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CURRENT ECONOMIC AND FINANCIAL CONDITIONS

By the Staff
Board of Governors
of the Federal Reserve System

September 22, 1965

IN BROAD REVIEW

Two of the three major uncertainties that dominated economic prospects a month ago have been clarified. A steel labor agreement has been reached without a strike and on a noninflationary basis. Recent strength of sterling on foreign exchange markets has greatly reduced the threat of international financial disorder from that source.

The steel settlement, for psychological as well as more tangible economic reasons, has removed one of the potential obstacles to continued price stability. At the same time, however, it has brought the possibility of some industrial contraction as excessive steel (and maybe other) inventories are being brought down to sustainable levels. Steel output this month is being cut 15 per cent or more and this will act as a down-drag on the total industrial production index of about 1 point. A similar down-drag is likely in October.

The third uncertainty is still present. The war in Vietnam has been stepped up and other hostilities have occurred in the Far East. For the short run, increased intensity of U.S. defense efforts has modified some of the earlier concern about whether overall economic expansion could continue uninterrupted in the face of the steel adjustment. Expert opinion, earlier divided about prospects beyond the fall months, has now shifted and there is near-unanimity that overall expansion will continue for some time although not necessarily at as rapid a rate as in recent quarters.

The shift in sentiment has been influenced by current economic and market developments. The confirmation given by successive surveys of business plans for continued increases in fixed capital outlays is

a strategic factor in the outlook. A July survey of consumer attitudes and plans, moreover, provides statistical evidence of high consumer optimism and increased plans to purchase autos and homes.

Meanwhile, Government expenditures are continuing to rise not only for defense purposes, including higher military pay rates, but also for nondefense purposes. A large and retroactive increase in social security benefits means an extraordinarily sharp rise in personal income in September.

Thus, for all major categories of final demand -- business, consumer, and government -- the prospect is for further expansion. Inventory demand, however, is expected to decline.

Actual data through August or early September are somewhat mixed but generally provide support to indications of improved sentiment. Thus, the labor market strengthened further in August and unemployment remained at the reduced level reached in July. Construction activity rose slightly, although housing starts in August were down. New orders for durable goods also declined in August but orders to the key machinery industry remained high. Auto and other retail sales were maintained at high rates in August and early September. Industrial commodity prices have shown little further rise since mid-year.

Additional firmness has developed in financial markets in August and September as a result of cumulating pressure on bank reserve positions, a further decline in corporate liquidity, heavy demands for funds from banks and the capital markets, and more buoyant expectations about future economic activity. Reflecting in part the cumulating pressure on reserve positions, the rate of bank credit expansion, although still large, has been declining.

Both long-term corporate and Treasury yields have reached the highest level since 1960, while yields on State and local government bonds have risen to their highest level since early 1962. Most recently, corporate bond yields, which earlier had shown the sharpest rise, have tended to level out, reflecting in part a smaller prospective calendar of new issues.

Short-term yields have also risen, but more modestly. Three-month Treasury bill yields are only a few basis points below their February peak, while those on 6-month bills have regained their earlier high. Money market conditions have been tauter, despite somewhat lower net borrowed reserves in recent weeks.

The stock market has also reflected the more optimistic business expectations and by late September had recovered almost all of its spring losses. Treasury fall financing needs are quite large but will be concentrated in the tax bill area.

The U.S. international payments position in July and August, roughly adjusted for seasonality, was not very different from the average for the first half of 1965, a deficit at an annual rate of \$1-1/4 billion.

Since the beginning of September a marked change for the better has occurred in exchange market attitudes toward sterling. Earlier, in August the two-year decline in U.K. Government bond prices has come to a halt.

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SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest Period	Amount			Per cent change:	
		Latest Period	Preced'g Period	Year Ago	Year Ago*	2 Yrs. Ago*
Civilian labor force (mil.)	Aug '65	75.8	76.2	74.3	2.0	3.8
Unemployment (mil.)	"	3.4	3.4	3.8	-11.1	-16.2
Unemployment (per cent)	"	4.5	4.5	5.1	-	-
Nonfarm employment, payroll (mil.)	"	60.7	60.6	58.3	4.1	6.9
Manufacturing	"	18.2	18.1	17.3	4.7	6.8
Other industrial	"	7.9	7.9	7.7	2.6	4.5
Nonindustrial	"	34.6	34.6	33.2	4.2	7.6
Industrial production (57-59=100)	"	144.4	144.2	134.0	7.8	15.2
Final products	"	141.9	141.2	133.1	6.6	12.6
Materials	"	146.6	146.9	135.3	8.4	17.4
Wholesale prices (57-59=100) <u>1/</u>	"	102.9	102.9	100.3	2.6	2.5
Industrial commodities	"	102.2	102.1	100.8	1.4	1.8
Sensitive materials	"	102.9	102.3	99.4	3.5	5.3
Farm products and foods	"	103.3	103.7	97.7	5.7	4.4
Consumer prices (57-59=100) <u>1/</u>	July '65	110.2	110.1	108.3	1.8	2.9
Commodities except food	"	104.7	105.1	104.3	0.4	1.2
Food	"	110.9	110.1	107.2	3.5	4.4
Services	"	117.8	117.6	115.3	2.2	4.2
Hourly earnings, mfg. (\$)	Aug '65	2.63	2.62	2.55	3.1	7.3
Weekly earnings, mfg. (\$)	"	107.46	107.01	103.90	3.4	8.4
Personal income (\$ bil.) <u>2/</u>	"	531.6	530.5	499.5	6.4	13.8
Retail sales, total (\$ bil.)	"	23.5	23.8	22.3	5.6	13.8
Autos (million units) <u>2/</u>	"	8.9	8.9	8.3	7.0	26.8
GAF (\$ bil.)	"	5.2	5.4	5.2	0.5	11.2
Selected leading indicators:						
Housing starts, pvt. (thous.) <u>2/</u>	"	1,402	1,461	1,513	-7.3	-9.3
Factory workweek (hours)	"	40.9	40.9	40.8	0.2	1.2
New orders, dur. goods (\$ bil.)	"	21.3	22.2	19.3	10.3	18.1
New orders, nonel. mach. (\$ bil.)	"	3.3	3.2	3.0	11.6	30.3
Common stock prices (1941-43=10) <u>1/</u>	"	86.49	84.91	82.00	5.5	21.9
Inventories, book val. (\$ bil.)	July '65	125.9	115.0	107.4	7.9	13.0
Gross national product (\$ bil.) <u>2/</u>	QII-'65	665.9	656.4	624.2	6.7	14.2
Real GNP (\$ bil. 1958 prices) <u>2/</u>	"	601.4	597.5	575.9	4.4	10.4

*Based on unrounded data. 1/ Not seasonally adjusted. 2/ Annual rates.

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SELECTED DOMESTIC FINANCIAL DATA

	Week ended	Four-Week	Last six months	
	Sept. 17	Average	High	Low
<u>Money Market</u> ^{1/} (N.S.A.)				
Federal funds rate (per cent)	4.13	4.09	4.13	2.00
U.S. Treas. bills, 3 mo., yield (per cent)	3.88	3.88	3.97	3.77
Net free reserves ^{2/} (mil. \$)	-156	-127	-11	-233
Member bank borrowings ^{2/} (mil.\$)	558	531	620	345
<u>Security Markets</u> (N.S.A.)				
Market yields ^{1/} (per cent)				
5-year U.S. Treas. bonds	4.23	4.23	4.22	4.12
20-year U.S. Treas. bonds	4.30	4.29	4.28	4.19
Corporate new bond issues, Aaa	4.67	4.69	4.71	4.37
Corporate seasoned bonds, Aaa	4.52	4.52	4.52	4.42
Municipal seasoned bonds, Aaa	3.25	3.20	3.25	3.09
FHA home mortgages, 30-year ^{3/}	5.45	5.45	5.45	5.44
Common stocks S&P composit index ^{4/}				
Prices, closing (1941-43=10)	89.60	88.17	89.90	83.55
Dividend yield (per cent)	2.96	3.01	3.11	2.90
	Change	Average	Annual rate of	
	in	change	change (%)	
	August	last 3 mos.	3 mos.	1 year
<u>Banking</u> (S.A., mil. \$)				
Total reserves	-49	48	2.5	5.1
Bank loans and investments:				
Total	4,500	2,300	9.9	10.6
Business loans	700	900	17.0	11.4
Other loans	2,300	1,300	13.1	12.7
U.S. Government securities	600	-600	-12.3	-5.8
Other securities	900	700	21.3	17.6
Money and liquid assets:				
Demand dep. & currency	200	900	6.7	3.6
Time and savings dep.	2,500	1,800	16.3	15.8
Nonbank liquid assets	3,300	1,800	8.7	6.7

N.S.A.--not seasonally adjusted. S.A.--seasonally adjusted.

^{1/} Average of daily figures. ^{2/} Average for statement week ending September 15.^{3/} Latest figure indicated is for month of August ^{4/} Data are for weekly closing prices.

U. S. BALANCE OF PAYMENTS

	1965					1964		1964
	Aug.	July	June	QII	QI	QIV	QIII	Year
Seasonally adjusted annual rates, in billions of dollars								
Balance on regular transactions				0.5	- 3.1	- 6.2	- 2.4	- 3.1
Current account balance				6.9	5.2	8.1	8.0	7.7
Trade balance <u>1/</u>		6.9	4.0	5.2	3.7	7.2	6.7	6.7
Exports <u>1/</u>		26.7	25.8	27.1	22.3	26.8	25.5	25.3
Imports <u>1/</u>		-19.8	-21.8	-21.9	-18.6	-19.6	-18.8	-18.6
Services, etc., net				1.7	1.5	0.9	1.3	1.0
Capital account balance				- 5.7	- 8.3	-12.5	- 9.1	- 9.7
Govt. grants & capital <u>2/</u>				- 3.8	- 3.2	- 4.1	- 3.7	- 3.6
U.S. private direct inv.				- 3.5	- 4.6	- 3.3	- 2.2	- 2.4
U.S. priv. long-term portfolio				0.5	- 2.8	- 3.3	- 2.4	- 2.0
U.S. priv. short-term				2.0	1.3	- 2.3	- 1.6	- 2.1
Foreign nonliquid				- 0.9	1.1	0.4	0.8	0.4
Errors and omissions				- 0.7	0	- 1.7	- 1.2	- 1.2
Monthly averages, in millions of dollars								
Balance on regular transactions (seas. adjusted, - = deficit)				40	- 260	- 517	-198	- 259
Less: Net seas. adjusted				16	- 174	1	143	---
Balance before adjustment	-336	-266	14	24	- 87	- 518	-340	- 259
Financing (unadjusted)	336	266	- 14	- 24	87	518	340	259
Special receipts <u>3/</u>		179		44	26	52	1	29
Liabilities increase								
Nonofficial <u>4/</u>	621	(217	89	- 52	66	217	187	129
Official <u>5/</u>		(-326	239	- 39	- 286	300	129	86
Monetary reserves decrease	-285	196	-342	23	281	- 50	23	14
of which: Gold sales	(54)	(80)	(313)	(196)	(277)	(57)	(- 7)	(10)
<u>6/</u> Memo: Official financing/ <u>6/</u>		(49)	(-103)	(28)	(21)	(301)	(153)	(129)

1/ Balance of payments basis which differs a little from Census basis.

2/ Net of associated liabilities and of scheduled loan repayments.

3/ Advance repayments on U.S. Govt. loans and advance payments for military exports: assumed zero in absence of information.

4/ Includes international institutions (except IMF), commercial banks and private nonbank.

5/ Includes nonmarketable bonds.

6/ Decrease in monetary reserves, increase in liabilities to foreign official institutions, and special receipts.

THE DOMESTIC ECONOMY

Industrial production. The slight rise in the total index in August to 144.4 from 144.2 in July was due primarily to a further sharp increase in business equipment; output of consumer goods changed little while a 4 per cent decline in output of iron and steel lowered the index for total materials to 146.6 from 146.9 in July.

