FR Annuals

THE LONGEST PROSPERITY

FEDERAL RESERVE BANK OF RICHMOND 1966 ANNUAL REPORT

THE LONGEST PROSPERITY

FEDERAL RESERVE BANK OF RICHMOND FIFTY-SECOND ANNUAL REPORT

CONTENTS

TO OUR MEMBER BANKS:

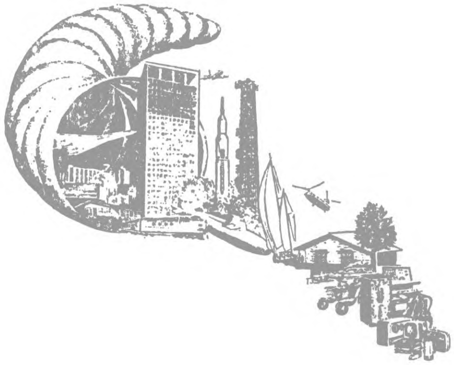
We are pleased to present the Annual Report of the Federal Reserve Bank of Richmond for 1966. The report features an analysis of "The Longest Prosperity," the period of economic expansion from 1961 to the present. Also included are the Bank's annual financial statements, a brief summary of the highlights of the year's operations, and a current list of officers and directors of our Richmond, Baltimore, and Charlotte offices.

On behalf of our directors and staff, we wish to thank you for the splendid cooperation and support you have extended to us throughout the past year.

Sincerely yours,

Edwin Hyde — Chairman of the Board

Edw. A. Wayne — President

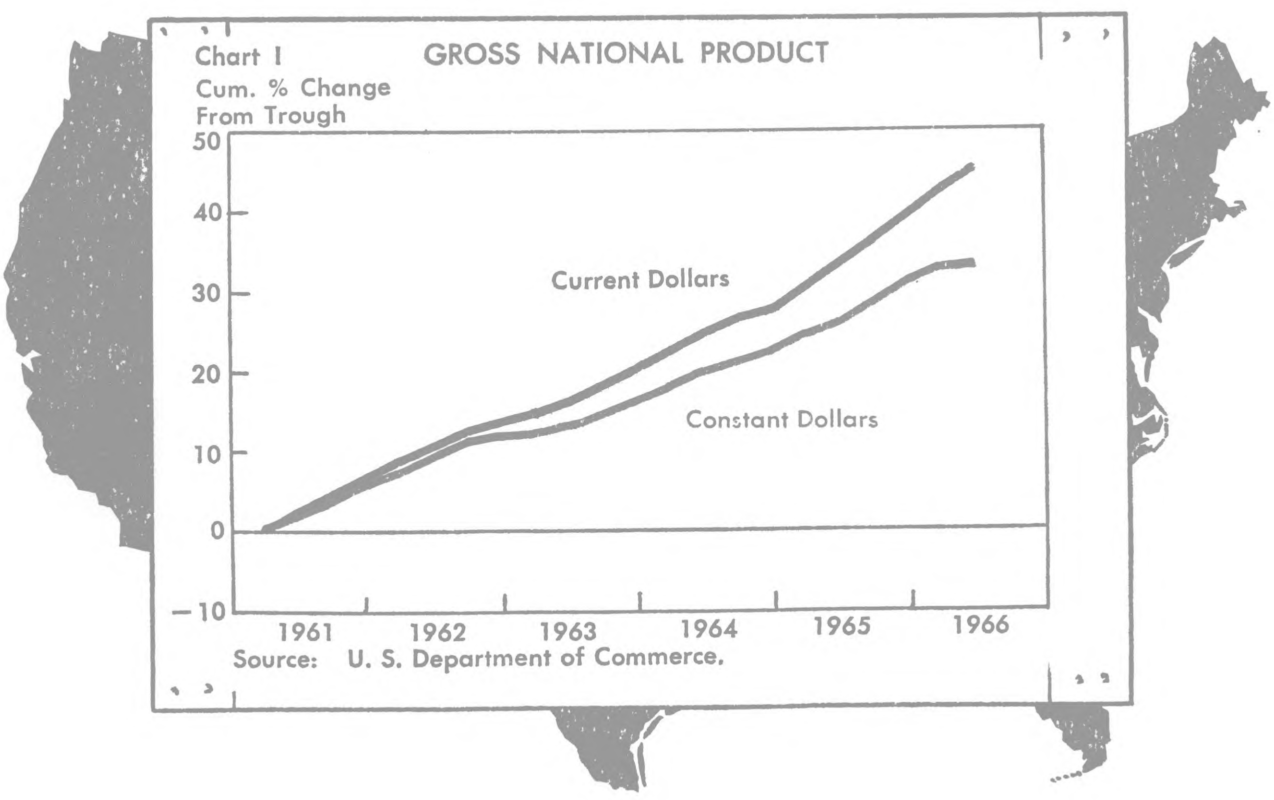


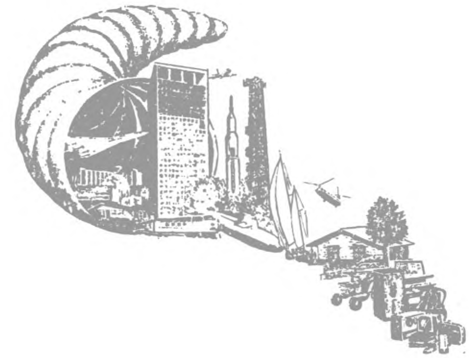
THE LONGEST PROSPERITY
STRATEGIC ELEMENTS OF A BUSINESS EXPANSION

The business expansion which began in early 1961 has perhaps been observed more closely than any other in history. In every phase and at all levels it has been described, diagnosed, analyzed, appraised, and evaluated. This is not surprising because it has been a remarkable period of prosperity. By the middle of 1966 it had added nearly seven million to the ranks of jobholders, raised industrial production and GNP by about a half, almost doubled corporate profits, and boosted per capita personal income by almost a third. Chart I shows the strong and steady growth of GNP in both current and constant dollars. Per capita disposable personal income in constant dollars rose by more than a fifth while net private debt was increasing by somewhat more than a half.

This period has been—by a wide margin—the longest expansion in our peacetime history. For a time it gave promise of being the ideal expansion —one which afforded substantial, balanced economic growth without inflation. But in late 1965 and throughout 1966, growing inflationary pressures made it necessary to invoke the strongest anti-inflationary measures used in a generation. At this writing the expansion continues although the restraints are biting in some sectors. It is still uncertain whether, when, and how the inflationary forces generally can be curbed without precipitating a damaging recession.

Because of the close range at which the expansion has been followed and the great detail in which it has been analyzed, the trees have received most of the attention at the expense of the forest. The present may be an appropriate time to take a longer look at the whole period, gain some perspective, and note some of the larger relationships. In future years, this long period will undoubtedly be the subject of many elaborate, comprehensive, and sophisticated studies. This report could not aim at such a study even if the time were appropriate. The much more modest goal is to make a summary review of the past six years, to point out the major or characteristic developments, to note, if possible, the factors which caused the expansion to get out of control, and to trace the policy moves which were made first to stimulate and later to restrain expansion.





A PANORAMIC VIEW

Economic developments are closely interrelated, and if they are presented in true perspective they should be discussed in the context of a large panoramic view of the economy. This section attempts to develop such a view, covering the period from the first quarter of 1961 to the second quarter of 1966. Later sections give more details.

For convenience, the whole time span is divided into subperiods. There is no entirely satisfactory way of doing this for all sectors of the economy although, with some logical support, three subperiods may be marked out. The first runs from the starting point in the first quarter of 1961 through the second quarter of 1964. The second covers the year from mid-1964 to mid-1965, while the third covers the following year. The logic for the division is given as each period is discussed. Throughout the study, quarterly data are used and in nearly all cases the charts show cumulative percentage changes by quarters from the starting point, which was the trough of the 1960-61 recession. This method was chosen as a middle course between presenting absolute data, which in many cases would underemphasize change, and quarter-to-quarter percentage changes, which would overemphasize it. Another advantage is that it facilitates comparison of one series with another and of one expansion with another.

BACKGROUND

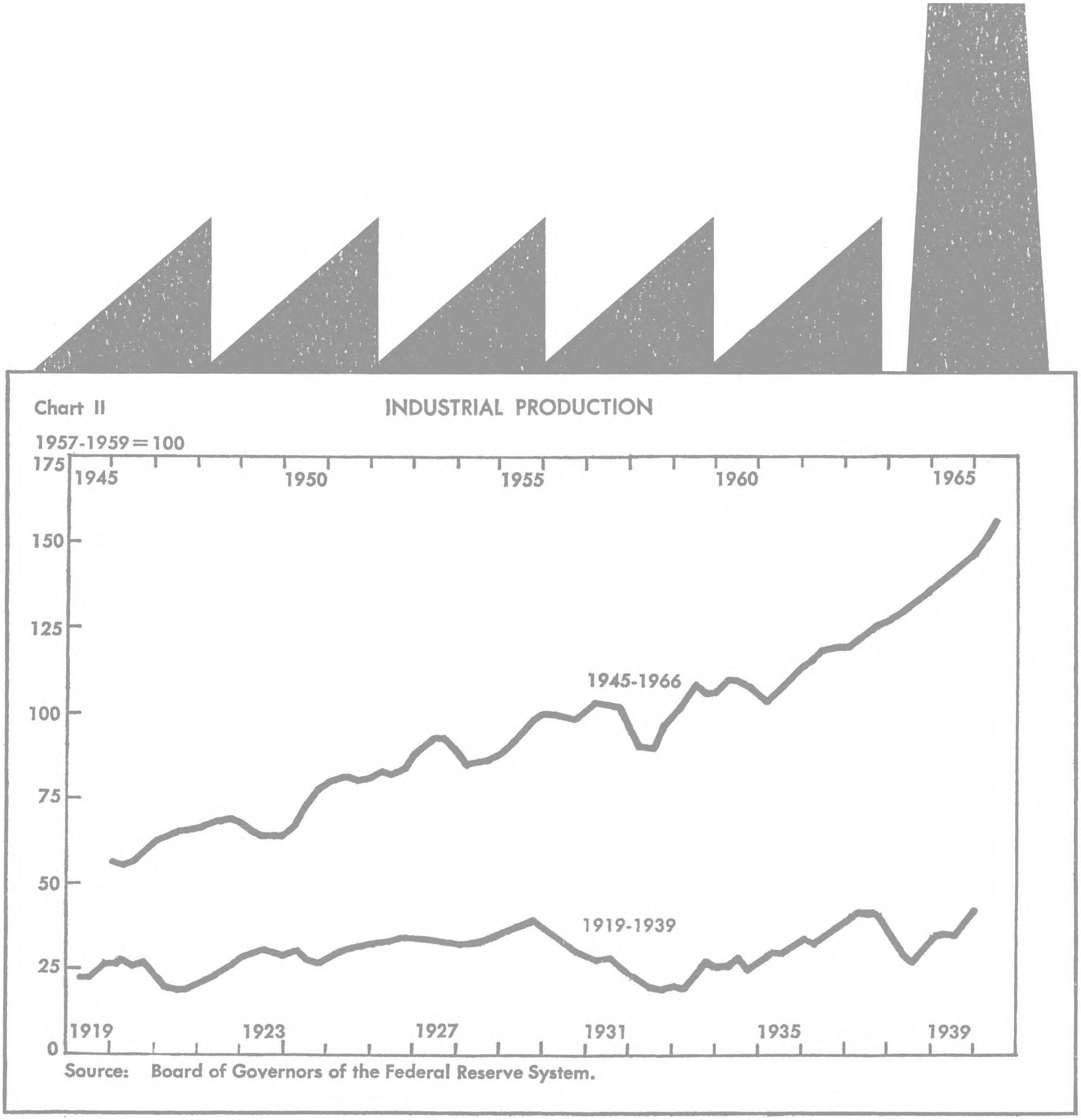
Some historical background is helpful in evaluating this expansion. For this purpose, the behavior of the index of industrial production is used as a proxy for the behavior of the economy as a whole. Two peacetime periods of approximately 20 years each are considered, each starting with the first quarter after the end of a major war. The first covers the years from 1919 to 1939 and the second runs from the end of 1945 to mid-1966. Chart II compares these periods, with the earlier period in the bottom panel and the later period at the top.

As the bottom panel shows, the trend line of the interwar years was quite flat. This was due in large part to the 50 per cent drop between 1929 and 1933, the sluggish recovery in 1934-35, and a second large drop in 1937-38. The average annual growth was only 1.4 per cent but the total rise from the low point of early 1919 to the high peak at the end of 1939 was 84 per cent. In sharp contrast, the postwar period showed an annual growth rate of 4.3 per cent, three times the prewar rate, and posted a total gain of 171 per cent. The prewar period, of course, would have made a much better record except for the long and deep depression of the thirties.

The economy's performance since early 1961 constitutes the most remarkable feature of the postwar period. Starting after 15 years of quite rapid growth, industrial production "took off" in the first quarter of 1961 and over the next five and a half years maintained a growth rate of 6.9 per cent per year—a rate almost two thirds above that of the previous 15 years and five times the prewar rate. Furthermore, after the first year, the growth accelerated as the period advanced, rising by 7.8 per cent in 1964-65 and 9.2 per cent in 1965-66. The smooth and steady expansion on a quarterly basis lends additional significance to the performance. While there were a few declines in monthly figures, the quarterly averages moved up without a break.

THE STARTING POINT

While the first quarter of 1961 marked the trough of the 1960-61 recession, it was a very shallow trough—the shallowest of the postwar period. From the peak in the second quarter of 1960 to the first quarter of 1961, GNP, civilian employment, and wholesale prices showed virtually no change. There were small declines in industrial production, inventories, and manufacturers' unfilled orders, but the drops were quite modest. As further



Source: Board of Governors of the Federal Reserve System.

evidence of the mildness of the recession, several major series registered small increases. These included consumer prices, expenditures for new construction, and personal income. Farm income and personal interest receipts rose appreciably. The comparative stability of personal income indicated that the "recession" was hardly more than a brief pause in the upward course of the economy.

Two major indicators showed substantial changes. Corporate profits dropped by 12.2 per cent, which was not unusual for this volatile series in a period of slack business. More important was the rise in the number of unemployed from 3.7 million to 4.9 million, or more than 30 per cent. The rate of unemployment rose from 5.3 per cent to 6.8 per cent. Total employment remained fairly steady near 67 million, and the sharp rise in unemployment was caused very largely by an increase of one million in the civilian labor force. This increase in nine months was much larger than the average *annual* increase in the preceding ten years.

Fiscal policy was a restraining force during the early part of the recession. For the calendar year 1960, the Federal cash budget produced a surplus of $3.6 billion, following a large deficit of $8.0 billion in 1959. For the peak second quarter of 1960, the surplus (unadjusted) was $4.5 billion; this declined rapidly and by the first quarter of 1961 there was a deficit of $2.3 billion.

Monetary policy was eased even before the peak was reached in May 1960, and by June free reserves appeared. By the first quarter of 1961 these amounted to about $500 million. Stimulated by these moves, the money supply increased and bank credit rose. Interest rates fell, but not as much as in earlier recessions. Long rates fell only slightly, while rates on short Treasury bills dropped by about a fourth. The Federal Reserve System did not supply reserves as generously as it might have done otherwise and it took special steps to put a floor under short-term interest rates, both in an effort to discourage the flow of funds abroad.

In summary, it was a very brief and very mild recession. In most areas activity slackened or leveled off for a brief time but there was no embarrassing accumulation of inventories nor any significant financial distress. There was no problem of adjusting business or individual debts and the economy was in a strong and healthy condition to resume the advance when the trough was passed in February 1961.

THE FIRST PHASE

The period chosen to represent the first phase of this expansion covers approximately three and a half years —from early 1961 to the middle of 1964. It is somewhat longer than the average of previous expansions in the postwar years. It was chosen primarily because it covers an extended span of substantial growth with stable wholesale prices. In many respects the expansion during this phase was similar to that in other upswings, but there were a number of important differences, some or all of which may account for the unusual length and magnitude of this expansion.

Well-Balanced Growth Perhaps the most significant general characteristic of this phase was a smooth, steady, and well-balanced growth. Some sectors did experience a slackening of growth in the last half of 1962, but otherwise the expansion proceeded at a relatively steady pace. Inventories were held in close control and usually grew less rapidly than sales, while manufacturers' unfilled orders increased only moderately. Expenditures for new plant and equipment remained moderate in 1961 and 1962 but in early 1963 started a long and steady rise. No major industry suffered any substantial reverse and none was stimulated into a speculative boom.

The automobile industry was in the forefront of the expansion and provided much of the impetus for the upswing. At times it appeared to be operating at an unsustainable pace as the production of passenger cars rose from 5.5 million in 1961 to 7.7 million in 1964. But sales kept pace and there was no inventory problem. To many observers it seemed that the market was insatiable as new sales records were set and broken regularly.

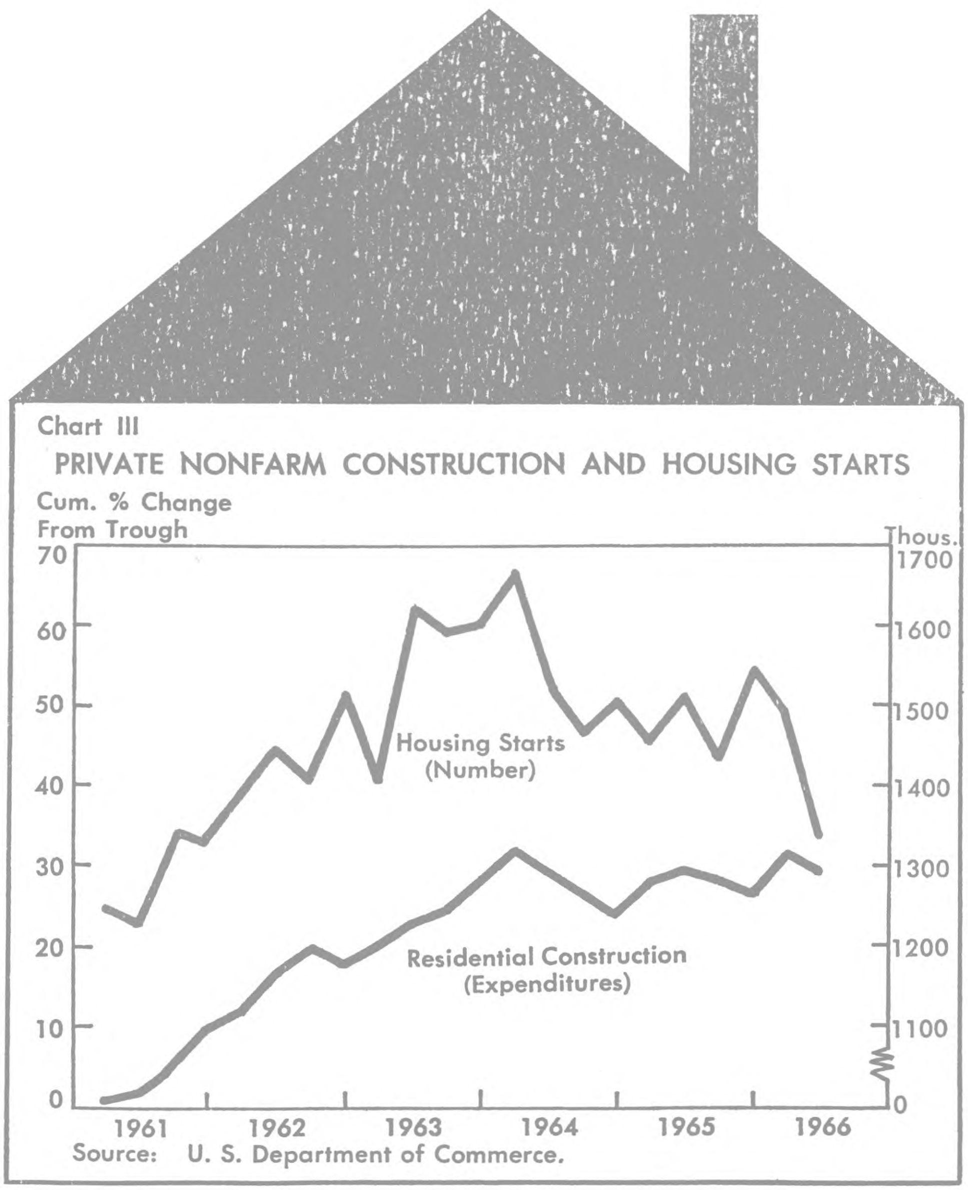
On the other hand, residential construction did not show the vitality it had displayed in the 1950's. In previous cycles, housing had frequently moved contra-cyclically, rising in recession years because of low interest rates and abundant credit and then being choked off in recovery as rising demand for credit raised rates and shut off the flow of funds. While interest rates remained stable and funds were readily available, housing nevertheless responded only sluggishly and peaked out in early 1964. Chart III shows the movements in expenditures for nonfarm residential construction and in housing starts. Perhaps consumers had reached a stage where they wanted many more automobiles and only a little more housing.

As in most recoveries, debt in its various forms increased faster than economic activity. From the end of 1960 to the end of 1963 net private debt grew at a rate some 40 per cent faster than GNP, while the consumer and mortgage debt of individuals was rising at a rate more than one and a half times as fast as disposable personal income.

It is not feasible to attempt to give here a definitive explanation for this moderate and balanced growth, but a few reasons may be suggested. First was the mildness of the 1960-61 recession. There had been no violent decline or widespread readjustment such as often stimulates a sharp bounce back. In particular, short-term interest rates had not dropped to very low levels. Second was the period of price stability which had prevailed since early 1958. One whole cycle, although a short one, had passed with practically no change in wholesale prices. This did much to dispel the inflationary psychology of the 1950's and to create a climate of price expectations more favorable to stable growth. Third, there was a considerable margin of unused producing capacity in the economy. According to one measure, manufacturing plants were operating at less than 80 per cent of capacity in early 1961. The cushion provided by this reserve capacity did much to discourage a scramble to place orders, accumulate inventories, and bid up prices. Better techniques of inventory control also contributed to this result. Finally, fiscal and monetary policies pursued during these years made important contributions to orderly growth.

