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# FEDERAL RESERVE BANK OF ST. LOUIS

# Review

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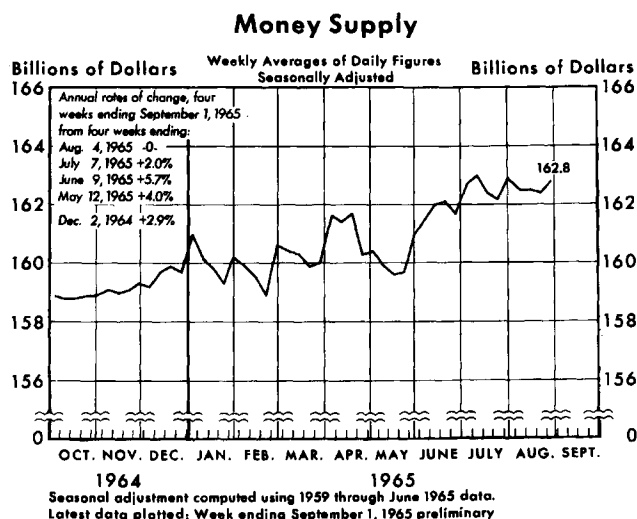
## *Interest Rates, Budget Policy, and Monetary Policy*

**F**ISCAL DEVELOPMENTS in recent months have been more stimulative than earlier this year, while monetary actions continue to be moderately expansive. The Federal budget position has moved from a modest surplus to a deficit. The stock of money has risen at about the same rate since spring as from November 1964 to April 1965. Longer-term interest rates have tended upward.

### Movements in the Policy Variables

#### *The Money Supply*

The rate of increase in money gyrated sharply from April to August but averaged 3 per cent per annum. This rate is about the same as since November 1964 but is somewhat less than the average since September 1962. A 3 per cent rate of monetary growth is about the same as the rate of increase



since the beginning of the current economic expansion in February 1961 and since May 1960, the last peak in national business activity. It is higher than the average 2 per cent rate of increase since 1951.

According to some analysts, variations in the money stock introduce—through a complicated chain of causation—variations in total demand for the product of the economy.

### Bank Credit

The earning assets of commercial banks have been increasing somewhat less rapidly in recent months than earlier. During the four months ending with August, bank credit increased at a 7 per cent rate, substantially less than the 12 per cent rate in the previous eight months. The decline in the rate of increase of bank credit reflects a slight moderation in the pace of loan expansion and a continued reduction in the banking system's holdings of U. S. Government debt (Table I). Fluctuations in the rate of increase in total bank credit do not necessarily reflect a shift in the stimulative influence of the commercial banking system on total spending. Instead, they may result from shifts in the volume of flows of funds through the banking system compared with other avenues.

### The Fiscal Situation

The budget of the Federal Government moved to a more stimulative position in the third quarter. Current estimates indicate that the consolidated cash budget will shift from a \$2 billion dollar surplus in the second quarter to a deficit in the third quarter. It is anticipated that the national income accounts budget will also move from surplus to deficit. The full employment budget, which indicates how the national in-

come accounts budget would move in the absence of shifts in economic activity, is expected to change from a \$7 billion surplus to a smaller surplus.<sup>1</sup> The movement from surplus toward deficit has resulted from increased expenditures (largely associated with expanded Social Security benefits and expanded military buying) and a lessening in the rise of revenues (largely associated with the cut in excise taxes).

A fiscal surplus or deficit may affect economic activity by two inconsistent primary routes. (1) A deficit may indicate that more funds are being placed in the spending stream than are being withdrawn by taxes. Thus a deficit may reflect a situation wherein total demands for the economy's product are being stimulated. (2) A deficit or surplus affects the flows in financial markets and, hence, influences interest rates. To the extent that the Treasury runs a deficit and does not draw down its cash balances, it must borrow; this tends to place upward pressure on interest rates, tending to inhibit investment and total demand. Running a surplus puts the Treasury in a position to repay debt and thereby place downward pressure on interest rates, with resulting encouragement of investment and final demand.

### Maturity of the Federal Debt

The maturity distribution of the Federal debt has changed little in recent months. What changes have occurred have been in the direction of lengthening the debt. Thus, debt management policy has recently been essentially neutral in its effect on economic activity, but with a slight tendency toward restriction.

How the maturity composition of the debt may have an influence on total demand for goods and services is not agreed upon by all observers. According to some analysts, an increase in the amount of longer maturities reduces the "liquidity" of the public, thereby limiting final demand. An alternative view focuses on the relation of the structure of the debt to the structure of interest rates. Lengthening the Federal debt may tend to place upward pressure on long-term rates and thereby tend to restrict investment and total economic activity.

### Interest Rates

Most interest rates have risen moderately in recent months. Since late February yields on short-term Government debt have declined; yields on intermediate and long-term issues have moved up.

<sup>1</sup>See the testimony of Gardner Ackley, Chairman of the Council of Economic Advisers, before the Subcommittee on Fiscal Policy of the Joint Economic Committee, July 20, 1965.

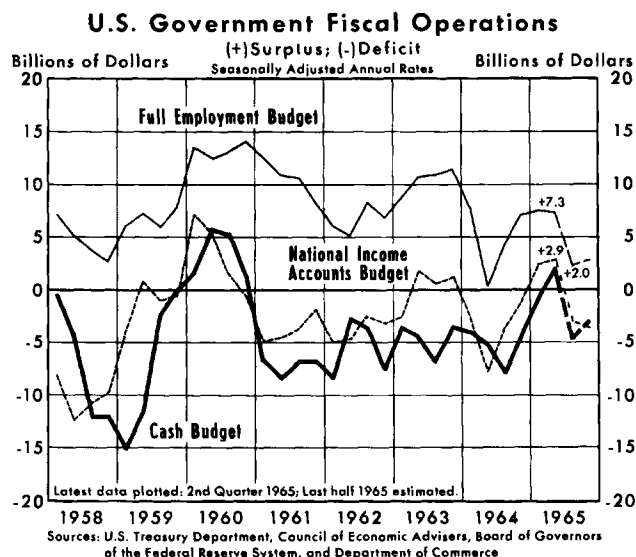


TABLE I  
**EARNING ASSETS OF COMMERCIAL BANKS<sup>1</sup>**

TOTAL BANK CREDIT																	
Compounded Annual Rates of Change																	
Initial Month																	
Terminal Month	4-64	5-64	6-64	7-64	8-64	9-64	10-64	11-64	12-64	1-65	2-65	3-65	4-65	5-65	6-65	7-65	Millions of Dollars
5-64	5.1																252,650
6-64	8.1	11.2															254,900
7-64	6.2	6.7	2.4														255,400
8-64	6.1	6.4	4.1	5.8													256,600
9-64	8.4	9.2	8.6	11.8	18.2												260,200
10-64	7.9	8.5	7.9	9.7	11.8	5.7											261,400
11-64	8.1	8.6	8.1	9.6	10.9	7.4	9.1										263,300
12-64	8.9	9.5	9.2	10.6	11.8	9.8	11.9	14.8									266,350
1-65	9.0	9.5	9.3	10.4	11.4	9.8	11.1	12.2	9.6								268,400
2-65	9.3	9.7	9.5	10.6	11.4	10.1	11.2	12.0	10.6	11.5							270,850
3-65	9.7	10.1	10.0	11.0	11.8	10.7	11.8	12.5	11.7	12.7	13.9						273,800
4-65	9.9	10.3	10.2	11.1	11.8	10.9	11.8	12.4	11.8	12.5	12.9	12.0					276,400
5-65	9.7	10.1	10.0	10.8	11.4	10.6	11.3	11.6	11.0	11.4	11.3	10.1	8.1				278,200
6-65	9.8	10.2	10.1	10.8	11.4	10.6	11.3	11.6	11.0	11.3	11.3	10.4	9.6	11.1			280,650
7-65	9.5	9.8	9.7	10.4	10.8	10.1	10.6	10.8	10.2	10.3	10.0	9.1	8.1	8.1	5.3		281,850
8-65	9.2	9.4	9.3	9.9	10.2	9.5	9.9	10.0	9.4	9.3	9.0	8.0	7.1	6.7	4.6	3.9	282,750

