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CONFIDENTIAL (FR)

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

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SUPPLEMENTAL NOTES

The Domestic Economy

Nonfarm business plans to spend \$46.9 billion on new plant and equipment in 1965, an increase of 5 per cent from this year, according to the McGraw-Hill Survey conducted during October. This compares with an indicated increase of 13.9 per cent^{1/} in 1964 and an increase of 5.1 per cent in 1963.

The indicated total for 1965 is only slightly above the annual rate for the current quarter shown in the August Commerce--SEC survey. Taken of itself, therefore, the survey suggests very little, if any, further expansion impetus. The McGraw-Hill staff, however, has taken the position, as they did last year, that "in an expanding economy business firms can make higher outlays than they anticipate, and they, therefore, revise their preliminary plans upward as final budgets are prepared." Last fall, when their survey indicated a rise of 4.2 per cent for 1965, McGraw-Hill stated that the fall surveys of the preceding 8 years had underestimated actual spending by an average of 3 percentage points, suggesting that a 7 per cent rise was more likely than a 4 per cent rise. For 1965, the McGraw-Hill staff expects actual spending to be up 8 per cent from this year. For a variety of reasons, the McGraw-Hill staff does not believe that the understatement will turn out anywhere nearly as large as for 1964, when the understatement was 9 or 10 per cent.

^{1/} The most recent Commerce-SEC survey taken in August shows an increase of 12.7 per cent in 1964. The McGraw-Hill estimate for 1964 is \$44.66, as compared with an indicated \$44.21 in the August Commerce-SEC survey. The difference is entirely attributable to higher McGraw-Hill estimates for the iron and steel and auto industries. McGraw-Hill is currently using the same estimates for these industries as in their April survey, since its latest survey confirms this higher figure.

These reasons include the length of the expansion period and of the well-sustained rise in fixed investment outlays; comments from respondents that they were spending more than anticipated earlier this year, i.e. borrowing from the future; comments from respondents that large projects were being completed; the fact that new orders for machinery, while high, have leveled off in recent months; and finally, the fact that the gap between actual and preferred operating rates in manufacturing was being narrowed only very slowly.

In this connection, it may be noted that another private survey of planned spending on plant and equipment, conducted in September, indicates a rise of 9 per cent for 1965. The difference is mainly accounted for by nonmanufacturing industries, with McGraw-Hill up 2.8 per cent and the other survey up 9 per cent. For total manufacturing, the two surveys are quite close--8 per cent for McGraw-Hill and 9 per cent for the other survey. Within manufacturing, however, indicated changes are strikingly different in the two surveys for many industries.

Planned changes in outlays from 1964 to 1965 range from -3.6 per cent for mining to + 7.9 per cent for manufacturing, as shown in the first column of the table. If the position taken by the McGraw-Hill staff is correct, differences between present plans and actual expenditures will be much smaller next year than they were this year for the various categories listed as well as for the total.

PLANS FOR SPENDING ON PLANT AND EQUIPMENT
(Changes in per cent)

	<u>McGraw-Hill Survey</u>		<u>Com.-SEC Survey</u>
	<u>October 1964 1964 to 1965</u>	<u>October 1963 1963 to 1964</u>	<u>August 1964 1963 to 1964</u>
All nonfarm business	4.9	4.2	12.7
Manufacturing, total	7.9	8.3	16.4
Nonmanufacturing, total	2.8	1.4	10.2
Mining	-3.6	.0	7.7
Railroads	.0	-14.0	32.7
Other transportation and communications	4.8	4.4	13.0
Electric and gas utilities	2.1	7.8	7.4
Commercial and other	3.0	-2.0	8.1

Most manufacturing industries reported plans to increase their spending next year. The largest increases are shown by chemicals (24 per cent), rubber (23 per cent), and automobiles (19 per cent). No change in spending is indicated for other transportation equipment (ships and railroad equipment), fabricated metals, and instruments. The only indicated decline is in nonferrous metals (-2 per cent).

The McGraw-Hill survey indicated that manufacturers as a whole were operating at 86 per cent of capacity in September. This rate compares with 85 per cent in December of 1963 and a preferred rate of 92 per cent. (Capacity utilization in manufacturing as estimated by the Board staff was 88 per cent for the third quarter as compared with 86 per cent in the fourth quarter of 1963.)