Chart III

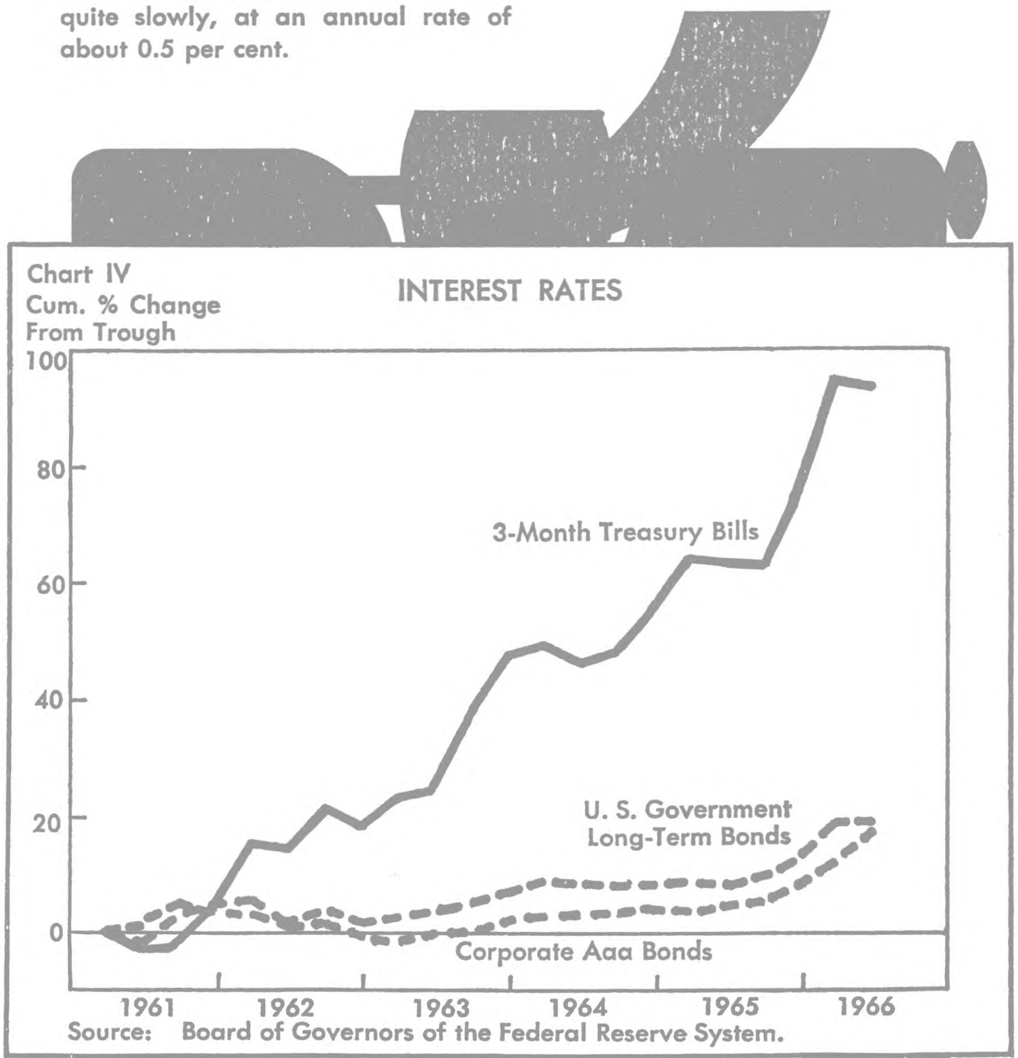
PRIVATE NONFARM CONSTRUCTION AND HOUSING STARTS



Source: U. S. Department of Commerce.

Stable Prices and Interest Rates The remarkable stability of wholesale prices which had begun in 1958 continued throughout this phase. Actually, the general index was slightly lower in mid-1964 than it had been in the first quarter of 1961. This long period of price stability was the more remarkable in view of the vigor of the expansion between 1961 and 1964. Further, all major components of the wholesale index showed about the same pattern, so the stability of the general index was not achieved by divergent movements of the components. Consumer prices moved up at a rate of 1.2 to 1.3 per cent per year, due chiefly to the long secular rise in the prices of services. Prices of consumer durable goods rose quite slowly, at an annual rate of about 0.5 per cent.

Interest rates were unusually stable for a period of expansion, as can be seen from Chart IV. Long-term rates were especially steady, showing no sustained upward trend. Several factors accounted for the stability. Rates had declined only moderately in the short recession of 1960-61. Savings were high and were sufficient to meet the demands on the capital markets. Monetary and fiscal policies, represented in part by "Operation Twist," attempted to keep short-term interest rates up for balance of payments purposes while maintaining low long-term rates to stimulate the domestic economy. In combination these factors produced three years of remarkably stable interest rates.



Source: Board of Governors of the Federal Reserve System.

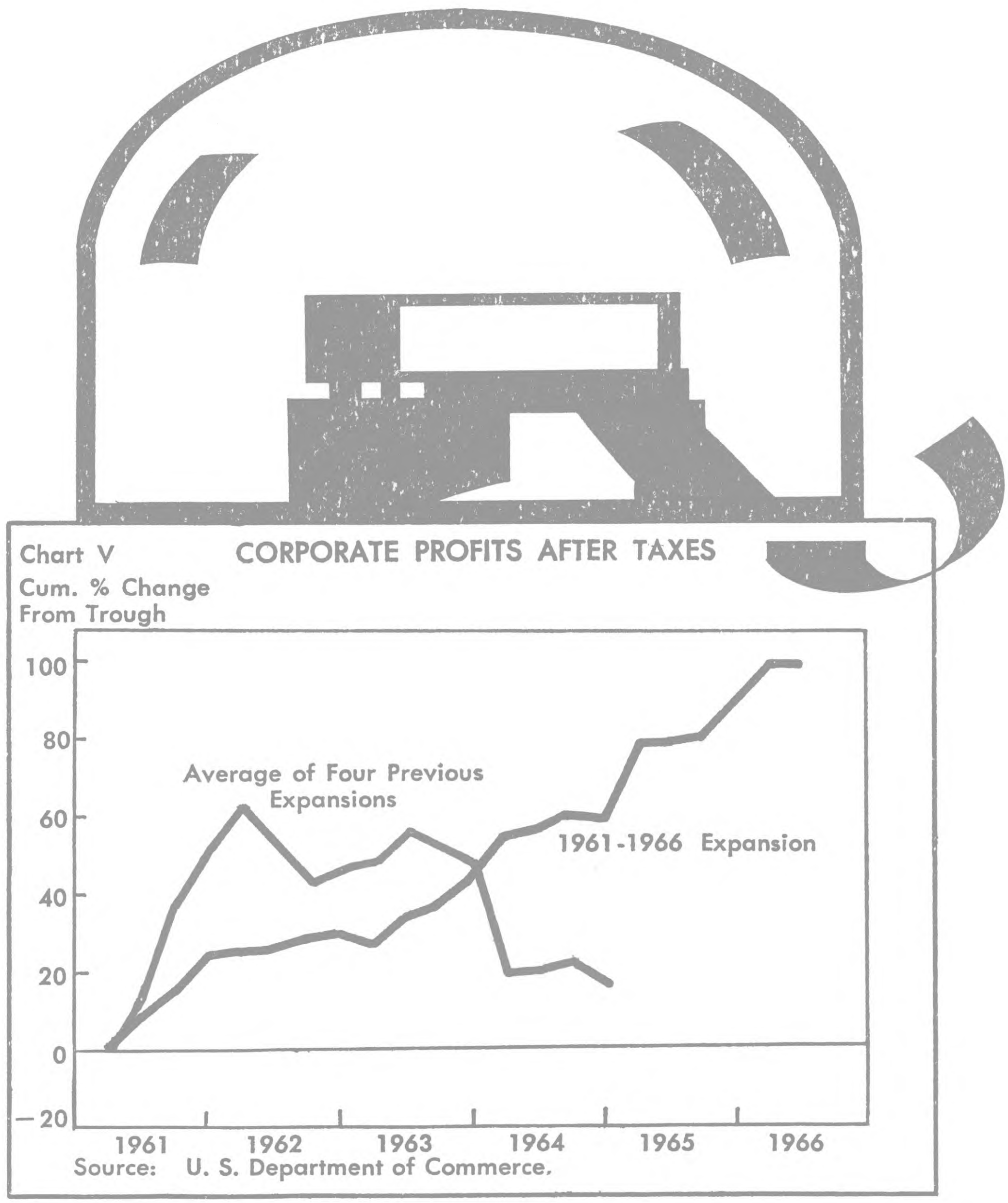
Corporate Profits and Capital Outlays The behavior of corporate profits was an outstanding feature of this phase and of the whole expansion period. Chart V compares profits after taxes in this expansion with a composite of their behavior in the four preceding postwar expansions. Typically, those earlier upswings had shown sharp rises in profits lasting only a year or a little more, followed by a leveling off or a decline. This time profits rose considerably more slowly but also more steadily and the upward movement continued much longer. By the end of the first phase, after-tax profits had risen by more than 50 per cent and by the middle of 1966 they had almost doubled.

Corporate profits are discussed in some detail in a later section, so only a few points are noted here. They were significant both as cause and effect. Several factors contributed to their substantial growth: (1) the steadily rising volume of economic activity; (2) steady or slightly declining unit labor costs; and (3) lower taxation. Soaring profits were an important factor in the expansion as they provided both a strong incentive and a large amount of funds to stimulate large programs of capital outlays. Steady interest rates and the ready availability of investment funds were important contributing factors in the investment boom which developed after the early part of 1963 to become a dominant feature of the expansion.

Fiscal and Monetary Policies Both fiscal and monetary policies played important roles in promoting balanced economic growth during this first phase. Fiscal policy contributed in the opening months through a number of large new expenditure programs. The closing months saw the enactment of one of the largest reductions in individual and corporate income taxes in our history. In between were the substantial liberalization of depreciation allowances and the enactment of the investment tax credit, both in 1962. The general purpose of all these measures was to raise the rate of economic growth and reduce unemployment. Federal cash payments rose steadily from $99.5 billion in fiscal 1961 to $120.3 billion in fiscal 1964, while cash receipts mounted from $97.2 billion to $115.5 billion. On a seasonally adjusted basis, there was a cash deficit each quarter, ranging between $0.7 billion and $2.1 billion. The total deficit for the 13 quarters was $17.4 billion.

The general position of monetary policy throughout the period was easy but the degree of ease declined after 1963. The constraint which prevented more ease was the large deficit in our balance of payments and the desire to prevent domestic short-term interest rates from going so low as to encourage the movement of funds abroad. Throughout 1961 the discount rate was 3 per cent, free reserves averaged somewhat more than $400 million, and the three-month Treasury bill rate fluctuated around 2¼ per cent. In the first half of 1964 free reserves averaged about $120 million, the discount rate was 3½ per cent, and the Treasury bill rate was near that level. The discount rate was raised in July 1963, almost entirely because of considerations affecting the balance of payments.

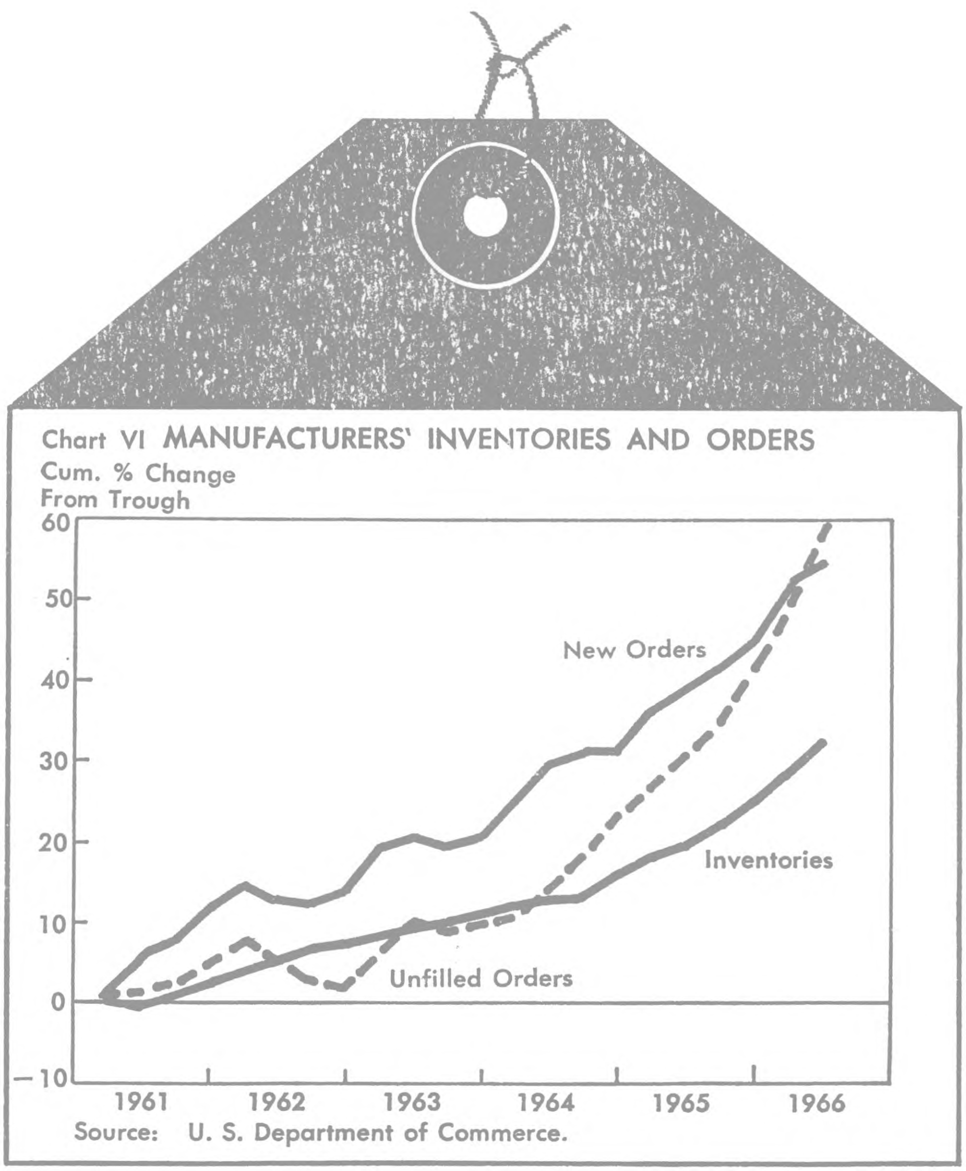
Major Problems Although the first phase was a period of substantial growth and prosperity, two major problems persisted. The first was the large and continuing deficit in the balance of payments. This problem is discussed in a later section. The second major problem was unemployment. In early 1961 the number of unemployed, seasonally adjusted, fluctuated close to five million or about 7 per cent of the labor force. By the second quarter of 1962 it had dropped to about four million, or 5.6 per cent, and then remained in that general range for about two years.



The stubborn refusal of these figures to decline as economic activity rose gave rise to a growing concern and to political pressures for action.

THE SECOND PHASE

The second phase covered the year from the middle of 1964 to the middle of 1965. In this phase economic activity moved ahead at a somewhat more lively pace, with some emerging signs of imbalance. Total civilian employment rose by 2.6 per cent, while the civilian labor force increased by less than 2 per cent; personal income was up by 7.2 per cent; and industrial production was higher by 8.0 per cent. Unemployment finally began to decline, dropping from about four million to near three and a half million, or from 5.4 to 4.6 per cent of the labor force.



Excess Demand Appears This was a year of incipient inflation. The stimuli were several. The money supply and bank credit grew at a faster pace. Spending for capital outlays accelerated, rising by 16 per cent. Capacity utilization approached the optimum level and labor shortages developed in some sectors. In the fiscal area, the full effects of the large tax cut of 1964 were realized and a number of excise taxes were eliminated or substantially reduced. A large number of new Federal expenditure programs in the welfare, educational, and developmental areas were initiated and some old ones were expanded. These included social security benefits, Medicare, housing and urban development, aids to education, manpower and training programs, Appalachian regional development, and others.

Evidence of growing inflationary pressures emerged with increasing frequency as the year progressed. Manufacturers' new orders continued their rapid but uneven growth. Unfilled orders—a significant measure of excess demand—turned sharply upward about the middle of 1964 and inventories began a distinctly faster rise about the same time. Movements in these series are shown in Chart VI. Wholesale prices also began to climb at the middle of 1964. In retrospect, it is clear that the acceleration of aggregate demand in this second phase, coupled with the progressive reduction in idle capacity and unemployment, laid the groundwork for the inflation which became increasingly evident in the following phase.

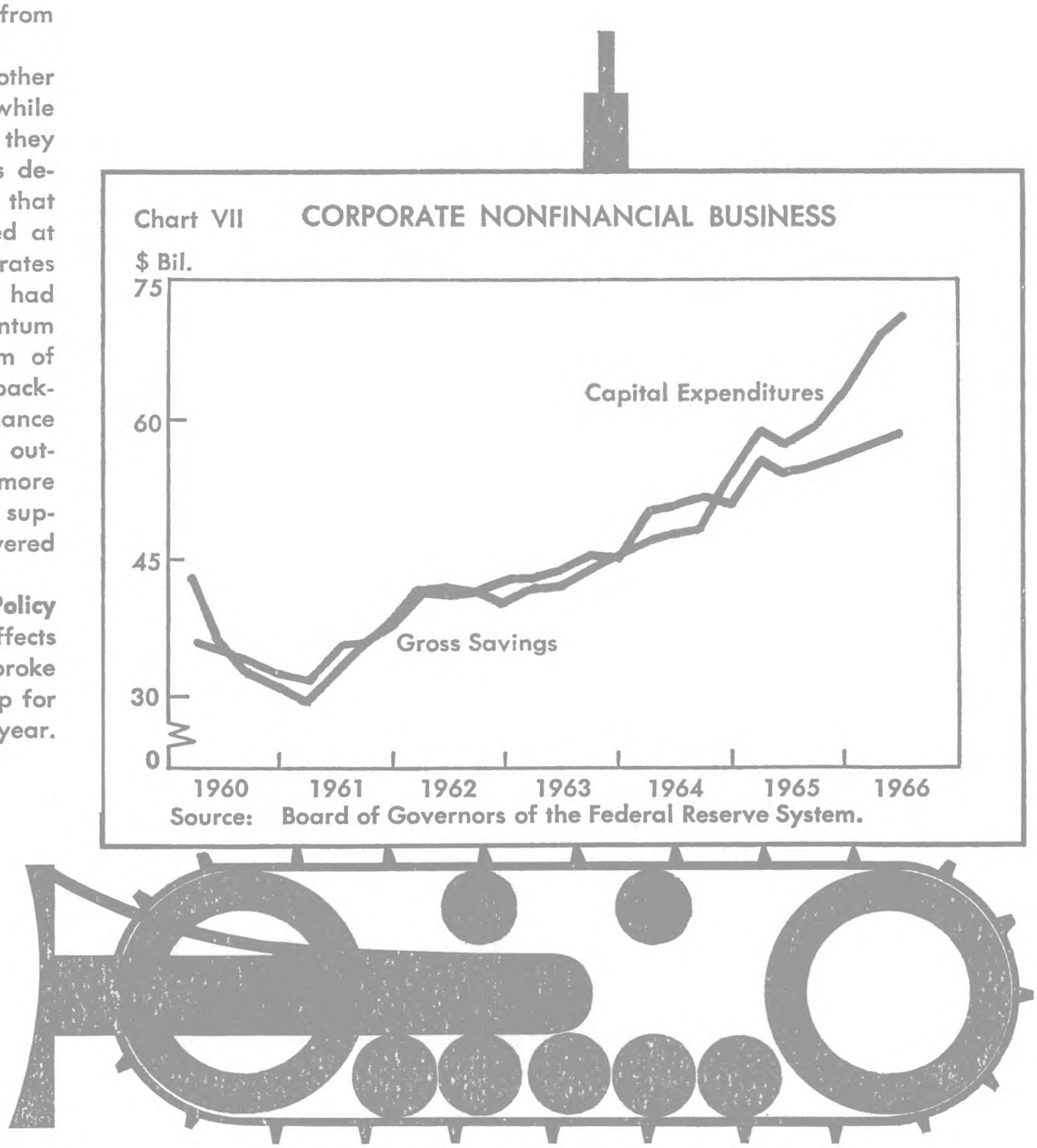
Sources of Financing Despite the fact that residential construction in this second phase was approximately stationary, gross private investment rose at a vigorous 13 per cent rate. The increase came mainly in nonresidential construction, producer durables, and inventories. Most of these outlays were financed by nonfinancial corporations and during this period there occurred a significant change in financing methods. As Chart VII shows, from 1961 to late 1964 gross savings of corporations (retained earnings plus depreciation) were about equal to business capital expenditures. After that, however, capital expenditures outran gross savings and corporations had to turn increasingly to the capital market and to banks for funds. As a result, corporations increased their use of external sources of financing from some $19 billion in 1963 to $31 billion in 1965. The increase in bank financing was from $2.8 billion to $8.6 billion.

Demand for funds from other souces was increasing also, and while personal savings were rising, they were not growing as rapidly as demand. It soon became evident that unless bank credit was increased at an ever faster pace, interest rates must rise. In brief, the economy had acquired a considerable momentum in the form of a large program of capital outlays and a mounting backlog of unfilled orders. To finance rising inventories, larger capital outlays, and other capital needs, more funds were required than were supplied by savings. Bank credit covered the deficit.

Price Pressures and Monetary Policy

The excess demand exerted its effects on prices. Wholesale prices broke their long stability and moved up for a rise of 2.8 per cent in one year. The rise was concentrated largely in farm products and processed foods which rose by 6.6 per cent; industrial commodities were up only 1.6 per cent. Consumer prices increased their rate of advance, rising by 2.0 per cent compared to 1.3 per cent in the previous year.

In the face of these price pressures, monetary policy was adjusted progressively toward less ease throughout this period. Free reserves declined steadily and near the end of the period net borrowed reserves appeared. The discount rate was raised in November 1964, very largely for balance of payments considerations. Shortly after this move, several commercial banks announced increases in their prime rates but rescinded their actions under considerable pressure. The maintenance of the prime rate at 4½ per cent at a time when market rates had moved much higher tended to channel credit demands into the banks and away from the capital market and thus to offset the restraint on investment that may have been exerted by the higher rates.



THE THIRD PHASE

This phase covers the period from mid-1965 to mid-1966, a year in which inflation emerged as a major problem. The economy responded as it always does when it is operating under the influence of inflationary forces and is approaching, but has not reached, the upper limit of productive capacity. Table 1 shows how some of the major segments of the economy behaved compared to their action in the previous year.