Although consumption of steel mill products by manufacturers is at record rates, inventories of these goods held by manufacturers at the end of July were about a third above the peaks of 1962 and 1963 and apparently rose further in August. In early September steel ingot production dropped, and output of steel mill products is also expected to drop sharply while inventories are being reduced, even though total stocks are not expected to reach the 1962 and 1963-64 lows. Decreases in output of iron and steel of 15 per cent or so in September and, also, in October would amount to a 1.0 point decline in the total production index in each month. The probable curtailment in steel raises the question of whether there is enough upward push in final products and materials other than steel to offset these declines?

INDUSTRIAL PRODUCTION
(Seasonally adjusted annual rates of change)
Per cent

	August 1965 from August 1964	August 1965 from January 1965
Total	7.8	7.2
Consumer goods	4.3	0.5
Consumer goods excl. autos	4.0	0.5
Business equipment	11.9	12.0
Materials	8.4	9.6
Iron and steel	8.7	10.8
Materials excl. I. & S.	8.3	9.6

Output of consumer goods has changed little since January after rising sharply in the last half of 1964. Auto assemblies have been at record rates so far this year and production schedules for September and the fourth quarter indicate little change from current high levels. Output of home goods and apparel has changed little at advanced levels. Retail sales of these goods, after declining somewhat from earlier highs, increased in June and July, and, according to preliminary figures, declined in August. Stocks, however, were at new highs by the end of July. Further incentives for increases in output for the cyclical consumer goods -- autos, home goods, and apparel -- could come if consumer demands strengthen as a result of the sharp rise in personal income in September.

Output of business equipment is continuing strong. However, a two point rise in this group only amounts directly to about .3 of one point in the total index. Output of defense equipment has increased 10 per cent since January and this accounted directly for .3 of a point in the total index.

Output of materials other than iron and steel has risen rapidly since January and was undoubtedly influenced by the prolonged demands for materials by the steel industry and by demands for inventory accumulation of semifinished metal products as well as by rising final use. Since late 1964 the index of materials output has been considerably above that for final products. This is in contrast to the 1962 and 1963 experience when the index of materials output was generally lower than that for final products.

Considering the magnitude of the expected decline in iron and steel and likely production developments in other areas as outlined above, the total production index is likely to decline one point or so in September and again in October.

Retail sales. Retail sales declined 1 per cent in August, but with July at a very advanced level August and July together averaged 2 per cent higher than the second quarter. In early September, with auto sales particularly strong, retail sales appear to have increased somewhat.

Sales of autos and other durable goods in August held at the advanced July levels and the July-August average for durable goods was nearly 4 per cent above the second quarter. Automotive dealer sales were up 5 per cent.

Sales of nondurable goods were down in August -- particularly for apparel -- but for the two summer months sales were up 1 per cent from spring levels. This fairly typical rise followed an unusually large (2.2 per cent) increase from the first to the second quarter.

Unit automobile sales and stocks. Sales of new domestic automobiles continued at advanced levels in August and early September; the seasonally adjusted annual rate in August was 8.9 million vehicles, equal to June and July rates and 7 per cent above a year earlier. Dealer deliveries in the first 10 days of September were 14 per cent above a year ago.

New car inventories continued well above a year ago in August and early September. Differences in the relationships between sales and stocks in the two years are difficult to interpret, however, because of the different changeover pattern this year. Last year the lowest production came in the first week of August, while this year it was in the last week of the month. New car introduction dates this year are one or two weeks later than last year.

Consumer credit. Credit buying tapered off a little in August, judging by early reports from commercial banks. Auto credit demands apparently were not quite so vigorous as earlier, although this was at least partly offset by increased use of credit to purchase furniture, appliances, color television, and other household durables. Meanwhile, repair and modernization loans and personal loans showed changes similar to those reported for July. Despite the slowing in August, total installment credit through the first 8 months of 1965 increased at an annual rate of close to \$8 billion, compared with less than \$6 billion for the same period in 1964.

Education loans have been in especially heavy demand this summer and fall, according to comments from a number of lenders. This has reflected not only a rise in tuition and related costs but also an increase in the number of students attending college. During the year ending June 1965, the Department of Health, Education, and Welfare granted loans of \$130 million under its Federal Aid to Education program. In anticipation of increased demand, HEW has asked that \$180 million be set aside for this purpose for the fiscal year ending June 1966.

Auto terms continue relatively easy at both sales finance companies and commercial banks. In the case of new car contracts, the easing has taken the form of a gradual rise in the proportion of contracts written for 36 months. A similar lengthening trend has been taking place for used cars. At present a larger proportion of all used car contracts is written on a 36-month basis than on a 24-month basis -- just the reverse of two years ago. In part, this shift reflects the younger average age of the used cars being sold.

Consumer buying plans. Consumers are optimistic about their future income prospects and are planning increased purchases of major items, according to the Census quarterly survey conducted in mid-July. The proportion of households reporting expectations of higher income a year hence was appreciably above a year earlier and also above any other period from 1959 to date. Plans to buy new autos over the coming 12 months were higher than a year earlier -- 9.6 per cent of all households indicated such plans with 9.0 per cent in July 1964. Definite plans to buy new cars within 6 months also were up appreciably from a year earlier. Buying intentions for used cars and for major household durable goods were about as strong as they were a year earlier.

Among the factors accounting for the large rise in new car sales in recent years has been expansion of multiple car ownership. The July survey revealed that the proportion of households owning two or more autos, which has been increasing in recent years, showed a large further

rise from mid-1964 to mid-1965 -- from 21.9 per cent to 23.6 per cent. As recently as 1960, this proportion was 17.9 per cent.

Personal income. Personal income rose a little more than \$1 billion in August to a seasonally adjusted annual rate of \$532 billion, a level 6.4 per cent above a year earlier. The August rise was limited by a large further decline in agricultural income following a sharp runup -- more than \$4 billion, annual rate -- in the second quarter mainly because of higher prices for livestock and for fresh fruits and vegetables. Excluding agricultural income, the August increase in personal income was only slightly less than in each of the three preceding months.

Personal income in September will rise sharply since it will include the recently enacted current and retroactive increases in social security benefits and higher military pay rates. The larger social security benefits include: (a) a 7 per cent permanent increase in old age and survivors' insurance benefits (around \$1.2 billion annual rate); (b) a \$885 million retroactive payment to cover the first eight months of the year (\$10.6 billion annual rate); and (c) small increases in some miscellaneous welfare benefits. In addition, military pay rates were increased effective September 1 and these add \$1.1 billion annual rate to military payrolls.

In summary, September personal income will include a continuing increase amounting to about \$2.5 billion, annual rate, and a one-time payment amounting to over \$10 billion, annual rate. If all other payments were

to continue at their August levels, these additional payments would raise personal income in the third quarter to around \$536 billion from \$525 billion in the second quarter. There is no reason to think that the bulk of these large additions to personal income will not, with some lag, be reflected in higher consumption expenditures.

Labor market. The labor market showed further improvement in August as the upward trend in nonfarm employment was maintained. All of the August increase in employment was in the nonmanufacturing sector. Factory employment leveled off following a steady rise beginning late last year.

In manufacturing, employment declined in primary metals and metal fabricating industries as steel inventory accumulation tapered off. Inability of standard seasonal factors adequately to adjust for the shift in timing of the automobile model changeover also affected reported employment. In machinery, rubber, ordnance, and aircraft industries employment continued to advance.

In nonmanufacturing, employment advanced in transportation and public utilities, service, and State and local government activities. Construction employment, which had dipped moderately in July because of strikes, recovered nearly all of that loss in August.

The unemployment rate, at 4.5 per cent in August, was unchanged from July but well below the 5.1 per cent of a year earlier. There were, however, shifts in the composition of unemployment, with rates for women and married men moderately higher than in July and rates for blue collar,

nonwhite, and young workers lower. The teenage unemployment rate, at 12.4 per cent in August fell to a three-year low, but the decline was accompanied by reductions in the teenage labor force and employment. Both of these reductions may have been a reaction to unusually large increases reported in July. The total civilian labor force also declined in August although it was still 1.7 million above a year earlier, and well above the average year-to-year growth of 1.2 million experienced in the first half of 1965. About one-half of this 1.7 million labor force growth over the year was accounted for by the teenage group.

Hours and earnings. The work week in manufacturing at 40.9 hours in August was little changed from that in recent months, but was slightly below the high reached in the first quarter. Overtime hours then had been unusually high because of the strike-hedge demands for steel, and the catchup in automobile output after last fall's strike. In recent months producers have tended to meet higher production schedules by increasing employment and by curtailing overtime hours paid for at premium rates.

Hourly compensation in manufacturing has continued to increase at about the same rate as earlier. In August, hourly earnings of factory production workers rose slightly to \$2.63 an hour, seasonally adjusted, a rise of 3.1 per cent from the year earlier. This was about the same rate of increase as in other recent years. Unit labor costs showed a moderate rise in August, as the rise in manufacturing output tapered off because of reduced steel production. Short-term reductions in output are not usually reflected immediately in corresponding declines in manhours of work and consequently, unit labor costs may tend to rise when growth in production slows.

Prices. The industrial commodity price index, unchanged in July, edged up .1 per cent in August. Weekly estimates indicate little or no change into mid-September. Thus, the industrial index has increased little more than .2 per cent in the four months since May, after rising more than 1 per cent from last autumn to May. Average prices of foodstuffs have declined slightly from their July peak, and the total wholesale price index has been stable during the past eight weeks.

Increases in prices of metals and machinery have been responsible for most of the rise in the industrial index, but an index for all industrial commodities excluding metals and machinery, which had shown little net change last year, has edged up slightly this year. The rise has reflected a sharp rise in hides and generally small increases in lumber, petroleum products, tires, and some textiles and paper products. Declines occurred in some consumer products such as appliances, radio and television sets.

The price of copper scrap has risen further as world demand for copper has continued to increase while supplies, although increasing, have frequently been disrupted. Aluminum producers are reported to be shifting from long-term price contracts to a policy of pricing at time of shipment; this change suggests expectations of a further rise in the ingot price. A release of 150,000 tons of zinc from the Federal stockpile during the next six months is expected to supplement current monthly production of 90,000 tons and to permit all domestic demands to be met.

Recently, a major auto producer announced somewhat higher list prices for most of its 1966 model cars. A large part of the rise can be

accounted for by incorporation of a number of safety features which previously were optional. Whether the remaining fraction of the increase can be attributed to other improvements or to a true price rise is as yet unclear.

Average prices of foodstuffs have drifted downward since July mainly because of greater than seasonal declines in fresh fruits and vegetables, and also because of price declines in meats and poultry resulting from increased supplies. Counteracting these reductions have been seasonal price increases in dairy products and eggs.

New orders for durable goods. New orders for durable goods, which had risen for two months, declined 4 per cent in August according to advance figures. About half the August decline was due to a sharp drop in steel orders. But new orders for most other types of products also declined moderately. Orders about equaled sales, which were off moderately from the record July level, and total unfilled orders were unchanged, with steel backlogs down sharply and backlogs for other durable goods up further.

Orders have been fluctuating around a relatively stable trend so far this year, but over the course of the year steel orders have been declining (from February to August the decline amounted to 37 per cent) while orders for other durable goods have advanced. In recent months new orders for defense products have been below the exceptionally high April level but above the beginning of the year. Orders for machinery and equipment have been increasing irregularly and in July and August averaged 10 per cent higher than in January and February.

Business inventories. Accumulation of business inventories (book value) which had slackened moderately in the second quarter, rose in July to equal the high first quarter rate, reflecting a step-up at manufacturers. The sharp July rise in factory stocks was probably temporary. It was concentrated in goods-in-process in the durable goods sector and was associated with the large spurt in output. Steel production declined in August and has declined substantially further in September. At distributors, the rate of increase in stocks slowed further in July. The slackening was pronounced at both durable (mainly autos) and nondurable goods retailers and at nondurable goods wholesalers.

On a GNP basis (which includes a valuation adjustment for price increases), nonfarm business inventory accumulation was at an annual rate of \$9.3 billion in the first quarter and \$7.1 billion in the second quarter. In the third quarter a further decline of \$1 billion or so in the rate of accumulation now appears likely, owing mainly to lower accumulation at distributors. Another and probably larger decline is in prospect for the fourth quarter, with the decline coming mainly from a shift from accumulation to liquidation of steel stocks.

