unemployment rate in the next few months.

Largest employment gains during the month were in State and local government, mainly reflecting the hiring of teachers as the new school year began. In manufacturing, employment gains in September were small and more selective than earlier. Most of the increase was in the machinery and ordnance industries while liquidation of steel inventories held employment in primary metals at the reduced August levels. Construction employment failed to show any improvement.

NONFARM PAYROLL EMPLOYMENT

Annual Rates of Change
(Seasonally adjusted, millions of persons)

Industry	June to Sept. '65	Mar. to June '65	Dec. '64 to Mar. '65	Sept. to Dec. '64
<u>Total</u>	<u>1.7</u>	<u>1.6</u>	<u>3.1</u>	<u>3.0</u>
Manufacturing	.6	.8	.9	.7
Construction	-.1	-.4	.2	.7
Trade	.2	.2	1.0	.5
Finance & service	.5	.3	.5	.3
Government	.4	.5	.4	.7
Other <u>1/</u>	.1	.1	.1	.1

1/ Mining, transportation and public utilities.

At 60.8 million in September, nonfarm employment was 2.4 million higher than a year ago but the rise in employment in the past two quarters has slowed significantly. The more moderate rate of expansion has been largely due to construction and trade. Construction employment has tended to drift downward since March reflecting some declines in residential activity; gains in trade employment which were unusually rapid between September 1964 and March 1965, have slackened considerably and in recent months have been closer to the longer-run trends in the industry. The manufacturing rise has been smaller in the past quarter in part because of recent reductions in output in steel and related industries.

Hours and earnings in manufacturing. The factory workweek was unchanged in September at 40.9 hours, seasonally adjusted, and has been relatively stable at these levels since March but was below the very high first quarter average of 41.4 hours. In primary metals

and related industries the average workweek was curtailed somewhat in September as steel inventory liquidation got underway. But in the transportation equipment industry, the workweek was lengthened and overtime increased as new model production was accelerated. In that industry the workweek was longer than a year ago.

Average hourly earnings in manufacturing continued to advance moderately. At \$2.63 per hour in September earnings continued moderately higher than a year earlier. For the first nine months of 1965 average hourly earnings increased 3.2 per cent. With the workweek holding relatively steady, the contribution of overtime pay to weekly earnings has tended to become somewhat less important than earlier. Average weekly earnings in September totaled \$180, up 3.3 per cent from a year ago. For the first nine months this year the average increase was 4.3 per cent.

Unit labor costs. The recent course of unit labor costs in manufacturing has been altered somewhat by upward revision in the total employee compensation data. As previously reported there had been a downward drift since 1960 of about 3 per cent. In contrast, the revised data show little change with the index remaining close to 100 over the whole period.

LABOR COSTS PER UNIT OF OUTPUT
IN MANUFACTURING

(1957-59 = 100)

Years	NEW Series	OLD Series	Months	NEW Series	OLD Series
1957	98.7	99.0	1965 - Jan.	98.9	96.7
1958	102.2	102.0	Feb.	99.5	97.1
1959	99.7	99.5	Mar.	99.1	96.9
1960	100.7	100.4	Apr.	99.8	97.1
1961	100.4	100.0	May	99.8	97.2
1962	100.4	99.7	June	99.6	96.9
1963	99.7	99.0	July	98.8	96.7
1964	99.6	97.8	Aug.	99.8	97.5
			Sept.	101.0	--

Source: Bureau of the Census

Through August, both series showed no significant change in unit labor costs this year. A rise in September to 101 in the new series was almost entirely attributed to the drop in steel output, while manhours of work and payrolls in manufacturing showed little change. Usually differences in timing in declines in output and manhours, and the fact that many nonproduction workers are not laid off, tend to cause an increase in costs when activity is curtailed. A similar rise occurred last year during the auto strike.

The unit labor cost index is derived from the Department of Commerce series on employee compensation in manufacturing (wages and salaries, and supplements to wages) and the FRB index on manufacturing output. The revision in total employee compensation was part of the newly published national income and product accounts. Although both wages and salaries and supplements to wages (employer contributions to public and private pensions and welfare funds) were revised upward,

the bulk of the change was in supplements. Apparently employer contributions to group insurance programs grew more rapidly in recent years than had been previously estimated. The output series was not revised and thus all changes result from the revision in employee compensation.

The statistical revision in the manufacturing wages and salary component was relatively small and because it greatly overshadows the supplements to wages, the overall revision in employee compensation was relatively minor. Supplements have increased sharply in recent years and in 1964 they accounted for 11 per cent of manufacturing employee compensation as compared to only 6 per cent in 1950. However, since 1963 the rate of increase in supplements has been about the same as in wages and salaries and the proportion of supplements to total compensation has shown no further rise.

Personal income. Personal income in September rose at a \$13.3 billion annual rate as a result of a \$10.6 billion lump-sum retroactive payment of the 7 per cent increase in old-age and survivors insurance benefits and a \$1 billion increase in military pay rates. Excluding these two special factors, personal income in September was up \$1.7 billion, annual rate, from August and was 6.4 per cent above a year earlier. The \$1.7 billion "regular" gain was about the same as in the two previous months. Private wages and salaries increased \$.8 billion in September, with small gains being about equally divided among commodity-producing, distributive, and service industries. Dividends and personal interest income also edged up further.

Without the retroactive OASI benefits, personal income in October will be considerably lower than the \$545 billion rate in September. It, however, will be augmented by the increase in the regular monthly OASI payments -- estimated at about \$1.3 billion annual rate -- and by the just-enacted higher pay scales for Federal civil service and postal employees of \$.6 billion annual rate.

Retail sales. Retail sales appear to have risen again in the first two weeks of October, following a small decline in August and September. In early October, sales of durable goods stores, which had been mainly responsible for the earlier decline, seem to have risen moderately although a true reckoning of the recent course of seasonally adjusted auto dealer sales is uncertain because of this year's shift in model changeover dates. Nondurable goods sales, which were relatively stable at advanced levels during the third quarter, were up in the first two weeks of October, with gains indicated for all major lines.

Unit sales of new domestic autos in the first 20 days of October were indicated to be below the 8.9 million annual rate during the summer but above the April-May levels.

Consumer credit. Demands for consumer credit were a bit stronger in September than in August, judging by early reports from commercial banks. Increases were reported for all major types of credit, but the auto area experienced the heaviest demands, reflecting continued high new car sales, and perhaps even more important, the changed mix of old vs. new model sales. With the later introduction dates this year

the bulk of new car sales in September was 1965 models. Consumers buying the 1965's would be more likely, past experience shows, to use credit than those purchasing the new models. The latter group traditionally includes a high proportion of cash buyers.

The September increase in total instalment credit was less than in the spring, and for the third quarter as a whole the increase was below the \$8 billion annual rate of the second quarter.

The August data on consumer loan delinquencies at commercial banks, as reported by the ABA, present a somewhat less favorable picture than earlier. The total delinquency rate bounced up rather sharply both on an unadjusted and a seasonally adjusted basis. The biggest increase came in auto loan delinquencies, particularly in the purchased paper category, and in home appliance loans. For home improvement loans, on the other hand, the delinquency rate showed some improvement in August.

Residential construction. Private housing starts in September, at a seasonally adjusted annual rate of 1,424,000 units, were unchanged from the revised (upward) August level. For the third quarter as a whole, starts reached the lowest rate in several years. Regionally, third-quarter starts held to their second-quarter level only in the South. The average rate in the West -- which had changed little over the preceding three quarters -- declined to the lowest point since the current series began in 1959.

The immediate outlook appears to be for no significant improvement in starts, judging at least from building permits, which precede

most starts but do not always follow precisely the same pattern.

Permits declined by 5 per cent in September, reducing the third-quarter average slightly to the lowest level in a number of years. Both 1-family and multifamily permits were lower in the third quarter.

PRIVATE HOUSING STARTS AND PERMITS

	3rd Qtr. 1965 (thousands of units <u>1/</u>)	Per cent change 2nd Qtr 1965	3rd Q '65 from: 3rd Qtr 1964
Starts (total)	1,440	-7	- 3
Permits (total)	1,206	-2	- 5
1 family	690	-2	- 1
2-or-more family	516	-2	- 9
Northeast	247	+2	+ 2
North Central	332	+6	+14
South	373	-8	- 5
West	254	-4	-25

1/ Seasonally adjusted annual rate; preliminary.

Industry analysts are generally projecting some increase in housing starts for next year. At the high end of the range, members of the National Association of Home Builders estimate an increase of 5 per cent. The F. W. Dodge Company, on the other hand, anticipates a smaller increase -- of 2 per cent -- and its outlook is about in line with most trade opinion. These trade estimates appear a bit higher than a preliminary staff projection which suggests at best little change in the number of starts. The staff projection is based on econometric and other analysis, which takes account of expected household formation and related factors.