Changes in a Boom Period The civilian labor force showed no increase in its growth rate, partly because of larger numbers entering the armed forces. Total civilian employment grew slightly faster, while both payroll and factory employment grew at considerably faster rates. This latter was possible partly because of a sharp drop in farm employment, which declined by 10.5 per cent in 1965-66. This represented the continuation of a trend which had been going on for a long time and which has caused, over the years, a large change in the structure of employment in the economy. The increase in factory employment was the more remarkable in light of the great advances in automation.

Industrial production grew even faster in 1965-66 than in the preceding year, rising at a rate of 9.5 per cent. The increase was general, but was especially strong in business equipment. Defense equipment began a very sharp rise in early 1965. Gains in food, fuel, and other consumer staples were considerably more

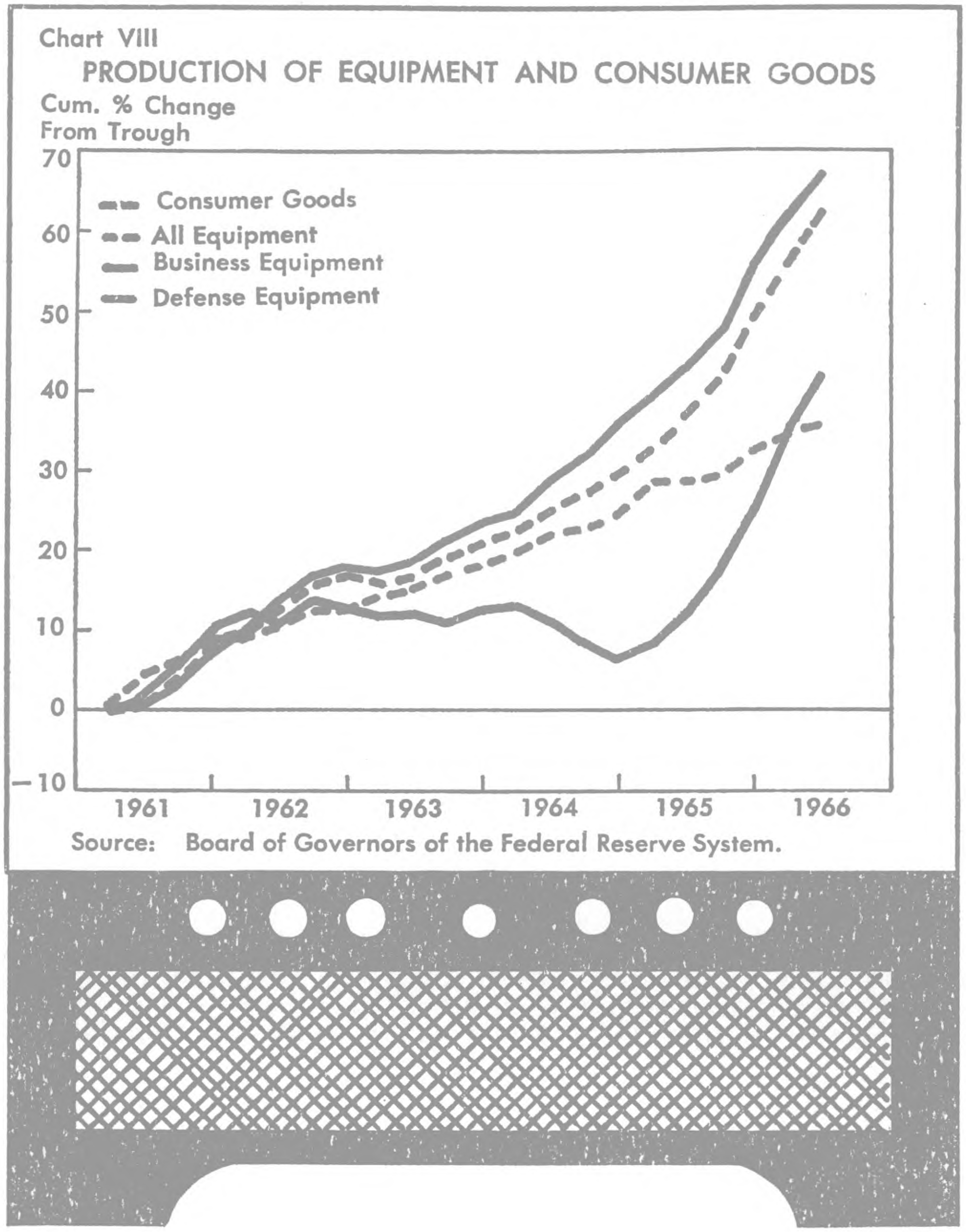


Chart VIII
PRODUCTION OF EQUIPMENT AND CONSUMER GOODS

Source: Board of Governors of the Federal Reserve System.

Table 1 ANNUAL RATES OF CHANGE

Series
Civilian labor force
Total civilian employment
Payroll employment
Factory employment
Number unemployed
Industrial production
Personal income
Retail sales
Wholesale prices
Consumer prices

Source: Board of Governors of the Federal Reserve System, U. S. Department of Commerce and U. S. Department of Labor.

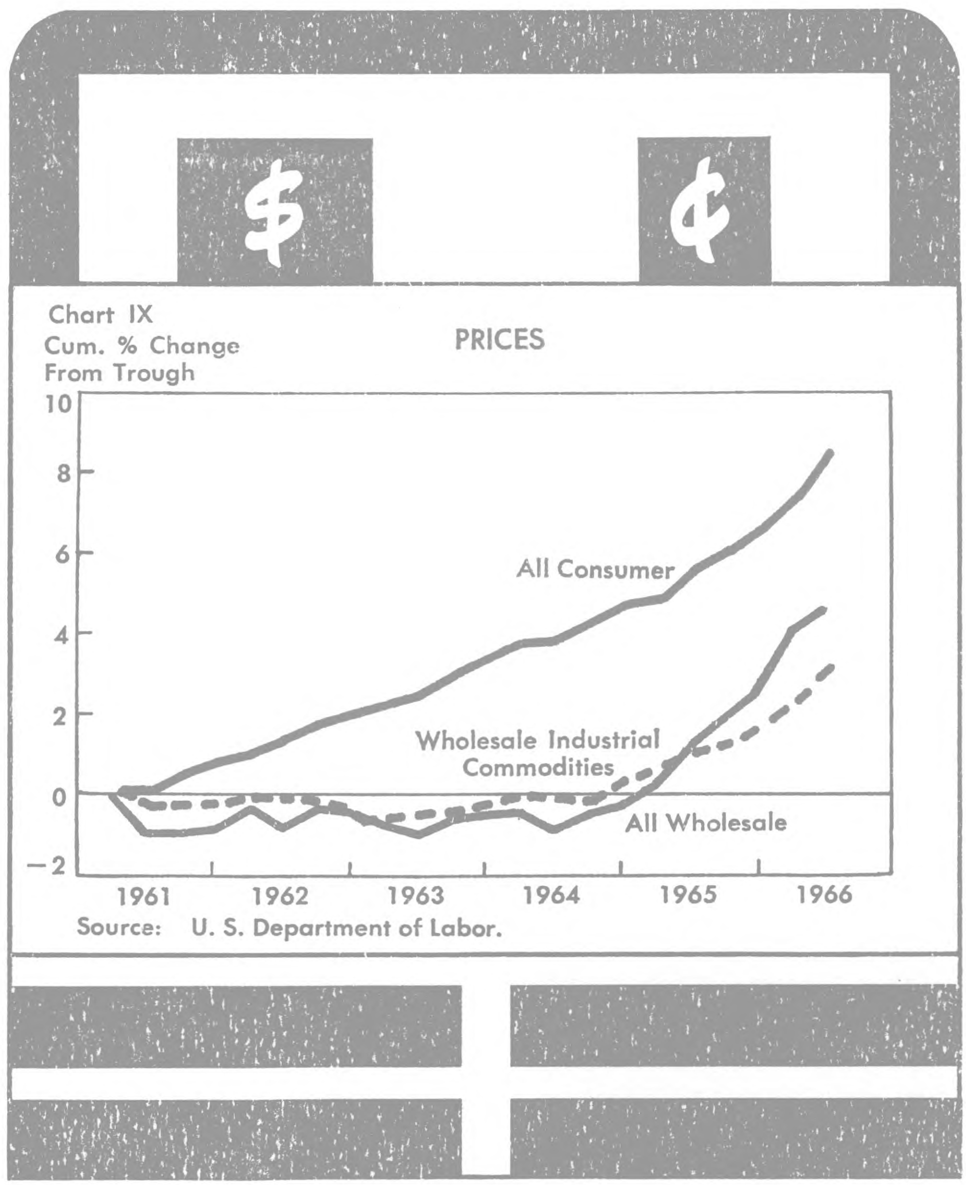
modest. The divergence between business equipment and consumer goods was striking, as is shown in Chart VIII. The gap between the two categories had been widening for some time as capital outlays mounted, but it assumed striking proportions in 1965-66 as the output of equipment rose by 17.2 per cent while production of consumer goods gained only 5.6 per cent.

Personal income not only continued to rise but increased its rate of gain to 8.5 per cent. Retail sales moved about in step, rising by 8.7 per cent. Feeling the impact of inflation, manufacturers stepped up their new orders by 11.8 per cent over the period while shipments rose only 10.3 per cent. Inventories mounted along with orders, gaining 11.5 per cent. Unfilled orders moved up from $60.6 billion to $74.8 billion, an increase of 23.4 per cent, or about twice the rate of growth of orders and shipments.

As usually happens when the economy is operating under pressure, prices moved up. The 2.5 per cent increase in wholesale prices was actually a little less than the 2.8 per cent increase of the previous year but the change in the behavior of the components was significant. In 1964-65 the greater part of the advance was in farm products and foods, which rose by 6.6 per cent; in 1965-66 those groups were up by only 4.1 per cent. As shown in Chart IX, prices of industrial commodities reversed this pattern, rising first by 1.6 per cent and then by 2.3 per cent. Consumer prices also moved up at a faster pace, rising by 2.5 per cent in 1965-66 against 2.0 per cent in 1964-65. Food and services showed the greatest advances while prices of durable commodities were virtually unchanged in both years.

OF SELECTED ECONOMIC SERIES

June 1964-June 1965	June 1965-June 1966
1.9	1.9
2.6	2.7
3.9	5.3
4.2	6.4
−10.3	−13.4
8.1	9.5
7.2	8.5
7.1	8.7
2.8	2.8
2.0	2.5



Sources of Imbalance In retrospect, we can see how imbalance developed in the economy. At the middle of 1965 the economy was operating at a high level, approaching the optimum rate. Unemployment was low and labor shortages were spreading. A large and growing program of capital investment was under way. Expenditures for new plant and equipment, which had started a sharp rise in 1963, continued and gathered speed, as can be seen from Chart X. As a proportion of GNP they exceeded 8 per cent, which is often regarded as a sign of overheating. In July our Viet Nam program was sharply increased, with a doubling of the monthly draft call and higher defense outlays. No revenue measures were adopted to meet the added expenditures. Indeed, a substantial reduction in excise taxes had just gone into effect. Moreover, increased social security benefits, retroactive to January 1965, became effective in September while increases in payroll taxes to cover them did not start until January 1966. Before the end of 1965 military and civil service pay scales were raised and a number of new expenditure programs were started. The budget for fiscal 1967, presented in January 1966, proposed only limited and temporary fiscal restraint, depending mainly on accelerating tax payments dates and the sale of assets or participations by Federal agencies.

The Federal cash budget operated with large deficits in the last two quarters of 1965 and the first quarter of 1966. In the second quarter of 1966 the full effects of the accelerated tax payments and the sale of assets were felt and the surplus in the cash budget soared to over $10 billion—probably the largest quarterly surplus in history. This was largely a temporary, nonrecurring development but it was a significant factor in causing some easing of inflationary pressures. Growth rates of economic activity declined and prices rose more slowly.

Monetary Policy in the Third Phase In the second half of 1965, money and credit policy became progressively firmer. In December the discount rate was raised from 4 to 4.5 per cent, the first discount rate action in the current expansion dictated primarily by domestic considerations. This increase came at a time when widening disparities between market rates and key institutional rates were creating serious distortions in the flow of funds through the nation's money and capital markets.

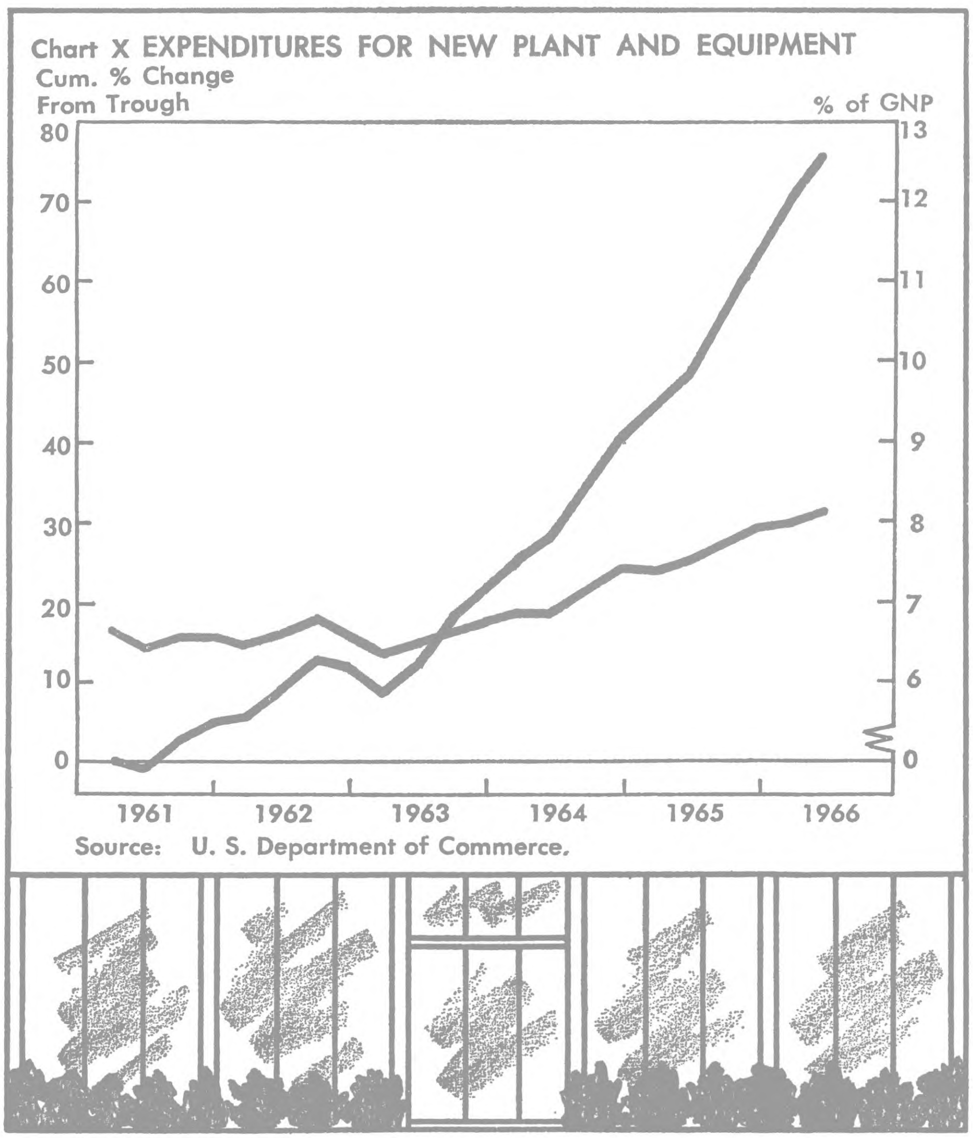
The discount rate change was not followed immediately by any reduction in reserve or credit availability. The Federal Reserve System provided new reserves liberally in order to facilitate an orderly adjustment to the new rate level. As a result, the money supply, bank credit, and related series grew for a time at unusually rapid rates. By late spring, however, money and credit expansion had been brought under firm control and the effects of monetary restraint began to manifest themselves. Reinforcing the effects of the large second quarter surplus in the Federal cash budget, tight money was also a major factor contributing to the economy's reduced rate of growth in the spring quarter.

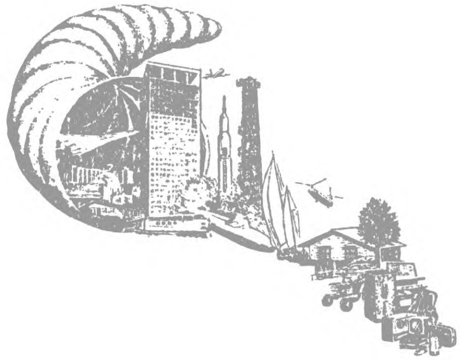
Second Half, 1966—A New Phase? After the second quarter of 1966 the economy moved into what appeared to be another phase. Defense spending continued to accelerate and the boom in business investment proceeded unabated. The rate of business advance picked up again, although it continued to fall short of the feverish first quarter pace. By midsummer it was clear that the long expansion had finally generated a significant inflation, with all its corollary problems.

The effects of tight money were increasingly obvious in the third quarter. Interest rates moved steadily upward, reaching the highest levels since the 1920's. Construction spending went into a tailspin as mortgage money became very scarce. Residential building fell off sharply. Automobile sales and production slowed significantly. Prices, while continuing to move up generally, began to behave more erratically and declines showed up in a few significant areas.

For the entire third quarter, monetary policy alone bore the brunt of the anti-inflationary effort. But it soon became clear that serious risks were involved in this course. Tight money and high interest rates have no effect on Federal spending and probably little on spending by state and local governments. Similarly, business investment plans are of a relatively long-run nature and outlays cannot be quickly curtailed in response to tight money. Yet the government sector and the business investment sector provided much of the impetus for the accelerating advance. Moreover, by midsummer tight money and rising interest rates had generated expectations which posed a threat to the smooth functioning of the capital markets. Increasingly it was noted that too much reliance on monetary policy was producing severe dislocations in the economy.

Against this background, Congress in October enacted legislation to suspend for 18 months the 7 per cent investment tax credit and two formulae providing accelerated depreciation allowances. Whether or not this fiscal measure will provide sufficient additional restraint on the boom is, at the present writing, problematical. This apparent disposition of the Administration to employ effective fiscal policy steps to curb the boom exercised a salutary effect on market expectations in much of the second half.





EMPLOYMENT AND PRODUCTION

Two major measures of the performance of an economy are the employment it affords and the amount of goods and services it produces. Both measures moved well into new high ground in the present expansion. This section considers briefly some further aspects of employment and output.

Civilian Labor Force During this expansion the civilian labor force grew from 71.7 million to 76.7 million, for a total increase of 7 per cent, or an annual average of about 1.25 per cent. The total population increased slightly more, 7.6 per cent, but the annual growth rate declined steadily and fell to near 1 per cent by 1965.

As can be seen from Chart XI, the labor force changed little during 1961 and 1962. The total growth for the two years was only about 0.8 million. The major reason for this was probably the low birth rates during the latter years of World War II. The babies of those years arrived at "civilian working age" in 1961 and 1962 and their numbers were not much larger than the numbers of those leaving the labor force. After 1962, however, something like 1.3 million people per year were added to the labor force. The growth slowed somewhat in late 1965 and early 1966, partly because of the increasing numbers going into the armed forces.

Employment and Unemployment The total number employed increased from 66.8 million to 73.7 million during this expansion. This was an increase of 6.9 million, or 10.3 per cent, and was about equal to the net gain during the whole decade of the 1950's. Since the number of farm workers declined about 1.5 million, the number of nonfarm workers increased by 8.4 million. Chart XI shows increases in employment regularly moving ahead of the rise in the labor force after the first year. As a result, unemployment was reduced by nearly two million, or about 40 per cent.

The number of unemployed in early 1961 was close to five million, or 7 per cent of the labor force. During the first year of the expansion the number fell by about a million, bringing the rate down to 5.6 per cent. But then the improvement halted, and for more than two years the number of unemployed fluctuated narrowly around the four million mark and the rate of unemployed moved between 5.6 and 5.8 per cent. Since nearly all other elements of the economy were moving up strongly, this seemed inconsistent. As it persisted it gave rise to more and more concern and, along with the balance of payments, came to dominate much of economic policy. Efforts to solve this stubborn problem resulted in fiscal and monetary policy moves which eventually generated much of the inflationary pressure of 1965 and 1966. On a preliminary analysis, four factors seem to have helped to maintain unemployment on a high plateau.

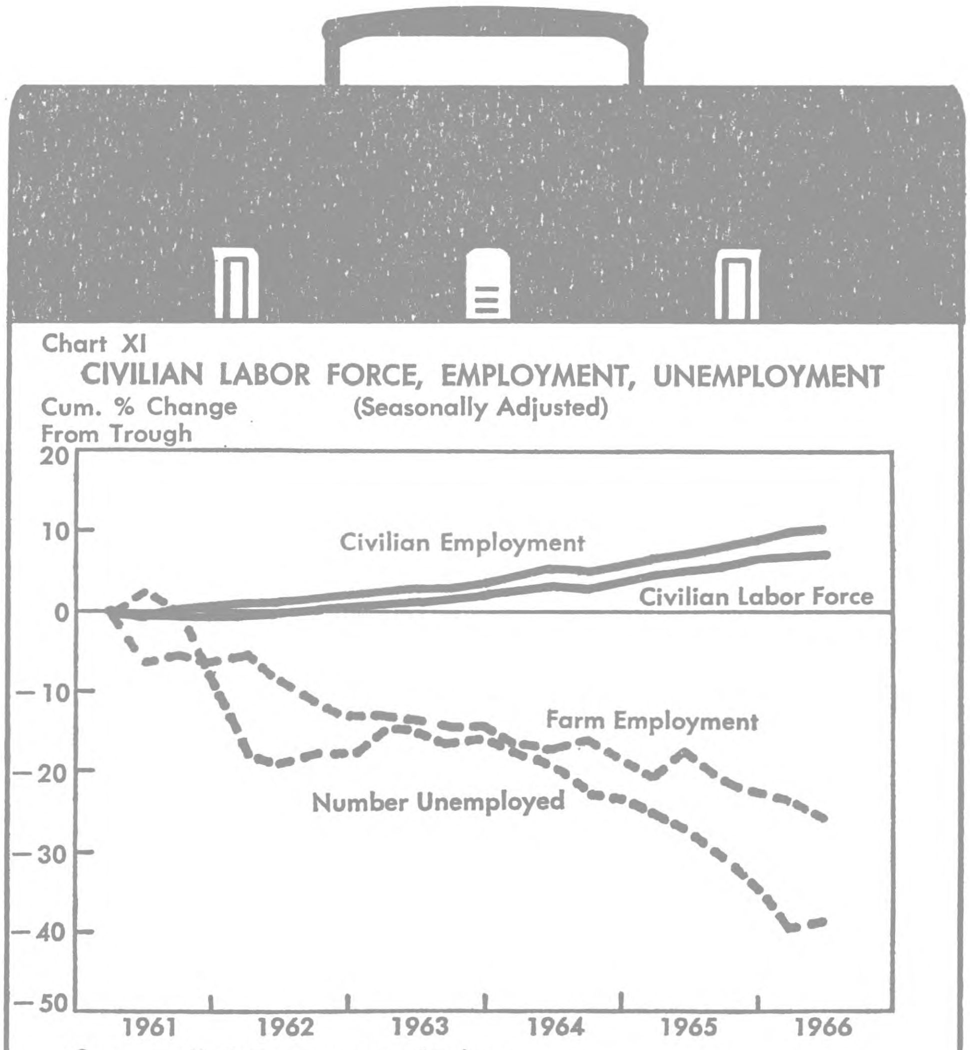
After the middle of 1962 the civilian labor force grew more rapidly, rising by more than a million each year. The growth rate of the economy was sufficient to reduce unemployment so long as the labor force grew slowly but not fast enough to do so when the labor force was growing at a rate of more than a million per year.

