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The Dollar in the World Today*

By ALFRED HAYES
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As we move into the tenth year of sizable deficits in the United States balance of payments, I am disturbed to find a growing sense of impatience in the American business and financial community, directed less toward our failure to cope adequately with this problem than toward the restraints which the problem itself imposes on the freedom of American capital to move abroad in response to purely private considerations. To oversimplify, there is a tendency to regard all American investment abroad as good *per se* and to look upon those who counsel restraint for balance-of-payments reasons as unrealistic adherents of outworn economic theories.

It is my view that these attitudes, while understandable, are quite wrong and, if given free rein, would result in a breakdown of the whole international financial system which has served world trade and world investment so well since World War II.

Now there is no denying that the United States economy is the strongest in the world today, that the United States offers almost unrivaled opportunities for the investment of short-term funds, and that the dollar is at present used as a vehicle currency for perhaps half of all international financial transactions, in addition to its unique role as a reserve currency for most of the leading industrial nations. All of these facts give the dollar a very large measure of inherent strength; but not even they can guarantee the preservation of that strength, unless we perform adequately on two counts: (1) We must see that the dollar's internal purchasing power is reasonably stable; (2) we must come reasonably close to equilibrium in our balance of payments, on the average, over a period of years.

It has been argued that, to the extent that our payments deficits are offset by an increase in our long-term assets abroad (and in recent years such assets have grown even more rapidly than our cumulative payments deficit), we need not worry "because the bank is decidedly solvent". The point is, however, that we cannot meet a short-term liability, if it is presented for payment, by offering a share in American-owned factories in foreign countries. Like any bank, we must keep enough liquid assets available, in proportion to our liquid liabilities, to inspire confidence in our lasting ability to pay off those liabilities on demand.

Of course, aside from the use of our dwindling gold stock, there are other ways of meeting the temporary pressures that may arise from such liquid claims. A whole spectrum of voluntary cooperative credit arrangements has been built up since World War II, with the International Monetary Fund occupying the central position and with strong support from the Federal Reserve swap lines and other central bank credits, the sale by the United States Treasury of foreign currency bonds, and related measures. These credit facilities have proved their worth in taking care of several massive speculative attacks on major currencies, as well as serious potential pressures on the dollar and a multitude of temporary payments swings; and over the coming years I am sure they can be further refined and enlarged. Incidentally, in the current Middle East crisis, Federal Reserve swap lines and other forms of central bank cooperation have again demonstrated their solid worth. But no amount of credit can ever assure stability if a one-way disequilibrium proves too large and too lasting.

The same comment applies to the current worthwhile efforts to reach agreement on some form of supplemen-

* An address before the Graduate School of Business Administration of New York University, June 8, 1967. On this occasion, Mr. Hayes was presented with the School's C. Walter Nichols Award.

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tary reserve asset which would relieve some of the burden on gold while preserving the usefulness of the dollar as a reserve currency. After all these years of study and debate, it would be very useful to find some agreement on such a contingency plan before too much additional time has elapsed. But no solution of this problem can relieve in the slightest degree our obligation to reach equilibrium in our international accounts.

Far from justifying a more casual and high-handed approach to payments imbalances than in the case of other currencies, the dollar's special position entails special responsibilities for prudent behavior. A country whose currency is held by many other countries as a monetary reserve may have available a considerable measure of automatic credit. On occasion this can be very useful indeed, and clearly there are a variety of benefits accruing to the United States by reason of the dollar's almost universal use as a vehicle and reserve currency. It seems to me wholly reasonable, however, to expect the United States to order its financial affairs in a way to merit the world's confidence in our currency.

There is another aspect of this question which is worth bearing in mind. The attitude of foreign countries toward American investment in their markets varies widely from country to country and, even within a single country, is a composite of differing strands of thought, both favorable and unfavorable. Suppose, for example, that a large United States firm is constructing a new industrial plant that will provide greatly intensified competition for existing domestically owned concerns. The move may be very popular with construction companies which will benefit from the initial investment activity, or with bankers who may handle a large volume of initial financing, or with companies which believe they will be able to buy the products of the new plant more cheaply than would have been possible if the older plants had been the only source of supply. And the officials responsible for development and economic growth may be very well pleased. On the other hand, the move may be anything but popular with the competing companies whose path will be more difficult under the new conditions, and with the central banking authorities who may feel that the additional stimulus is more than can be absorbed without undue inflationary pressure. In addition, there may be those who fear that worldwide United States enterprises may be becoming too dominant in their national economy. On balance, the attitude may be highly favorable. But, if it should become obvious that the United States was deliberately following a policy of fostering overseas investment without any regard for a huge concurrent accumulation of dollar holdings abroad, the balance of forces in the country in question could swing sharply against us, even to the point where severe restraints were initiated against further American investments.

In arguing that we must not and cannot ignore the discipline of balance-of-payments pressures, I am certainly not contending that the burden of adjustment should rest entirely with the deficit country. There are many steps that can and should be taken by the surplus countries to try to reduce their surpluses—steps involving a loosening of restraints on capital exports, encouragement of merchandise imports, the selection of an appropriate mix of monetary and fiscal measures, etc. In the present setting, it seems to me quite reasonable that we continue to call upon Europe for more effective "cooperation" in carrying out its share of the adjustment process.

In so doing, we should neither assume nor imply that we ourselves have done everything that we can to achieve equilibrium. While equilibrium may not prove attainable as long as Vietnam expenditures are at anything like their present level, this does not excuse us from continuing our efforts in this direction. There may be additional possibilities for savings in our public outlays abroad, although here we must of course weigh the political and military factors as well as the financial. But if, as I believe, our best hope of coming closer to payments equilibrium lies in achieving a larger trade surplus, then it is not good enough to feel satisfied if, as in the past year or so, our costs and prices have risen no more rapidly than those of most other industrial nations. Obviously, we must do even better than they if our relative competitive position is to be improved, with consequent benefits to our trade surplus. I think that it is in this area of costs and prices that there is still inadequate awareness, on the part of many Americans, of the vital importance of achieving greater stability. When union leaders and business executives are ready to give this international factor due weight in every wage negotiation and price decision, then we may be well on the way to building the larger trade surplus that we need. And of course appropriate fiscal and monetary policies also play a big role in influencing both the trade balance and other important elements in our overall balance of payments. Progress on these fronts, as well as more effective cooperation by the surplus countries, would open the way to eliminating the kinds of emergency restraints on capital exports which have proved so understandably irksome to our bankers and businessmen. These restraints must certainly be regarded as a necessary evil—desirable only in the sense that they are preferable to the financial chaos that would probably follow from our failure to keep our overall payments under some control.

I might add that, while the restraint on foreign bank

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lending has been relatively severe, it seems to me that direct investment has been subjected to only rather moderate curbs. The major effort has been to prevent further increases in an outflow which has been at record levels for the past two years, well above the level of the early sixties.

In my judgment, it will not be necessary for us to attain absolute equilibrium, year in and year out, in our so-called liquidity balance. If the dollar continues to perform usefully its function as a vehicle currency to finance international trade and investment, there will undoubtedly be a need for some gradual growth in private dollar holdings. And I would not preclude a gradual growth over the years in the dollar reserves of foreign countries which are prepared to strengthen their financial positions in this way. After all, there is no absolute rule as to the proper relation between our gold holdings and our current liabilities to the rest of the world. In my own estimate, the present relationship between these quantities would be accepted by the world as quite "conservative" if only it could be demonstrated that large continuing deficits are a thing of the past. In the years ahead, of course, the world's entire reserve structure should be strengthened by the addition of some new type of asset.

I hope that I have said enough to demonstrate why I would emphatically disagree with the suggestion of some private citizens that we should perhaps threaten other countries with radical changes in the role of the dollar if they failed to perform in ways that we deemed desirable. Such a threat is only too likely to backfire and defeat our purpose, besides being quite inappropriate to the dignity and responsibility of the world's most powerful nation. It is heartening that our Government has made clear its determination to preserve the dollar's present role.

I regard the fixed relationship of gold to the dollar at $35 per ounce, on both the buying and the selling side, as the very keystone of the world's financial structure. Fortunately this fact is recognized by the world's monetary authorities, and our own Government's unchanged policy with respect to this relationship has been forcefully reiterated on many occasions. Those private commentators who are inclined to make light of this relationship, and even to suggest some measures calculated to alter it, would do well to reflect on the major contribution which this keystone has made to the world's unprecedented measure of prosperity in the years that have passed since the far-sighted Bretton Woods arrangements were first set up. Our best assurance of further growth and prosperity lies in leaving the keystone in place and reinforcing it with appropriate domestic policies and appropriate measures of international financial cooperation.

