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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I welcome the opportunity of meeting with this Committee again to discuss some of the key economic problems facing the nation. We are, at long last, beginning to make some headway in dealing with a major economic problem that has plagued us for over 3 years--inflation. Progress has been slow, but that is understandable after so much inflationary momentum has been generated by the delay in getting the nation's finances in order. I am optimistic, however, that the forces of fiscal and monetary restraint set in motion last year will gradually bring us back to reasonable price stability.

Optimism about the ultimate success in containing inflationary pressures should not, however, blind us to the difficulty of the task in the months immediately ahead. We must deal with a heritage of cost and price increases that is continuing to generate further cost and price increases, and--importantly--has become deeply embedded in business and consumer expectations. After several years of rapidly rising prices, it is only natural that many spending decisions are motivated now by the fear that prices will be even higher next year, or by the conviction that inflation will bail out even the most marginal speculation. The price component of our national product has advanced with increasing rapidity, from an average increase of less than $1\frac{1}{2}$ per cent a year in the early 1960's, to 2 per cent in 1965, $2\frac{1}{2}$ per cent in 1966, 3 per cent in 1967, and close to 4 per cent last year. Public skepticism about the Government's ability to "do something" about prices has its roots in this history of ever-quickenening inflation.

This skepticism has been reinforced by the initially inauspicious results of fiscal restraint. The immediate response to enactment of the tax and expenditure control legislation last June was, admittedly, disappointing. For a month or two after withholding taxes were raised, consumers continued to increase their outlays at a rapid rate, drawing on their savings and borrowing heavily to finance both higher taxes and higher spending. The ebullient behavior of consumers infected the business community. With retail sales booming, business plans for adding to inventories and plant capacity were revised upward sharply, and in this heady atmosphere, cost increases were rapidly passed on in the form of higher prices. The pause in the spiral of prices last summer lasted only briefly; by early fall, the price indexes were headed up again at an accelerating pace.

Our foreign trade balance, too, has shown the effects of the last 4 years' spiraling rise in prices and costs in this country. In 1968, the U. S. merchandise trade surplus virtually disappeared. Exports increased fairly well, at least until the port shutdowns near the end of the year. But imports increased substantially, as aggregate demand in the United States expanded excessively and as our prices rose.

In retrospect, I believe that the Federal Reserve was overly hasty last summer in expecting an immediate impact from fiscal restraint. As the published record of Board and Federal Open Market Committee deliberations indicates, monetary policy moved promptly to an accommodative stance at mid-year, anticipating that an easing of demands and of financial market pressures would ensue with little delay after the

enactment of the fiscal restraint legislation. The easing in financial markets that did occur in early summer enabled the banking system to rebuild its liquidity rapidly. Inflows to banks of time and savings deposits, which had contracted during the spring, expanded rapidly during the summer, permitting a resurgence in bank credit expansion to finance both Federal and private borrowing. Federal Reserve open market operations provided the reserve base to support this expansion; while deposits expanded rapidly, banks were able to reduce their borrowings at the discount window.

The business statistics that emerged over the summer and early fall indicated far less of an impact of fiscal restraint on aggregate demands than had earlier been anticipated, and as the pace of inflation quickened, monetary policy moved back toward a posture of restraint. The intensification of this restraint has been gradual, rather than abrupt, in keeping with our assessment of the economy's needs over the longer term.

It takes some time for such a change in monetary policy to have its full effect on financial markets and financial flows, and as the policy is working through there are likely to be disparate movements in key financial indicators. Interest rates often tend to react most quickly, because they reflect market participants' assessment of the future of policy and its interactions with the economy.

The effects of policy changes on the general availability of money and credit, however, typically take more time to work through. The very flexibility that is a key attribute of our financial system

over the longer run allows some short run crosscurrents in financial flows to occur. At times of policy tightening, institutional lenders typically have some cushion of liquidity that they can utilize, at a cost, to maintain loans. Borrowers, too, have liquid resources at their disposal and can take advantage of past arrangements to command additional funds, at least for a time. Individual and business holdings of money balances are importantly influenced over the short run by such technical factors as fluctuating transfers in and out of U. S. Government deposits, as well as by the play of market uncertainties and pressures on investors' decisions, and by underlying forces stemming from changes in monetary policy.

Nonetheless, the effects of a policy of restraint becomes more and more evident as these liquidity cushions are worked off and the effects of temporary aberrations and transitional adjustments fade. As was pointed out in our staff's report on financial developments during the fourth quarter of 1968, submitted to this Committee earlier in the month, the developing monetary restraint last autumn was first indicated by a considerable slowing in the growth of the volume of reserves supplied to banks through open market operations. As a consequence, banks were forced to increase their borrowings from the Federal Reserve, and to bid more aggressively for certificates of deposit in order to maintain expansion in their loans and investments. Banks with branches abroad had to pay relatively high interest rates even to retain Euro-dollar deposits. With the passage of time, these adjustments of bank sources of funds had to be supplemented by modifications of bank

lending and investing policies; banks generally began to withdraw from active participation in the markets for U. S. and State and local Government securities, while also stiffening lending terms to businesses and consumers.

By late November and early December, the developing pressures on the banking system had pushed the effective offering rates on large negotiable time certificates of deposit to Regulation Q ceiling limits. Shortly thereafter, interest rates on competitive market instruments, such as on Treasury bills and commercial and finance company paper, moved above the Q ceilings.

The result has been a steady reduction in outstanding large-denomination time certificates of deposit at banks, particularly at large banks which account for the bulk of such deposits. From the first week in December through the first half of February, these deposits declined by almost \$4 billion, or about 15 per cent of the total outstanding. In addition, there has been a slowdown in net inflows of other time and savings deposits to banks during this period. Although banks with branches abroad built up Euro-dollar borrowings sharply in January, aided by a heavy outflow of funds from Germany, outstanding bank credit has, on balance, shown little growth over the past several weeks.

