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CONFIDENTIAL (FR)

CURRENT ECONOMIC and FINANCIAL CONDITIONS

Prepared for the Federal Open Market Committee

By the Staff

BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM

June 2, 1966

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SUMMARY AND OUTLOOK

Outlook for GNP

The rate of growth in the over-all economy has slowed this spring, owing in large part to the sharp drop in auto sales. In the third quarter, resumption of a faster rate of growth appears likely. The amount of step-up in the GNP rise after midyear will depend, to an important degree, on the extent of recovery in auto sales, the course of defense expenditures, and the scope of the further rise in prices. Payments under Medicare will begin this summer and the Federal pay raise may also be effective on July 1 -- both of these will give a special boost to personal income and consumption expenditures in the third quarter.

Total consumption expenditures are about keeping pace with the rise in disposable income, after considerably exceeding a larger rise in income in the first quarter, and the saving rate appears to be holding at the low first quarter level (5 per cent). A recent survey of consumer buying intentions suggests continued strength in demands for new cars; if not sooner, recovery in auto sales may be stimulated by the new models, now planned for unusually early introduction.

The rise in defense spending, which in the first quarter was the largest since the Korean War period, is slowing moderately in the current quarter, but developments after midyear have not as yet been clarified. Meanwhile, new orders for defense products were quite strong through April and the unfilled order backlog has been built-up sharply. The uncertainties of the war in Vietnam and the question of prospective further rate of growth in defense spending remain key factors in the near-term and longer-run outlook.

Sustained rapid growth in business fixed investment spending throughout the year has recently been confirmed by new direct surveys of business plans, as well as by persistently rising orders for equipment and construction contract awards. According to the McGraw-Hill survey, conducted in mid-May, some companies reported that -- with costs of installing new capacity rising more rapidly than anticipated earlier -- they are adding a smaller volume of physical capacity for a given amount of budgeted funds. Thus, manufacturing capacity may not show the extraordinary 8 per cent rate of increase business anticipated early this year.

Prices and costs

Given the outlook for GNP, pressures on resources are likely to remain strong enough to maintain the rise in industrial prices at close to the pace of recent months. Utilization of manufacturing capacity in the current quarter is expected to continue at about the 92 per cent rate of the first quarter. Unemployment of experienced workers and of long-term unemployed is very low. A large inflow of students in May and June, however, may tend to maintain or increase over-all unemployment rates in the next few months.

Wages in manufacturing, on the average, still are rising only a little more than last year and no key contract negotiations in manufacturing are immediately ahead. Unit labor costs, however, are moving up since a little more increase in wages is being accompanied by somewhat slower growth in productivity. Prices of hides and lumber, which rose rapidly in the first quarter, have eased somewhat recently, and steel scrap and some other basic materials also have declined from February or March highs. But for other industrial materials and for many finished products, price increases in the current quarter are apparently continuing at about the first quarter rate.

If, because of increases in supplies, food prices rise less than seasonally in the current quarter, as expected, the rise in the over-all measures of prices -- the wholesale and consumer price indexes and GNP implicit deflator -- will be less marked than in the first quarter.

Outlook for credit markets

Recent developments on both the demand and supply sides of credit markets suggest that the up-drift of long-term interest rates and the tightening of credit terms in evidence since early April is likely to continue during the weeks immediately ahead. Pressures arising from restrictions on the supply of funds have been most pronounced in mortgage markets. Net savings inflows to depositary-type intermediaries have been reduced. Moreover such lenders face potentially sizable deposit withdrawals after the midyear interest-crediting period, although the possibility of Congressional and official actions that might moderate the situation remains to be resolved. Under current circumstances, mortgage rates and terms have tightened generally along with curtailment of new commitments, although total loan disbursements of mortgage funds by private lenders may actually be fairly well maintained over the near-term because of the backlog of loan commitments already outstanding.

In addition to mortgages, the supply of consumer credit appears generally more restricted and is likely to continue so; for instance, smaller finance companies are finding it more difficult to obtain funds from banks and all such companies are finding it more costly to raise funds in the market or through direct placement. However, the recent reduction in auto sales has tended to moderate demands placed on the consumer credit market.

Pressures arising from expanded demands for funds have continued to center in the markets for corporate and Federal Agency securities. The volume of corporate bond financing is likely to pick up in June above the more moderate May levels, and total corporate security financing (through stocks as well as bonds) is likely to be the largest of the year -- all of which should operate to maintain upward pressures on bond yields. The heavy continuing volume of Agency securities, including participation certificates, will place an added burden on credit markets -- on the short- and intermediate-term sectors directly.

In the market for State and local government securities, yields have tended to lag those on new corporate and agency issues since April. But more recently, yield mark-ups on new issues, together with a moderate build-up of dealers' advertised inventories in the face of the seasonally large June calendar, suggest that further increases in municipal yields are likely. Pressure on these yields would be intensified by any efforts to redistribute savings flows away from banks towards other depository institutions.

The recent rise in corporate and Agency yields has been accompanied by a widening of the differential between these yields and yields on Treasury issues to unusually large margins. This may serve to exert some upward pressure on Treasury bond yields. The Treasury may begin raising some of its second half cash needs in early summer, but probably through tax bills.

Bank loans and deposits

Loan demand at commercial banks is expected to be strong over the weeks ahead. Business loans may continue to expand at or possibly above the rapid pace of May. Such loan demand will be buttressed in June by unusually heavy corporate tax payments, by the expanding need for funds for investment and other outlays, and by the recent relative rise in capital market rates.

Expected continuation of rapid loan expansion over the near-term in the face of restrictive loan policies adopted by banks in recent months is indicative not only of the force of such loan demand, but also of banks' willingness to accommodate temporary tax and dividend period borrowing. The capacity of banks to accommodate prospective loan demands without generating substantial further upward pressures on interest rates will depend in part on their ability to roll over their maturing CD's and continue to attract "other" time deposit money. Experience in that respect during recent months has been quite favorable, but, with respect to CD's, banks have gradually shortened maturities (to 3 and 4 months in some reported cases) on which they have been offering the 5-1/2 per cent ceiling rate for CD's.

Even assuming no legislation restricting banks' ability to compete for time deposits, one might still expect the net inflow of time and savings deposits at banks to slow down in June from the relatively rapid April-May pace. The pace of "other" time deposits, however, could rise again in July following the semiannual interest-crediting at some savings institutions.

Balance of payments

The seasonally adjusted rate of over-all payments deficit appears to have been roughly as large in April-May as in the first quarter, on both the liquidity basis and the basis of official reserve transactions. There would have been a sizable increase in the liquidity deficit if several hundred million dollars held in this country by foreign official institutions and by international organizations had not been shifted, much of it at the suggestion of the U.S. Government, into long-term time deposits and U.S. Government agency bonds and notes -- assets that are not classified as liquid in U.S. statistics.

Most of the increase in the liquidity deficit from an annual rate of $1-1/2 billion in the fourth quarter of 1965 to about $2-1/2 in January-April of this year (and to more than $3 billion corrected for the asset shifts mentioned) was accounted for by a decline of more than $1 billion (annual rate) in the merchandise trade surplus. An additional factor was the bulge in new Canadian security issues. Reflows of bank credit and liquid funds have continued, and direct investment outflows have probably not increased. No data are yet available on military expenditures abroad or on Government economic aid -- two items that are expected to be larger this year than last -- or on transactions in services.

For the four months through April, the rate of merchandise imports was 6-1/2 per cent higher than in the fourth quarter while exports were up less than 1 per cent. Imports had thus risen at an annual rate of more than 20 per cent, or more than twice as fast as GNP. Exports, on the other hand, rose much more slowly than the imports of foreign countries, so that the U.S. share in foreign markets diminished.

Both the very rapid expansion of imports and the disappointing export performance reflect the excessive domestic demand pressures that have prevailed during this period. Even if such pressures were now to be brought sufficiently under control so that the trade balance ceased to deteriorate, the trade surplus for the year would be roughly $1 billion smaller than in 1965. If demand pressures are not checked, a year-to-year deterioration in the trade balance of $2 billion seems well within the range of possibility.

SELECTED DOMESTIC NONFINANCIAL DATA

(Seasonally adjusted)

	Latest Period	Amount: Latest Period	Amount: Preced'g Period	Amount: Year Ago	Per cent change: Year Ago	Per cent change: 2 Yrs. Ago*
Civilian labor force (mil.)	Apr'66	76.7	76.3	75.3	1.8	2.9
Unemployment (mil.)	"	2.9	2.9	3.6	-20.7	-28.2
Unemployment (per cent)	"	3.7	3.8	4.8	--	--
Nonfarm employment, payroll (mil.)	"	62.9	62.9	59.8	5.1	8.8
Manufacturing	"	18.8	18.8	17.8	5.7	9.6
Other industrial	"	8.1	8.2	7.8	3.9	6.4
Nonindustrial	"	36.0	35.9	34.3	5.0	9.0
Industrial production (57-59=100)	"	153.4	153.0	140.9	8.9	17.3
Final products	"	153.1	152.2	139.4	9.8	16.9
Materials	"	153.9	154.0	142.6	7.9	17.4
Wholesale prices (57-59=100)1/	"	105.5	105.4	101.7	3.7	5.2
Industrial commodities	"	103.9	103.6	101.8	2.1	3.1
Sensitive materials	"	106.4	105.4	101.6	4.7	7.2
Farm products and foods	"	108.7	109.4	100.2	8.5	11.1
Consumer prices (57-59=100)1/	"	112.5	112.0	109.3	2.9	4.4
Commodities except food	"	106.0	105.6	105.0	1.0	1.6
Food	"	114.0	113.9	107.3	6.2	7.9
Services	"	121.1	120.1	117.3	3.2	5.5
Hourly earnings, mfg. ($)	"	2.68	2.68	2.59	3.5	6.8
Weekly earnings, mfg. ($)	"	111.28	111.06	106.24	4.7	8.6
Personal income ($ bil.)2/	"	563.1	561.4	520.5	8.2	15.5
Retail sales, total ($ bil.)	"	25.2	25.6	22.8	10.4	17.7
Autos (million units)2/	"	7.9	9.2	8.2	- 4.4	1.7
GAF ($ bil.)	"	6.0	5.9	5.2	15.0	20.3
Selected leading indicators:						
Housing starts, pvt. (thous.)2/	"	1,495	1,561	1,552	- 3.7	- 2.4
Factory workweek (hours)	"	41.5	41.5	41.0	1.2	1.7
New orders, dur. goods ($ bil.)	"	24.2	24.9	22.0	9.6	18.1
New orders, nonel. mach. ($ bil.)	"	3.6	3.5	3.1	14.8	21.4
Common stock prices (1941-43=10)	May'66	86.81	91.60	89.28	- 2.8	7.5
Inventories, book val. ($ bil.)	Feb'66	121.5	120.7	111.9	8.6	14.9
Manufacturers'	Apr'66	70.3	69.6	64.0	9.8	16.1
Gross national product ($ bil.)2/	QI'66	713.9	697.2	657.6	8.6	16.3
Real GNP ($ bil., 1958 prices)2/	"	633.6	624.4	597.7	6.0	11.7

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

SELECTED DOMESTIC FINANCIAL DATA

Item	Week ended May 27	Four-Week Average	Last six months High	Last six months Low
Money Market 1/ (N.S.A.)				
Federal funds rate (per cent)	4.72	4.84	5.13	1.00
U.S. Treas. bills, 3-mo. yield (per cent)	4.63	4.63	4.70	4.12
Net free reserves 2/ (mil. $)	- 351	- 341	98	- 352
Member bank borrowings 2/ (mil. $)	653	653	685	218
Security Markets (N.S.A.)				
Market yields 1/ (per cent)				
5-year U.S. Treas. bonds	4.97	4.88	5.03	4.51
20-year U.S. Treas. bonds	4.72	4.69	4.81	4.44
Corporate new bond issues, Aaa	*5.57	5.27	5.57	4.79
Corporate seasoned bonds, Aaa	5.02	4.98	5.03	4.60
Municipal seasoned bonds, Aaa	3.57	3.53	3.63	3.37
FHA home mortgages, 30-year	--	n.a.	6.00	5.46
Common stocks S&P composite index 3/				
Prices, closing (1941-43=10)	86.89	86.82	94.06	83.63
Dividend yield (per cent)	3.31	3.30	3.38	3.01

Item	Change in April	Average change last 3 mos.	Annual rate of change (%) 3 mos.	Annual rate of change (%) 1 year
Banking (S.A., mil. $)				
Total 4/	- 117	93	5.0	4.5
Bank loans and investments:				
Total	2,800	1,900	7.7	9.2
Business loans	600	800	14.1	11.3
Other loans	1,100	1,200	11.3	11.5
U.S. Government securities	300	- 500	-10.5	- 5.4
Other securities	800	400	10.8	11.4
Money and liquid assets:				
Demand dep. & currency 4/	-1,200	600	4.5	6.2
Time and savings dep. 4/	1,400	1,400	11.3	13.7
Nonbank liquid assets	- 300	800	3.8	5.5

N.S.A.--not seasonally adjusted. S.A.--seasonally adjusted. n.a.--not available.
1/ Average of daily figures. 2/ Averages for statement week ending May 25.
3/ Data are for weekly closing prices. 4/ Change in May. * Not representative.