Manufacturers' inventory and sales expectations. According to the Commerce survey conducted in late July and August, manufacturers anticipate inventory accumulation of \$800 million (book value) in the current quarter, little changed from the actual rate of accumulation in the preceding two quarters. For the fourth quarter, however, manufacturers are projecting inventory accumulation at a substantially reduced

rate--\$500 million--because of a run off in steel stocks held by durable goods producers. In the first and second quarters, actual inventory accumulation turned out close to the anticipations recorded in the successive Commerce quarterly surveys.

Almost the entire book value increase at manufacturers in the first half of the year was in durable goods and perhaps half of the durable increase represented accumulation of steel stocks. Durable goods producers (in late July and August) expected steel stockpiling to continue in the third quarter and anticipated a book value increase of \$600 million, moderately less than earlier. In the fourth quarter, considerable liquidation of excessive steel stocks is anticipated and total durable goods accumulation is now projected at only \$200 million.

Manufacturers as a whole expect further expansion of sales in the current quarter and also in the fourth despite probable sharply reduced activity in the steel industry. A 4 per cent sales rise is now projected from the second to the fourth quarter, with nondurable goods showing somewhat more rise than durable goods. In comparison, manufacturers' sales increased 5-1/2 per cent between the fourth quarter 1964 and the second quarter 1965. Sales generally exceeded expectations in that period.

Construction activity. Expenditures for new construction in August remained near the record seasonally adjusted annual rate reached in June. Business construction, already at a record high, moved higher while public construction continued to fluctuate at an advanced level.

Private residential construction, which had shown some recovery in the first half of the year, edged off as it had in July, but held within 4 per cent of the peak reached in March of last year.

NEW CONSTRUCTION PUT IN PLACE

	August <u>1</u> / (Billions)	Per cent change from	
		Month ago	Year ago
Total	\$68.7	1	5
Private	48.3	--	6
Residential	26.7	-1	2
Nonresidential	21.6	--	12
Business	16.1	1	18
Public	20.3	3	2

The slackening in residential construction is associated with declining housing starts since June. In August, starts were the lowest since early 1963, although on a three-month moving average basis, -- which provides a better measure of the trend of activity -- starts in the most recent period were at an annual rate of nearly 1.5 million units, slightly above the first quarter of this year. Building permits as well as starts dropped further in August with both single- and multi-family permits declining.

PRIVATE HOUSING STARTS AND PERMITS

	August <u>1</u> / (thousands of units)	Per cent change from	
		Month ago	Year ago
Starts (total)	1,402	-4	-7
Permits (total)	1,195	-4	-7
1 family	681	-3	-2
2-4 family	89	-2	-7
5-or-more family	425	-5	-14

1/ Seasonally adjusted annual rate; preliminary.

One factor in the lower level of single-family housing activity in recent months has been speculative builder caution about housing inventories even though indications of final demand have remained fairly favorable. In July, the downtrend in the number of unsold houses continued to another new low for the series, which began in late 1962. As in the first six months, actual home sales by speculative builders about matched sales a year earlier. And the Census Survey of consumer intentions in July found plans to buy new and existing homes within the next six months at least as high as in July last year.

Plant and equipment expenditures. Business outlays for new plant and equipment will continue to rise through the balance of the year, and the increase in the second half will be as much as in the first half, according to the August survey of business plans conducted by the Department of Commerce and the Securities and Exchange Commission. Thus, business fixed investment -- a sometimes volatile and determining factor in cyclical developments -- is continuing to provide economic strength. The fourth quarter level is now expected to be about 11 per cent above that in late 1964, as compared to a 16 per cent rise over the preceding year. The total for 1965 is now projected to be 13.4 per cent above 1964, as compared with an increase of 14.5 per cent last year. Moreover, plans for fixed capital outlays have steadily strengthened during the year; the preceding (May) survey had indicated a 12.5 per cent rise and the February survey a 12 per cent gain.

At a seasonally adjusted annual rate of \$52.9 billion, fourth quarter outlays will be \$19.5 billion, or more than 50 per cent, above the recession low reached 4-1/2 years earlier. Total business fixed investment outlays at year-end are likely to represent a little more than 10 per cent of GNP, not quite up to the 10.6 per cent at the peak of the 1955-57 investment boom.

Continued high rates of capital spending by manufacturers, at least through the first half of 1966, are suggested by a recent NICB survey of capital appropriations by the nation's 1000 largest manufacturers.

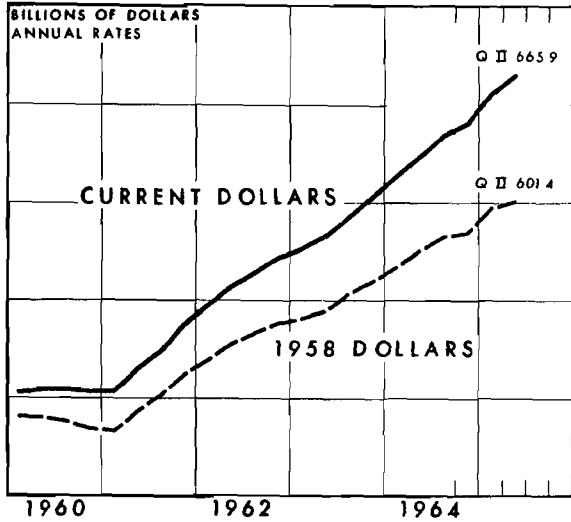
EXPENDITURES FOR NEW PLANT AND EQUIPMENT
(Per cent change)

	1965 from 1964	1964 from 1963	1965-IV from 1964-IV	1964-IV from 1963-IV
All Industries	13.4	14.5	10.9	15.9
Manufacturing	17.8	18.4	14.1	22.5
Durable goods industries	16.2	20.1	14.3	22.3
Metal producing	15.7	31.5	12.2	36.1
Machinery	21.3	19.2	16.0	22.0
Transportation equipment	25.6	25.2	15.2	39.4
Nondurable goods	19.2	16.8	14.0	22.7
Mining	10.1	14.4	3.8	23.8
Railroad	14.9	28.2	6.5	14.8
Transportation other than rail	17.2	24.0	15.4	23.8
Public utilities	7.6	10.1	4.7	9.5
Communication, commercial, and other	9.9	9.5	9.2	9.0

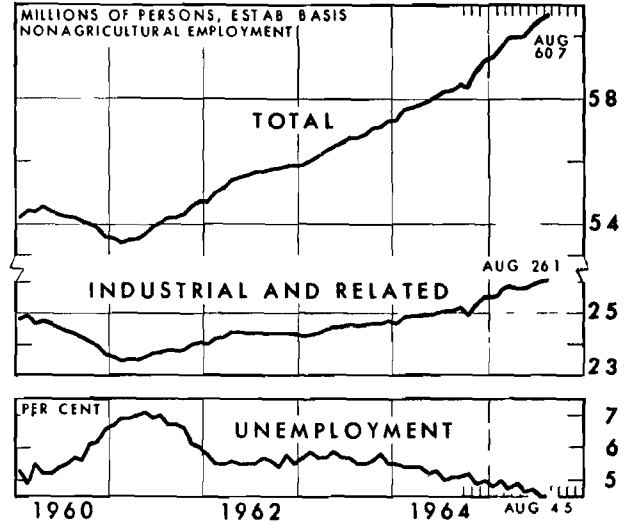
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