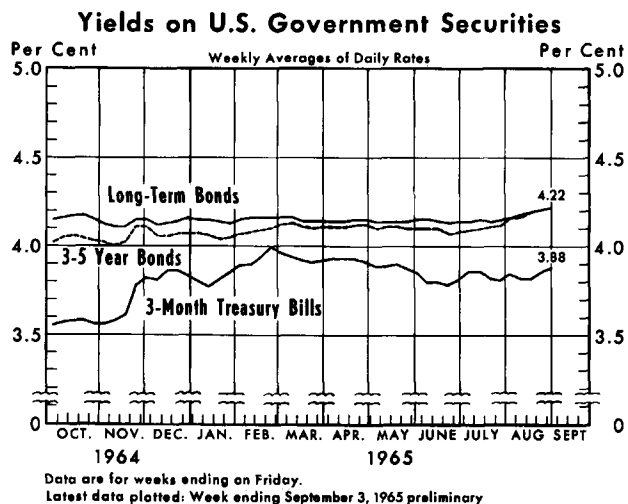
**EARNING ASSETS OTHER THAN U. S. GOVERNMENT SECURITIES**

Compounded Annual Rates of Change																	
Initial Month																	
Terminal Month	4-64	5-64	6-64	7-64	8-64	9-64	10-64	11-64	12-64	1-65	2-65	3-65	4-65	5-65	6-65	7-65	Millions of Dollars
5-64	13.0																192,100
6-64	15.4	17.9															194,750
7-64	13.3	13.5	9.3														196,200
8-64	11.7	11.3	8.1	7.0													197,300
9-64	12.2	12.0	10.1	10.5	14.2												199,500
10-64	11.5	11.2	9.6	9.7	11.1	8.1											200,800
11-64	11.4	11.1	9.8	10.0	11.0	9.4	10.7										202,500
12-64	11.8	11.7	10.6	10.9	11.9	11.2	12.7	14.9									204,850
1-65	12.5	12.5	11.7	12.1	13.2	12.9	14.6	16.6	18.4								207,750
2-65	13.2	13.2	12.6	13.1	14.2	14.1	15.7	17.4	18.7	19.1							210,800
3-65	13.7	13.8	13.3	13.8	14.9	15.0	16.4	17.9	18.9	19.1	19.2						213,900
4-65	14.2	14.3	13.9	14.4	15.4	15.6	16.8	18.1	19.0	19.2	19.2	19.2					217,050
5-65	14.1	14.2	13.9	14.4	15.2	15.3	16.4	17.4	17.9	17.8	17.4	16.5	13.8				219,400
6-65	14.5	14.6	14.3	14.8	15.6	15.7	16.7	17.6	18.1	18.0	17.8	17.3	16.4	19.0			222,600
7-65	14.4	14.5	14.3	14.7	15.4	15.5	16.4	17.1	17.5	17.3	16.9	16.4	15.5	16.3	13.7		225,000
8-65	14.1	14.2	14.0	14.3	15.0	15.0	15.7	16.3	16.5	16.2	15.8	15.1	14.1	14.2	11.9	10.0	226,800 e

**U. S. GOVERNMENT SECURITIES**

Compounded Annual Rates of Change																	Millions of Dollars
Initial Month																	
Terminal Month	4-64	5-64	6-64	7-64	8-64	9-64	10-64	11-64	12-64	1-65	2-65	3-65	4-65	5-65	6-65	7-65	
5-64	—16.2																60,550
6-64	—12.0	— 7.6															60,150
7-64	—13.9	—12.7	—17.4														59,200
8-64	—10.1	— 8.0	— 8.2	2.0													59,300
9-64	— 2.9	0.8	3.7	16.2	32.3												60,700
10-64	— 2.7	0.2	2.3	9.8	13.9	—2.0											60,600
11-64	— 1.8	0.8	2.6	8.3	10.5	1.0	4.0										60,800
12-64	0.1	2.7	4.5	9.6	11.6	5.4	9.3	14.8									61,500
1-65	— 1.7	0.3	1.4	5.0	5.6	—0.2	0.3	— 1.5	—15.4								60,650
2-65	— 2.7	— 1.1	— 0.3	2.5	2.6	—2.6	—2.7	— 4.8	—13.3	—11.3							60,050
3-65	— 2.7	— 1.3	— 0.6	1.8	1.7	—2.6	—2.7	— 4.4	—10.0	— 7.2	— 2.9						59,900
4-65	— 3.4	— 2.2	— 1.6	0.3	0.1	—3.8	—4.1	— 5.6	—10.1	— 8.3	— 6.8	—10.5					59,350
5-65	— 4.0	— 2.9	— 2.4	— 0.8	— 1.1	—4.7	—5.0	— 6.5	—10.2	— 8.9	— 8.1	—10.5	—10.6				58,800
6-65	— 4.8	— 3.8	— 3.5	— 2.1	— 2.5	—5.8	—6.2	— 7.6	—10.9	—10.0	— 9.7	—11.8	—12.4	—14.3			58,050
7-65	— 6.0	— 5.3	— 5.1	— 4.0	— 4.5	—7.6	—8.2	— 9.6	—12.6	—12.1	—12.3	—14.5	—15.8	—18.3	—22.2		56,850
8-65	— 6.8	— 6.1	— 6.0	— 5.1	— 5.6	—8.5	—9.1	—10.5	—13.2	—12.9	—13.2	—15.1	—16.2	—18.0	—19.8	—17.4	55,950 e

<sup>1</sup> Dollar amounts are averages of seasonally adjusted data for end of preceding and current month. Compounded annual rates of change were computed from these averages.  
e-Estimated.



Yields on most maturities of private debt have risen moderately in recent months. Medium-grade corporate bond yields (Baa) rose from 4.78 per cent in February to 4.88 per cent in early September; yields on highest grade corporate securities rose from 4.41 per cent to 4.49 per cent during the period. Secondary market rates on large-denomination certificates of deposit rose from 4.20 per cent in February to 4.28 per cent in August.

Interest rate increases are desirable when they are part of a monetary-fiscal policy mix which promotes optimum total demand and international payments balances.

Interest rates may affect final demand, production, employment, and prices through several channels. To the extent that interest rates represent a cost to the borrower, higher rates may inhibit borrowing. Furthermore, because current interest rates determine the capital value of rights to anticipated future income streams, a rise in interest rates decreases the value of any anticipated future income stream, thereby reducing wealth.

Appropriate interest rates may depend upon the combination (or mix) of policies used to achieve optimum total demand for goods and services. To the extent that there is increased reliance on fiscal policy to expand demand, there is a corresponding rise in the appropriate structure of interest rates. In this sense and context, an interest rate increase does not necessarily indicate that the combined effects of stabilization policies are restrictive; that is, rising interest rates in themselves do not necessarily indicate a "tightening" in policy.

### Impact of the Policy Variables

We have indicated above that monetary and fiscal developments have recently been more stimulative.

But, while this interpretation is indicated by a simple examination of current data, the timing of the effect of such policy measures is not certain.

Consider first the stock of money. Movements in the stock of money may affect the economy with a lag—perhaps a variable one. It is not at all clear whether very recent changes in money are most relevant for economic developments of the near future—or whether changes which occurred some time ago are more important. Similarly, with respect to the Federal budget the major impact of Federal spending decisions on the private economy may be when contracts are let, not when payments are made. Private firms make decisions which affect economic activity at the time Government contracts are let. According to this view, the payments simply represent an "unwinding" of commitments. Accordingly, some of the economic effects of the current Federal budget position may already have occurred.

### The Policy Setting

Monetary and fiscal policies are bearing upon a domestic economy which is continuing a strong expansion. Production, employment, spending, and prices have increased rapidly in recent months. The domestic expansion is occurring within an international environment in which, recently, there has been a surplus in the U. S. international accounts. Over a long previous period, however, the nation had large chronic payments deficits.

### Domestic Business Activity

Industrial production in July reached 144 per cent of its 1957-59 average, up sharply from June. Output had risen at about an 8 per cent annual rate since spring, approximately the same rate as from a year earlier. Much of the rise since spring has been in metals industries, where increases have been influenced by possibilities of a steel work-stoppage.

In August automobile assemblies, which were at an annual rate of 9.5 million units from April to July, remained near this level—having declined seasonally for model changeover. Steel ingot production was curtailed in August; this adjustment was made in anticipation of reduced production of finished steel in September.

Employment has continued to show strong gains. From last spring to August, total employment rose at about a 3 per cent annual rate. Payroll employment has risen at a 4 per cent rate, with especially strong increases in durable goods manufacturing but also with gains in trade and service industries. Unemployment

ment reached 4.5 per cent of the labor force in July and August, continuing the downtrend of the past two years. The unemployment rate for married men averaged 2.4 per cent in the three months ending with August, compared with 2.5 per cent in the previous three months and 2.7 per cent in the corresponding year-earlier period.

Prices of wholesale industrial commodities have crept upward in recent months, continuing the rise which began in mid-1964. In August these prices reached 102.6 per cent of their 1957-59 average, somewhat higher than the level attained near the last peak in business activity in early 1960. Consumer prices other than for services—whose short-run movements are heavily influenced by a strong, long-run, upward tendency—and other than for food—whose short-run movements are heavily influenced by seasonal or erratic

shifts in supply conditions—have declined since spring. In comparable periods of recent years such prices have moved up or been about unchanged.