U.S. BALANCE OF PAYMENTS
(In millions of dollars)

	1966 Apr.	1966 Mar.	1966 Feb.	1966 QI p/	1965 QIV	1965 QIII	1965 QII	1965 Year (billions)
	Seasonally adjusted							
Current account balance					1,434	1,590	1,746	6.1
Trade balance 1/	200	450	330	1,106	1,271	1,232	1,317	4.8
Exports 1/	2,300	2,550	2,290	7,113	7,027	6,827	6,798	26.3
Imports 1/ 2/	-2,100	-2,100	-1,960	-6,007	-5,756	-5,595	-5,481	-21.5
Services, etc., net					160	355	426	1.3
Capital account balance (regular transactions)					-1,708	-1,957	-1,549	-7.3
Govt. grants & capital 3/					-973	-941	-988	-3.7
U.S. private direct investment					-701	-515	-891	-3.3
U.S. priv. long-term portfolio					-111	-357	159	-1.0
U.S. priv. short-term					-41	53	417	0.7
Foreign nonliquid					118	-197	-246	--
Errors and omissions					-252	-316	-81	-0.7
Balances, with and without seasonal adjustment (- = deficit)								
Bal. on regular transactions, S.A.				-615	-542	-658	107	-1.9
Seasonal component				-501	12	-497	-41	--
Balance, N.S.A.	-322	-140	71	-114	-554	-1,155	66	-1.9
Liquidity bal., S.A.				-582	-366	-509	230	-1.4
Seasonal component				-501	14	-497	-41	--
Balance, N.S.A. 4/	-275	-52	52	-81	-352	-1,006	189	-1.4
Official settlements bal., S.A.				-262	-1,205	261	242	-1.3
Seasonal component				-641	50	-533	-188	--
Balance, N.S.A. 5/	-194	-97	172	379	-1,155	-272	54	-1.3
Memo items:								
Monetary reserves (decrease -)	-110	64	-263	-424	-271	-41	-68	-1.2
Gold purchases or sales (-)	-70	-73	--	-68	-119	-124	-590	-1.7

1/ Balance of payments basis which differs a little from Census basis.
2/ Monthly figures tentatively adjusted for changes in carry-over of import documents.
3/ Net of associated liabilities and of scheduled loan repayments.
4/ Differs from balance on regular transactions by counting as receipts (+) debt prepayments, advances on military exports, and net sales of non-convertible Roosa bonds.
5/ Differs from liquidity balance by counting as receipts (+) increase in liquid liabilities to commercial banks, private nonbanks, and international institutions (except IMF) and by not counting as receipts (+) increase in certain nonliquid liabilities to foreign official institutions.

THE ECONOMIC PICTURE IN DETAIL

The Nonfinancial Scene

Gross national product. The rise in GNP shaping up for the current quarter is not so large as in the first quarter, in either dollar or real terms. In current dollars, GNP is estimated at a seasonally adjusted annual rate of $726 billion in the current quarter, up $12 billion from the first quarter. This rise compares with an increase of nearly $17 billion in the first quarter and a quarterly average increase in 1965 of $14 billion.

Much of the decline in GNP growth reflects the sharp drop in new domestic auto sales this spring. In addition, residential construction activity now appears to be declining; in the first quarter it had shown a temporary brisk spurt. Moreover, defense expenditures -- still a dynamic expansive force -- are estimated to be rising at a less rapid rate than in the first quarter. While these three sectors are contributing to the slowing pace of GNP expansion, a partial off-set is being provided by the rate of business inventory investment, which is estimated to be rising moderately following a decline in the first quarter. Expenditures in other GNP sectors are continuing to expand at about the first quarter rate, except for net exports which are continuing the deterioration evident over the period since last spring.

In the first quarter, with new domestic car sales rising substantially to a seasonally adjusted annual rate of 9.3 million and with consumer purchases of other durables also increasing, personal consumption expenditures on durable goods increased at a rate of almost $2.5 billion. In the current quarter, sales of new domestic autos are estimated at a rate of less than 8 million and, despite a further gain in purchases of home goods, durable consumption expenditures are down at a rate of about $2.5 billion.

With such a large shift in durable goods and continued growth in purchases of nondurable goods and services, total consumption expenditures in the current quarter are showing little more than half as much rise as in the first quarter. In the first quarter, thanks in part to the auto buying spree, the rise in consumption considerably outpaced the rise in income (which was limited to some extent by the large increase in social security taxes) and the savings rate declined to 5 per cent, about as low as it has been in recent years. In the current quarter, the income rise has slowed, in part because of tapering off of the essentially unsustainable increases in employment and wages and salaries in the early months of the year. Consumption is about keeping pace with income, and the savings rate is holding at 5 per cent.

In view of the probably temporary nature of the safety factor in the recent decline in auto sales and the strength in new car demand for the coming 12 months as indicated by the Census mid-April survey of consumer buying intentions, auto sales may rise again in the near future although probably not to the very high first quarter rates. Consumption generally is expected to show a larger rise in the third quarter as growth in income accelerates owing in part to payments under the Medicare program and a Federal pay raise.

The slowing of the rise in defense spending from a $3 billion rate in the first quarter to an estimated $2 billion in the current quarter is, according to the official schedule for such spending, a prelude to a further distinct slowing of expansion over coming months. However, the current and future course of defense spending must be as uncertain as the course of developments in Vietnam, and this could result in wide disparities between actual spending and the earlier official (Budget) plans. A possible indication of a potential increase in the defense spending rate is that the build-up in order backlogs for defense products was very large through April.

The build-up in order backlogs for producers' equipment and the rise in commercial and industrial construction contracts awarded have also been very large and this evidence of continued rapid growth in business fixed investment outlays is now supported by new surveys of business plans. As of mid-May, business plans for this year's spending for new plant and equipment were about as strong as they were in February and March. In the current quarter business fixed investment is estimated to be rising at about the $2.5 billion rate of the first quarter.

Little evidence is yet available on inventory investment in the current quarter. Inventory accumulation by manufacturers in April was at a moderately higher rate than in the first quarter, and retail auto stocks rose considerably when sales broke in April and May and auto producers made only relatively moderate output adjustments. Altogether a rise in the rate of total nonfarm business inventory accumulation is estimated for the quarter as a whole -- to a rate not quite so high as in the fourth quarter.

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GROSS NATIONAL PRODUCT AND RELATED ITEMS
(Expenditures and income figures are billions of dollars,
seasonally adjusted annual rates)

			1965			1966	
	1964	1965	II	III	IV	I	II
Gross National Product	628.7	676.3	668.8	681.5	697.2	713.9	726.0
Final sales	623.9	668.1	662.4	673.9	687.1	705.8	717.2
Personal consumption expenditures	398.9	428.7	424.5	432.5	441.0	451.8	458.0
Durable goods	58.7	65.0	63.5	65.4	66.4	68.7	66.0
Nondurable goods	177.5	189.0	187.9	190.5	195.0	200.1	205.0
Services	162.6	174.7	173.1	176.7	179.6	183.0	187.0
Gross private domestic investment	92.9	105.7	102.8	106.2	110.3	111.7	114.3
Residential construction	27.5	27.6	28.0	27.7	27.2	28.2	27.7
Business fixed investment	60.5	69.8	68.4	70.9	73.0	75.5	77.8
Change in business inventories	4.8	8.2	6.4	7.6	10.1	8.1	8.8
Nonfarm	5.4	7.9	6.6	7.0	8.9	7.4	8.3
Net exports	8.6	7.1	8.0	7.4	6.9	6.4	6.0
Gov. purchases of goods and services	128.4	134.8	133.5	135.4	139.0	144.0	147.6
Federal	65.3	66.6	65.7	66.5	69.2	72.5	74.6
Defense	49.9	49.9	49.2	49.8	52.0	55.0	57.0
Other	15.4	16.7	16.5	16.7	17.2	17.5	17.6
State and local	63.1	68.2	67.8	68.9	69.8	71.5	73.0
Gross National Product in constant (1958) dollars	577.6	609.6	603.5	613.0	624.4	633.6	639.0
GNP Implicit deflator (1958=100)	108.9	110.9	110.8	111.2	111.7	112.7	113.6
Personal income	495.0	530.7	524.7	536.0	546.0	557.1	566.0
Wages and salaries	333.5	357.4	353.6	359.0	368.1	377.0	383.7
Personal contributions for social insurance (deduction)	12.4	13.2	13.0	13.3	13.6	16.8	17.0
Disposable personal income	435.8	465.3	458.5	471.2	480.3	488.7	496.0
Personal saving	26.3	24.9	22.4	26.8	27.1	24.4	25.0
Saving rate (per cent)	6.0	5.4	4.9	5.7	5.6	5.0	5.0
Total labor force (millions)	77.0	78.4	78.1	78.5	79.0	79.4	79.7
Armed forces "	2.7	2.7	2.7	2.7	2.8	2.9	3.0
Civilian labor force "	74.2	75.6	75.4	75.8	76.2	76.5	76.7
Employed "	70.4	72.2	71.9	72.4	73.0	73.6	73.9
Unemployed "	3.9	3.5	3.6	3.4	3.2	2.9	2.8
Unemployment rate (per cent)	5.2	4.6	4.7	4.5	4.2	3.8	3.7

Industrial production. Industrial production rose only 0.3 per cent in April, to 153.4 per cent of the 1957-59 average, but was 9 per cent above a year earlier. The April rise was small in part because of strikes that reduced auto and coal output; output of most other final products and materials increased further. The index for manufacturing alone increased 0.6 per cent in April and was 9.5 per cent above a year earlier. In may, the total index is likely to rise somewhat further, possibly by half to a full point, despite further reductions in auto output.

The rates of increase in output from March to April for the total index and many of its major components were considerably slower than from the fourth quarter of 1965 to the first quarter of 1966, but were still appreciable, as shown in the table.

INDUSTRIAL PRODUCTION
(Annual rates of change)

	IV Qtr. 1965 to I Qtr. 1966	March 1966 to April 1966
Total Index	13.2	3.1
Final Products	9.6	7.0
Consumer goods	6.0	4.1
Durables	8.4	--
Nondurables	4.8	5.2
Business equipment	14.8	13.0
Defense equipment	29.2	17.9
Materials	16.0	--
Durables	23.2	7.6
Steel	49.6	12.0
Nondurables	9.2	- 8.4

In May, domestic auto assemblies were at an annual rate of about 8.6 million units, down 7 per cent from April. This decline and probable declines in output in supplying industries will amount to a loss of 0.3 to 0.4 points in the total index. This amount is about equal to the contribution to the index resulting from recovery in coal production from the strike-reduced April level.

Sales of apparel and consumer durables goods other than autos have been at the least maintained at the high first quarter levels, and production of these goods, which increased in April, probably rose again in May. Output of defense and business equipment is also estimated to have advanced further in May.

Actual and prospective curtailment in production of autos and continued expansion in production of most other finished products are exerting conflicting influences on demands for industrial materials, for inventory as well as for consumption. The rise in production of iron and steel slowed in April and May, following an increase of more than a fifth from the November low. At the May level, production was close to the records of March and April 1965 when the strike-threat was stimulating inventory demand. Consumption of steel is quite a bit higher now, but nevertheless it is likely that inventories held by steel consuming manufacturers, which declined over one-fourth from last October to the end of March, are on the rise. Among non-durable materials, output of crude petroleum, refined petroleum products, and paperboard continued strong in early May.

A major uncertainty in the outlook is the course of auto sales. In the first quarter of this year, sales of new domestic cars were at an annual rate of 9.3 million units. They declined to 7.9 million in April and then to a rate of about 7.3 million in the first 20 days of May. The disparity between the current rate of sales and the current production rate of 8.6 million, with exports accounting for only 0.2 million of the difference, cannot persist. New car inventories rose further in mid-May and on the 20th totaled 1.7 million cars, 30 per cent more than a year earlier. Sales of used cars, which declined 5 per cent from March to April, declined 3 per cent further in the first 20 days in May and were about the same amount below a year ago.

Retail sales. Following a sharp run-up in late 1965 and the early months of this year, retail sales have declined moderately since March. The advance April figure was down a little more than 1 per cent, and data for the first three weeks of May suggest a similar decline last month. These figures are subject to revision.

The bulk of the decline in total retail sales now indicated for April and May has been at auto dealers. Sales of furniture and appliance stores have been maintained at advanced levels, and sales of nondurable goods have continued to expand. The remarkable expansion in nondurable goods sales -- at a rate of 1 per cent a month since last Fall -- has reflected in part higher retail prices, particularly for food.

<u>Consumer credit</u>. Consumer borrowing slackened noticeably in the first four months of the year. The pace picked up a little in March as retail sales advanced to new highs, but slowed again in April and, according to fragmentary data, in early May as well. The seasonally adjusted annual rate of increase in the January-April period was $7.2 billion, substantially lower than the $8.0 billion rate for all of 1965.

The slower rate of growth in borrowing to purchase cars has been a major factor, but growth rates for all types of credit have slackened since last winter. Personal loans bulged somewhat in April as people borrowed for tax purposes, but the rise still was not as great as a year earlier when underwithholding of taxes was a common problem.

The slower increase in credit has reflected supply as well as demand factors. Lenders have been encountering strong competition in obtaining new funds and have had to pay higher interest rates on the funds they have obtained. As a result, they have become more restrictive in their lending policies and have been screening new credit applicants more carefully than earlier.

The ratio of repayments on instalment debt to disposable personal income edged up only slightly further in the first quarter. As a result of the increase in social security taxes, the rate of gain in disposable income slowed to a little under 2 per cent, compared with a rise of 2.5 per cent in repayments.

RATIO OF REPAYMENTS TO DISPOSABLE INCOME	
1963	13.7
1964	14.0
1965	
Q1	14.4
Q2	14.5
Q3	14.5
Q4	14.6
1966	
Q1	14.7

Delinquency rates on consumer loans are a little higher than a year earlier but below those of late 1960 and 1961. The over-all delinquency rate, as compiled from data reported by the ABA for a sample of banks, has averaged about 1.5 per cent, in recent months, with rates on home appliance loans somewhat higher than that and rates on direct auto loans well below it.

Consumer buying plans. According to the Census mid-April survey, consumer intentions to buy autos were as strong as a year earlier and buying plans for major household equipment exceeded year-earlier levels. Indications of sustained strength in buying plans were supported by a large increase in the proportion of households reporting higher incomes than a year earlier and also by a sizable increase in the proportion of households expecting higher incomes in the coming year.