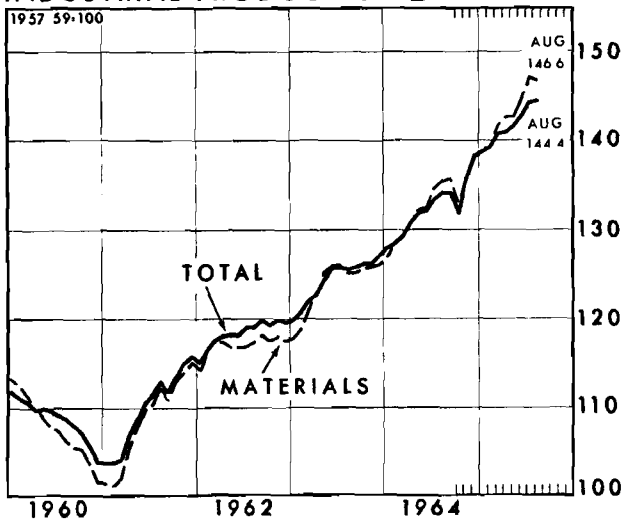
GROSS NATIONAL PRODUCT



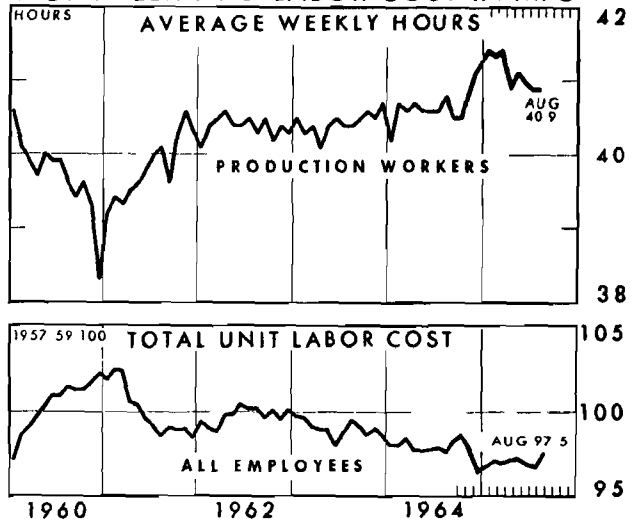
EMPLOYMENT AND UNEMPLOYMENT



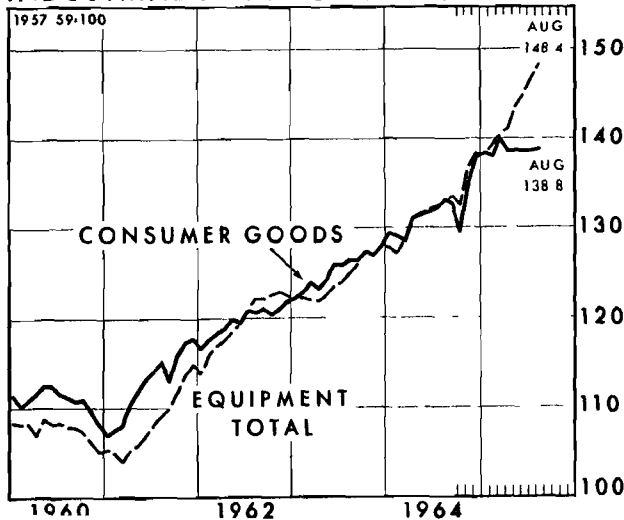
INDUSTRIAL PRODUCTION - I



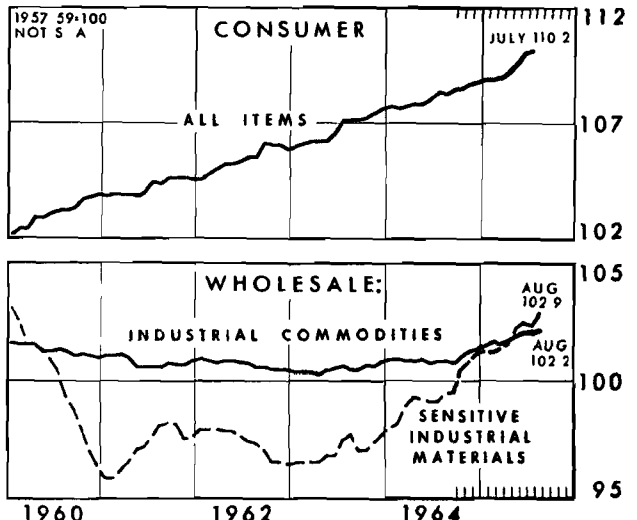
WORKWEEK AND LABOR COST IN MFG



INDUSTRIAL PRODUCTION - II



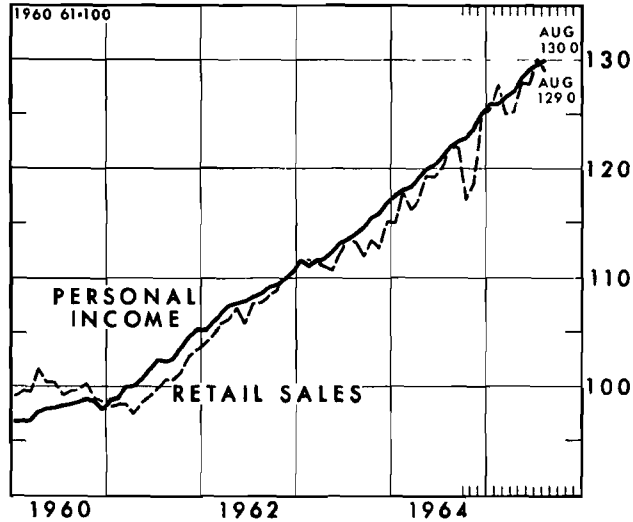
PRICES



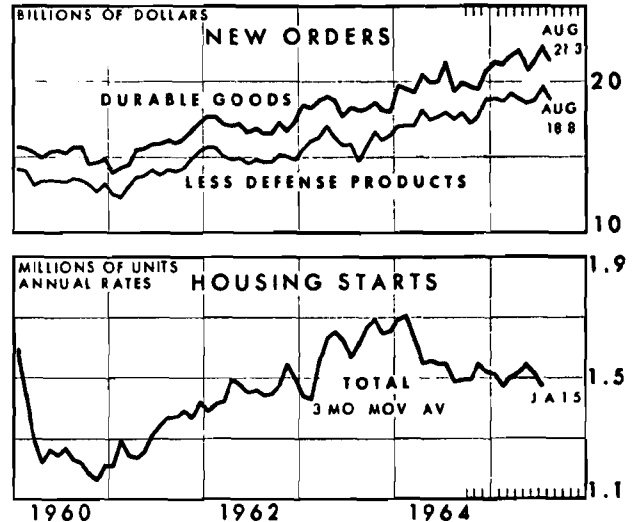
ECONOMIC DEVELOPMENTS - UNITED STATES

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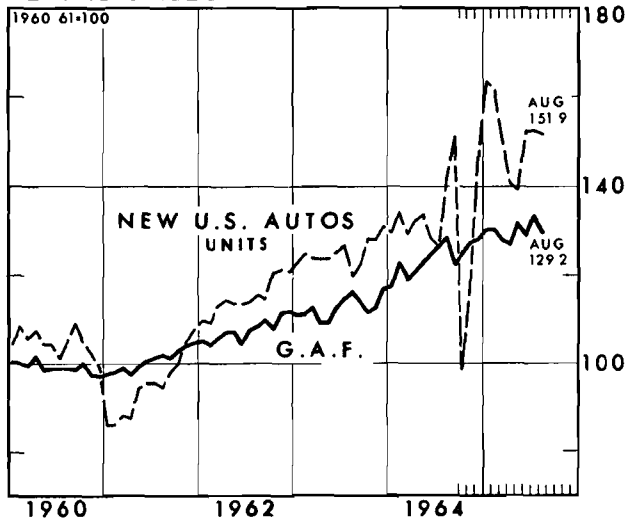
INCOME AND SALES



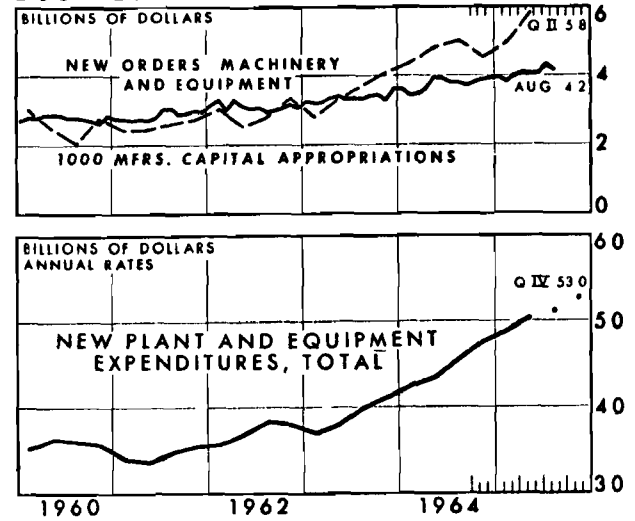
NEW ORDERS AND HOUSING



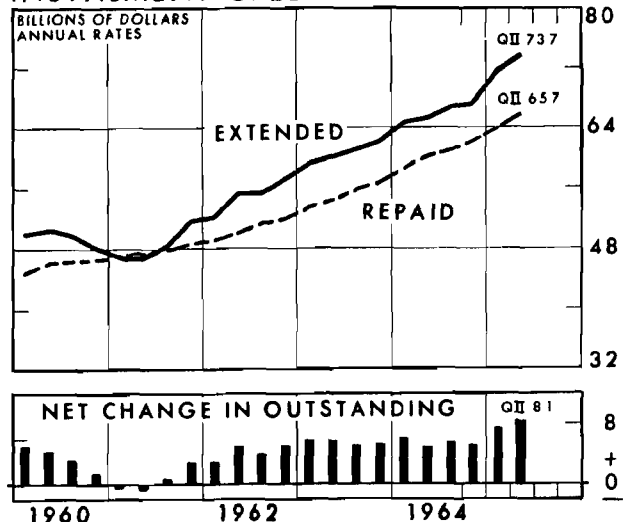
RETAIL SALES



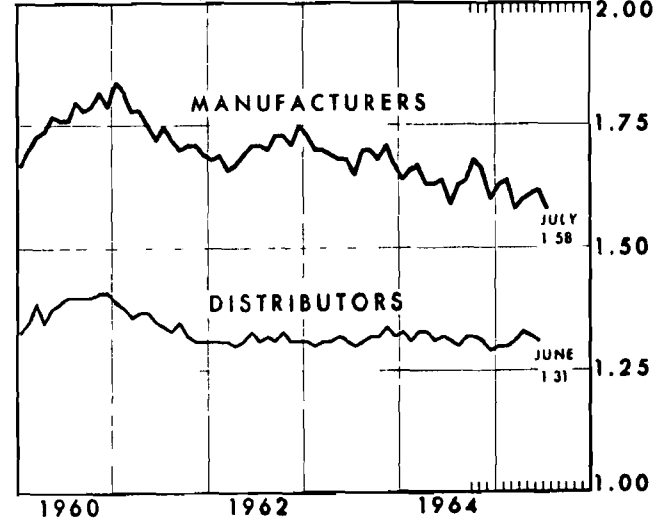
BUSINESS INVESTMENT



INSTALMENT CREDIT



INVENTORY/SALES RATIOS



Bank credit. Credit expansion at city banks since late August appears to have moderated somewhat. In the two weeks prior to the mid-September tax period, loans and investments at these banks declined in contrast with the usual increase. Expansion during the tax week, while substantial, was about the same as the average of the preceding two years. Thus, after allowance for seasonal influences, the rate of credit growth over the past three weeks may have fallen somewhat below the rate that has prevailed in recent months.

As indicated by the following analysis, some of the factors contributing to this slowdown are likely to prove temporary. Nevertheless, a moderation of the rate of credit expansion over the remainder of the year from that in recent months is a reasonable possibility, barring any major shift in the strength of credit demand.

1. Decline in Treasury balances. In late August and the first half of September, banks were under heavy pressure owing to an unusually large run-off of Treasury Tax and Loan Account balances. Presumably associated with these deposit losses, banks found it necessary to make further marked reductions in their holdings of U. S. Government securities. Substantial redressing of these balances is in prospect for late September and early October as a result of crediting of income tax receipts and the proceeds of a large projected cash financing. This may be accompanied at least temporarily by some increase in bank holdings of government securities.

2. Slackened business loan demand. Business loan demand weakened considerably in the weeks immediately prior to the tax period. This reflected, in part, the beginning of liquidation of inventory borrowing in the metals group, following a protracted earlier buildup. It also resulted

from a slowdown in loan expansion in several other industry groups--including public utilities, trade, and miscellaneous manufacturing and mining--which had contributed importantly to the earlier sharp rise in business lending. While loan liquidation in the metals group is likely to continue for some weeks, the marked slackening in other industry groups may prove short-lived, as suggested by the substantial generalized borrowing during the tax period discussed below. In addition, the normal seasonal upswings in loans to food processors and commodity dealers have recently appeared after having been held in abeyance for some time by continued liquidation of the dock-strike loan bulge.

3. Reduced acquisitions of municipals. City bank holdings of municipal and other securities showed little change in late August and early September, a period in which they usually rise appreciably. This development probably reflects mainly a temporary lull in deliveries of new securities as a result of the reduced volume of underwritings in August. To some extent, it may also indicate some reduction in the availability of funds for municipals following a period of several months of unusually rapid acquisitions--during which bank holdings of Governments had been sharply reduced through switches to municipals, and monetary policy had become somewhat firmer.

While the above three special influences on recent credit expansion have been on the down side, an unusual pattern of finance company borrowing has provided strong temporary support to credit growth. As a result of heavy late-season production and the late model change-over dates in the automobile industry, finance company borrowing at banks to finance dealer inventories was unusually heavy in late August

and early September. These borrowings have now peaked out and finance companies probably will make larger than usual repayments of bank debt over the next two months.

Business loan expansion at city banks during the tax and dividend payment week ending September 15 was broadly based and somewhat larger than the substantial rise in that period last year. Borrowing by finance companies and the run-off of CD's also were larger than a year ago. On the other hand, dealer loans at banks and bank acquisitions of U. S. Government securities were smaller, suggesting that businesses placed less reliance on sales of Governments to satisfy their tax period needs this year.

These developments appear consistent with the adjustments that businesses might have been expected to make in meeting increased tax and dividend payments under conditions of somewhat reduced liquidity.

Money and time deposits. Growth in the money supply moderated in August following substantial expansion in June and July. The \$200 million rise for the month was at an annual rate of about 1-1/2 per cent. Over the last four months, however, the annual rate of increase has been about 3 per cent, slightly higher than over the first four months of the year. Preliminary data indicate that there was a rapid rise in the first half of September, presumably associated with a more than seasonal decline in U.S. Government deposits during that period.

Seasonally adjusted turnover of demand deposits at banks outside New York City rose somewhat in August to 35.5 following a sharp decline in July. The average for the two months was about the same as that for the second quarter, but about 6 per cent above the July-August average last year.

Growth in time and savings deposits at commercial banks accelerated further in August from the advanced July rate of expansion. The \$2.5 billion rise for the month--representing an annual rate of almost 22 per cent--exceeded the large inflows of January and February associated with time deposit rate increases. Preliminary data indicate that the rate of growth may have dropped in early September.

Bank reserves. Net borrowed reserves declined over the first three weeks of September, averaging about \$125 million. This compares with \$165 million in August, a level little different from that of the three previous months.^{1/} Average member bank borrowings declined somewhat over the three-week period although they were relatively high again by the midmonth. In addition, excess reserves increased somewhat. The effective rate on Federal funds dropped below 4-1/8 per cent on only 3 of the 14 trading days in the period. A few transactions took place as low as 1 per cent and, more frequently, as high as 4-1/4 per cent.

U. S. Government securities market. Yields on Treasury notes and bonds continued to edge higher in the first half of September and then stabilized around midmonth. The earlier market weakness was associated with net investor selling, in part on switches into higher-yielding corporate bonds, and continued dealer efforts to reduce their positions in Treasury bonds. A somewhat steadier market atmosphere developed in mid-September, when dealer offerings of notes and bonds

^{1/} Based on average of daily figures for all reserve weeks ending in the month, as used in the reserve memorandum to the FOMC.

contracted and some dealer and other professional demand appeared. This represented a response to the announcement of further international arrangements to support the pound sterling, the excellent reception accorded a large corporate bond issue, and the development of a better technical position in the market. Investor interest in U.S. Government bonds has not reappeared, however, as an underlying uncertainty about the effects of economic expansion on the prospective level of bond yields remain.

On September 20, dealer holdings of Treasury bonds due in over-5-years totaled \$162 million, including \$69 million due in over-20-years; at the end of August, these totals had been \$287 million and \$123 million, respectively. The recent decline in dealer holdings was more than accounted for by System and Treasury purchases.