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The Business Situation

Early spring saw little change in the pace of economic activity. The readjustment in business inventories continued to have a dampening effect on production, employment, and incomes. In addition, labor disputes in the trucking industry during April apparently played some role in holding down the volume of economic activity. Taken together, the most recent data seem to indicate that, early in the second quarter, the economy remained on the high plateau which had characterized it since the start of the year. The general stability of the economy, in the face of this year's very sharp reduction in the rate of inventory accumulation, attests to the continued strength of other demand forces. Additional declines in inventory spending seem probable, perhaps resulting in some actual liquidation of aggregate stocks. However, the rate of adjustment is unlikely to be so sharp as in recent months, and the resulting reduction in spending should thus have appreciably less impact on overall production. At the same time, the prospects are for substantial further growth in other demand categories, including especially residential construction and government spending. The recent outbreak of war in the Middle East has, of course, added a substantial element of uncertainty to the outlook.

PRODUCTION, ORDERS, AND RESIDENTIAL CONSTRUCTION

Industrial output in April was slightly below the level of the preceding two months. The Federal Reserve Board's seasonally adjusted production index dropped to 155.9 per cent of the 1957-59 average, 0.5 percentage point under the reading in both February and March. The decrease put the overall index at a level 2 per cent under the record high touched last December. Modest output declines in April were widespread among manufacturing industries, the only significant exception being motor vehicle production which rose strongly for the second month in a row. The spring brought an improvement in new car sales as well as in producers' expectations regarding the sales outlook. As a result, the industry has been able to work down auto inventories and reduce the stock-sales ratio from the exceptionally high level reached early in the year. Responding to the improved situation, automobile producers rescinded some earlier cuts in second-quarter production schedules, thus adding strength to the rise in the assembly rate. Auto output in April, seasonally adjusted, rose by nearly 10 per cent to an annual rate of about 7⅔ million units, and a further increase was recorded in May.

In contrast to the renewed strength of motor vehicle output in recent months, production of other consumer durable goods has continued to slacken. Retail sales of furniture and home appliances have been weak, and significant inventory problems have developed in some lines. The market for television sets has experienced a particularly dramatic swing away from the surging growth that characterized the 1964-66 period. In April, output of television sets was fully 30 per cent below the peak reached in December.

The easing of overall industrial production in 1967 has reflected not only a sluggishness in consumer demand but also a slowdown in the growth of capital spending. The volume of business equipment output in April was almost 3 per cent under its December peak and about equal to the level of late last summer. The restoration by Congress of the tax incentives for investment that were suspended last fall should give some boost to demands for capital equipment. Even with the restoration, however, the recent easing of capacity utilization rates and the decline in profits in the first quarter suggest that 1967 will see only a modest further rise in spending on capital investment. According to the latest survey of businessmen, taken in May by the Commerce Department and Securities and Exchange Commission, total capital outlays this year will be 3 per cent above the 1966 level. This represents a modest downward revision in anticipated 1967 spending from the figure reported in the Government's February survey, with the bulk of the reduction being concentrated in the first half of the year.

The inflow of new orders for durable goods increased moderately in April and at $22.3 billion was somewhat

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Source: United States Bureau of the Census.

larger than the first-quarter average. Most major industries reported orders gains for the month, including the primary metals producers whose orders had slumped quite sharply in March. The machinery and equipment industries experienced a second consecutive rise in new bookings; from last October through February, such orders had dropped month by month. Shipments of durable goods declined in April—in part, perhaps, because of labor disputes in the trucking industry. Since shipments and orders were virtually equal, the total backlog of unfilled orders showed no significant change in contrast to the substantial declines in the earlier months of the year. The backlog of primary metals producers declined significantly further in April. However, the aircraft industry's backlog grew strongly, while unfilled orders changed little in most other durables industries.

The volume of new orders for defense products rose in April, returning to the February level. This series, which tends to be heavily influenced by swings in orders for aircraft, can give only a rough approximation of the actual trend of defense buying of durable goods. The Commerce Department's figures on new orders for defense products do not include all defense ordering of durables and, on the other hand, they do record some nondefense ordering, especially of aircraft. While new orders for defense products have been essentially stable for some months, there can be little doubt that the impact of military demands on the economy has continued to be very substantial. A revision of first-quarter gross national product (GNP) figures shows that the rise in Federal purchases of goods and services for defense purposes was $4.2 billion at a seasonally adjusted annual rate, accounting for more than 25 per cent of the total rise in final demand, that is, GNP excluding inventory investment.

The recovery in residential construction is continuing. On a seasonally adjusted basis, the number of private nonfarm housing starts rose only slightly in April after a small March decline (see Chart I). Underlying these figures, however, is the fact that the actual number of starts succeeded in scoring the very strong March-April advance which is expected as a seasonal phenomenon and is thus allowed for in the seasonal adjustment of the data. In unadjusted terms, housing starts rose by almost 50 per cent in March and by more than 20 per cent in April. These rises occurred despite the relatively short period of time that had been available to the home-building industry to adjust to a higher rate of operations, in the wake of last year's steep decline.

The resurgence of residential building can also be seen in the trend of building permits issued by local authorities (see Chart I). In areas requiring permits, there has been a strong rise in authorizations of both single-family homes and of units in multifamily structures. (While only about 80 to 85 per cent of total starts in recent years have been covered by permits, nearly all multifamily structures are built under permit authorizations.) The slump last year in construction of multi-unit housing followed two previous years of weakness which had resulted from earlier overbuilding in some areas, especially in the West. There was no tangible decline in the national rate of vacancies in rental units until 1966, when the vacancy rate in the West, which had previously stopped rising, finally turned downward. Vacancy rates moved still lower in the first quarter of 1967, and their substantial decline in the past year or two suggests the existence of an appreciable volume of potential demand for rental housing.

EMPLOYMENT, INCOME, AND CONSUMER BUYING

Manufacturers made further reductions in both April and May in the number of production workers on their

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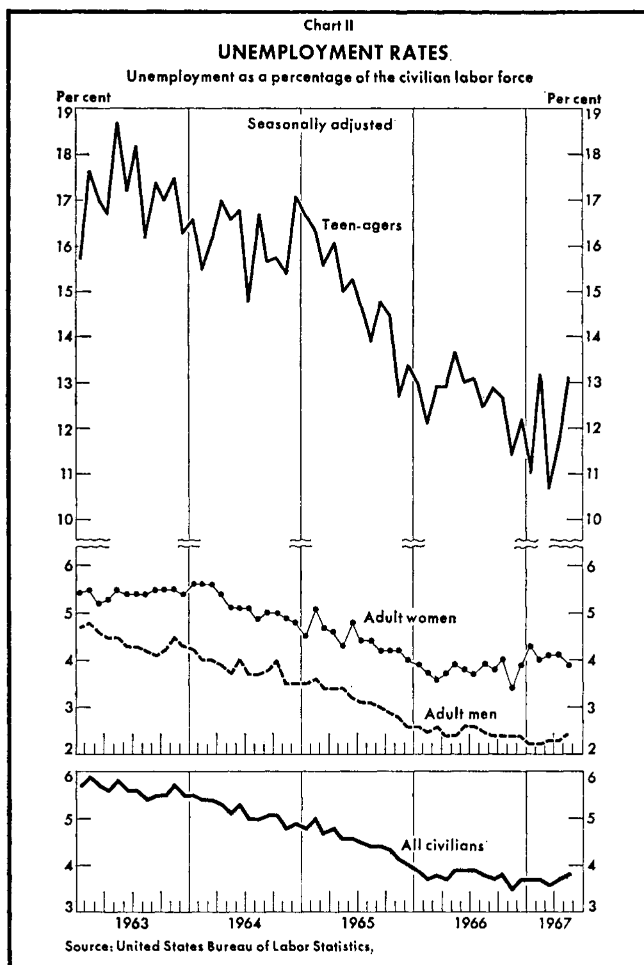
payrolls. A large part of the May decline was attributable to the effects of strikes in the rubber industry. Employment expanded in most other sectors of the nonfarm economy, with government continuing to show a particularly strong uptrend, but the total number of persons on nonagricultural payrolls nevertheless declined in both months. The May cutback in manufacturing employment was the fourth in a row and, at the same time, the average length of the workweek dropped back to the February figure following two small increases. Average weekly hours in durables manufacturing have been essentially unchanged since February, but in nondurables the workweek lengthened slightly in March and April and then fell back in May. Having made a very sharp reduction in the workweek during the winter months, manufacturers in the spring were apparently making further adjustments to slower production largely by way of cuts in employment.