A second factor was the moderate level of capital investment, which is the source of most new jobs. The expansion started with a considerable margin of unused capacity, and there was no strong inducement for business firms to expand capital outlays until most of this capacity was brought into use. Capital investment did not begin on a large scale until 1963. One development which probably delayed its start was the sharp decline in stock prices in the second quarter of 1962, which was followed by a distinct slowing of growth rates in several important sectors of the economy in the second half of that year.

As another factor, Congress in 1961 raised the minimum wage from $1.00 to $1.25 per hour and extended its coverage. The provisions went into effect at different times, ranging up to four years. The increase was upward of 25 per cent for some of those newly covered. These moves affected also the wages of many in wage brackets just above the minimum. Unless it is assumed that the demand for labor is entirely independent of the wages at which it can be hired, these increases must have had a restraining effect on the number of people employed as the economy grew. At the same time it quite likely stimulated the demand for more automatic, labor-saving machinery and equipment, which, in turn, required more capital investment. That was a factor in the investment program discussed above. But time was required to plan, finance, and activate an investment program, and in the interim the demand for labor lagged below what it would have been without the increase in the minimum wage. This is indicated empirically by the fact that unemployment in those groups which are marginal with respect to the minimum wage, mainly teenagers and nonwhites, has consistently been significantly higher than in other groups.

Chart XI

CIVILIAN LABOR FORCE, EMPLOYMENT, UNEMPLOYMENT



Source: U. S. Department of Labor.

Finally, the secular decline in farm employment has contributed to the unemployment problem. After declining for many years, farm employment fell further—from 5.7 million in early 1961 to 4.3 million in the second quarter of 1966. From an annual decline of 4.5 per cent in 1961-65, it plunged to 10.5 per cent in 1965-66. In the face of this remarkable reduction, total farm production was not only maintained but increased. The index of total farm production rose from 107 in 1961 to 115 in 1965. This feat was accomplished, of course, only by extensive changes in farm size, equipment, techniques, plant varieties, and cropping patterns. This revolution in farm technology released at least 1.5 million workers for employment elsewhere in the economy.

Employment Patterns Except for agriculture, nearly all sectors of the economy showed increases in employment. Relatively, as Chart XII shows, civilian government employment led the list with an increase of 27.5 per cent, from 8.5 million to 10.8 million. This increase was equal to approximately one fourth of the total gain in nonagricultural employment. State and local governments, with an increase of 2.0 million, or 32.5 per cent, accounted for the greater part of the increase in the public sector. Much of the increase in employment by the Federal Government came in the first two quarters of 1966.

Perhaps the sharpest break with past patterns of employment occurred in manufacturing. After showing only a weak and erratic upward trend for 15 years, factory employment rose by 2.9 million, or 18.1 per cent, in this expansion. This was substantially

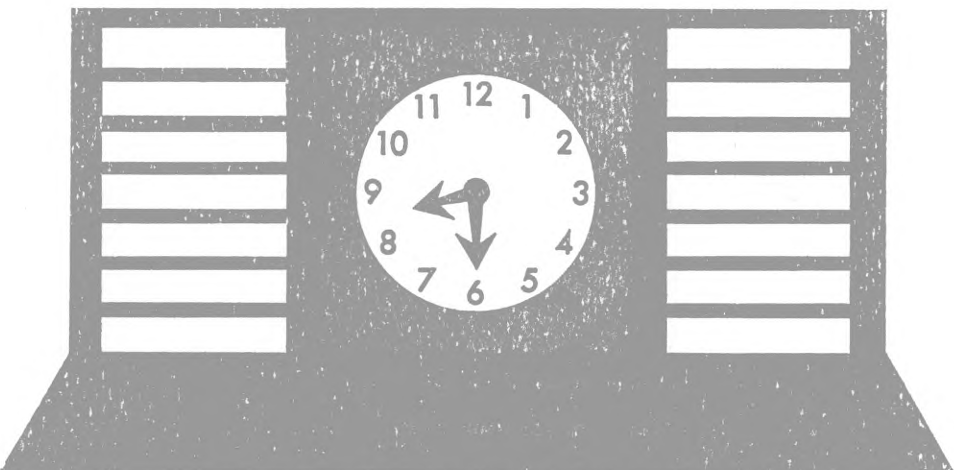
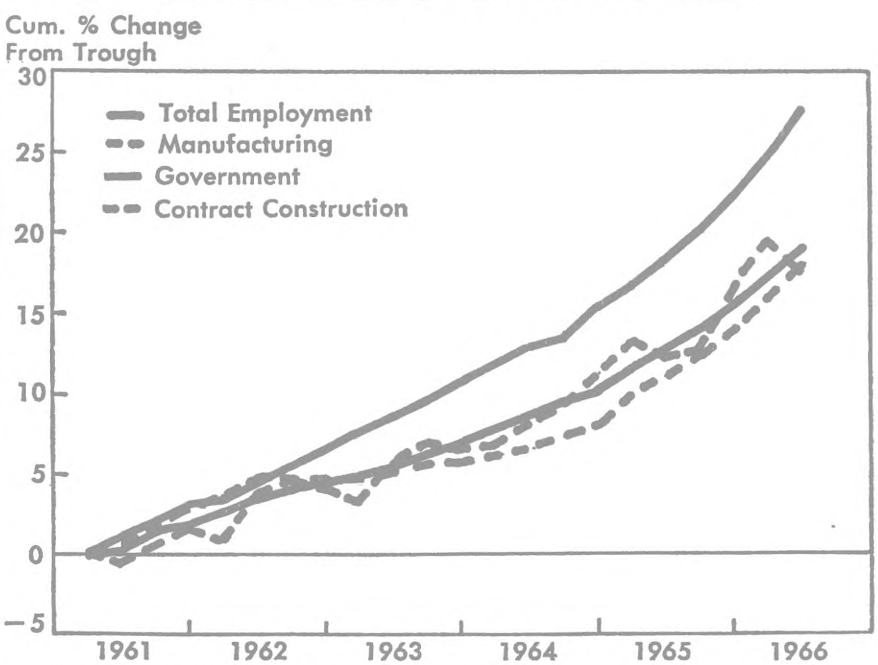


Chart XII NONAGRICULTURAL PAYROLL EMPLOYMENT



Source: U. S. Department of Labor.

greater than the total increase between 1946 and 1960. Durable goods industries accounted for 77 per cent, or 2.2 million, of the recent rise, while the remaining 23 per cent, or 0.7 million, was in nondurable goods industries. Despite its great increase, however, manufacturing's share of total nonfarm payroll employment declined slightly, as Table 2 shows.

Elsewhere in the economy, the residual category of finance, services, and miscellaneous showed gains second only to those in the government sector, with a rise of 2.4 million, or 23.4 per cent. Although it involved a relatively small number of workers, contract construction had an increase of 17.5 per cent, representing a little less than a half million workers. This, however, was after a sharp drop in the second quarter of 1966. Employment in wholesale and retail trade grew by some 1.9 million, but this constituted a growth somewhat below the average.

Industrial Production Industrial production rose by 12 per cent in the first year of recovery but registered little additional gain in the second half of 1962. Thereafter the rise was resumed at a pace which accelerated from an annual rate near 4 per cent to one of about 9 per cent. The total increase to the second quarter of 1966 was 49.6 per cent, or a little more than the 45 per cent gain realized in the entire decade from 1950 to 1960.

Manufacturing accounts for an overwhelming part (over 86 per cent) of the index of industrial production. It is pertinent, therefore, to take a closer look at manufacturing production. In the comparison which follows, the statistical base used in measuring growth in the present expansion is shifted from the first quarter of 1961 to the annual average for 1960. The reason is that durable goods production was rather sharply depressed in the first quarter of 1961, and the use of that period as a base would unduly distort some of the comparisons.

Table 2 DISTRIBUTION OF NONFARM PAYROLL EMPLOYMENT

	1961 First Quarter		1966 Second Quarter	
	Number (000)	Per Cent	Number (000)	Per Cent
Total	53,465	100.0	63,617	100.0
Manufacturing	16,120	30.2	19,031	29.9
Durables	8,906	16.7	11,136	17.5
Nondurables	7,214	13.5	7,895	12.4
Nonmanufacturing (private)	28,888	54.0	33,802	53.1
Mining	678	1.3	618	1.0
Contract construction	2,800	5.2	3,290	5.2
Transportation and public utilities	3,907	7.3	4,130	6.5
Wholesale and retail trade	11,298	21.1	13,170	20.7
Finance, insurance, real estate	2,704	5.1	3,078	4.8
Service and miscellaneous	7,501	14.0	9,516	15.0
Government	8,457	15.8	10,784	17.0
Federal	2,229	4.2	2,532	4.0
State and local	6,229	11.7	8,252	13.0

Source: U. S. Department of Labor.

Table 3 shows the increases in production for selected components of industrial production for the 1950-1960 decade and for the present expansion. Changes in employment also are shown for three major components. Three aspects of the data are worthy of note. First, the increases in production in the present expansion are of the same order of magnitude as the increases for the entire previous decade. Second, gains in production were several times the growth in employment in both periods, but the difference was somewhat less in the second period, suggesting a slower growth in productivity. In nondurable lines, production increased 17 times as much as employment between 1950 and 1960, but less than five times as much since 1960. Third, the figure for the production of motor vehicles and parts for the present period is misleading. As Chart XIII shows, until the end of 1965 gains in this component were greater than most others, except for the drop in the fourth quarter of 1964 caused by strikes. For much of the time they ran ahead of gains in both all manufacturing and durable goods. The leveling off in late 1965 and the decline in early 1966 brought it to a level only a little above that for nondurable goods.

A brief analysis of the movements of the major components of manufacturing production may give some indication of when and where imbalances developed in the industrial sector of the economy. While relative increases during the 1950-1960 decade cannot be regarded as norms or standards, the figures may have some value as a basis of comparison. As Table 3 shows, each of the major components moved up in the previous decade by amounts not far from 45 per cent. Machinery did somewhat better, but motor vehicles lagged far behind. During 1961 and early 1962 distortions produced by the recession were corrected and the rates of gain of the various components converged, as can be seen in Chart XIII. Thereafter, for about two years, all series advanced at substantially the same rate. Beginning in early 1964 the rates began to diverge and continued to do so at accelerating rates, except for motor vehicles, through 1965 and 1966.

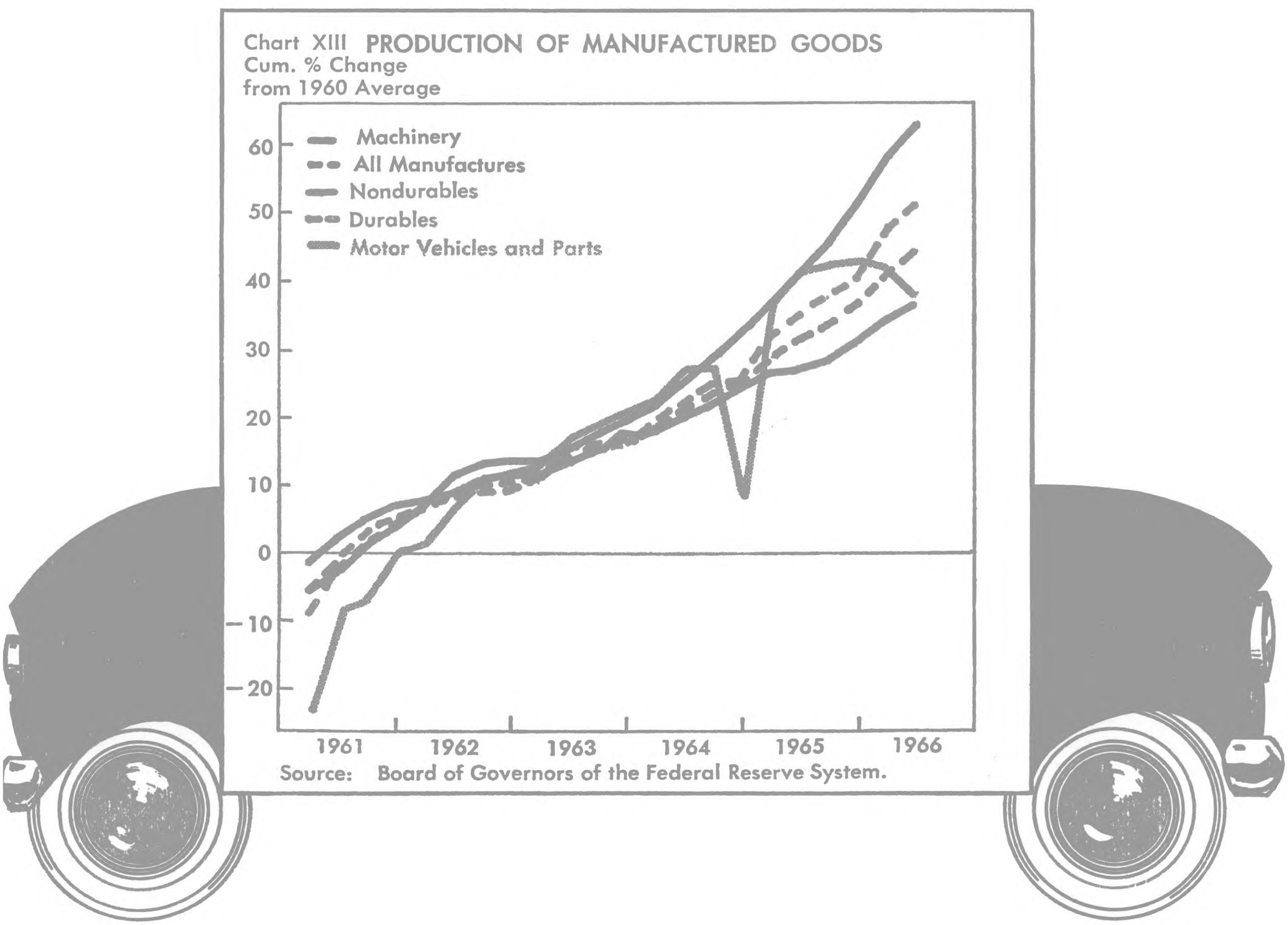
Table 3 PER CENT CHANGES IN SELECTED COMPONENTS OF INDUSTRIAL PRODUCTION AND EMPLOYMENT

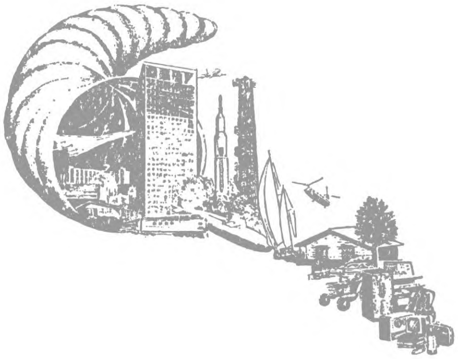
	1950 to 1960		1960 to 2nd Q 1966	
	Industrial Production	Employment	Industrial Production	Employment
Total production	45.1		42.8	
All manufacturing	43.7	10.2	44.8	13.3
Durable goods	46.4	16.9	51.3	17.7
Nondurable goods	44.1	2.6	36.5	7.6
Motor vehicles and parts	25.1		38.4	
Machinery	52.4		63.0	

Note: Changes computed from averages of monthly data.

Source: Board of Governors of the Federal Reserve System and U. S. Department of Labor.

In the first quarter of 1964 there were only insignificant differences between the cumulative growth rates of production in all manufacturing, durable goods, and nondurable goods, but machinery showed a substantially greater growth after the middle of 1963. By the second quarter of 1966, however, durable goods had advanced 15 per cent more, and machinery 41 per cent more, than all manufacturing, while nondurables had fallen behind by 19 per cent. Durable goods would have shown an even greater gain except for the decline in automobile production in 1966. It may not have been entirely coincidental that this divergence in growth rates became pronounced at about the same time the wholesale price index began to move up.





CORPORATE PROFITS

The behavior of corporate profits has been one of the outstanding, and probably one of the most dynamic, developments of the present expansion. A brief look at the behavior of profits in the earlier postwar years will afford some perspective for an evaluation of their recent performance. In this discussion *profits* will mean profits after taxes unless a different meaning is indicated.

Corporate profits are inherently volatile and fluctuate widely during the course of a business cycle. This was especially true in the 15 years before 1961, when profits often declined even in periods of business expansion. In the 40 quarters from the end of 1950 to the end of 1960, profits declined in 18 although GNP declined in only eight.

The general cyclical pattern before 1961 was a sharp rise in profits during the first year or so of recovery, followed by an irregular decline during the rest of the expansion. This is shown clearly in Chart V. Over the years this pattern produced a slow and irregular secular growth. In 1949 profits amounted to $18.5 billion. By 1960, which had a position in the cycle approximately comparable to 1949, they had risen to $26.7 billion. This was a total increase of 44 per cent and was equal to an annual growth rate of 2.8 per cent. During the same period GNP grew by 96 per cent and personal income by 93 per cent. As a margin of sales, profits *before taxes* were 8.3 cents per dollar in 1949, rose to nearly 12 cents in 1950, and then declined irregularly to below 7 cents in 1958 and 1960. As a return on net worth, profits of large corporations as compiled by the First National City Bank of New York declined rather steadily from 11 per cent in 1949 to 9.1 per cent in 1960. In brief, corporate profits during this period fluctuated irregularly but declined significantly in relation to GNP, personal income, sales, and net worth.

Since 1960 the trend of profits has been substantially different. Compared with earlier upswings, they grew more slowly in the early months of this expansion, but then accelerated and have continued upward for a much longer period. In the 21 quarters after the first quarter of 1961, they were unchanged in two, showed small declines in two, and rose in 17. By years, the percentage increases, beginning with 1961, were: 1.9, 14.7, 6.1, 16.9, and 15.0. Over the period as a whole, to the middle of 1966, profits approximately doubled, a growth somewhat more than twice that of GNP and personal income. As a margin of sales, they rose from less than seven cents per dollar in early 1961 to nearly ten cents in the first part of 1966. As a return on net worth, profits were up from 8.7 per cent in 1961 to 11.1 per cent in 1965. In relation to GNP they rose from 5.2 to 6.5 per cent. Thus the trends which had prevailed in the 1950's were reversed in this expansion.

Because of the slow and irregular growth of profits between 1950 and 1960, it may be instructive to look at profits over a longer period. From 1950 to the second quarter of 1966, the increases were: GNP, 157 per cent; personal income, 152 per cent; and corporate profits, 96 per cent. Thus over the whole span of more than 15 years profits increased by less than two thirds as much as the other two variables.

The long, steady, and vigorous growth of profits in the present expansion was the result of a number of factors. First, and perhaps most importantly, it was the natural cyclical reaction of profits to a prolonged period of business expansion. A steadily rising volume of business should normally produce a substantial increase in profits. In addition, corporations were producing a somewhat larger proportion of the total national product. Second, unit labor costs in manufacturing held steady or declined somewhat over almost the whole period. In earlier expansions this type of development usually marked the first year or so of the expansion and then was reversed. This time wage increases were more moderate and were approximately offset by a steadily growing productivity. Third, corporations realized larger profits from foreign operations, an amount now estimated by one authority at more than $3 billion per year.

A final important factor in the growth of profits after taxes was tax reduction. During World War II the peak rate applicable to most corporate profits was 40 per cent but many corporations were subject to an excess profits tax. The peak rate was reduced to 38 per cent after the war but was raised to 52 per cent during the Korean War and again an excess profits tax was levied for a short time. The regular corporate tax rates were not lowered in the tax reduction of 1954, but provisions for accelerated depreciation were enacted in that year. Thus in 1960 the *regular* corporate tax rates were somewhat above those in effect during World War II. In 1962 depreciation schedules for tax purposes were liberalized considerably and corporations were granted a tax credit, equal in most cases to 7 per cent, for new investment in producing facilities. As a part of the general tax reduction of 1964, the tax rate on corporate income was reduced, in two steps, from 52 to 48 per cent. It has been estimated that in 1965 these three measures saved corporations more than $6 billion.

The strong growth of profits was cause as well as effect. When it became evident that profits were not going to repeat their former roller-coaster pattern and when Congress showed a definite intention to reduce the tax load on corporations, confidence and optimism rose in the business community. In particular, as production approached the optimum level in one industry after another, businessmen were encouraged to embark on ambitious programs of capital outlays. This was all the more true because retained earnings and depreciation allowances provided much of the funds needed to finance the outlays, at least in the early stages.

DOMESTIC INVESTMENT

While investment has been an important source of strength in this business expansion, its timing and composition have differed significantly from earlier postwar experience.

Housing In previous postwar cycles, residential construction activity, as measured by housing starts, rose sharply in the recession and early recovery periods, peaking out about six months after the trough in general business activity. Starts generally declined throughout the rest of the expansion phase, providing a partial offset to other expansive factors. In this expansion housing starts behaved quite differently. There was no discernible upturn before the general recovery got under way, and the upswing which finally came was quite mild. It lasted for approximately three years, however, peaking in January 1964.

