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CONFIDENTIAL (FR)

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

May 24, 1968

SUPPLEMENTAL NOTES

The Domestic Economy

Unit auto sales and stocks. Dealer deliveries of new domestic autos in the first 20 days of May were well above a year earlier and were at a seasonally adjusted annual rate of about 8-1/2 million units as compared with 7.9 million in the month of April.

Consumer buying expectations. The indexes of consumer buying plans for the second half of 1968 for cars, household durables, and houses were up sharply in April from last year according to the Quarterly Survey of Consumer Buying Expectations (CBE). The most striking increase occurred in houses, partly reflecting a substantial increase in the price which purchasers expected to pay. In April 1968, prospective buyers expected to pay \$20,474 for a house, 5.6 per cent more than the \$19,396 reported last year. The index of buying plans for houses was also up sharply from January but buying plans for autos and household durables were only up slightly, and the changes were too small to be significant.

The proportion of families reporting that their incomes were "substantially higher" or "higher" than a year earlier rose to 41 per cent in April 1968, compared with 36.0 per cent a year ago, a record for the six quarters of the survey. Liberalized social security benefits increased the proportion with rising incomes sharply among families with an annual income of less than \$3,000--28.5 per cent compared with 16.2 per cent a year earlier.

INDEXES OF EXPECTED NEW AND USED CAR PURCHASES
AND EXPECTED EXPENDITURES ON HOUSES AND HOUSEHOLD DURABLES:
Quarterly Surveys, January 1967-April 1968

(Average of January 1967 and April 1967 = 100.0)

Date of survey	New cars	Used cars	Houses	Household durables
January 1967 ^{1/}	101.0	98.7	98.1	100.8
April 1967	99.0	101.3	101.9	99.2
July 1967	104.7	101.0	106.6	100.9
October 1967	102.2	101.6	102.5	99.4
January 1968	103.9	103.4	105.7	100.1
April 1968	104.3	103.9	114.7	101.6

^{1/} Not strictly comparable because of change in format.

The Domestic Financial Situation

After reaching new highs on May 21, yields on U.S. Government securities have since declined rather sharply, as shown by the last two columns in the key interest rate table. This reversal of yield tendencies occurred in response to a statement by Chairman Mills that the House will enact the proposed fiscal package in early June, and to a subsequent news report that top economic aides of the President have indicated support of the \$6 billion tax cut. Given this changed outlook, rumors of an imminent increase in the Federal Reserve discount rate, which had circulated rather widely among market participants, quickly lost their credibility.

KEY INTEREST RATES

	1967		1968		
	High	Nov. 17 ^{1/}	Apr. 29	May 21	May 24
<u>Short-Term Rates</u>					
3-months					
Treasury bills (bid)	5.07 (12/5)	4.67	5.55	5.92	5.74*
Bankers' acceptances	5.63 (12/29)	4.88	5.88	6.13	6.13
Euro-dollars	6.88 (11/28)	5.75	6.56	7.06	7.13
Federal agencies	5.30 (12/29)	5.05	5.54	6.11	6.10
Finance paper	5.88 (1/6)	5.13	5.75	6.00	6.00
CD's (prime NYC)					
Highest quoted new issue	5.50 (12/29)	5.25	5.88	6.00	6.00
Secondary market	5.70 (12/29)	5.30	5.95	6.15	6.20
6-months					
Treasury bills (bid)	5.60 (12/1)	5.13	5.64	6.08	5.94*
Bankers' acceptances	5.88 (12/29)	5.00	6.00	6.25	6.25
Commercial paper	6.00 (1/16)	5.13	5.88	6.13	6.13
Federal agencies	5.55 (12/29)	5.40	5.73	6.26	6.25
CD's (prime NYC)					
Highest quoted new issue	5.50 (12/29)	5.38	6.00	6.25	6.25
Secondary market	6.00 (12/29)	5.60	6.15	6.30	6.30
1-year					
Treasury bills (bid)	5.71 (12/29)	5.27	5.64	6.03	6.05 ^{2/}
Federal agencies	5.95 (12/29)	5.75	5.80	5.97	6.01
Prime municipals	4.00 (12/29)	3.40	3.65	3.80	3.90
<u>Intermediate and Long-Term</u>					
Treasury coupon issues					
5-years	5.91 (11/13)	5.72	5.96	6.21	6.12**
20-years	5.81 (11/20)	5.70	5.50	5.66	5.65**
Corporate					
Seasoned Aaa	6.25 (12/28)	6.13	6.25	6.27	6.28**
Baa	6.98 (12/28)	6.76	6.99	7.03	7.07**
New Issue Aaa					
With call protection	6.55 (12/7)	6.53	6.66	6.62	6.84
Without call protection	6.70 (12/1)	6.68	--	--	--
Municipal					
Bond Buyer Index	4.45 (12/7)	4.33	4.43	4.52	4.71
Moody's Aaa	4.15 (12/28)	3.98	4.18	4.25	4.35
FHA home mortgages					
30-years	6.81 (Dec.)	6.77 (Nov.)	6.94 (Apr.)	--	--