The rate of unemployment in the civilian labor force edged back up in April to the 3.7 per cent figure that had prevailed from December through February, and moved to 3.8 per cent in May (see Chart II). Thus, the unemployment rate has changed but little this year despite a definite slowing in the economy. In part, the fact that the rate has been so nearly stable is the result of a reduction in average output per worker. This reduction, in turn, is attributable to the combined effects of a cut in workers' average weekly hours and a halt to the growth of productivity, that is, output per man-hour.



Moreover, in periods when there is a slowing in economic activity and in the growth of job openings, it is quite common for some women to withdraw from—or to refrain from entering—the labor force. This is often true of teen-agers as well. There has been some evidence of such a development in recent months. In 1966, when the economy was growing very rapidly and demands for labor were very strong, there was a vigorous expansion in the number of women in the labor force, with virtually all the growth representing an advance in the number of women employed. During the first five months of this year, in contrast, the average number of women in the labor force was only very slightly larger than in the preceding five months, and the average number of women employed declined. Largely as a consequence, overall labor force growth has slowed during the early months of 1967.

The April cutbacks in manufacturing employment and overtime were accompanied by a drop in total wage and salary payments in that sector, which in turn held down the growth of personal income. Also working to hold back the expansion of income in April was the fact that accelerated payments of dividends on veterans' life insurance had temporarily swelled personal income in February and March; this buoying influence then disappeared in April. Altogether, the rise in personal income for the month was the smallest in well over a year.

Since the closing months of 1966, consumers have sharply stepped up the proportion of their after-tax incomes allocated to savings. Over the same period, aggregate retail sales volume has been virtually stable and consumption spending on goods and services has contributed only modestly to overall GNP expansion. According to recent revisions of GNP figures, personal consumption expenditures grew by $5.8 billion in the first quarter, at a seasonally adjusted annual rate,[1] rather than the $8.1 billion indicated

[1] With various other components also revised, the net effect of the revisions was to reduce total first-quarter GNP by $0.6 billion to $763.7 billion.

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by the preliminary estimate and reported last month in this *Review*. The downward revision was largely in purchases of nondurable goods, and was chiefly due to the fact that preliminary estimates had overstated retail sales in February and March. With consumption spending revised downward, the ratio of savings to disposable income was revised upward to 6.5 per cent, compared with 5.9 per cent in the fourth quarter and a quite low 4.8 per cent in the third quarter.

As a concomitant of the recent vigorous growth of savings, there has been a strong buildup in consumers' holdings of liquid assets, such as savings deposits. This trend suggests that a favorable basis is being established for the development of renewed vigor in the expansion of consumer spending. Preliminary April data, however, provided little evidence of any appreciable strengthening in the behavior of overall retail sales. Sales of nondurables increased by about 1 per cent, and outlets dealing in motor vehicles and related goods also registered a gain in dollar volume. Sales declined at other durables stores, however. Total April sales were estimated as being up by less than 1 per cent, following a slightly stronger rise in March.

Sales of new automobiles made a relatively good showing in both March and April. A rise of about 5½ per cent in the latter month brought sales to a seasonally adjusted annual rate of 7.6 million units. May sales held very close to the April pace. While the current selling rate is low, relative to the experience of the last few years, the improvement during the spring has buoyed manufacturers' expectations regarding the sales outlook.

COST AND PRICE DEVELOPMENTS

The general stability of output in recent months has been accompanied by a cessation of growth in overall output per man-hour, with some sectors of the economy apparently recording actual declines. Hourly compensation has shown a strong rise, and labor costs per unit of output have continued to increase at a significant rate. Nonfinancial corporations, whose activities generate well over half of total GNP, experienced a first-quarter rise in unit labor costs equal to almost 10 per cent at an annual rate. The quarter's increase for manufacturing firms alone was of nearly the same magnitude. The pressure of rising unit costs was clearly a factor behind the first-quarter drop in corporate profits, and price increases aimed at protecting profit margins could well become more common over the months ahead.

According to preliminary figures, the wholesale price index rose in May, following three months of decline. There has been no change since February in the average level of industrial commodity prices. Thus, the behavior of the overall index has been dominated by agricultural prices, which trended downward through April but then rose rather sharply in May, largely as the result of an upturn for livestock and meats. This recent advance in wholesale food prices may well be followed by a renewed rise at the consumer level. In April, however, the consumer food price index continued to decline, but increases for other goods as well as for services pushed the total consumer price index up by 0.3 percentage point—the largest advance since last October.

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The Money and Bond Markets in May

The money and capital markets exhibited divergent movements in May. Conditions in the money market remained generally comfortable and some short-term interest rates declined further, but yields in the intermediate- and long-term sectors—which had begun to climb sharply in April—continued to advance until the last week of the month. At their late May highs, offering yields on new corporate issues were very close to their 1966 peaks, and yields on tax-exempt issues were within about ½ percentage point of last year's peaks. Yields on long-term Treasury issues reached 4.84 per cent in late May, before falling somewhat over the final week of the month.

The upward pressure on bond yields during May largely reflected the same factors that pervaded the capital markets in April. In particular, congestion persisted in both the corporate and tax-exempt sectors under the weight of the heavy flow of current and prospective flotations. Only a few of the new issues in May were accorded good investor receptions despite progressively higher yields. In addition, there was growing apprehension over anticipated large Treasury financing needs (including sales of participation certificates) in the months ahead, especially in view of possibly increased military spending for the Vietnam war. While the statistics released during the month indicated little change in the level of economic activity, and resulted in some temporary improvement in market sentiment around mid-May, most market participants generally looked for an early strengthening in the economy. The better market tone that emerged late in the month was most pronounced in the Treasury sector. The technical position of that market had improved considerably, reflecting the cumulative effects of sizable official purchases during the month. There were also expectations—stimulated by discussion in the press—that the Federal Reserve might continue to purchase some Treasury coupon issues over succeeding weeks in the course of meeting the midyear reserve needs of the banking system. In addition, investors began to find the prevailing high yields on corporate and municipal securities attractive, and underwriters were able to clear out some of their inventories of unsold new issues.

In the Treasury bill market, rates declined throughout the month with some issues falling to their lows of the year. There was good demand from investors and other sources. Demand particularly favored shorter maturities, in part reflecting generally cautious investor attitudes, and thus there was a progressive widening in the rate spread between short- and long-term bills.

Free reserves continued to fluctuate in the range of recent weekly variations during May, and the distribution of reserves shifted in the second half of the month toward banks in the money centers, who apparently were making preparations for loan demands expected in connection with mid-June corporate tax payments. Banks had little difficulty in covering most of their residual needs in the Federal funds market at rates generally at or below 4 per cent, and borrowings from the Federal Reserve System were light. A heavy volume of negotiable certificates of deposit (C/D's) matured during May, and to stem further attrition some banks moved up their offering rates, especially on longer maturities. This contrasted with movements in other short-term rates, which generally declined during May.

THE GOVERNMENT SECURITIES MARKET

Early in May, attention in the market for Treasury notes and bonds was centered on the Treasury's refunding of up to $22.1 billion of notes and bonds maturing in May, June, and August (of which $9.0 billion was held by the public). Holders of May and June maturities were offered the right to exchange them for either a 4¼ per cent fifteen-month note or a 4¾ per cent five-year note; holders of August maturities were given the opportunity to exchange them for the latter note only.[1] Market reaction to the terms of the refunding, announced on April 26, was somewhat hesitant for a while but gradually became more positive. By the time the subscription books were closed on May 3, the public had exchanged 81½ per cent of its

[1] For further details of the offering, see this *Review* (May 1967), page 90.

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holdings of May and June maturities and about 26½ per cent of its holdings of August maturities, taking a total of $2.0 billion of the new fifteen-month note and $2.7 billion of the five-year note.

The improved tone of the market extended through May 4, when a reduction in the British bank rate from 6 per cent to 5½ per cent was announced. Investor activity subsequently contracted, however, and as a weaker overall tone reemerged, dealers became increasingly restive with their newly enlarged positions of refunding issues. In this atmosphere, professional offerings expanded and prices of Treasury coupon issues declined throughout the list.

The downward movement in prices of outstanding coupon issues accelerated somewhat on May 8 and 9, as professional offerings of intermediate-term issues—where dealer positions were largest—weighed heavily on the market and as prices of Government securities were strongly affected by further deterioration in the corporate and tax-exempt markets. In addition, there was widespread apprehension that the size of the Treasury cash financing needs might be larger than previously anticipated in the last half of this calendar year and in fiscal 1968 generally, particularly in view of newspaper reports of the possibility of further escalation of the Vietnam conflict. However, sizable investment orders from official accounts as well as other buying at the lower price levels on these two days removed some of the heavy overhanging supply of securities on dealers' shelves, and prices of intermediate-term issues subsequently moved back up somewhat, with some of the gains also carrying over into the longer term sector. Reports of lower retail sales in March than had previously been estimated, a large drop in bank loans to businesses in the statement week ended on May 10, and the absence of any significant selling prior to the refunding settlement date helped reinforce this improved atmosphere.