Final demand is probably being further expanded currently by the stepped-up military effort. However, in order to present a balanced picture, it should be noted that the economy may face substantial adjustments after the resolution of steel wage negotiations. The dimensions of the adjustments depend upon numerous factors. There has been the basic question of whether there will be a strike. There is also a question of whether the inventories of steel consumers are substantially in excess of current needs. To the extent that steel users have excessive inventories which must be worked down, steel production will be adversely affected.

Table II  
**WHOLESALE PRICES—INDUSTRIALS<sup>1</sup>**

Compounded Annual Rates of Change  
Initial Month

Terminal Month	3-64	4-64	5-64	6-64	7-64	8-64	9-64	10-64	11-64	12-64	1-65	2-65	3-65	4-65	5-65	6-65	1957-1959 = 100
4-64	0.0																101.1
5-64	0.0	0.0															101.1
6-64	-0.8	-1.2	-2.3														100.9
7-64	0.0	0.0	0.0	2.4													101.1
8-64	0.0	0.0	0.0	1.2	0.0												101.1
9-64	0.0	0.0	0.0	0.8	0.0	0.0											101.1
10-64	0.7	0.8	1.0	1.8	1.6	2.4	4.9										101.5
11-64	0.7	0.9	1.0	1.7	1.5	2.0	3.0	1.2									101.6
12-64	0.9	1.0	1.2	1.8	1.7	2.1	2.8	1.8	2.4								101.8
1-65	1.0	1.1	1.2	1.7	1.6	1.9	2.4	1.6	1.8	1.2							101.9
2-65	0.9	1.0	1.1	1.5	1.4	1.6	1.9	1.2	1.2	0.6	0.0						101.9
3-65	0.9	1.0	1.1	1.5	1.3	1.5	1.8	1.2	1.2	0.8	0.6	1.2					102.0
4-65	0.9	1.0	1.1	1.4	1.3	1.5	1.7	1.2	1.2	0.9	0.8	1.2	1.2				102.1
5-65	1.0	1.1	1.2	1.5	1.4	1.6	1.8	1.4	1.4	1.2	1.2	1.6	1.8	2.4			102.3
6-65	1.1	1.2	1.3	1.6	1.5	1.7	1.9	1.5	1.5	1.4	1.4	1.8	2.0	2.4	2.4		102.5
7-65	1.0	1.1	1.2	1.5	1.4	1.5	1.7	1.3	1.3	1.2	1.2	1.4	1.5	1.6	1.2	0.0	102.5 p

<sup>1</sup> Not seasonally adjusted.

p-Preliminary.

Source: U. S. Department of Labor.

Table III  
**CONSUMER PRICES—COMMODITIES LESS FOOD<sup>1</sup>**

Compounded Annual Rates of Change  
Initial Month

Terminal Month	3-64	4-64	5-64	6-64	7-64	8-64	9-64	10-64	11-64	12-64	1-65	2-65	3-65	4-65	5-65	6-65	1957-59 = 100
4-64	0.0																104.3
5-64	0.0	0.0															104.3
6-64	0.0	0.0	0.0														104.3
7-64	0.0	0.0	0.0	0.0													104.3
8-64	-0.2	-0.3	-0.4	-0.6	-1.1												104.2
9-64	0.0	0.0	0.0	0.0	0.0	1.1											104.3
10-64	0.5	0.6	0.7	0.9	1.2	2.3	3.5										104.6
11-64	0.7	0.8	1.0	1.2	1.5	2.3	2.9	2.3									104.8
12-64	0.8	0.9	1.0	1.2	1.4	2.0	2.3	1.7	1.2								104.9
1-65	0.7	0.8	0.9	1.0	1.2	1.6	1.7	1.2	0.6	0.0							104.9
2-65	0.4	0.5	0.5	0.6	0.7	1.0	0.9	0.3	-0.4	-1.1	-2.3						104.7
3-65	0.5	0.5	0.6	0.6	0.7	1.0	1.0	0.5	0.0	-0.4	-0.6	1.1					104.8
4-65	0.6	0.7	0.7	0.8	0.9	1.2	1.2	0.8	0.5	0.3	0.4	1.7	2.3				105.0
5-65	0.7	0.8	0.9	0.9	1.0	1.3	1.3	1.0	0.8	0.7	0.9	1.9	2.3	2.3			105.2
6-65	0.6	0.7	0.7	0.8	0.8	1.0	1.0	0.7	0.5	0.4	0.5	1.2	1.2	0.6	-1.2		105.1
7-65	0.3	0.3	0.3	0.4	0.4	0.5	0.5	0.1	-0.1	-0.3	-0.4	0.0	-0.3	-1.1	-2.8	-4.5	104.7

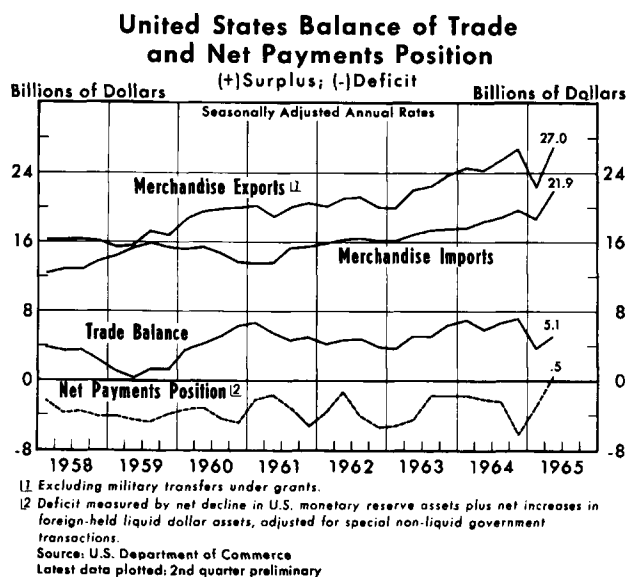
<sup>1</sup> Includes home purchase costs which were classified under services prior to 1964.

Not seasonally adjusted.

Source: U. S. Department of Labor.

## International Developments

The U. S. balance of payments for the second quarter showed a surplus, the first since 1957. Net receipts from foreigners were at a \$528 million annual rate, compared with a first quarter deficit of \$3 billion. Major factors contributing to the second quarter gain were a \$1.4 billion improvement on merchandise account and a marked reduction in private capital outflows. Bank-reported capital movements resulted in a net inflow of \$1.5 billion at an annual rate, in contrast with a first quarter outflow of \$1.8 billion.



The second quarter figures reflected, to a great extent, temporary influences. The impact of the Voluntary Credit Program on capital outflows, very large initially, will probably not produce continuing quar-

terly improvements in the future. The dock strike early in the year tended to exaggerate the improvement in the trade balance from the first to the second quarter. The trade balance for the first half of 1965 was \$2.0 billion less than for the first half of 1964, primarily because of greatly expanded imports. In the present context of world trade, growing at a 6 per cent rate compared with last year's 12 per cent, the prospects for export growth are less promising. On the other hand, prospects for poor European harvests give rise to the possibility of increased U. S. grain exports.

Despite the U. S. net payments surplus, the gold stock declined in the second quarter by nearly \$600 million to about \$14 billion.

Long-term interest rates have been rising in Europe, especially in Germany. The German bank rate was increased from 3.5 to 4.0 per cent on August 13. Such developments intensify the forces attracting capital funds from the United States to Europe and prolong imbalances in international accounts.

## Summary

To the extent that Government fiscal policies are relatively more relaxed, a rise in the structure of interest rates is consistent with that mix of total Government policy which is appropriate to optimum total demand. Such a rise in rates cannot meaningfully be interpreted as restrictive. Such a policy mix which relies more heavily on stimulative fiscal actions—and hence, implies higher optimum interest rates—may be more conducive to needed basic adjustment vis-a-vis foreign countries than a mix wherein low interest rates are associated with restrictive fiscal policy.



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# Fiscal Policy, Monetary Policy, and International Disequilibrium

## *Introduction*

THE INTERNATIONAL FINANCIAL SYSTEM has been unable to avoid persistent imbalances of international payments over the past several years. One aspect of this problem has been the "chronic deficit" in the U. S. balance of payments with its obverse, a "chronic surplus" for certain European countries. During the last two years rising U. S. capital outflows to various developed countries<sup>1</sup> have maintained and perhaps increased this international financial disequilibrium.

The traditional remedy for controlling capital exports is to reduce the interest rate differentials which provide the incentive for foreign lending. Monetary policies in either the capital importing or capital exporting country can be employed to influence interest rate differentials between countries. Such policies may, however, have undesirable domestic consequences. The policy problem at hand in such cases is to find means which foster international adjustment without undue cost in terms of internal goals.