Sales of new nonfarm 1-family houses in August were somewhat more active than a year earlier, and the inventory of unsold new homes declined slightly further, according to the Census Bureau's monthly sample survey. The ratio of homes-for-sale to homes sold improved again, and reached the lowest level (3.5 months) since the series began nearly three years ago. Partly reflecting upgrading, median prices of homes sold and of homes-for-sale continued to show sharper year-over-year gains than in the same month a year earlier.

Livestocks prospects. Recent livestock reports indicate that improved meat supplies are in prospect for this quarter. The number of cattle on feed on October 1 was 7 per cent larger than a year ago, and feeders' reported intentions of expanding marketings 5 per cent from the fourth quarter of 1964 appear reasonable in the light of distributions of weights and the time-on-feed of the inventory. Broiler production is now 11 per cent larger than a year ago and expanding. Turkey production is 5 per cent larger. Hog marketings, which this year have averaged 8 per cent below a year earlier, are now rising seasonally but they are still well below last fall. Beginning of the build-up phase in hog numbers this fall is indicated by farmers' reports and by the slowdown in sow slaughter, but pork supplies probably will not increase appreciably until the second half of 1966. The USDA, citing the experience of previous hog cycles has warned producers against overexpansion of production and a concomitant depression in prices.

New farm law. The Food and Agriculture Act of 1965 now awaiting the President's signature provides the framework for a far-

reaching and complex farm program covering the next four years. Its eight titles provide for stabilization programs covering feed grains, wheat, rice, cotton, dairy products, and wool; for a cropland adjustment program; and among other things, for the use of projected yields rather than historical average yields in crop program calculations. The Act gives the Secretary wide discretion in administering the programs. A wheat program for 1966 is expected to be the first program announced under authority of the new act.

The Act extends to cotton the policy already applied to feed grains and wheat of stabilizing producer incomes through (1) price support extended in two ways -- price-support loans at close to world price levels, and supplementary payments based on specified percentages of normal production, and (2) rental payments for acreage diverted from production.

The cotton title spells out in detail the 1966 cotton program and directs the Secretary to provide similar programs for 1967, 1968, and 1969 crops. On the 1966 crop: (1) the loan rate for Middling 1-inch is set at 21 cents, a little under the world price; (2) producers are required to divert 12.5 per cent of acreage allotments and may divert up to a total of 35 per cent at rental payments of about \$50 per diverted acre; and (3) price support payments are provided in an amount equal to 9.42 cents per pound multiplied by projected yield on 65 per cent of the total allotment. The blend price derived from these benefits will probably range from 29.15 to producers making the mandatory diversion only up to 36.07 to those making the maximum 35 per cent diversion. A

small national quota of 250,000 acres may be allocated in 1966 to producers willing to forego all price support and to sell in the export market only.

The budget expenditure on the 1966 program is expected to be about \$100 million less than the \$750 expenditure on cotton in 1964-65. Payments to producers will be greatly increased but equalization payments to mills of about \$400 million annually will be eliminated.

A producer referendum on marketing quotas and acreage allotments will be held on November 23, 1965. If it should not be approved by two-thirds of producers, price support loans only will be available to producers planting within their allotment at the relatively low levels of 50 per cent of parity or about 21 cents.

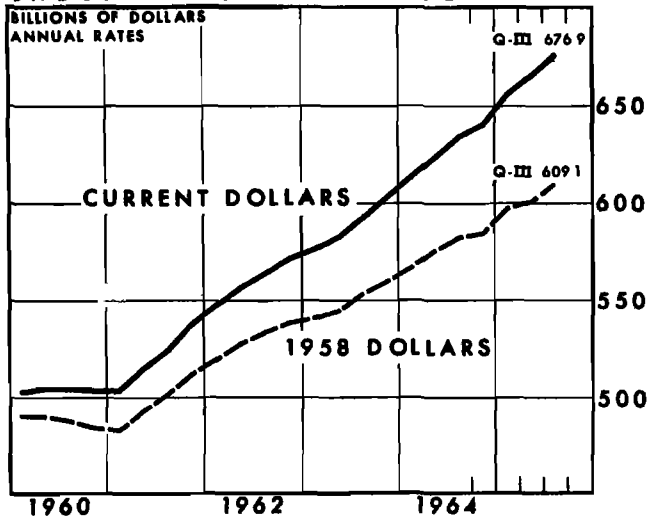
Other programs. Voluntary feed grain and wheat programs essentially like the 1965 programs are extended through 1969. The Wool Act is also extended. For rice, provision is made for an acreage diversion program if cuts in acreage allotments should be required within the term of the Act. The dairy program permits each of the 75 marketing order milk sheds to adopt by referendum a Class I base plan which would give Class I production quotas to producers. The cropland adjustment program is similar in many respects to the soil bank program. The administration of the program is left almost entirely to the Secretary of Agriculture.

The USDA has estimated that the new programs will cost less than the \$4 billion annual outlay for price stabilization and foreign assistance of recent years. Undoubtedly weather and producer response to these programs will be important determinants of the net expenditure.

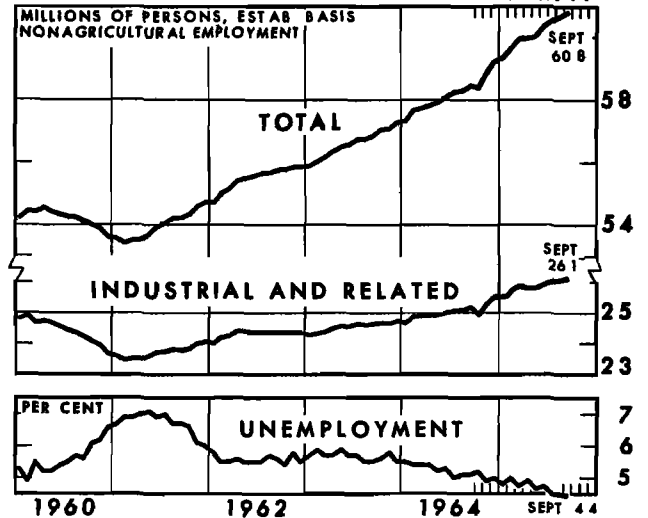
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