The survey reported 18.7 per cent of the households expressed intentions to buy a new or used auto within the next 12 months, as compared with 18.8 per cent in April 1965. For new cars alone, the figure was 9.3 per cent, the same as a year earlier. Intentions to buy new autos within a 6-month period also were about the same as a year earlier. Recent 12-month new car buying plans are below the levels recorded in the three quarterly surveys in the period intervening between April 1965 and April 1966, but because of seasonal and other problems the differences do not appear significant.

Owing mainly to an upping of plans to purchase refrigerators, television sets, and clothes dryers, the proportion of households reporting intentions to buy any of the 7 major household durable goods covered by the survey in the 6 months ahead was 18.8 per cent in mid-April as compared with 17.4 per cent a year earlier. In the two preceding surveys, January 1966 and October 1965, year-over-year increases were also reported for intentions to buy these goods.

Orders for durable goods. New orders for durable goods, which had shown an unusually large bulge (5 per cent) in March, declined 3 per cent in April. The April level was above any earlier month except March and was 10 per cent above a year earlier. New orders remained well above shipments in April, and unfilled orders increased substantially further.

The April decline in new orders was mainly in fabricated metal products, aircraft, and miscellaneous durable goods -- all of which had shown large increases in March. Despite the sizable decrease for aircraft, total new orders for defense products were down only moderately. In the first four months of this year, defense orders averaged 36 per cent above the corresponding period a year earlier. New orders for machinery and equipment, which have also been trending upward, showed a large further increase in April.

Shipments of durable goods also increased sharply in March and then declined moderately in April. Backlogs continued to rise in all major groups, but the bulk of the large April increase was for defense products and machinery and equipment. At the end of April, the total durable backlog was up 21 per cent from a year earlier, with defense products up 27 per cent and the machinery and equipment backlog up 24 per cent. The ratio of unfilled orders to shipments for all durable goods combined was 3.0 in April as compared with 2.7 a year earlier and an average of 2.6 in the three-year period 1962-64. In the year 1956, this ratio averaged 4.2.

Manufacturers' inventories. The book value of manufacturers' inventories increased $625 million in April, moderately above the rate of accumulation prevailing in the first quarter and in the last half of 1965. Over that 9-month period, the increase averaged $560 million per month, with relatively small variations from quarter to quarter. The ratio of manufacturers' inventories to shipments in April at 1.61 equalled the average of the preceding 9 months.

Accumulation of durable goods inventories totaled $450 million in April, as compared with a monthly average of $370 million in the preceding 9 months. Growth in work-in-process stocks in machinery and defense industries continued to account for the major part of total durable accumulation. In addition, stocks of durable materials and supplies showed some rise in April, after several months of little change. In nondurable goods industries, stocks of materials and finished goods continued to edge up, while work-in-process inventories continued to show little change.

Construction activity. Seasonally adjusted new construction outlays changed little in April from the record $77.5 billion annual rate in March. Within the private sector, both residential and non-residential expenditures held about unchanged at $27 billion. The recent equivalence in outlays for these two major groups is unprecedented in the post-World War II period and underscores the strength of the recent surge in private nonresidential construction. Public construction was down slightly in April from substantially revised (upward) levels.

Private housing starts, which rose appreciably in March, declined moderately in April. Building permits also declined, mostly for single family units; such units had accounted for virtually all the rise in March.

The April decline in starts was less than generally expected. In view of the large backlog of commitments still to be worked down, trade expectations are that the major impact on starts of tightening mortgage market conditions may not show up until the summer months or even later. If starts decline by 5 per cent or more this year from the 1.5 million units in 1965, the fourth quarter rate might be down to 1.3 million or lower.

Regionally, changes in both starts and permits continued to be selective, with major declines reported only in the North Central states where heavy rains and a work-stoppage in and around Chicago were contributing factors. Basic demand had been particularly strong in this region, and vacancy rates there have exhibited a definite downward trend for some time.

HOUSING STARTS AND PERMITS

	April 1/ (thousands of units)	Per cent change from March	Per cent change from Year ago
Starts (total)	1,495	- 4	- 4
Permits (total)	1,176	- 9	- 1
1 family	650	-14	- 4
2-or-more family	526	- 1	+ 3
Northeast	258	- 8	+14
North Central	283	-26	- 8
South	403	+ 2	+ 5
West	232	- 3	-14

1/ Seasonally adjusted annual rate; preliminary.

Nationally, rental vacancy rates at 7.5 per cent in the first quarter were little changed from the fourth quarter of last year and the average of the past four years. At the recent peak in vacancies in 1961, the annual average had been 7.9 per cent. Among areas, rental vacancy rates in the West (10.7 per cent) remained especially high despite the substantial reduction in starts in recent years. Also, since early 1965, a moderate downtrend in rental vacancy rates within metropolitan areas has been accompanied by an upward trend in rates outside such areas.

Fixed capital investment plans and appropriations. Business fixed capital spending plans for 1966 were substantially the same in mid-May as two months earlier, according to a recheck survey made by McGraw-Hill. If these recheck plans are realized, plant and equipment investment will be up 18.0 per cent for the year following an increase of 15.7 per cent in 1965. The increase now indicated is slightly less than shown in a recheck of another private survey but above the February Commerce-SEC survey results.

PLANS FOR FIXED CAPITAL SPENDING[1/]
(Per cent change from 1965)

	Planned for 1966	
	In March	In May
All business	18.6	18.0
Manufacturing	23.9	21.9
Durable goods	27.4	24.8
Nondurable goods	20.3	18.8
Nonmanufacturing	14.6	15.0

1/ McGraw-Hill.

The indicated spending plans were a little lower in manufacturing, but a little higher in nonmanufacturing. Within manufacturing, reductions in plans of producers of iron and steel, nonelectrical machinery, autos, fabricated metals and instruments and of most nondurable goods more than offset small increases by producers of transportation equipment other than autos, food and beverages, and textiles.

Newly approved capital appropriations of manufacturers were nearly 2-1/2 per cent less in the first quarter of this year than in the final quarter of last year, according to the latest National Industrial Conference Board survey. All of the decline was at durable goods manufacturers, where new appropriations were off almost 4-1/2 per cent. But appropriations of all manufacturers still exceeded their record high capital expenditures, and the backlog of unspent appropriations increased to another all-time high. In terms of the stepped-up first quarter capital expenditures the backlog at the end of the quarter was about as high as any time in the last two years and thus would support a high rate of capital spending for the next three or four quarters even if there were some further decline in new appropriations.

Employment. Strikes in mining and construction in April substantially reduced payroll employment in these industries and total nonfarm employment was unchanged at a level 3 million higher than a year earlier and almost 2 million higher than six months ago.

Employment increased further in manufacturing in April and continued to advance strongly in Federal and state and local governments. The private service sector also maintained its strong upward trend. A 50,000 decline in trade apparently reflected inadequate adjustment for the Easter holiday and may be reversed in May.

The attention given to the role of durable goods manufacturing industries in the recent expansion in nonfarm employment has tended to obscure the large increases in other less volatile sectors. In the six months since October of last year, nonfarm employment has increased at an annual rate of 3.8 million, or 6 per cent, with durable goods manufacturing rising at an annual rate of about 10 per cent. The rate of advance was also nearly 10 per cent in government, which accounted for one-fourth of the over-all rise in nonfarm employment. Including trade and service, the three nonindustrial sectors in the past 6 months have been adding employees at a rate of 2 million per year. Even if expansion in industrial employment were to slow somewhat it seems likely that government and other nonindustrial employment would continue to expand at close to recent high rates.

INCREASES IN NONFARM EMPLOYMENT
(Seasonally adjusted, annual rates)

	In thousands			Per cent		
	Apr.'65 to Oct.'65	Oct.'65 to Apr.'66	Apr.'65 to Apr.'66	Apr.'65 to Oct.'65	Oct.'65 to Apr.'66	Apr.'65 to Apr.'66
Total nonfarm	2,310	3,770	3,040	3.9	6.2	5.1
Manufacturing	720	1,320	1,020	4.0	7.3	5.7
Durable	560	1,030	800	5.5	9.8	7.8
Nondurable	160	290	220	2.1	3.8	2.9
Construction	110	350	230	3.6	10.9	7.4
Transportation and public utilities	120	90	100	2.9	2.2	2.5
Trade	380	540	460	3.0	4.3	3.7
Finance and service	500	550	530	4.2	4.6	4.4
Government	490	970	730	5.0	9.5	7.4
Federal	80	240	160	3.6	10.2	7.0
State and local	410	720	570	5.4	9.3	7.5

Unemployment. Unemployment compensation data for May indicate no slackening in demand for workers with previous job experience. For example, the number of persons filing new claims for unemployment insurance declined about seasonally in May to a weekly average of 150,000, and were at the lowest level for this time of the year since the end of World War II and one-fifth lower than in May of last year. In May as in April, the average number of persons receiving weekly unemployment insurance benefits was 2.1 per cent of all covered workers; the previous postwar low of 2.4 per cent was in May 1953. Since these data exclude new entrants and others ineligible to receive benefits, they tend to understate the current available labor supply. Nevertheless unemployment insurance data do provide a fairly good measure of the number of male workers with previous job experience who are involuntarily out of work. Unemployment among teenagers, who generally are not covered, has remained high despite strong demands, and now accounts for more than one-third of all unemployment.

Teenagers. The number of teenagers in the labor force has increased sharply in the past year. Although their employment has also risen significantly, the proportion of young workers among the unemployed has also gone up substantially, partly due to the rapid decline in unemployment among adult males. As a consequence of the large numbers of unemployed youths and the sharp fluctuation in their unemployment rate from month to month, the over-all unemployment rate has tended recently to fluctuate with the count of teenagers seeking work.

A further large addition of teenagers can be expected this spring and summer. The search for summer work or permanent jobs begins in May and usually reaches a peak in June. While the level of teenage employment reaches a peak in July, net additions to the civilian labor force between June and July are usually relatively small because many of those unable to find summer work drop out of the labor force. Last year a total of 3.7 million 14 to 19 year olds were added to the civilian labor force between April and July; in 1964, only 2.9 million entered the labor force. Atypically, more than 1 million of the summer rise in 1965 occurred between June and July. This deviation from the usual pattern reflected in part the early date of the June survey week, which occurred while some students were still in school and, in part, government programs and special efforts of the business community to provide job opportunities for teenagers, which picked up momentum in July. This year the survey week in June is a week later and the April-June labor force additions will probably be much larger than last year.

Assuming the participation rates of teenagers increase by the same amount between April and July this year as last year, teenage additions to the civilian labor force will be 200,000 higher than last year, or 3.9 million. Moreover, labor market conditions likely to prevail this summer would suggest some greater increase in participation rates of teenagers. The effect of these developments would more than offset any reduction due to an increase in the armed forces of draft-age youths.

The growing importance of youth in the labor force has made reductions in total unemployment more difficult to achieve than earlier. Currently, 1 in 3 unemployed is a teenager, compared with less than 1 in 5 a decade ago when over-all unemployment was about the same as it is now. Largely, the increased representation of youths is a reflection of the wartime and early postwar bulge in births. Since the unemployment rate of teenagers, even in good times, is well above the average, their increased proportion of the labor force tends to "weight up" the total unemployment rate. Moreover, their unemployment rate is the least sensitive to rising demands because of the lack of job experience and the tendency for their labor force to expand as job opportunities increase.

LABOR FORCE AND UNEMPLOYMENT BY AGE

	April 1953	April 1965	April 1966
	Percentage distribution		
Civilian labor force	100.0	100.0	100.0
14-19 years	7.8	9.2	10.2
Adult men	64.6	59.7	58.5
Adult women	27.7	31.1	31.3
Unemployment	100.0	100.0	100.0
14-19 years	18.5	28.1	32.6
Adult men	55.5	42.4	37.1
Adult women	25.9	29.6	30.2
	Per cent of civilian labor force		
Unemployment rate	2.7	4.8	3.7
14-19 years	6.5	14.7	12.0
Adult men	2.4	3.4	2.4
Adult women	2.6	4.6	3.6

Unit labor costs. Unit labor costs for all manufacturing employees have risen moderately further continuing the upward tendency of recent months. At the beginning of the year, unit costs were not much different from a year earlier, despite a rise in social security payments. By April, however, the differences had widened reflecting both a little more rapid rise in wages and a somewhat slower rate of increase in productivity this year. In April, hourly compensation of all employees in manufacturing including fringe benefits, was 3.6 per cent higher than a year earlier, about a half per cent more than the increase in 1965. At the same time, the rise in manufacturing productivity in April was 2.8 per cent above a year earlier. This rate is less than the rise in output per manhour of 3.6 per cent for 1965 as a whole.

Wholesale prices. The industrial commodity price index rose 0.3 per cent from mid-March to mid-April to 103.9 per cent of the 1957-59 average. Through the first four months of the year, the index rose 1.1 per cent, and estimates based on a variety of sources indicate a continuation of the rise into late May. Average prices of foodstuffs, which accounted for much of the rise in the total index from early 1965 to early 1966, has continued downward from the February peak; it declined 0.6 per cent from March to April, and the weekly estimates indicate a further decline of 1 per cent or more into late May. The total wholesale price index since February has changed little as a result of compensating price movements in industrial commodities and foodstuffs.

The industrial commodity price index rose 1.2 per cent from the fourth quarter 1965 average to mid-April. Reflecting the pressure of strong demands, average prices of industrial materials increased 1.6 per cent. Major contributors to this rise were hides and leather, lumber, nonferrous metals, and fabricated metal products. Wholesale prices of consumer finished products over the same period rose only

0.6 per cent, with the significant increases in apparel, footwear, and household furniture. Prices of producer equipment rose 1 per cent, under the influence of the investment boom.

The rise in lumber and plywood prices which began early this year apparently has come to an end, and some decline has occurred in recent weeks, A reduction in defense buying and easing of the boxcar shortage are partly responsible for the recent declines.