A heavier tone returned to the market again on May 15—the settlement date for the Treasury's refunding. Sentiment was initially dampened by Secretary Fowler's request for two revisions affecting the 4¼ per cent interest rate ceiling on long-term Treasury issues. Specifically, the requests were to extend from five to ten years the maximum maturity on Treasury notes, to which the ceiling does not apply, and for authority to sell up to $2 billion of bonds annually without regard to the interest ceiling.[2] Treasury requests for an increase in the debt ceiling and its estimates of budgetary deficits had largely been anticipated and had only a limited initial effect on quotations, but over succeeding days more and more attention was focused on the prospects of very large Treasury cash needs in the second half of this calendar year. Of immediate concern, moreover, was the likelihood of another sizable sale of participation certificates before the end of the current fiscal year. Pressure on long-term rates eased somewhat during the last week of the month, and the heavy atmosphere that had been in the market earlier gradually lifted. Market participants took heart from indications of concern within the Administration over the recent steady rise in interest rates and from increased discussion of the possibility of a tax rise later this year. System purchases of coupon issues around this time contributed to a further improvement in the technical position of the market, and overall sentiment was buoyed by discussion of the likelihood of additional System buying in the course of meeting reserve needs over the weeks ahead.

Treasury bills were in strong demand during May. Over the month as a whole, market rates declined generally by 15 to 30 basis points on outstanding bills maturing within five months and by 4 to 20 basis points on longer maturities. Demand as a rule favored the shorter maturities, and consequently the rate spread between three- and six-month bills widened to 28 basis points at the end of the month, the largest differential since November 1966. The broad-based demand for bills reflected in part expectations by some investors of continued upward pressure on long-term rates. Additional demand for bills came from commercial banks and from other financial institutions rebuilding their liquidity, while corporations were active buyers of the June tax anticipation bills. In addition, some of the proceeds of recent corporate and tax-exempt bond flotations apparently have been invested temporarily in Treasury bills. Bidding in the five weekly bill auctions held in May was aggressive, as dealers sought to rebuild their generally depleted positions. At the final weekly auction, average issuing rates on the new three- and six-month issues were set at 3.477 per cent and 3.733 per cent, respectively, down about 24 and 4 basis points from the rates established in the last auction in April. Demand was not so insistent for the longer maturities, however. In the auction of nine-month and one-year Treasury bills in late May, average issuing rates were set at levels about 10 basis points above the rates set a month earlier, though they remained below the levels of March. (For information on average issuing rates of other Treasury bill auctions in May, see Table III.)

Movements in the market for Government agency securities during May closely paralleled those in the market for

[2] Later in the month, the House Ways and Means Committee voted approval of an extension of the maximum maturity of Treasury notes to seven years but did not approve the sale of bonds outside the interest ceiling.

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1967

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

Factors	Changes in daily averages—week ended on					Net changes
	May 3	May 10	May 17	May 24	May 31	
"Market" factors						
Member bank required reserves*	— 89	+ 159	+ 89	+ 226	+ 40	+ 425
Operating transactions (subtotal)	— 291	— 451	+ 304	— 184	— 219	— 841
Federal Reserve float	— 52	— 57	+ 128	+ 20	— 382	— 343
Treasury operations†	— 109	+ 146	+ 102	— 114	+ 230	+ 255
Gold and foreign account	— 7	— 16	+ 21	+ 1	— 37	— 38
Currency outside banks*	— 139	— 485	+ 109	+ 133	— 19	— 401
Other Federal Reserve accounts (net)‡	+ 16	— 38	— 59	— 222	— 10	— 313
Total "market" factors	— 380	— 292	+ 393	+ 42	— 179	— 416
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities	+ 197	+ 174	— 226	+ 287	+ 127	+ 559
Bankers' acceptances	— 1	+ 3	—	— 2	+ 1	+ 1
Repurchase agreements:						
Government securities	+ 253	+ 163	— 157	— 300	+ 69	+ 28
Bankers' acceptances	+ 43	— 8	— 42	— 18	— 28	— 53
Federal agency obligations	+ 5	— 5	— 3	—	—	— 3
Member bank borrowings	+ 36	— 71	+ 60	— 73	+ 52	+ 4
Other loans, discounts, and advances	—	—	—	—	—	—
Total	+ 533	+ 255	— 369	— 105	+ 222	+ 536
Excess reserves*	+ 153	— 37	+ 24	— 63	+ 43	+ 120

Member bank:	Daily average levels					
Total reserves, including vault cash*	23,627	23,431	23,366	23,077	23,080	23,316§
Required reserves*	23,228	23,069	22,980	22,754	22,714	22,949§
Excess reserves*	399	362	386	323	366	367§
Borrowings	134	63	123	50	102	94§
Free reserves*	+ 265	+ 299	+ 263	+ 273	+ 264	+ 273§
Nonborrowed reserves*	23,493	23,368	23,243	23,027	22,978	23,222§

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					
Less than one year	+ 763	— 352	—3,161	— 83	+ 427	— 2,406
More than one year	—	—	+2,878	+ 102	+ 109	+ 3,089
Total	+ 763	— 352	— 283	+ 19	+536	+ 683

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 five weeks ended on May 31.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS MAY 1967

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on					Average of five weeks ended on May 31*
	May 3	May 10	May 17	May 24	May 31*	
Eight banks in New York City						
Reserve excess or deficiency(—)†	29	62	13	16	38	32
Less borrowings from Reserve Banks	39	21	36	—	—	19
Less net interbank Federal funds purchases or sales(—)	681	960	864	691	329	705
Gross purchases	*1,292*	*1,446*	*1,326*	*1,332*	*1,038*	*1,287*
Gross sales	*611*	*486*	*462*	*641*	*709*	*582*
Equals net basic reserve surplus or deficit(—)	— 692	— 920	— 887	— 676	— 291	— 693
Net loans to Government securities dealers	865	684	607	577	591	665
Thirty-eight banks outside New York City						
Reserve excess or deficiency(—)†	4	127	10	— 46	4	20
Less borrowings from Reserve Banks	60	2	46	22	56	37
Less net interbank Federal funds purchases or sales(—)	1,035	1,432	1,267	1,137	917	1,158
Gross purchases	*1,832*	*2,176*	*1,991*	*2,022*	*1,768*	*1,958*
Gross sales	*797*	*744*	*723*	*886*	*852*	*800*
Equals net basic reserve surplus or deficit(—)	—1,092	—1,307	—1,303	—1,205	— 969	—1,175
Net loans to Government securities dealers	731	677	640	577	476	620

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—May 1967				
	May 1	May 8	May 15	May 22	May 29
Three-month	3.770	3.671	3.628	3.493	3.477
Six-month	3.907	3.831	3.802	3.692	3.733

Maturities	Monthly auction dates—March-May 1967		
	March 28	April 25	May 24
Nine-month	4.078	3.842	3.944
One-year	4.074	3.832	3.933

