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The Business Situation

Business activity continues to expand and price pressures remain strong as the economy moves into late summer. Although the recent rate of the expansion has been less hectic than in the dangerously overexuberant first quarter, there are indications that activity may quicken in the second half of the year, intensifying the strains on the economy's productive resources. Thus, consumer spending over the balance of the year should be strengthened by Federal pay increases and by the beginning of Medicare payments, both of which became effective July 1. Moreover, capital spending by business could accelerate relative to the second-quarter rate of advance, unless strikes continue to hamper construction activity, as was apparently the case in the April-June period. Finally, spending at both the state and local and the Federal levels appears to be headed up strongly over the balance of the year.

The second quarter ended on the more restrained note that had characterized April and May. While there were gains in industrial production and auto sales in June, as well as a sizable rise in payroll employment, developments in other areas were more mixed, with continued softness in residential construction and apparently some slight easing of intense labor market pressures. Newly released data on gross national product (GNP) in the second quarter indicate a substantial slowdown relative to the first three months of the year. Indeed, the April-June increase in GNP was the smallest for any quarter since the final three months of 1964, when there was a major strike in the auto industry. Analysis of the new figures, however, strongly suggests that special factors played a significant role in the second-quarter slowdown. Thus, as already noted, strikes apparently were a factor in restraining business outlays on factory construction. In addition, the relatively feeble rise in consumer spending, the most important single element in the overall deceleration, accompanied the smallest gain in after-tax personal incomes in three years. This development, in turn, was attributable partly to the unusually heavy amount of final tax payments made by consumers in April and by the switch to the new graduated withholding system in May.

Even though the growth of demand moderated somewhat in the second quarter, the annual rate of increase in the prices of the goods and services included in GNP remained at the rapid 3.6 per cent first-quarter pace. Prices moved up again at both the wholesale and retail levels in June and may have advanced further in July. Over the first half of the year the consumer price index rose at a 3.4 per cent annual rate, compared with a 2.4 per cent rate over the same period last year. Similarly, industrial wholesale prices increased at a 3.3 per cent annual rate, as against only 1.4 per cent in the first six months of 1965. There is every prospect that demand pressures on prices will persist. Moreover, "cost push" factors may well become increasingly important in determining price behavior, particularly when the heavy round of wage negotiations begins about the turn of the year.

PRODUCTION, ORDERS, AND EMPLOYMENT

A further advance in industrial output during June boosted the Federal Reserve Board's seasonally adjusted production index by 0.8 percentage point to 155.8 per cent of the 1957-59 average (see Chart I). Though production had increased by a somewhat larger amount in May, when output rebounded from the effects of coal-mining and railroad strikes, the latest rise was still equal to the average of the preceding two months. With the exception of a small decline in the output of defense products, following sustained large gains over the past year, all major industry sectors shared in the June advance. For the second quarter as a whole, overall production rose

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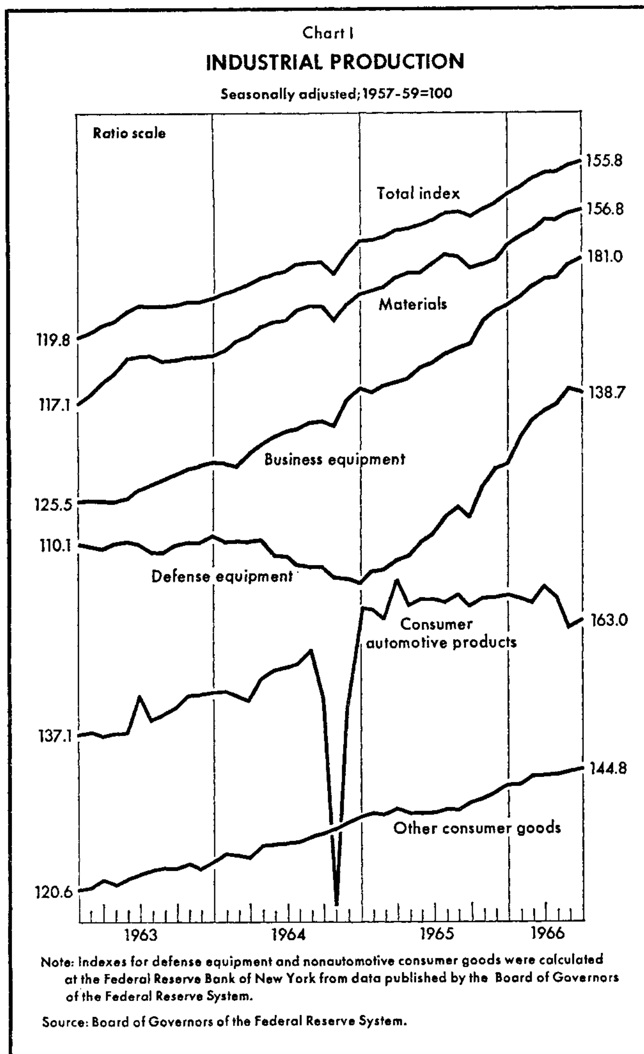

at an annual rate of nearly 8 per cent, considerably below the first-quarter growth but right in line with the strong rate of gain for all of 1965.

Reflecting the reduced rate of new-car sales in the second quarter and the record high level of dealer inventories, automobile assemblies were cut back sharply to a seasonally adjusted annual rate of 7.7 million units in July, down slightly less than 10 per cent from June. By the end of July, virtually all production of 1966 models had been terminated. Although a few plants are already at work turning out 1967 cars, most car makers apparently plan a somewhat longer changeover period than usual in order to allow their dealers time to reduce the record carry-over of 1966 models.

Other available indicators of July industrial activity point to advances in output. Thus electric power production increased sharply on a seasonally adjusted basis, partly reflecting the very high temperatures prevailing over wide areas of the country. In addition, steel ingot production rose by roughly 1.2 per cent to an annual rate of around 140 million tons (seasonally adjusted), just below this year's high set in April. The sustained boom in capital spending is reported to be the major source of buoyancy in steel demand, and industry observers point to the large backlogs of orders on the books of capital goods producers as indicating a strong future demand for steel. Indeed, the record high level of unfilled orders of durables manufacturers as a group supports the outlook for overall production increases over the near term. While the incoming flow of new orders received by these manufacturers was largely unchanged in June, such orders continued to exceed the shipments rate by a wide margin. As a result, the backlog of durable orders rose by a very large 2.1 per cent in June, bringing the total advance in backlogs to over $8.5 billion in the first six months of the year or roughly equal to the gain for all of 1965.

More than 800,000 people entered the civilian labor force in June (on a seasonally adjusted basis), reflecting a sizable influx of teen-agers into the job market as well as the addition of a substantial number of adult women. This exceptionally large increase in the labor force was mostly absorbed by the expanding economy, and the total number of people employed rose sharply. In nonagricultural industries, payroll employment increased by nearly as much as the rapid average monthly gains recorded in the first quarter of the year, thus reversing some of the weakness in April and May. Advances were registered in all major categories, including the construction industry where employment had been affected by strikes in several areas of the nation.

The overall unemployment rate remained at 4 per cent in June, as a decline in the unemployment rates for both teen-agers and adult women offset a slight rise in the unemployment rate for adult men. For the second quarter as a whole, the average overall unemployment rate edged higher by 0.1 percentage point to 3.9 per cent. More significantly, this slight lessening of pressures in the labor market was also reflected by some shortening during the second quarter in the average length of the workweek and in the number of overtime hours worked.

GROSS NATIONAL PRODUCT IN THE SECOND QUARTER

The nation's total output of goods and services (measured at a seasonally adjusted annual rate) rose by $10.8