Under these conditions, banks have had to turn increasingly to liquidation of short-term securities to accommodate loan demands. They have also had to cut back sharply their net purchases of other securities. While the liquidity position of banks as a group is not

quite as strapped as it was in the spring of 1968, or in the fall of 1966, the ability and willingness of banks to help finance credit-based spending is clearly becoming more and more limited.

Outside the banking sector, evidences of the effect of monetary restraint are also becoming somewhat more widespread. Interest rates on high grade corporate and State and local Government bonds have edged up further from the advanced levels reached in December of last year. These high yield levels have been maintained even though the prospective volume of bond offerings has not tended to build up, and there is evidence that some potential borrowers have postponed bond issues in view of tight current market conditions.

In mortgage markets, interest rates rose during the fourth quarter of last year and have moved steadily higher in recent weeks. Demands for mortgage credit have remained strong while the availability of new funds has become increasingly constrained. Net inflows of savings to thrift institutions tapered off in December, as market interest rates rose further, and preliminary data suggest a further tapering in January. Net savings withdrawals at these institutions during the reinvestment period of late December and early January were somewhat larger than a year earlier, and it appears that the subsequent deposit build-up was less than usual.

Currently, the mortgage market does not seem to be quite as dependent on thrift institutions as in earlier years, nor do these institutions themselves seem to be quite as sensitive to monetary restraint as in, say, 1966. The existing structure of ceiling rates

on deposits at bank and thrift institutions has contributed to a more even-handed slowing of consumer deposit flows among the major savings institutions. Thus, monetary restraint has developed so far without an excessive burden falling on the homebuilding industry, although new supplies of funds for the housing market are becoming increasingly restricted.

Even while credit markets were in the process of tightening during the fourth quarter, expansion in the privately held money supply accelerated, to a $7\frac{1}{2}$ per cent annual rate. A principal cause was the larger than seasonal rundown in U. S. Treasury balances at commercial banks during the fall. A little later, around year-end, deposit balances were swollen by the combination of seasonal money market pressures, large year-end international and domestic flows of money, and market uncertainties about the intensity and course of monetary restraint. In the ensuing weeks of 1969, however, the money supply contracted, while U. S. Government deposits were being rebuilt more than seasonally.

In my judgment, monetary restraint is now fully reinforcing fiscal restraint. And fiscal restraint is becoming increasingly effective. In retrospect, it appears that while the Federal Reserve was overly optimistic in anticipating immediate benefits from fiscal restraint, the business community may have been overly hasty, last fall, in writing it off as a complete failure. For just about the time that business spending plans were being enlarged, consumers' spending enthusiasm began to wane. Retail sales reached a peak in August, but

have remained below that level since then. The consequence was a rapid rise in business inventories in the fourth quarter; for some types of merchandise, the build-up of stocks in distributors' hands became excessive before year-end, and production of these goods has begun to be curtailed. Moreover, the impetus provided to consumer incomes and business activity by rising Government spending also began to moderate after mid-year. In the second half of last year, the rate of Government purchasing of goods and services rose by less than \$2 billion, compared with a rise of \$6½ billion in the first half of the year.

Federal spending is scheduled to flatten out further during the winter and spring months, and the full impact on consumer spending of the higher taxes legislated last June is only now coming to be felt, as retroactive personal income tax payments are made to cover surcharge liabilities for the period before increased tax withholdings began. Over the next few months, therefore, the economy's advance should be at a more moderate pace, and that should provide a start on alleviating some of the demand pressures underlying the advance in price levels.

Expectations of inflation are deeply embedded, however, and speculative fervor is still strong. A slowing in expansion that is widely expected to be temporary is not likely to be enough to eradicate such expectations. The experience of early 1967 is a lesson in point. Moderation in economic activity at that time did indeed produce a significant slowing in the rate at which prices advanced. But the moderation was short-lived. As economic activity accelerated after mid-year, so did prices. The rate of increase in the GNP deflator, which had slowed to about 2 per cent by the spring of 1967, almost doubled by the end of that year.

The critical test for stabilization policies in 1969 will be their ability to keep such a rebound in activity and prices from developing. If we were to dissipate again the benefits derived from a reduction in excessive demands, the credibility--at home and abroad--of Government economic policies would be severely strained.

We have been fortunate this past year that the poor results in the U. S. trade balance have not damaged the international standing of the dollar. In fact, we had a surplus in the overall balance of payments, both on the so-called liquidity basis of calculation and as measured by official reserve transactions. The surplus was the result of favorable flows of capital: greatly enlarged foreign purchases of U. S. equities at the same time as foreigners were acquiring a substantial volume of securities that U. S. companies were issuing abroad in compliance with the compulsory direct investment controls; repayments by foreigners of U. S. bank loans, in accordance with the Federal Reserve voluntary foreign credit restraint program; and, large flows of foreign liquid funds out of other currencies into the Euro-dollar market where they were borrowed by U. S. banks.

This year a slowing of the excessive expansion of domestic demand should bring with it a slowing in the growth of U. S. imports, and an improvement in the trade balance. On the other hand, capital flows are not likely to be as favorable as in 1968, even with relatively taut credit conditions here.

The problems of restoring international payments equilibrium are truly international problems. It has been recognized more and more widely that better international balance requires positive actions by

countries in surplus as well as by those in deficit. For our part, whatever else we or any other country may be doing, one absolute essential is to check the inflation in this country and to make a start in restoring a healthy and lasting surplus in our trade with the rest of the world.

Much of the burden of accomplishing the containment of domestic demand pressures this year will rest on monetary policy, for even with continuation of the 10 per cent surcharge into fiscal year 1970, fiscal policy is scheduled to become less restrictive after mid-year. Completion of the retroactive tax payments on 1968 liabilities, the increase in pay scheduled for Federal workers, and the rise indicated in the January Budget for other Federal expenditure programs will reduce the Budget surplus substantially in the second half of the year, and at the same time increase the flow of incomes available for spending. A sharp upturn in consumer spending would be likely to rekindle business incentives to acquire additional inventories and to add further to plant capacity. With pressures for additional housing still strong, and the spending requirements of State and local Governments continuing to mount, the stage would be set for a strong resurgence in overall demand.