* 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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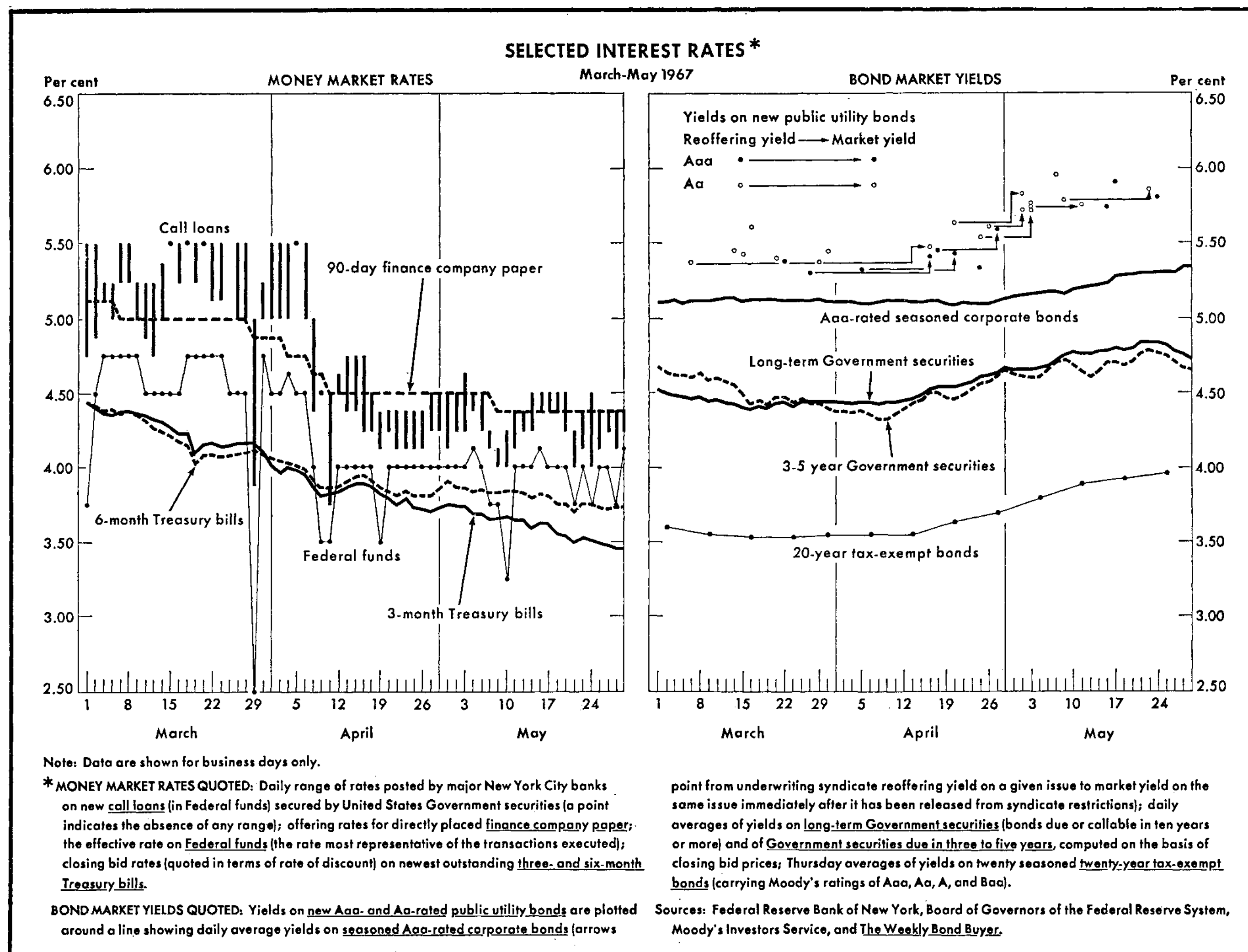
direct Treasury coupon securities. Prices generally moved lower over the month, with the largest changes in the longer maturity area, which was especially affected by concern over expected further sales of participation certificates in the next several weeks. These expectations were confirmed on May 31, when the Federal National Mortgage Association announced that it would sell $900 million of participation certificates on June 15, $250 million of which would be sold directly to Government trust accounts. Only two issues due beyond a year were offered during the month. One was a $341 million offering of twenty-month Federal Land Bank bonds priced to yield 4⅞ per cent. This offering, which was made on May 10, raised $161 million of new money; it was well received. On May 16, the Tennessee Valley Authority sold $70 million of twenty-five year bonds on a competitive basis to an underwriting syndicate. The issue afforded five-year call protection and was reoffered to investors at a 5.70 per cent yield. The offering was well received. A total of approximately $1.1 billion of shorter term agency issues was marketed during the period and most were generally accorded good initial receptions by investors.

OTHER SECURITIES MARKETS

Prices continued to decline in other sectors of the capital market during May, as the volume of current and prospective new corporate and tax-exempt offerings remained at near-record levels. An improved tone in the market for corporate securities developed temporarily early



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.

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in the month, when investor interest expanded at the higher yield levels that were reached following a spate of syndicate terminations. News of the reduction in the British bank rate also encouraged market participants briefly. With indications of heavy future demands for capital funds continuing to mount, however, the pessimistic climate reappeared and persisted through the remainder of the month despite announcements around mid-May of postponements of a total of $328 million of corporate securities. The respite was generally expected to be short-lived, and indeed $100 million of the postponed bonds was offered the following week. The $935 million of new corporate bonds that came to market during the month was typically offered at progressively higher yields but, even so, only a few issues were completely sold at the original reoffering yields. Near the end of the month, two A-rated industrial issues were offered at about 5.70 per cent with ten years of call protection, near the highest yield on any comparable issue marketed last year. Significant additions to the forward calendar of corporate debt offerings were made during the month, including one issue of $250 million of telephone company debentures scheduled for August 1. Corporate bonds on the calendar for June totaled $1.4 billion, and heavy offerings loom in later months as well.

The market for tax-exempt bonds was also generally weak throughout May, and dealers were able to move bonds only at rather substantial price reductions; after several syndicate terminations, price adjustments resulted in yields 20 to 45 basis points higher than original reoffering yields. These price cuts enabled dealers to reduce the volume of tax-exempt offerings advertised in the Blue List to $576 at the end of May, compared with the recent peak of $847 million reached on April 26. The largest tax-exempt offering of the month was the $100 million issue of State of California bonds (Aa-rated) at reoffering yields of 25 to 45 basis points above those on comparable maturities in the state's previous issue marketed March 21. The bonds met a fairly good reception. Several tax-exempt bond issues scheduled for offering during May were canceled or postponed because of market conditions. The largest such postponement, announced on May 23, was that of a $96.3 million issue of New York City bonds.

The average yield on Moody's Aaa-rated seasoned corporate bonds rose substantially during May, closing the month at 5.35 per cent. *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues, carrying ratings ranging from Aaa to Baa, rose by 27 basis points to 3.96 per cent (see the right hand panel of the chart). These indexes, however, are 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.

BANK RESERVES AND THE MONEY MARKET

Conditions in the money market were generally comfortable during May. The Federal Reserve System supplied a large volume of reserves through open market operations, and a decline in member banks' required reserves tended to increase excess reserves as bank credit showed only moderate growth. Free reserves averaged $273 million during the five weeks ended on May 31, in the upper part of the range of variation in April. Federal funds, trading in a narrow range around 4 per cent, accommodated most short-term needs of banks in reserve deficit, and borrowings from the System averaged a relatively light $94 million over the period. (See Table I.)

The major money market banks remained in a basic reserve deficit during May, but moved into a considerably more comfortable reserve position toward the end of the month, as they apparently began to prepare for loan demands expected around the June tax date. In the final week of the month, the forty-six major money market banks had a basic reserve deficit aggregating only $1.3 billion, the smallest deficit since November 30, 1966. Several of the major money market banks moved to stem attrition in their outstanding C/D's during the month by bidding somewhat more aggressively for large deposits. Some banks in New York City raised posted rates by ¼ to ½ percentage point during May, and some were reportedly paying as much as 5 per cent on a negotiated basis for six- or seven-month maturities. In contrast, the highest rate available in New York City at the end of April was reportedly 4½ per cent. New York City banks recorded a $224 million rise in their outstanding C/D's in the five weeks ended on May 31, following a drop of $257 million in April.

Most other short-term rates declined during May. In addition to the easing in rates on the three- and six-month maturities of Treasury bills noted above, rates on prime commercial paper declined by ⅛ per cent in May, while yields on call loans to Government securities dealers and bankers' acceptances showed no overall change despite a large volume of acceptances being offered on the market.

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Recent Economic Policy Measures in Industrial Countries Abroad

Since the beginning of 1967, there has been a progressive relaxation of policies of monetary restraint in a number of industrial countries abroad. During 1966, monetary policy had been tightened in many countries to contain acute inflationary pressures or to resist a deterioration in the balance of payments.[1] In the absence of sufficiently restrictive fiscal action, interest rates had soared to their highest levels in the postwar period. Later in the year, however, conditions in the financial markets eased slightly, as demand pressures subsided in several previously overheated economies. By early 1967, policy formulation in virtually all countries took place in a context of better balance between demands and resource availabilities. At the same time, considerable progress had been made in some countries toward the correction of payments imbalances. In view of the slower growth in some countries, credit conditions were allowed to ease slightly toward the end of 1966. Since the start of the year, there has been a further and more rapid reversal of last year's upward spiral of interest rates—a reversal marked by repeated reductions in central bank discount rates. In Germany, the discount rate was lowered early in January in the first of a series of overt moves toward monetary ease. This change was quickly followed by reductions in discount rates in Canada, Belgium, and Sweden. In subsequent months, discount rates were cut further in these countries and credit conditions eased in other industrial countries as well. Following the relaxation of monetary restraint abroad and with the recovery of confidence in sterling, the Bank of England has lowered the bank rate in several steps.

[1] For a detailed discussion of developments in 1966, see "Recent Economic Policy Measures in Industrial Countries Abroad", this *Review* (June 1966), pages 144-49, and (December 1966), pages 268-73.