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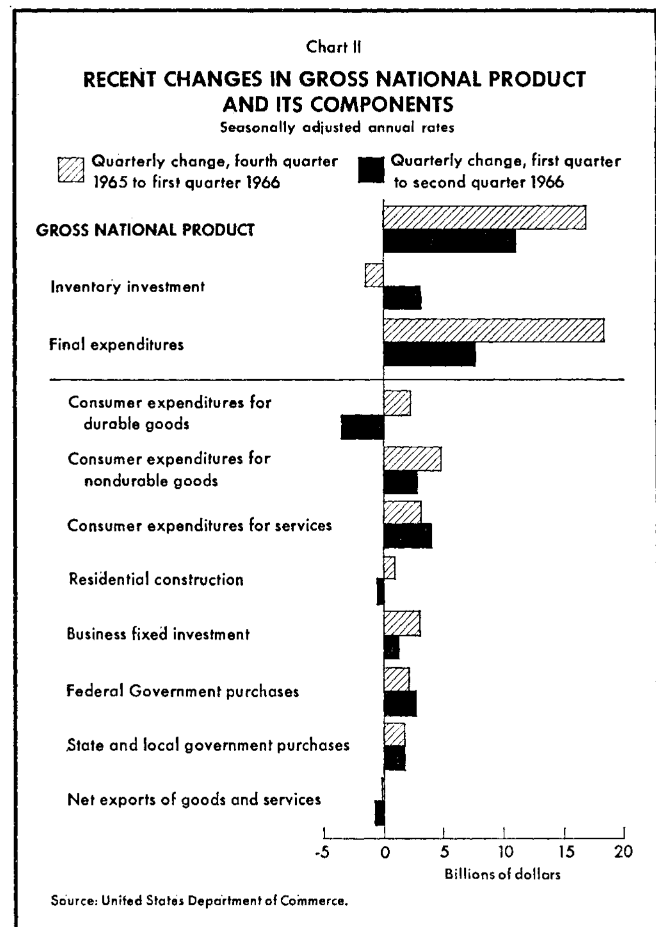
billion in the second quarter to a level of $732.0 billion, according to the Commerce Department's preliminary estimates (see Chart II).[1] This advance was considerably more moderate than in the two preceding quarters, when the largest dollar gains of the entire postwar period were registered. At the same time, however, the average price of output rose at the first-quarter rate of 3.6 per cent, sharply faster than the 1.8 per cent average increase in 1965. Thus, the annual rate of increase in real output in the second quarter slowed to 2.3 per cent, markedly below the 5.9 per cent rate of gain recorded in the opening three months of the year and in all of 1965. Since the growth of industrial production was still relatively fast, however, the slower rate of expansion of real GNP does not appear to reflect significant limitations on industrial capacity.

One major factor holding down the expansion in total expenditures during the latest quarter was a notable reduction in the growth of consumer demand, following the rapid gains registered in recent quarters. The slump in automobile sales was, of course, the main feature of the slower rate of gain in consumer spending. Consumer purchases of other durable goods, however, also declined slightly, while expenditures on nondurable goods expanded only moderately. Outlays for services, in contrast, showed the largest quarterly rise in the postwar period, due in part to the very sharp run-up in prices of services during the April-June period.

The weakening in consumer demand during the second quarter in large measure reflected the reduced growth of disposable income; the proportion of disposable income saved remained virtually unchanged from the first quarter. The speedup in withheld personal income taxes, effective May 1, cut some $800 million (annual rate) from the second-quarter growth of disposable income. Final payments of 1965 personal income taxes in April also put a drag on after-tax income growth, amounting to about $1.6 billion at an annual rate. With the beginning of the current quarter, however, disposable income received a substantial boost as a result of the pay raise for Federal Government civilian and military personnel together with the inauguration of the Medicare program. The combined effect on incomes of these two factors may amount to some $4.0 billion at an annual rate and should provide considerable stimulus to consumer spending. In July, new-car sales were roughly unchanged from the 8.3 million units (seasonally adjusted annual rate) sold in June, after having averaged 7.6 million in April and May.

The second-quarter decline in automobile sales was accompanied by a sharp rise in dealer inventories of new cars and was thus a major factor in the unusually sizable buildup of total business inventories during the quarter. Net additions to inventories amounted to $12 billion at a seasonally adjusted annual rate, the largest for any quarter in over fifteen years and $3.1 billion more than in the first quarter of this year. In addition to the expansion in automobile inventories, there were especially rapid inventory gains in the machinery and aircraft industries where production has been rising sharply. Over the near term, aggregate inventory investment will be restrained by the efforts of auto dealers to work down their



[1] The Commerce Department's usual midyear revisions of the national income and product accounts had the effect of raising GNP by $1.3 billion in 1963, $3.0 billion in 1964, and $4.9 billion in 1965. For the first quarter of 1966, GNP was revised upward by $7.3 billion to a level of $721.2 billion; however, the revision had virtually no effect on the size of the rise in GNP from 1965-IV to 1966-I.

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huge supply of new cars. Businessmen in other key industries, however, have generally continued to keep a tight rein on their inventory positions, as evidenced by conservative inventory-sales ratios.

Business investment in fixed capital expanded by $1.3 billion in the second quarter, maintaining the ratio of such expenditures to GNP at the 10.7 per cent first-quarter level—the highest in the postwar period. This second-quarter gain in capital spending was only about half as large as the advance registered in the previous quarter, however, and appeared to fall below the increase called for by the latest Government survey of capital spending plans. The slower growth of investment outlays may have partly reflected the combined effects of supply bottlenecks, skilled labor shortages, and the higher cost and reduced availability of funds. More importantly, however, work stoppages in the construction industry probably had a significant depressing influence, as business outlays for new and modernized structures actually declined from the first-quarter level. Additional expenditures for business equipment, in contrast, were substantially larger than the gain posted for the first quarter of the year.

In the government sector, state and local spending for goods and services rose by $1.7 billion for the second consecutive quarter, thus staying within the range of advances recorded in the past few years. At the Federal level, purchases increased by $2.7 billion in the second quarter, equal to the largest previous gain recorded in this business expansion. The bulk of the second-quarter rise again reflected stepped-up spending for national defense purposes; nondefense outlays increased somewhat less than the average gains registered in recent quarters.

Among other major components of national output, expenditures for residential construction declined slightly in the second quarter, bringing the rate of such spending back to the year-ago figure. Moreover, current indicators of prospective home-building activity point to some further slackening in the months ahead. Thus, nonfarm housing starts during the second quarter averaged about 10 per cent below the first quarter and were at the lowest rate in five years. Similarly, newly issued building permits fell 13 per cent in the second quarter, reaching the lowest level since 1958.

Net exports of goods and services declined for the fourth consecutive quarter, dropping to $5.3 billion—the smallest margin of exports over imports since the opening quarter of 1963. The sharp reduction this year of the export surplus has been a serious obstacle to the solution of our balance-of-payments problem and reflects the exuberance of the domestic economy as well as the conflict in Vietnam.

The Money and Bond Markets in July

The money market was generally firm during July, although there was some temporary easing at the end of the statement periods. The airline strike resulted in a large bulge in Federal Reserve float around midmonth, which also eased the pressure on bank reserve positions for a short time. The Federal Reserve was able to offset the reserve effects with minimal market impact, however, using for the first time sales of Treasury bills with matched purchases of the same bills for delivery several days later. Federal funds traded at rates as high as 5¾ per cent, the first trading recorded at a 1¼ per cent "premium" over the Federal Reserve discount rate. Major New York City banks reportedly continued to pay the ceiling rate of 5½ per cent for negotiable certificates of deposit with maturities as short as thirty days. Effective July 14, dealers in bankers' acceptances raised their rates by ⅛ of a percentage point. The new rates—5¾ per cent bid and 5⅝ per cent offered for one- to ninety-day unendorsed acceptances—matched the peak rates in 1929 but were still substantially below the record levels reached in 1920. Toward the end of the month, major finance companies raised their offering rates generally

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JULY 1966

In millions of dollars; (+) denotes increase, (—) decrease in excess reserves

Factors	Changes in daily averages—week ended				Net changes
	July 6	July 13	July 20	July 27	
"Market" factors					
Member bank required reserves*	— 346	+ 303	— 232	+ 66	— 209
Operating transactions (subtotal)	— 612	+ 70	+ 944	— 221	+ 181
Federal Reserve float	+ 27	+ 424	+ 795	— 450	+ 796
Treasury operations†	+ 184	— 302	— 136	— 71	— 325
Gold and foreign account	— 54	+ 62	— 14	— 12	— 18
Currency outside banks*	— 748	— 142	+ 209	+ 219	— 462
Other Federal Reserve accounts (net)‡	— 20	+ 27	+ 90	+ 95	+ 192
Total "market" factors	— 958	+ 373	+ 712	— 155	— 28
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 786	+ 72	— 969	+ 189	+ 78
Bankers' acceptances	+ 2	— 3	— 5	— 10	— 16
Repurchase agreements:					
Government securities	+ 4	— 1	— 3	—	—
Bankers' acceptances	+ 3	— 54	— 100	—	— 151
Member bank borrowings	+ 56	— 9	— 187	+ 49	— 91
Other loans, discounts, and advances	—	— 5	—	+ 2	— 3
Total	+ 849	+ 2	—1,265	+ 231	— 183
Excess reserves*	— 109	+ 375	— 553	+ 76	— 211
	Daily average levels				
Member bank:					
Total reserves, including vault cash*	23,173	23,245	22,924	22,934	23,069§
Required reserves*	22,823	22,520	22,752	22,686	22,695§
Excess reserves*	350	725	172	248	374§
Borrowings	827	818	631	680	739§
Free reserves*	— 477	— 93	— 459	— 432	— 365§
Nonborrowed reserves*	22,346	22,427	22,293	22,254	22,330§
	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 846	— 335	— 442	+ 27	+ 96
More than one year	+ 81	—	—	—	+ 81
Total	+ 927	— 335	— 442	+ 27	+ 177

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended July 27.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS JULY 1966