Whether such a surge in demand will in fact occur cannot be predicted with any assurance, but it would be foolhardy to increase the risk by adding the fuel of easy credit. In the hope that it will be useful to your Committee, I am attaching to my statement a projection, prepared by the Board's staff, of the monetary and credit conditions

that would be consistent with progress toward achieving the objective of reducing inflationary pressures. The progress envisioned would necessarily be gradual, for an effort to "disinflation" abruptly, after so extended a period of cumulating inflationary pressures, would risk wrenching the economy sharply, with major dislocations in employment and in the structure of production. The state of the economic art does not, of course, permit precision--or too much confidence--in such projection exercises, but they are useful in describing the general financial environment that would be appropriate in light of prospective private and public resource demands.

As I noted in my opening remarks, I am optimistic about the prospects for gradual success of the stabilization policies now in force, if we have the fortitude and patience to give them time to work. It is essential for us to do so; at stake is not only the opportunity of restoring a stronger base for equilibrium in our international payments situation, but also of restoring a sound base for continued domestic growth.

Attachment.

**STAFF PROJECTION OF ECONOMIC AND
FINANCIAL DEVELOPMENTS IN 1969**

February 25, 1969

**Division of Research and Statistics
Division of International Finance**

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Board of Governors of the Federal Reserve System

Economic Background

A moderation in the pace of economic expansion began to be evident late in 1968, and has continued into 1969, largely as a result of the fiscal restraint measures adopted in the middle of last year. In real terms, economic growth diminished to less than a 4 per cent annual rate in the fourth quarter, compared with 5 per cent in the third and 6 per cent or more in the first half. In current dollars the diminution in the growth rate of Gross National Product was not as large, however, as average prices rose somewhat faster late in the year.

The slower pace of economic expansion late in 1968 was accompanied by a change in the structure of GNP growth. The rise in final sales (GNP expenditures other than for inventories) dropped from an annual rate of 10 per cent in the third quarter to just over 6 per cent in the fourth, and inventory investment contributed substantially more to the GNP increase in the 4th quarter than in the third.

In retrospect, it appears that failure of the economy to respond more promptly to the enactment of the Revenue and Expenditure Control Act reflected a temporary willingness of consumers to maintain unusually high rates of spending in the face of markedly reduced growth of disposable income during the summer. As a consequence, while the effects of cutbacks in some categories of Federal expenditures

began to be felt shortly after midyear, the effect of the tax increase was blunted by one of the sharpest quarterly increases of recent years in consumer spending relative to disposable income. Total consumer purchases in the third quarter rose at a 10 per cent annual rate, and this spurt appears to have been a significant factor in the subsequent upward revision of planned expenditures by business for plant capacity and inventories.

It is now clear that the rate of growth in consumer spending in the fourth quarter dropped abruptly to just over a 4 per cent annual rate. Retail sales, in fact, began to drift downward after reaching a peak in August of last year. January sales picked up from the sluggish December pace, but not quite enough to regain the November level. Among the major elements of consumer spending, unit auto purchases have shown the most significant weakness, with the annual sales rate for domestically produced cars, including Canadian imports, dropping from a high of 9 million units in October to about 8-1/4 million in January. Moreover, sales of nondurable goods have also eased somewhat since last August.

Business investment in inventories, however, advanced considerably in the fourth quarter, to a \$10-1/2 billion annual rate, partly reflecting this distinct slowdown in the growth of consumer purchases. There is no clear evidence that businesses, in the aggregate, regard themselves as heavily burdened with excessive stocks. But it does appear that some downward adjustments have

occurred in production schedules for autos and other consumer lines in response to recent inventory-sales developments.

An economic projection for 1969 must take into account, therefore, the increasing evidence that fiscal restraint is working, though with a somewhat longer lag than the Board staff and most economists elsewhere had assumed. Moreover, the pressure of fiscal restraint will be intensified in the period just ahead. Federal purchases of goods and services are projected in the January Budget document to show no further advance in the first half of this calendar year, and the total of all Federal expenditures included in the national income accounts should register only very modest increases during this period. Federal receipts, meanwhile, will be increased sharply further by the rise in social security taxes in the first quarter and by retroactive payments on 1968 income tax liabilities in both the first and second quarters. The Federal budget on a national income accounts basis will thus be moving to a significant surplus in the months immediately ahead.

With Federal purchases leveling out and the growth of disposable income and consumer spending tempered by increased tax payments, a further slowing in the overall pace of economic expansion seems highly probable in the first half of 1969. The rate of business inventory accumulation may well taper off in the months ahead. Some recovery in consumer spending from the sluggish pace of the fourth

quarter is to be expected, and the momentum of rising housing starts and increasing business expenditures for plant and equipment during the last half of 1968 is likely to carry forward into the opening months of this year. But our assessment of the economic climate on which our staff projection for 1969 is based starts with the premise that the fiscal restraints adopted last summer are working and, together with the intensification of monetary restraint since last fall, will slow the pace of expansion further in the first half of this year.

A second major element of the economic environment to be taken into account in developing a projection for 1969 is the climate of inflationary expectations that has developed over the past 3-1/2 years. This long period of predominantly overheated conditions has quite clearly begun to affect private spending decisions. Since about the middle of last year, for example, plans for business fixed investment have strengthened measurably, despite relatively low rates of capacity utilization in manufacturing, as businesses have sought to find ways to hold down the pressure of rising costs on prices and profits. Housing starts, especially multi-family units, have also shown exceptional buoyancy. Interest rates as high as 7 per cent and over have not been enough to cause deferral of investment intentions in the climate of strongly inflationary expectations that has prevailed.

Excess demand in the domestic economy during this period has also spilled over into world markets. U.S. imports have risen very rapidly, and our trade surplus last year almost disappeared. Thus, balance of payments considerations reinforce the need to persevere with policies to combat domestic inflation.