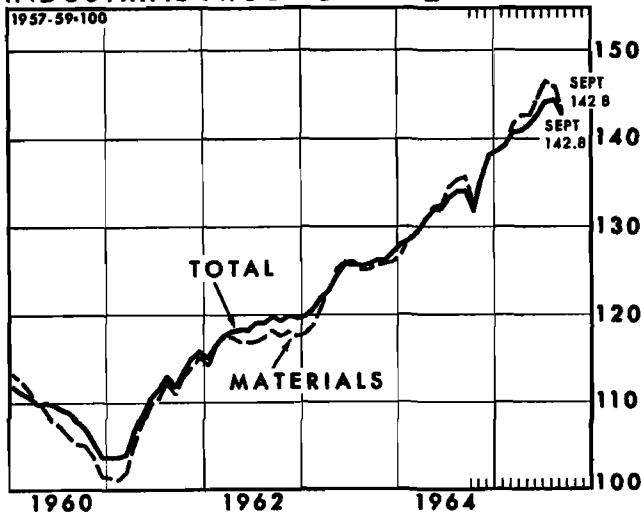
GROSS NATIONAL PRODUCT



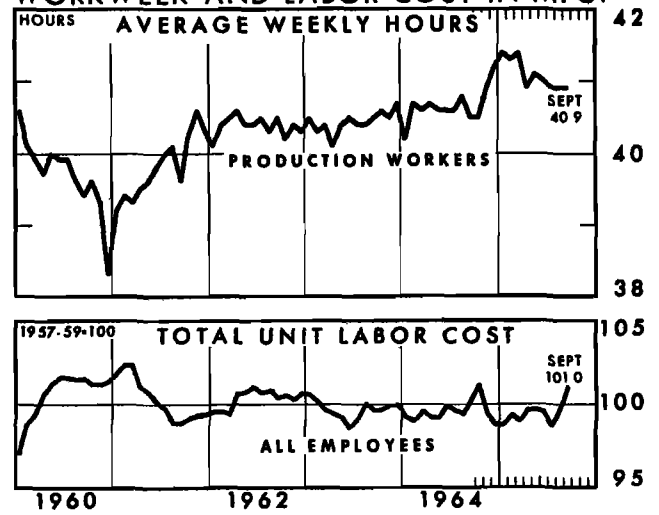
EMPLOYMENT AND UNEMPLOYMENT



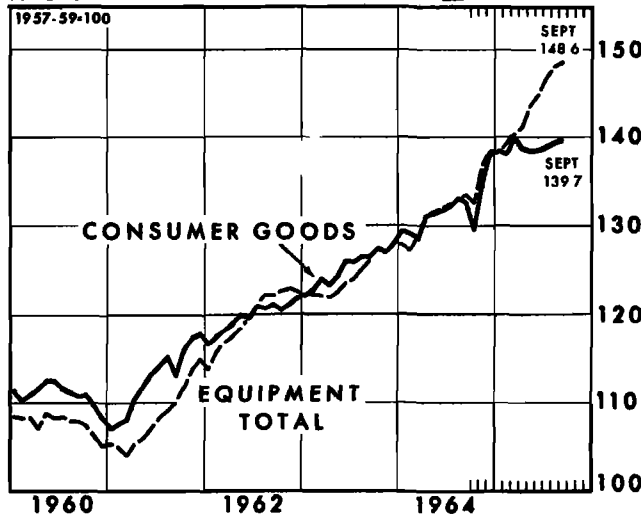
INDUSTRIAL PRODUCTION - I



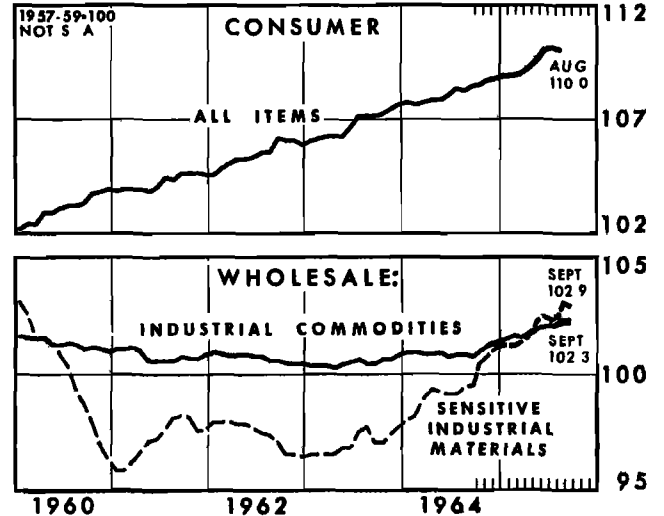
WORKWEEK AND LABOR COST IN MFG.



INDUSTRIAL PRODUCTION - II



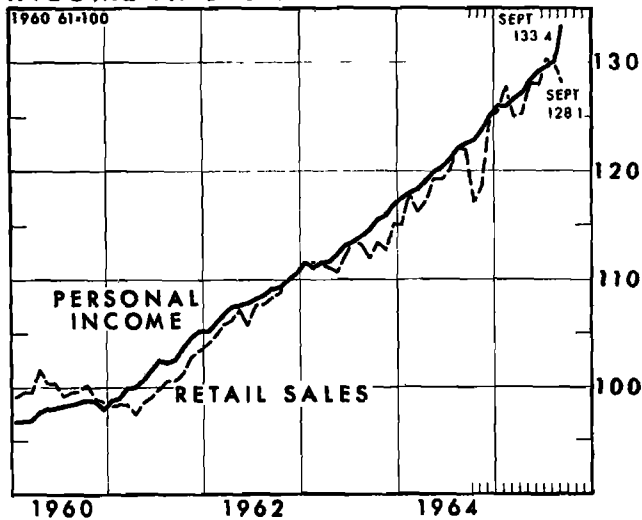
PRICES



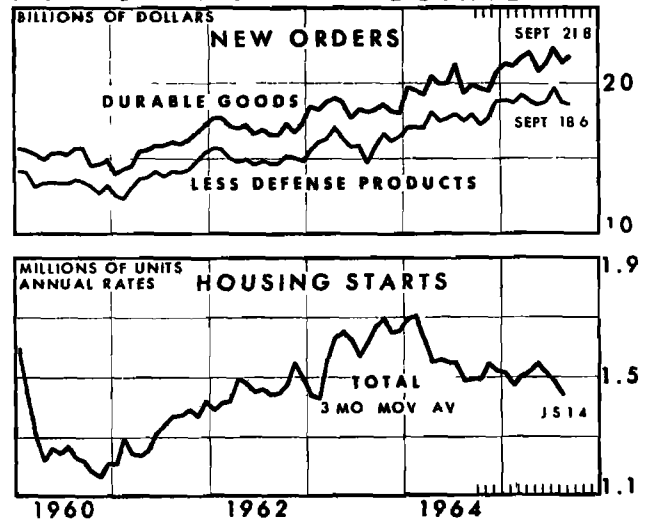
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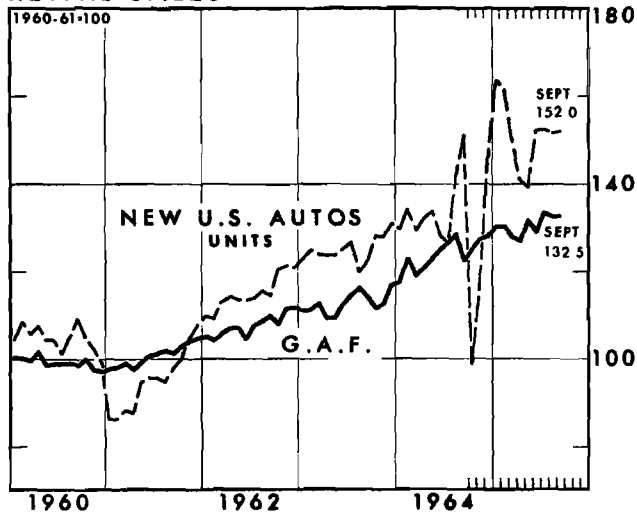
INCOME AND SALES



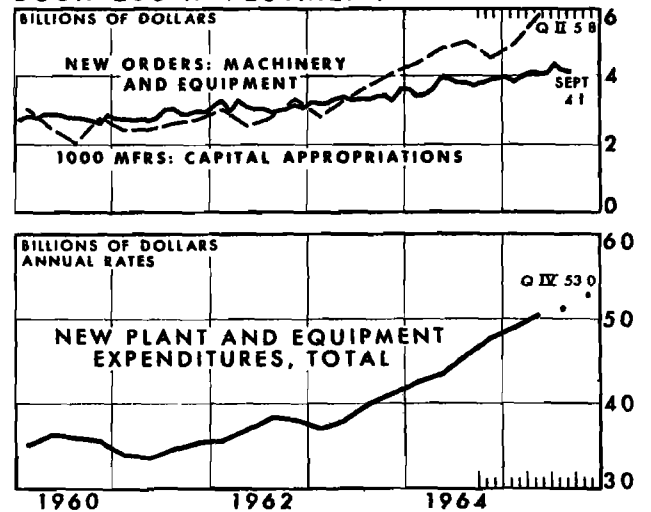
NEW ORDERS AND HOUSING



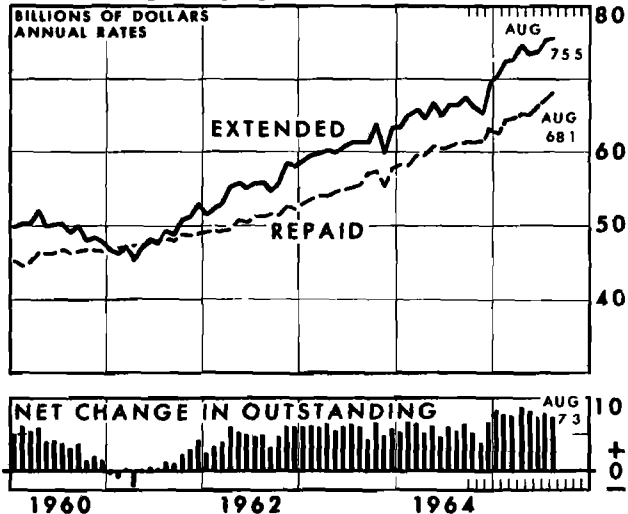
RETAIL SALES



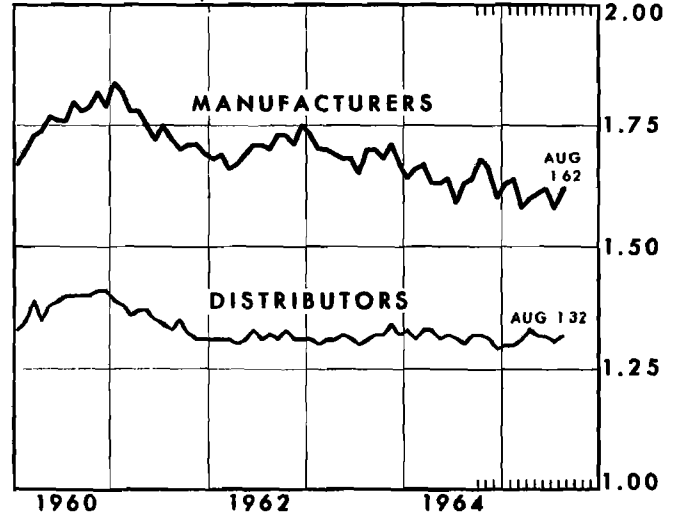
BUSINESS INVESTMENT



INSTALMENT CREDIT



INVENTORY/SALES RATIOS



DOMESTIC FINANCIAL SITUATION

Bank credit. Bank credit expansion during the early weeks of October was dominated by bank acquisitions of the Treasury's new issue of March and June tax bills carrying full tax and loan credit. Virtually all of the \$2 billion contraseasonal increase in earning assets at weekly reporting members during the first two weeks of the month was accounted for by purchases of Treasury securities and loans to Government security dealers. Government dealers added to their inventories of bills after heavy official purchases late in September had depleted them.