This article discusses stabilization policies from two standpoints. First, some of the relationships between national stabilization policies and desired economic goals—both internal and external—are outlined. Second, recent experience in various major countries is examined to determine whether stabilization policies being pursued are most appropriate for the attainment of national objectives and the preservation of international financial equilibrium.

## *Stabilization Policies—Concepts and Measurements*

Government policies in most industrialized, well-developed market economies are directed toward goals of economic growth, full employment, price stability, and appropriate balance in external transactions. It is generally recognized that two main responsibilities of government—regulation of the private financial system and management of the public finances—can exert

a powerful influence on the total demand for goods and services in an economy. Hence, policies regarding monetary and fiscal actions have come to play a major role in the attempts of governments to stabilize their economies and attain national economic goals.

Whenever an economy is operating with less than appropriate total demand, either monetary or fiscal actions can be taken to raise the level of total spending and output. An increase in the money supply can be brought about which will tend to lower interest rates and encourage spending; or the government may stimulate total demand by increased spending or by reduced taxes.

Monetary and fiscal actions can also be used to restrain total spending whenever it appears that planned expenditures would lead to excessive total demand with unwanted general price increases or an undesirable deficit in the balance of payments. Monetary expansion can be reduced, contributing to higher interest rates and reduced private spending. Taxes can be increased or government expenditures reduced in order to moderate the level of over-all demand.

There is little unanimity among economic analysts and observers as to the appropriate method of assessing monetary and fiscal policies. Some, in viewing monetary experience, choose to emphasize changing credit conditions or interest rates as the best measure of monetary actions. Others prefer to examine the liquidity of the banking system for signs of monetary ease or restraint. A third view finds that the close historical relationship between the money stock and economic activity is significant evidence for judging monetary policy by the behavior of the money supply. Until further advances in economic analysis permit the resolution of these alternative views, it may be useful to weigh and consider each in evaluating monetary experience.

As with monetary policy, there are a variety of ways of measuring changes in fiscal policy. At first glance, the government net budget position (administrative, cash, or national income accounts basis) may seem to be a good measure of the impact of fiscal actions on aggregate spending. Tax receipts reduce private

<sup>1</sup>See this *Review* of March 1965 for a discussion of capital exports by type and area.

purchasing power, and government expenditures raise total spending. Hence, a deficit in the government accounts is a net stimulus, and a surplus is a net restraint on the economy.

However, the actual deficit or surplus may not indicate fiscal stimulus or restraint, respectively. A diminution of private expenditure may lower total incomes and hence Federal tax receipts. Similarly, certain government expenditures (e.g., unemployment compensation) may increase. The consequent "passive" deficit then reflects the effects of reduced private spending on government accounts and is not a good measure of affirmative fiscal policy. To arrive at a better measure of discretionary fiscal actions, the "full employment budget" is used.<sup>2</sup> This device estimates what the net budget position might be, given tax and expenditure programs, at a desired or optimal level of business activity. When total spending is insufficient to attain this desired level of activity, the full employment budget figure isolates the contribution of Federal fiscal actions to realized aggregate demand and indicates what fiscal actions are appropriate.

### ***Policy Mix in an Economy with Little Foreign Trade***

In terms of regulating total spending in the economy, it might seem to be a matter of indifference whether main emphasis is placed on monetary or fiscal policies. Each policy tool has its merits and drawbacks, however, which under various circumstances tend to establish a preference between the two. Administratively, monetary policy can be applied rather quickly and flexibly, compared with fiscal policy operating under present-day administrative procedures and political restraints. On the other hand, it has often been acclaimed a virtue of fiscal policy that, by directly increasing or decreasing total spending, its effects are realized much faster and more reliably than those of monetary actions, which affect spending less directly via interest rates and portfolio readjustments.

Perhaps a more important consideration regarding the desirable mix of policies is that the composition of total demand is affected by the relative weight given each arm of policy. Total demand, employment, and price goals might be attained by any one of several policy combinations, but economic growth might not be the same, depending on the policy mix. If expansionary government actions are appropriate and main reliance is placed on monetary policy, lower interest rates would be an inducement for greater private investment and contribute to a faster rate of economic

growth. If fiscal policy is utilized to provide the main forces of economic expansion, the government could either reduce taxes or increase expenditures. In either case, increased borrowings resulting from the larger government deficit would tend to put upward pressure on interest rates, which could inhibit private investment and retard the pace of capital formation, productivity increases, and economic growth.

### ***Policy Mix in an Economy with Significant Foreign Trade***

When taking into account the maintenance of balance in international transactions, further problems arise of choosing a mix of policies appropriate to meeting all desired policy goals. If the demand for a nation's exports is determined by the state of foreign markets and imports are related primarily to its national income, a given level of total demand will have the same implications for the balance on goods and service transactions<sup>3</sup> regardless of the combination of monetary and fiscal policy. But if capital is free to move internationally and is responsive to interest rates at home and abroad, net capital flows will be affected by policy mix. If, in pursuing a policy stimulative to the domestic economy, monetary ease is effected, domestic interest rates will be lower than if fiscal policy had been employed. The relative attractiveness of foreign versus domestic investment will encourage outward private capital flows. Conversely, when taking actions to restrain total demand, primary reliance on monetary policy will tend to raise interest rates and increase net capital inflows.

### ***Policy Mix and the Adjustment of International Imbalances***

It is possible that the economies of nations pursuing similar policy goals will fall short of achieving those goals in differing ways. Total demand may be excessive or deficient; the balance of payments may be in deficit or surplus; and differing combinations of these problems may exist in the respective national economies. In countries facing excessive total demand along with deficit on foreign account, actions of restraint are called for. Deficient total demand accompanied by a foreign surplus calls for policies of ease. In neither of these simple cases is there a conflict of domestic and international goals which suggests a particular mix of monetary and fiscal policies.

In other situations requiring domestic and foreign adjustment, the combination of monetary and fiscal policy used to influence total demand may not be a

<sup>2</sup>See this *Review* of April 1965 for a discussion of the full employment budget and recent U. S. fiscal policy.

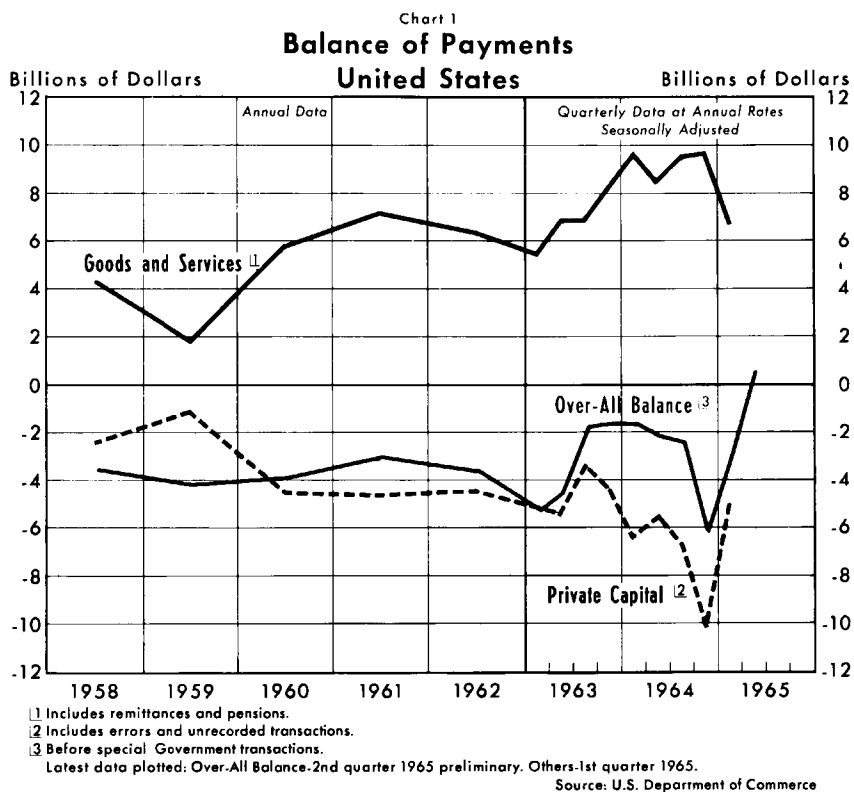
<sup>3</sup>Neglecting, in the short run, income on foreign investment.

matter of indifference. If a nation faces excessive total demand and is experiencing a balance-of-payments surplus, monetary restraint, while moderating inflationary developments, by raising interest rates would lead to capital inflows and a yet greater foreign surplus. In the case of a nation with deficient total demand and a balance-of-payments deficit, monetary ease may stimulate the domestic economy, but at the cost of promoting greater capital outflows and an increased foreign deficit. Had fiscal policies been used to influence total demand and monetary policies been directed toward influencing international capital flows, both domestic and foreign policy goals might be attained in each instance. If a policy mix which is inappropriate for foreign goals is followed to achieve domestic goals, the international payments situation may deteriorate further and call for reversal of policy actions before desired domestic results have been achieved. In the end, such vacillating actions may result in failure to attain either domestic or foreign aims. It may then be deduced incorrectly that the policy goals are insoluble by general policy instruments and recourse will be had to unconventional measures of economic control.