YIELDS ON U. S. GOVERNMENT SECURITIES

Date (closing bids)	3-month bills	6-month bills	3 years	5 years	10 years	20 years
<u>1965</u>						
Highs	4.00	4.09	4.25	4.24	4.28	4.30
Lows	3.76	3.81	4.00	4.08	4.17	4.17
<u>1965</u>						
July 28	3.81	3.88	4.09	4.15	4.20	4.21
Aug. 31	3.90	4.00	4.20	4.22	4.27	4.28
Sept. 21	3.93	4.09	4.22	4.24	4.28	4.30

Rates on Treasury bills rose several basis points in this period, with upward rate pressure concentrated in longer maturities where dealer inventories have been relatively large and where the Treasury's cash financing in early October is expected to add to market supplies. Since around the mid-September tax date, dealer holdings

have had to be financed at generally higher borrowing costs both in and outside New York. There has also been some upward movement in CD rates as money market banks sought to attract deposits to offset some of their large CD maturities on the tax and dividend dates.

Treasury finance. The Treasury in late September is expected to announce its first cash financing of the current fiscal year. The market generally anticipates an offering of March tax bills to be followed later in the fall by June tax bills, and perhaps, if market conditions permit, by a cash offering in the short-term coupon area. As the first column of the accompanying table shows, the Treasury's net cash needs in the second half of 1965 could be on the high side, and they will be more concentrated in the last three months of the year than in other recent years when more of the second half cash need had been raised in July-September.

JULY-DECEMBER TREASURY CASH FINANCINGS
(In millions of dollars)

Year	July-December	July-September	October-December
A. Net cash borrowing			
1961	9.2	5.7	3.5
1962	6.2	1.4	4.8
1963	4.8	1.2	3.6
1964	6.8	3.2	3.6
1965	6.0-7.0(?)	-0.1 ^e	6.0-7.0(?)
B. Increases in bills			
1961	6.5	5.1	1.4
1962	6.0	0.2	5.8
1963	4.1	0.9	3.2
1964	5.6	2.6	3.0
1965	6.0-7.0(?)	--	6.0-7.0(?)

^e Estimated.

With Treasury cash borrowings likely to be concentrated in the bill area over the balance of this year, additions to the market supply of bills in the fourth quarter may be about twice as large as in the corresponding period of the two previous years. This year's borrowing pattern, as it has developed, may then put somewhat more than usual upward pressures on bill rates in the fall months. Critical in this respect will be the extent of bill demand. Through July of this year banks and corporations were considerably larger net sellers of bills than last year. Thus, the question remains whether a continuation of economic expansion at recent rates will be accompanied by any further pressure on the bill market as a result of liquidity adjustments by these groups.

Corporate and municipal bond markets. After rising persistently for more than a month, yields on new corporate bonds finally found a level last week which attracted active investor interest. Indeed, yields on new and recently offered issues turned down several basis points. Even in the municipal market, where yields on seasoned issues continued to advance, underwriters reported some pick-up of investment interest.

BOND YIELDS

	Corporate Aaa		State and local government	
	New	Seasoned	Moody's	Bond buyer (mixed qualities)
<u>1964</u>				
High	4.53	4.45	3.16	3.32
Low	4.30	4.35	2.99	3.12
<u>1965</u>				
High	4.71(8/27)	4.52(9/17)	3.25(9/16)	3.36(9/16)
Low	4.33(1/29)	4.41(3/12)	2.94(2/11)	3.04(2/11)
<u>Week ending:</u>				
July 23	4.56	4.48	3.16	3.25
Aug. 20	4.67	4.50	3.15	3.23
Sept. 10	4.70	4.52	3.21	3.30
Sept. 17	4.67	4.52	3.25	3.36

Unexpectedly enthusiastic reception accorded last week's large Southern Bell Telephone offering appears to have acted as a catalyst in changing the tone in corporate bond markets. Despite a reoffering yield of 4.68 per cent -- several basis points below what most underwriters and market analysts were anticipating -- the issue sold out quickly. As this favorable market response became clear, remaining unsold balances of other recently offered bonds -- which previously had been moving rather slowly despite their advanced yields -- were quickly cleaned up.

To some extent, recent strengthening of corporate bond markets has reflected the same general modification of earlier interest rate expectation evident in the U.S. Government bond market. The prospect of at least a temporary let-up in the corporate calendar of public offerings after the current week is apparently lending some further support to prices.

During August, yield advances in the municipal bond market had lagged behind those in other markets as dealers bid actively for a seasonally reduced supply of new issues. During September, however, the volume of offerings has expanded again to the \$900 million monthly average level prevailing earlier in the year. At the same time bank investment demand has reportedly slackened somewhat, and dealers have had to raise yields on advertised inventories to reflect developments in other bond markets. At 3.25 per cent, Moody's average yield on high quality municipals is 10 basis points above a month ago and only about 10 basis points below the level that prevailed in late 1961 just before the 1962 change in Regulation Q. As in the corporate bond market, however, the volume of new issues seems likely to be somewhat smaller in the weeks immediately ahead, and dealers are apparently anticipating at least a brief period in which market supply pressures may diminish.

BOND OFFERINGS ^{1/}
(In millions of dollars)

	Corporate				State & local govt.	
	Public offerings		Private placements			
	1965 ^{e/}	1964	1965 ^{e/}	1964	1965 ^{e/}	1964
Jan.-Sept. average	477	343	650	486	938	912
July	542	234	717	411	1,000	943
August	380	183	500	433	700	799
September	600	376	700	672	900	920

^{1/} Includes refundings -- data are gross proceeds for corporate offerings and principal amounts for State and local government issues.

Corporate finance. Statistics that have recently become available on second quarter working capital positions of corporations provide some additional insight on the recent and prospective volume of corporate external financing. Not only do they help to explain the heavy volume of summer corporate borrowing, they also suggest that general corporate needs for financing over the remaining months of the year are likely to remain large.

Despite generation of a record volume of internal funds, the first half of 1965 was marked by exceptionally heavy corporate external financing, at banks as well as in the capital markets. This combination of large internal and external financing suggested the possibility that a part of the heavy borrowing might have been undertaken in anticipation of future needs. While some of this may have occurred during the summer, data now available on corporate liquid asset holdings at midyear show that the total of internal funds and external financing actually fell short of meeting total corporate needs for funds. Corporate liquid assets were drawn down by more than \$4 billion in the first half of the year, compared with a reduction of about \$2.5 billion in the first half of each of the three preceding years.

While corporate liquidity, as measured by the ratio of cash, deposits and U.S. Government security holdings to total current liabilities, has been declining for many years, this decline has been especially rapid since last fall. At the end of the second quarter this year, the ratio stood at only 27.5 per cent which compares with 28.6 per cent three months earlier and 31.4 per cent at mid-1964. If the definition of liquid

assets is broadened to include "other current assets" -- the item which includes holdings of short-term marketable securities other than U.S. Governments -- the downtrend in liquidity is less drastic but still remains.

As may be seen from the table, corporate investment in accounts receivable and inventories was unusually large in the second quarter, and undoubtedly absorbed funds that might otherwise have been held in liquid forms, moderating the fall in liquidity. In the period immediately ahead, aggregate inventory accumulation is likely to moderate, reflecting adjustments in holdings of steel and steel-using items. But given the anticipation of further substantial increases in plant and equipment outlays over the remainder of the year, and assuming that internal funds will remain at about recent levels, corporate demands for external funds could still continue quite large.

CHANGE IN WORKING CAPITAL POSITIONS OF U.S. CORPORATIONS

	Second quarter change		
	1963	1964	1965
(In billions of dollars)			
<u>Assets and Liabilities</u>			
Liquid assets	.7	.7	-1.0
Cash and deposits	1.2	1.9	1.2
U.S. Govts.	-.5	-1.2	-2.2
Accounts receivable	4.2	4.0	5.2
Inventories	1.4	1.0	2.4
Other current assets	<u>.9</u>	<u>.4</u>	<u>1.2</u>
Total current assets	7.2	6.1	7.9
Short-term bank loans	1.1	.7	2.1
Other accounts payable	2.7	2.1	2.5
Fed. inc. tax liab.	.1	-.4	-.7
Other current liab.	<u>1.0</u>	<u>1.3</u>	<u>1.1</u>
Total current liab.	4.9	3.7	5.1
Net working capital	2.3	2.4	2.7
<u>Liquidity Ratios</u>			
	<u>At end of quarter</u>		
Liquid assets/total current liabilities	31.9	31.4	27.5
Liquid assets plus other current assets/total current liabilities	39.6	39.4	36.0

Mortgage markets. Trade expectations generally are for no significant upward shift in mortgage interest rates over the near term and, on balance, recent statistical indicators appear to support this view.

Secondary market yields on FHA-insured mortgages, at 5.45 per cent remained within the narrow range which has prevailed since early 1963. Contract rates for conventional first mortgages on existing homes rose from 5.85 per cent to 5.90 per cent in August (rounded to the nearest five basis points). Rates for loans on new homes, however, held at the earlier level of 5.80 per cent.

Normally, any general shift in contract rates would be preceded by a tightening in nonrate mortgage terms. But in July (the latest available) loan-to-price ratios and maturities on conventional first mortgage loans for both new and existing homes were generally somewhat more liberal than in June or in most other recent months.

Some change in market tone is suggested by recent further increases in private investor sales of Government-underwritten mortgages in the secondary market to the Federal National Mortgage Association. These increases have been from very low earlier levels, however, and in August the total was still far below pre-1963 peaks.

AVERAGE TERMS ON CONVENTIONAL FIRST MORTGAGES FOR HOME PURCHASE

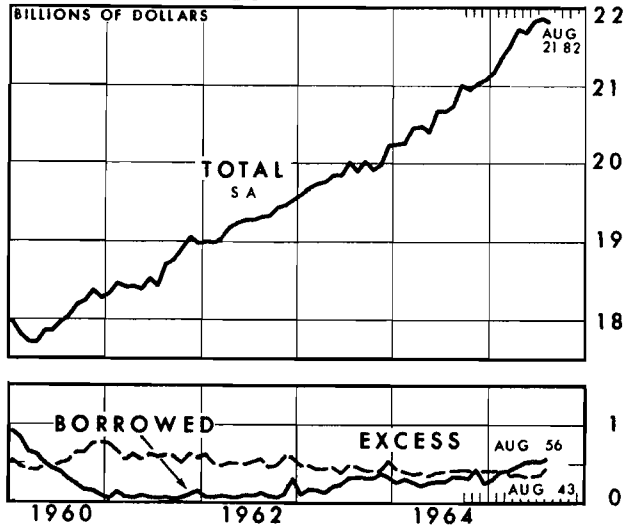
	June	July	Per cent increase in July 1965 from a year ago
New home loans			
Purchase price (\$1,000)	24.0	24.7	+ 4
Loan/price (per cent)	73.9	75.0	+ 2
Maturity (years)	24.6	25.0	+ 2
Existing home loans			
Purchase price (\$1,000)	20.0	20.2	+ 4
Loan/price (per cent)	72.1	72.5	+ 2
Maturity (years)	20.6	20.6	+ 1

The number of foreclosures on nonfarm properties, mainly homes, rose further in the second quarter of the year. The year-to-year increase -- 6 per cent -- was the smallest, however, in recent years, apparently because of improved loan screening by lenders, further increases in consumer incomes and other factors.