As Treasury deposits are drawn down over the next few weeks to cover the large seasonal Treasury cash deficit, bank holdings of bills are also likely to decline, but perhaps less rapidly than was anticipated earlier. Indeed, New York banks added to their holdings of bills the week after the financing. Rapid increases in private deposits, and a slowdown in loan demand from the late September rate, apparently have moderated the need to reduce Treasury holdings.

Most other categories of loans and investments did not increase materially in early October, after allowance for seasonal movements. Finance company borrowings declined relatively sharply in New York, where some banks have increased interest rates charged to these borrowers. The deceleration in bank purchases of municipal and Federal agency securities, observed in September, has apparently continued into October, in contrast to very rapid growth during the summer. The reduced rate of purchases of municipals probably reflects the effect of the accelerated reduction in bank liquidity so far this year.

Business loan expansion at New York banks was stronger than during similar previous periods and about seasonal at other banks in early October. Loans to metal and metal products firms showed only roughly seasonal declines in outstandings with somewhat more than usual liquidation at New York banks during the third week of October. Loans to trade firms, however, continued strong.

Business loan expansion so far in 1965 has accounted for almost half of the increase in bank credit. While such loans have been spread over most industry categories, the durable goods industries have been particularly heavy borrowers. The metal and metal products industries, for example, which accounted for only one-seventh of outstanding business loans at weekly reporting banks at the end of 1964, were responsible for over one-fourth of the increase in such loans over the first three quarters of 1965. With the elimination of their need to stockpile inventory in anticipation of a strike, loan demands of these firms should moderate somewhat. But with the continued strong pace of the economy--especially in the fixed investment area--business loan demand is likely to remain vigorous and to account for a large proportion of the increase in total bank credit over the coming months.

Bank deposits. Rapid growth in demand and time deposits in the first weeks of October suggests that the month may show another large rate of increase in private bank deposits. Data for the first weeks of October imply a monthly seasonally adjusted annual rate of increase in private demand deposits--and the money stock--which is likely to be larger, although below the very high September rate; reductions in Government

balances are continuing to contribute to the growth in private demand balances. For the first nine months of the year, demand deposits have increased at a 3.5 per cent annual rate, and the money supply has expanded at a 3.8 per cent rate.

Time and savings deposits are expected to show a rate of expansion near the July-August average of 18.5 per cent. Although savings deposits have accounted for most of the growth, continued large sales of CD's-- especially in New York--have contributed to the increase. By mid-October, total outstanding CD's had regained their pre-tax date high. Reflecting somewhat lower yields on other short-term securities and high rates of inflows of demand and savings deposits. CD offering rates at New York banks have eased somewhat since late September.

U.S. Government deposits at banks, reflecting the tax bill financing, rose around the middle of the month by enough to offset reductions in these balances in late September and early October. High rates of expenditures are expected to reduce these balances substantially through mid-November. On a seasonally adjusted basis, a decline of somewhat over a billion dollars is expected in November. From the high week in October to the low week in November, the actual reduction is expected to be about \$3 billion. This decline should contribute to expansion in private deposits.

U.S. Government securities market. Yields have risen recently in all maturity sectors of the U.S. Government securities market. The increase in Treasury bond yields since mid-October has generally offset the declines earlier in the month and these yields are currently at or

close to 1965 highs. Treasury bonds have continued to be dominated by trading among market professionals with investment activity remaining light on both buying and selling sides of the market. The general tone of the market has been one of caution and sensitivity to news or rumors which might suggest further acceleration in the pace of economic activity or tightening of monetary policy.

Treasury bill rates have inched up since about mid-October despite fairly sizable investment demand from corporations and to a lesser extent from state funds. The prospect of further additions to the bill supply by the Treasury later this fall as well as continuing bank sales distribution of tax bills auctioned earlier this month have exerted a dampening influence on the market.

YIELDS ON U.S. GOVERNMENT SECURITIES
(Per Cent)

Date (closing bids)	3-month bills	6-month bills	3 years	5 years	10 years	20 years
<u>1965</u>						
Highs	4.05	4.21	4.36	4.37	4.38	4.34
Lows	3.76	3.81	4.00	4.08	4.17	4.17
<u>1965</u>						
July 28	3.81	3.88	4.09	4.15	4.20	4.21
Sept. 29	4.05	4.21	4.35	4.34	4.36	4.34
Oct. 13	4.01	4.18	4.29	4.30	4.30	4.30
Oct. 26	4.05	4.18	4.35	4.37	4.38	4.33

In the first two statement weeks of November, the System is likely to be an active buyer of bills in view of the need to supply about \$800 million of reserves in that period. Dealers also anticipate some

demand from holders of maturing issues in the November refunding. These factors should tend to keep upward pressures off bill rates through the early days of November. But over a longer time span the sustainability of current yield levels will depend on the strength of credit demands and of continuing corporate interest in bills.

The Treasury is expected to announce the terms of its November refunding on October 27. The market generally expects a short-term issue in all likelihood an 18-month note, to refund the \$3.3 billion of publicly-held maturing debt. The Treasury will have to return to the market soon after the completion of the November refunding to raise a substantial amount of cash. On the basis of earlier indications by Treasury officials, the market anticipates that the Treasury will need some \$3.0 billion. However, the amount could be reduced to \$2.5 billion because the Treasury balance will be increased by \$375 million on December 1 when payment is due for the recently announced FNMA issue of participation certificates.

Corporate and municipal bond markets. Yields on corporate bonds have remained generally stable in October, as the volume of new publicly-offered issues has dropped to less than half the September total. On the other hand, yields on State and local Government bonds rose again last week, when investor interest in the very large weekly calendar of new offerings proved to be disappointing. Earlier in the month, with new issue volume unusually light, yields on municipals, like those on corporates, had showed a stabilizing tendency.

At present levels, yields on seasoned corporate bonds of top quality are the highest they have been since February 1960, only 4 basis

points below the post-World War II high reached earlier that year. Yields on top quality municipals have moved up to the levels that prevailed prior to the Regulation Q change in early 1962. Since yields on U.S. Treasury bonds have risen more since midsummer than those on corporate issues, the yield spread between the two markets has narrowed somewhat. However, the spread between yields on long-term Government and top-quality seasoned corporate issues remains substantially wider than it had been during most of the preceding two and one-half years.

BOND YIELDS

	Corporate		State and local government	
	Aaa		Moody's	Bond buyer (mixed qualities)
	New	Seasoned		
Post-war				
<u>Previous High</u>	5.13(9/18/59)	4.61(1/29/60)	3.65(9/24/59)	3.81(9/17/59)
<u>1965</u>				
High	4.71(8/27)	4.57(10/22)	3.31(10/21)	3.41(10/7)
Low	4.33(1/29)	4.41(3/12)	2.94(2/11)	3.04(2/11)
<u>Week ending:</u>				
July 23	4.56	4.48	3.16	3.25
Oct. 1	-- <u>1</u> /	4.53	3.31	3.41
Oct. 15	-- <u>1</u> /	4.57	3.31	3.38
Oct. 22	-- <u>1</u> /	4.57	3.31	3.40

1/ No representative issues offered.

In the corporate market, public offerings of only \$300 million during October were well below the 1965 monthly average of \$462 million. Reflecting this reduction in supply, underwriters experienced little difficulty in distributing most new issues at prevailing prices, and unsold syndicate balances are low. Adding to the technical strength of the market is the fact that the immediate calendar of scheduled public-offerings remains a bit light.