As noted earlier, the expectation of a slowdown in the domestic economy during the current half year is predicated mainly on the belief that fiscal measures already adopted will become increasingly effective in restraining spending. After midyear, Federal expenditures--assuming they follow the path laid out in the January Budget--will be rising more briskly, and the completion of retroactive tax payments by individuals will give rise to more rapid growth in disposable income. Fiscal policy will become less restrictive in the second half of 1969, therefore, even if the tax surcharge is extended. The strength in markets for goods and services that could result, in an atmosphere of protracted inflation, could touch off a new spurt of business and consumer spending, with its inevitable effects on prices and costs. Should the surcharge be allowed to lapse, inflationary pressures could break out even more strongly in the latter half of this year.

Policy Assumptions

It would seem apparent that the principal task of stabilization policies this year will be to ensure that significant progress is made in curbing the rate of inflation in the domestic economy, and that the initial steps are taken towards restoration of our traditional trade surplus. It will be especially important, if these results are to be accomplished, to adopt policies that prevent resumption of an excessively rapid pace of spending in the second half of the year, following the slower pace of advance expected in the first six months.

In our projection, therefore, we assume the surcharge will be extended, as recommended in the January Budget document, since without that extension the prospects of cooling off the economy appear dim indeed. We are also assuming that the projected pattern of Federal expenditures outlined in the January Budget will be realized. Of course, unforeseen developments in Vietnam or elsewhere could alter the outlook for defense spending radically, and stabilization policies will have to stand ready to alter course with any marked change in those outlays.

The projections also assume a monetary policy of substantial-- but not severe--restraint, dictated by the need for a steady pressure of stabilization policies to contain the strong inflationary pressures in the economy. The shift toward greater monetary restraint initiated

last fall has already begun to have noticeable effects in financial markets. Growth rates of money and bank credit have declined from the rapid pace of the second half of 1968, while interest rates have risen well above their average 4th quarter levels. As the year progresses, credit restraint should become increasingly effective in moderating the pace of private spending.

The staff projection assumes that the growth rate of bank credit will be reduced from the 11 per cent rate of 1968 to a rate in the range of 4 to 7 per cent in 1969. The decline in credit expansion rates would reflect reduced growth in bank deposits, particularly a turnaround in large-denomination negotiable CD's, from a rapid expansion during 1968 to significant reduction in 1969. A decline in the growth rate of the narrowly-defined money stock (currency plus demand deposits) should also occur, in the financial market conditions arising from bank credit expansion at such a rate and the projected slower growth in GNP. We project a reduction in the growth rate of the money stock from the 6-1/2 per cent rate of 1968 to a rate in the range of 3 to 6 per cent during 1969. The stance of policy assumed implies a somewhat higher growth rate of bank credit (on an end-of-month basis) than that which occurred in January and currently seems in prospect for February.

GNP Projection

Based on these fiscal and monetary policy assumptions, as Table 1 indicates, current dollar GNP for the year as a whole is projected to be in a range of \$918 billion to \$920 billion, which would mean an increase from 1968 of about \$60 billion, or a little less, compared with a gain of \$71 billion from 1967 to 1968.

Following the moderation that began in the latter half of last year, the reduced growth rate foreseen in this projection should be increasingly apparent in the first half of 1969. The most important factors in the anticipated cooling off during the first half are an expected leveling out and then a decline in inventory accumulation, and a marked shift of the Federal Budget into substantial surplus. Final sales during the first half of the year should continue to expand at about the reduced \$14 billion rate of the fourth quarter of 1968, reflecting some increase in the growth of consumer spending from the exceptionally low fourth-quarter rate, continued though diminishing strength in business investment, and a topping out of housing starts in the first quarter. Real growth in the economy during the first six months is expected to drop a little more sharply than dollar expenditures, given the prospects for continued sizable price increases, and might average near a 2 per cent annual growth rate if our current dollar GNP projection is realized.

For the last half of the year, the course of GNP depends importantly on the assumption of continuing and increasingly effective monetary restraint. Although fiscal policy is scheduled

in the Budget to become more stimulative around mid-year--even with continuation of the surcharge--we believe that quarterly GNP increases in current dollars during the second half might be held down to an average only a little higher than projected for the first half, given sufficient monetary restraint and continuation of the surcharge. Real growth in GNP also would be a little larger in the second half, as inflationary pressures diminish.

Federal Budget Outlook

The surplus in the Federal Budget, as measured in the national income accounts, should reach an annual rate of around \$6 billion during the first half of 1969. But as expenditures increase and receipts level out after mid-year, this surplus may well disappear. Thus, the surplus for the calendar year as a whole is projected at around \$2 billion to \$3 billion.

A significant part of the projected growth of Federal expenditures is due to the rise in military and civilian pay on July 1, with the net increase estimated at \$2.8 billion (annual rate). The January Budget calls for defense outlays, excluding the pay raise, to continue on a plateau, with reductions in Vietnam spending offset by increases on other military programs. Nondefense expenditures are scheduled in the Budget to rise somewhat in the last half of the year.

In contrast to the somewhat faster rise in Federal expenditures after mid-year, receipts are likely to rise sharply in the first half and then stay on a plateau during the last half, even though

the surcharge is maintained. This reflects the completion of retroactive tax payments, together with the effect on tax receipts of the projected slowdown in the growth of personal income and some weakness in corporate profits.

Disposable Income and Consumer Spending

The impact of the surtax on disposable income was appreciable in the last half of 1968, and gains in after-tax income should continue to be limited in the first half of this year as a result of the retroactive portion of the higher tax payments and the anticipated slowing in economic expansion. Therefore, we expect that growth in consumer expenditures will continue relatively moderate, despite the prospect of some acceleration from the small rise of \$6 billion in the fourth quarter of 1968. Such an acceleration would require a decline in the rate of personal savings during the first half. That pattern does not seem unreasonable, assuming that the fourth quarter rise in the saving rate was due in part to special factors--such as the flu epidemic--and given the fact that the saving rate typically falls when a temporary slowdown occurs in the growth of disposable income.