### Recent Experience with Stabilization Policies

The U. S. balance-of-payments deficit averaged \$3.4 billion from 1958 to 1964, despite a rising net surplus on goods and services and relatively stable outflows on government account (Chart 1). By contrast, the balance of payments of six selected European countries has shown a persistent surplus as a declining balance on goods and services was more than offset by rising capital inflows (Chart 2).

Similarly, experience with the domestic goals of stabilization policy has differed in Europe and the United States. In Europe total demand for goods and services probably has been excessive in recent years; unemployment has remained remarkably low (Table I), and prices have risen. In the United States a larger portion of the labor force has been unemployed,



and price increases have remained negligible relative to past experience or to recent European inflation (Chart 5).

Over the past several years there has been a body of opinion which has advocated higher U. S. interest rates in order to reduce capital outflows and thus the over-all payments deficit of the United States. To some extent, policy measures in accord with this view have been taken. Maximum rates payable by commercial banks on time and savings deposits have been raised three times—in January 1962, July 1963, and November 1964—and the Federal Reserve discount rate was raised on each of the latter two dates. Earlier, in 1960 and 1961, short-term interest rates were

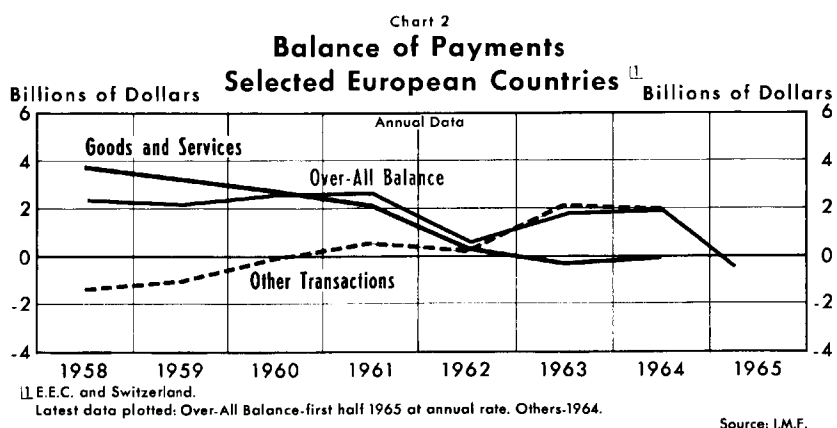


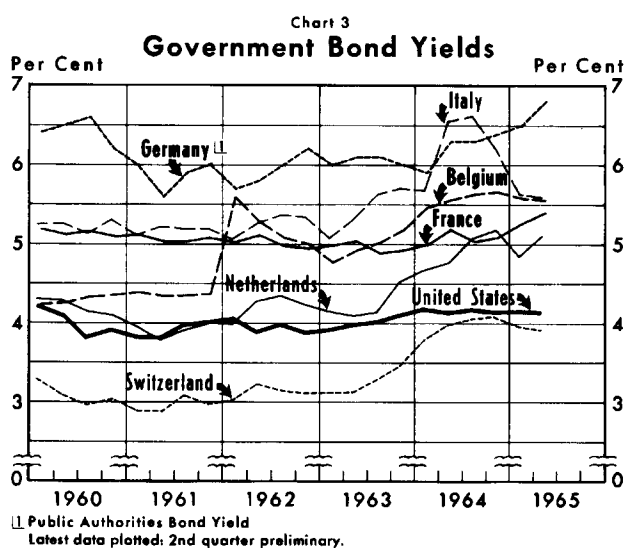
Table I  
UNEMPLOYMENT

	Annual averages							
	1958	1959	1960	1961	1962	1963	1964	
Belgium <sup>1</sup> .....	5.2	6.0	5.2	4.2	3.3	2.7	2.3	
France <sup>2</sup> .....	3.2	7.9	5.3	3.0	1.8	1.8	2.2	
Germany <sup>1</sup> .....	3.5	2.4	1.2	0.8	0.7	0.8	0.7	
Italy <sup>1</sup> .....	6.6	5.6	4.2	3.5	3.1	2.5	2.7	
Netherlands <sup>1</sup> .....	2.3	1.8	1.2	0.9	0.8	0.9	0.8	
Switzerland <sup>2</sup> .....	0.8	0.5	0.2	0.1	0.1	0.1	0.1	
United States <sup>1</sup> .....	6.8	5.5	5.6	6.7	5.6	5.7	5.2	

<sup>1</sup>Per cent of labor force.

<sup>2</sup>Number unemployed relative to job vacancies.

Sources: Organization for Economic Co-Operation and Development; United Nations.



not permitted to decline to the low levels of previous periods of business recession. The Treasury bill rate, which had fallen below 1 per cent in both the 1954 and the 1958 recessions, stayed above 2.2 per cent during 1960 and 1961 (Chart 4). However, developments abroad, primarily in Canadian and British money markets, made foreign short-term investments attractive and led to outflows averaging \$1.4 billion for these two years.<sup>4</sup>

Since mid-1962 capital outflows in the form of U. S. purchases of foreign securities, bank loans to foreigners, and direct investments have assumed increasing importance. With U. S. long-term rates relatively stable and considerably below most foreign rates (Chart 3), net outflows from foreign security transactions, which had averaged less than \$1 billion per annum from 1959 to mid-1962, rose sharply and had doubled by the first half of 1963. The Administration then proposed an interest equalization tax, and these

<sup>4</sup>See Samuel I. Katz, "Yield Differentials in Treasury Bills, 1959-64," *Federal Reserve Bulletin*, October 1964, for a discussion of short-term capital movements.

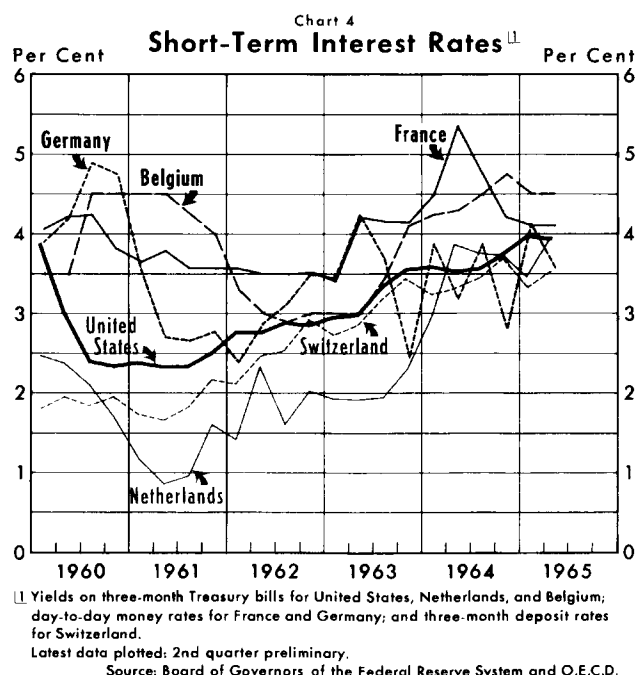
flows averaged \$0.2 billion over the next year. Over the six quarters from mid-1963 to the end of 1964, increases in bank credit to foreigners averaged \$2.2 billion per annum, compared with an annual rate of \$0.6 billion for the preceding two years. As a result, in February 1965 the Voluntary Credit Restraint Program was introduced to provide restraints on all major U. S. lenders to foreigners.