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended				Average of four weeks ended July 27*
	July 6	July 13	July 20	July 27	
Eight banks in New York City					
Reserve excess or deficiency(—)†	93	22	86	—	50
Less borrowings from Reserve Banks	161	116	104	16	99
Less net interbank Federal funds purchases or sales(—)	962	1,105	705	310	771
Gross purchases	*1,426*	*1,512*	*1,429*	*1,136*	*1,376*
Gross sales	*464*	*407*	*724*	*826*	*605*
Equals net basic reserve surplus or deficit(—)	—1,030	—1,199	— 722	— 326	— 819
Net loans to Government securities dealers	474	383	285	190	333
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)†	44	38	42	15	35
Less borrowings from Reserve Banks	230	362	237	252	270
Less net interbank Federal funds purchases or sales(—)	688	787	1,038	848	840
Gross purchases	*1,573*	*1,609*	*1,698*	*1,539*	*1,605*
Gross sales	*885*	*822*	*660*	*689*	*764*
Equals net basic reserve surplus or deficit(—)	— 874	—1,111	—1,233	—1,085	—1,076
Net loans to Government securities dealers	149	131	312	94	172

Note: Because of rounding, figures do not necessarily add to totals.
* Estimated reserve figures have not been adjusted for so-called "as of" debits and credits. These items are taken into account in final data.
† Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—July 1966			
	July 1	July 11	July 18	July 25
Three-month	4.731	4.876	4.996	4.818
Six-month	4.915	4.999	5.095	4.919

Maturities	Monthly auction dates—May-July 1966		
	May 25	June 23	July 26
One-year	4.966	4.697	4.964

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

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⅛ of a percentage point to 5⅝ per cent for 30- to 270-day paper which they placed directly with investors.

Treasury bill rates rose sharply during the first half of July, as demand slackened somewhat and a steep rise in bank call loan rates widened the adverse spread between bill yields and dealer financing costs. Widespread expectations of further increases in interest rates, and market discussion of a possible increase in the Federal Reserve discount rate, contributed to the uneasiness in the Treasury bill market. After midmonth, however, bill rates backed down from record high levels as strong demand pressed against limited market supplies. Demand from various investment sources was augmented by dealer buying late in the month in anticipation of demand for bills stemming from the Treasury's approaching refunding. Such demand proved disappointing, however, and bill rates moved higher on the last two days of the month.

In the bond markets, prices penetrated their late-February, early-March lows during the first half of July, when uncertainty over the future course of interest rates dominated the markets. Around midmonth, however, prices of Treasury, corporate, municipal, and Government agency debt securities began to recover as the belief spread that prices might have bottomed out. Prices of intermediate- and long-term Treasury issues declined on the final two days of the month in reaction to the Treasury's offer of a 5¼ per cent coupon—the highest in forty-five years—in its August refunding. (For details of the refunding announcement, see below.)

THE MONEY MARKET AND BANK RESERVES

The money market remained firm during most of July, though periods of relative ease did emerge occasionally. Week-to-week fluctuations in net reserve availability were unusually wide during July, partly reflecting the effect of a strike against five major airlines which normally account for about 70 per cent of the nation's air mail service. The resulting delays in transport gave rise to an abnormal increase in Federal Reserve "float", the amount of checks credited to member bank reserve accounts (according to a specified time schedule) but not yet presented for payment. The uneven dispersal of these reserves throughout the banking system apparently contributed to the heavy pressure on banks in the major money centers during the first three weeks of the month. The basic reserve deficit of the forty-six major reserve city banks averaged $2,056 million during the three weeks ended July 20, more than double the average level during the five statement weeks ended in June. These banks bid aggressively for Federal funds on several days, driving the "effective" rate up to 5⅝ per cent for the first time and to 5¾ per cent late in the month. Occasionally, however, Federal funds traded at considerably lower rates, as banks approached the ends of their reserve-averaging periods with more reserves than anticipated. (See the left-hand panel of the chart on page 176 for a record of the daily effective rates on Federal funds.)

In the statement week ended July 6, nationwide net borrowed reserves rose to $477 million, while member bank borrowings from the Reserve Banks averaged $827 million, the highest weekly average levels since February 17, 1960. The money market was very firm until the final day of that week, when it became quite comfortable. The temporarily easy tone of the money market is a phenomenon which frequently arises at the end of the statement weeks in periods of monetary restraint. Banks often adopt a cautious approach to the management of their reserve positions, bidding strongly for Federal funds and sometimes borrowing from their Reserve Banks early in the statement week. As the end of their reserve-averaging period approaches, banks sometimes discover that they had overestimated their reserve needs earlier and have accumulated excessive reserves. When banks attempt to sell their excess reserves, the Federal funds market tends to become temporarily easier. Such a situation is most likely to arise on those alternate Wednesdays which mark the end of reserve-averaging periods for both reserve city and "country" banks. On Wednesday, July 6, Federal funds went begging at rates as low as 1 per cent, member bank borrowings from the Reserve Banks dropped to $260 million, and the forty-six major reserve city banks found themselves with more than $1 billion of unused reserves.

Nationwide net reserve availability rose sharply in the week ended July 13, as float bulged due to the airline strike, and then fell back sharply in the week ended July 20, after the Federal Reserve System moved to absorb the redundant reserves through open market operations. It was expected that float would rise substantially in the wake of the airline strike, which began at 6 a.m. on Friday, July 8, but the timing and magnitude of the bulge were uncertain. As it turned out, the money market was quite taut during the statement week ended July 13 until the end of the week, largely because of the substantial buildup in excess reserves at country banks that typically takes place about the second week in July. Federal funds traded at the historically high effective rate of 5⅝ per cent on Friday through Tuesday, and some funds traded at 5¾ per cent. Not until Wednesday morning did the full effect of the strike upon float become apparent and the money market begin to ease significantly. Nationwide net borrowed reserves declined to $93 million on average for the

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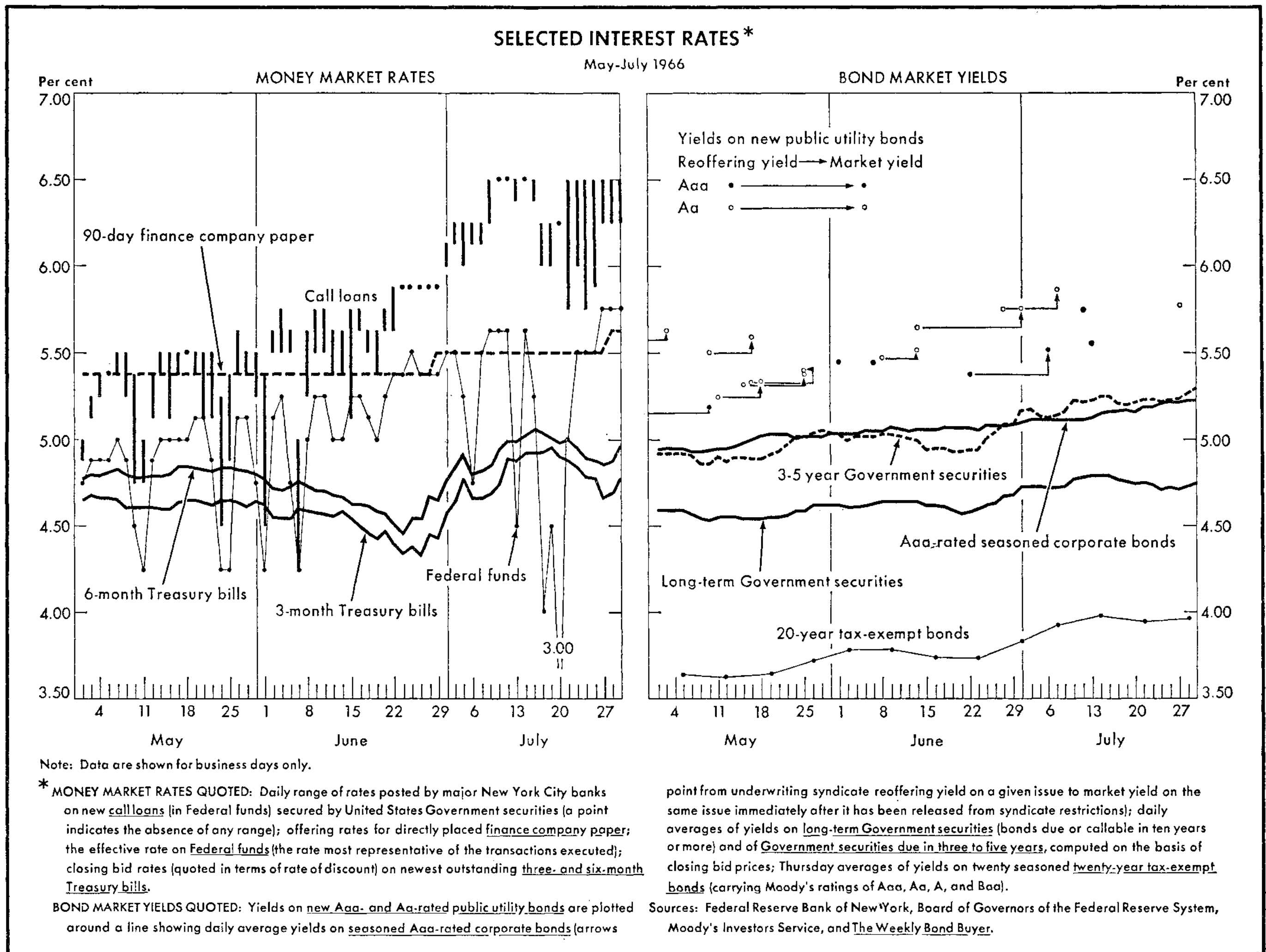

Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields on seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

week from $477 million in the week before, but member bank borrowings from the Reserve Banks averaged $818 million, about the same as a week earlier. The reserves created by the rise in float added to the excesses in country banks, which built up average excess reserves of $663 million during the week. Banks in major money centers, on the other hand, remained in deep basic reserve deficits, bidding strongly for Federal funds and covering sizable residual reserve needs through recourse to the Federal Reserve "discount window".

Federal Reserve open market operations absorbed a large volume of reserves in the statement week ended July 20, when float remained abnormally large due to the continuing airline strike. Despite a sharp contraction in nationwide net reserve availability to $459 million of net borrowed reserves, however, the money market grew considerably more comfortable as the excess reserves accumulated by country banks the week before spilled into the major money centers during the second half of the biweekly country bank reserve-settlement period. Indeed, following the buildup of reserves in the previous week, country banks in the aggregate actually ran a slight average reserve deficiency during the week ended July 20, the first such deficiency on record. Federal funds traded predominantly at 5¼ per cent or higher before the weekend but, as the funds began to pour into the market, rates fell to as low as ½ of 1 per cent on Wednesday. Average borrowings from the Federal Reserve declined to $631 million for the week.

The money market was again firm during the week ended

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July 27 and became rather tight at the end of the week. Federal funds traded predominantly at 5½ per cent over most of the week but at 5¾ per cent—a record effective rate—on the final day. Net borrowed reserves were little changed from the previous week, but the distribution of reserves shifted, reducing the pressure on the major New York City banks considerably and on the other money market banks to a lesser extent. While borrowing by banks outside the major money centers rose somewhat, overall member bank borrowings from the Federal Reserve remained well below the level of the first half of the month.

THE GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds declined during the first half of July, in continuation of a trend which developed late in June when several money market rates—including the prime lending rate of commercial banks—were scaled upward. Apprehension over the future course of interest rates prompted a nervous atmosphere in the Treasury securities market until mid-July. At that time yields ranged to 5.34 per cent in the intermediate-term sector and 4.98 per cent on long-term bonds, as much as 15 basis points higher than at the year's previous peak around the end of February. About midmonth, however, market participants began to feel that the sell-off had perhaps been overdone and that existing rate levels might prove viable. Prices moved sharply higher in professional trading, and market sentiment swung to the belief that investors might be receptive to an issue of as long as four to five years' maturity in the Treasury's August refunding.

After the close of the market on July 27, the Treasury announced that it would offer holders of notes and bonds maturing on August 15 the right to exchange them for either of two new issues: 5¼ per cent one-year certificates maturing on August 15, 1967, and 5¼ per cent four-year nine-month notes maturing on May 15, 1971. In addition, holders of certificates, notes, and bonds maturing on November 15 were offered the four-year nine-month notes in exchange prior to maturity. A total of $14.9 billion of securities was eligible for the exchange, about $8.1 billion of which was held by the public and $6.8 billion by the Federal Reserve and Government Investment Accounts. Subscription books were open from August 1 through August 3, with payments and deliveries scheduled for August 15. Both of the new issues were priced at par, and the 5¼ per cent coupon represented the highest rate paid by the Treasury on a coupon-bearing direct obligation since 1921. The market reacted favorably to the terms of the offering.

A brief technical rally in the market for Treasury coupon-bearing securities was sparked on July 5 and 6 by reports casting doubt upon the sustainability of the North Vietnamese war effort and by President Johnson's comments that the deficit in the Federal administrative budget for fiscal 1966 had turned out much smaller than expected. The atmosphere of optimism was quickly dispelled, however, following news reports that the Warsaw Pact nations had agreed to send volunteers to Vietnam if requested by the Hanoi government. Further caution in the bond market was generated by the weekly banking statistics published on Friday, July 8—which revealed a reduction in reserve availability and continued strength of business loan demand—and by growing discussion of the likelihood of new pressures on the British pound. By the time the British bank rate was raised from 6 per cent to 7 per cent on Thursday, July 14, the move had largely been discounted. The market remained nervous, however, as many participants expected an announcement of an increase in the Federal Reserve discount rate that night. When the discount rate remained unchanged, sentiment emerged that yields were perhaps near their peaks, and dealers withdrew offerings and sought to cover short positions. The market for Treasury notes and bonds reversed direction, and prices moved generally upward until the announcement of the August refunding, which stimulated offerings by dealers in anticipation of switching by investors out of outstanding issues into the new notes. As a result of this largely professional pressure, prices of most issues declined on the final two days of the month, except for the "rights" issues, some of which moved higher. Over the month as a whole, prices of most issues maturing beyond one year showed declines ranging from ⅛ to more than a full point, though there were a few scattered fractional price increases.

Rates for Treasury bills moved sharply higher over the first half of the month, as the special factors that had added to demand in June disappeared. Dealers became aggressive sellers, as they faced steeply higher costs of financing their inventories in the wake of the late June increase in the prime rate and other money market rates. The major New York City banks, whose reserve positions were under heavy pressure, raised their rates on dealer loans generally to a range of 6 to 6½ per cent, about ⅝ of a percentage point higher than the range which generally prevailed in June. Uncertainty over movements in interest rates, including the Federal Reserve discount rate, as well as the heaviness of the Government agency and corporate bond markets, contributed to the nervous atmosphere of the Treasury bill market. Against this background, dealers and investors bid very cautiously in the first two regular weekly bill auctions of the month,

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on July 1 and 11, and the resulting wide ranges of prices of accepted tenders in turn aggravated the nervousness of the market. The rate on the three-month bills in the July 18 auction was set at a record-high 4.996 per cent (see Table III) and, at the higher rate levels, bidding was more enthusiastic than in the two previous auctions. Bill rates moved lower over the July 18-27 interval, as active investment demand reemerged and pressed against market scarcities in many maturities. The average issuing rate set on the three-month bills in the weekly bill auction held on July 25 was about 18 basis points lower than the average rate set a week earlier. Toward the end of the month, dealer buying was stimulated by anticipation of demand for bills by sellers of rights who chose not to exchange for the Treasury's new offerings. As it turned out, such demand proved disappointing, and bill rates moved up rather sharply on the last business day of the month under the pressure of aggressive dealer selling. Over the month as a whole, rates for Treasury bills rose about 5 to 25 basis points.

A heavy atmosphere also dominated the market for Government agency securities during the first half of the month. Rising money market rates and the prevailing uncertainties over the course of interest rates led to price declines throughout the list. Prices of intermediate- and long-term issues recovered under the pressure of a quite strong demand after midmonth, but still closed generally ¼ to 1¼ points lower for the month, while prices of short-term issues rose slightly. New agency issues marketed during the interval totaled $1,744 million, of which $485 million represented the raising of new money. At historically high yields, the new issues encountered mixed investor receptions. In the face of near-term uncertainties over market conditions, one issue scheduled to be priced on Thursday, July 14, was postponed until after the weekend.

Investor interest in two new issues of the Federal Home Loan Banks, offered on July 12, was particularly disappointing. The offering, which replaced a $500 million maturity and raised $285 million in new money, consisted of $535 million of one-year 5¾ per cent bonds offered at par and $250 million of eighteen-month 5¾ per cent bonds discounted to yield 5.80 per cent. The issues quickly traded below their original offering price and contributed to a marked deterioration in market sentiment. An offering of the Banks for Cooperatives scheduled for pricing Thursday, July 14, was priced on Monday, July 18, for offering the following day, to yield a record 5.90 per cent. The $266 million issue was an immediate sellout at this rate. On July 21, the Federal Intermediate Credit Banks were able to offer $298 million of nine-month debentures with a 5⅞ per cent coupon. The debentures, which were offered at par, were accorded an excellent reception. The Tennessee Valley Authority auctioned $50 million of 120-day discount notes on July 26 at an average rate of 5.661 per cent, up only 3 basis points from the rate on a comparable issue auctioned in June.