In the second half of 1969, faster expansion in disposable income could again provide the potential for a renewed strong consumer buying. At that time, too, the effects in consumer markets of an abrupt change in income growth should be cushioned to a degree by a change in the saving rate. To hold expansion within bounds, however, we are depending importantly on continuation of the tax surcharge and the success of restrictive monetary policy in altering business

expectations and spending decisions. If this restraint can be accomplished, slower growth of nonconsumption demands should act to offset the latent strength in consumer markets and to dampen aggregate demands.

Housing

Higher mortgage interest rates, a slackening in the flow of loanable funds through banks and other depository institutions, and an anticipated curtailment in the volume of new mortgage commitments should limit housing starts this year. The drop in starts in December was followed by a large rise in January, as this series continues to display large erratic movements. As the year progresses, however, we expect the policies of monetary restraint in train since late last year to begin registering their effects on housing starts and residential construction expenditures. By the second half, the annual rate of housing starts may drop somewhat from recent high levels, but the monetary policy assumptions underlying the projection suggest a much more moderate decline than in 1966, when the financial crunch reduced housing starts by a third. For the year as a whole, therefore, housing starts are projected to average around 1.5 million units, and the dollar volume of residential construction is expected to register a small rise from the 1968 level.

Business Investment

The current surge of investment in plant and equipment in the face of a relatively low rate of capacity utilization would appear to reflect considerable business optimism about the course of the

economy in the near term. Expectations of future growth in sales, a concern about rapidly rising prices and the need to offset some of the increasing pressures from labor costs are likely to produce a continued uptrend in investment outlays. Considerable business optimism also is reflected in recent surveys of business plans to spend for new plant and equipment. Quarterly increases in business fixed investment are therefore expected to average somewhere around \$2 billion during the first half--and would be larger but for an anticipated sharp decline in commercial construction and in investment by aircraft manufacturers. However, once manufacturing production begins to level off, declining capacity utilization rates and lower profit margins--together with credit restraint--should tend to dampen optimism. Although plant and equipment expenditures are projected to rise by roughly 10 per cent for the year as a whole, we anticipate a marked slowing in these expenditures as the year progresses, with little further dollar growth--and perhaps some decline in real terms--after midyear.

The staff's projection also takes an optimistic view about the prospects for cooling off investment in inventories, given our assumption that final demands will be held in check. Some dampening influence should result from the imbalances which already have developed between output and consumption. Exactly when the accumulation of stocks will begin to outrun businessmen's confidence in the prospects for higher sales and prices is problematical. By early

spring, however, we think that downward production adjustments to temper the inventory buildup should become more general, so that, on average, the rate of inventory investment would decline in the first half. If growth in final demands is kept to a moderate pace in the second half, the rate of inventory accumulation may decline somewhat further, especially in view of the greater cost and difficulty of holding large stocks when funds are tight.

Resource Utilization

If growth of real output moderates in line with the projection to a range of 2 to 3 per cent in 1969, pressures on both physical and manpower resources should gradually abate. As Table 2 shows, the rate of capacity utilization in manufacturing is expected to fall from 84.5 per cent in 1968 to a range around 82 per cent in 1969, reflecting both the slowing of growth in industrial production and continuing large additions to manufacturing capacity. At the same time, employment gains are likely to fall short of prospective net additions to the labor force. The adjustment is expected to occur mainly in manufacturing, where cutbacks in the length of the work-week may be followed by effects on employment once it becomes clear that prospects for further growth in product demand are less ebullient. The uptrend in employment in nonindustrial sectors will undoubtedly continue, but probably at a slower pace than in the last several years. As a result, the unemployment rate is projected to rise somewhat from

the exceptionally low rate of 3.3 per cent in recent months, but the average is projected to stay under 4 per cent for the year as a whole.

Upward pressures on wage levels should abate somewhat in 1969 if the GNP projection is realized. Key factors here include a sharp reduction in the number of workers covered under collective bargaining agreements up for renegotiation this year, the smaller second- and third-year wage increases under earlier settlements, and the smaller and less pervasive increase in the minimum wage scheduled for this year. However, the effect on costs is likely to be offset in large part by a slowing in productivity gains as the rise in output moderates. As a consequence, the increase in unit labor costs could continue at close to the recent 4 per cent rate during the first half of 1969, and then edge down somewhat in the latter months of the year.

Prices

With labor and other costs continuing to climb and business demands very strong, industrial prices recently have been moving up at a very fast pace. But if the slowing in growth in the economy indicated in our projections is achieved, the rise in industrial prices should moderate, especially in the latter part of the year after upward wage pressures ease and business expectations and spending plans have lost their steam. The sharp consumer price gains witnessed during most of last year also seem likely to moderate in 1969. Prospects are for some slowing in consumer products prices

in response to smaller increases in industrial prices, although service prices seem certain to continue climbing at a fast pace--perhaps around a 6 per cent annual rate--for some time to come.

On balance, if we can continue to make headway in avoiding excessive rates of expansion in GNP, the rise in average prices should diminish as the year progresses. The projection implies a steady downward drift in the GNP implicit price deflator, adjusted for the third quarter Federal pay raise, towards something around a 3 per cent annual rate of increase in the closing months of 1969.

Financial Projection

The GNP projection just described, together with the assumptions about fiscal and monetary policies on which it rests, imply a significant reduction in the rate of total credit expansion this year, with the total volume of funds raised declining from about \$100 billion in 1968 to a range of \$75 to \$80 billion in 1969, as Table 3 indicates. We are in the process of experiencing a substantial swing in Federal borrowing requirements, from an annual borrowing rate of over \$15 billion in the last half of '68 to debt repayment at around a \$2 billion annual rate this half year. Federal borrowing--measured to include the borrowing of Federal agencies as well as the Treasury--should pick up again in the second half, however, to register an annual total in the \$2 billion to \$3 billion range, substantially less than in 1968.