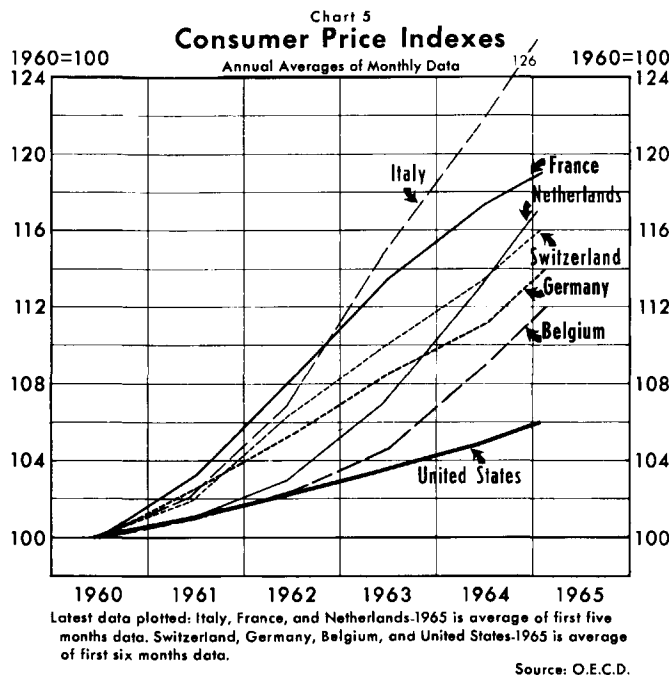
In most major European nations, government policies since 1962 have given consideration to control of excessive demand and price inflation.<sup>5</sup> Monetary growth has been at a somewhat reduced rate in most countries (Table II), and interest rates have risen (Charts 3 and 4). On the other hand, the effect of government fiscal operations on total demand was generally expansionary in 1962 and 1963 relative to 1961. In April 1964 the European Economic Community Council of Ministers recommended a greater degree of fiscal restraint as part of a general anti-inflationary policy for the Community. It also recommended that the member countries "maintain or tighten present restrictive credit policies."<sup>6</sup> In the United States during 1962 and 1963 fiscal policy, as measured by the full employment budget surplus,<sup>7</sup> was relatively

<sup>5</sup>See the May 1964 issue of this *Review* for a discussion of these policies.

<sup>6</sup>*European Community*, May 1964, p. 4.

<sup>7</sup>To compare the U. S. full employment budget position with actual European budget figures seems appropriate. It is generally believed that the European unemployment rates reflected full utilization of economic resources during this period, whereas U. S. rates indicated that total demand was not such as to attain potential levels of output. See above, p. 8.





restrictive, and monetary policy was easy compared with previous expansion periods. The money supply expanded at a 4.1 per cent annual rate, compared with the 1951-62 rate of 1.9 per cent.

Interest rate differentials between countries, while not providing a full explanation for all international capital movements, are a major determinant of much foreign investment. These differentials result from a number of factors. Gross savings and marginal productivity of capital in each country are perhaps fundamental. Market organization, willingness or ability of lenders to acquire long-term assets, and the degree to which the savings-investment process is subject to government control are also important.<sup>8</sup> But beyond these considerations, monetary and credit policies are of major significance in the economic and financial processes by which interest rates are generated. For this reason, the preceding examination of the mix of national stabilization policies may contribute to an understanding of comparative interest rates and international capital flows.

## Conclusion

This article has related recent stabilization policies pursued in Europe and this country to policy goals. Domestic objectives seem to have been pursued in

<sup>8</sup>See U. S., Congress, Joint Economic Committee, *Economic Policies and Practices (Paper No. 3): A Description and Analysis of Certain European Capital Markets*, 88th Cong., 2d. Sess., 1964, for an account of the extent to which government control of some capital markets may result in higher interest rates in the uncontrolled markets.

Table II  
MONETARY AND FISCAL DEVELOPMENTS  
UNITED STATES AND SELECTED EUROPEAN COUNTRIES  
Government Net Budget Position as a Per Cent of GNP\*

	1961	1962	1963	1964
Belgium .....	-1.4%	-1.5%	-2.0%	-1.5%
France .....	-1.4	-1.7	-2.1	-0.4
Germany .....	0.1	-0.4	-0.8	-0.1
Italy .....	-0.4	-0.7	-1.3	-1.0
Netherlands ....	-0.2	-1.1	-0.5	-1.2
Switzerland ....	0.8	-0.1	0.2	0.7
United States ...	2.0	1.2	1.8	0.6

Monetary Growth  
Annual rates

	1958-62	1963	1964
Belgium .....	5.4%	9.7%	7.1%
France .....	18.1	14.7	8.0
Germany .....	11.4	7.4	8.7
Italy .....	19.5	13.9	4.6
Netherlands .....	7.4	9.2	8.1
Switzerland .....	11.9	7.2	6.6
United States .....	1.1	4.1	4.1

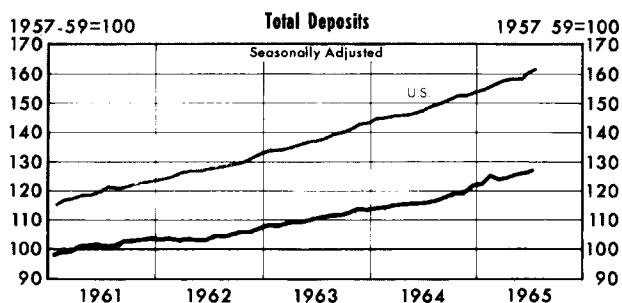
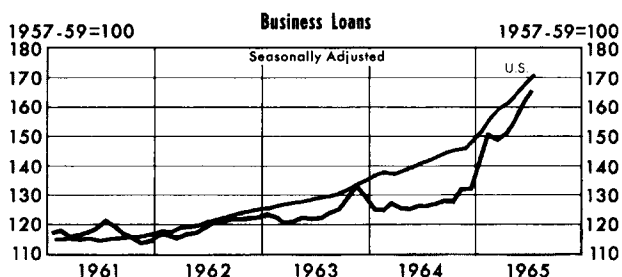
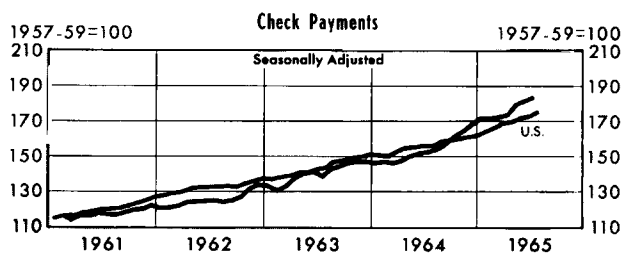
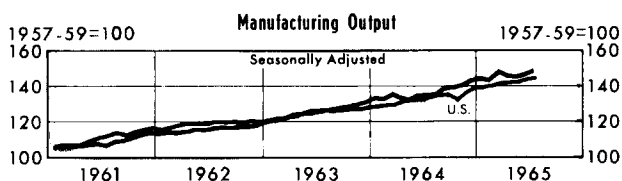
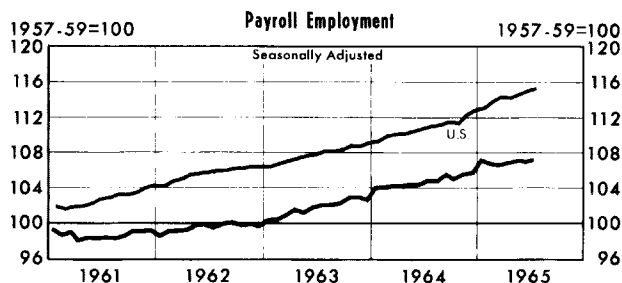
\*GNP in current prices; cash budget deficit (—) or surplus for European countries; full employment budget for the United States.

Sources: Board of Governors of the Federal Reserve System; International Monetary Fund.

both cases by a set of policy "mixes" that might have been inappropriate had the reduction of external imbalances been accorded greater consideration in policy formulation. A greater reliance on tight fiscal policy rather than monetary restraint in Europe during recent years might have moderated the rise in interest rates and at the same time dampened inflationary pressures. Similarly, had stimulative fiscal measures been employed earlier in this country in recent years, it is possible that less expansionary monetary policies would have been in order. Under these circumstances, it seems likely that comparative interest rate developments would not have produced so great an incentive for the excessive capital movements which were a major factor in the balance-of-payments disequilibria of the United States and Europe. In the present international payments system, the maintenance of given exchange rates, currency convertibility, and freedom of capital movements logically call for a greater degree of international cooperation with regard to national interest rate policies.<sup>9</sup>

<sup>9</sup>For further discussion of this point, see Bank for International Settlements, *Thirty-fifth Annual Report*, June 1965, pp. 29 and 164-66; Hal B. Lary, statement presented at hearings before the Subcommittee on Economic Statistics of the Joint Economic Committee, 89th Cong., 1st Sess., Part 2, June 8, 1965, p. 161; Harry G. Johnson, "Major Issues in Monetary and Fiscal Policies," *Federal Reserve Bulletin*, November 1964, pp. 1403-04.

## St. Louis



# Economic Expansion in Central Mississippi Valley Cities

ECONOMIC ACTIVITY in the Central Mississippi Valley has advanced at about the same rate in 1965 as in the previous four years of the current business expansion. Growth in the four largest metropolitan areas—St. Louis, Louisville, Memphis, and Little Rock—has generally kept pace with the nation since December and since early 1961.

## St. Louis

Economic growth in the St. Louis metropolitan area has been more rapid in 1965 than earlier in the current expansion. Payroll employment has increased at a 2.4 per cent annual rate since December 1964, reflecting primarily a large gain early in the year, compared with a 1.7 per cent average annual rate from the first quarter of 1961 to the fourth quarter of 1964.<sup>1</sup> Manufacturing employment has remained near the high December level in the first seven months of 1965. Nonmanufacturing employment has risen moderately since December, reflecting growth in trade and services.