^{1/} Pre-devaluation yield levels.

* - 1:15 p.m. quotations.

^{2/} When-issued quote on bill auctioned May 23.

** - May 23 close.

International Developments

The Bank of England yesterday tightened credit policy by setting an inclusive ceiling on bank loans, at their present level. The clearing banks and other banks were instructed to limit credit to an amount 4 per cent above the level outstanding in November. Four per cent, seasonally adjusted, is the amount by which clearing bank credit has increased since November.

The ceiling originally set when the pound was devalued was not inclusive. Categories of loans then exempted included those aiding the balance of payments and those to local authorities and nationalized industries. The ceiling imposed yesterday applies to all loans except to nationalized industries. Since loans for exports and other purposes which improve the balance of payments are still to receive priority, non-priority loans will have to be reduced.

The Bank specifically calls for intensified restriction of loans for imports, whether for consumption or for inventory buildup. It also instructs the banks to reduce lending to local authorities. Such lending was a significant factor in the rise of bank credit since November, as local authorities found the cost of borrowing from their customary sources very high.

The price of gold in London reached a peak of \$42.60 an ounce on Tuesday, May 21, and then dropped sharply on Wednesday and Thursday to \$41.40. However, pre-weekend buying pushed the quotation up to \$41.75 this morning.

Work stoppages in France may have contributed to the sharp rise in the gold price early in the week. Trading in the French franc has been mostly suspended this week. The disorders disrupted communications and closed most of the banking system--including the foreign exchange market and the Bank of France--and there has been little trading of francs in exchange markets outside France because of uncertainty as to when payments can be made through French banks. In the New York market the French franc slumped sharply to 20.15 cents but generally held above the 20.14 cent level at which the Bank of France will support the rate.

Corrections

Page III - 31, in the text table. The net cash drain for June should be plus \$3.5 billion, not minus.

SUPPLEMENTAL APPENDIX A: UNITED KINGDOM FOREIGN TRADE*

Continuation of large deficits in Britain's balance of merchandise trade through April has stirred doubts that the balance of payments will respond to last November's devaluation as planned. Disappointment over Britain's trade performance has been an important factor in the recent weakness of sterling in foreign exchange markets.

However, market pessimism about the success of the devaluation based on these trade developments would seem, at the least, to be premature. More time must elapse before the full effects of the November devaluation and the March budget measures can show up in exports and imports. The export performance through April was encouraging. The main cause for concern has been the increase in the volume of imports since devaluation; but imports fell off in March and April and seem likely to decline further in the next few months.