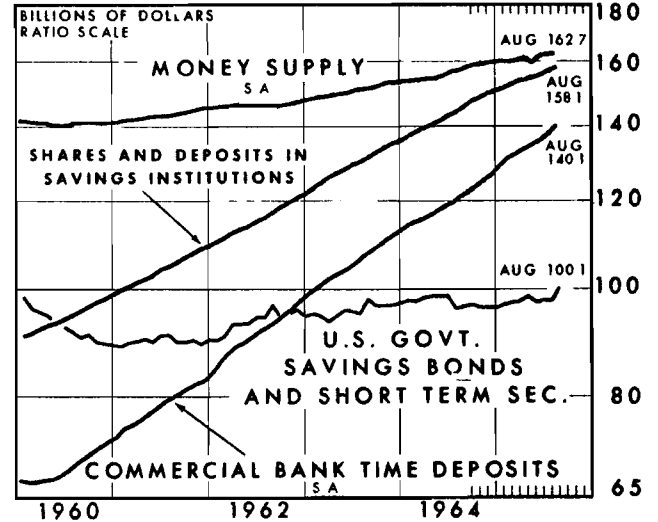
Stock market. Average stock prices, as measured by Standard and Poor's index of 500 common stocks have advanced about 3 per cent this month. At the September 21 close of 89.81, they were about 10 per cent above the late June low and only 0.5 per cent below the record high reached in mid-May. Trading volume in recent weeks has been extremely heavy, and last week averaged more than 7 million shares per day -- considerably above the daily average of 5.5 to 6.0 million that accompanied rising prices earlier in the year. Unlike the earlier period when heavy trading tended to take place on days of rapid price change, recent high activity has been recorded on many days when broad price indexes have shown slight movement. This may suggest some quickening of speculative tempo in the

FINANCIAL DEVELOPMENTS - UNITED STATES

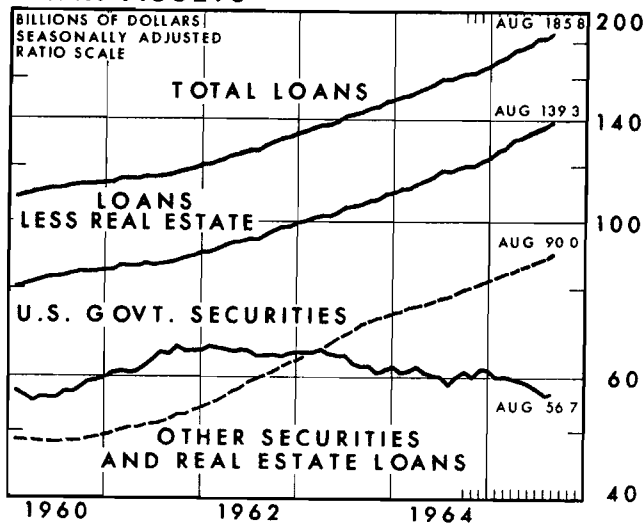
BANK RESERVES



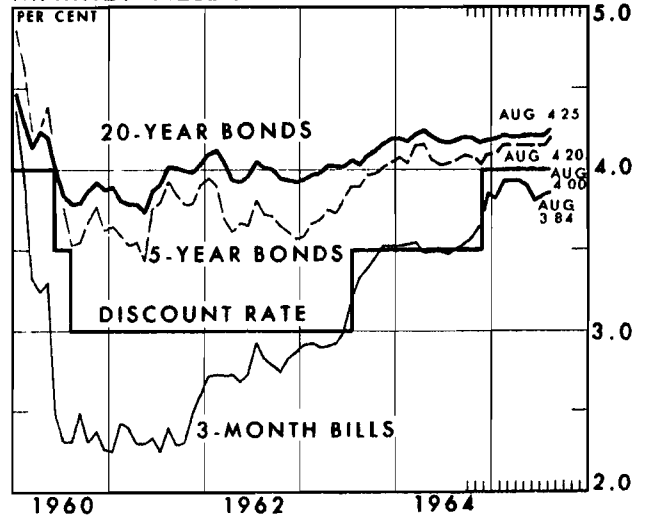
LIQUID ASSETS HELD BY PUBLIC



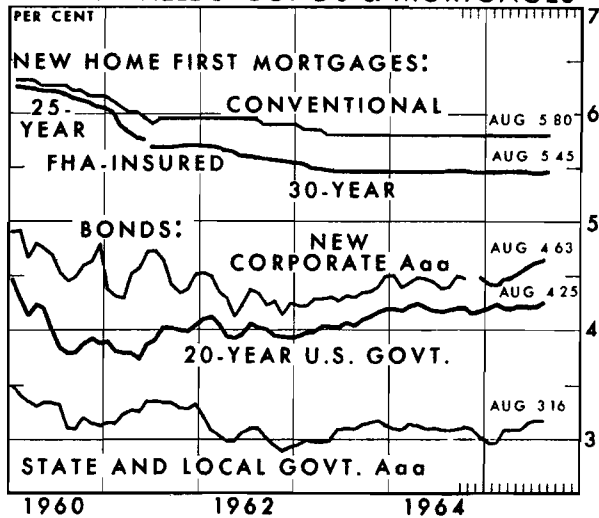
BANK ASSETS



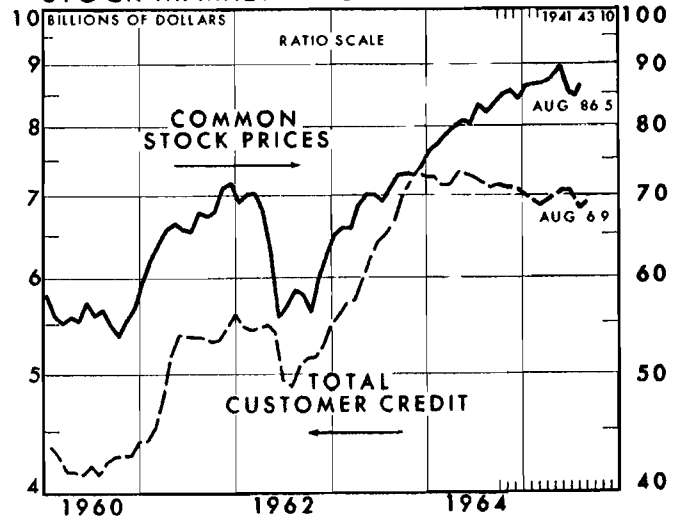
MARKET YIELDS - U.S. GOVT. SEC.



MARKET YIELDS - BONDS & MORTGAGES



STOCK MARKET PRICES AND CREDIT



INTERNATIONAL DEVELOPMENTS

U.S. balance of payments. The U.S. payments deficit on regular transactions in July and August (combined) after rough allowance for seasonal variation was at a rate approximately equal to the average in the first half of this year, a \$1-1/4 billion annual rate.

A further large reflow of U.S. short-term loans and acceptance credits in July, as well as reflows of liquid funds reported by both banks and nonbank concerns, helped to hold down the payments deficit in that month. A rise in exports in July also benefitted the payments position; exports, apparently little affected by the seamen's strike, were up 3 per cent from June to an annual rate of \$27.2 billion. The July import figure was down 9 per cent from June to a level of \$20.0 billion, but the extent to which U.S. payments for imports were reduced is unknown: one-third of the July decline resulted from a change in statistical reporting procedures, and much of the remainder reflected delays in unloadings related to the strike.

Balance of payments data for the first half show improvement as compared with rates for the full year 1964 in U.S. short-term private capital flows (a shift of \$3.7 billion at an annual rate) and in errors and omissions (a shift of \$0.8 billion), and deterioration in the balance on goods and services (\$1.5 billion at an annual rate) and in flows of direct and long-term portfolio investment (\$1 billion at an annual rate).

The improvement on short-term capital account reflected the very substantial reduction in net outflows of bank credits and the reflows of liquid funds (in contrast to sizable outflows of both types

of capital last year) which have already been publicized in reports on the voluntary program.

The reduction in the U.S. surplus on goods and services stemmed from the large rise in imports and consequent reduction in the trade surplus, partly offset by an increase of about 20 per cent in investment income.

The increased net outflow on direct and portfolio investment reflected foreigners' sales of U.S. corporate securities (primarily for official British account) and, more important, continued very high U.S. direct investment outflows.

U.S. DIRECT INVESTMENT ABROAD
(millions of dollars)
(Outflow -)

	1964				1965		
	Year	I	II	III	IV	I	II
<u>Total</u> Seas. adjusted		-464	-540	-551	-821	-1159	-882
<u>Total</u> Unadjusted	<u>-2376</u>	<u>-420</u>	<u>-606</u>	<u>-440</u>	<u>-910</u>	<u>-1115</u>	<u>-951</u>
W. Europe	-1342	-288	-382	-303	-369	- 536	-367
Canada	- 250	- 66	39	- 15	-208	- 222	-147
Latin Am.	- 290	- 38	- 88	- 64	-100	- 76	-111
All Other (incl. un- allocated)	- 494	- 28	-175	- 58	-233	- 281	-326

As shown in the first line of the table, direct investment outflow in the second quarter, seasonally adjusted, remained well above last year's rate. In both the first and second quarters, direct investment outflows were swollen by the bunching of several large transactions. These included: payments on oil leases on new concessions; provision of funds by oil companies to enable subsidiaries to make retroactive tax payments under renegotiated agreements with Middle Eastern countries;

and the takeover of a Canadian finance company whose debts to U.S. lenders were assumed by the U.S. company that made the acquisition (with little net effect on the balance of payments). However, direct investment has frequently been characterized by special transactions, and the second quarter outflow, even apart from the special transactions, must be regarded as surprisingly large. Even if there is a sizable reduction in outflows over the balance of the year, it is likely that the total for the year will be significantly larger than earlier estimates had indicated.

Credit conditions and interest rates in Europe. Following the large rises in British and German long-term interest rates from last spring through July, a sharp easing in British long-term Government bond yields in August and early September (despite continued credit restraint) reflected an important change for the better in market attitudes. In Germany, on the other hand, continued pressures on the bond market necessitated a moratorium on new issues; short-term interest rates advanced further in Germany during August and early September. Credit conditions have continued easy in Italy and tight in the Netherlands.

In Britain, increasing scarcity of bank credit was a factor in a marked increase in the flow of new corporate security issues in July-August. Nevertheless, in the market for Government bonds a less pessimistic view began to be taken about Britain's balance of payments problem after the Government's decision in late July to cut back public and private investment spending. After the publication of the July

export figures, bond prices rose sharply. This change in attitudes was strengthened by the September 2 announcement of the early warning system for wage and price increases, and by the September 10 announcement of foreign central banks' commitments to help defend sterling in case the need should arise. The yield on War Loan dropped from 6.84 per cent on August 6 to 6.35 per cent on September 17.

Bank credit has continued to show the effects of the various measures of restraint taken earlier. Outstanding advances, seasonally adjusted, declined slightly further in June-August following the downturn last May. In the consumer credit field, a new stiffening of terms was introduced on July 27, when the maximum repayment period was shortened from 36 to 30 months. On June 3, minimum downpayments had been raised, a move which helped to slow the expansion of consumer credit in June and July.

On the other hand, as the building societies have received an inflow of new funds since they raised their deposit rates in early June, these institutions expect to increase their loan volume in the coming months.

Since just after the reduction of Bank Rate from 7 to 6 per cent on June 3, the 3-month Treasury bill rate has shown little change; in mid-September it was 5.44 per cent. In the week to Sept. 17, the rate on new local authority deposits dropped from 6.56 to 6.31 per cent. The forward discount on sterling in the past week has been 1.9 per cent per annum, compared with about 2-1/2 per cent during most of August.

In Germany, pressures on the bond market, especially from governmental borrowers, became so intense as to necessitate a moratorium

on new issues after July 29. Short-term interest rates have moved up further, and the discount rate was raised in mid-August.

Average yields on 6 per cent public authority bonds, which had already reached 7.21 per cent at end-May, rose further to 7.61 per cent on July 27, when they were nearly 1 percentage point higher than at the close of last year. On July 28, the Cabinet imposed a moratorium on new bond issues, and discussions were initiated on ways to cut back the borrowing demands of the local governments, states, and Federal Government agencies. A decline in yields then ensued. But after the moratorium was formally lifted at the beginning of September, the announcement of a large new loan by the Railways pushed the yield average for 6 per cent public authority bonds up again to its earlier high. A de facto extension of the moratorium followed: the Railways loan was postponed indefinitely, and only one small new bond issue was authorized for September. Major public borrowers are now consulting on future financing.

In the short-term money market, the rate on 90-day inter-bank loans rose further to 5.25 per cent on August 13, and to 5.38 in mid-September. On August 13, the Bundesbank raised its discount rate from 3-1/2 to 4 per cent, and the rate on advances from 4-1/2 to 5 per cent.

In other European countries, changes in money market conditions during the summer were largely, but perhaps not wholly, of seasonal character. In August, markets eased at least seasonally in most countries.

In Italy, the balance of payments surplus, swollen by seasonal receipts from tourists added to bank liquidity. With encouragement from the authorities, the banks increased their liquid assets abroad in June, July and August. Through June, the demand for bank loans remained almost static, and the banking system was continuing to add rapidly to its bond holdings. Changes in bond yields were negligible in June-July.