Private Borrowing

Borrowing by the private domestic nonfinancial sectors (business, consumers, and State and local governments) is also expected to recede a little in 1969. This is a reflection partly of the assumed effects of monetary restraint in reducing the degree to which expenditures are financed by credit, but the projected slower pace of economic activity resulting from both monetary and fiscal restraints will also help to reduce private credit expansion.

The projected effects of monetary restraint on private credit expansion are perhaps best illustrated by considering the volume of borrowing by consumers and businesses, and the relation of borrowing to projected net investment in these two sectors (shown at the bottom of Table 3). Total borrowing by these two sectors together is projected to decline in 1969, despite continued high demands for credit. For example, even though the rate of inventory investment is projected to drop, business needs for external financing will be sustained in the first half by large tax payments and further growth in plant outlays, at a time when profits are projected to be squeezed.

But the very essence of monetary restraint is to prevent some credit demands from being satisfied. Given the degree of restraint assumed, businesses and consumers should have to dig further into their liquid assets to realize spending plans, and--more importantly--to trim

these plans in areas heavily dependent on credit availability.

The ratio of borrowing to net investment is projected to fall below 90 per cent, compared with 96 per cent for 1968.

Bank Credit Expansion

This decline in private credit expansion, like the maintenance of a more moderate pace of GNP growth during the latter half of 1969, is predicated on the assumption that monetary restraint is maintained during most of 1969. Based on our judgments of the relations between financial variables and rates of GNP expenditure, we believe the GNP projection--and its financial counterpart in terms of total funds raised--could be realized if bank credit growth were limited to an annual rate in the 4 to 7 per cent range. At this projected growth rate, the banking system would be supplying from about one-fifth to about one-third of total funds raised during 1969, compared with two-fifths or more during each of the past two years.

Time and Savings Deposits

In the banking system, the effect of restraint on the growth of deposits seems to us likely to show up mainly in time and savings accounts, rather than in demand balances and the money stock, as Table 4 indicates. Much of the expected reduction in growth rates of time deposits relates to the projected outlook for large-denomination negotiable CD's. The rise in rates of interest on competing short-term money market instruments late last year, together with the existing Regulation Q ceiling rates that banks may offer to attract time deposits,

have made it very difficult for banks to roll over maturing CD's since early December 1968. Consequently, the total volume of large CD's issued began to decline after mid-December, and fell \$2.3 billion in the first six weeks of the year.

Our projection assumes that monetary conditions will remain taut enough to keep large banks under pressure in the CD market. It also assumes, however, that attrition of CD's will diminish from the very high rates of January and February; rates of decline that large would not be consistent with growth rates of bank credit in the 4 to 7 per cent range projected for the year as a whole.

The projection also implies some reduction in growth rates of time and savings deposits held by households. Given prospective interest rate relationships, we are projecting that households will divert a larger share of their savings flows into market securities. The annual growth rate of household time and savings deposits at commercial banks is projected to decline to a range of about 8 to 10 per cent--less than the rate in the latter half of 1968.

Nonbank Savings Accounts

This divergence of household savings flows from depository claims to market securities is likely to affect nonbank intermediaries also. Inflows to these institutions were curbed in December and January, and we project them to stay at a reduced pace of about 5 per cent, only a little above the amounts that would result from interest crediting. The reduction in flows projected, however, is much less severe than in 1966.

Money Stock

We do expect that, in addition to affecting time and savings deposits at banks and nonbank intermediaries, the tighter monetary conditions assumed in this projection will produce some slowing in the rate of expansion of the narrowly defined money stock (currency and demand deposits). Interest rates are high enough now to induce some further economization of cash; additionally, the moderation of GNP growth is projected to hold down the rise in transactions demand for money. The overall monetary policy projected seems consistent with an annual rate of expansion in the money stock in the 3 to 6 per cent range.

Effects on Credit Markets

At the reduced growth rates of deposits projected, both banks and nonbank intermediaries will find themselves under pressure to reduce the availability of credit to private borrowers.

This restraint on funds flowing through the major depository institutions is the principal factor underlying the projected decline in the rate of private credit expansion relative to spending mentioned earlier, and the trimming of expenditures on goods and services that is essential to moderate the rate of expansion in GNP during the second half.

While some of the impact of reduced credit availability will inevitably be felt by the mortgage market, and consequently by the residential building sector, other markets for loanable funds would also likely be affected by the restrictive credit policy assumed

here. With limited supplies of funds available because of the reduced rate of growth in their time and savings deposits, banks would presumably cut back on new investment in municipal securities; last year they took roughly 80 per cent of the net increase in such debt. The projected diversion of household savings flows into market securities will help to fill the gap left by the banking system's reduced purchases, but we also are projecting some moderation in the total of new issues during 1969, in response to the reduced availability of funds. More importantly, the posture of monetary policy assumed in this projection implies that banks will have to intensify significantly further their rationing of credit to businesses and other customers as the year proceeds. This is expected to impel businesses to turn increasingly to market financing, and we are projecting a rise in corporate security issues to about one-fifth to one-fourth above the 1968 level. Such an increase in the supply of new issues would presumably raise the cost of capital financing to large businesses which, together with the intensified rationing by banks, would help to moderate the course of business spending for fixed investment and inventories.

Balance of Payments

The gradual cooling off of demand pressures projected for the domestic economy should have helpful implications for the external balance of payments, since it would be accompanied by changes in the structure of receipts and payments in the right direction for

getting nearer to a sustainable equilibrium. Last year some of the capital inflows that contributed to our overall balance-of-payments surplus were clearly at unsustainable rates. While net capital inflows in the year ahead will probably not be as large as last year's, the slowdown in the pace of domestic expansion should bring some improvement in the goods and services account.