UNITED KINGDOM

Since the adoption of a sweeping stabilization program in July 1966, inflationary pressures in the United Kingdom have eased considerably and during the fourth quarter there was a dramatic improvement in the balance of payments. The introduction in July of more stringent restrictions on instalment purchases, in combination with the effects of an earlier policy of credit restraint, led almost immediately to a reduction in sales of consumer durables. At the same time there was a pronounced change in business expectations, which led to some downward revision of investment plans. New housing starts also dropped as a consequence of an emerging squeeze on consumers' disposable income and the jolt to business confidence. Moreover, the rate of inventory accumulation, which had been fairly rapid earlier in the year, fell sharply in the fourth quarter—partly because of the decline in final sales and partly because imports were postponed in anticipation of the removal at the end of November of the remaining part (10 per cent) of the import surcharge that had been introduced in October 1964. Despite a recovery in exports, industrial production turned down in the autumn months (see Chart I). As employers reappraised their labor requirements, employment began to fall and the seasonally adjusted unemployment rate rose from 1.2 per cent in June to almost 2 per cent by the year-end. In conjunction with the decline in overall demand, the standstill on wages and prices, adopted as part of the July program, proved very effective. Hourly wage rates, which rose at an annual rate of almost 7 per cent during the first half of 1966, remained virtually unchanged during the second half. Although retail prices rose by 1½ per cent from July to December, this change largely reflected an increase in indirect taxes imposed in July rather than an erosion of the price freeze.

In the closing months of the year, the authorities took a

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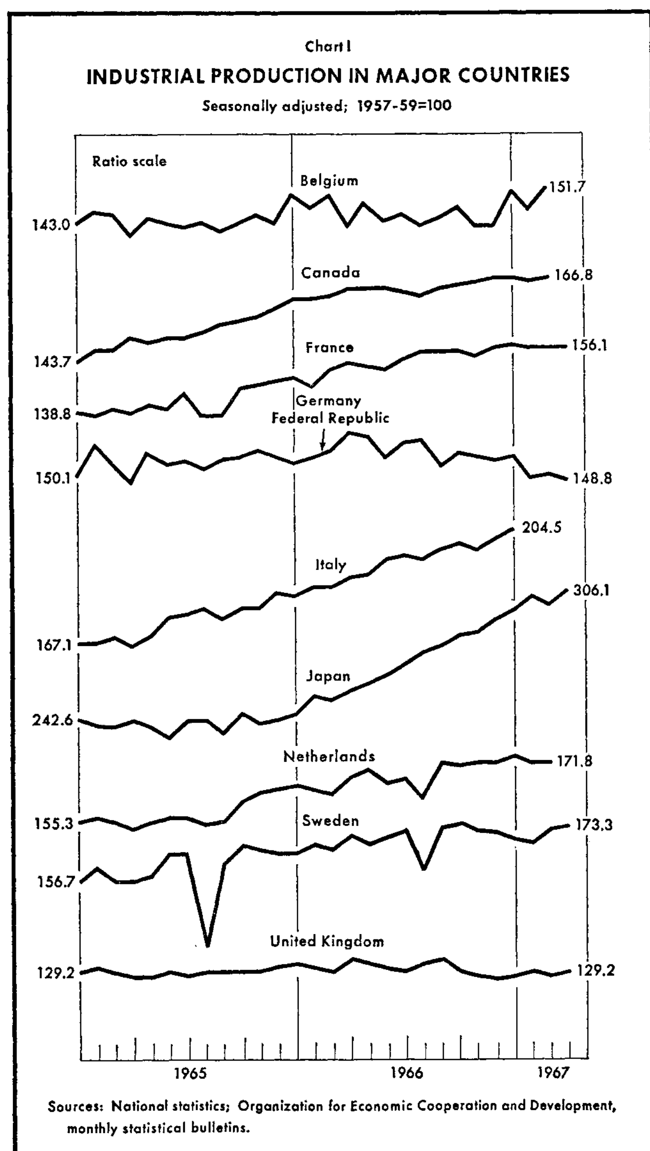
number of steps to bolster business confidence and cushion the readjustment. In November, the Bank of England pointed out that outstanding credit extended by the clearing banks was below the ceiling on loans to the private sector, which had been renewed as part of the July stabilization program, and made it clear that banks had the resources to meet all justified demands from priority borrowers. Then, on December 1, the government increased the amount of direct grants for certain investment projects —from 40 per cent to 45 per cent of expenditures in the so-called development areas and from 20 per cent to 25 per cent elsewhere. By the turn of the year, there were signs that the domestic economy had begun to stabilize after the sharp adjustment in the autumn. Consumer expenditures began to pick up in the early months of 1967, industrial production appeared to have bottomed out, the seasonally adjusted unemployment rate was only slightly higher than at the year-end, and the fall in demand for bank credit was beginning to moderate.



Sources: National statistics; Organization for Economic Cooperation and Development, monthly statistical bulletins.

Externally, the austerity program began to exert a corrective effect on the balance of payments in the closing months of 1966. After allowance for seasonal factors, exports were significantly higher in the fourth quarter while imports fell sharply, partly in anticipation of the removal of the import surcharge at the end of November. Despite a rebound in import deliveries in December, the average level of imports in the fourth quarter was 7 per cent lower than in the first nine months of the year, clearly suggesting that the July measures had begun to take hold. With the turnabout in the trade balance, the current account moved into substantial surplus and, after allowing for the repayments on the United States and Canadian government loans, resumed in full in the fourth quarter, there was an underlying improvement in the long-term capital account as well. Thus, after having run a very large balance-of-payments deficit during the first three quarters of 1966, the United Kingdom developed a $380 million current-account surplus (seasonally adjusted) in the last quarter alone, and the balance of payments moved into substantial surplus. The trade balance moved back into slight deficit during the first quarter of 1967, but the overall balance on current and long-term capital account appears to have remained in surplus thus far this year. Moreover, with the further recovery of confidence in sterling and the reversal of "leads and lags", foreigners continued to rebuild their sterling balances. During the first four months of the year, the Bank of England was able to increase its reserves by substantial amounts, even after repaying all its drawings under the Federal Reserve swap facility and fully liquidating the short-term credits provided by other central banks last summer. In addition, the Bank of England in January paid off in their entirety the special credits obtained earlier from the Federal Reserve and the United States Treasury.[2] This pattern of gradual improvement was interrupted in April, when the trade balance worsened, with imports rising much faster than exports. However, in May the United Kingdom was able to repay, six months ahead of schedule, $405 million owed to the International Monetary Fund under a 1964

[2] See Charles A. Coombs, "Treasury and Federal Reserve Foreign Exchange Operations", this *Review* (March 1967), pages 43-51.

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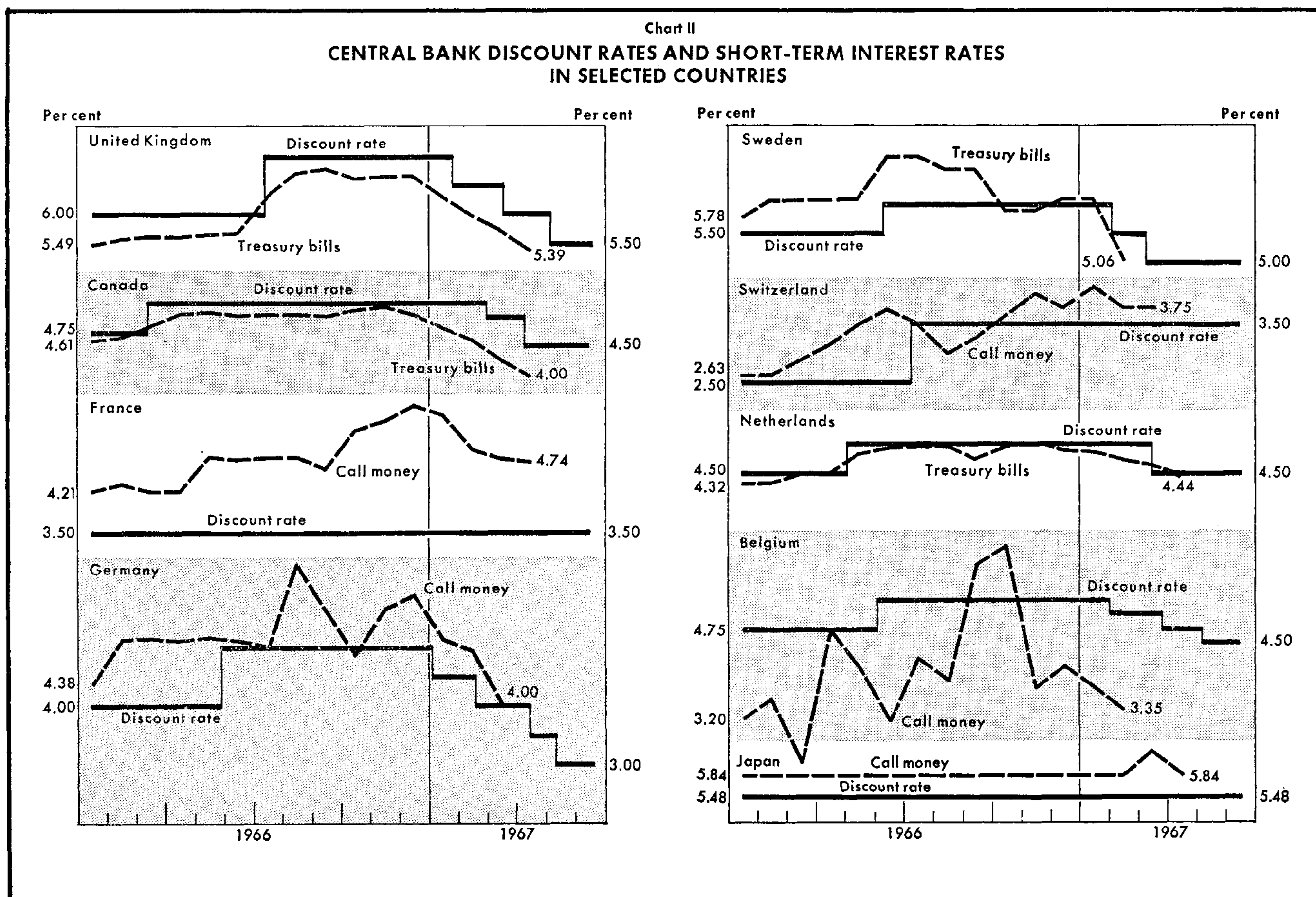
Chart II
CENTRAL BANK DISCOUNT RATES AND SHORT-TERM INTEREST RATES IN SELECTED COUNTRIES