The high world price of copper and of domestic scrap continues to result in price increases among fabricated copper products. The Government has begun a program to subsidize copper mine development and output; however, little or no increase in output this year will result from this program. Adding further to market tightness, the copper "setasides" -- the fraction of refining and fabricating capacity immediately available for priority Government orders -- have now been raised from 10 per cent to 13 per cent. Increasing efforts to substitute aluminum in many copper uses appears to be adding further strain on aluminum fabricating capacity. This new demand added to heavy existing civilian and military demand has created market expectations of further price increases for aluminum products such as sheet, cable, and wire.

The price of zinc is softening under the influence of large increases in world mine capacity and, following the recent decrease in lead, is expected to decline. Reflecting this market softness, the price of zinc scrap has fallen in recent weeks after many months of no change.

Major steel producers have announced a number of upward and downward price adjustments which are in line with a new policy of adjusting specific product prices to their individual demand and cost conditions. But the BLS has estimated that these changes will raise the index of steel mill products by only 0.1 per cent to a level less than 1.5 per cent above a year ago.

Average prices of foodstuffs have declined over 2 per cent from the February peak which was nearly 12 per cent above a year earlier. Livestock and meats were primarily responsible for the earlier sharp rise. Prospects for larger supplies and slower growth of income point to a continuation of the downward movement of livestock and meat prices that began in March.

Consumer prices. The consumer price index from mid-March to mid-April rose 0.4 per cent after increasing 0.4 per cent in March and 0.5 per cent in February. At 112.5 per cent of the 1957-59 average, the index in April was 2.9 per cent above a year earlier. A part of the April rise is attributable to restrictive economic policy -- the rise in mortgage interest rates and the restoration of some excise taxes.

Foods, which accounted for much of the earlier rise in the index, rose only 0.1 per cent in April as meats declined about 1.5 per cent mainly as a result of a 5.5 per cent fall in pork. Meat prices are expected to decline further over the year, and should slow the rate of increase of the total consumer price index.

Services increased by 0.8 per cent in April with about one-third of the increase attributable to restoration of the telephone service excise tax. Higher interest rates on new FHA and VA mortgages also contributed to the increase, and medical care services rose 0.5 per cent further.

Nonfood commodities rose 0.2 per cent to a level 0.8 per cent above a year earlier. New car prices increased 0.3 per cent because of the restoration of the excise tax, and apparel and used cars rose more than seasonally.

CONSUMER PRICE INDEXES
1957-59=100

Commodity group	Index April 1966	Per cent change to April, 1966 from March 1966	January 1966	April 1965
All items	112.5	.4	1.4	2.9
Foods	114.0	.1	2.3	6.2
Meats	118.1	-1.4	1.3	11.8
Nonfood commodities	106.0	.4	.7	1.0
Apparel	107.6	.5	1.3	2.2
Footwear	118.1	1.0	2.2	5.4
Household durables	96.4	.2	.3	-1.5
New cars	97.4	.3	--	-3.3
Used cars	117.4	1.7	2.3	-2.7
Fuel oil and coal	108.5	- .4	- .4	2.9
Services	121.1	.8	1.3	3.2
Transportation	123.0	.3	.4	3.8
Medical care	131.4	.5	1.5	4.1
Household services less rent	120.2	1.4	2.0	3.4

<u>Farm land values</u>. Sharply rising values of farm land boosted the national index to 150 (1957-59 = 100) on March 1, 1966, 3 per cent above November and 8 per cent above March 1, 1965. Annual increases in values in the two preceding years had averaged around 6 per cent.

A major shift in trend occurred in the Corn Belt with annual increases of 12 to 15 per cent reported in the major corn-hog producing states this March 1 compared with 4 to 5 per cent in recent years. Much of the Corn Belt upsweep occurred between November and March as shown in the table. Values along the East coast and across the South, which had long been leading areas of strength, lagged behind the national average this year with the exceptions of values in Georgia and in the three Mississippi Delta states where increases matched the Corn Belt. Annual increases in values along the West coast were about the same as the 7 per cent of the preceding year.

Higher incomes since the second quarter of 1965 have undoubtedly been an important stimulus to land markets. Returns from sales of hogs and other livestock and products have been unusually good and crop yields and pastures were better in 1965 than in 1964. Improvement has been most marked in the Corn Belt as shown in the table. Enactment of a 4-year farm program last October following several years of temporary legislative programs may also have encouraged farmers to buy land in the feed grain and livestock areas.

In the South, a variety of influences are affecting land values. Texas and Florida, following years of unusually rapid increases in values, had much more moderate increases in the latest year. In

Texas, the relatively small increase -- 4 per cent -- reflects, at least in part, the lowering water tables in the Northern Plains and consequent depreciating values of irrigated land. In Florida, the increase of only 2 per cent reflects declines in citrus grove values resulting from smaller returns per acre last year. Throughout the Cotton Belt, lease or sale of cotton allotments authorized by the Act of 1965 is affecting land values but it is too early to evaluate the effects.

The more favorable expectations of farmers evident in accelerated advances in land prices in many areas were also evident in the rise in their borrowings for production since mid-1965. Farmers' debts to the PCA's at the end of April were 15 per cent above last April. As shown in the table, sharpest increases were in the Western Corn Belt where farmers' indebtedness to the PCA's averaged 22 per cent above a year earlier and smallest in the cotton states of the South. Retirement of a fourth or more of cotton acreage in return for cash payments under the new cotton program is undoubtedly a factor in the smaller loan activity in the Southern states. Farm tractor sales, up sharply in most areas in the first quarter according to trade association reports, lagged in the cotton states. This also suggests smaller increases in investment in current production in the cotton states than in other areas.

SELECTED AGRICULTURAL STATISTICS

	Farm real estate values March 1, 1966			Cash receipts year ending March 30, 1966		PCA 1/ loans outstanding April 30, 1966	
	Index (1957-1959)	Per cent change from: Nov. 1, 1965	Per cent change from: March 1, 1965	Amount (bil.of dollars)	Per cent change from a year ago	Amount (bil.of dollars)	Per cent change from a year ago
Total, U.S.	150	3	8	40.4	9	2.93	15
North	147	4	7	3.9	5	.25	19
South	168	4	6	8.2	7	.66	8
Mid West							
E. Corn Belt	148	7	10	8.6	12	.78	14
W. Corn Belt	140	3	8	13.1	13	.85	22
West	158	2	7	6.6	7	.38	14

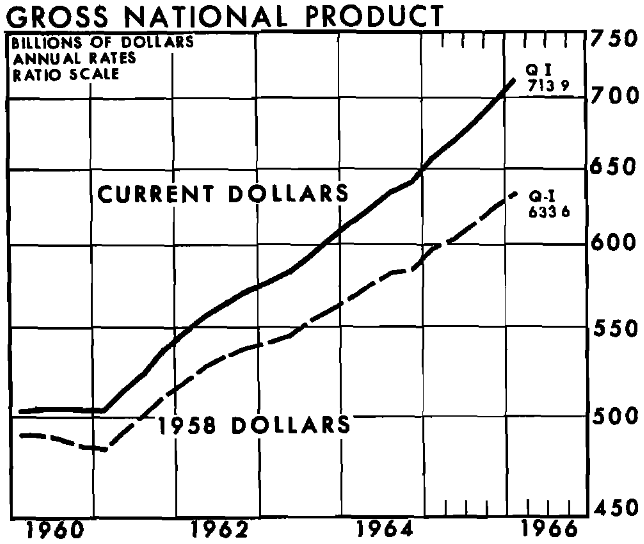
1/ The 484 production credit associations of the Farm Credit System.

NOTE: Land values data are to be regarded as confidential until released by the USDA in late June.

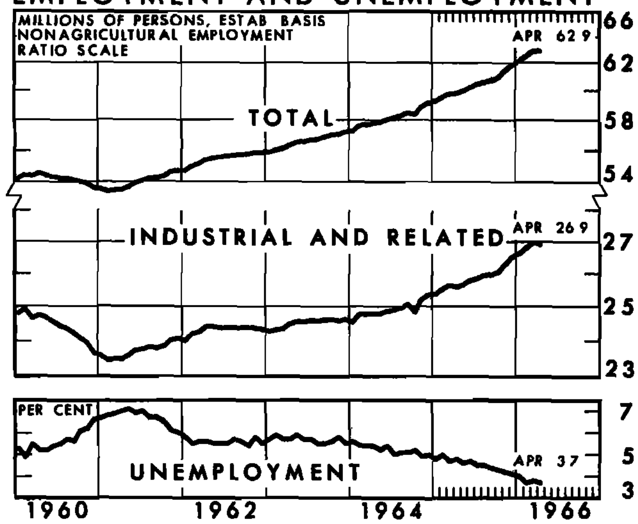
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

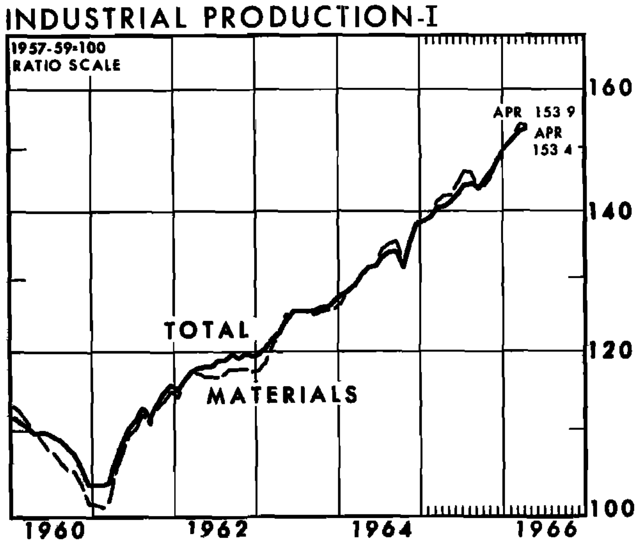
GROSS NATIONAL PRODUCT



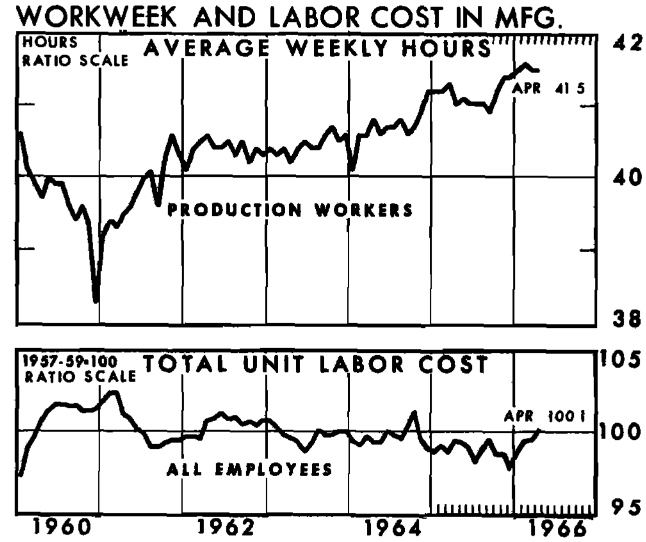
EMPLOYMENT AND UNEMPLOYMENT



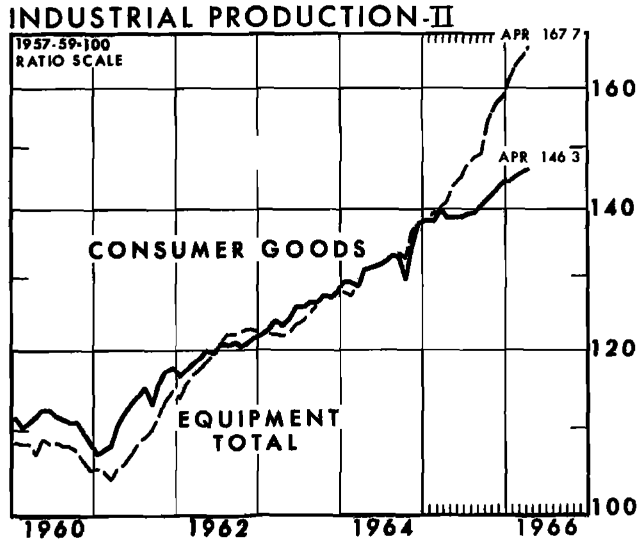
INDUSTRIAL PRODUCTION-I



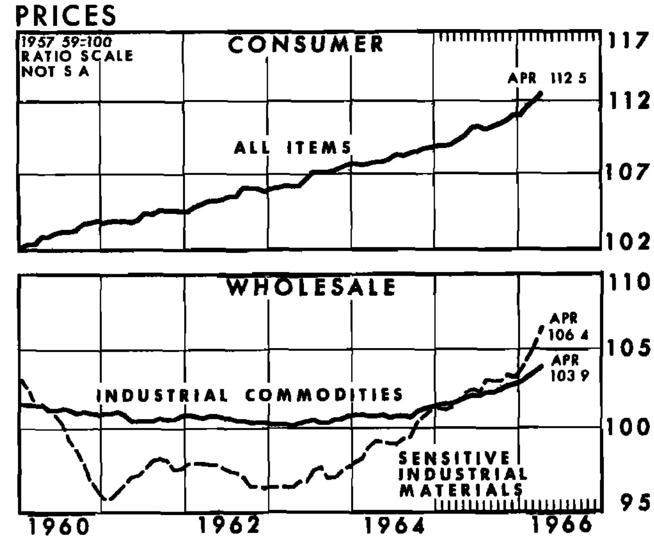
WORKWEEK AND LABOR COST IN MFG.