In the municipal market more than half of October's \$800 million total of new offerings was concentrated in the week of October 18-22. With new issue volume unusually low during the two preceding weeks, dealers had been able to reduce their advertised inventories of unsold municipal securities by nearly \$200 million to less than \$600 million--although not without some further price concessions. But less than half of last week's large volume of competitive offerings has been distributed, and the general tone of the market has weakened again. While the supply of new offerings is light in the current week, volume for November is likely to pick up as the period progresses and--if another block of public housing bonds is offered within the month--may ultimately total nearly as much as in October.

BOND OFFERINGS^{1/}
(In millions of dollars)

	Corporate					
	Public offerings		Private placements		State & local govt.	
	1965 e/	1964	1965 e/	1964	1965 e/	1964
Jan.-Oct. average	462	327	649	526	945	907
August	369	183	438	453	750	799
September	640	376	700	693	1,000	920
October	300	181	700	642	800	852

^{1/} Includes refundings--data are gross proceeds for corporate offerings and principal amounts for State and local government issues.

Mortgage markets. Secondary-market operations of FNMA in recent weeks continue to suggest some lessening of ease in home mortgage markets. In the four-week period ending October 14, there were further increases in offerings of Federally-underwritten mortgages to FNMA as well as in

purchases by FNMA, reflecting in part efforts by some mortgage companies to liquidate heavily-warehoused inventories. For the third quarter as a whole, FNMA recorded the largest quarterly purchase volume in 3-1/2 years.

Another sign of less ease during September was an additional slight increase in secondary-market discounts on certain FHA-insured new-home loans. FHA reports about contract rates on conventional first mortgages, however, continued to show averages of 5.80 per cent on new-home loans and 5.90 per cent on existing-home loans.

Outstanding mortgage debt reached about \$333 billion at the end of the third quarter. The seasonally adjusted annual rate of expansion has continued to approximate \$30 billion, with the year-over-year pace of growth--the smallest in some time--less than 10 per cent. Commercial banks were the only major private lender with somewhat larger net mortgage acquisitions in the third quarter than in the same period of last year. Net takings by savings and loan associations were down the most.

Mortgage commitments of reporting savings banks, savings and loan associations, and life insurance companies suggest that a continued large volume of such lending is in prospect. Thus, at the end of August outstanding commitments for these three types of institutions were about 8 per cent above the year-earlier level. This is a record backlog and is said to be one factor making many mortgage lenders more cautious about entering into additional loan arrangements.

On October 21, the Federal National Mortgage Association announced plans to offer on November 16 an additional \$375 million in participation certificates backed by a pool of Federally-owned mortgages.

The issue, to be dated December 1, will consist of 15 annual serial maturities of \$25 million each, falling due from 1966 to 1980.

Judging from results of two earlier issues, most of the \$375 million in FNMA participation certificates will find their way into the hands of investors who do not specialize in mortgage lending. At the end of September, FNMA's outstanding participation certificates were reported to be held chiefly by others than banks, savings and loan associations, and life insurance companies. These four major types of lenders, which own four-fifths of all privately-held mortgage debt, held only a fourth of the \$525 million of FNMA certificates issued in July and a third of the \$300 million issued last November. State and local pension funds held 10 and 8 per cent of the two issues respectively, and fire and casualty companies 11 and 6 per cent. Miscellaneous holders on which no break-down is available accounted for half of the July issue and for nearly half of the November issue.

Stock market. Common stock prices, as measured by Standard and Poor's composite index of 500 stocks, have continued to advance to new high levels this month in very heavy trading. At the close on October 26, this index registered 92.20, about 2 per cent above its May peak and 13 per cent above its summer low of 81.60 (on June 28). Since October 1, the volume of trading on the NYSE has averaged 7.9 million shares per day, 0.5 million shares above the average daily volume in September and 3.1 million shares higher than that of October a year ago. Moreover, on 9 of the last 12 trading days, activity has exceeded 8.0

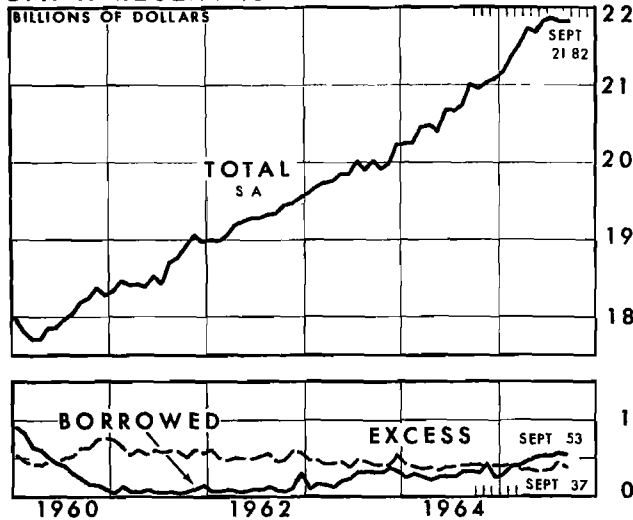
million shares. Much of this expansion in activity since summer seems to have been concentrated in so-called glamour stocks and low-priced speculative issues.

Stock price changes continue to vary greatly from one industry group to another. Of the group indexes comprising the Standard and Poor's composite, 44 are now above their early May levels but 38 remain below. Indexes for radio-TV manufacturers, electronics, air transport, aerospace, and machine tools have posted the greatest gains (ranging from 17 per cent up to 52 per cent) while so-called defensive groups, such as utilities, retail, food-related and many other consumer soft goods industries, still lag well behind their spring levels.

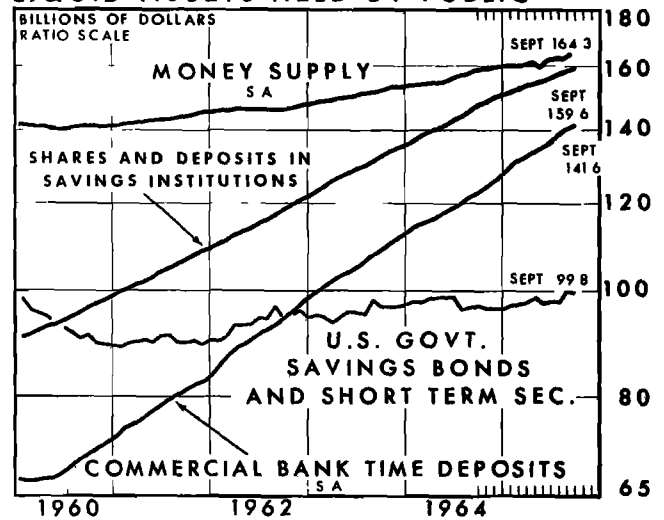
Through September, despite this buoyant and active character of the market, there was no significant increase in stock buying on credit. Such credit, as measured by debits in margin accounts for a sample of margin customers, remained unchanged in September, although customers' net debit balances, as reported by NYSE member firms, rose \$108 million. The latter figure includes temporary clearing debits in cash accounts, which appear to have expanded with the sharp increase in transactions volume in the closing week.