OTHER SECURITIES MARKETS

In the corporate and municipal bond markets, prices declined during the first half of the month in the face of increases in money market rates and uncertainties over future movements in interest rates. New-issue activity in both the corporate and municipal sectors was significantly reduced from the June level. With the slackening of the pace of new offerings, dealers in municipal bonds succeeded in reducing their inventories substantially, though often at the cost of price concessions. A heavier calendar of new offerings is scheduled for August.

In addition to the pressures on the capital markets in general, the municipal market suffered from liquidation of holdings of tax-exempt bonds by commercial banks and an abatement of bank demand for new issues, as pressures on bank reserve positions intensified. A $112.9 million offering of New York City bonds was awarded on July 26 at a net interest cost of about 4.65 per cent, 41 basis points more than the City paid in April. The corporate market was influenced in the early part of the interval by the overhang of two syndicate-bound issues with large unsold balances. When price restrictions were lifted on July 6 and 7, respectively, the bonds moved out with upward adjustments of 10 to 15 basis points in yield. Two Aaa-rated corporate issues were reoffered on July 12 and 13 at somewhat higher yields. One, a telephone issue with five-year call protection, sold out immediately at 5.55 per cent, while the other, a power company issue callable only at a penalty price, eventually sold out at a 5.75 per cent yield.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 13 basis points to 5.23 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose by 13 basis points to 3.96 per cent (see the right-hand panel of the chart). These indexes are, however, based on only a limited number of seasoned issues and do not necessarily reflect market movements fully, particularly in the case of new and recent issues.

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Recent Banking and Monetary Developments

In the second quarter, banks faced continued heavy loan demands and increasing reserve pressures as their sources of funds became more costly and less certain. With nationwide reserve availability shrinking, trading in Federal funds took place at premiums as high as 1 to 1⅛ percentage points above the discount rate. At the same time, rising money market rates made it increasingly difficult for banks to compete for short-term funds in the form of negotiable certificates of deposit (C/D's). Consequently, they were forced to raise offering terms, and rates paid on these deposits reportedly hit the 5½ per cent Regulation Q ceiling for maturities as short as thirty days; the same ceiling was quite commonly paid on longer maturities. With money market conditions tightening, banks more frequently found themselves forced to turn to the "discount window" and average member bank borrowings from the Federal Reserve increased. Bank liquidity positions also tightened further during the quarter, as loans were added and investments liquidated so that loan-deposit ratios continued their seemingly unending climb. Credit demand and reserve supply pressures culminated in a rise on June 29 and June 30 in the prime lending rate of most commercial banks from 5½ per cent to 5¾ per cent.

Despite higher rates paid on C/D's and other time deposits, total savings flows into commercial bank interest-bearing accounts continued to fall behind those of recent years. The available evidence seems to suggest that, while consumer-type time deposits and other related deposits grew substantially over the second quarter, roughly two thirds of this gain was offset by a sharp decline in passbook savings accounts. The rate of advance in seasonally adjusted private demand deposits, on the other hand, bettered the substantial first-quarter gain and contributed to a second-quarter money supply growth rate that fell just short of the fast pace set in the year 1965.

Primarily reflecting a sharply reduced flow of liquid savings into time deposits and savings and loan shares, total liquid assets held by the nonbank public grew at a slower rate in the second quarter of this year than in the preceding quarter. But, as a result of a corresponding slowdown in gross national product, the ratio of total liquid assets to GNP remained about unchanged from the first quarter to the second quarter.

BANK CREDIT

Total loans and investments at all commercial banks grew at an 8.3 per cent seasonally adjusted annual rate in the second quarter of this year. This advance is roughly in line with the 8.0 per cent first-quarter gain in bank credit, and remains somewhat below the 10.2 per cent expansion in all of last year. Total loans by banks increased at an annual rate of 12.7 per cent, a bit slower than the 13.8 per cent first-quarter pace and even further behind the 14.7 per cent gain experienced over 1965 as a whole. There was, on the other hand, a smaller second-quarter decline in bank investment holdings than over the first three months of the year.

The second-quarter advance in business loans by banks matched the sharp rise in the preceding quarter and was attributable in part to cash needs stemming from stepped-up corporate tax payments. This was evidenced by particularly heavy business loan demands around the June tax date and in the latter part of June, when a new collection schedule for personal income and social security taxes withheld by large employers went into effect. Business loan demand has apparently also been inflated by the continuing tendency of investment expenditures to outpace internally generated funds. In response to business demands, banks continued to tighten loan terms—as evidenced by the late-June increase in the prime rate referred to above—and rates charged on other types of loans followed a similar pattern. Rates posted by the major New York City banks on call loans to Government securities dealers rose, for example, by 1 to 1⅛ percentage points over the second quarter to 6⅛ per cent at the end of June. Around mid-June some large city banks also raised the rate of interest discounted in advance on most types of consumer instalment loans by ½ of 1 percentage point.

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Loans by commercial banks to nonbank financial intermediaries also rose sharply in the second quarter, reflecting in part heavy tax-related finance company borrowing. There was, on the other hand, a marked second-quarter slowdown in consumer loan growth, explainable in large part by a corresponding decline in automobile purchases. The growth of real estate loans also moderated over the second quarter, falling to barely more than half the 1965 rate of advance.

Banks followed up a substantial first-quarter reduction in their holdings of United States Government securities with another sizable $1.5 billion rundown (seasonally adjusted) in the succeeding three months. This decline was nearly offset, however, by a $1.4 billion increase in bank holdings of other securities, apparently prompted in large part by the fact that rates on these obligations became increasingly attractive over the quarter. Available data suggest that bank participation in a heavy volume of new Government agency issues probably accounted for a substantial portion of this rise.

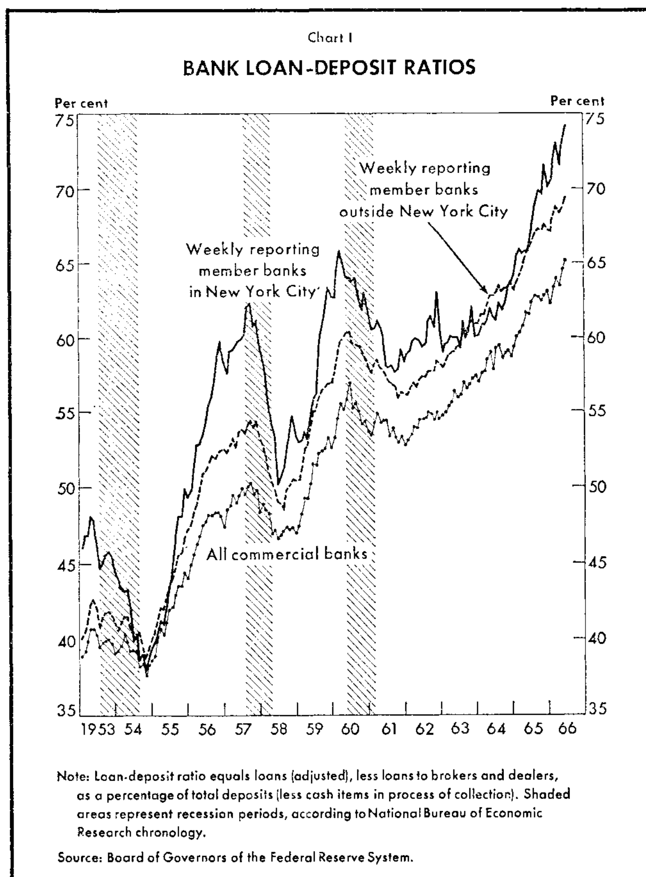

Chart I

BANK LOAN-DEPOSIT RATIOS

Note: Loan-deposit ratio equals loans (adjusted), less loans to brokers and dealers, as a percentage of total deposits (less cash items in process of collection). Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.

Source: Board of Governors of the Federal Reserve System.

The second-quarter increase in loans brought further pressure to bear on bank liquidity positions. The loan-deposit ratio for all commercial banks climbed to 65.2 per cent by the end of June, from 63.9 per cent at the end of March (see Chart I). During this same period, the loan-deposit ratio at all weekly reporting banks rose by a full percentage point to 70.8 per cent. An even more striking increase was registered by the loan-deposit ratio for New York City reporting banks—from 72.4 per cent at the end of March to 74.4 per cent by the end of June. Indeed, lending by these large money market banks has resulted in a rise of no less than 4.5 percentage points in their aggregate loan-deposit ratio over the first half of the year. In view of current money market conditions, the steady rise in loan-deposit ratios to the highest levels in decades would seem to call for an increased measure of restraint on the part of banks in accommodating loan demand.

BANK DEPOSITS AND RESERVES

The daily average money supply grew at a 4.5 per cent seasonally adjusted annual rate during the second quarter of this year, closely in line with the 4.3 per cent pace of the first three months of the year and only slightly below the rapid 4.8 per cent advance in all of 1965. Relatively sharp swings in the money supply from month to month again reflected the relatively close inverse relationship between private demand deposits and United States Government deposits, which have shown unusually large month-to-month changes.