In France, bond yields declined in midsummer, and the money market eased seasonally in August. Yields on public sector bonds dropped 10 basis points from mid-June to mid-July, and since then have fluctuated narrowly around the 5.70 per cent level (net of a 10 per cent withholding tax). Corporate bond yields have been stable since the end of July at a level 15 basis points lower than in mid-June. The money market remained seasonally tight in June and July, but since early August day-to-day money has generally been 3-1/2 per cent (equal to the basic discount rate). The banks' liquid asset reserve requirement was accordingly raised in August from 34 per cent to the normal 36 per cent.

The Swiss money market also eased in August, partly because of inflows of foreign exchange and partly because the central bank supplied funds to the market. The 3-month deposit rate dropped to 3.69 per cent on August 27, its lowest level since early June. Government bond yields moved up about 3 basis points in June-August.

In the Netherlands, yields on Treasury bills and on outstanding government bonds rose further in June and July, but by early

September had fallen back to end-May levels. Yields on new bond issues were reportedly at record high levels in August. Central government and municipal borrowing requirements are expected to prolong the recent strains on the capital market.

In the London Euro-dollar market, rates declined more than seasonally throughout the summer, reaching their lowest point on September 3, when the 90-day rate was 4-3/8 per cent, compared with a peak of 5-1/4 per cent in May and a level of 4-1/4 per cent a year ago. Subsequent increases have been small. The Italian banks were important suppliers of funds to the market, and the British local authority deposit rate was low enough -- given the discount on forward sterling -- to influence banks in London to switch some of the funds they had been employing in the local authority market back into the Euro-dollar market. On the side of use of funds, U.S. bank branches continued to draw from the Euro-dollar market in August and added to their balances at head offices as they had in June-July.

Credit conditions in Canada. Interest rates have risen in Canada under the two-pronged impact of a vigorous upsurge in demands for funds and reduced supplies of credit from the United States.

Short-term money rates in Canada, which had been falling earlier this year, began to move up in April, and by mid-September were 50 to 70 basis points above April levels. The latest yields are 4.11 per cent on Treasury bills and 5 per cent on finance company paper. A sharp rise in bank credit, particularly in the second quarter, and in consumer credit extended by non-bank institutions,

indicate that expanding credit demands were a major cause of the increase in rates. New bond issues have been much larger this year than in 1964.

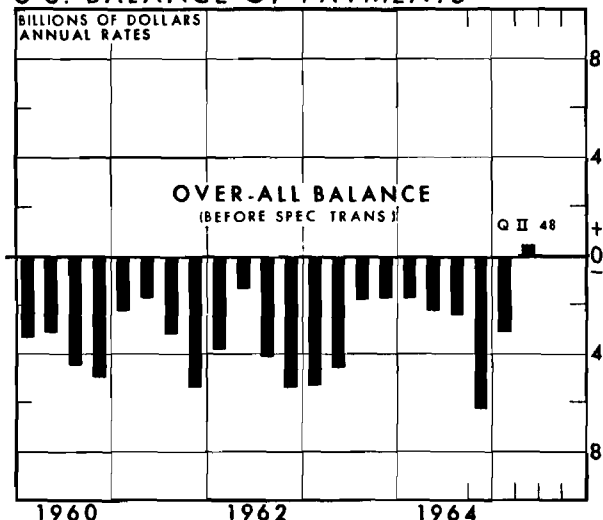
On the supply side, Canadian money markets have been adversely affected by changes in flows of short-term funds from U.S. investors since the start of the U.S. balance of payments program. U.S. investments in Canadian money market paper were probably reduced sharply between February and June. However, a withdrawal of \$700 million of U.S.-owned U.S.-dollar deposits from Canadian banks between end-January and end-June does not appear to have affected Canadian markets, having been financed by a drawdown of the Canadian banks' U.S.-dollar assets in London and New York.

Canadian government bond yields rose by 15 to 40 basis points from the end of April to mid-August. In subsequent weeks there was little change in yields on longer-term bonds, but yields on short bonds fell off.

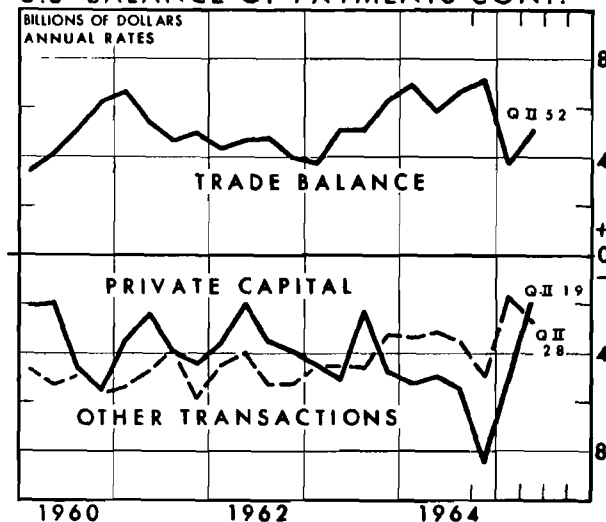
U.S. AND INTERNATIONAL ECONOMIC DEVELOPMENTS

SEASONALLY ADJUSTED

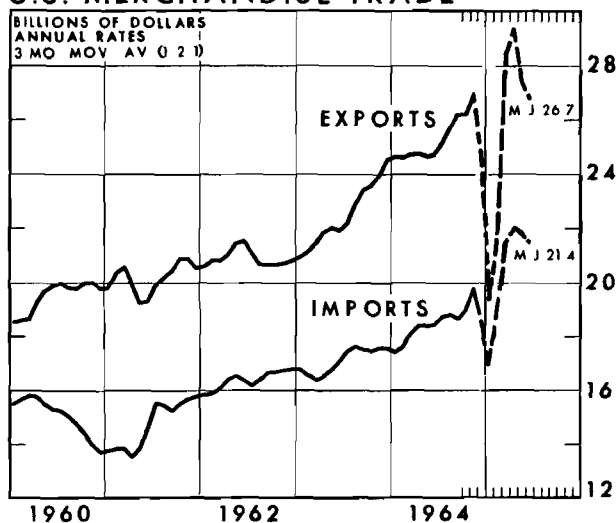
U.S. BALANCE OF PAYMENTS



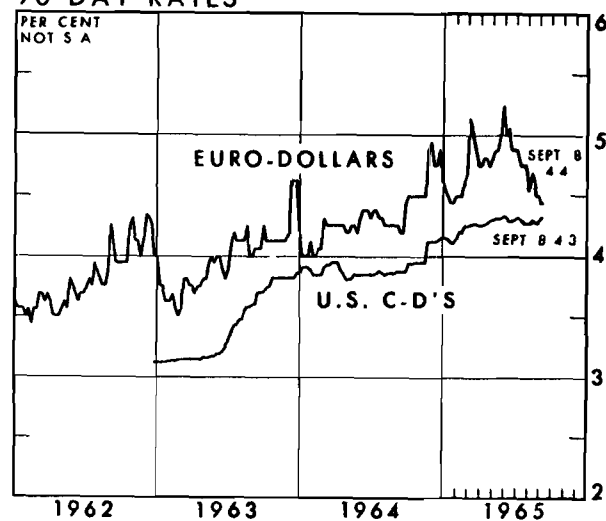
U.S. BALANCE OF PAYMENTS-CONT.



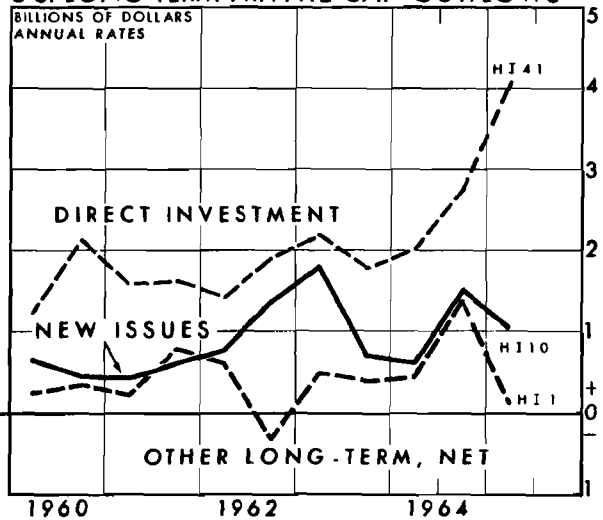
U.S. MERCHANDISE TRADE



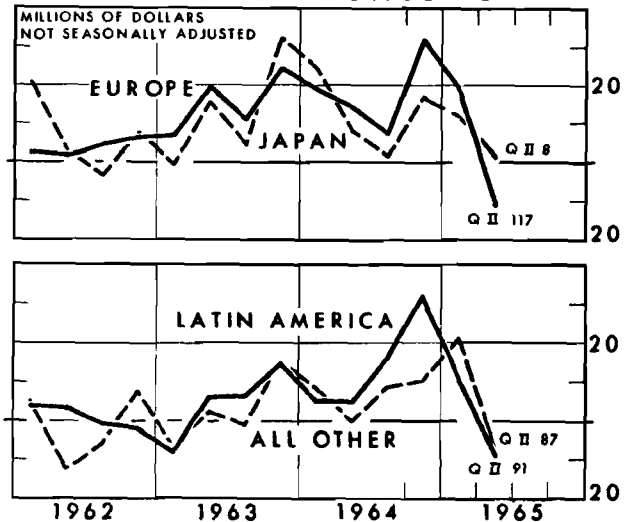
90-DAY RATES



U.S. LONG-TERM PRIVATE CAP OUTFLOWS



U.S. BANK CREDIT OUTFLOWS



APPENDIX A: THE STEEL AGREEMENT *

The new steel contract has been valued by the Council of Economic Advisers at 48 cents or a rate of increase in hourly compensation of 3.2 per cent per year--the current guidepost figure--and should contribute to continuing stability in unit labor costs in manufacturing industries. The rate of increase is also about in line with growth in productivity in the steel industry and labor costs per ton of steel should not rise. The settlement is more moderate than earlier agreements in such major industries as automobile, can, rubber, and aluminum. While the new steel pact provides for a somewhat higher increase in hourly compensation than the 2.5 per cent negotiated in 1962 and 1963, it is below the 3.7 per cent increase granted in 1960, when manpower and physical resources were in easier supply than now; it is far below the 8 per cent annual increase negotiated in 1956.

Although there have been a wide variety of estimates of the cost of the contract--ranging from 47.3 to 52 cents for the total package and from 3.2 per cent to 3.7 per cent for average annual increase in hourly compensation--the Council's method of computation and results seem reasonable. Differences in pricing out the contract are due to: a) varying estimates of the size of the package; b) inclusion of the 4-month interim settlement as part of the new contract; and c) compounding the total package to take into account the timing increases go into effect.

The only detailed breakdown of the contract has come from the union (see table). Apparently the larger estimates given by the companies reflect their higher valuation of future pension costs. Use of the lower end of the range of 48 cents by the Council stems, in large part, from estimates of pension costs prepared by government experts which found that even the lower union figures probably overestimate such costs. They would price the total package 3 - 5 cents below the union figure of 47.3 cents.

Each worker had credited to him under the interim settlement, starting May 1, an 11.5 cents an hour increase on a base pay of \$4.41. In the final settlement, an increase in wage costs of 13.9 cents an hour is indicated for September 1, but this is not on top of the earlier increase. The employer pays out on the average only 2.4 cents an hour more per worker than he did in the previous four months. The only reasonable approach is to include the 11.5 cents per hour as part of a 39-month contract as the Council has done. Compounding and pricing the contract by taking into account the time when the wage or fringe increase goes into effect are more accurate than a simple average of costs spread evenly over the duration of the contract and this is also consistent with the guidepost concept.

* Prepared by Murray S. Wernick, Senior Economist, National Income, Labor and Trade Section, Division of Research and Statistics.

Although the total cost is less, most of the basic provisions in the new steel contract are similar to the ones negotiated earlier in the aluminum industry. Pensions are increased substantially and voluntary early retirement after 30 years of service is also provided. Pensions and other fringe benefits account for almost half the value of both contracts. Wage increases are confined to the first and last year of the contracts (the last previous wage increases in steel and aluminum were in 1961). However, the steel agreement provides an additional wage increase of 14.6 cents an hour for those highly skilled workers who are not covered by incentive programs.