FINANCIAL DEVELOPMENTS - UNITED STATES

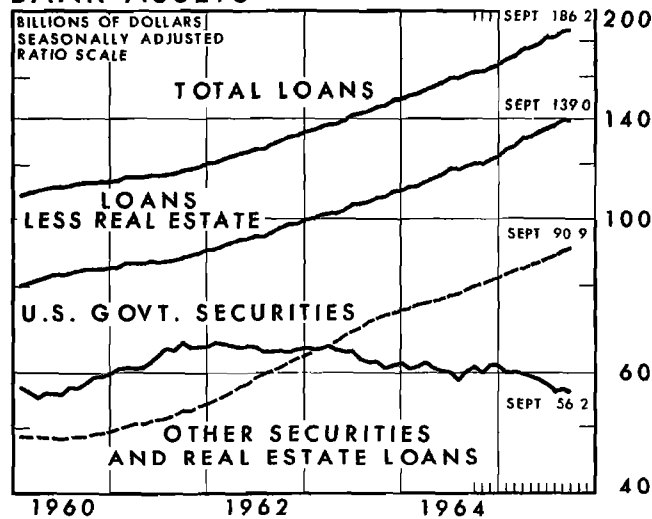
BANK RESERVES



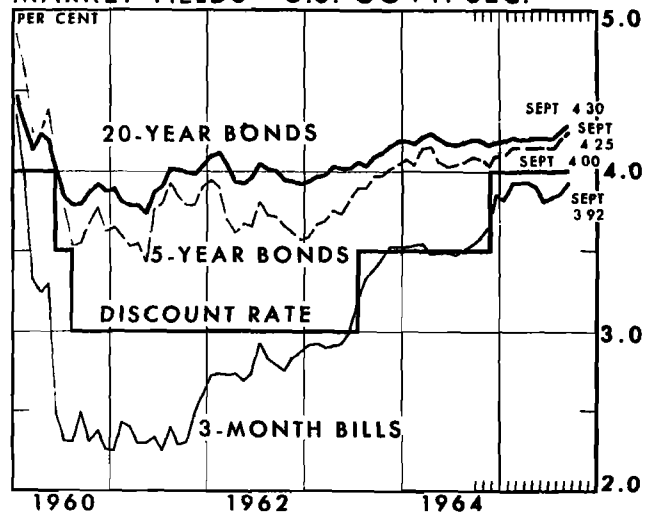
LIQUID ASSETS HELD BY PUBLIC



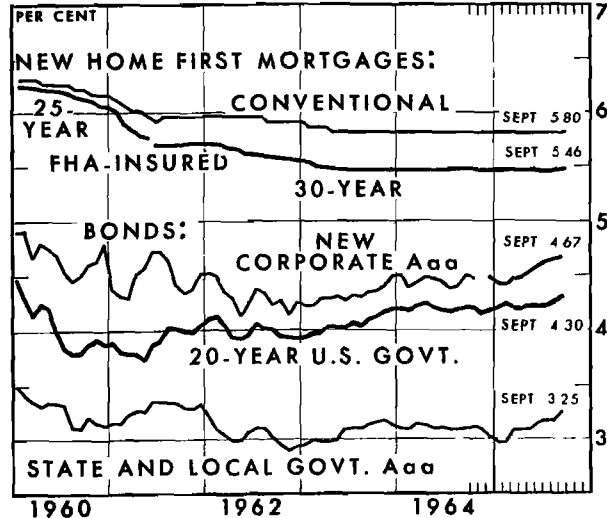
BANK ASSETS



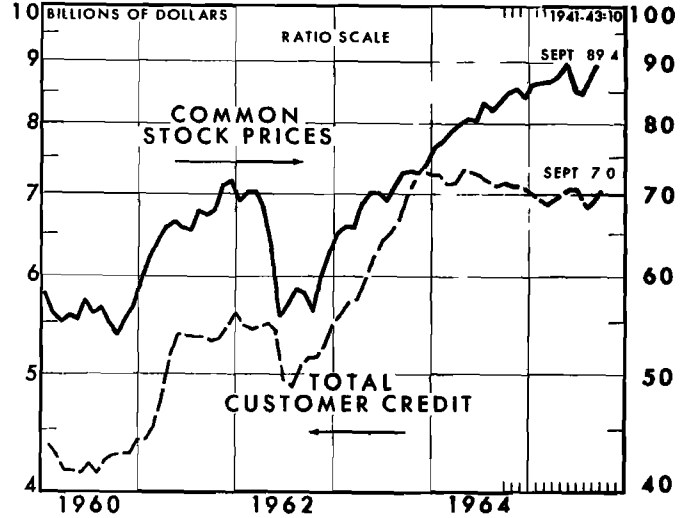
MARKET YIELDS - U.S. GOVT. SEC.



MARKET YIELDS - BONDS & MORTGAGES



STOCK MARKET PRICES AND CREDIT



INTERNATIONAL DEVELOPMENTS

U.S. balance of payments. The U.S. payments deficit on regular transactions in September was about \$450 million, unadjusted, and the deficit for the third quarter is now estimated at \$700 million after seasonal adjustment. This latter figure is about double the rate of deficit in the first half, and also above earlier indications for the third quarter. On the official settlements basis there was only a small surplus, estimated at less than \$100 million for the quarter after seasonal adjustment, despite very large inflows of foreign liquid funds in July-August. These figures will not be released until mid-November.

The deficit on regular transactions for the third quarter represented a deterioration of about \$800 million from the surplus achieved in the second quarter as a result of temporary factors. Detailed data available at present explain only a relatively small part of this shift.

In fact, the trade account shows an improvement of about \$250 million from the second quarter, despite the fact that the second-quarter trade surplus had been swollen by net exports delayed by the earlier port strike. Merchandise exports in the third quarter averaged \$27.2 billion at an annual rate, up slightly from the swollen second-quarter rate, and up 7 per cent from a year earlier. Imports, although up 12 per cent from a year earlier, were below their second-quarter rate; in the third quarter they were about \$20.9 billion (annual rate) after rough adjustment for a change in statistical coverage. The trade surplus thus rose to an annual rate of \$6-1/4 billion.

Movements of bank credit and new security issues do explain some of the third-quarter deterioration, as was to have been expected since the second-quarter reflows of bank credit had been exceptionally large and new issues had been small.

Net liquidation of bank-reported claims in the third quarter, amounting to \$270 million, was substantially less than in the second, and much of it may have reflected the usual seasonal reflows. Outflows on new foreign security issues in the third quarter, seasonally adjusted, appear to have been about \$400 million, or close to twice the second-quarter figure.

These two items show adverse shifts from the second quarter totaling about \$1/2 billion, seasonally adjusted. While this more than offsets the \$1/4 billion improvement on trade, it still leaves more than \$1/2 billion of deterioration unexplained.

Current estimates imply some deterioration on travel, and perhaps also a decline in investment income. It seems likely, too, that the reflow of liquid funds was substantially smaller than in the second quarter. It had been thought, however, that such changes as these would be partly offset by a falling off in the net outflow on direct investment (for which no data are yet available). Present information simply is inadequate to explain the third-quarter balance of payments.

The cumulated "regular transactions" deficit for the first three quarters of 1965 is nearly \$1.4 billion, i.e. an annual rate of about \$1.8 billion.

On the "official settlements" basis, the third quarter shows a small seasonally adjusted surplus of about \$50 million, reflecting large inflows of foreign private balances. For the year to date the deficit on this basis is about \$400 million. In the third quarter, inflows of foreign commercial funds, concentrated in July and August, were particularly large. In September, recovery of sterling was among the factors checking such inflows.

In appraising the significance of the wide difference between the two measures of the U.S. deficit in the third quarter, it should be borne in mind that during that period the Italian commercial banks put several hundred million dollars, net, into the Euro-dollar market, acquiring the dollars from the Bank of Italy under swap arrangements. Indirectly, some of the increase in U.S. liabilities to commercial banks abroad reflected this shift of ownership of dollars from the central bank to commercial banks.

On either system of measurement the balances both in the third quarter and in the preceding quarter have been adversely affected by British official actions to liquefy their holdings of American securities. While the proceeds of sales have not been taken into published official U.K. reserves, probably a large part has increased U.S. liquid liabilities to foreign official accounts. In each of the last two quarters, net British sales (probably mainly official) of U.S. corporate stocks and bonds and U.S. Government agency bonds amounted to about \$200 million.

Payments balances of other countries. A sharp improvement occurred in September in the British balance of payments, as measured by the change in official reserves, IMF account, and liabilities to other central banks. Published reserves rose \$171 million after falling \$420 million in the three preceding months. A better measure of the drain on British reserves and related accounts in June-August is a figure of about \$1.0 billion (confidential data received through BIS).

The August-to-September shift of several hundred million dollars in the U.K. monthly balance of payments seems to have had part of its counterpart in the increase of about \$400 million in the U.S. deficit on the "official settlements" basis between August and September. In addition, the reserves of nine Continental European countries (adjusted for related accounts) increased somewhat less in September than they had in August (\$25 million as against \$150+ million on the basis of official settlements accounts only, or \$250+ million as against \$300+ million if increases in the net external short-term assets of commercial banks are also counted as settlement items). None of the figures in these paragraphs is adjusted for seasonal variation, and the usual caveats against giving undue significance to monthly data in this field should be borne in mind.

Quarterly data indicate that most of the nine Continental European countries covered (which include the largest reserve gainers of the recent past) had smaller balance-of-payments surpluses in the third quarter this year than they had a year earlier (as measured in

PAYMENTS BALANCES MEASURED BY CHANGES IN
NET OFFICIAL RESERVES AND COMMERCIAL BANKS' POSITIONS 1/
(quarterly averages in millions of dollars)

	Third Quarter		January-September		Year 1964
	1965	1964	1965	1964	
France	<u>2/ a/</u> 148	181	<u>2/ a/</u> 264	181	199
Germany	-256	-130	-43	143	24
Netherlands	<u>a/</u> 37	111	<u>a/</u> -2	-47	17
Belgium	<u>a/</u> 8	42	<u>a/</u> 30	12	45
Italy	<u>843</u>	<u>535</u>	<u>458</u>	<u>110</u>	<u>201</u>
Total EEC (Excluding Italy)	780 (-63)	739 (204)	707 (249)	399 (289)	486 (285)
Switzerland <u>3/</u>	-164	-49	-94	-38	37
Austria <u>4/</u>	<u>a/</u> 72	44	<u>a/</u> 24	12	27
Spain <u>5/</u>	68	197	3	105	90
Sweden	<u>16</u>	<u>64</u>	<u>12</u>	<u>47</u>	<u>47</u>
Total these four	-8	256	-55	126	201
Grand total for nine	<u>772</u>	<u>995</u>	<u>652</u>	<u>525</u>	<u>687</u>

1/ The data available are not strictly comparable for all periods, but the inconsistencies appear to be minor. Confidential BIS data shown for Group-of-ten countries differ somewhat from published data.