The average monthly trade deficit on a balance of payments basis (i.e., with imports f.o.b. rather than c.i.f.) was £90 million (\$216 million) in March-April 1968, considerably greater than the average deficit of only £24 million (\$67 million at the old parity) in January-September 1967, before the figures began to be distorted by the dock strikes of October-November. (See Table 1.)

Some deterioration in the trade balance in the months immediately following devaluation was anticipated, since the initial consequence of a devaluation is a sharper rise in import than in export prices (in domestic currency) while offsetting changes in trade volume follow more slowly. However, the magnitude of the deterioration was surprising. For example, the National Institute of Economic and Social Research as late as February had forecast a trade deficit of only £115 million for the first half of 1968; the actual deficit in January-April alone was £284 million.

Imports surge following devaluation

The explanation for the larger-than-expected trade deficit lies in the unexpected surge of imports that took place following devaluation. The physical quantity of imports, which was supposed

* Prepared by Martin J. Kohn, Europe and British Commonwealth Section, Division of International Finance.

Table 1. United Kingdom Foreign Trade, 1967-68
(Seasonally adjusted monthly averages)

<u>Period</u>	<u>Value (£ million)</u>				<u>Volume (1967-I = 100)</u>	
	<u>Exports</u> <u>(fob)1/</u>	<u>Imports</u> <u>(cif)2/</u>	<u>Trade balance</u>		<u>Exports</u>	<u>Imports</u>
			<u>with</u> <u>imports</u> <u>cif</u>	<u>with</u> <u>imports</u> <u>fob</u> 3/		
1967-I	467	525	-58	-8	100	100
II	443	525	-82	-38	95	101
III	436	515	-79	-27	94	96
IV	391	566	-175	-111	81	102
1968-I	513	642	-129	-66	104	109
1968-Jan.	518	617	-99	-35	106	106
Feb.	515	656	-141	-70	105	112
Mar.	506	652	-146	-92	101	110
April	504	645	-141	-87	100e	108e
1967-Jan.-Sept.	449	522	-73	-24	96	99
1968-Mar.-April	505	649	-144	-90	101e	109e

e Partly estimated.

1/ Includes re-exports.

2/ Excludes purchases of U.S. military aircraft.

3/ Balance of payments basis.

to stabilize after the devaluation, was about 10 per cent larger in March-April 1968 than in January-September 1967, although down a little from the peak reached in February 1968. (See Table 1.)

The post-devaluation rise in imports may partly have reflected delayed effects of pre-devaluation developments. For example, if orders were unusually heavy immediately before devaluation -- as importers sought to beat an anticipated parity change -- imports might have been correspondingly inflated in later months, given the lag between orders and deliveries. Furthermore, the rise in imports may have been partly attributable to a catching-up of deliveries delayed by the dock strike. However, this latter factor -- though it played a major role in the advance of exports early in 1968 -- appears to have been of relatively minor importance with respect to imports. Of much greater significance were the boom in consumer spending, touched off by the devaluation and anticipation of new restraints, and an apparent acceleration of inventory accumulation.

The vigor of the post-devaluation consumer spending boom is illustrated by the sharp rises that took place in retail sales (excluding autos) -- almost 5 per cent after correction for price increases from October through March, with a better than 2 per cent rise from the fourth to the first quarter. (See Table 2.) March was a particularly active month. Automobile sales advanced at a torrid pace; registrations of new cars increased by 9 per cent from the fourth quarter to the first quarter, to a level 29 per cent above that of a year earlier, despite a tightening of instalment buying regulations in November.

Table 2. United Kingdom: Indicators of Consumer Spending
(Seasonally adjusted monthly averages, volume, 1967-I = 100)

	Retail Sales (ex. autos)	New Automobile Registrations
1967-I	100.0	100.0
II	99.7	88.3
III	101.3	103.6
IV	102.7	118.2
1968-I	105.0	129.1
1968-January	103.7	133.6
February	104.7	137.7
March	106.6	116 e
April	n.a.	74 e

n.a. Not available.

e Partly estimated.