drawing and an $80 million loan obtained from Switzerland in 1964. With the repayment, the United Kingdom's remaining indebtedness to the IMF due this year was reduced to $393 million. Sterling drawings by other IMF members are expected to reduce this indebtedness further.

Against this background of considerable progress toward restoration of external and internal balance, the Bank of England on January 26 lowered the bank rate from its crisis level of 7 per cent to 6½ per cent (see Chart II). This was followed by another ½ percentage point cut in mid-March after a slight easing in money market rates. However, clearing bank loans (seasonally adjusted) declined in January but leveled out in February. As a result, the margin between outstanding advances and the ceiling on bank loans continued to widen. In April the ceiling was removed from the clearing banks and the Scottish banks, but at the same time it was announced that special deposits by these banks would be used more flexibly to control the volume of bank credit, and the qualitative guidance covering the direction of bank lending was reaffirmed. So far as all other banks were concerned, the ceiling was to remain in force until suitable alternative methods of credit control could be arranged. Moreover, the few tax changes announced in the budget in April were designed to be essentially neutral in their impact on the economy, reflecting the government's view that it "should not take any substantial action to influence demand just now". The budget was well received abroad and, following further reductions in interest rates at home and abroad, the bank rate was cut to 5½ per cent in early May.

RELAXATION OF MONETARY RESTRAINT IN OTHER INDUSTRIAL COUNTRIES

The slowdown in economic activity in Germany, which first became apparent in the spring of 1966, developed

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at an unexpectedly rapid rate in the second half of the year. Fixed private investment weakened steadily, while spending by state and local authorities was particularly hard hit by the stringency in the money and capital markets. The slack in domestic demand was reflected in a marked slowdown of imports and a sharp rise in exports. The resultant improvement on trade account was the major force behind the reemergence of a payments surplus in the latter half of 1966. These trends continued into the new year. By March, the level of industrial production, seasonally adjusted, had fallen 7 per cent below its earlier peak and the unemployment rate had reached an unusually high 2.2 per cent. However, in April there were some signs that the economy was beginning to respond to a number of expansionary policy measures.

Conditions in the financial markets had already begun to ease slightly toward the end of 1966, as the emerging balance-of-payments surplus resulted in a large inflow of liquid funds. Then, early in January, the German Federal Bank lowered its discount rate from 5 per cent to 4½ per cent in the first of a succession of overt steps designed to lower interest rates and to expand bank liquidity. On February 1, reserve requirements against nonresident deposits were reduced to the levels applied to the banks' domestic liabilities. This move was followed by another ½ percentage point cut in the discount rate in mid-February and by an across-the-board 10 per cent reduction in reserve requirements, effective on March 1. However, the pull of relatively high money rates abroad, particularly in the Euro-currency markets, resulted in a substantial outflow of liquid funds, which tended to brake the decline in domestic interest rates during the first two months of the year. The authorities cut the disccunt rate to 3½ per cent on April 14 and, after a further reduction in reserve requirements, the discount rate was reduced by another ½ percentage point on May 11. With interest rates abroad also declining, these moves were more fully reflected in lower domestic interest rates.

The shift toward monetary ease in Germany has been accompanied by a more flexible use of fiscal policy. Thus, in an effort to stimulate investment, the authorities have introduced liberalized depreciation allowances for expenditures on fixed assets incurred before the end of October 1967. The regular budget is expected to be in deficit, as the slowdown in activity is likely to lead to a shortfall of revenues below the budget estimates. In addition to the regular budget, the new coalition government also adopted in January a strongly expansionary "contingency budget", which provides for a substantial increase in public investment. In order to alleviate any strains in the financial markets resulting from the government's increased borrowing requirements, the German Federal Bank has indicated its readiness to help finance the Federal deficit.

The Canadian economic situation and the policies adopted to meet it have also altered in recent months. The pace of the business expansion lost some of its upward momentum during the latter part of 1966, reflecting in part the effects of monetary and fiscal actions taken earlier in the year to moderate demand pressures.[3] Despite the slower growth in final demand, the average increase in wages continued to be far in excess of productivity gains, and upward pressures on prices were still very strong. Fiscal policy remained oriented toward the need to contain inflationary pressures through September, when the government reduced certain planned expenditures. Moreover, the government announced that additional taxes would soon be proposed in a supplementary autumn budget to cover higher social security payments which were scheduled to begin in January. However, the posture of policy shifted in subsequent months, as evidence accumulated that the investment boom was running out of steam and that industrial production had leveled off. Credit conditions were allowed to ease considerably late in the year. Commercial bank liquidity continued to increase after the turn of the year, and bond yields declined substantially over a wide range of maturities. On January 30, the Bank of Canada lowered its discount rate from 5¼ per cent to 5 per cent. The discount rate was again reduced on April 7, to 4½ per cent, partly reflecting the change in credit conditions that had already occurred and partly in response to a concurrent ½ percentage point cut in the Federal Reserve discount rate.

This shift in monetary policy has been supported by the removal of earlier fiscal restraints on business investment. To be sure, the supplementary budget, which had been postponed until mid-December, called for a modest increase in sales taxes, but this increase was calculated to do no more than offset higher social security benefits. Early in March, it was announced that the refundable tax on corporate profits, which had been introduced in May 1966, would be terminated on April 1, 1967—a full seven months before it was originally scheduled to expire. At the same time, depreciation allowances, which had been cut last year in an effort to restrain an exceptionally large increase in planned business investment, were restored to their earlier levels. The budget for fiscal 1968, presented to Parliament on June 2, was designed to provide a mod-

[3] For a discussion of these measures, see "Monetary and Fiscal Policy in Canada", this *Review* (August 1966), pages 182-87.

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erate offset to the continuing softness of private demand. With expenditures expected to rise more rapidly than revenues, the budgetary deficit is estimated at Can.$740 million, compared with the actual outturn of Can.$428 million for the fiscal year ended on March 31. In view of the large increase in expenditures and continuing upward pressures on costs and prices, the government was not prepared to reduce taxes on personal or corporate income. However, it announced that the 6 per cent sales tax on machinery and equipment, which was originally scheduled to expire next April, would be removed immediately to encourage a recovery of private investment.

In the Netherlands, demand pressures abated in the latter part of 1966, as a restrictive monetary policy and certain anti-inflationary fiscal measures began to take effect. Although fixed private investment continued to rise, there was some slowdown in public investment, particularly by local authorities, and the growth in exports subsided as the year-end approached. The rate of increase in prices leveled off around the turn of the year, and at the same time there was an unexpectedly rapid rise in unemployment. Accordingly, the government announced in January that cash grants would be made available to attract more industry to those areas of the country where structural unemployment is a particularly serious problem. With manufacturers' order backlogs dwindling, the Netherlands Bank reduced its discount rate from 5 per cent to 4½ per cent on March 15, and also took steps which, in effect, raised the quantitative limit on credit expansion imposed on Dutch commercial banks. In a fiscal move designed to alleviate the strains in Dutch capital markets and achieve a better balance between monetary and fiscal measures, a planned increase in turnover taxes originally scheduled to take effect next year was advanced by six months to July 1, 1967, while a planned reduction in income taxes originally scheduled for January 1, 1967 was postponed until midyear.