Commercial bank time deposits continued to expand in the second quarter at a diminished rate relative to last year's pace. Over the first six months of this year, daily average time deposits have grown at a 9.8 per cent seasonally adjusted annual rate, as against the 16.1 per cent advance in 1965. Largely as a result of this slowdown, the money supply and time deposits combined rose at a 6.9 per cent annual rate over the first half of this year, somewhat below the 9.8 per cent gain throughout last year. Data for weekly reporting member banks indicate that the slower time deposit growth continues to be largely attributable to a marked contraction in passbook savings accounts (see Chart II). Indeed, funds in these accounts have declined by some $2.1 billion over the second quarter alone, in marked contrast to the $805 million increase over the comparable period last year.

The flow of new funds into C/D's also diminished during the second quarter. At weekly reporting banks, C/D's rose by $530 million, only a little over one third of the $1.4 billion increase during the comparable period in 1965,

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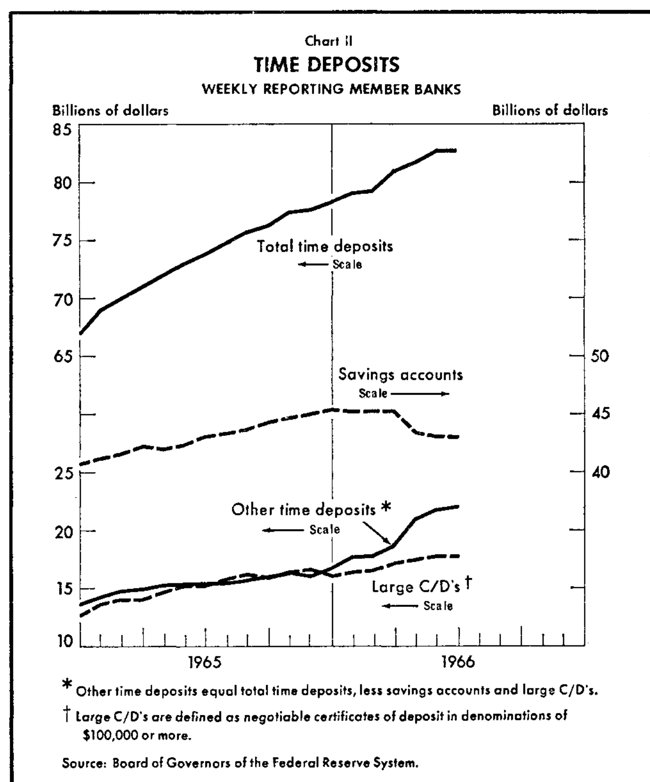

as the banks faced increasing difficulties in competing against other short-term investment outlets. By the end of the second quarter, rates paid on most maturities of C/D's were, as already noted, at the maximum permissible rate of 5½ per cent. At the same time, the rates on finance company paper and other competing money market instruments have become increasingly attractive to corporate treasurers. Over the second quarter alone the rate on ninety-day finance company paper rose by some 37 basis points to 5½ per cent, and more recently has moved to 5⅝ per cent.

A sharp second-quarter rise of some $3.3 billion in "other" time deposits (total time deposits less savings accounts and C/D's in denominations of $100,000 or more) at weekly reporting banks has run counter to the reduced overall flow of funds into bank interest-bearing accounts. Of special interest within this residual category has been the recent sharp rise in consumer-type time deposits. The Federal Reserve System's recently published survey of member bank time and savings deposits has found, for example, that between December 1965 and May 1966 consumer-type time deposits (savings certificates and bonds plus nonnegotiable and small denomination C/D's) increased by some $5.3 billion, or by 40 per cent. Widespread increases in rates paid on these time deposits over this same period were apparently the primary factor in this sharp increase. The System survey disclosed, for instance, that between December and May over half of the member banks soliciting consumer-type time deposits raised their rates on each type of instrument offered. This survey also revealed that the larger banks that were most successful in attracting funds into these instruments were also those having the sharpest declines in their passbook savings accounts. Such a finding suggests that some of the funds destined for consumer-type time deposits would otherwise have been lodged in savings accounts; thus, in numerous cases, banks may have been competing to some extent with themselves for these funds.

Member banks relied somewhat more heavily on the discount window to meet reserve needs arising out of the overall expansion in their demand and time deposit liabilities during the second quarter. Borrowings from the Federal Reserve increased from an average level of $626 million in April to a $674 million average in June. At the same time member bank net borrowed reserve positions (excess reserves less borrowings) deepened from an average of $268 million in April to a $360 million June average. On a seasonally adjusted basis, member bank nonborrowed reserves grew at a 3.2 per cent annual rate in the second quarter of this year, more rapidly than the depressed first-quarter pace of 1.6 per cent but considerably below the 4.2 per cent gain over 1965 as a whole.

NONBANK LIQUID ASSETS

Liquid assets[1] held by the nonbank public rose at a 5.7 per cent seasonally adjusted annual rate in the second quarter, appreciably slower than the 8.4 per cent gain in the first quarter and less than the 7.8 per cent increase for the full year 1965. Within this total there has been, in addition to the decline in the growth rate of commercial bank time deposits, a marked drop both in the rate of expansion of mutual savings bank deposits and in savings and loan share growth. This general weakness in the interest-bearing deposit and share components of total liquid assets ap-

[1] Total liquid assets are defined to include demand deposits and time deposits (adjusted) at all commercial banks and currency outside banks—all measured on a last-Wednesday-of-the-month basis—as well as deposits at mutual savings banks, savings and loan shares, postal savings deposits, United States Government savings bonds, and the nonbank public's holdings of United States Government securities maturing within one year—all measured on an end-of-the-month basis. A quarterly average of monthly liquid assets figures is used in this section for the growth rate computations and in deriving the ratio of liquid assets to GNP.

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parently continued to reflect the increasingly attractive yields on state and municipal bonds and other competing open market instruments.

The ratio of total liquid assets to GNP was 80.2 per cent during the second quarter of this year, which is about in line with the previous quarter but somewhat below last year's second-quarter figure of 81.0 per cent. The relative stability in the ratio from the first quarter to the second quarter of the year—despite the marked second-quarter slowdown in total liquid assets growth—was attributable to a similar decline in the rate of growth of GNP.[2]

[2] For more information on movements in GNP, see "The Business Situation" in this *Review*, especially pages 171-73.

Monetary and Fiscal Policy in Canada*

By mid-1966 the Canadian economy had moved into its sixth year of continuous economic expansion. The vigor and duration of the Canadian expansion reflect in considerable part the pace of the broadly concurrent upswing in the United States. Nevertheless, Canada's prosperity also owes much to the flexibility with which the Canadian authorities have adapted fiscal, monetary, and other policies to changing economic conditions.

Throughout most of 1965 the Bank of Canada allowed credit conditions to tighten, and thereby helped to contain the advance in aggregate demand. However, with the labor market tightening and capacity stretched to the limit in some industries, costs and prices moved up at a significantly faster rate, and there was an abrupt deterioration in Canada's balance on current international transactions. As evidence accumulated that most or virtually all the economy's slack had been absorbed, it became increasingly clear that monetary policy alone could not bear the entire burden of providing the needed restraint. Accordingly, in the budget presented last March, the Canadian authorities reversed the 1965 cut in personal taxes. In addition, the government has adopted a number of temporary tax measures designed to dampen the investment boom now in progress. The new tax program thus represents a significant shift in the posture of fiscal policy. Together with a continuing policy of monetary restraint, this year's tax program will help mitigate inflationary excesses, and thereby contribute to further balanced growth.

* Martin Barrett, Economist, Foreign Research Division, had primary responsibility for the preparation of this article.

THE EXPANSION IN PROFILE

Whether measured in terms of its longevity or in terms of the magnitude of the gains in output and employment, the current expansion has been unequaled in postwar Canadian experience. Although somewhat less vigorous in its early stages than previous periods of rapid growth, the current upswing has turned out to be much more durable. Since early 1961, when the recovery got under way, real gross national product (GNP) has increased by more than one third, for an average annual increase of almost 6½ per cent. Over the five years ended in the spring of this year, total employment has increased by 23 per cent, enough not only to absorb an unusually rapid increase in the labor force but also to reduce substantially the number of unemployed.