Consumer buying is now receding rapidly from the levels reached in the period before the announcement on March 19 of a restrictive budget. New automobile registrations apparently fell by about 15 per cent in March and 35 per cent in April. There are reports from retail outlets, particularly those specializing in consumer durables, of post-budget declines in sales. To the extent that the import surge was associated with the consumer buying spree, the decline in such buying since the budget should begin to be reflected soon in a decline in imports.

Statistical studies have demonstrated a close link for the United Kingdom between movements in imports and inventory accumulation. The import figures for recent months, against the background of inventory developments last year, strongly imply that business has been building up inventories at a rapid rate.

There was very little increase in the physical volume of inventories in 1967. In manufacturing alone stocks were run down, on balance, during the year, by about £40 million at constant (1958) prices; and the volume of inventories in other sectors were about unchanged during the second half year, apart from those that represented strike-delayed exports. (See Table 3.) With inventories low, and with a substantial expansion in economic activity under way and expected to continue, both manufacturers and distributors have probably been trying to rebuild inventories recently. The very steep increase in imports of industrial materials -- 28 per cent in value terms from the last four months of 1967 to the first four months of 1968 -- probably reflects a switch from inventory decumulation to accumulation.

Table 3. United Kingdom: Inventory Changes
(Seasonally adjusted, £ million, 1958 prices)

	<u>Inventory Change</u>	
	<u>Total</u>	<u>Manufacturing</u>
Change from end of preceding year or quarter		
1964	590	354
1965	365	217
1966	199	129
1967	<u>1/96</u>	-39
1967-I	37	-8
II	46	11
III	-22	-18
IV	<u>1/35</u>	-24

1/ These figures include an estimated £50 million of export merchandise delayed by the dock strikes.

About 40 per cent of total British purchases abroad are accounted for by industrial materials. The rapid rate at which these expanded -- about twice as fast as total imports from September-December to January-April -- suggests that industrial inventory building may have been the most important cause of the post-devaluation climb in imports.

Identifying the causes of import expansion still begs the question of why the rises were as large as they were, and especially why import substitution appears to have made so little headway. There are no ready answers, only more questions, such as whether import substitution is simply a slower process than many forecasters thought or whether such non-price factors as speed and reliability of delivery may overshadow price changes even of the magnitude entailed in a 14.3 per cent devaluation.

In this connection, the possibility has been suggested that the British import propensities are undergoing an upward shift. The principal evidence is the rapid rise in the quantity of imports from late 1966 to late 1967, when industrial production and gross domestic product, in real terms, were advancing only slowly. In the previous three years, these measures of aggregate output and imports had moved at similar rates. (See Table 4.)

Table 4. United Kingdom: Imports, Industrial Production, and GDP
(Seasonally adjusted; 3-quarter moving averages, centered)

<u>Center of period</u>	<u>Volume indexes, 1963-I = 100</u>			<u>Ratios of indexes</u>	
	<u>Imports</u>	<u>Industrial production</u>	<u>GDP</u>	<u>Imports to Ind. prod.</u>	<u>Imports to GDP</u>
1963-I	100	100	100	1.000	1.000
1966-II	118.7	117.2	113.5	1.013	1.046
1967-III	126.7	117.4	114.7	1.079	1.105
IV	130.5	118.7	n.a.	1.099	n.a.

n.a. Not available.

Special factors, however, doubtless contributed to the rise in the ratios of imports to output last year. These include the removal of the import surcharge at the end of November 1966 and, later on, import purchases spurred by expectations of devaluation. In the post-devaluation period, imports initially grew much faster than total output, but, even if the various factors cited above cannot wholly explain this development, it appears that the import/output ratio is now retreating to lower levels. This is implicit in the decline in the volume of imports in March and April, months when total output appears to have been expanding. Thus the evidence of rising import propensities is inconclusive at best.