Output of manufacturing firms has increased more slowly since December than from early 1961 to late 1964. Manufacturing output has advanced at a 6 per cent annual rate since December, compared with a 9 per cent average rate in the longer run period.

Spending in St. Louis has followed the national pattern of more rapid growth since December. The volume of spending as measured by check payments has increased at a 15 per cent annual rate in St. Louis

<sup>1</sup>All data are seasonally adjusted. Sources of data used in this article are: payroll employment, state employment security offices; manufacturing output, U. S. Department of Commerce, public utility companies, and firms using self-generated power; check payments, samples of commercial banks; business loans and total deposits, weekly reporting commercial banks. The statistics used in this article appear in "Selected Economic Indicators," a monthly publication of the Research Department, Federal Reserve Bank of St. Louis, P. O. Box 442, St. Louis, Missouri 63166.

since December, compared with a 12 per cent rate in the earlier period. Nationally, check payments have also risen at a 15 per cent rate in 1965, compared with a 10 per cent rate from 1961 to late 1964.

Banking activity has advanced at a brisk pace in 1965. Total loans outstanding at St. Louis banks have increased substantially, and business loans have risen even more sharply since December. In contrast to the national pattern of decline in recent months, investments at St. Louis banks have expanded.

Total deposits have increased at an 8 per cent annual rate this year. Demand deposits declined from December to July, while time deposits increased substantially.

### Louisville

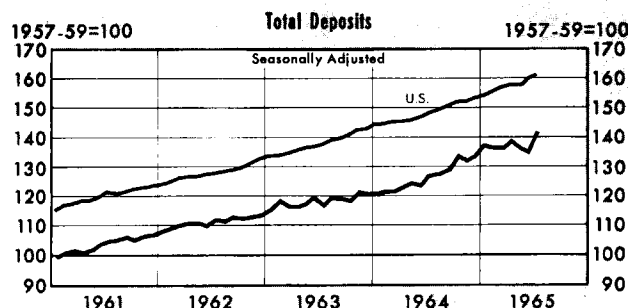
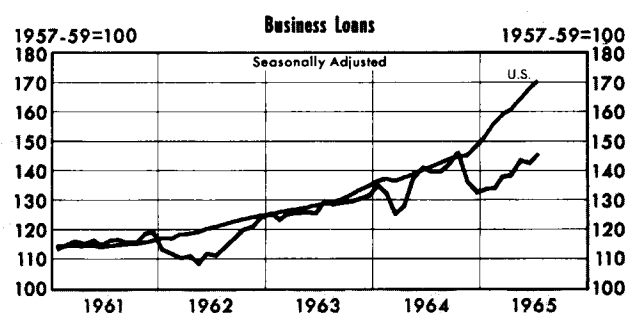
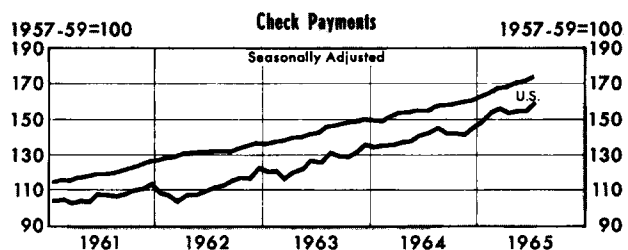
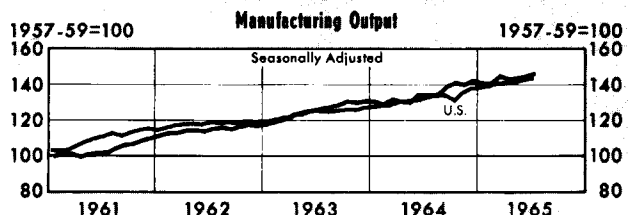
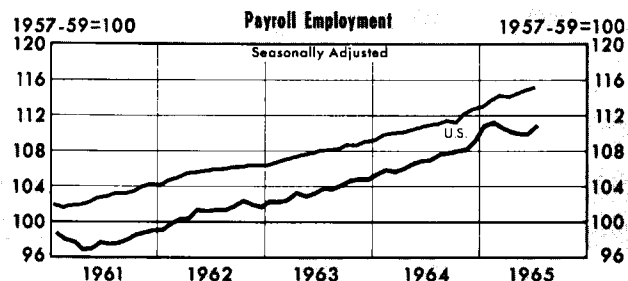
Economic activity in the Louisville metropolitan area rose markedly early in 1965 and has remained on a high plateau since February. Payroll employment has risen at an average 2.7 per cent annual rate in the last seven months, compared with a 3.7 per cent rate from early 1961 to late 1964. All of the nonmanufacturing categories of employment have shared in the recent growth, but gains have been most significant in government. Manufacturing employment has risen slightly since December. Employment in durable goods industries, particularly transportation equipment, has increased, while employment in nondurable industries has declined.

Production in Louisville, as measured by industrial use of electric power, has risen more slowly in recent months than in the period from 1961 to late 1964. Manufacturing output has risen at a 6 per cent annual rate since December, about half the rate in the earlier period. The pace of spending, on the other hand, has accelerated in 1965. Check payments have risen at a 17 per cent annual rate since December, compared with a 10 per cent rate earlier in the expansion.

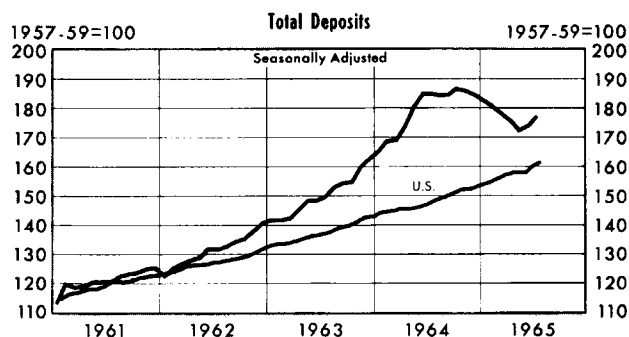
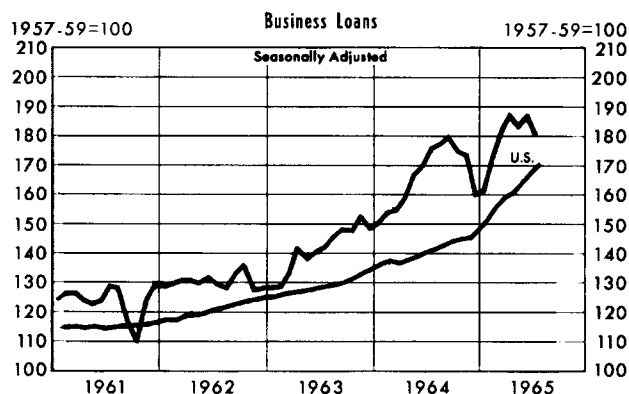
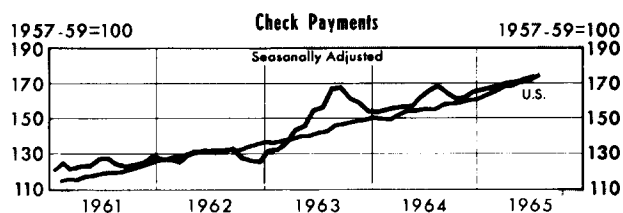
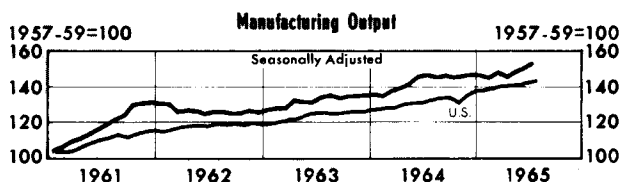
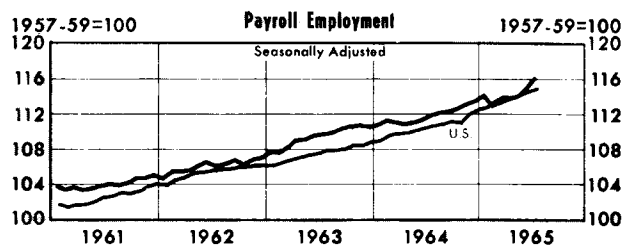
Banking activity has generally followed the national pattern in recent months. Loans have risen significantly in both the city and the nation, with a rise in business loans accounting for much of the increase. Bank investments in both Louisville and the United States as a whole have declined since December, following a moderate upward trend earlier in the current expansion.

Bank deposits have fluctuated widely since December. Demand deposits have risen at a 5 per cent rate, and time deposits at a 20 per cent rate, compared with average rates of 2 per cent and 34 per cent respectively in the earlier period.