2/ Includes advance debt repayment to the United States of \$179 million.

3/ Balances measured by changes in net official reserves only. Thus, unlike the balances of the other countries, these balances include the effect on official reserves of outflows or inflows of commercial bank funds.

4/ Official reserves are "gross" instead of "net."

5/ Official reserves are "gross" instead of "net." Also, the lack of commercial bank balances has the same effect on payments as in the case of Switzerland.

a/ Approximate, due to the lack of September data for commercial banks.

the manner indicated by the table). Italy was a very important exception: the lag in Italian imports, as compared with its rapidly rising exports, has contributed to an increased surplus, and Italy's seasonally favorable tourist receipts were even more favorable this year than last.

For Germany, unlike Italy, the third quarter is normally not a favorable one. The increase in the German deficit since the third quarter of 1964 indicates, however, that the underlying position of Germany's balance of payments has shifted into deficit; this is the result mainly of a large and continuous rise in German imports since 1963. In September, the German deficit was reduced considerably, and in recent weeks there have been suggestions that very high German bond yields are tending to pull capital into Germany.

A relatively recent reduction in France's monthly surpluses is not fully apparent from the figures in the table. Contrary to experience in 1964, French monthly surpluses fell off markedly in August and September this year, and the exchange rate has remained below the upper support limit during most of October.

Deterioration in the payments balances of the Netherlands, Switzerland, Sweden, and Spain over the past year reflects strong internal demand, and in the case of Spain a rise in prices of the order of 15 per cent.

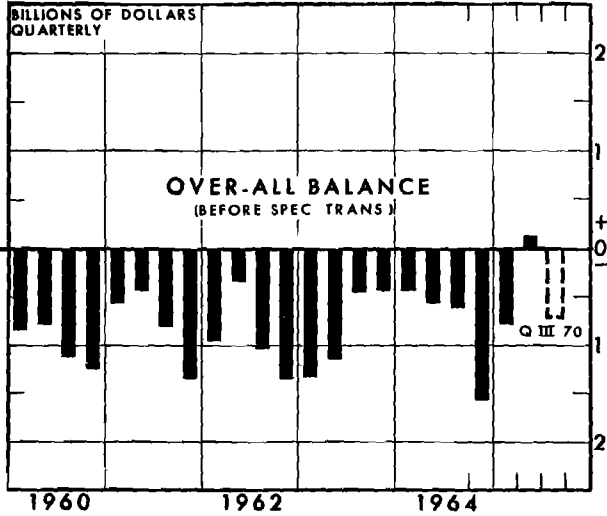
Outside Europe, Canada's balance of payments, which had been moving toward smaller surpluses, strengthened in the third quarter of

1965 as a result of wheat sales to Russia and Canadian borrowing in the United States. Japan's balance of payments, too, shows recent improvement, with a downtrend in reserves giving way to small increases; strong Japanese exports have generated a current account surplus exceeding the unusual Japanese deficit on capital account this year.

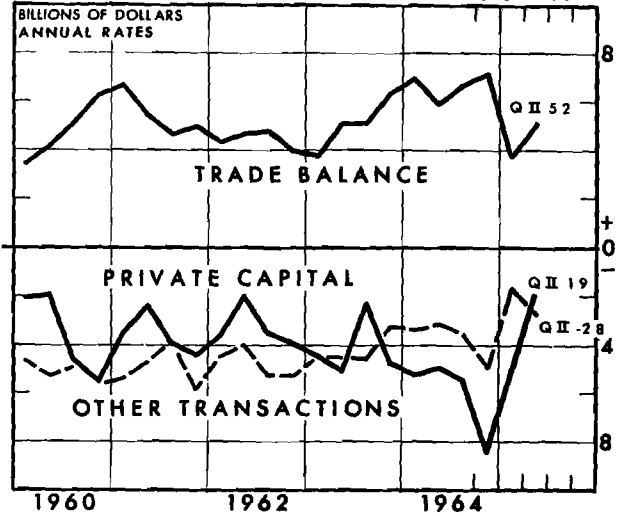
U.S. AND INTERNATIONAL ECONOMIC DEVELOPMENTS

SEASONALLY ADJUSTED

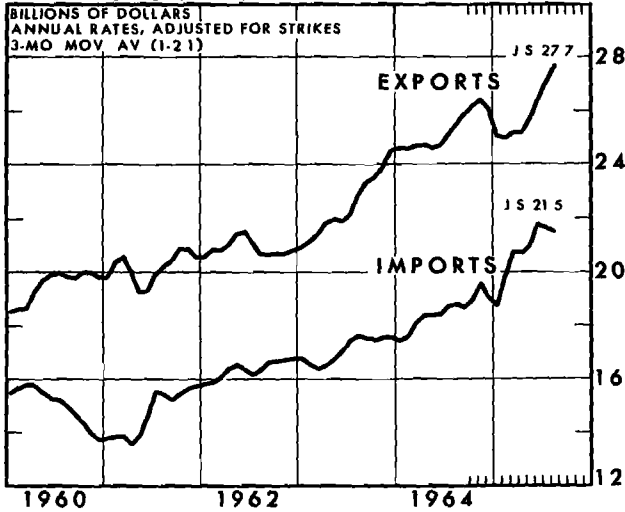
U.S. BALANCE OF PAYMENTS



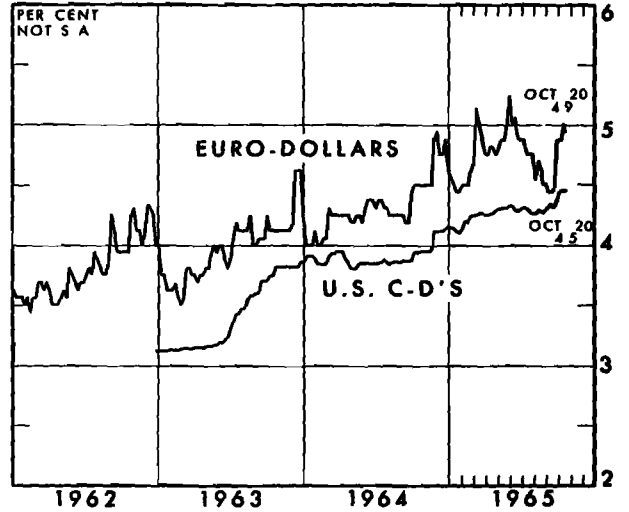
U.S. BALANCE OF PAYMENTS-CONT.



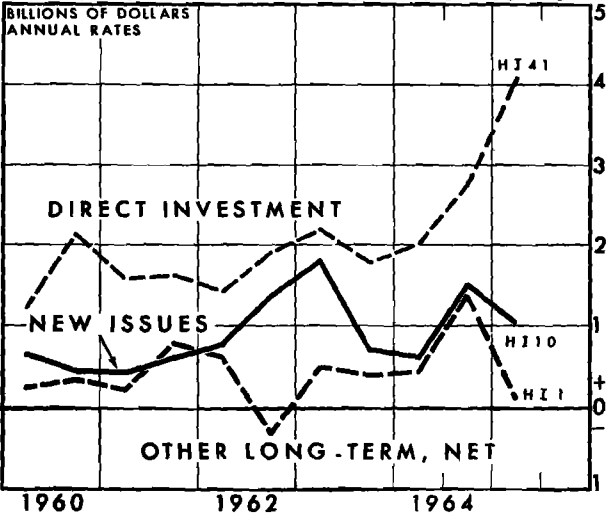
U.S. MERCHANDISE TRADE



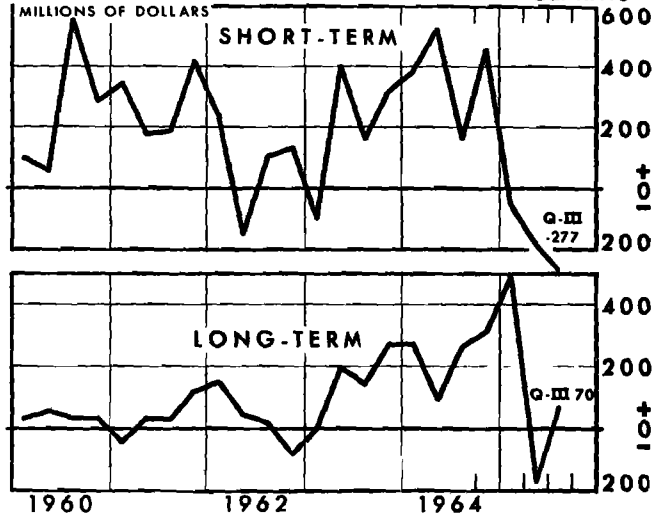
90-DAY RATES



U.S. LONG-TERM PRIVATE CAP. OUTFLOWS



PRIV. CAP. OUTFLOWS - BANK REPT. CLAIMS



**APPENDIX : AUTHORITATIVE STATEMENT OF FRENCH VIEWS ON
INTERNATIONAL MONETARY PROBLEMS**

(Statement by Finance Minister Giscard d'Estaing before the National Assembly on October 13, 1965 in defense of Article 62 of the 1966 Finance Bill which would authorize the government to agree to a 25 per cent increase in Fund quotas.)