INDUSTRIAL PRODUCTION-II



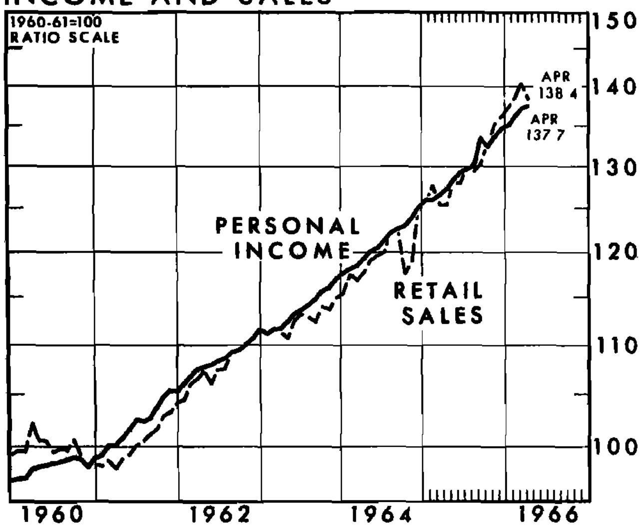
PRICES



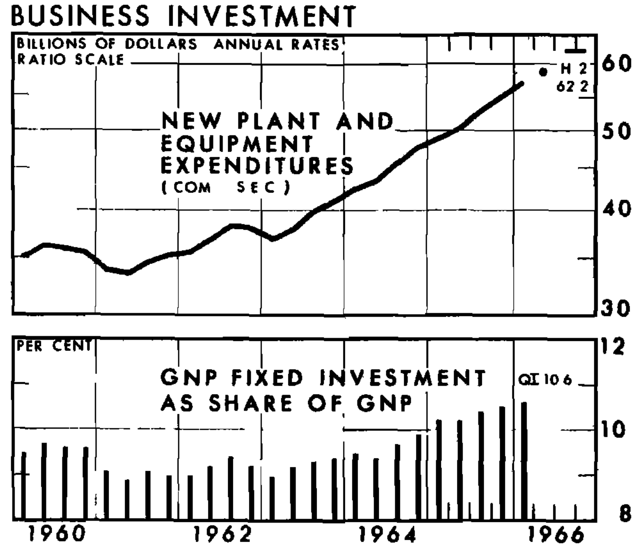
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

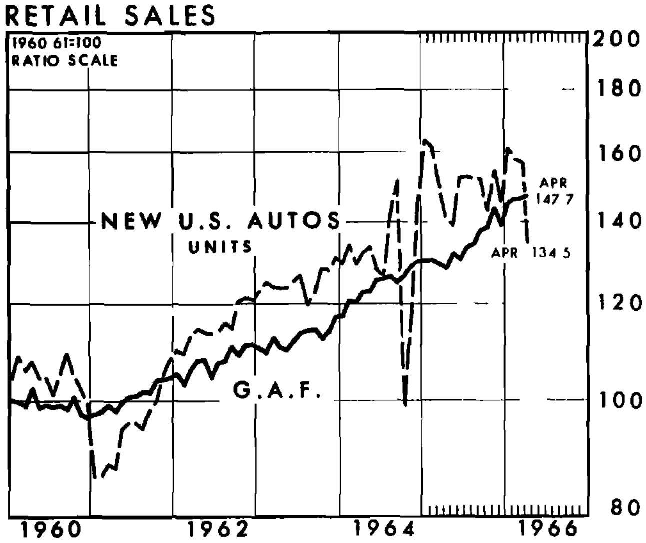
INCOME AND SALES



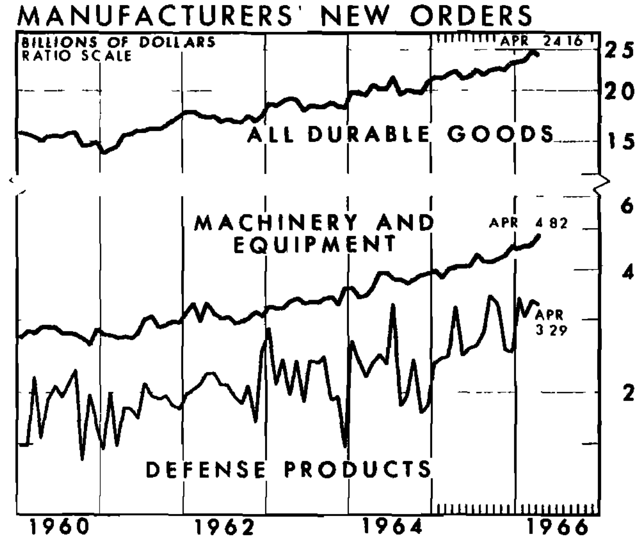
BUSINESS INVESTMENT



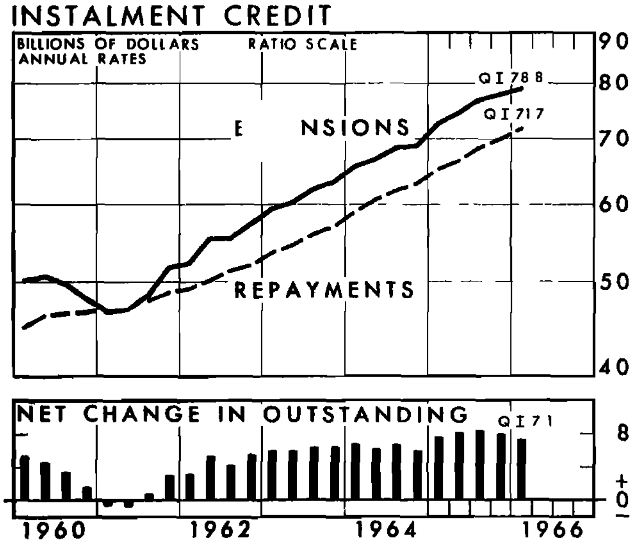
RETAIL SALES



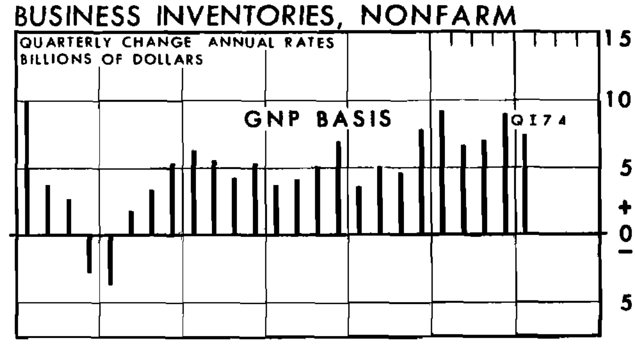
MANUFACTURERS' NEW ORDERS

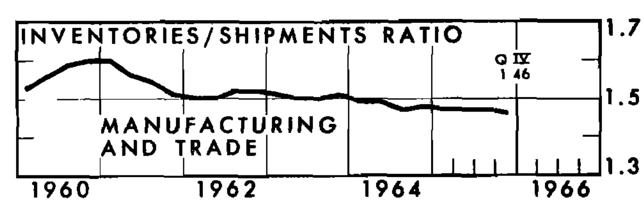


INSTALMENT CREDIT



BUSINESS INVENTORIES, NONFARM





DOMESTIC FINANCIAL SITUATION

Bank credit. Total bank credit is estimated to have expanded at an annual rate of only about 5-1/2 per cent from the end of April to the end of May, about half the March-April average rate of growth. While business loan demand was strong, expansion in total loans was moderate, reflecting in part repayments of heavy March and April tax-related borrowing by finance companies and securities dealers.

Following substantial acquisitions of investments in April, when deposit inflows were large and business loan demands less strong, banks reduced their total security holdings by about $200 million in May. About $1.2 billion of Treasury issues were liquidated, with a large part of the decline evidently reflecting maturing obligations that were not exchanged for the refunding 4-7/8 per cent 18-month note. The large attrition in the refunding was due in part to the relative attractiveness of new Federal Agency issues. Bank holdings of securities other than Treasury issues rose at an annual rate of more than 25 per cent, following a 20 per cent rate in April. These acquisitions, which probably included substantial purchases of Federal Agency issues, were heavily concentrated in the San Francisco District, where total time and savings deposit inflows recently have been quite large.

Business loan expansion in May accelerated to about the 20 per cent annual rate of the first quarter of this year -- or twice as much as the April expansion, which had been retarded by two large loan repayments from the proceeds of capital market issues. Expansion was widely distributed by industry, except for construction, where demands were less than seasonal, and food processors, commodity dealers, and trade firms, where demands were only seasonal in amount. It thus appears that over-all business demands for credit remain large. With the decline in new capital market issues from the high first quarter pace and with the liquidation of assets to pay March and April tax liabilities having reduced corporate liquidity, more of these demands may be in the process of being directed toward banks.

Bank deposits. Following the very large increases in March-April, private demand balances at banks are estimated to have declined at about a 15 per cent annual rate in May. In part, this decline reflected a larger than usual build-up of Government deposits from late April to mid-May, but it also reflected a delayed reaction to the very sharp run-up in money balances over the previous two months.

Time and saving deposits at all commercial banks are estimated to have expanded at about an 11 per cent annual rate in May, down somewhat from the 16 per cent rate of April but above the 7 per cent rate of the first quarter. The May pattern of deposit inflows was similar to that in April. As indicated in the table, savings deposits continued to decline, although at a sharply reduced rate, and time deposits other than negotiable CD's continued to expand, also at a reduced rate. These movements, of course, reflect increased offering rates on time deposits since mid-March, particularly on smaller denomination certificates, and the slow-down from April to May is due mainly to the end of one-time shifts of funds after time deposit rates were raised in late March and early April.

New York City bank inflows of total time and savings deposits in both April and May remained below the 1965 pace, but other weekly reporting banks have been able to increase their total time and saving deposit inflows more rapidly than during the comparable period last year. Both groups lost savings deposits, but city banks outside of New York -- especially on the West Coast -- had sharp inflows of time deposits other than negotiable CD's.

Country banks -- whose inflows of time and savings deposits decelerated in March and April--experienced sharply increased deposits in May, while reserve city bank inflows in May were less than in April. This reversal may reflect, in part, the competitive reaction of country banks, which previously have paid relatively low rates on time and savings deposits and which might have posted rate increases only after retardation of deposit inflows forced this action. The evidence, however, is spotty, and seasonal adjustment problems do not permit any fine disaggregation of rates of growth by class of bank.

CHANGES IN TIME AND SAVINGS DEPOSITS
WEEKLY REPORTING BANKS
(millions of dollars)

	Total		New York City		Other	
	1966	1965	1966	1965	1966	1965
			First quarter*			
Total	2,741	4,259	687	1,454	2,054	2,805
Savings	- 251	1,625	-157	274	- 94	1,351
Negotiable CD's	1,096	1,379	333	614	763	765
Time deposits other than CD's	1,896	1,255	511	566	1,385	689
			April*			
Total	812	941	205	522	607	419
Savings	-1,734	- 174	-230	- 34	-1,504	- 140
Negotiable CD's	309	779	154	614	155	165
Time deposits other than CD's	2,237	336	281	- 58	1,956	394
			May*			
Total	870	787	185	480	685	307
Savings	- 178	299	- 41	49	- 137	250
Negotiable CD's	295	369	131	414	164	- 45
Time deposits other than CD's	753	119	95	17	658	102

* For the first quarter, changes were calculated from December 29, 1965 to March 30, 1966, and from December 30, 1964 to March 31, 1965; for April, from March 30 to April 27, 1966 and from March 31 to April 28, 1965; for May, from April 27 to May 25, 1966 and from April 28 to May 26, 1965.

Outstanding negotiable CD's increased by less than $300 million in May, with 55 per cent of the growth occurring outside New York City. New York banks since mid-May have increased their offering rates on CD's about 12 basis points on 6-12 month maturities, and other large weekly reporters have posted similar or moderately larger increases. By the month-end, most often quoted rates were generally at 5.50 per cent for 6-month and over CD's, with some reports of shorter maturities also at 5.50. Very short maturities -- especially those under 60 days -- generally bore rates of 5 to 5-1/8 per cent, considerably below secondary market yields on comparable maturities, suggesting that banks were not greatly interested in selling such CD's.

While competition from other short-term instruments has tended to put upward pressure under CD rates in the last 2 months or so, banks may also have found the CD market to be somewhat tighter than previously for institutional reasons. Bank sales of shorter CD's has tended to make secondary market trading rather thin, reducing the liquidity of CD's, and perhaps tending to lead to a reduction of corporate demand for these instruments at a time when a premium is being placed on liquidity. In addition, recent Congressional discussion of proposed legislation to outlaw or impose statutory rate ceilings on these instruments may also have influenced the demand for them.

Distribution of excess and borrowed reserves. Since the early weeks of this year, country member banks have sharply increased their borrowings from the Federal Reserve to well above the 1959 level. In addition, the number of country banks using the discount window -- both at any time or continuously within the most recent 12 weeks -- has risen to the highest level of this expansion, although the number of country banks discounting has not reached the highs of 1959. Reserve city banks, on the other hand, have increased their borrowings only modestly over this period. Indeed, from February through May, country banks have accounted for about 70 per cent of the increase in member bank borrowing and 93 per cent of the increased net borrowed reserve position of member banks.

Country bank excess reserves also have declined relatively more than those of reserve city banks in the last three months, although the absolute decline has been small. However, thus far during the 1960's excess reserves at country banks have shown a pronounced downward trend and currently are at the lowest level since 1933. With excess reserves approaching minimal levels and their borrowing rising, country banks as a group in May were in a net borrowed position for the first time since 1933.

The factors occasioning the recent sharp increase in borrowing by country banks (both absolutely and relative to city banks) and further reduction in excess reserves are not completely clear. There may be a number of explanations that can only be discerned from a more disaggregated analysis. But it does appear that country banks are managing their reserves more closely as interest rates, especially the

Federal funds rate, rise. The rise in the funds rate to levels as high as 3/4 of a percentage point above the discount rate may also be an expression of the extent to which large city banks are willing to finance their reserve needs without recourse to the discount window. As they do so in a period when the System is tightening up on net reserve availability, the burden of reserve adjustment through borrowings will fall on other banks unable or unwilling to acquire Federal funds at the premium rate.