While no precise explanation of this different behavior is possible, a partial explanation may be a decline in the underlying demand for housing and a different monetary policy. With the tremendous backlog of demand having been worked off in the 1950's, housing activity in the early 1960's did not surge forward as money became easy. In contrast to earlier experience, monetary policy in this latest expansion remained easy for a long time, and this probably contributed to the prolonged rise in housing activity, despite weaker underlying demand. The latter factor finally outweighed the stimulus of easy money and housing starts began drifting down from an annual rate of about 1.6 million units in early 1964 to about 1.5 million units in early 1966. Since that time a sharp rise in mortgage yields and reduced availability of mortgage credit have contributed to a precipitous drop.

The composition of residential construction has also been different in this expansion. Single family dwellings declined in relative importance, while a virtual boom occurred in apartment construction. Multifamily starts as a fraction of the total rose from 21 per cent in 1960 to 37 per cent in 1963, but declined somewhat later.

Inventories Inventory investment also has differed from earlier cyclical patterns. In earlier expansions inventories rose sharply from about the beginning of general recovery until about midway of the expansion, when a marked falloff in the rate of accumulation occurred. In this expansion, inventory investment rose sharply in the first year of recovery, then leveled off and remained on a plateau until the latter part of 1964.

The slower rate of accumulation during most of this expansion has been due to both secular and cyclical factors. On the secular side, the growing use of computer-based methods of inventory control has enabled businessmen to operate with reduced inventories relative to sales. At the same time, the cyclical factors encouraging accumulation have been weaker. Until 1964 prices were stable and excess capacity permitted prompt delivery of orders. These conditions began changing in 1964 and for the past two years inventory accumulation has proceeded at a distinctly faster pace.

It has been customary to assume that the relatively low ratio of inventories to sales, in both manufacturing and trade, is an indication that inventories are not excessive and are in a stable equilibrium. The optimum relationship here, however, has probably been changed significantly by the secular trend toward better methods of inventory control. In view of this, a leveling off or a slight upturn in inventory-sales ratios might have a significance equal to much sharper upturns in earlier expansions.

Plant and Equipment The long and accelerating growth in expenditures for plant and equipment has been a dominant feature of this expansion since early 1963. On the average, these expenditures have increased at a rate of nearly $1.8 billion per quarter since the first quarter of 1963, far greater than the $1.0 billion average quarterly increase in the 1954-57 expansion, and more than twice the average increases in the 1958-60 and the 1949-53 periods. They climbed from 6.5 per cent of GNP in the second quarter of 1961 to slightly more than 8 per cent in early 1966, the highest ratio since 1956-57.

In the first two years of the present expansion these outlays, shown in Chart X, were concentrated heavily on modernization, but after the middle of 1963 they were devoted increasingly to enlarging capacity. From an annual rate of $37 billion in the first quarter of 1963, they rose to a level of $60 billion in the second quarter of 1966, a total increase of 61 per cent. Over the past three years the annual increase has ranged from 14 to 17 per cent. This growth has put great pressure on the capacity of machinery and equipment producers, who in turn have had to expand their facilities. Their expenditures for plant and equipment increased 19 per cent in 1964, 33 per cent in 1965, and an estimated 31 per cent in 1966.

Plant and equipment expenditures are significant for several reasons. Like all forms of capital formation, they are in the first instance expansionary. So long as there is a reserve of producing capacity in the economy, this is a healthy development and contributes toward fuller employment and production, but when demand is pushing close to capacity it can generate strong inflationary pressures. Also, they involve a long lead time, or "turnaround time." When large programs have been planned and started it is very difficult and costly to halt them before completion. Corporations with large spending programs well advanced are often prepared to bid very high rates to get the necessary funds to complete them. Their demand for funds in the face of strong monetary restraints can produce serious dislocations in money and capital markets.

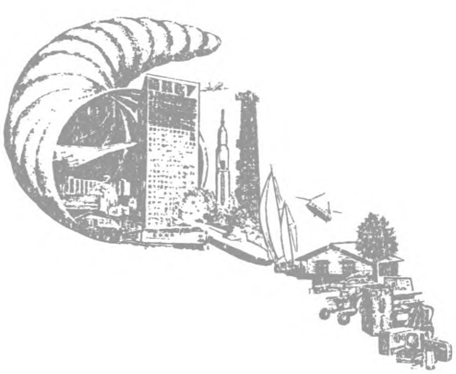
Finally, capital outlays are highly cyclical. On the basis of past experience, annual increases of 14 to 17 per cent cannot be sustained for any extended period of years. In previous postwar expansions, additions to capacity outran demand for final output soon after expenditures on plant and equipment began moving up. Declining capacity utilization rates signaled overinvestment relative to final demand and cutbacks in plant and equipment expenditures followed after a considerable lag. Over most of this expansion, capacity expansion has been more in line with demand, and utilization rates have edged upward. For the past several quarters, however, utilization rates have remained on a high plateau.

Financing Corporate Investment Since World War II, corporations in this country have obtained a majority of their investment funds from internal sources; that is, from their cash flow which is composed almost entirely of retained earnings and depreciation allowances. Only marginal amounts have had to be financed by borrowing in the capital market or at commercial banks. Like all marginal figures, this external financing has tended to fluctuate widely. It has grown sharply in the past two years and thereby contributed substantially to the pressure on capital markets and helped to produce high interest rates.

In earlier expansions corporations were forced to resort to external financing fairly early in the upswing. The reason was that profits usually faded out early, before capital outlays, which usually lag behind other business activities, started upward. Thus by the time capital spending programs got under way, retained earnings were declining and borrowing was necessary. This increasing dependence on outside borrowing, at rising rates of interest, fairly early in the upswing tended to dampen the investment spending and keep it within limits.

In this expansion it was different. Retained earnings grew over a longer period, and at the same time depreciation allowances were significantly liberalized. The use of internal funds by nonfinancial corporations moved up from $35.6 billion in 1961 to $51.0 billion in 1964, while external funds used remained steady at slightly below $19 billion. As a proportion of total funds used, external funds dropped from 35 to 27 per cent. But by 1965 outlays were far outstripping cash flows and the use of external funds increased sharply from $18.6 billion to $33.4 billion—an increase of 80 per cent. In that year external funds represented 38 per cent of total investment funds. A large part of this increase was accounted for by bank loans, which rose by $6.5 billion, or 190 per cent. This spurt in bank lending was due in considerable part to the fact that the bank prime rate remained for nearly the whole year at 4.5 per cent while market rates were rising, in many cases to well beyond 4.5 per cent. The large increase in bank loans was a major factor contributing to the 10 per cent increase in bank credit in 1965—the largest increase since World War II.

Corporations continued to rely heavily on external financing in 1966. At annual rates the figures for the first half were $35.4 billion, higher than the figure for the whole of 1965 but somewhat below that for the fourth quarter of that year. Corporate borrowing moved more heavily into the capital market, however, and the growth of bank loans dropped sharply from 35.9 per cent of the total to 28.0 per cent. This helped to hold down the growth of bank credit to an annual rate of 8.6 per cent for the first six months of 1966.



FISCAL POLICY

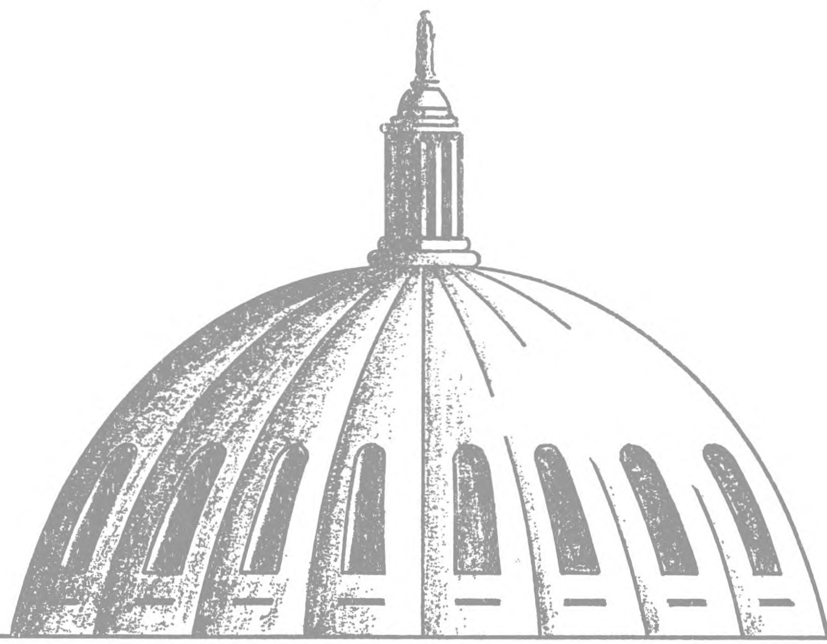
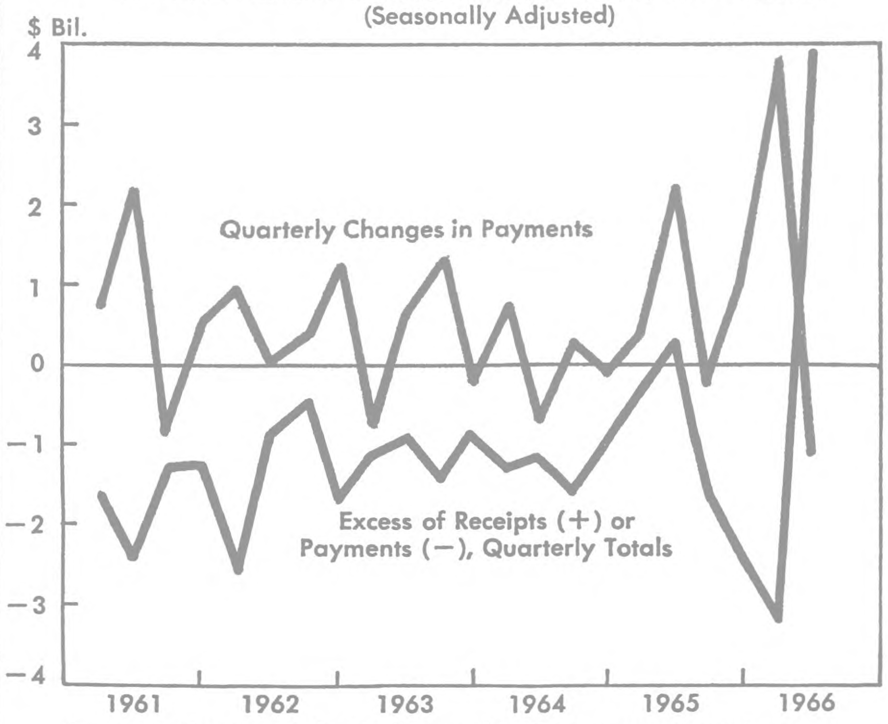


Chart XIV

FEDERAL CASH TRANSACTIONS WITH THE PUBLIC

(Seasonally Adjusted)



Source: Bureau of the Budget and U. S. Treasury Department.

Fiscal policy has substantially influenced economic developments during this expansion. On the expenditure side, three types of expenditures have grown rapidly: those for defense, those for social security and the older welfare programs, and those for new welfare and development programs. Chart XIV shows the quarterly changes in cash payments and the amounts of the quarterly deficits or surpluses.

On the revenue side, two innovations featured the period. First, two important measures were designed specifically to reduce business taxes. Second, there was a major reduction in income taxes at a time when business was expanding and the budget was still showing a sizable deficit. Other significant developments in the fiscal area included the moving up of certain tax payment dates, a greater use of revolving funds, and larger sales of assets by Federal agencies.

Receipts, Payments, and Deficits Table 4 gives a summary statement of the Federal cash budget for the fiscal years 1961 to 1966. Receipts and payments each increased by 38 per cent, but payments are understated because of the sales of assets while receipts are overstated because of the acceleration of tax payments in 1966. Reflecting the large corporate profits, receipts from the corporate income tax showed the largest increase. Despite the Viet Nam War, national defense expenditures rose proportionately less than the total and declined in relative importance. Payments in the general areas of health, education, welfare, and labor experienced the largest increase, rising by $7.1 billion, or 24 per cent, in fiscal 1966.

The large general tax reduction of 1964 only slowed, and did not stop, the increase in receipts. Receipts from individual income taxes were approximately unchanged for one year, but there was no discernible effect on revenue from the corporate income tax. In 1966 receipts from both sources showed large increases to the highest totals on record.

Deficits in the cash budget, shown in Table 4 and Chart XIV, were registered in every quarter but two and usually ranged well over $1 billion. On a fiscal year basis, annual deficits ranged between $2.3 billion and $5.8 billion. The expansionary effect of the deficit was especially important and troublesome in the last half of 1965 and the first quarter of 1966. On a seasonally adjusted basis the cash budget was approximately in balance in the first half of 1965. But in the second half the Viet Nam War was escalated sharply, social security benefits were increased, and military and civil service pay scales were raised. After seasonal adjustment the deficit for the half was $3.9 billion and the "net fiscal stimulus" as estimated by the President's Council

Table 4

FEDERAL CASH RECEIPTS FROM AND PAYMENTS TO THE PUBLIC

	Fiscal Years						1961-1966
	1961	1962	1963	1964	1965	1966	% Change
	(billions of dollars)						
RECEIPTS							
Individual income tax	41.3	45.6	47.6	48.7	48.8	55.4	+34.0
Corporation income tax	21.0	20.5	21.6	23.5	25.5	30.1	+43.5
Other receipts	35.0	35.8	40.6	43.3	45.4	48.9	+39.9
Total receipts	97.2	101.9	109.7	115.5	119.7	134.4	+38.2
PAYMENTS							
National defense	47.7	51.5	53.4	54.5	50.8	58.4	+22.5
Education, health, labor, and welfare	23.3	25.0	26.9	28.6	29.8	36.9	+58.2
Other payments	28.5	31.2	33.4	37.2	41.8	42.3	+48.2
Total payments	99.5	107.7	113.8	120.3	122.4	137.6	+38.2
EXCESS OF PAYMENTS	2.3	5.8	4.1	4.8	2.7	3.2	
	Per Cent Distribution						
Individual income tax	42.5	44.8	43.4	42.2	40.8	41.2	
Corporation income tax	21.6	20.1	19.6	20.3	21.3	22.4	
Other receipts	35.9	35.1	37.0	37.5	37.9	36.4	
Total receipts	100.0	100.0	100.0	100.0	100.0	100.0	
National defense	47.9	47.8	47.0	45.3	41.5	42.5	
Education, health, labor, and welfare	23.4	23.2	23.6	23.8	24.3	26.8	
Other payments	28.7	29.0	29.4	30.9	34.2	30.7	
Total payments	100.0	100.0	100.0	100.0	100.0	100.0	

Source: Bureau of the Budget and U. S. Treasury Department.

of Economic Advisers was "about $7 billion." The trend continued in the first quarter of 1966 when the seasonally adjusted deficit was $3.2 billion. Coming at a time when the economy was operating near optimum capacity these deficits generated strong inflationary pressures.

Tax Reductions A prominent feature of tax policy since 1961 has been the reduction of taxes on organized business, by both specific and general measures. Representatives of business had long complained about inadequate depreciation allowances for tax purposes. These inadequacies were accentuated by the sharp price rises after World War II and by the rapid pace of technological change which speeded obsolescence. New depreciation guidelines issued by the Treasury Department in 1962 substantially increased the allowances, producing an annual tax savings to corporations estimated at the time of $1.5 billion.

To stimulate new capital investment further as a means to create new jobs, Congress in 1962 amended the tax law to allow a credit against the income tax equal to a portion of the new investment in qualified *personal property* (thus excluding real estate). The amount of the credit was 7 per cent in most cases; public utilities were allowed 3 per cent. At the 1962 level of investment the annual tax saving was estimated at a little more than $1 billion; by 1966 the estimated amount had risen to about $2 billion. These measures stimulated investment in three ways. First, by increasing corporate earnings they promoted optimism and confidence. Second, the investment tax credit provided a special bonus for making investments. Finally, they provided the means, in the form of retained earnings, to finance a substantial part of the costs of the investments.

In addition to these two specific measures, Congress in 1964 enacted a general and substantial reduction in both individual and corporate income taxes. It became effective in two steps, the larger one in 1964 and the other in 1965. The reduction took the form mainly of lower rates on all tax brackets; the cuts were especially large on the very high rates applicable to the top brackets. The rate on most corporate income was reduced, in two steps, from 52 to 48 per cent. At 1964 income levels, it was estimated that tax savings would amount to about $11 billion for individuals and $3 billion for corporations. This reduction gave another boost to corporate profits and also added substantially to consumer demand.

The final tax reduction, applying to a number of excise taxes, came in 1965. The total reduction was about $4.6 billion, to take effect in several stages extending to 1969. The first two stages, effective in June 1965 and January 1966, provided cuts of $1.75 billion each. Early in 1966, however, Congress partially restored the cuts in two of the taxes.

Estimates of the total tax savings accomplished by these several measures, made as of the time the various acts were passed, amount to about $21 billion per year. But levels of income and investment have risen considerably in the interim, and the annual savings at 1966 levels of income and investment would be substantially higher.

While these reductions were being made, employment taxes were rising rapidly to cover the costs of the expanding social security program. Collections of employment taxes rose from $12.4 billion in fiscal 1961 to $16.9 billion in fiscal 1965. On January 1, 1966, rate increases became effective estimated to produce additional revenues of $6 billion per year. Collections in fiscal 1966 were $20 billion and were estimated at $24.3 billion in fiscal 1967. Thus, a substantial part of the savings on income and excise taxes was offset by increases in employment taxes.

Budgetary Practices The budget for fiscal 1967 made extensive use of budgetary practices which affected the stated amounts of receipts and/or expenditures. These practices were not new, but they were used more widely in the 1967 budget than before. They are the acceleration of tax payment dates, the use of revolving funds, and the sale of Government-owned assets or participations in those assets.

The acceleration of a tax payment date does not change the ultimate tax liability of a taxpayer, or the amount of taxes eventually collected by the Government. It merely advances the time when the payment is made, and thus is, in a sense, a borrowing from the future. The 1967 budget provided three forms of acceleration: graduated withholding on individual income taxes, semimonthly instead of monthly deposit of withheld taxes by employers, and earlier dates for payment of corporate income taxes. Much of the impact of accelerated payments came in the second quarter of 1966 when cash receipts (unadjusted) jumped sharply to $46.1 billion, to produce a surplus for the quarter of $10.1 billion. On a seasonally adjusted basis, receipts were $39.6 billion and the surplus $3.8 billion.

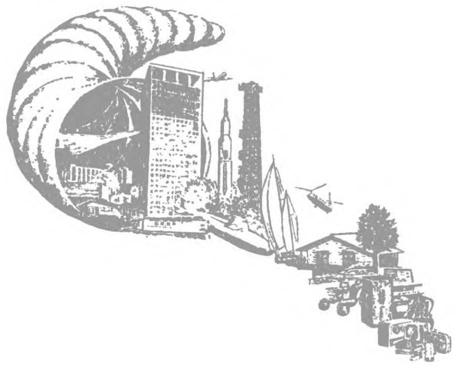
The 1967 budget made extensive use of the sale of assets and participations in assets. In a sale of an asset, a Federal agency or department sells to the public mortgages, notes, or other similar assets which it holds in its portfolio. The proceeds of such a sale are not counted as a receipt but as a reduction of expenditures. Those proceeds can then be spent or reloaned without showing an increase in expenditures. Thus, budget totals for both receipts and expenditures are held down. Further, if the agency involved normally draws its funds from the Treasury, a sale of assets permits it to engage in additional operations without using Treasury funds, which would cause further borrowing by the Treasury and push the total debt closer to its statutory ceiling. The sale of participations in assets has essentially the same effect as a sale of assets. A Federal agency, in effect, borrows from the public, pledging assets which it holds as collateral. Debts incurred by Federal agencies are not subject to the statutory ceiling on Federal indebtedness.

Fiscal Policy and Money and Capital Markets Budgetary deficits and surpluses affect the total demand for credit and hence interest rates, and within limits fiscal policy can be managed to produce desired interest rate effects. Over most of the current expansion, the Federal Government has been a large net borrower in the market, mostly in the short-term end, and chiefly through the sale of Treasury bills. This tended to concentrate the upward rate pressures in the short-term area and away from the long-term area, which was consistent with the program to reduce the deficit in our balance of payments. Debt management operations were also handled with this end in view, although the advance refunding technique was often employed to achieve some lengthening of average maturities.

By the second half of 1965, increases in the Treasury's demands on the market were superimposed upon a swollen demand from the private sector and from state and local governments. As a result, interest rates came under strong upward pressure despite continuing increases in bank reserves and bank credit. By the final quarter of 1965 rates were rising in all sectors of the money and capital markets.

Markets in 1966 were affected also by heavy borrowing by Federal agencies. From January through June, Federal agencies sold over $11 billion of new obligations, including large amounts of participation certificates. Of this total, $5.1 billion represented net new borrowing. Coming at a time when the markets were already heavily congested with corporate and municipal offerings and a policy of monetary restraint was in effect, these offerings helped push market rates to record high levels. Because these agency issues often carried yields well above 6 per cent, they diverted funds from other important market sectors and contributed to the extreme stringency that developed in the mortgage market. Moreover, the prospect of continuing large agency demands was probably an important factor promoting market expectations of further rate rises.

The combination of burgeoning credit demands and a tight money policy produced serious strains on money and capital markets in August and September. The conviction grew that monetary policy alone could not be counted on to contain the business boom, without risking serious dislocations in the money and capital markets. Fiscal action was needed to support monetary restraint. In early September the Administration announced a threefold program to slow the spiraling demand for credit. First, the Treasury announced temporary postponement of the sale of participations by the Federal agencies and limitation of agency borrowings to refinancing needs. Second, the President ordered a cutback in Federal nondefense spending. Finally, the Administration asked Congress to rescind temporarily the 7 per cent investment tax credit and those provisions of accelerated depreciation applying to real estate. Passage of the requested legislation was delayed until early October but the market reacted immediately. The capital market took on a sharply stronger tone and it was soon clear that the steady uptrend of interest rates had been halted, at least temporarily.