The year-to-year increases in output, however, have varied considerably over the course of the upswing, partly reflecting similar variations in the United States. Thus, after a rapid start in 1961-62, the rate of growth slowed down considerably in 1963. Toward the end of 1963 and throughout 1964, the pace of the advance in activity picked up once again as a renewed surge of fixed business investment was reinforced by an exceptionally large

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increase in exports. The revival of investment was the result not only of the gradual decline in unused productive capacity but also of a number of tax incentives, including authorizations for rapid amortization of certain capital assets. The export gains reflected both the improved competitive position of Canadian industries following the exchange rate depreciation of 1961-62 and the beginning of large bulk sales of wheat to Eastern countries. Although exports rose much less rapidly in 1965, there was a further acceleration of business investment, and real GNP increased by almost 6½ per cent, or about the same rate as in 1964. The recent emergence of fixed business investment as a source of thrust for the economy contrasts with its somewhat weaker role during the initial stages of the current upswing. On the other hand, exports expanded more slowly in 1965 after several years in which exceptionally large increases had made an important contribution to the expansion of domestic production and employment.

The strong surge in aggregate demand in recent years has resulted in a significant reduction in the amount and rate of unemployment. Following relatively small gains in employment early in the recovery, total employment began to rise rapidly in 1964-65. Toward the end of 1965 and in early 1966, unemployment had been reduced to less than 3½ per cent of the labor force (seasonally adjusted), compared with nearly 5 per cent as recently as mid-1964 and almost 8 per cent early in 1961. With the decline in the overall unemployment rate in 1965, there were some signs that manpower shortages, which had previously been localized and confined largely to skilled employees, had begun to spread to a widening range of occupations and skills and a growing number of regions.

When the recovery began, there was a large margin of excess industrial capacity inherited from the investment booms of the fifties. Thus in its early and middle stages the recovery was conspicuously free of the strains, bottlenecks, and pressures that had often accompanied earlier periods of rapid growth. The productivity gains associated with fuller utilization of industrial capacity permitted a moderate rise in wage rates to be absorbed without increases in labor costs per unit of output in manufacturing or a deterioration of producers' profit margins. With cost trends thus fairly well stabilized, aggregate price measures edged up at a very moderate rate in 1961-62 and held almost steady in 1964. However, 1965 was marked by a distinct acceleration of the rate of advance of costs and prices. Employment gains were accompanied by larger wage settlements, and productivity gains slowed down appreciably, despite the substantial additions to plant facilities that had been made in preceding years. Some part of the rise in costs was absorbed through a halt in the growth of profit margins. In addition, a substantial increase in imports helped to relieve the upward pressure on prices where demand had outrun the growth of domestic supplies. Nevertheless, consumer prices advanced by almost 3 per cent, and the average of final product prices, as measured comprehensively by the implicit GNP deflator, rose at a slightly higher rate.[1]

MONETARY POLICY

Throughout most of the current long upswing, monetary policy in Canada has been designed primarily to facilitate and sustain the expansion. Credit conditions remained relatively easy through the first four years of the expansion, and interest rates generally fluctuated within a fairly narrow range as the monetary authorities enabled the commercial banks to accommodate the demand for bank credit. In the boom atmosphere that was developing in 1965, however, monetary policy gradually became less expansive, and the continued strong demand for credit—especially by businesses—was more fully reflected in upward pressure on interest rates. By the end of 1965 the posture of monetary policy had clearly shifted to one of active restraint.

Although oriented primarily toward domestic requirements, there have been periods in recent years when monetary policy was shaped largely by changes in Canada's exchange and balance-of-payments positions and by temporary strains in Canadian financial markets. Thus, in early 1962, with the emergence of heavy drains on official exchange reserves, credit conditions were allowed to tighten, and in June of that year the discount rate was raised to 6 per cent as part of a comprehensive program to restore confidence in Canada's newly established par value. The reserve loss was arrested and reversed almost immediately after the announcement of the June emergency program, and the need for monetary restraint proved short-lived. The bank rate was lowered in successive stages to 4 per cent, and the money supply rose steadily throughout the latter part of 1962 and the first half of 1963.[2] By May of that year, when the discount rate was lowered to 3½ per cent, credit conditions were approxi-

[1] The implicit deflator is a price index computed by dividing constant dollar estimates of the major components of GNP into the corresponding estimates in current prices.

[2] The money supply in Canada is defined as currency in circulation and bank deposits (including personal savings deposits) other than those of the federal government.

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mately as easy as they had been a year earlier.

During the summer of 1963 Canadian financial and foreign exchange markets again became unsettled, although these disturbances were not comparable in either intensity or duration with those arising from the 1962 exchange crisis. The proposed United States interest equalization tax played an important role in the short-lived foreign exchange problem, but the announcement of an exemption for Canada did much to dispel the apprehensions that had arisen in Canadian markets.[3] Credit conditions tightened sharply but only temporarily, and after the September announcement of massive wheat exports to the Soviet Union, the Bank of Canada was able to formulate its policies on the basis of a strong balance-of-payments and exchange position. The tempo of monetary expansion was stepped up, and at the same time the banks rebuilt their liquidity to some extent. By the end of 1963, monetary conditions reflected substantially complete readjustment to the summer disturbances, with interest rates only slightly higher than they had been at the start of the year.

As the expansion gained momentum in 1964, there was a strong increase of demands for credit by the private sector. At the same time a sharp decline in the cash requirements of the federal government helped to relieve any congestion in the money and capital markets that might otherwise have developed, and interest rates held steady over the year. The rapid rise in bank loans brought about a general tightening of bank liquidity. The ratio of the banks' "more liquid" assets—mainly cash reserves, Treasury bills, and other government securities—to the total of their major assets turned down slowly from about 36 per cent at the start of the year to around 32 per cent in December, the decline occurring largely in bank holdings of Treasury bills.

During 1965, the underlying strength of the Canadian business expansion was reflected in a further substantial increase in the demand for bank credit. However, the expansion of bank lending was accompanied by increasing pressure on the reserves and liquidity of the banking system, and interest rates began to rise early in the year. Following the failure of a medium-sized finance company in June, the Bank of Canada temporarily eased the pressure on bank reserves to reassure the money and capital markets and requested the commercial banks to accommodate creditworthy finance companies. As evidence of increasing inflationary strains continued to accumulate, however, the Bank of Canada allowed the banks' liquidity positions again to reflect the underlying strength of credit demand.

With commercial bank reserves under considerable pressure at most times during 1965 and supplies of credit and capital from nonbank sources somewhat reduced in comparison with the 1964 flow, the prevailing heavy demands for funds resulted in a rather steady upward movement of interest rates from the spring to the closing months of the year. In December, the discount rate was raised from 4¼ per cent to 4¾ per cent, partly in response to the change in credit conditions that had already occurred and partly in response to a concurrent ½ per cent increase in the Federal Reserve discount rate. Then, in March 1966, following further intensification of demand pressures, the Canadian discount rate was raised again, to 5¼ per cent. This most recent action was the first discount rate change since 1963 in which the timing was not associated with a change in the Federal Reserve discount rate, and was described by the Governor of the Bank of Canada as reflecting the Bank's view that some moderation of the growth of overall demand was desirable.

RECENT FISCAL DEVELOPMENTS

After several years of large and apparently intractable budgetary deficits, the federal government's budget, as recorded in the national income accounts, has moved into substantial surplus.[4] In both 1961 and 1962 the deficit amounted to almost $500 million. As the economy moved closer to full employment, however, the normal growth in revenues was reinforced by tax increases in

[3] In connection with Canada's exemption from the interest equalization tax, the Canadian authorities stated that it was not their intention to increase Canada's official international reserves through the proceeds of borrowings in the United States. Canada's exemption from the tax has been maintained since 1963, as has Canada's undertaking with respect to its reserve holdings. While the Canadian authorities must take the reserve agreement into account in the formulation of monetary policy, they have been able to pursue a monetary policy which was, in its broad lines, appropriate to the requirements of the domestic situation as it has developed since 1963.

[4] The government's fiscal position, as measured in the national accounts, differs significantly in definition from that shown in the regular budgetary estimates submitted to Parliament, which are comparable to the administrative budget used in the United States. Most importantly, government receipts on a national accounts basis record corporate taxes when the tax liability is accrued rather than when the tax payment is made. Moreover, the transactions of the old-age security and other social insurance funds are recorded on both the receipts and expenditures sides of the national income budget, but excluded from the regular budget. However, all borrowing or lending transactions are excluded from the national accounts budget, although included in the cash budget. Unless otherwise indicated, all amounts are stated in Canadian dollars.

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the 1963 and 1964 budgets. These revenue gains, together with a moderation of expenditure increases, brought about a rapid shift toward budgetary balance. By mid-1964, government receipts (seasonally adjusted) exceeded payments for the first time in many years. This trend continued through the second quarter of 1965, when the surplus reached a seasonally adjusted annual rate of about $650 million. The emergence of a substantial and increasing surplus was felt to be inappropriate during a period when unemployment was still relatively high. In addition, the Canada and Quebec Pension Plans, scheduled to come into effect on January 1, 1966, were expected to result in substantial initial reductions in disposable consumer and business income.[5] Accordingly, in the April 1965 budget message, the Finance Minister said that the budget should be more expansionary and proposed to make it so through a flat 10 per cent cut in basic rates of personal income tax. Shortly after the tax cut became effective in July 1965, the advance in revenues slowed down and there was a moderate acceleration of expenditures. However, the tax cut itself helped to raise the level of taxable income, and for 1965 as a whole the surplus amounted to almost $500 million.