Statistical indexes of export unit values for the United States, Germany, and Japan clearly illustrate the need for a persistent effort to check the deterioration that has been going on since 1965 in our costs and prices compared with those of some of our dynamic rivals in world trade. But positive benefits for the balance of trade from improvement in price relationships cannot be quickly achieved. The significance for the 1969 balance of payments of the assumption of a gradual slowing of price inflation lies mainly in the assurance it provides against a further worsening of the trade balance and against any general weakening of confidence in the dollar as a key currency and reserve currency.

Improvement in the trade balance in 1969 would result from continuing export expansion and a slowing of the rise in U.S. demand for imports. On the export side, it seems likely that continental European economic activity will continue to rise strongly this year, so that growth of world demand may bring an advance in the value of U.S. merchandise exports by 9 or 10 per cent (\$3 billion annual rate in round terms). Over the past several years U.S. nonagricultural exports have risen about in line with total world exports of manufacturers,

and our percentage share has not changed significantly. This performance is creditable so far as it goes, though in the light of apparent U.S. propensities to import goods and invest abroad it seems to be inadequate.

While the strongly rising trend in U.S. imports--a major element in the world payments disequilibrium--cannot be quickly modified by cost and price developments, last year's import swing above trend should be followed by a dip below trend this year, as happened in the first three quarters of 1967 when growth of domestic demand slowed that year. The rise in merchandise imports in 1969 will probably be somewhat more than \$1 billion. Taking exports and imports together, the merchandise trade surplus for the year 1969 might approach \$2 billion, compared with about \$100 million last year.

When we add in flows of services, investment income, and military expenditures abroad, net exports of goods and services may be around \$4 billion this year, about double last year's net exports. While growth in payments for transportation may be below normal in a year of slow import expansion, and while a renewed acceleration in receipts from foreign travel in the United States may occur, these and other services will not contribute much on balance to the improvement. Interest payments to foreigners will be larger, offsetting much of the gain in investment income receipts. As for military expenditures abroad, they are projected as leveling off now, and then dipping slightly later this year, but on the other side of the account military export sales also are passing their peak.

Outflows of U.S. private capital last year were apparently near \$5 billion, including the investment abroad of funds obtained through long-term borrowings abroad by U.S.-based companies. The net outflow of U.S. funds after deducting such borrowings was perhaps not much over \$2 billion in 1968. This net outflow is projected to be greater in 1969, despite the assumed continuance of credit restraint in the United States and the probability that financial conditions abroad will not restrict seriously the ability of U.S. businesses to sell securities abroad or to obtain credit from banks in Europe. The main reason for expecting a larger net outflow is that last year's heavy borrowings abroad by U.S. companies built up a large target leeway under the direct investment controls, and it is assumed that some of this leeway will now be used. Furthermore, there will probably not be the net reflow of bank credit we saw in 1968.

We assume, however, that the domestic credit restraint that is needed to bring inflation under control will help to prevent a resumption of the trends shown in earlier years toward much greater outflows of U.S. private capital. For example, corporations will still be encouraged to do some borrowing abroad.

For foreign private capital, exclusive of the flow of liquid funds to the United States through commercial banks abroad, the inflow last year apparently amounted to about \$6 billion if bond issues sold in Europe and bank loans obtained in Europe by U.S. companies for direct investment financing are included, and about \$3-1/2 billion if these are netted out against U.S. capital outflows. In 1969 the

corresponding net inflow could be smaller, but any projection would be subject to much uncertainty. While inflows are influenced by relative financial market conditions, they also depend very heavily on factors other than interest rates. First, over \$2 billion of last year's inflow was to acquire U.S. stocks and to make direct investments here. A large inflow into U.S. equities is expected again in 1969, but its magnitude is uncertain. Second, something like \$1 billion of last year's private capital inflow was apparently in such miscellaneous accounts as commercial credit, advance payments for aircraft, and foreign working balances in the United States.

After taking account of transactions in goods and services, Government loans and grants, other unilateral transfers, and all private capital flows other than flows of liquid funds to the United States through commercial banks abroad, there was a negative balance last year of somewhat under \$2 billion. That was more than covered by about \$3-1/2 billion of liquid funds from U.S. bank branches and other commercial banks abroad, so that on the official settlements basis the balance of payments showed a surplus of \$1.7 billion.

It is difficult to foresee at present whether the adverse balance in the accounts mentioned above will be larger or smaller than \$2 billion in 1969. The projected improvement on current account would make it smaller, while the probable shifts in flows of private capital (apart from liquid funds through banks) would make it larger.

But in any event the inflow of funds through U.S. bank branches and foreign banks is not likely to be as large as last year's \$3-1/2 billion, in view of the very high interest rates U.S. banks are now having to pay to attract fresh funds into the Euro-dollar market out of assets in other currencies. Thus a surplus on the official settlements basis is rather unlikely in 1969. It is quite possible, however, that the over-all deficit to be settled by using U.S. reserve assets or by increasing U.S. liabilities to foreign monetary authorities may be small.

Given the assumptions we are making about the U.S. economy and conditions abroad, the U.S. balance of payments in 1969 is not likely to give rise to acute difficulties. As noted earlier, the prospective improvement in the goods and services account is a change in the right direction. But we have a long way to go, since this year our net exports get the benefit of a favorable cyclical conjuncture here and abroad; because capital controls, hoped to be temporary, are still in force; and because interest rate relationships are more favorable now for the U.S. balance of payments than they may become later.

Policy Problems in 1969

From a purely technical viewpoint, the monetary policy assumed in this projection could be difficult to achieve. The projection of bank deposit and credit growth depends importantly on the maintenance of the appropriate degree of restraint exerted

on the larger banks in the banking system, a restraint consistent with a continued gradual decline in outstanding CD's as 1969 progresses, but at a rate more moderate than the steep descent of January and early February. This will not be easy to accomplish. The response of banks and potential holders of CD's to fluctuations in the spread between market rates and CD ceilings is neither smooth nor easily predictable; at times a shade of difference can trigger large inflows to or outflows from banks. It may be necessary to vary the intensity of restraint on bank reserve positions from time to time in order to keep the degree of tautness needed, if this projection is to be realized.