### Louisville



## Memphis



## Memphis

Economic expansion in Memphis has been especially rapid during 1965. Payroll employment has increased at a 4.1 per cent annual rate since December, compared with a 2.4 per cent rate from 1961 to late 1964. Employment in service industries and government has risen most rapidly since December, with the anti-poverty program partly responsible for the increase. As in St. Louis and Louisville, employment in manufacturing industries has increased more slowly than in nonmanufacturing industries in the first seven months of 1965.

Total employment in Memphis has advanced at a 4.8 per cent annual rate since December, but the labor force has also risen rapidly. During the seven-month period unemployment has fallen from 3.6 to 3.3 per cent of the labor force.

Manufacturing output as measured by the industrial use of electric power has increased at an 8 per cent annual rate since December, with production of nondurable goods advancing most rapidly. Check payments have risen at a 9 per cent rate in 1965, about the same rate as earlier in the expansion.

Trends in banking activity have been mixed. Loans have increased at a 12 per cent rate since December. Business loans, after adjustment for seasonal influences, have risen sharply at Memphis banks, as in the other large Central Mississippi Valley cities. Bank investments have declined substantially.

Total deposits in Memphis have decreased in recent months. Demand deposits in July remained at about the December level. In contrast to upward trends in the rest of the nation, time deposits have declined at a 13 per cent annual rate since December, after advancing at a 33 per cent rate from 1961 to late 1964. The

probable reason for the recent decline in time deposits is the higher rates paid on such deposits in other areas. A state law limits the rate of interest paid on time deposits in Tennessee to 4 per cent.

### Little Rock

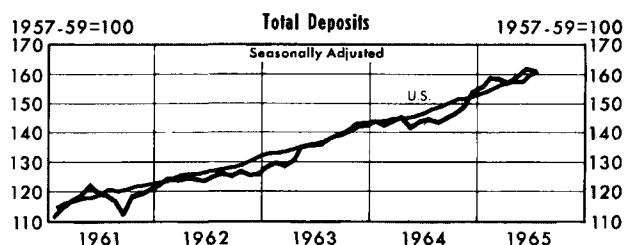
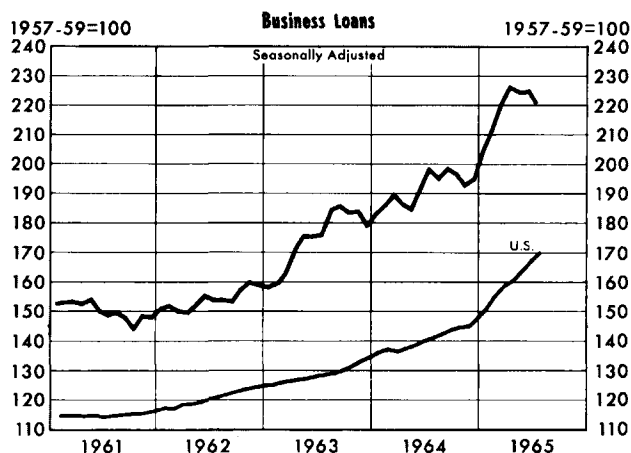
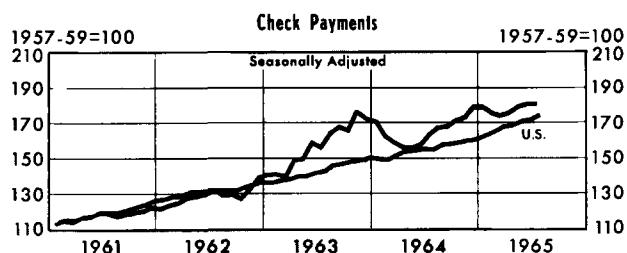
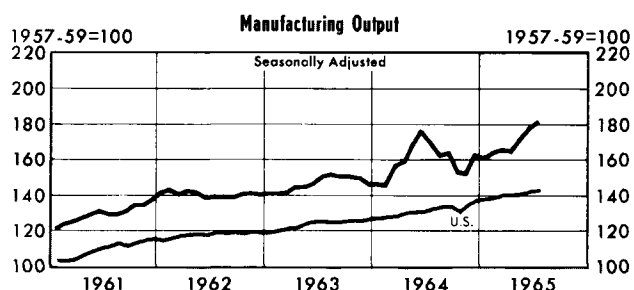
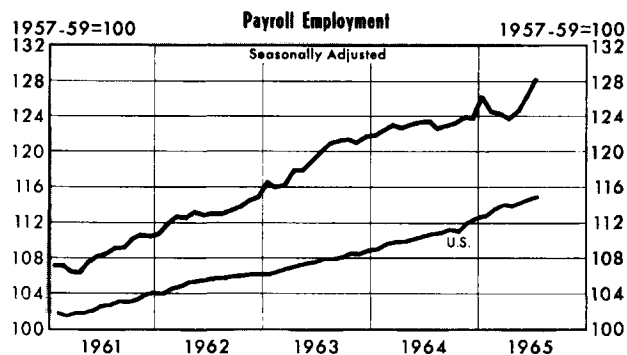
Economic activity in the Little Rock metropolitan area has continued to advance rapidly in 1965. Employment growth since December has exceeded the rate for the United States as a whole, although month-to-month fluctuations in Little Rock have been great. Payroll employment has increased at a 6 per cent rate since December, with manufacturing employment expanding most rapidly. The metals industry has been responsible for much of the manufacturing employment growth in Little Rock this year.

Nonmanufacturing employment has risen more rapidly since December than earlier. From May to June there was a sharp rise in government employment largely attributable to the Neighborhood Youth Corps and a larger number of students than usual working during the summer.

Manufacturing output in Little Rock has advanced significantly in 1965, more than offsetting declines in the second half of 1964. Check payments have increased at a much slower rate in recent months than earlier.

Loans have dominated the Little Rock banking picture recently. In periods of business expansion loans often rise faster than deposits as banks liquidate investments. This seems to be the case at Little Rock banks. Loans have risen at a 24 per cent rate since December, while deposits have increased at only an 8 per cent rate. Consequently, bank investments have declined substantially since late 1964.

### Little Rock



# Agriculture in the Central Mississippi Valley

**F**ARM INCOME PROSPECTS in the Central Mississippi Valley area have improved substantially in recent months. Cash receipts from farm marketings have risen significantly since April, compared with levels of a year earlier. Higher prices for livestock products have been a major factor. Crop prospects are favorable.

Farm commodity sales in June of this year were 7.8 per cent above the June 1964 level in the five state area. All states in the area had sales above year-earlier levels. Total second quarter sales were up 6.0 per cent, after having trailed 1964 sales by 6.2 per cent in the first quarter (see Table). Higher prices for livestock products were a major factor in the increases. All major livestock products in the area except eggs were selling above year-earlier prices by mid-year. Hogs, however, were the leading gainer, rising to an average of \$23.10 in July, 44 per cent above July 1964 prices.

## PERCENTAGE CHANGE IN PRICES OF MAJOR LIVESTOCK PRODUCTS

(July 1964 - July 1965)

Hogs .....	+44%
All beef cattle .....	+17
Steers and heifers .....	+17
All milk, wholesale .....	+ 2
Chickens, all, live .....	+ 5
Eggs .....	— 1

The lower farm receipts for the area in the first quarter compared with 1964 resulted from greatly reduced sales of the prior year's tobacco crop in Kentucky, Tennessee and Indiana.

Crop income prospects are excellent for the Central Mississippi Valley. Record yields and production are estimated for most of the major crops in the area. Prices for 1965 crops are not likely to change much from the 1964 average. The level of Government price supports has generally determined the price of most area crops in recent years. Such supports for 1965 were not changed significantly from the 1964 rate.

## SELECTED CROP PRICES

	1964	1964	1965
	Support Price	Av. Price Received by Farmers	Support Price
Corn (bu.) .....	\$1.25	\$1.16	\$1.25
Soybeans (bu.) .....	2.25	2.66	2.25
Rice (cwt.) .....	4.71	4.92	4.50
Tobacco (lb.) .....	0.589	0.602	0.595
Cotton (lb.) .....	0.3350	0.295	0.3335

## CASH RECEIPTS FROM FARM MARKETINGS

Central Mississippi Valley

Per Cent Change

(1965 compared with 1964)

	June	2nd Quarter	1st Quarter
Central Mississippi Valley			
States Total <sup>1</sup> .....	7.8	6.0	— 6.2
Arkansas .....	5.5	1.8	20.6
Illinois .....	15.8	12.2	3.0
Indiana .....	15.7	8.8	— 5.1
Kentucky .....	13.9	7.8	—38.5
Mississippi .....	7.5	5.6	21.0
Missouri .....	6.4	7.4	1.6
Tennessee .....	10.2	6.5	—11.5
United States .....	11.1	9.1	— 0.5

<sup>1</sup>Five states: Arkansas, Kentucky, Mississippi, Missouri, and Tennessee.