Most durable goods industries were operating 5 or more percentage points below their preferred rate. Nonferrous metal producers were

operating right at their preferred rate; data on operating rates are not available for iron and steel producers. Electrical machinery producers were operating 12 percentage points and nonauto transportation equipment 17 per cent below their preferred rates. Nondurable goods producers on the average were operating slightly closer to their preferred rates than durable goods industries, with textile and rubber producers only 1 per cent below.

Manufacturers, taken together, expect their sales to increase about 6 per cent in terms of physical volume in 1965, with continued gains in most industries. Iron and steel producers see no increase in their sales, and motor vehicle and parts producers see only a 2 per cent rise. Manufacturers reported expectations of a 1 per cent rise in prices of products they sell (as did all businesses taken together), with increases of 2 per cent expected for machinery and for iron and steel products, and 3 per cent for nonferrous metals.

Nonmanufacturing industries are planning an increase of only 3 per cent in plant and equipment spending. For utilities, the increase is only 2 per cent, as compared with 7 this year. Electric utilities are showing a rise of about 5 per cent and gas utilities a decline of about 5 per cent (these separate figures have not been published).

The book value of business inventories increased \$450 million in September and the level of August, which was originally unchanged from July and June, has been revised upward somewhat. Accumulation totaled \$550 million for the third quarter as a whole and averaged \$675 million for the first three quarters of the year. The quarterly average for 1963 was about \$1.2 billion.

The third quarter increase was entirely in manufacturers' stocks, which increased steadily throughout the quarter and at a faster pace than earlier in the year. The book value of distributors' inventories increased \$260 million in September--an amount that equaled the decline in the preceding two months--and from the end of June to the end of September the level of distributors' stocks was unchanged.

For distributors, inventories increased fairly generally in September but the September level for durable goods was moderately below midyear, owing in part to lower new car stocks, while nondurable goods inventories were up somewhat for the quarter.

The Domestic Financial Situation

The Treasury announced on November 5 that it had received cash subscriptions totaling about \$21.8 billion for the new 4 per cent notes of May 1966. The Treasury accepted about \$9.5 billion of these tenders and private investors were allotted 16-1/2 per cent of their subscriptions above a minimum of \$100,000. The proceeds from this cash financing will be used to pay off about \$8.7 billion of securities maturing November 15 and will provide about \$800 million of net new money.

Third quarter reports of corporate earnings suggest that corporate profits before taxes probably declined slightly from the seasonally adjusted annual rate of \$57.9 billion reached in the second quarter. In order for seasonally adjusted profits to have remained unchanged from the second to the third quarter, profits before taxes would have had to be at least 13 per cent, and profits after taxes

nearly 20 per cent, larger than in the third quarter of last year. The actual year-to-year increases appear to have been smaller than this, largely because of a narrowing in the gains reported for manufacturing industries.

Third quarter profits of manufacturing corporations are estimated to have shown a year-to-year increase of 12 per cent, before taxes, and of 16 per cent, after taxes. These are slightly smaller gains than those reported in the second quarter and well below the 1963-64 increases of 22 per cent (before taxes) and 27 per cent (after taxes) that occurred in the first quarter. The estimates for the third quarter of 1964 are based on data available for over 800 companies that account for two-thirds of the profits of all manufacturing corporations. Four-fifths of these 800 companies reported larger after-tax profits than in the third quarter of last year, though in some cases the increase was small and due entirely to the cut in Federal income tax rates.

It is difficult to say whether the performance of profits in the third quarter marks the beginning of the long-expected cyclical peaking-out of profits, or whether it is simply another of the several brief hesitations which have interrupted the upward course of profits during the present expansion period.

International Developments

Britain's gold and foreign exchange reserves fell by \$87 million in October, despite substantial assistance from foreign central banks. Although a calmer atmosphere appeared to prevail in foreign exchange markets following announcement of the measures taken to reduce the large trade deficit, uneasiness about the pound has not been dissipated. Renewed pressure on the pound appeared at the end of the week with sizable reserve losses by the Bank of England, reflecting growing recognition of the partial and temporary nature of the measures so far taken.