Export developments have been encouraging

The performance of British exports since the devaluation has been encouraging. In contrast to imports, exports in the first four months of 1968 have lived up to expectations, closely conforming, for example, to the National Institute's February forecast of a first half total value of just over £3 billion. In fact, the volume of exports appears to have been greater thus far in 1968 than even the high alternative in the Treasury's official forecast in March implied it would be.

The favorable trend has been somewhat obscured by the effects of last fall's dock strikes. With deliveries delayed by the strike steadily diminishing (all told, such deliveries probably represented about 7 per cent of the total volume of exports in the first four months of the year), exports have actually drifted downward during the year. The decrease was 2.7 per cent from January to April in value terms and perhaps as much as 5 per cent in volume terms.

With exports having virtually ceased by now to be inflated by deferred shipments, though, the extent of the underlying improvement is easier to gauge. The value of exports in April, for example, was about 8 per cent higher than in the first quarter of 1967, indicating -- after allowance for price rises and possible small lingering effects of the dock strikes -- that exports in real terms have reattained the record breaking highs reached in the first quarter of 1967.

The strengthening trend to date has probably been more a function of recovery abroad than of devaluation, as is indicated by the most notable export gains since last summer having been in shipments to the EEC and the United States. (See Table 5.) The value of exports to the EEC (which accounted for 19 per cent of British exports in 1967) increased from the third to the fourth quarter, despite the dock strike. Exports as a whole declined by over 10 per cent in this period. In the first quarter exports to the EEC increased by 18 per cent, and were 15 per cent higher than in the first quarter of 1967. The corresponding year-to-year change for total exports was about 10 per cent.

The gains in exports to the United States, which accounted for about 12 per cent of the United Kingdom's total exports in 1967, have been even larger. There was only a slight decline from the third to the fourth quarter and then a 37 per cent increase from October-December to January-March. The increase from first quarter 1967 to first quarter 1968 was 27 per cent.

Table 5. United Kingdom: Exports by Area
(Seasonally adjusted, £ million, monthly average)

	1967				1968	
	<u>I</u>	<u>II</u>	<u>III</u>	<u>IV</u>	<u>I</u>	<u>April</u>
Sterling area	144	138	130	97	150	142
North America	75	67	68	67	93	83
United States	55	50	49	51	70	n.a.
Western Europe	168	159	155	154	178	182
EEC	83	80	78	81	96	99
Rest of world	<u>64</u>	<u>67</u>	<u>67</u>	<u>56</u>	<u>78</u>	<u>79</u>
Total <u>1/</u>	451	428	420	376	496	486

1/ Components may not add up to total because of rounding and seasonal adjustments.

The outlook is for continuing strength in exports, with the advance likely to gain speed toward the end of the year, assuming that a high rate of economic activity is sustained among Britain's major customers. This hopeful prognosis is based on the optimism expressed by British exporters themselves and on favorable (if somewhat sketchy) data on new export orders, as well as on calculations of the impact, both as regards magnitude and timing, that is to be expected from the devaluation.

The numerous surveys of businessmen's expectations conducted since the devaluation uniformly point to a significant improvement in the prospects for exports. These soundings -- conducted at varying intervals by the National Institute, the Confederation of British Industries, the Association of British Chambers of Commerce and The Financial Times -- do not in themselves provide a basis for precise quantitative forecasts. Generally, the surveys elicit only qualitative information from respondents, such as whether they are more or less optimistic about future prospects than they were at some previous date. In cases where quantitative predictions are made, the past record for accuracy has varied widely. However, the consistently sanguine character of the responses since the devaluation, combined with the encouraging export returns and new orders information implies that the outlook is in fact favorable. The important aero-space and machine tool industries have been the beneficiaries of particularly large gains in new export orders.