U.S. Government securities market. Yields on Treasury notes and bonds have risen since mid-May, after exhibiting slight decline earlier in the month. Yields on issues in the 3-5 year maturity area are currently very close to new highs while yields on long-term bonds remain below their highs reached in late winter. Treasury bill rates have fluctuated in a narrow range since early May, in contrast to other short-term rates which have risen further.

YIELDS ON U.S. GOVERNMENT SECURITIES
(Per cent)

Date (closing bids)	3-month bills	6-month bills	3 years	5 years	10 years	20 years
1959-1961						
Highs	4.68	5.15	5.17	5.11	4.90	4.51
Lows	2.05	2.33	3.08	3.30	3.63	3.70
1966						
Highs	4.70	4.90	5.12	5.03	5.02	4.81
Lows	4.46	4.65	4.78	4.76	4.56	4.49
1965-1966						
Dec. 3	4.12	4.26	4.54	4.52	4.52	4.44
Feb. 28	4.64	4.84	5.06	5.03	5.02	4.81
May 2	4.65	4.77	4.98	4.86	4.80	4.71
May 17	4.64	4.85	4.95	4.84	4.75	4.66
June 1	4.63	4.78	5.10	4.97	4.79	4.73

During the past month yields on long-term Treasury bonds have been alternately affected by bullish and bearish background developments, including in particular changes in stock prices and the fluctuating outlook for a tax increase. Most recently, some advance in yields occurred on the appearance of investment selling which reportedly included some swapping into relatively attractive corporate and Federal Agency issues. An additional note of caution was introduced into the market in late May following the Treasury's suggestion that Congress might wish to consider raising the 4-1/4 per cent coupon ceiling in the next fiscal year and allow the Treasury to issue up to, say, $5 billion longer-term bonds at higher interest rates.

The narrow movement of bill rates in recent weeks has reflected a neutralization of strong opposing tendencies. Over-all demand for bills, including that from the System, has been substantial since late April and most recently dealer bill inventories have been reduced to quite low levels. Despite this demand and inventory situation, however, the bill market has retained a cautious undertone and the tendency for bill rates to move lower has been restrained by higher dealer financing costs and by rising rates in other sectors of the short-term debt market. These other short-term rates are shown in the table which follows:

SELECTED SHORT-TERM INTEREST RATES 1/

	1965	1966	
	Dec. 3	May 2	May 31
Commercial paper 4-6 months	4.375	5.375	5.50
Finance company paper 30-89 days	4.375	5.375	5.375
Bankers' Acceptances 1-90 days	4.25	5.125	5.375
Certificates of deposit (prime NYC)			
Most often quoted new issue:			
3-months	4.50	5.125	5.25
6-months	4.50	5.25	5.40
Highest quoted new issue:			
3-months	4.50	5.375	5.40
6-months	4.50	5.40	5.50
Federal Agencies:			
3-months	4.34	4.98	5.10
6-months	4.49	5.12	5.33
9-months	4.58	5.42	5.56
Prime Municipals 1-year	2.65	3.25	3.30

1/ Rates are quoted on offered side of market; rates on commercial paper, finance company paper, and bankers' acceptances are quoted on a bank discount basis while rates on the other instruments are on an investment yield basis.

Federal Agency securities market. Yields on Federal Agency securities have risen sharply in recent weeks, reflecting continuing pressure from a large supply of new offerings. Issues reaching the market in late May were priced at new high yields, including a 5.60 per cent rate on 9-month FICB debentures. As the accompanying table indicates, the total amount of new cash to be raised through Federal Agency debt in the second quarter is expected to approximate $4-1/2 billion, including $1-3/4 billion in pool sales. Staff projections suggest, however, that the net amount of new cash to be raised in this market during the third quarter is likely to fall off sharply from the record second quarter pace. Nevertheless, in both the third and fourth quarters the total is still expected to be sizable in relation to earlier quarters, as the table shows. It should be noted that the quarterly pattern of pool sales is highly uncertain and could be adjusted in keeping with market developments. For fiscal 1967 as a whole, the Budget Document has projected pool sales totaling $4.2 billion compared with $3.1 billion in the current fiscal year. Legislation enacted in late May would permit an expansion in these pool sales since the growing total of now eligible securities will approximate $11 billion at the end of the current fiscal year.

AGENCY DEBT ISSUES
(Billions of dollars)

	Net Cash Borrowing through Direct Agency Debt 1/	Pool Sales 2/	Total
1965 - Q1	*	--	*
Q2	1.1	--	1.1
Q3	.4	.5	1.0
Q4	.2	.4	.5
1966 - Q1	.9	.4	1.2
Q2	2.6	1.8	4.4
Q3	.8	1.0	1.8
Q4	.3	1.0	1.3
Fiscal Year			
1965	1.4	.8	2.1
1966 estimated	4.1	3.1	7.1
1967 projected	2.8	4.2	7.0

* Less than $50 million.

1/ In addition to net cash borrowing, Agencies will have to refund some $3.4 billion of maturing issues in the third and fourth quarters of 1966.

2/ Total sales, exclusive of any maturities. Such maturities were about $400 million in fiscal year 1966 and will be about $900 million in fiscal year 1967.

Treasury finance. The Treasury's cash operating balance is expected to rise to around $10 billion at the end of June, below the postwar $11.5 billion record set last June but about the same as in June 1964. A large seasonal cash drain is projected for July and while the Treasury is likely to have enough cash to meet this drain, it may begin its program of financing the second half deficit in that month. An issue of tax anticipation bills would be the most probable financing instrument. The Treasury's next regularly scheduled financing will be the August refunding involving a moderate $3.2 billion of publicly-held maturing debt.

Corporate and municipal bond markets. Yields on corporate and municipal bonds rose further during May, carrying reoffering quotations on new corporate issues through the earlier postwar highs reached at the beginning of March. While yields on outstanding State and local government bonds are still 6 to 12 basis points below their early March highs, recent advances in reoffering rates on new issues, along with an expansion of dealers' advertised inventories, suggest that further near-term increases in municipal yield averages are likely.

BOND YIELDS
(Per cent per annum)

	Corporate Aaa		State and local Government	
	New	Seasoned	Moody's Aaa	Bond buyer (mixed qualities)
Previous Postwar High	5.13(9/18/59)	4.61(1/29/60)	3.65(9/24/59)	3.81(9/17/59)
1965 low	4.33(1/29)	4.41(3/12)	2.94(2/11)	3.04(2/11)
Weeks ending:				
Dec. 3	4.79	4.60	3.37	3.50
Mar. 4(high)	5.38	4.85	3.63	3.83
Apr. 8(low)	4.90	4.98	3.44	3.55
May 13	5.15	4.95	3.52	3.62
May 20	5.21	5.01	3.52	3.64
May 27	5.57*	5.02	3.57	3.72

*--Not representative.

Spreads within the structure of long-term rates have widened further, as yields on new corporate bonds have advanced more than those on other bonds. Thus, at the end of May margins between yields on new corporate bonds and those on outstanding Treasury and corporate issues were about as wide as in the 1959-60 period of peak interst rate pressure. To a considerable extent enlarged current yield spreads reflect increased premiums being placed on call protection at a time when rates are historically high. But beyond this, the current tendency for corporate bond yields to run ahead of other long rates reflects the continuing pressure of large corporate demands on available supplies of long term funds.

While estimates of bond offerings in the current quarter suggest that the weight of such corporate borrowing demands may have moderated somewhat relative to the first quarter (particularly so if one allows for the fact that corporate borrowing typically peaks in the second quarter of the year), new capital financing by corporations in June -- including stock as well as bonds -- is expected to be substantially larger than in March, the previous peak month of the year.

In May the volume of publicly-offered corporate bonds fell below that of earlier months and was also smaller than in May a year ago. While public offerings in June will rise sharply relative to May, gross corporate bond offerings for the second quarter are likely to be less than in the first quarter, and unless private placements continue to show an unprecedented year-to-year growth, they may not greatly exceed the second quarter of 1965. The impression of reduced corporate financing pressure suggested by these data is somewhat misleading, however, for in June a year ago more than half of the large volume of publicly-offered debt represented issues of financial corporations. This year's large June bond calendar is wholly attributable to the accumulated borrowing requirements of nonfinancial corporations, and with six such companies also scheduled to raise about $850 million on stock offerings in June, the monthly volume of new capital financing of all types may amount to $2.5 billion.

In the face of these large continuing corporate demands for funds, rate pressures have also developed on the supply side of the market as funds available for bond acquisition at the types of institutions which lend major support to the corporate bond market have become less plentiful. During the first quarter, heavy corporate debt offerings, historically high yield levels, and a view that long-term yields might turn-down by the end of the year apparently encouraged pension funds and life insurance companies to make unusually large forward commitments of funds. At the same time, larger than expected take-downs of outstanding loan commitments, a drop-off in loan prepayments, and, at life insurance companies, accelerated withdrawals of dividend accumulations and increases in policy loans have reportedly put further strain on institutional cash flows at some companies. Consequently, funds available for current commitments are quite limited relative to those of other recent years. In these circumstances an increasing number of life insurance companies have turned to commercial banks to draw on credit lines which in the past had typically gone unused.

CORPORATE SECURITY OFFERINGS 1/
(In millions of dollars)

	Bonds				Stocks	
	Public Offerings 2/		Private Placements			
	1966	1965	1966	1965	1966	1965
January	480	161	860e/	565	190	131
February	560	187	800	450	133	155
March	753	557	1,000e/	658	417	143
April	650e/	422	700e/	648	250e/	162
May	490e/	694	700e/	630	100e/	449
June	700	748	1,000e/	980	850e/	309

1/ Data are gross proceeds.
2/ Includes refundings.

In the market for State and local government bonds, a large calendar of prospective offerings, together with rising yields in other bond markets, has led dealers to raise yields on new and recently offered issues in an effort to minimize the build-up of their advertised inventories. Even so, inventories have risen from less than $500 million to more than $575 million over the past few weeks. While the June volumes of new issues is presently estimated at $1.2 billion, larger than a year ago, a few small issues have been postponed recently, and $300 million of the indicated June total represents two large negotiated offerings whose timing is uncertain and might be affected by the state of market yields.

MUNICIPAL BOND OFFERINGS
(In millions of dollars) 1/

	State and local government	
	1966	1965
January	1,833	849
February	816	966
March	845e/	1,036
April	1,150e/	994
May	900e/	987
June	1,200e/	1,065

1/ Data are for principal amounts of municipal issues.

Mortgage markets. The full impact of the still tightening mortgage market on net debt formation and on construction activity may be delayed for some time mainly because of the relatively large backlogs of commitments still outstanding. In April, the year-to-year pattern of net debt formation reported in the first quarter apparently still continued; the increase for the Federal National Mortgage Association more than offset year-to-year declines in net holdings within the private-lender group for which data are currently available. Allowing for life insurance companies, which probably exceeded their net increase in April of last year ($344 million), the total decline for private holders would be less than implied in the table.

NET CHANGE IN MORTGAGE HOLDINGS
April
(Millions of dollars)

	1963	1964	1965	1966
Total, incl. FNMA	1,623	1,614	1,348	1,480
Private only	1,900	1,643	1,507	1,264
Savings and Loan Associations	1,073	909	709	609
Mutual Savings Banks	327	334	298	155
Commercial Banks	500	400	500	500
FNMA	-277	-29	-159	216

For the future, however, recent Federal Reserve and other reports indicate that tightening within the mortgage market has accelerated over the past two months in the case of both new and existing properties, particularly residential structures. Not only are mortgage funds generally more expensive but also new commitments have become much more difficult to secure than earlier this year. In most Federal Reserve districts such commitments have ranged a fifth or more below a year earlier, with some lenders reportedly out of the market altogether for the time being. Also the increasingly restrictive FNMA purchasing policy resulted in net additions to FNMA holdings in April below both the $315 million for March and the monthly average in the first quarter. In view of the reduced volume of mortgages being offered for purchase by FNMA, some further reduction in the amount of expansion in the FNMA portfolio is indicated for May.

For the private-lender group, slowing in net portfolio growth has reflected mainly reduced net savings inflows to all depository institutions, particularly savings and loan associations and mutual savings banks. While repayment flows from regular amortization and prepayment on existing portfolios have been a strong support, uncertainty has continued with respect to (1) the pattern of net savings inflows just before or after July 1 when quarterly and semiannual dividend periods for savings and loan associations will be completed; (2) the levels to which contract rates and other terms might go; and (3) prospects of further changes in current FHLBB, FNMA and other agency regulations that might affect near-term developments.

Contract rates on conventional first mortgages on homes increased appreciably in April, according to the Federal Home Loan Bank Board. This series, which moves more sluggishly than a similar series reported by FHA, showed a nine-basis point rise in April to a level 20 to 25 basis points above a year earlier. Among the major lender-groups, the year-to-year increases were most marked for life insurance companies. at about 40 basis points for loans on existing homes and somewhat more for loans to purchase new homes. Fees and charges have also risen appreciably from a year earlier. Less liberality in loan-to-price ratios and maturities has been reported particularly in the case of new home loans, but the shift has not been pronounced.