MONETARY POLICY

1960-1963: Active Ease Monetary policy in the past six years has run the gamut from easy to very tight. Starting in March 1960, the Federal Reserve made reserves more freely available. Before the end of the year net free reserves rose to over $500 million and remained near that figure throughout 1961. Credit expansion was stimulated further in January 1962 when Regulation Q was amended to permit banks to pay higher rates on time and savings deposits except those with maturities of six months or less. This enabled banks to compete more vigorously for the savings of individuals. It also facilitated the marketing of negotiable certificates of deposit, which by August 1966 swelled in volume to more than $18 billion. An additional incentive to solicit time and savings deposits was provided in October 1962 by a reduction in reserve requirements on such deposits from 5 to 4 per cent.

1963-1964: Restrained Ease In early 1963 the first signs of a departure from the active ease of almost three years began to appear. Net free reserves began to fall, and borrowings at Federal Reserve Banks, which had been small in 1961 and 1962, rose substantially. The continuing increase in bank reserves, bank credit, and the money supply indicated clearly, however, that any firming in credit was due to an acceleration in the demand for credit and not to a reduction in the supply of reserves. Federal Reserve credit supplied through open market operations continued to rise steadily. Reserves might have been supplied more liberally, however, had it not been for a serious and persistent balance of payments deficit and the urgent need for additional measures to deal with it, as explained elsewhere. For that reason the supply of reserves was increased at a slower pace than the demand and interest rates rose. The gradual tightening which ensued was reinforced by an increase in the discount rate from 3 to 3½ per cent in July 1963. At the same time, Regulation Q was revised to permit higher rates on all time deposits with maturities of less than one year.

In November 1964 the discount rate was raised from 3½ to 4 per cent, but again the change was due almost entirely to balance of payments pressures and was not intended to restrain domestic economic growth. The move followed a rise in both official and market rates in London. The purpose of the increase was to maintain domestic short-term rates in line with foreign rates. The Federal Reserve continued to supply reserves sufficient to allow for the expansion of the economy at a moderate pace, and interest rate movements were related primarily to international developments.

Growth of Time Deposits The expansionary policies which began in 1960 bore fruit in the form of an unprecedented deposit expansion over the next five years. Total bank deposits, which rose little in 1959 and 1960, increased by more than $100 billion, or nearly 50 per cent, by the end of 1965. Remarkably, about three fourths of this phenomenal increase was in time and savings deposits, which more than doubled. The explosive growth in time deposits marked a new attitude toward such deposits. Banks found that they could sell negotiable certificates of deposit in the money market. The success of these instruments led to a proliferation of similar devices, both negotiable and nonnegotiable, for sale to individual depositors as well as to institutions. Banks became quite aggressive in the competition for new deposits to provide funds which could be used profitably in the loan and security markets.

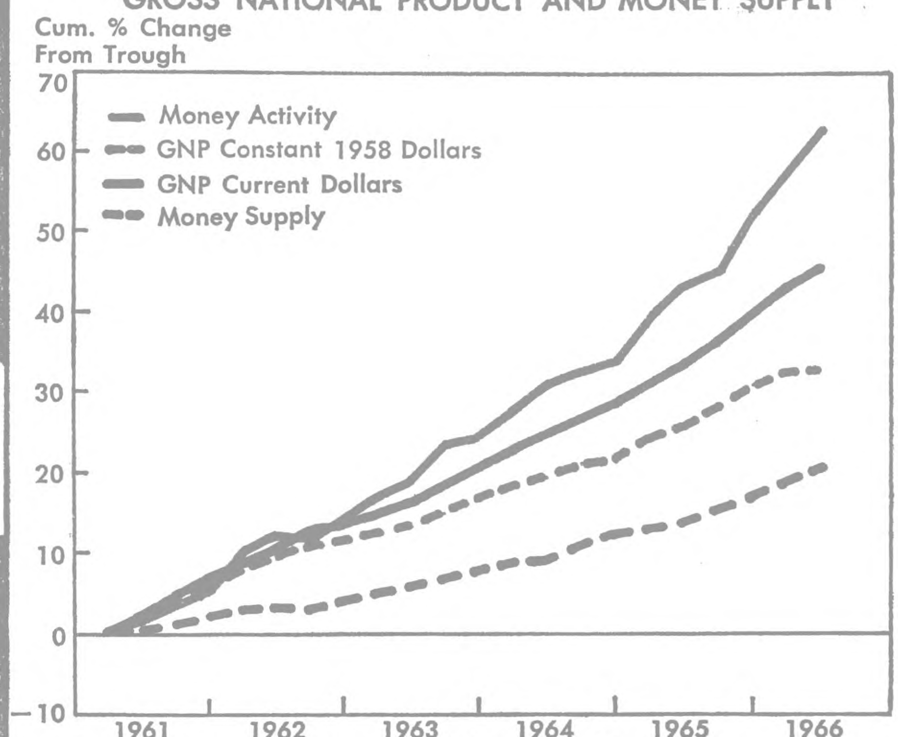
The comparatively slow rate of growth of demand deposits was unusual for a period of such rapid expansion. Chart XV shows that gross national product, even when measured in constant dollars, grew more rapidly than the money supply. Many holders of demand deposits, influenced perhaps by rising interest rates on time deposits and other earning assets, trimmed their deposits sharply in order to keep funds fully invested. As a result, money was used much more intensively. It can be seen in Chart XV that money activity, which is the conventional money supply with the demand deposit component multiplied by an index of velocity for centers outside New York City, began to outpace GNP early in 1963 and has climbed more rapidly ever since.

Not all banks welcomed the shift in the composition of deposits. Some found themselves drawn into the intense competition for deposits agains their will, and many of them felt th any increase in total deposits was n large enough to offset the increas cost of the rising time deposi Nevertheless, at most banks time an savings deposits grew in relative im portance and at some banks they rose well above demand deposits.

1965-1966: The Need for Restraint Late in 1964 the economy began to show signs of overheating. One of the first signs of friction was an increase in wholesale prices, which had remained stable for six years but began a definite rise as 1964 drew a close. Consumer prices, which h advanced steadily but not rapid throughout the expansion, began climb faster in 1965. Services, ren and "food away from home" were th items on which prices rose most rapidly. By 1966 the increases became larger and more general.

Chart XV

GROSS NATIONAL PRODUCT AND MONEY SUPPLY

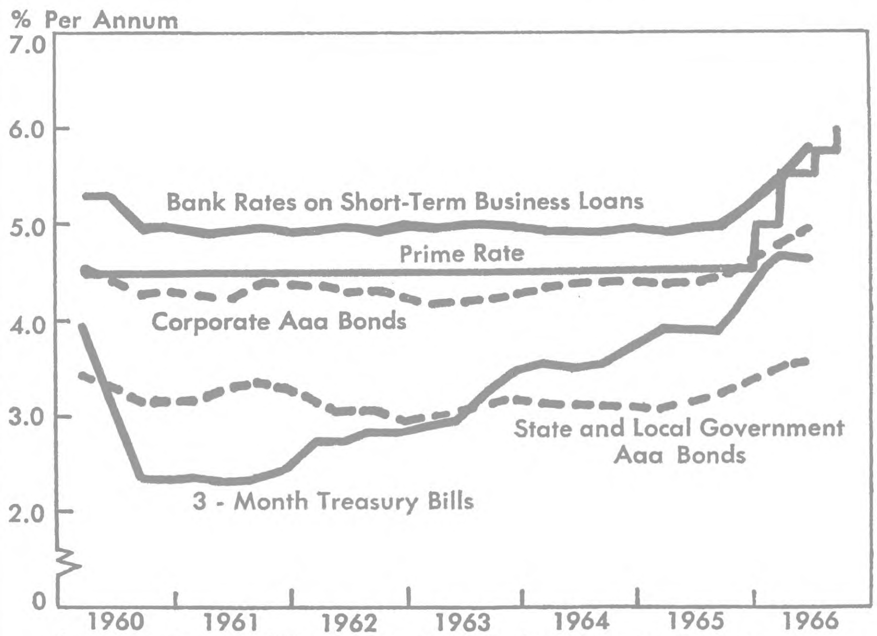


Source: Board of Governors of the Federal Reserve System; U. S. Department of Commerce.

Monetary policy had begun to move toward restraint, however, before the price pressures of 1965 became apparent. On February 2, the Open Market Committee, primarily because of recent sharp increases in capital outflows, modified its policy by moving gradually toward slightly firmer money market conditions. This move was soon reflected in a sharp increase in borrowing from Federal Reserve Banks and a sustained net borrowed reserve position for member banks for the first time since early 1960.

In the face of strong loan demand even this slight tightening put considerable upward pressure on market interest rates, but bank rates remained stable, as can be seen in Chart XVI. Thus the effects of the restrictive policy were not transmitted to bank borrowers where they would have exerted their maximum restraint on both inflation and the outflow of funds. In fact, the stability of bank rates in the face of the rapidly growing demand for credit probably had the effect of speeding up the growth of the money supply and bank credit. The banks' prime rate was below the rate at which most corporations could sell new bonds. This diverted demand away from the capital market and increased the demand for bank loans. Banks usually met this demand, thereby increasing their required reserves. The Open Market Committee usually sets its short-term monetary policy goal in terms of specified conditions in the money market. A rapid rise in bank loans and deposits tends to tighten conditions more than the System's goal calls for and the System supplies additional reserves, thus, in effect, validating the actions of the commercial banks. In this way a sharp rise in the demand for bank credit calls forth, in the short run, an automatic increase in reserves instead of providing an automatic brake on the expansion of bank credit.

Chart XVI SELECTED INTEREST RATES



Source: Board of Governors of the Federal Reserve System.

The stability in bank rates in late 1964 and early 1965 may be attributed to two factors. First, considerable pressure was exerted on the few banks which announced rate increases and those moves were rescinded. Second, in spite of the discount rate increase, most banks still could get sufficient reserves to enable them to expand loans at prevailing interest rates. Total Reserve Bank credit supplied continued to rise at a rapid pace, and banks found it unnecessary to ration credit by means of interest rate increases.

In the second half of 1965, however, the demand for bank credit mounted at an accelerated pace, and market rates rose relative to bank rates. By late 1965, bank rates were so far out of line with other rates that when the breakthrough finally occurred, a very steep rise took place. Over the next few months the prime rate was raised, in four steps, from 4½ to 6 per cent.

A firm credit policy was followed by the Federal Reserve throughout most of 1965, but it was not until December that the discount rate was raised. The higher discount rate did not in itself bring about tighter money, however. On the contrary, in the period immediately following the increase, the Federal Reserve provided an abundance of reserves through open market operations in order to smooth the transition to a higher level of rates and reassure a nervous market.

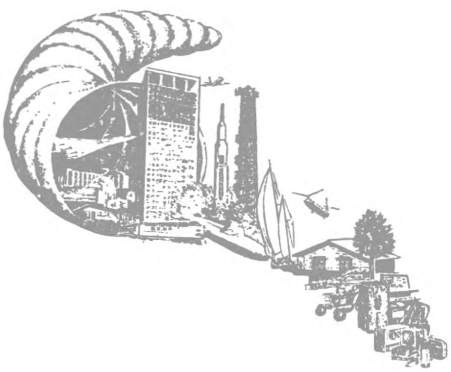
Early in 1966, however, as the demand for credit continued to increase at a spectacular pace, the System increased its restrictive policies. As the volume of reserves supplied increased more slowly than the burgeoning demand, banks trimmed their excess reserves or borrowed at the discount window and net borrowed reserves for all member banks rose rapidly to levels approaching those of 1959 and early 1960.

Restrictions on credit expansion intensified competition for the available supply of funds, and interest rates rose to record levels as borrowers bid against each other. Governments as well as private borrowers competed for funds. Governments raised interest rates on their obligations, and Federal Government agencies made large sales of participations at attractive yields.

Thrift institutions generally suffered in the competition for funds. The growth rate of savings deposits at commercial banks, after climbing steadily since 1960, slowed substantially. Savings at mutual savings banks and savings and loan associations showed an even slower growth and in a few months declined in absolute amounts. More attractive corporate securities, state and local government issues, and Federal agency issues pulled funds out of the thrift institutions or lured away potential deposits.

These developments added up to a severe squeeze on the market for mortgage funds in the spring of 1966. The ensuing difficulties for potential home builders or buyers and for the construction industry led to a number of measures designed to channel additional funds into the mortgage market.

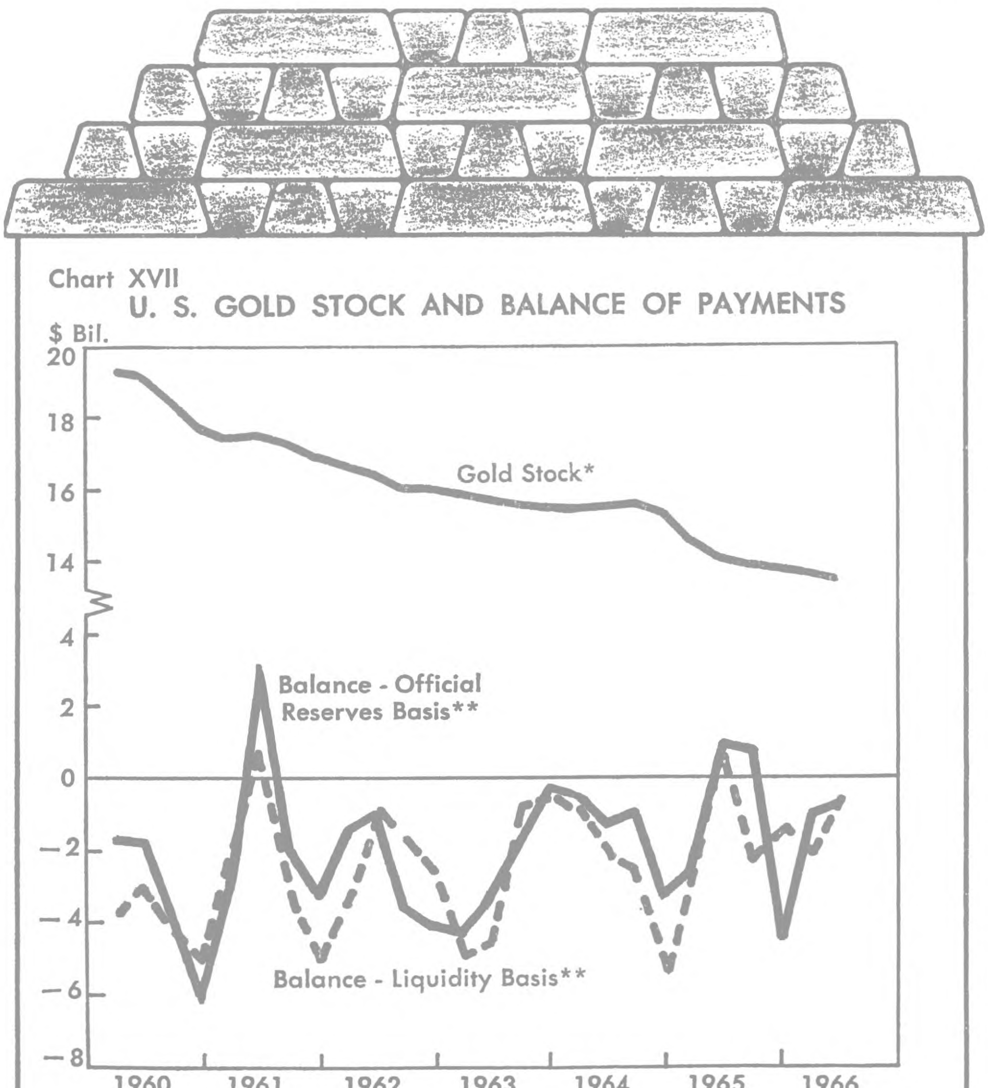
In addition, Congress enacted legislation to permit Federal regulatory agencies, in setting ceilings on interest rates to be paid on time deposits, to set different rates based on size of deposits. Immediately the Board of Governors, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board acted to set rates which gave thrift institutions a small advantage over commercial banks in the rates they could pay on deposits up to $100,000. This was expected to limit the very keen competition which had developed in this area, and reduce the drain of funds from the thrift institutions.



BALANCE OF PAYMENTS

A continuing large deficit in the United States balance of international payments has affected both policy and developments in this expansion. The size of the deficit depends on how it is measured. Chart XVII shows the deficits in recent years measured by the two methods presently employed by the Department of Commerce, the liquidity basis and the official reserve transactions basis. On the official reserve transactions basis, the deficit is measured by the change in U. S. official reserve assets (gold, convertible foreign currencies, and gold tranche position at the International Monetary Fund) and changes in liquid and certain nonliquid liabilities to foreign *official* agencies. On the liquidity basis, the deficit reflects changes in U. S. official reserve assets and in liquid liabilities to all foreigners, both *official* and *private*.

Chart XVII
U. S. GOLD STOCK AND BALANCE OF PAYMENTS



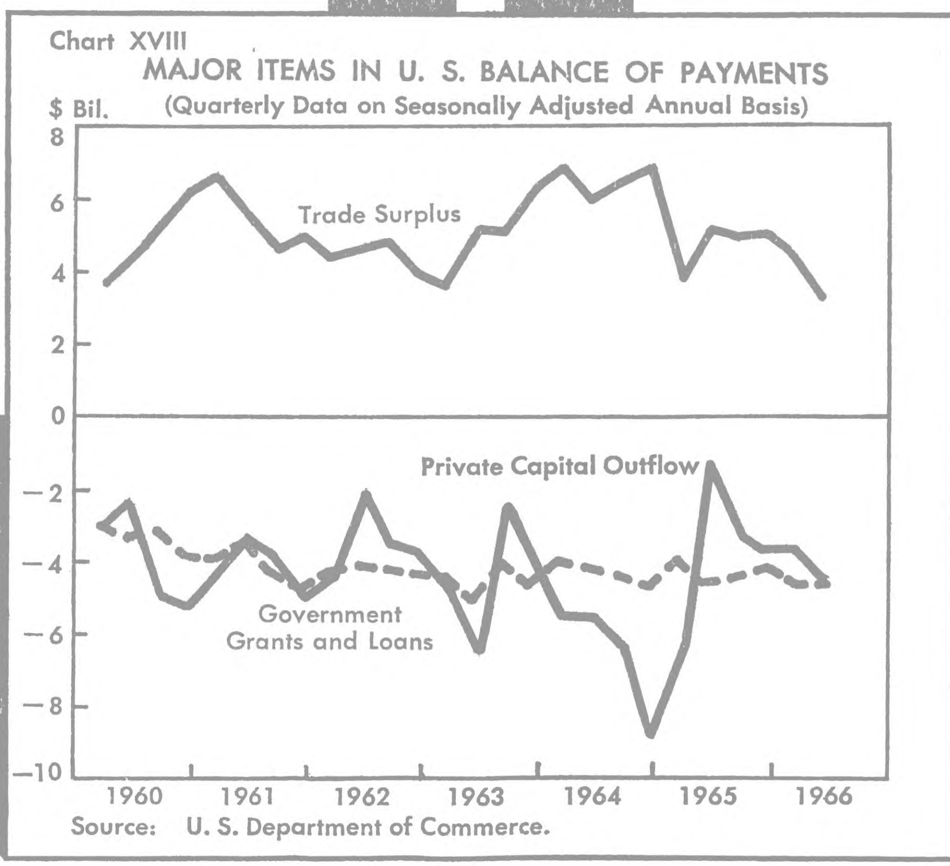
*As of end of quarter.
**Quarterly data on seasonally adjusted annual basis.
Source: U. S. Department of Commerce.

Although the balance of payments on a liquidity basis has shown a deficit in every year but one since 1950, these deficits did not become especially serious until 1958. From 1958 through 1960, the deficits on a liquidity basis averaged about $3.7 billion per year. In the next four years they were smaller, ranging between $2.2 billion and $2.8 billion, but a considerable part of the reduction was attributable to special Government transactions. The deficit declined to $1.3 billion in 1965 and ran at about the same annual rate in the first half of 1966. Gold losses were very large from 1958 through 1962, and as time went on it became increasingly clear that more direct action was required to reduce the size of these deficits and curtail our gold losses.

The traditional prescription for a persistent balance of payments deficit is based on the idea that deficits arise out of excessive demand pressures in the economy. Under such conditions tight money, high interest rates, and a restrictive fiscal policy are appropriate for both domestic and international purposes. But excess demand did not exist during the first several years of the expansion. Consequently, the classical prescription was not followed in the attack on the balance of payments problem. An attempt was made to keep short-term interest rates up for balance of payments purposes while maintaining low long-term rates for the benefit of the domestic economy, the so-called "Operation Twist."

Early Attempts to Reduce Deficit

Early efforts to improve the payments balance included attempts to reduce dollar costs of overseas military expenditures and Government grants and loans to foreigners. Military expenditures abroad, which were $3.4 billion in 1958, were reduced to a rate of about $3.0 billion in 1959 and 1960. Efforts to reduce this outlay consisted primarily of increased military procurement in the United States and attempts to persuade U. S. allies to purchase more military equipment here. Little was achieved in reducing foreign military expenditures, but annual military sales rose about $350 million from 1958 to 1963. U. S. Government grants and capital outflows actually increased from $3.1 billion in 1958 to about $4.25 billion in 1964 and 1965, as Chart XVIII shows. Much of the increase was in the form of loans, and an increasing portion of development aid was tied directly to the purchase of U. S. goods and services.



These measures made little, if any, net contribution toward eliminating the balance of payments deficit. Attention was directed next toward reducing the outflow of private capital which had risen from an annual average of $2.7 billion in 1958-59 to $3.8 billion in 1960-62. It moved even higher in early 1963. Although direct investment was the most important item in this flow, new issues of foreign securities in this country became an increasingly important component. In an effort to halt this large outflow of capital, President Kennedy proposed an "interest equalization tax" on the purchase of foreign securities by Americans. At about the same time discount rates at Federal Reserve Banks were raised from 3 to 3½ per cent.

Interest Equalization Tax This proposal was advanced in July 1963, but more than a year passed before it became law. There was uncertainty as to what the provisions of the law would be, however, and since the provisions were to be effective as of July 19, 1963, the proposal had an immediate impact on capital flows. Foreign securities newly issued in the United States fell very sharply, but this was partially offset by a rapid expansion of long-term bank loans, a substantial portion of which probably represented a substitution of bank credit for bond financing.

The law, finally enacted in early September 1964, required Americans buying securities from foreigners to pay a tax of 15 per cent on stocks and a tax ranging up to 15 per cent on debt securities with maturities beyond three years. Securities of underdeveloped countries were not covered and those of countries heavily dependent upon United States capital could be exempted by the President. Canada was granted an exemption under this provision. Bank loans were also exempt, but the President was empowered to extend the tax to bank loans with maturities in excess of one year if in his judgment bank credit was being substituted for security issues.