As for what can be expected from the devaluation, research on the price sensitivity of British exports indicates that the elasticity, for manufactures at least, which account for about 85 per cent of total British exports, may be as high as two. That is, the volume of exports can be expected to increase by 2 per cent for every 1 per cent decline in price, with the result of a 1 per cent rise in value. Though estimates vary, it appears that foreign currency prices of British exports to countries which did not devalue (such countries buy over 80 per cent of the United Kingdom's exports) will be cut by about half of the 14.3 per cent by which the pound was devalued. Thus the foreign exchange value of British exports of manufactured goods to non-devaluing importers could rise by as much as 7 per cent over what it would have been in the absence of devaluation, with a volume increase twice that large.

Some items may respond quickly to devaluation. Automobile manufacturers, for example, expect the volume of motor vehicle exports (which were about 6.5 per cent of total exports in 1967) to rise by 35 per cent in 1968 over 1967, with approximately half of the anticipated gain being ascribed to devaluation; and, in fact, production of automobiles for export has risen very rapidly this year (though reported shortages of shipping have prevented a commensurate rise in deliveries). Other goods, though -- particularly those where custom building is an important element -- may not begin to reap substantial benefits from devaluation for a year or more. Finding new customers and negotiating contracts with them takes time, and there may be a lengthy interval between the reception of an order and delivery of the item ordered. A study of machine tool exports, for instance, revealed that the waiting time between placing of orders and deliveries ranged from about eight months to a year.*

Thus the devaluation itself -- ignoring other influences -- is unlikely to produce dramatic gains in exports in a few months. The gains from devaluation are likely to be gradual, with the adequacy of the new sterling parity as a stimulus to exports to be judged, in any event, no sooner than late this year.

Conclusion

While the import surge in the post-devaluation months came as a surprise and a disappointment, it can be largely explained in terms of temporary influences. The consumer spending boom is already waning, and the rapid rebuilding of inventories will begin to taper off at some point. There was a small decline in the volume of imports in March and April, and further declines are to be expected.

* Steuer, M.D., Ball, R., and Eaton, J.R., "The Effect of Waiting Time on Foreign Orders of Machine Tools," Economica, No. 132, November 1966.

Meanwhile the trend of exports, when corrected for carryover from the dock strikes last fall, has been upward, and should continue upward as the twin result of the November devaluation and the business expansion in Europe and elsewhere. Thus, the prospects are for a very substantial improvement in the trade balance in the months ahead.

It is too early to be sure that the balance of payments target that the United Kingdom is aiming at can be attained on schedule. But the large deficits of early 1968 do not rule out the possibility that the goal is achievable.

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SUPPLEMENTAL NOTES

International Developments

U.S. exports of goods in April expanded by 18 per cent (balance of payments basis) from the low March level. This jump reflects, in large measure, shipments delayed by the New York port strike at the end of March. Aircraft deliveries and shipments to Canada were unusually low in March, and a recovery in such exports may also have occurred in April (data not yet available). However, March-April exports were still about 3 per cent lower than those of January-February combined.

Imports increased only slightly in April and this rise may be largely an effect of the port strike. Imports have remained fairly stable in total during the first four months of this year; March-April arrivals were only one per cent above those in January-February.

U. S. MERCHANDISE TRADE
Balance of Payments Basis
(seasonally adjusted annual rates; billions of dollars)

	Exports	Imports	Balance
1963	22.1	17.0	5.1
1964	25.3	18.6	6.7
1965	26.2	21.5	4.8
1966	29.2	25.5	3.7
1967	30.5	27.0	3.5
1967 - I	30.6	26.7	3.9
II	30.8	26.4	4.4
III	30.5	26.2	4.3
IV	29.9	28.6	1.3
1968 - I	31.7	31.3	0.4
1968 - Jan.	32.8	31.4	1.4
Feb.	33.1	31.2	1.9
2-month average	32.9	31.3	1.6
Mar.	29.3	31.4	-2.0
Apr.	34.5	31.7	2.8
2-month average	31.9	31.5	0.4