With the relatively high sensitivity of tax collections to increases in GNP, the federal government's revenues have been adequate to cover not only its own rises in expenditure, but also stepped-up transfers to the provinces, which have played an increasingly important role in the public sector in recent years.[6] However, in 1966, it was expected that the federal government's revenue gain would slow down, reflecting in part the difference between the full-year and part-year effects of the mid-1965 tax cut and in part an increase in income tax abatements to the provinces last January.

In his budget message to Parliament on March 29 of this year, the Finance Minister stated that, on the basis of then-existing tax rates and a prospective advance in GNP of more than 9 per cent, revenues were expected to rise by only 7 per cent to $8,229 million during the fiscal year ending March 31, 1967. With expenditures programmed at $8,450 million, or nearly 10 per cent above the 1965-66 outturn, there would have been a regular budgetary deficit of $230 million, compared with the actual deficit of $34 million in the preceding fiscal year. In terms of the national accounts, the transactions implicit in these forecasts would have resulted in a surplus of $370 million in fiscal 1966, compared with a surplus of almost $500 million in the previous year. Superimposed on an exceptionally large rise in planned business investment, these changes in the federal government's accounts in a period of increasing inflationary pressures were regarded by the Finance Minister as wholly inappropriate and calling for a program of restraint to moderate the boom.

The expenditure estimates submitted to Parliament reflected the government's decision not to undertake any substantial new programs or projects that were not already announced. Moreover, the authorities decided to cut outlays on construction programs in process in an effort to alleviate particularly severe strains in the construction industry. The Finance Minister also appealed to the provincial governments to defer some of the construction projects they had scheduled for the current year. But the scope for contracyclical reductions in expenditures is relatively small, and the government has relied therefore almost exclusively on tax increases to restrain aggregate demand.

In order to reduce the rate of increase in consumer expenditures, the Finance Minister proposed—and Parliament approved—the withdrawal of most of last year's cut in individual income taxes. Specifically, the present limit on the tax cut for any taxpayer was reduced, effective June 1, from $600 to $20 per year. To be sure, the basic rates of personal income tax were also lowered but, with the new limit of $20, only those taxpayers with lower-than-average incomes will benefit from this rate change. On the other hand, those with higher-than-average incomes will revert to tax levels only slightly below the levels that prevailed in 1964. The net effect of these changes will be to increase revenues by an estimated $140 million in the current fiscal year and by about $210 million on a full-year basis.

[5] It has been estimated that employer and employee contributions to these plans would total some $570 million during 1966. However, the reduction in aggregate spending was expected to be well below this figure because: (1) part of the contributions would be financed by decreased personal and business savings, (2) tax liabilities would be reduced since contributions to the pension plans are deductible from personal and corporate income, and (3) provincial spending would probably increase since the Pension Fund reserves would be lent to the provinces at their request.

[6] Under Canadian constitutional provisions, the responsibilities of the provinces are centered in such areas as education, health, urban renewal, and resource development—all fields in which the needs and wants of the nation's population have been rising rapidly. Despite perennial rate increases for many of their own sales and property taxes and, more importantly, repeated shifts in the allocation of funds initially collected by the federal government, the net deficits of the provincial and municipal governments have remained around $300 million in recent years. The most important reallocations have taken the form of "abatements" to the provinces of certain taxes (mainly individual income taxes) collected on a nationally uniform basis by the federal government for itself and for the provincial governments under tax-sharing arrangements. In addition, there is a substantial amount of conditional and unconditional grants from the federal government to the provinces, including "equalization" payments, which are intended basically to give each province approximately the same effective per capita yield from the standard taxes subject to abatement.

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With respect to business capital outlays, the government proposed three interrelated measures, each of which is designed to cut down, and stretch out, a prospectively large increase in business investment. The first of these measures, which is to become a permanent feature of the Canadian tax system, provides for the gradual elimination of the sales tax (currently 11 per cent) on machinery and equipment. The immediate removal of the tax in its entirety would have tended to reinforce the investment boom now in progress. However, the government's proposal, which has been approved by Parliament, calls for the reduction of the tax by only 5 percentage points in April 1967, and its complete removal by April 1968. The advance enactment of the reduction and eventual elimination of the tax was proposed deliberately, and clearly provides some incentive for businesses to defer the acquisition of investment goods for at least one year.

The government's other tax proposals are intended only as temporary measures, but will provide prompt pressures on businesses to defer capital expenditures. The first of these measures, which was put into immediate effect by the government through an amendment to the Income Tax Regulations, reduces the capital cost allowances that may be claimed on most kinds of new construction, machinery, and equipment acquired during the eighteen-month period ending October 1, 1967. In adopting this measure, the Finance Minister stated that, after several years of using increased capital cost allowances as inducements for accelerating business investment, it was now logical to use reductions in these allowances to induce business to defer a part of its investment.

The other temporary measure, a 5 per cent refundable tax, is a wholly new device in Canada and virtually without precedent elsewhere. The tax has a built-in time limit and, as described by the Finance Minister, is intended to "divert and immobilize temporarily a modest portion of the flow of funds that is the chief source of finance for the increasing capital expenditures of business". The refundable tax is essentially a levy on gross business profits, and is payable on a monthly basis for an eighteen-month period ending on October 31, 1967.[7] However, the amounts received under this measure would be repaid, with interest at 5 per cent, within eighteen to thirty-six months after receipt. The timing of the repayments within this range would be determined by the government in the light of economic prospects as assessed late in 1967.

The Finance Minister stated that, after allowance is made for the effect of these various tax changes, revenues would rise to $8,300 million, even though GNP would increase somewhat less rapidly than originally estimated. With expenditures unchanged at $8,450 million, the regular budgetary deficit would amount to only $150 million for the current fiscal year. As measured in the national accounts, federal transactions are now expected to result in an excess of revenues over expenditures of $615 million, compared with an estimated $370 million before the tax changes and an actual surplus of about $500 million in fiscal 1966.

CONCLUDING COMMENTS

In terms of its direct effect on income, the government's fiscal program will moderate the expansion of overall demands and, in the process, help to contain the advance in prices. The three measures affecting capital investment taken together are expected to cut the increase in business investment by a third of a billion dollars and would thus help to bring the increase in final demands much closer into line with the increase in the economy's productive capacity.[8] To be sure, GNP is still expected to rise by about 5 per cent in real terms and by something over 8½ per cent in current prices. While the estimated advance in GNP is only slightly less than last year's dollar increase of 9 per cent, the marginal effect of the new tax measures in the latter half of 1966 may be considerably greater than is suggested by the year-to-year comparison of growth rates—simply because the actual effect of the new measures will occur mainly in the second half of the year or later.

The fact that the temporary tax measures will be effective until October 1967 suggests that, in the government's view, fiscal restraint will be needed at least up to

[7] Specifically, the tax is payable on the taxable income of the company, as ordinarily estimated, less the regular income tax, plus capital cost and depletion allowances deducted in determining income. Any company would also be allowed to deduct from taxable income principal payments due on any debt which had an original term of three years or longer and which was contracted before April 1, 1966. Moreover, there would be a general deduction of $30,000 in order to mitigate the impact of tax on small businesses which do not have recourse to the capital market.

[8] As shown in the government's January investment survey, the prospective increase in business investment in 1966 over 1965 amounted to $1,250 billion, or 16 per cent. Thus, the estimated combined effect of the three measures would be to cut back the rise in business investment to 12 per cent. They may also help to restrain whatever increase in Canada's current account deficit that might otherwise occur.

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that time. Of course there is always a possibility, however small, that the Canadian expansion might slow down before October 1967. If the economic situation should fail to bear out current expectations, or if the economic impact of the taxes proves larger than anticipated, certain elements of flexibility in the tax measures themselves could be utilized to advantage as needed. The Finance Minister has indicated that he would not hesitate to recommend the complete elimination of the sales tax before it is scheduled to expire, if it should become necessary to induce some acceleration of business investment. Similarly, the capital cost allowances could be quickly liberalized by still another amendment to the Income Tax Regulations. Finally, the authorities could disburse the receipts from the refundable tax if it became desirable to ease the pressures on the money and the capital markets.

At this particular juncture, however, the possible need for fiscal stimulus seems remote. Indeed, in recent months wage increases in some industries have risen much faster than productivity and have led to further substantial upward pressures on costs and prices. Nevertheless, Canada has clearly made a major effort to adapt general monetary and fiscal policy to the requirements of a strongly stimulated economy and has, in the process, broken new ground in the development of flexibility in fiscal policy.

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