AVERAGE TERMS ON CONVENTIONAL FIRST MORTGAGES FOR HOME PURCHASE

	1966		Per cent change in April from a year ago
	March	April	
New home loans			
Contract rate	5.90	5.99	4
Loan amount ($1,000)	18.9	18.2	1
Loan/price (per cent)	74.3	73.9	--
Maturity (years)	24.7	24.6	-1
Existing home loans			
Contract rate	6.01	6.09	3
Loan amount ($1,000)	14.7	14.5	4
Loan/price (per cent)	72.5	72.2	1
Maturity (years)	20.9	20.6	1

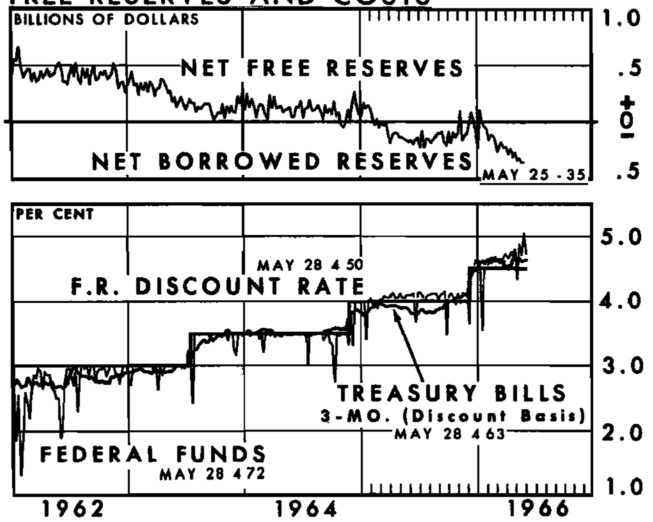
Stock market. Showing considerable sensitivity to day-to-day news of changing economic and political events, stock prices have continued to fluctuate rather widely in recent weeks. Nevertheless, until Monday of this week when stock prices suffered a sharp decline, the very recent price trend had been upward. For example, by May 27 Standard and Poor's composite index of 500 stocks had recovered nearly half of the 9-1/2 per cent price decline experienced from April 21 through May 17. Since then it has lost about 1-1/2 per cent of this recovery and currently stands at 86.10, roughly 8 per cent below its all-time high on February 9.

A significant development since the April market break has been the general contraction of stock trading activity. At mid-April the average volume of such activity was running about 10.7 million shares per day, whereas in the most recent week it had dropped to 6.2 million shares a day. Over the same period trading on the American Stock Exchange also dropped from 6.1 million to less than 3 million shares per day. To some extent this general decline in trading activity may reflect the tighter margin requirements imposed on day-traders by the two exchanges, effective April 25. But a more significant influence on trading has probably been the discouragement to speculative activity created by the late-April to mid-May price correction.

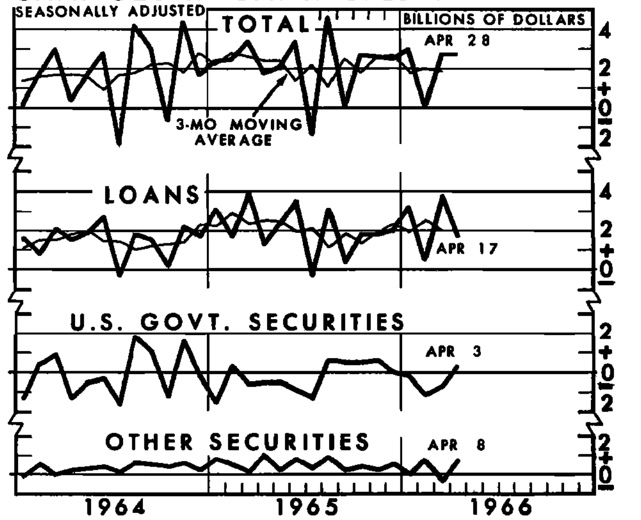
For all of April when speculative incentives were generally more ebullient and stock prices showed substantial net advances, stock market credit rose $168 million. Customers' net debit balances with brokers were wholly responsible for the increase, since purpose loans at banks declined another $22 million. Taking a somewhat longer view, stock market credit rose $285 million over the first four months of 1966, a slower rate of expansion than in the period of renewed stock market credit growth that developed in the final five months of 1965. From August through December of 1965 total stock market credit had expanded $875 million, more than offsetting the $460 million decline that had occurred from November 1963 -- when margin requirements were last raised -- through July 1965.

FINANCIAL DEVELOPMENTS - UNITED STATES

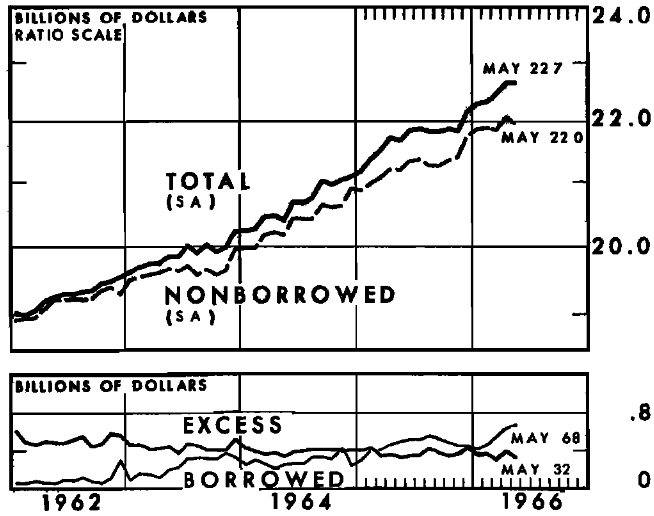
FREE RESERVES AND COSTS



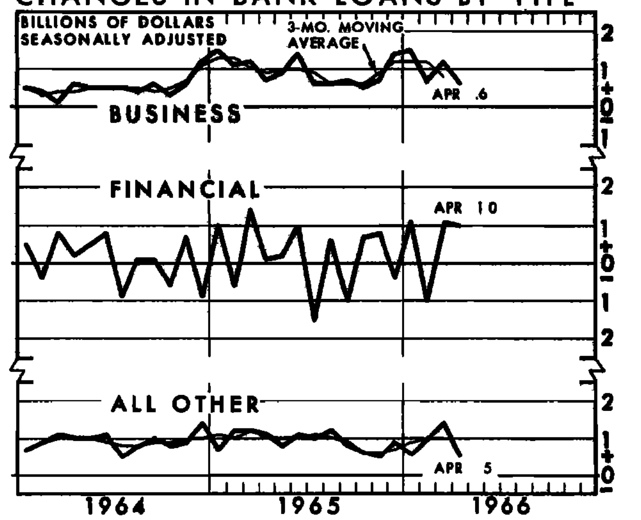
CHANGES IN BANK CREDIT



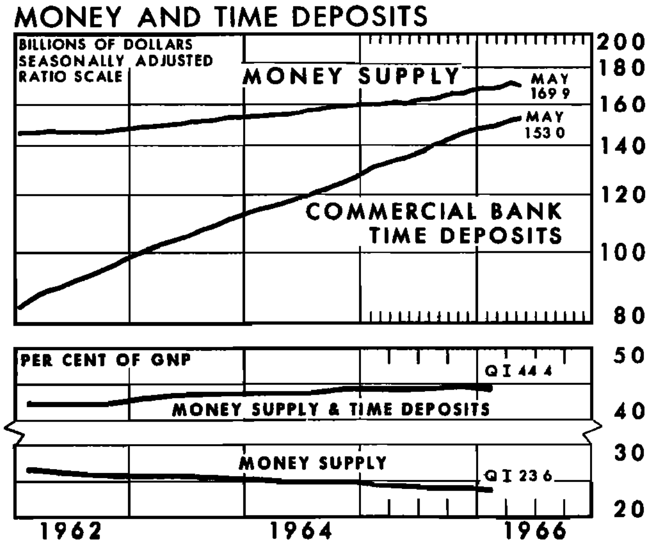
BANK RESERVES



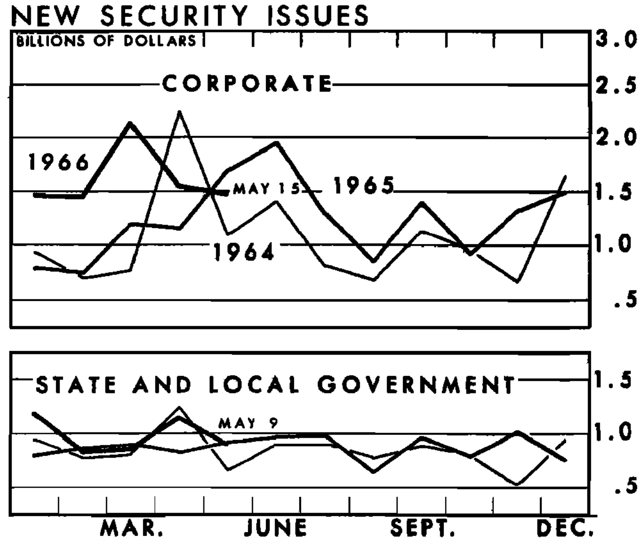
CHANGES IN BANK LOANS-BY TYPE



MONEY AND TIME DEPOSITS

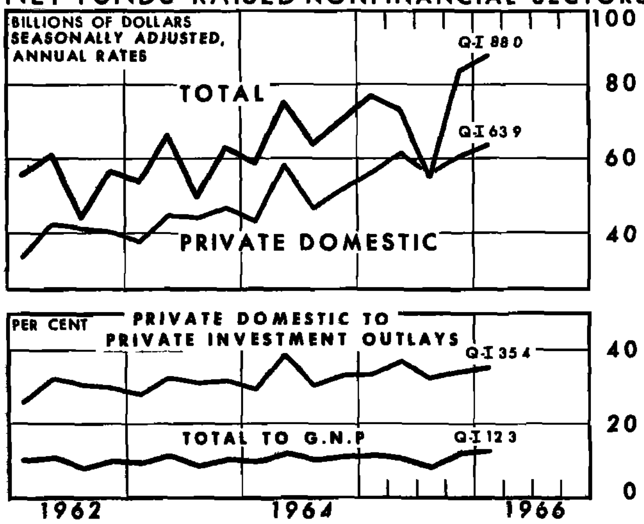


NEW SECURITY ISSUES

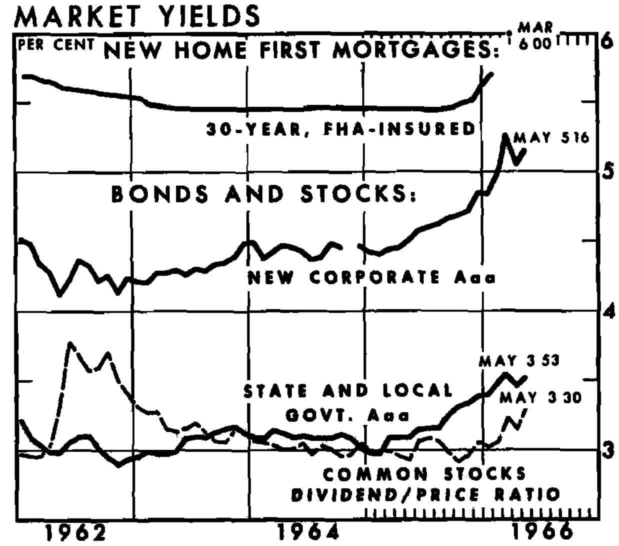


FINANCIAL DEVELOPMENTS - UNITED STATES

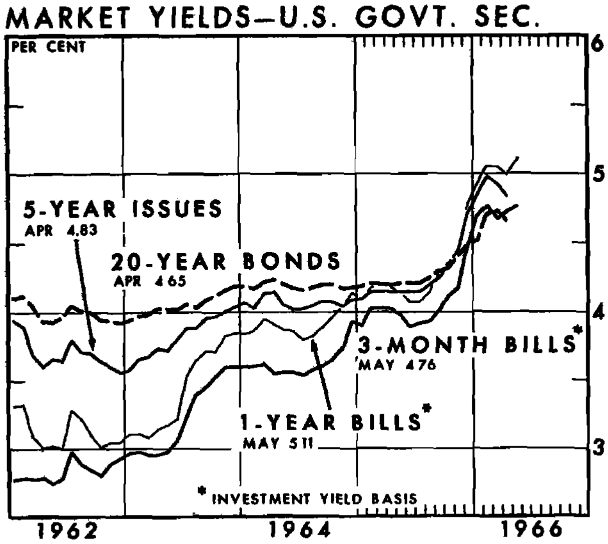
NET FUNDS RAISED-NONFINANCIAL SECTORS



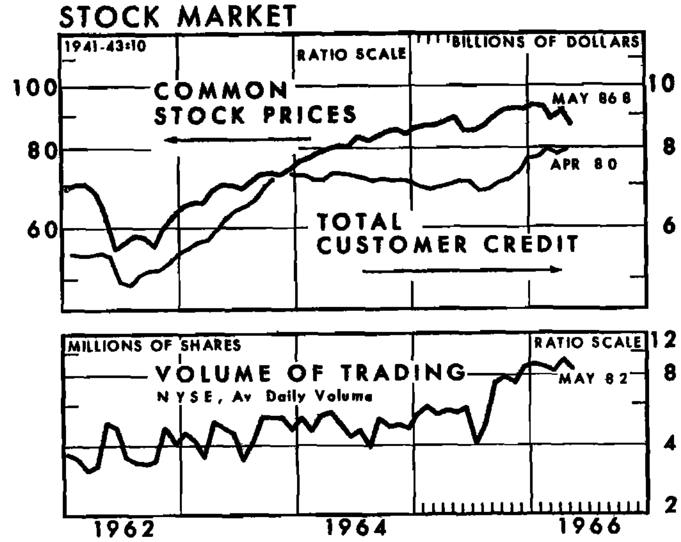
MARKET YIELDS



MARKET YIELDS—U.S. GOVT. SEC.



STOCK MARKET



INTERNATIONAL DEVELOPMENTS

U.S. balance of payments. The April deficit on the official reserve transactions basis was $200 million and the deficit on the liquidity basis was $275 million (both figures before seasonal adjustment). If a zero or small adverse seasonal adjustment is assumed for April and if the April figures are combined with first quarter data ($260 million deficit on official reserve transactions and $580 million deficit on liquidity basis, both figures seasonally adjusted), the annual rate of the official reserve transactions deficit in the first third of the year has been about $1-1/2 billion and that of the liquidity deficit about $2-1/2 billion.