Passage of the legislation removed uncertainties and caused further changes in capital flows. In the fourth quarter of 1964, there were almost no new issues of taxable securities, but exempt issues, especially Canadian, rose sharply, reflecting the backlog that had built up. Bank loans and acceptance credits also rose sharply, especially to Japan and countries of Western Europe.

Additional Measures of Restraint in 1964 International considerations prompted several changes in monetary policy in the second half of 1964. Large deficits in the second and third quarters induced a slightly firmer policy, and from mid-August until late November the money market was kept under a little more pressure. The pound sterling came under intense pressure and in November the Bank of England raised its discount rate from 5 to 7 per cent, following which Federal Reserve Banks raised their discount rates from 3½ to 4 per cent. In addition, the Federal Reserve supplied large amounts of reserves to meet strong seasonal demands and to reassure an unsettled money market.

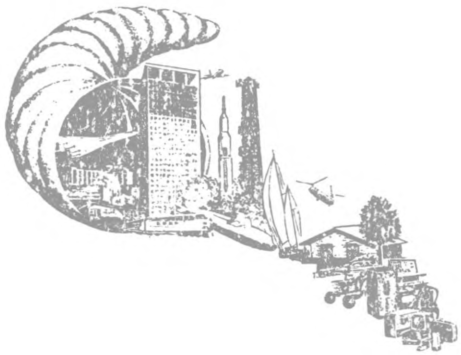
Voluntary Foreign Credit Restraint In the last quarter of 1964 and the first two months of 1965, there was a rapid expansion in long-term bank loans to countries affected by the interest equalization tax. On February 10, President Johnson outlined to Congress a program designed to deal with this increasingly serious problem. Among other things, this program extended the interest equalization tax to bank loans with maturities of more than one year, except loans to borrowers in less developed countries and loans to finance exports. The tax on debt securities was broadened to include those with maturities of more than one year. In addition, the President proposed a voluntary foreign credit restraint program.

This program called on commercial banks, nonbank financial institutions, and nonfinancial business concerns to reduce voluntarily the outflow of capital. Banks and other financial institutions were asked to follow certain guidelines in their foreign lending and investing. Banks were asked to limit their outstanding credits to foreigners in 1965 to 105 per cent of the amount outstanding at the end of 1964. Ceilings for 1966 were the 1965 target plus 1 per cent each quarter. A related program was applied to foreign credits and investments of nonbank financial institutions. About 500 large nonfinancial corporations were asked to set up a balance of payments for 1964 which would reflect their foreign operations and then consider ways to improve the balance by 15 to 20 per cent in 1965.

The voluntary foreign credit restraint program had an immediate and pronounced effect on the outflow of capital. The total private capital outflow in 1965 was only $3.7 billion, of which $1.6 billion was in the first quarter, compared with $6.5 billion in 1964. In the last three quarters of 1965, claims of U. S. banks on foreigners *declined* by about $540 million as compared with an *increase* of $1.8 billion in the last three quarters of 1964 (all figures seasonally adjusted). Direct investments, however, were almost $1 billion greater in 1965 than in 1964. Unfortunately, part of the substantial improvement in the capital account was offset by a decline in the trade surplus.

General Credit Restraint In 1965 the Federal Reserve System reduced further the availability of reserves to the banking system. Loan demand remained strong and in the second half of the year the pressures on the economy and the banking system increased sharply, raising prices and interest rates. To dampen inflationary pressures and to correct distortions in the structure of interest rates, the Federal Reserve discount rate was raised from 4 to 4½ per cent in early December 1965. At the same time the rate ceiling on time deposits was raised to 5½ per cent. The tremendous demand for credit was reflected in increasing tightness in money and credit markets, and interest rates rose to the highest levels in some 45 years.

The increasing pressure on the reserve positions of commercial banks strongly reinforced the voluntary foreign credit restraint program and brought about a significant reduction in the outflow of bank credit in the first three quarters of 1966. But the rapid expansion in the domestic economy brought about a sharp increase in imports and reduced the trade surplus. Thus, for the first time during the current expansion, domestic economic conditions came to resemble those traditionally associated with a balance of payments deficit, and the classical prescription of tight money and restrictive fiscal policy became appropriate both for domestic and balance of payments reasons.



PROBLEMS OF PROSPERITY

Increased economic activity following the tax cuts of 1964 and 1965 and the escalation of the Viet Nam War progressively reduced the economy's margin of unused resources. After June 1964 the unemployment rate, which had averaged somewhat more than 5.5 per cent for 18 months, dropped sharply, reaching 4 per cent by the end of 1965. Simultaneously, the rate of capacity utilization in manufacturing moved up and by December 1965 was estimated at 91 per cent, a level widely regarded as optimal. Reports of labor bottlenecks multiplied and upward pressure on wages increased. Business outlays for new plant and equipment, already at unusually high levels, were further accelerated. By summer 1965, the economy clearly was in the midst of the greatest investment boom since World War II.

As 1965 progressed, the unemployment and slow growth problems receded into the background. The question of whether the unemployment rate was too high gave way to the question of what unemployment rate represented the minimum below which the risk of serious inflation became unacceptable as a matter of public policy. The Federal budget was increasingly evaluated in terms of "fiscal stimulus" provided rather than "fiscal drag" exerted. New problems were emerging; and economic observers were coming face to face with the fact that high level prosperity, for all its enchantment, also has its pitfalls.

Problems of an Expanding Economy The problems of an expanding economy are likely to center around the relationship between the growth rates of money expenditures and the output of goods and services; that is, between total demand and total supply in the economy. Total demand can expand rapidly without creating problems if total supply is increasing at the same pace without undue increases in cost. In the short run, increases in total supply depend on the availability of basic productive resources. So long as a substantial pool of unemployed, qualified labor, production facilities, and the necessary materials exist in the economy, supplies can be expanded rapidly. But once production rates have been stepped up to the point of absorbing the previously unemployed resources, the rate of increase in total supplies of goods and services will taper off. Unless there is a corresponding tapering in the growth of total spending, an excess of demand will develop in the economy.

It is reasonably clear, in retrospect, that the growth of domestic spending began to outstrip the growth of output by a significant amount some time in 1965. Prices began to advance at an accelerated pace, and labor markets tightened sharply as the unemployment rate fell to the lowest level since the Korean War. Interest rates advanced more steeply in the latter half of the year. Imports gained rapidly on exports and the large trade surplus which this country had long enjoyed was whittled steadily away.

The problems occasioned by these trends did not become significantly acute in 1965 to catch popular attention. But as spending continued to outpace production in 1966, the rising cost of living and ever tighter money became commonplace topics of conversation. The dramatic breakdown of the wage-price "guideposts" attracted widespread attention. The steady decline of the trade surplus and continued gold losses touched off renewed concern over the strength of the dollar and the future of the international payments system. In brief, as 1966 progressed the problems of an economy expanding too rapidly became obvious problems, even at the popular level.

Rates of Increase in Spending and Producing In each of the six years of the current upswing, total spending as measured by GNP in current dollars grew faster than real output as measured by GNP in constant dollars. Moreover, in each year the constant dollar measure lagged increasingly behind the current dollar figure. From 1960 to 1964 the increase in GNP in constant dollars was about one fourth less than the increase in current dollars. In 1965 it was about a third less. For the first three quarters of 1966 it was lower by more than a half.

Prices and Costs The years 1961-64 were relatively free of price pressures. The consumer price index rose 1 to 1.5 per cent in each year, with the increases confined largely to the services component. Wholesale prices first began to move up in the last half of 1964 but the index for the year was slightly below its 1960 level.

In 1965 all price indexes registered substantially greater gains than in any of the preceding four years. The consumer index advanced 2.0 per cent, while the wholesale index rose nearly 3.5 per cent. All components of the wholesale index gained substantially, but farm products and processed foods rose at a considerably faster pace than industrial materials and producer finished goods. The upward movement quickened in 1966. For the first three quarters both consumer and wholesale indexes rose at an average annual rate in excess of 3.5 per cent, although the rise in wholesale prices slowed in the third quarter. By contrast with the 1965 movement, most of the 1966 increases in the wholesale index centered in the industrial materials and the producer finished goods components.

Many of the wholesale prices represent, of course, production cost items in many stages of production and thus increases in these prices affect either the pricing or the production policies of these producers. Throughout 1965 and 1966 producers increasingly complained of rising costs, while organized labor argued that rising consumer prices necessitated higher wages. In many crucial industrial areas wage increases exceeded the Administration's guideposts, which are geared to estimated productivity increases, and this added further upward pressure on production costs. This interaction of wages and prices in a relationship under which each tends to push the other upward, commonly referred to as the wage-price spiral, becomes one of the thorniest problems in an expanding economy. While the mutual upward pressures did not assume unmanageable proportions in 1966, the basic ingredients of a wage-price spiral were clearly present in the economy.

The Labor Markets and Full Employment A feature of basic significance in the current expansion has been the unusually large increase in the nation's labor force. This rapid growth of the manpower pool added to the difficulty of reducing unemployment in the early years of the upswing. But as the rate of spending accelerated in 1964 and 1965 the new workers became of vital importance in adding to the economy's output. Without them, the accelerated spending in 1964-65 would have generated inflationary pressures at a considerably earlier date.

Enhanced by the increased military buildup, the expansion in 1965 and 1966 created labor requirements greater than could be met out of net additions to the labor force. By the middle of 1965 the unemployment rate had been cut to 4.5 per cent and was declining. The rate was considerably lower for experienced wage and salary workers and in a growing number of markets it became increasingly difficult for producers to meet their labor requirements. In brief, labor, and especially skilled labor, was in an increasingly favorable sellers' market throughout 1965 and 1966.

The ever-tightening labor market turned attention once more to the question of when, as a practical matter, full employment of the labor force has been achieved. In a free society, there will always be a margin of workers who are unemployed by choice: those moving on to better jobs, those who leave a job voluntarily in the hope of finding a better one, etc. The question of the minimum size of this margin is of fundamental importance for the policy maker because any attempt to push employment beyond this margin through monetary and fiscal action will almost inevitably create inflationary pressure. Yet on this question there is no general agreement. Some argue that it is 5 per cent of the labor force, while others contend that the figure can be pushed down to 4 per cent or even 3 per cent without serious risk of inflation.

The empirical record on this question is not altogether clear. Yet in the current expansion, the record appears to indicate some inverse relationship between price movements and unemployment rates when the latter drops below 5 per cent. As shown in Chart XIX, wholesale prices were almost completely stable in the years 1960-64, when the unemployment rate was 5 per cent or higher. As the latter rate approached 5 per cent in late 1964, the wholesale index began to move upward. Moreover, the steep decline in the unemployment rate to 4 per cent and lower, was accompanied by a sustained rise in wholesale prices.

It is possible, of course, to make too much of this record. The minimal margin of unemployment consistent with price stability depends on a great variety of factors, many of which are not easily measurable. The skills and aspirations of the labor force and institutional factors that bear on personal incentives, as well as on opportunities of individuals to acquire new skills, all play a role in determining this level, and there is nothing magic about a 5 per cent or 4 per cent or 3 per cent figure. But it is clear that sustained business expansion can be threatened by efforts, whether they be of the private economy or of the policy makers, to "overemploy" the labor force.

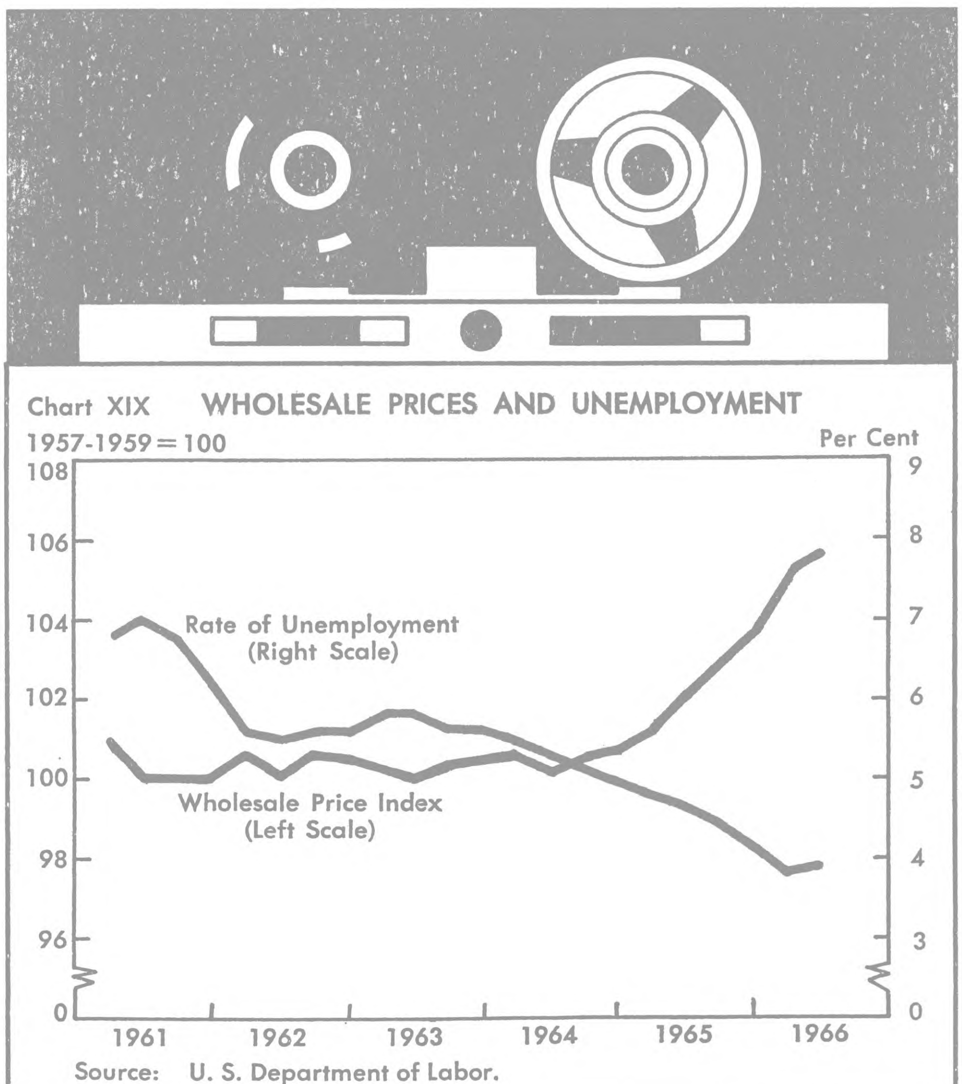


Chart XIX WHOLESALE PRICES AND UNEMPLOYMENT

Source: U. S. Department of Labor.

Tight Money and Credit Markets Economic historians will no doubt characterize 1966 as a year of business boom, rising prices, and tight labor markets. But the year probably will be remembered chiefly as a year of high interest rates and tight money. Interest rates across the board rose to the highest levels since the 1920's. Mortgage money was at a premium and yields of 6 per cent or higher were commonplace on Federal agency issues. Even the 90-day obligations of the Treasury approached the 6 per cent level on several occasions. The prime rate of commercial banks was hiked to 6 per cent, the highest level in the history of that rate.

Yet tight money may be more a symptom than a disease; and it can be symptomatic of a basic ailment, the appropriate prescription for which is no simple matter. The tight money situation of 1966 appears to fall in this class. That it was a result of excess demand in the economy is clear from the data. Through the spring, summer, and autumn the money supply and the volume of loan funds grew at a pace only slightly below the rapid 1965 rate and at a considerably faster pace than in the easy money period of 1961-63. Over the first three quarters of 1966, the money supply grew at an annual rate of just over 4 per cent, compared with 4.8 per cent in 1965 and less than 3 per cent in 1961-63. For total loans and investments of commercial banks the rate of increase was 9 per cent, compared with 10.2 per cent in 1965 and 4 per cent in 1961-63.

The high interest rates and the credit stringency that developed despite these large increases in money and credit bespeak a great surge in the demand for funds. That demand grew out of the accelerated rate of spending by consumers, businesses, and government and represented efforts on their part to raise the funds necessary to finance enlarged spending plans. The high interest rates were simply the market's reflection of the fact that the savings of the public and the new credit created by the banking system were not sufficient to meet all these demands and that some rationing was required.

The tight money "problem" obviously would have been alleviated if the supply of loan funds had grown fast enough. Higher rates should work in this direction by raising the reward for savings. But if the demand continues to outpace the funds offered, upward pressure on rates can be alleviated only by increasing the amount of new bank credit created. This would increase both the volume of credit extended to borrowers and the money holdings of the public and would almost certainly lead to a further increase in spending. The significant question in 1966 was whether a higher rate of spending could have been matched by a comparable increase in output. The tightening of labor markets and the acceleration of price rises in 1966 are strong evidence that more spending could not have been matched by a comparable increase in real output, but instead would have led to larger price increases and a faster rate of growth in credit demands.

Tight money in 1966 created serious problems for large groups in the economy. Aspiring home owners, the construction industry, and certain kinds of financial institutions were especially affected. But the economy's general dilemma in 1966 involved a choice between these tight money problems on the one hand and inflation on the other. During 1966 some actions were taken to alleviate the problems which tight money made for some groups. Fundamentally these problems resulted from sharp changes in credit flows through the nation's financial markets. Because of legal limitations on some interest rates and other market imperfections, a general tightening of credit usually means that some market rates move up faster than others. Credit will naturally flow to those markets paying the greater return and some markets will accordingly be starved of funds more quickly than others. Attempts to redress some of the effects of tight money on credit flows in 1966 have been discussed in earlier sections. In addition, the Federal Reserve took action designed to reduce the relative amounts of bank credit going into business loans.

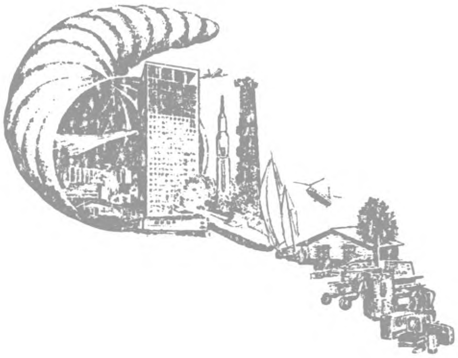
Basically, however, the problem of tight money in 1966 was a problem of general overspending by consumers, businesses, and government, taken in the aggregate. Only a reduction in this aggregate rate of spending could eliminate the dilemma of having to choose between tight money and inflation.

The Declining Trade Surplus Rising prices, tight labor markets, and tight money also created serious problems for the position of the dollar abroad and posed a serious threat to continued domestic prosperity. In 1966 there was a sharp increase in this country's imports and only a relatively small gain in its exports. The result was a significant decline in this country's trade surplus which, in turn, arrested the progress made since 1963 toward eliminating the deficit in the U. S. balance of payments.

Usually, in a rapidly expanding economy imports increase more rapidly than exports. In the current expansion, however, export growth generally kept pace with import gains until 1965. Actually, the surplus of exports over imports in 1964 was a record $6.7 billion, over $1 billion greater than in 1961. But in 1965 imports grew by nearly $3 billion while exports increased only about $1 billion, reducing the surplus to $4.8 billion. The same trends continued in 1966 and by the third quarter the surplus on an annual rate basis was only $2.8 billion, or about half its value in 1964.

This decline in the trade surplus handicapped the country's efforts to eliminate its balance of payments deficit, which had been reduced from $4 billion in 1961 to only about $1.5 billion in 1965. At this writing the prospect is that 1966 will show a deficit on a liquidity basis of about $2.5 billion.

Foreign confidence in the dollar remained strong in 1966 despite the weakening in the trade surplus. Nonetheless, the worsening of the overall U. S. payments position coupled with the continuing difficulties of the British pound posed important problems of confidence in the existing international finance mechanism, which rests heavily on the dollar and the pound. These problems, in turn, have an important bearing on the ability of the existing payments system to accommodate continued growth in foreign trade and investment, which, in their turn, bear heavily on the continuation of prosperity in the entire free world. Moreover the worsening of the U. S. position also appears to have cast a damper on international negotiations to reform the international payments mechanism with a view to avoiding the development of purely financial obstacles to trade and investment expansion.



SUMMARY

However the current business expansion may eventuate, it is clear that it will command the close study of economists and economic historians for many years. It is of historic dimensions in length, breadth, and height, and in its detail it will probably present an unparalleled opportunity to evaluate the success of specific policy applications in overcoming cyclical tendencies in business activity. From the standpoint of the history of economic policy, the period is doubly interesting in that it confronted simultaneously problems of both domestic and international stability.

At the current juncture it is, of course, premature to offer a definitive assessment. Yet certain features of the period already stand out in relief. First is the remarkable stability and extent of the advance in its first four years. From early 1961 to the end of 1964, GNP grew by over one fourth while industrial production increased by nearly one third. Some four million new jobs were created in the face of rapid improvement in technology, much of it of the labor-saving variety. Corporate profits rose by about 60 per cent, providing both the incentive and the means for efficiency-improving investment. Wages rose steadily but productivity gains kept pace and with money, credit, and total spending growing commensurately with output, the advance was achieved with little upward pressure on prices or interest rates. Most of the upward rate adjustments were in the short-term area; long rates were actually somewhat lower in 1964 than in 1961.

The economy's performance from 1961 to 1964 was perhaps as remarkable as in any four-year period of this country's history. European observers, grown accustomed to applying the term "economic miracle" to European postwar recovery, increasingly pointed out the economic miracle of U. S. economic growth without inflation in the 1960's. Similarly, observers at home were emboldened to talk about the obsolescence of the business cycle and forecasters showed little hesitation in projecting the advance well beyond the outer limits suggested by experience. Confidence in the ability of policy makers to tailor policy measures to fit the requirements of an ever-advancing economy was probably at a high point.

Throughout the period 1961-64, monetary and fiscal policies were closely coordinated to bring about this happy end. The problems confronted were those of underutilization of resources at home and balance of payments disequilibrium in the international sphere. Money and credit policy remained easy and reserves were supplied to support steady monetary expansion. Measures were taken to keep short-term rates up for balance of payments reasons but long-term rates were deliberately held down to encourage domestic investment. On the fiscal side, investment incentives were provided through more generous depreciation rules and through investment tax credits to business. Then in 1964 and 1965 came the massive tax cuts that provided a major new stimulus to expansion.