In any case, Article 62 would certainly have called for some explanations; this has become even more important after the remarks of the Rapporteur General, which were very interesting even though he concluded against approval of the Article, whereas the Government will ask you to adopt it.

What is our national line of conduct in the international monetary field? It involves two elements which should be kept in mind simultaneously; the continuation of international monetary cooperation and the reform of the world monetary system. Our action is constantly inspired by these two concerns.

For example, last year at about this same time, France participated in several operations under the heading of international monetary cooperation, in particular when Great Britain was faced with special difficulties. Last spring, we confirmed these acts of international monetary cooperation by participating in the operation to make additional resources available to the International Monetary Fund for the benefit of Great Britain.

At the same time, we insist on the necessity of a reform of the world monetary system. In this respect, what is the essential criticism we have made of that system, and does it or not justify Mr. Vallon's observations?

We criticize the world monetary system for offering exceptional advantages to reserve currency countries in balance of payments deficit, because they can finance their deficits through the holding of their currencies by other countries.

Thus for nearly ten years the U.S. deficit has been financed through the holding of large dollar assets by a certain number of countries, including France.

The criticism is justified. On this point, as you certainly noted, there was a change of tone and attitude during the most recent discussions in the International Monetary Fund. No one continued to argue that the international monetary system, such as it has been functioning, should be prolonged. On the contrary, everyone was in agreement on the necessity of a reform. The reserve currency countries specifically confirmed that they had now realized the necessity of restoring the equilibrium of their balances of payments prior to any new action.

The significance of the result obtained should not be minimized. Whereas proposals for reform of the international monetary system were looked on as a kind of scandal three years ago, speakers representing the principal countries have now recognized the necessity of such reform. Let us take solemn note of the point.

During the summer of 1964 the ten countries which signed the Paris Agreements nearly four years ago jointly drew up several conclusions after one year of study.

The first of these conclusions noted the timeliness of considering the reform of the world monetary system. The second related to the putting into effect of a system of multilateral surveillance of the financial facilities which countries grant one another. The third provided for a moderate increase in the quotas of the International Monetary Fund.

On the first point, the recognition by the ten countries of the necessity of actively undertaking preliminary studies with regard to reform of the international monetary system clearly represented an appreciable success for the theses which our country had defended.

The second point, the putting into effect of a system for surveillance of the financial facilities which countries grant one another, was also a very considerable result, for you know that during 1962 and 1963 the countries in deficit--the United States and Great Britain--had multiplied the most ingenious and most clandestine systems to create for themselves complementary facilities in the form of what was called either swaps or Roosa bonds, the latter being named after their creator. As a result, it was impossible for the world monetary community to have a clear idea of the public, semi-public, or other assistance granted under these various forms.

Since last summer multilateral surveillance exists, which means that each country is obliged to indicate the nature and extent of the

assistance it is receiving, and thus world opinion can bring to bear its observations, its criticisms, or its doubts with respect thereto.

On the third point, namely the increase in the quotas of the International Monetary Fund, there is to my mind some contradiction between wanting to decrease the role of the reserve currencies and wanting to oppose the increase of IMF quotas.

In this matter we must make a choice. From the moment when certain countries are in balance of payments deficit--and what country has not been, is not, or will not be in temporary deficit?--these countries must be able to call upon some assistance. This assistance cannot be a questionable facility like that enjoyed by the reserve currency countries when other countries accumulate balances in their currencies. If facilities of this nature are denied, coordinated mechanisms for compensating deficits must be allowed to operate, specifically through the International Monetary Fund.

During the above-mentioned discussion among the Ten, our British and American partners clearly had in mind a considerable increase in quotas; they no doubt had the idea of creating by that device large facilities that would make it possible for them to get on top of their difficulties once and for all, and at the same time to escape the discipline of restoring equilibrium in their balances of payments.

In agreement with our European partners, who in this matter follow the same line of thought and action as we, we asked that the increase be moderate. As a matter of fact, as of that time the quotas of the International Monetary Fund had not been raised for several years, even though world trade had grown and transactions had increased. It was thus normal to bring quotas into line with actuality.

This is why we accepted a 25 percent increase in IMF quotas, which was of the same order of magnitude as the evolution of world trade and payments during the same period. This decision having been taken, the moment arrived to put it into effect.

The Bretton Woods Agreements provide for payment of one-fourth of quotas in gold and three-fourths in currency, The remarks of the Rapporteur General are very pertinent in this respect. As far as we are concerned, we have been intending to pay one-fourth in gold and three-fourths in currency--that is, in francs. For the reserve currency countries, in particular the United States, the problem presents itself in the following fashion. The United States never contested that it would have to pay its own share one-fourth in gold and three-fourths in

its own currency, but it pointed out that with all countries increasing their quotas, certain among them, in order to get the necessary gold, would seek the conversion of dollars into gold, and by this fact the United States would be subjected to an additional drain on its reserves.

There is thus no refusal on the part of the United States to subscribe its own quota increase, but rather an effort to mitigate the indirect effect flowing from the requirements of other countries for gold to finance the increases in their quotas. In this connection, we made it very clear from the beginning that we did not intend to ask for the conversion of dollars, but that we would use gold held by our own central bank.

The truth is that the device invented to offset these supplementary effects on the United States is open to severe criticism both from the technical viewpoint and as a matter of simple good sense, for it consists--I shall not go into detail--of counting the same gold twice, which, after all, is not a model of the best accounting practices.

Finally, from the viewpoint of world monetary policy, the device is an absurdity, since the reserve currency countries, after having explained that their currencies are as good as gold, when confronted with such conversions into gold, invent devices, low tricks which diminish very greatly the significance of their affirmations.

Thus, to mark our disapproval, and in agreement with our franc area partners, we voted against this device. Politically speaking, this is the first time within the International Monetary Fund that the member countries of the franc area have registered a negative vote on question of this degree of importance.

This minority vote having been registered, the problem now is to decide whether or not we should increase our IMF quota, in conformity with the decision adopted by the majority.

After having considered the matter, the Government decided that the French quota should be increased for the following reasons.

First, this increase is consistent with the evolution of the position of our country. Since the role of France in international financial and economic life has increased very appreciably in recent years, it would thus be abnormal that the position of our country in an international institution should be diminished because we did not keep pace with the average progression of others.

In the second place, whatever may be the absence of memory which most frequently governs relationships among nations, our country cannot forget the large appeals which it made in the past to international monetary solidarity, at a time when, certainly, the present majority did not control the Government, but when, nevertheless, as a nation, we benefited from the advantages of that cooperation.

It would not be appropriate, I think, that in a question of this nature such a consideration should be entirely absent from our memory.

Third, it is important to demonstrate by our attitude that the reforms sought by France and with which she is progressively associating an increasing number of countries, does not in our mind exclude international cooperation.

The type of reform we are trying to obtain will preserve international monetary cooperation and will accord their just place to the institutions for such cooperation, that is, will very precisely define their functions. In addition, the reform will involve an overhauling of the instruments of the world monetary system.

If therefore the Government asks you to adopt Article 62 it does this, if I may say so, in the perspective of the reform towards which we are moving. There will still be temporary balance of payments deficits which will have to be financed under normal conditions, in accordance with the original text of the Bretton Woods Agreements, that is, by recourse to the resources of the International Monetary Fund.

On the other hand, the problem of reserve currencies and the creation of international liquidity is an entirely different one, which clearly must be dealt with outside of the institutions of the International Monetary Fund. If the attention you have devoted to this problem and the vote of the Finance Committee indicate a belief that expanding the operations of the International Monetary Fund will not bring about a reform of the world monetary system, the Government very willingly gives you its agreement as to the sense of such a vote.

It is, however, essential to maintain international monetary cooperation, within the context of any reform. That is why the Government invites you to adopt Article 62.