Given the high degree of sensitivity that exists among banks and depositors to changing differential rates of return on market securities and bank deposits, there may well be periods of time in which actual rates of growth of bank credit, time deposits, and the money stock are outside their projected ranges. Nonetheless, if the general direction of policy is maintained along the course outlined, its effect should be increasingly observed in all credit markets.

The more important substantive issue to which we must be alert in 1969 is the possibility that the course of credit restraint projected here, even if realized, may not produce the GNP expenditure patterns that we presently are projecting. The relationships between financial variables and GNP expenditures are not fixed; our

economic and financial history indicates very clearly that there are wide variations in relative rates of growth of GNP and money or bank credit, and in the relationship of GNP expenditures to interest rates. Our judgmental projections could well have overestimated the potency of monetary factors in slowing down the rate of expansion in GNP--especially at the present time, when inflationary expectations are strong. On the other hand, the course of monetary policy assumed here could entail greater effects on GNP growth than envisaged in the staff projection. Monetary policy must remain flexible, and policy makers alert to the actual course of developments as the year progresses.

Finally, it seems appropriate to note that the staff GNP projection, if realized, would result in economic conditions that are still a long way from being fully satisfactory. For example, it seems quite clear that we cannot, and should not, hope to restore fully our traditional trade surplus in one year. The costs both at home and abroad of such an abrupt change in our international trade position would be too great. Also, price inflation seems likely to plague us for quite some time, even if the real economic growth rate is reduced during 1969 in line with the projection, and some slack begins to develop in markets for resources. Yet, the declining rates of resource utilization projected for 1969 are evidence that even this modest step in the movement toward a noninflationary economy will not be without its costs. The momentum of inflationary pressures is so great that efforts to accomplish a more rapid return to reasonable

price stability could result in a much heavier toll in real output and employment. The gradual cooling off of demand pressures embodied in the projection, however, is an essential first step in the longer-term task of halting inflation and assuring a sustainable rate of economic expansion.

Table 1

1969 PROJECTION OF GNP AND RELATED ITEMS
(Billions of Dollars)

	<u>Annual Totals</u>		<u>Annual Changes</u>	
	<u>1968</u>	<u>Projected 1969</u>	<u>1968</u>	<u>Projected 1969</u>
GNP, Current \$	860.6	910-920	70.9	58-60
Personal Cons. Exp.	533.8	567-569	41.6	33-35
Gross Private Domestic Investment	127.7	135-137	13.4	7-9
Res. Construction	29.9	30-32	5.3	1-2
Business Fixed Inv.	90.0	98-100	6.4	8-10
Inventories	7.7	5-7	1.6	(-)3 to (-)1
Net Exports	2.0	3.5-4.5	(-)2.8	1-2
Gov't Purchases	197.2	210-212	18.8	13-15
Federal	100.0	103	9.4	3
State & Local	97.2	107-109	9.4	10-12
Personal Income	685.8	735-737	57.0	49-51
Disposable Pers. Inc.	589.0	622-624	42.7	33-35
Corporate Profits Before Tax	92.3*	89-92	10.7*	(-)3 to 0
Total Federal Exp., NIA Basis	182.2	192	18.6	10
Total Federal Receipts, NIA Basis	176.9	194-195	25.7	17-18
Surplus (+) or Deficit (-)	(-)5.3	2-3	7.1	7-8

* Based on an estimate for the fourth quarter of 1968.

Table 2

REAL GROWTH, RESOURCE USE, AND PRICES

	<u>1968</u>	<u>Projected 1969</u>
Percentage Growth of GNP in Constant (1958) Dollars	5.0	2 - 3
GNP Implicit Price Deflator, Annual Percentage Change	3.8	3.1 - 3.5*
Total Labor Force	82.3	83.5 - 84.0
Armed Forces	3.5	3.5
Civilian Labor Force	78.7	80 - 80.5
Unemployment Rate	3.6	3.8 - 4.0
Capacity Utilization in Manufacturing	84.5	81.5 - 82.5

* Excluding effects of the Federal pay raise in the third quarter.

Table 3

FUNDS RAISED IN CREDIT MARKETS
(Billions of dollars)

	<u>1968</u>	<u>Projected 1969</u>
Total, All Nonfinancial Borrowers	97.5	75 to 80
Federal Government*	16.9	3 to 4
Foreign Borrowers	3.0	2 to 3
Private Domestic Non-financial sectors	77.7	70 to 75
Loans	29.7	24 to 27
Consumer Credit	11.0	6 to 8
Bank Loans	12.7	9 to 12
Other Loans	6.0	7 to 9
Securities	22.7	23 to 26
State & Local	10.0	8 to 10
Corporate	12.7	15 to 17
Mortgages	25.3	22 to 24
Consumer & Business Borrowing Included in Private Domestic Nonfinancial Sectors		
Total	67.4	62 to 65
Per cent of Net Investment	96.0(%)	86 to 90(%)

* Includes agency issues and participation certificates. Home Loan Banks, Land banks, and FNMA are consolidated with other government agencies in this table, which departs in this respect from new budget concepts. Table includes net issues by these agencies but excludes interagency transactions.

Table 4

BANKING AND MONETARY VARIABLES
ANNUAL PERCENTAGE RATES OF CHANGE

	<u>1968</u>	<u>Projected 1969</u>
Total Reserves*	7.2	3 - 5
Money Supply	6.5	3 - 6
Currency	7.4	5 - 6
Demand Deposits	6.2	3 - 6
Time Deposits at Commercial Banks	11.3	1 - 5
Total Bank Credit	11.0	4 - 7
Nonbank Savings Accounts	6.4	4.5 - 5.5

* Adjusted for reserve requirement changes.

NOTE: Data for reserves, money supply and time deposits at commercial banks are on a daily average basis. Bank credit and nonbank savings accounts are on an end-of-month basis.