At some point in 1965, the rate of spending began to diverge more sharply away from the rate of output growth. Some overheating was evident in the first quarter, but this was widely attributed to the impact of the automobile strike of late 1964. When this effect wore off, however, it became obvious that the overheating was due to more fundamental causes. The large tax cuts of 1964-65 were followed by great increases in consumer outlays. Business spending for new plant and equipment was rapidly assuming boom proportions. Then in early 1965 began a step-by-step escalation of the Viet Nam War, each step involving large increases in defense outlays. Paralleling these augmented defense expenditures, Congress passed in early 1965 a series of new and expensive welfare and development measures. The coincidence of enlarged outlays by consumers, businesses, and government, coming at a time when the margin of unused resources was rapidly dwindling, led to an acceleration in the rate of spending that could not be matched by output gains even in the face of improving technology and a growing labor force. The balanced growth of the preceding four years had quite definitely been interrupted.

Precisely when the problem of resources underutilization was transformed into a problem of resources overutilization is problematical. That an acceleration in the rate of advance of most important business indicators took place in early 1965 is evident from the charts in the preceding sections of this report. In any event, from early 1965 through most of 1966, labor markets tightened progressively and order backlogs piled up. Pressure on both costs and prices became increasingly obvious. While money and credit continued to expand at about the same rate as in 1964, ever-enlarging credit demands pushed market interest rates steadily higher. By the last quarter of 1965 it was obvious that the disparate movement of rates, especially of market rates relative to institutional rates, was distorting the flow of funds through the capital markets. At about the same time, the sharp uptrend of imports relative to exports posed a serious threat to continued progress in solving the balance of payments problem. In brief, it appears in retrospect that by mid-1965 the economy was operating at or near to optimum capacity and that the higher rate of spending beyond that time increasingly encountered problems of overemployment.

Policy making in an open society is subject to important political and social constraints which vary with the nature of the problems confronted. Democratic societies tend to be more congenial to policies designed to encourage the fuller use of resources than to those required to restrain overutilization. The former policies seek to stimulate, while the latter necessarily aim at dampening, spending. To reduce the rate of increase in spending, it is necessary to do such things as raise taxes, reduce government spending, and slow down the growth rates of the money supply and bank credit. Tax increases and reductions in government spending are, in their nature, unpopular and are likely to arouse political opposition. In the face of a growing private demand, heavier government borrowing and a reduced rate of lending by the banking system will almost inevitably be accompanied by tight money and high and rising interest rates, which, in turn, bear heavily on large groups of borrowers and are likely to be only slightly less unpopular than tax increases. Moreover, both fiscal and monetary measures are likely to raise serious questions of social equity since it is not clear that their incidence affects all groups equally.

On the other hand, a rapidly growing rate of spending is likely to generate, at least for a time, a popular air of euphoria. Tight labor markets enhance the ability of workers to find jobs and to secure pay raises; moreover, they provide a climate congenial to the objectives of organized labor. Easy money and low interest costs fit well not only with the expansion plans of businesses but also with the aims of the ordinary home owner and the consumer. High rates of government spending please public officials and other direct beneficiaries, and are often a source of satisfaction to sizable elements in the business community.

In any event, the problems confronting the policy maker in a rapidly expanding economy are not entirely economic problems. They contain large political and social components which pose a serious constraint on the policy maker's ability to adapt rational solutions. The political and social elements in the overall problem should be included as an important part of the challenge of maintaining stability in a full employment economy. They clearly played an important role in determining both the characteristics and the timing of monetary and fiscal policy measures in 1965 and 1966.

HIGHLIGHTS OF 1966

EARNINGS AND CAPITAL ACCOUNTS

Net earnings before payments to the United States Treasury rose $26,339,052.90 to a record $115,525,628.99 in 1966. Member banks in the Fifth District received statutory dividends of 6 per cent per annum, totaling $1,747,437.88, and $112,294,941.11 was paid to the Treasury as interest on Federal Reserve notes.

Capital stock rose $1,483,250.00 to $29,575,700.00 and the surplus account was increased $1,483,250.00 to $29,575,700.00.

CHECK COLLECTION

The number of checks processed continues to climb each year. During 1966 the increase was 11 per cent over the previous year.

In an effort to further improve the check collection system we have arranged with American Courier Corporation for motor carrier transport of outgoing cash items to virtually all banks in the Fifth District. This service, which will be initiated early in 1967, will assure more prompt delivery of our cash letters and result in a reduction in both collection time and float.

The installation of new electronic check handling equipment was completed at the Baltimore and Charlotte offices during the year. Baltimore acquired two IBM "360" systems, and Charlotte installed two IBM "1979" configurations. At Richmond an order was placed in July for three Burroughs "300" systems to be installed in the spring of 1967.

In a further effort to streamline check collection operations all banks in the Fifth District were notified on August 8, 1966, that as of September 1, 1967, Federal Reserve Banks will discontinue handling as cash items any checks that are not inscribed in magnetic ink with routing symbol-transit numbers of drawee banks.

THE COIN SITUATION

During the latter part of 1966, coins other than half dollars were in sufficient supply. An all-out effort by the Bureau of the Mint produced about 9 billion pieces of coin in 1966 compared with only 3.4 billion pieces in 1962.

FUNCTIONAL COST ANALYSIS

During the fall of 1966 the Bank initiated a Functional Cost Analysis Program for member banks. This is a simplified cost accounting service designed to produce cost and earnings figures for the lending, investing, deposit, capital funds, trust, safe deposit, and computer service functions of each participating bank and figures for similar banks with which the individual bank is compared. The participating banks collect the data and forward them to the Reserve Bank, which in turn prepares the finished reports. Orientation sessions were held in Richmond, Baltimore, Charlotte, and Roanoke for member banks interested in the program.

NEW CULPEPER FACILITY

In late September construction was begun on a Communications and Records Center, with completion anticipated in 16 months. The building, largely underground, will be located on a 16-acre site near Culpeper, Virginia.

NEW MEMBER BANKS

Three newly formed Fifth District banks entered the Federal Reserve System during the year, and two former nonmember banks converted to System membership. The Second National Bank, Richmond, Virginia; The Blueville Bank of Grafton, Grafton, West Virginia; and The Valley National Bank of Huntington, Huntington, West Virginia, were the member banks opening for the first time in 1966. The Williamsburg State Bank, Kingstree, South Carolina, converted to a national charter and joined the System, and the Johnsonville State Bank, Johnsonville, South Carolina, became a state member.

CHANGES IN DIRECTORS

In the fall of 1966 Fifth District member banks elected one Class A and one Class B director to three-year terms on the Board of Directors at the Head Office. Robert C. Baker, President and Chairman of the Board, American Security and Trust Company, Washington, D. C., was elected a Class A director, succeeding Robert T. Marsh, Jr., Honorary Chairman of the Board, First & Merchants National Bank, Richmond, Virginia. Elected as a Class B director was Thaddeus Street, President, Carolina Shipping Company, Charleston, South Carolina, who succeeds Robert E. L. Johnson, former Chairman of the Board, Woodward & Lothrop, Inc., Washington, D. C.

The Board of Governors appointed Robert W. Lawson, Jr., Senior Partner, Charleston Office, Steptoe & Johnson, Charleston, West Virginia, to a three-year term as a Class C director at the Head Office. Mr. Lawson fills the vacancy on the Board caused by the expiration of the term of William H. Grier, President, Rock Hill Printing and Finishing Company, Rock Hill, South Carolina. The Board of Governors also designated Wilson H. Elkins, President, University of Maryland, College Park, Maryland, as Deputy Chairman of the Board of Directors, a position previously held by Mr. Grier.

The Richmond Board of Directors appointed C. C. Cameron, Chairman of the Board, First Union National Bank of North Carolina, Charlotte, North Carolina, to fill a vacancy on the Board of the Charlotte Branch occasioned by the resignation of Carl G. McCraw, former Chairman of First

Union National Bank of North Carolina. The Richmond Board of Directors also appointed J. Willis Cantey, President, Citizens & Southern National Bank of South Carolina, Columbia, South Carolina, to a three-year term on the Board of the Charlotte Branch. Mr. Cantey succeeds W. W. McEachern, Chairman, The South Carolina National Bank, Greenville, South Carolina.

FEDERAL ADVISORY COUNCIL

The Board of Directors selected J. Harvie Wilkinson, Jr., Chairman of the Board, State-Planters Bank of Commerce & Trusts, Richmond, Virginia, to serve as the member of the Federal Advisory Council representing the Fifth Federal Reserve District for the year 1967. Mr. Wilkinson succeeds John F. Watlington, Jr., President, Wachovia Bank & Trust Company, Winston-Salem, North Carolina.

CHANGES IN OFFICIAL STAFF

Roger P. Schad, Assistant General Auditor, resigned effective August 1, and Joseph M. Nowlan, Vice President and Cashier, retired on September 1.

Effective September 1, Harmon H. Haymes and Aubrey N. Snellings were elected to the position of Assistant Vice President in the Research Department, and William F. Upshaw joined the Bank as Assistant General Counsel. On October 1, John C. Horigan, formerly Chief Examiner, was appointed Assistant General Auditor, and Lloyd W. Bostian, Jr., was elected Examining Officer. At the end of December, H. Ernest Ford, Assistant Vice President, was promoted to Cashier; J. Lander Allin, Jr., was advanced to Assistant Vice President; and Andrew L. Tilton was elected Assistant Cashier. Mr. Allin's duties are in the Money, Printing and Supplies, and Building and Equipment Departments, and Mr. Tilton is assigned to the Transit Department.

Summary of Operations

	1966	1965
CHECK CLEARING & COLLECTION		
Dollar amount		
Commercial bank checks*	122,455,850,000	108,683,006,000
Government checks**	10,458,478,000	9,468,158,000
Other items	831,043,000	701,191,000
Number of items		
Commercial bank checks*	385,844,000	339,698,000
Government checks**	59,097,000	59,423,000
Other items	4,851,000	4,312,000
CURRENCY & COIN		
Currency disbursed—Dollar amount	2,470,387,445	2,293,759,320
Coin disbursed—Dollar amount	108,171,445	69,121,605
Dollar amount of currency withdrawn for destruction	1,016,230,052	834,771,400
Dollar amount of currency burned	479,337,600	59,948,400
Daily average of currency burned		
Dollar amount	1,894,615	236,017
Number	664,435	180,667
DISCOUNT & CREDIT		
Dollar amount		
Total loans made during year	4,744,173,000	4,610,836,667
Daily average loans outstanding	29,330,216	24,969,669
Number of banks borrowing during the year	120	95
FISCAL AGENCY ACTIVITIES		
Marketable securities delivered or redeemed		
Dollar amount	7,653,310,182	8,276,880,668
Number	198,431	174,593
Coupons redeemed		
Dollar amount	106,208,880	100,109,860
Number	372,840	371,763
Savings bond issues (including reissue)		
Dollar amount	385,733,092	348,910,372
Number	8,827,459	8,418,449
Savings bond redemptions		
Dollar amount	454,216,001	418,478,236
Number	9,195,462	8,726,857
Depositary receipts for withheld taxes		
Dollar amount	3,253,601,402	2,501,017,121
Number	937,367	859,108
TRANSFERS OF FUNDS		
Dollar amount	187,256,202,943	159,039,470,295
Number	306,835	283,619

* Excluding checks on this Bank
** Includes postal money orders

COMPARATIVE

Condition

	December 31, 1966	December 31, 1965
ASSETS:		
Gold certificate account	$1,043,549,157.27	$1,012,486,436.66
Redemption fund for Federal Reserve notes	157,273,352.00	142,512,550.00
Total Gold Certificate Reserves	1,200,822,509.27	1,154,998,986.66
Federal Reserve notes of other Federal Reserve Banks	86,988,583.00	102,010,149.00
Other cash	15,846,119.60	8,773,823.52
Discounts and advances	4,000,000.00	2,650,000.00
U. S. Government securities:		
Bills	855,175,000.00	643,686,000.00
Certificates	315,231,000.00	-----------
Notes	1,543,327,000.00	1,756,015,000.00
Bonds	449,100,000.00	463,254,000.00
Total U. S. Government Securities	3,162,833,000.00	2,862,955,000.00
Total Loans and Securities	3,166,833,000.00	2,865,605,000.00
Cash items in process of collection	811,145,082.44	699,625,048.59
Bank premises	5,514,769.21	4,736,309.27
Other assets	68,167,258.63	53,520,673.80
TOTAL ASSETS	$5,355,317,322.15	$4,889,269,990.84
LIABILITIES:		
Federal Reserve notes	$3,680,408,151.00	$3,388,300,616.00
Deposits:		
Member bank—reserve accounts	961,654,898.49	824,915,070.66
U. S. Treasurer—general account	569,637.23	68,830,632.64
Foreign	8,160,000.00	7,500,000.00
Other	14,520,350.64	12,749,807.26
Total Deposits	984,904,886.36	913,995,510.56
Deferred availability cash items	614,523,849.61	518,052,215.27
Other liabilities	16,329,035.18	12,736,749.01
TOTAL LIABILITIES	5,296,165,922.15	4,833,085,090.84
CAPITAL ACCOUNTS:		
Capital paid in	29,575,700.00	28,092,450.00
Surplus	29,575,700.00	28,092,450.00
TOTAL LIABILITIES AND CAPITAL ACCOUNTS	$5,355,317,322.15	$4,889,269,990.84

Contingent liability on acceptances purchased for foreign correspondents	$ 9,781,800.00	$ 7,180,000.00

STATEMENTS

Earnings and Expenses

	1966	1965
EARNINGS:		
Discounts and advances	$ 1,353,103.83	$ 1,048,591.04
Interest on U. S. Government securities	129,428,481.05	103,120,760.22
Foreign currencies	1,120,756.89	699,210.82
Other earnings	30,207.69	20,538.04
Total Current Earnings	131,932,549.46	104,889,100.12
EXPENSES:		
Operating expenses (including depreciation on bank premises) after deducting reimbursements received for certain Fiscal Agency and other expenses	13,721,308.51	12,844,811.25
Assessments for expenses of Board of Governors	462,000.00	428,900.00
Cost of Federal Reserve currency	2,128,879.59	2,521,522.65
NET EXPENSES	16,312,188.10	15,795,233.90
CURRENT NET EARNINGS	115,620,361.36	89,093,866.22
Additions to Current Net Earnings	80,329.72	97,860.47
Deductions From Current Net Earnings:		
Loss on sales of U. S. Government securities (net)	173,244.94	840.27
All other	1,817.15	4,310.33
Total Deductions	175,062.09	5,150.60
NET ADDITIONS OR DEDUCTIONS	− 94,732.37	92,709.87
NET EARNINGS BEFORE PAYMENTS TO U. S. TREASURY	$115,525,628.99	$ 89,186,576.09
Dividends paid	$ 1,747,437.88	$ 1,629,632.11
Payments to U. S. Treasury (interest on Federal Reserve notes)	112,294,941.11	85,603,893.98
Transferred to surplus	1,483,250.00	1,953,050.00
TOTAL	$115,525,628.99	$ 89,186,576.09

SURPLUS ACCOUNT

	1966	1965
Balance at close of previous year	$ 28,092,450.00	$ 26,139,400.00
Addition account of profits for year	1,483,250.00	1,953,050.00
BALANCE AT CLOSE OF CURRENT YEAR	$ 29,575,700.00	$ 28,092,450.00

CAPITAL STOCK ACCOUNT

(Representing amount paid in, which is 50% of amount subscribed)

	1966	1965
Balance at close of previous year	$ 28,092,450.00	$ 26,139,400.00
Issued during the year	1,570,450.00	1,978,200.00
	29,662,900.00	28,117,600.00
Cancelled during the year	87,200.00	25,150.00
BALANCE AT CLOSE OF CURRENT YEAR	$ 29,575,700.00	$ 28,092,450.00

Directors (DECEMBER 31, 1966)

EDWIN HYDE	Chairman of the Board and Federal Reserve Agent
WILSON H. ELKINS	Deputy Chairman of the Board

CLASS A

GEORGE BLANTON, JR.	President, First National Bank Shelby, North Carolina (Term expires December 31, 1967)
WILLIAM A. DAVIS	President, Peoples Bank of Mullens Mullens, West Virginia (Term expires December 31, 1968)
ROBERT T. MARSH, JR.	Honorary Chairman of the Board, First & Merchants National Bank Richmond, Virginia (Term expired December 31, 1966) Succeeded by: Robert C. Baker President and Chairman of the Board American Security and Trust Company Washington, D. C. (Term expires December 31, 1969)

CLASS B

ROBERT RICHARDSON COKER	President, Coker's Pedigreed Seed Company Hartsville, South Carolina (Term expires December 31, 1967)
ROBERT E. L. JOHNSON	Former Chairman of the Board (Retired), Woodward & Lothrop, Inc. Washington, D. C. (Term expired December 31, 1966) Succeeded by: Thaddeus Street President, Carolina Shipping Company Charleston, South Carolina (Term expires December 31, 1969)
CHARLES D. LYON	President, The Potomac Edison Company Hagerstown, Maryland (Term expires December 31, 1968)

CLASS C

WILSON H. ELKINS	President, University of Maryland College Park, Maryland (Term expires December 31, 1968)
WILLIAM H. GRIER	President, Rock Hill Printing & Finishing Company Rock Hill, South Carolina (Term expired December 31, 1966) Succeeded by: Robert W. Lawson, Jr. Senior Partner, Charleston Office, Steptoe & Johnson Charleston, West Virginia (Term expires December 31, 1969)
EDWIN HYDE	President, Miller & Rhoads, Inc. Richmond, Virginia (Term expires December 31, 1967)

MEMBER FEDERAL ADVISORY COUNCIL

JOHN F. WATLINGTON, JR.	President, Wachovia Bank and Trust Company Winston-Salem, North Carolina (Term expired December 31, 1966) Succeeded by: J. Harvie Wilkinson, Jr. Chairman of the Board State-Planters Bank of Commerce & Trusts Richmond, Virginia (Term expires December 31, 1967)

BANK OF RICHMOND

Officers

EDWARD A. WAYNE, President

AUBREY N. HEFLIN, First Vice President

ROBERT P. BLACK, Vice President

J. GORDON DICKERSON, JR., Vice President

WELFORD S. FARMER, Vice President and General Counsel

DONALD F. HAGNER, Vice President

EDMUND F. MAC DONALD, Vice President

UPTON S. MARTIN, Vice President

JOHN L. NOSKER, Vice President

JAMES PARTHEMOS, Vice President

B. U. RATCHFORD, Vice President and Senior Adviser

RAYMOND E. SANDERS, JR., Vice President

JOSEPH F. VIVERETTE, Vice President

H. ERNEST FORD, Cashier

J. LANDER ALLIN, JR., Assistant Vice President

CLIFFORD B. BEAVERS, Assistant Vice President

JOHN G. DEITRICK, Assistant Vice President

WILLIAM C. GLOVER, Assistant Vice President

WILLIAM B. HARRISON, III, Assistant Vice President

HARMON H. HAYMES, Assistant Vice President

JIMMIE R. MONHOLLON, Assistant Vice President

ARTHUR V. MYERS, JR., Assistant Vice President

V. E. PREGEANT, III, Assistant Vice President and Secretary

AUBREY N. SNELLINGS, Assistant Vice President

WILLIAM F. UPSHAW, Assistant General Counsel

EDWARD L. BENNETT, Examining Officer

LLOYD W. BOSTIAN, JR., Examining Officer

JOHN E. FRIEND, Assistant Cashier

ROBERT L. MILLER, Assistant Cashier

CHESTER D. PORTER, JR., Examining Officer

R. HENRY SMART, Examining Officer

ANDREW L. TILTON, Assistant Cashier

JACK H. WYATT, Assistant Cashier

G. HAROLD SNEAD, General Auditor

JOHN C. HORIGAN, Assistant General Auditor

BALTIMORE BRANCH

DONALD F. HAGNER, Vice President

A. A. STEWART, JR., Cashier

B. F. ARMSTRONG, Assistant Cashier

E. RIGGS JONES, JR., Assistant Cashier

GERALD L. WILSON, Assistant Cashier

CHARLOTTE BRANCH

EDMUND F. MAC DONALD, Vice President

STUART P. FISHBURNE, Vice President and Cashier

WINFRED W. KELLER, Assistant Cashier

FRED C. KRUEGER, JR., Assistant Cashier

E. CLINTON MONDY, Assistant Cashier

Directors (DECEMBER 31, 1966)

BALTIMORE BRANCH

JOSEPH B. BROWNE	President, Union Trust Company of Maryland Baltimore, Maryland (Term expires December 31, 1968)
E. WAYNE CORRIN	President, Consolidated Gas Supply Corporation Clarksburg, West Virginia (Term expires December 31, 1968)
LEONARD C. CREWE, JR.	Chairman of the Board, Maryland Specialty Wire, Inc. Cockeysville, Maryland (Term expires December 31, 1967)
ARNOLD J. KLEFF, JR.	Manager, American Smelting and Refining Company Baltimore, Maryland (Term expires December 31, 1969)
ADRIAN L. McCARDELL	President, First National Bank of Maryland Baltimore, Maryland (Term expires December 31, 1967)
MARTIN PIRIBEK	Executive Vice President, The First National Bank of Morgantown Morgantown, West Virginia (Term expires December 31, 1967)
JOHN P. SIPPEL	President, The Citizens National Bank Laurel, Maryland (Term expires December 31, 1969)

CHARLOTTE BRANCH

WALLACE W. BRAWLEY	President, National Bank of Commerce of Spartanburg (Organizing) Spartanburg, South Carolina (Term expires December 31, 1967)
C. C. CAMERON	Chairman of the Board, First Union National Bank of North Carolina Charlotte, North Carolina (Term expires December 31, 1967)
JOHN L. FRALEY	Executive Vice President, Carolina Freight Carriers Corporation Cherryville, North Carolina (Term expires December 31, 1968)
W. W. McEACHERN	Chairman and Chief Executive Officer, The South Carolina National Bank Greenville, South Carolina (Term expired December 31, 1966) Succeeded by: J. Willis Cantey President, The Citizens & Southern National Bank of South Carolina Columbia, South Carolina (Term expires December 31, 1969)
WILLIAM B. McGUIRE	President, Duke Power Company Charlotte, North Carolina (Term expires December 31, 1967)
JAMES A. MORRIS	Vice President, Division of Advanced Studies and Research, University of South Carolina Columbia, South Carolina (Term expires December 31, 1969)
G. HAROLD MYRICK	President and Trust Officer, First National Bank Lincolnton, North Carolina (Term expires December 31, 1968)