The pace of the Swedish expansion slowed down in the latter part of 1966 in response to generally weaker demand conditions both domestically and abroad. The growth of investment moderated, labor shortages became less marked, and Sweden's external position improved as imports stabilized. When signs of a slowdown in economic activity became apparent in the summer months, the Bank of Sweden engaged in sizable open market purchases and bank liquidity eased considerably in the second half of the year. This shift in monetary policy has continued thus far this year. The Bank of Sweden cut the discount rate from 6 per cent to 5½ per cent on February 3 and then to 5 per cent on March 10, in line with declining domestic and foreign interest rates. Despite the slowdown in industrial activity, upward pressures on costs and prices continued to increase through the early months of 1967, partly as a result of a large retroactive increase in wages that was paid at the end of 1966. In order to moderate consumption and restrain continuing cost increases, the budget, presented to Parliament last January, called for a substantial increase in sales and excise taxes, some of which have already gone into effect.

In Belgium, monetary policy remained generally restrictive through the end of 1966 in an effort to contain continuing inflationary pressures. Conditions in the financial markets tightened from the spring through the end of 1966, as domestic credit demands accelerated and the emergence of a balance-of-payments deficit strained the liquidity of the banking system. Industrial production, after having remained generally stable through most of 1966, picked up around the turn of the year. In subsequent months, however, the pace of economic activity slackened again and, as earlier tightness in the labor market abated, there was some relaxation of monetary policy. The National Bank of Belgium reduced its discount rate from 5¼ per cent to 5 per cent on February 2. As market rates of interest, both domestic and foreign, continued to move downward, the discount rate was lowered on March 23 and again on May 11—by ¼ percentage point each time. In a complementary fiscal move, the government obtained special powers from Parliament early in April to enable it to institute by decree a number of measures designed to stimulate investment and to speed up regional development programs. Under these powers, certain indirect taxes were quickly raised, but the higher revenues are to be used primarily to increase public investment. Decrees were also issued to provide tax relief for new investment, particularly in newly defined development areas.

ITALY, JAPAN, FRANCE, AND SWITZERLAND

Italian economic policy remained expansionary throughout 1966. The recovery in economic activity, which had been hesitant and unevenly distributed throughout most of 1965, accelerated and became more broadly based during 1966. A rise in exports was reinforced by resurgence of domestic consumption, and in the latter part of the year there was a recovery of fixed private investment. For 1966 as a whole, industrial production was almost 12 per cent higher than in 1965 while the overall advance in real gross national product (GNP) was 5.5 per cent. Fragmentary information for the early months of 1967 suggests that the advance has remained brisk in most industrial sectors and that upward pressures on wage rates and prices are still fairly moderate despite a continued decline in the un-

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employment rate. Within this context of noninflationary growth, monetary policy has remained relatively easy. Despite a substantial increase in credit demands, particularly by the public sector, and a sharp rise in interest rates abroad, Italian interest rates held steady in 1966, as the Bank of Italy expanded its advances and rediscounts to the banking system. The banks continued to make large short-term investments abroad, particularly in Euro-dollars, and thereby helped to ease the strain in that market resulting from the strong demand from United States banks and German borrowers. In the closing months of 1966, the growth in exports tapered off and there was a substantial increase in long-term capital outflows, reflecting higher interest rates abroad. Nevertheless, the overall balance of payments remained in substantial surplus. Since the start of the year, however, there has been some reversal of earlier outflows of bank funds, as the rise in domestic loan demands has outstripped the increase in deposits.

The Japanese recovery from the 1965 recession gathered momentum in 1966, as a strong surge in fixed private investment was reinforced by a sharp increase in exports. For the year as a whole, GNP advanced by about 9 per cent in real terms and the level of industrial production increased by 14 per cent. There was a substantial outflow of long-term capital last year, but the normal cyclical deterioration on trade account was partially offset by increased United States military expenditures in connection with the Vietnam conflict, and the balance of payments moved into surplus. Thus far this year, new and unfilled orders for machinery have continued to rise, import demand has accelerated, and there have been some signs of emerging labor shortages. Since the turn of the year the trade balance, seasonally adjusted, has moved into substantial deficit, but the deterioration of trade account has been partly offset by renewed inflows of short-term funds, as Japanese importers and other borrowers have taken advantage of rapidly declining interest rates abroad to meet part of their financing requirements. Despite the strong demand for bank credit, the average interest rate on bank loans continued its downward trend through February. Credit conditions tightened somewhat early in March, but then eased again, when the Bank of Japan increased its limit on loans to large city banks and supplied increased funds to the private sector through purchases of securities. However, in view of the unexpectedly rapid recovery in investment and the resultant deterioration in the trade balance, the government, in a special session of the Diet in mid-March, warned businessmen to exercise caution in new plant and equipment expenditures. Moreover, the budget estimates for the fiscal year that began on April 1 provide for a smaller overall deficit, and the government explained that this was designed to prevent overheating.

In France, real GNP rose by almost 5 per cent for 1966 as a whole but the pace of the expansion slowed down in the latter half of the year. Fixed private investment, stimulated in part by a 10 per cent tax credit granted in May 1966, continued to rise but consumer demand was somewhat sluggish as the year-end approached and the growth in exports leveled off. Consumer prices advanced by less than 3 per cent during the year, and the labor market has remained free of the strains that were present before the 1963 stabilization program. However, the overall balance of payments moved into deficit in the fourth quarter of 1966, when the slowdown in Germany and some other countries resulted in a substantial deterioration in the trade balance. Against this background of somewhat slower growth, French economic policy has remained cautiously expansionary. Interest rates moved upward during the fourth quarter of 1966 in response to higher interest rates in other financial centers, but this trend has been partially reversed this year. Fiscal operations provided a mild stimulus for the economy last year, and the 1967 budget, which was presented to Parliament last December, is also expected to be moderately expansionary.

While there has been little change in the general stance of monetary and fiscal policy, the authorities implemented a number of broad-gauged structural reforms. In January, they began to replace the existing required liquidity ratio with a new system of cash reserve requirements for the banking system. The former compulsory assets ratio, under which a portfolio of Treasury bills, medium-term commercial paper, and certain other assets had to be held as a proportion of sight and time deposits, was in principle abolished, but as an interim measure minimum holdings of medium-term paper by banks were prescribed in order to facilitate the transition to the new reserve system. The controls on financial relations with other countries were also relaxed toward the end of January. As a rule, all exchange transactions and payments are now freely permitted except those which specifically remain subject to control, such as direct investments. Furthermore, nonresidents are now allowed to issue securities in the French capital market on the same terms as domestic borrowers, subject to prior authorization. Such clearance also is required for borrowing abroad by French residents. However, French banks are exempt from this control and can freely lend and borrow abroad.

In Switzerland, there has been little change in the posture of monetary policy, which is still oriented toward the need to contain inflationary pressures. During the fourth quarter of 1966, interest rates moved upward in response to relatively high interest rates in neighboring countries.

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As conditions in the domestic money market tightened, the commercial banks raised the rate for savings deposits by ¼ per cent to 3¾ per cent early in January. Moreover, interest rates on long-term maturities also moved up further, despite strict controls on new bond issues. The 1964 emergency legislation, which provided for the introduction of quantitative ceilings on bank credit, expired in March. In view of the persistence of inflationary pressures, however, the Swiss National Bank asked the commercial banks to limit the overall growth of their short- and long-term advances during 1967 to 7 per cent of the amount outstanding at the end of 1966—an increase slightly less than the actual expansion last year.

CONCLUDING REMARKS

The acute tensions that developed in financial markets last year dramatized the need for more flexible use of other policy instruments. The need for monetary restraint would have been less compelling and the rise in interest rates might have been less pronounced, if fiscal measures had been used more vigorously to cope with inflationary strains. But in most of the countries discussed here, fiscal action was delayed or insufficiently restrictive and the burden of restraint was largely carried by monetary policy. At this particular juncture, the need for credit restraint has become less acute in most European countries, and indeed several countries have already moved in the direction of monetary ease. This shift has been most pronounced in Germany, where domestic economic conditions called for active stimulus. However, in view of the high sensitivity of capital movements to international interest rate differentials, the shift toward monetary ease in Germany was partly diluted by short-term capital outflows. Movements of short-term funds have often placed limits on the ability of monetary policy to adapt to changing domestic requirements, but the continued development of the Euro-currency markets, which have become the focal points for international capital movements, has narrowed these limits. Thus, the need for flexibility in fiscal policy may be equally urgent, when domestic economic conditions call for stimulus.

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