The steel companies successfully opposed any new cost-of-living adjustments in the new contract. Earlier the union had argued that, in addition to productivity gains, some allowance for increases in consumer prices should be made to maintain "real" wages--cost-of-living clauses had been eliminated from steel contracts in 1962. The companies were also able to obtain greater flexibility in the handling of vacation schedules in order to limit any future concentration of vacations among skilled seniority workers on extended vacations. Hiring of additional skilled workers during vacation periods have been necessary and apparently costly to the companies in the past two years of high production.

The steel agreement should contribute to keeping increases in hourly compensation in other settlements this year close to the rise in economy-wide productivity. Many metal fabricating companies are currently or soon will be negotiating with the Steelworkers Union. They generally are expected to accept the pattern of the steel contracts. However, the union has been following a policy of settling with some lower-profit fabricators for less than that for steel mills in order to keep these companies competitive.

The impact of the settlement outside of steel and related industries should also be significant. Companies entering negotiations will not have an important precedent for negotiating an inflationary settlement. Increases above the guidepost average in the near future will undoubtedly occur, but they are unlikely to be pattern-setting in the sense that a steel settlement might have been.

COST OF STEEL - USW SETTLEMENT
September 1, 1965 - August 1, 1968
(Based on Union estimates)

	Estimated cost (cents per hour)
Beginning September 1, 1965:	<u>13.9*</u>
<u>Wages</u>	
Basic wage increase	10.0
Increase to maintain grade differentials	2.1
15 per cent roll-up effect of wage increase on overtime and fringes	1.8
* Not in addition to 11.5 cents agreed to in interim settlement May 1, 1965 - in effect, a 2.4-cent increase above interim settlement.	
Beginning January 1, 1966:	
Upgrading of skilled trades wages. Increase of 14.6 cents per hour for about 40,000 workers.	<u>2.3</u>
Beginning August 1, 1966:	<u>17.6</u>
<u>Pensions</u>	
Increase in pensions to \$5.00 per month for each year of service	8.2
Voluntary retirement after 30 years of service and \$75 month supplementary pay for those whose retirement is due to disability or layoffs	5.5
Other pension benefits	3.9
Beginning August 1, 1967:	<u>13.5</u>
<u>Wages</u>	
Basic wage increase	6.0
Increase to maintain grade differentials	1.4
15 per cent roll-up effect of average increase on overtime and fringes	1.1
Sickness and accident insurance	5.0
<hr/>	
Recapitulation:	
Total cost (cents)	<u>47.3</u>
Average annual increase (per cent)	3.2
Based on 39-month contract and compound rate to take into account timing increases go into effect.	

APPENDIX B: SOME SPECIAL COMMENTS ON THE INVENTORY SITUATION*

For the purpose of indicating some major factors in the cyclical position of the economy two charts of components of the industrial production index have been prepared which may help account for the rapid expansion in business inventories and bank credit since last autumn.

In the upper panel an approximation of a measure of output of materials for further industrial processing is provided by subtracting construction materials and general business supplies from the published component of the index for materials. This measure represents about four-fifths of all materials and is 34 per cent of the total index. Since both output and inventories relative to final sales of goods were apparently adequate in 1962-63, that period is used as a comparison base.

Owing to possible revision in the production series and for other reasons no precise value should be attached to the exact amount of the rise in the margin of about 8 per cent to July shown between maturities and final products output over the past year and a half. In each postwar period of cyclical expansion a margin of 5 per cent or more has developed as output and stocks of industrial materials have increased more than final products. In the subsequent readjustments in 1960, 1958, 1954, and 1949 output of materials declined about twice as much as final products with an average of about 14 per cent.

In addition to this possible imbalance in materials output, there has been little further growth so far this year in the indicated rate of final takings of consumer goods. Consequently, in addition to the advanced level of output of materials for processing versus output of final products, there has been a sizable margin between output of autos and other major consumer goods and their rate of final sales. Manufacturers' and distributors' stocks of these goods have risen 14 per cent in the past six months.

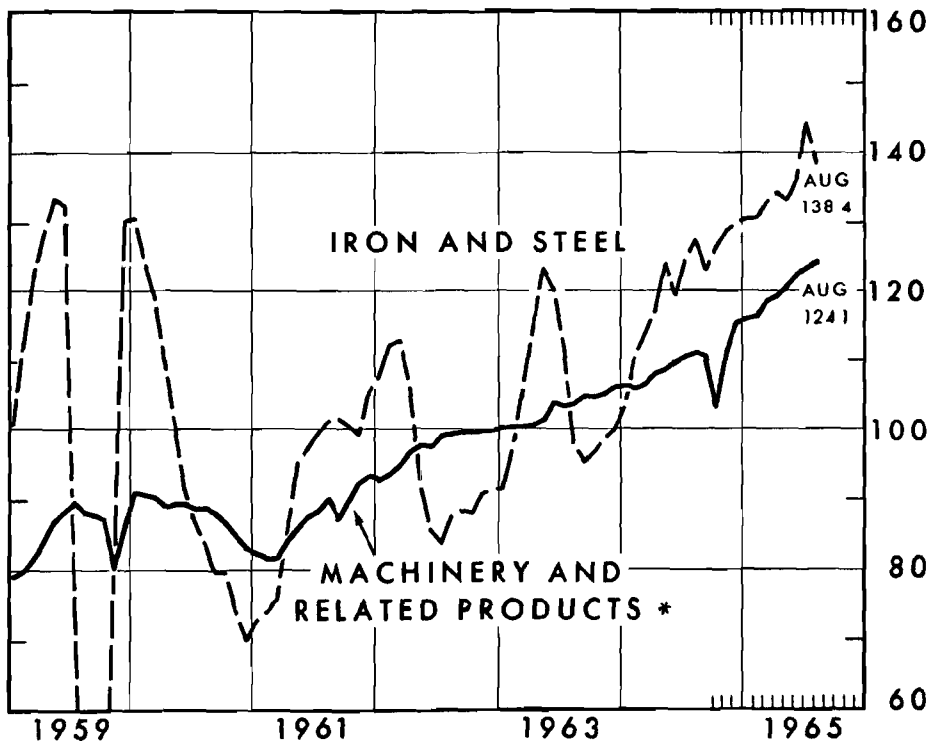
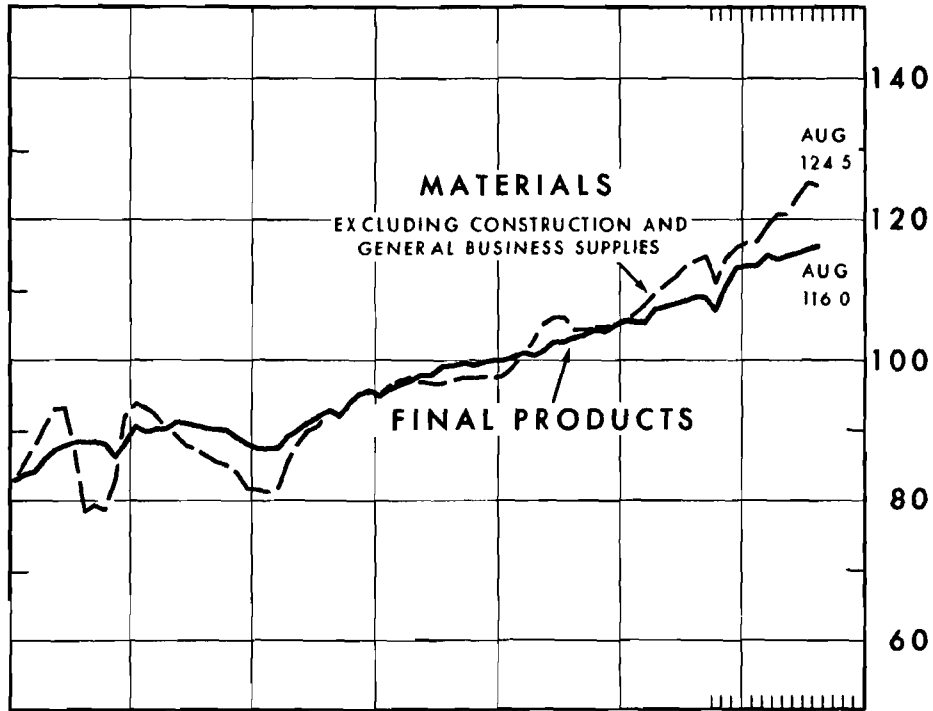
In the bottom panel of the chart a comparison is made of steel output and activity in the final steel consuming industries in manufacturing. For this purpose output of the fabricated metal products group is not included partly because intermediate metal products were probably also stockpiled in considerable volume in anticipation of a steel strike, settlement of which was deferred by four months. Consumption of steel in the construction industry can not be adequately represented so that, as in the case of the other chart, for reasons of coverage, weights, and other considerations no precise meaning should be inferred from the differences shown.

* Prepared by Clayton Gehman, Chief, Business Conditions Section, Division of Research and Statistics.

During the earlier periods of steel inventory adjustments, after prospective steel strikes did not materialize, there were declines in steel output of about one-fourth in the second quarter of 1962 and the third quarter of 1963. This time the expansion in steel inventories has been larger in both absolute and relative terms than before, although possibly not as much as in 1960, when steel output was halved and a general recession in industrial activity developed. Marked increases in retail sales and output consumer goods could moderate the current decline in steel inventories.

INDUSTRIAL PRODUCTION

1962-63:100



* ELECTRICAL AND NONELECTRICAL MACHINERY, TRANSPORTATION EQUIPMENT, INSTRUMENTS, AND ORDNANCE

APPENDIX C: REVISION OF RETAIL TRADE INVENTORIES*

The regular annual adjustment by Commerce Department of monthly retail trade inventory figures to year-end benchmark levels obtained from the Census survey, 1964 Retail Trade, has resulted in a substantial upward revision of retail trade inventory figures for 1964 and 1965 and, through them, of total business inventories.

The book value of retail trade--and total business-- inventories was raised by \$1.5 billion in December 1964, the key date in the revision, and this increase was "wedged" back to January 1964. A small additional increase in level was added in early 1965. Thus, in June 1965, the book value of retail trade--and total business--inventories has been revised upward by close to \$1.7 billion.

The main effect on the indicated rate of accumulation was, of course, throughout 1964. The old retail trade inventory figures had shown a book value increase of only \$240 million from December 1963 to December 1964; the increase now is \$1,750 million. The indicated total business inventory accumulation during 1964 was raised correspondingly, from \$3.9 billion to \$5.4 billion. These revised figures were incorporated in the recent GNP revision: nonfarm business inventory accumulation now totals \$5.4 billion during 1964, up from the earlier \$3.6 billion.

The upward revision (the counterpart of the downward bias in the original monthly figures) was greatest for all the durable goods categories and, among nondurable outlets, for department stores. The

* Prepared by L. C. Trueblood, Economist, National Income, Labor, and Trade Section, Division of Research and Statistics.

following table shows, in both absolute and relative terms, the revised and old increases or decreases in book value of inventories from the end of 1963 to the end of 1964, by class of retail store:

CHANGE IN SEASONALLY ADJUSTED BOOK VALUE OF INVENTORIES,
December 1963 to December 1964

	In millions of dollars		In per cent	
	Revised	Old	Revised	Old
Retail trade - Total	1,747	238	5.9	0.8
Durable Goods	773	-289	6.2	-2.3
Automotive	149	-390	2.7	-7.2
Furniture-appliances	141	20	7.0	1.0
Lumber-Bldg. Materials	203	- 4	8.5	-0.2
Jewelry & Other ^{1/}	280	85	10.5	3.2
Nondurable Goods	974	527	5.8	3.1
Apparel	133	143	3.8	4.0
Food	228	265	6.4	7.4
General Merchandise	498	6	9.6	0.1
Department Stores	309	91	11.3	3.3
Drug & Other ^{1/}	115	113	2.5	2.5

^{1/} Not published.

With this large upward revision of inventories, stock-sales ratios have of course been raised for the period affected. For all retail trade, stock-sales ratios are now shown to have been about stable in 1964 and 1965 at the average 1962-63 level, instead of declining appreciably. And, consequently, the total business stock-sales ratio shows less decline than earlier in 1964 and 1965.