Growth of U.S. liquid liabilities in the first four months of the year was held down by several unusual transactions. Foreign governments shifted some $130 million into long-term time deposits and Federal agency securities not guaranteed by the U.S. Government. International institutions likewise placed upwards of $200 million in long-term time deposits and such Federal agency bonds. While shifts of funds into these non-liquid forms by international institutions may represent a continuation of past practices, a major factor explaining the shift in foreign official funds has been pointed encouragement from the U.S. Government. All these transactions have had the effect of improving the liquidity deficit. None effectively lessens the "exposure" of the U.S. gold stock.

The seasonally adjusted official settlements deficit in January-April was nearly as large as a year earlier, and the liquidity deficit was significantly larger. Yet U.S. reserve assets declined only half as much -- \$0.5 billion compared with \$1.1 billion in the first four months of 1965. About half of the decrease was in holdings of convertible currencies (mainly sterling, reflecting repayment of the U.K. swap); there were also drawings on the IMF, reducing our gold tranche position. The gold stock declined only \$138 million, compared with \$991 million a year earlier (when France made large purchases). This year's decline would have been larger if the IMF had not deposited \$147 million of gold to mitigate the impact on the U.S. gold stock of the current round of IMF quota increases, and if Canada had not sold \$100 million of gold to the United States. The gold stock declined \$86 million further in May.

The foreign trade returns for April are discouraging. Exports, which had risen sharply in March, dropped back to an annual rate of less than \$28 billion on the balance of payments basis -- some 2-1/2 per cent below the first-quarter average. Imports, at an annual rate of about \$25 billion, were close to the high March level and much above January-February. Viewing the first four months of 1966 as a whole, the trade surplus was about \$4 billion (annual rate) as compared with just over \$5 billion for the fourth quarter 1965. Exports were only fractionally higher than in the fourth quarter, while imports were up by about 6 per cent.

The increase in imports from the fourth quarter to January-April was dominated by consumer goods and capital equipment, categories which had shown particularly marked increases last year. Imports of autos were up by one-third. In part this was the result of imports from Canada under a duty-free arrangement and may have been partly offset by the high level of exports of auto parts from the U.S. to Canada. Imports of non-food consumer goods other than autos are estimated to have increased by as much as 10 per cent between the fourth quarter of 1965 and January-April 1966. Machinery imports, which had risen rapidly in 1965, increased 8 per cent further.

On the other hand, industrial materials imports increased by less than 2 per cent, as a sharp fall in steel imports, concentrated in January and February, partly offset a 3 per cent rise in other industrial materials.

The sluggish export performance can be attributed in part to the decline of agricultural exports from the exceptional level ($6.8 billion at an annual rate) reached in the fourth quarter of 1965 to an annual rate in January-April of $6.6 billion. However, non-agricultural exports this year have been only about 1 per cent above the fourth quarter level. Little information beyond that reported in the last Green Book is available on the composition or area distribution of exports.

Other April data relating to the balance of payments are confined to bank-reported assets abroad and new foreign security issues. There were further substantial reflows of bank credits in April. For the first 4 months of 1966 the net reduction in outstanding short- and long-term claims on foreigners reported by banks in the United States has been at a seasonally adjusted annual rate of about $1 billion. (Bank claims under the VFCR, for which the seasonal adjustment could be expected to be similar, also declined at a $1 billion annual rate).

Three-fourths of the reflows this year have been in short-term assets, with sizable declines in outstanding bank loans and acceptance credits and also in bank-reported holdings of deposits and money market paper. (Through March, non-banks reported net outflows of liquid funds of about $100 million, approximately offsetting the reflows reported by banks.) Outstanding long-term bank claims were cut in the first quarter, in part as a result of sell-offs of loans from head office portfolios to foreign branches, but long-term loans rose in April.

Recent data on new long-term loan commitments to foreigners do not appear to foreshadow any significant reflow on term loans. New commitments in March and April were close to a rate of $100 million a month, after having fallen to about half this rate in January-February. The March-April rate of new commitments, if matched by disbursements, would probably offset the current reflow of amortizations and repayments, and thus maintain the volume of outstanding term loans to foreigners near present levels. (A similar rate of new commitments in the last 10 months of 1965 was accompanied by little change in long-term loans, apart from reductions attributable to sell-offs.) In the absence of further reflows of long-term loans, the $1 billion annual rate of reflow of total bank credit is unlikely to be sustained -- barring any such major structural shift in the financing of trade as would be involved in the Japanese authorities' allowing extensive replacement of external by domestic credit in the financing of Japanese importers.

On the other hand, the net outflow on new foreign security issues in the first 4 months has been exceptionally high, under the pressure of very heavy Canadian offerings. The total outflow for the 4 months has been at a seasonally adjusted annual rate of about $1-3/4 billion, including Canadian issues postponed from late 1965. While Canadian issues this year will doubtless set a record, some easing in the total outflow of foreign issues from the January-April rate should be expected in the rest of 1966 (and in fact foreign security issues fell sharply in May). Such a reduction in outflows on new issues may go a considerable way toward offsetting the effects on the payments balance of reduced reflows of bank credits.

Financial markets abroad. In the past three or four months interest rates have risen in many countries. Especially sharp increases have occurred in Germany, the Netherlands, and Canada. (For earlier developments see the Green Book of February 24.) France, Italy, and Japan continue to have relatively easy credit market conditions.

In Britain, bond yields have risen further and are now at about the peak level of August 1965, or about 1/2 percentage point higher than last October. By May 26, War Loan yielded 6.80 per cent.

Pushing up bond yields, new corporate security issues since last October have been running about three times as large in total as a year earlier. One factor behind this is that the squeeze on bank credit has become very tight. Since early February the ceiling on seasonally adjusted bank credit to the private sector has been fixed, for an indefinite time ahead, at 105 per cent of the March 1965 level. In April 1966 bank loans were only 1/2 of 1 per cent below this ceiling. A factor stimulating bond issues in preference to equities is the deductability of interest payments for the new corporate income tax; previously, interest and dividends were on an equal footing in the British tax structure.

Another factor behind the decline in bond prices and rise in yields may have been the mounting evidence that inflationary pressures were not being held in check by the stabilization effort. Prices and wages have continued to advance steadily. In May unemployment remained at a very low level and job vacancies were the highest for that month in 15 years. Imports in March-April averaged 3 per cent above the 1965 fourth-quarter level.

Mortgage lending by the building societies has expanded strongly since last autumn. The increase last June in the deposit rates paid by building societies, just as competitors for funds were lowering their rates because of the Bank rate decrease at that time, has produced a large inflow of funds to the societies. The higher deposit rate cut into profit margins, with the consequence that a proposal to raise the lending rate from 6-3/4 to 7-1/8 per cent is now under consideration.

There has been no significant change in the levels either of Treasury bill yields or of local authority deposit rates since the Bank rate cut of June 3, 1965 from 7 per cent to 6 per cent. The local authorities have been able to turn to the Public Works Loan Board for medium- and long-term funds whenever the short-term markets have become too tight. As happened in the last fiscal year, it is possible that such borrowings from the central government will exceed the budget estimate -- about $1.2 billion for the current fiscal year, ending March 31, 1967.

It is unlikely that market rates of interest in Britain, short-term or long-term, will ease significantly unless and until the signs of overheating in the British economy begin to diminish and the foreign trade account shows substantial improvement.

In Germany, after a period of seasonal easing at the beginning of the year, market rates of interest resumed their rise, and at an even faster pace than during 1965. The 90-day interbank loan rate, for example, which stood at 3-3/4 per cent in May 1964 and at 4-3/4 per cent in May 1965, averaged 6-1/8 per cent in the first three weeks of May 1966.

In the bond market, the brief rally that started on December 31 gave way within a few weeks to almost complete demoralization. Yields on 6 per cent Government bonds rose from 7.59 per cent in January to 8.05 per cent in mid-May. Even at these yields, funds are not forthcoming in sufficient volume, and new public authority issues are being kept off the market during the months of May and June. Local authorities have turned to the banks for medium- and short-term loans. Outside the officially recognized bond market, borrowers -- both public and private -- have been selling notes that are subject neither to licensing nor to reporting requirements, at rates of about 9 per cent.

These conditions reflect, on the one hand, the severely tightened liquidity position that has been imposed on the banks by the Bundesbank's restrictive monetary policy (implemented in part by reserve requirement increases and rediscount quota decreases), and on the other hand the persistently heavy demand for credit. Demands for funds by governmental units at various levels still reflect deficitary imbalances that are due in part to the income tax cut at the beginning of 1965. Public expenditure trends are strongly upward, and cash balances are no longer large. Strong demand for funds by business borrowers -- despite indications that business capital expenditures are no longer rising rapidly -- has been attributed in part to willingness to assume heavier debt burdens because of the general conviction that now exists in Germany (as well as in some other European countries) that the rise in prices and incomes will continue to cancel off the costs of high interest rates.

Given the Bundesbank's determination to maintain a restrictive monetary policy until cost and price inflation is checked, the May 27 increase in the central bank discount rate from 4 to 5 per cent was virtually mandatory in view of the increases that had already occurred in market rates. Rediscounts had been growing rapidly; many banks had approached and some had reached their rediscount quotas and were willing to pay an additional 1 per cent for "Lombard credits," which are not limited by the quotas. Such advances by the Bundesbank last month were at the unprecedented level of DM 900 million, while rediscounts amounted to DM 7.5 billion. The Lombard rate was raised on May 27 by 1-1/4 per cent.

Before the rise in the Bundesbank rates, bank lending rates had been rising toward the legal maxima, then 7 per cent for discountable paper and 8-1/2 per cent for most other credits. These two ceilings move up automatically by 1 per cent with the discount rate.

Following the discount rate increase, the Federal Banking Supervisory Office raised the rate ceilings for various types of time and savings deposits, effective July 1. The basic savings rate was moved up from 3-3/4 to 4-1/2 per cent. Savings deposits with a notice of 12 months to 2-1/2 years will now receive 5-1/2 rather than 5 per cent. Rates on time deposits for 3 months or longer in amounts exceeding DM 100,000 ($25,000) were freed from restrictions.

In the Netherlands, the central bank discount rate increase of May 2 from 4-1/2 to 5 per cent was the first increase since early 1964, and followed strong advances in market rates during 1965 and the first four months of 1966. Rediscounting at the central bank had become increasingly profitable. This development, together with the emergence and persistence since the latter part of 1965 of substantial deterioration in the Dutch external current account, explains the reversal of the Netherlands Bank's earlier policy of avoiding a discount rate increase.

After three years of inflationary pressures, profit margins have been declining and capital expenditures by Dutch industry have tended to level off. The hesitance about raising the discount rate stemmed partly from a wish not to discourage industrial investments, in view of the continuing labor shortage and the need for productivity gains to enable Dutch industry to compete effectively in world markets.

In Canada, the central bank discount rate was raised on March 14 from 4-3/4 to 5-1/4 per cent, making a total rise of 1 per cent since early December of last year. The Canadian 3-month Treasury bill rate has been close to 5 per cent in the past two and a half months, as compared with 4 per cent last autumn and with levels fluctuating around 3-3/4 per cent during much of 1964 and the first quarter of 1965.

The rise in Canadian interest rates, short- and long-term, that began in the spring of 1965 has reflected a booming economy and a mildly restrictive monetary and credit policy of the Bank of Canada. The spread between Canadian and U.S. long-term rates did not alter much between mid-1965 and February 1966. Since the end of February, however, the dip in U.S. bond yields and further advance in Canadian has widened the spread considerably.

In April there was further expansion of seasonally adjusted bank loans, accompanied, however, by a running down of bank holdings of Government securities. The ratio of "more liquid assets" to total assets fell from 31.0 per cent in January to a record low of 27.9 per cent on May 4. The conventional minimum for this ratio is 30 per cent. By May 18, it was brought up again to about 29 per cent. (This ratio covers cash, money market loans, Dominion Government securities of all maturities, and net foreign assets.)

In several Continental European countries besides Germany and the Netherlands financial markets have tightened over the past twelve months. In Belgium this is a very recent development. The central bank discount rate was raised this week (effective June 2) from 4-3/4 to 5-1/4 per cent. Credit expansion ceilings were reimposed in late April, after having been suspended in mid-1965. In early May, the Cabinet approved an anti-inflationary program that includes a 3-months price freeze. Tariffs and indirect taxes on certain commodities are being lowered in return for commitments from business concerns to reduce prices.

The Belgian internal economic situation resembles the British, in that little expansion of output has occurred over the past year, while prices have been advancing. In March consumer prices were 5.5 per cent higher than in March 1965; wholesale prices were up somewhat less than 3 per cent, but since last autumn their rise had accelerated.

In Switzerland, the tightening of financial markets since early 1965 has been largely a reaction to tighter conditions and higher interest rates in other countries. The 3-month deposit rate by March was back up to its December level of 4.00 per cent. Recently there have been reports of funds being bid for at rates up to 4.25 per cent, in contravention of the agreement among the major Swiss banks. The moderately restrictive ceiling on bank credit expansion has not been altered.

Since mid-1965 Swiss long-term interest rates have been at or close to an all-time high, around 4 per cent for Government bonds. This spring, to facilitate the financing of low and medium-priced housing, the authorities modified the restrictions on foreign capital in Switzerland, effective April 1, to allow foreign purchases of mortgages and mortgage bonds.

In Sweden, long-term bond yields have risen beginning last December. Despite the leveling off in industrial production since mid-1965, prices have continued to rise; the cost of living in February was 8 per cent higher than a year earlier. Business investment expenditure plans are reportedly strong.

In France, Italy, and Japan, the relative ease of credit conditions contrasts with the situation in most other industrial countries. The situation in these countries is a reflection of the larger margins of resources they now have to permit economic expansion, in turn the result of earlier anti-inflationary measures.

Resumption of expansion in France since the spring of 1965 has begun to put some upward pressure on interest rates. Drains on bank liquidity, from currency expansion and from public sector transactions with the central bank, were only partly offset by reserve funds supplied through growth of net official gold and foreign exchange reserves; consequently, rediscounts at the central bank have increased considerably. However, the Bank of France has used variations in the asset ratio, along with its own operations in the money market, to prevent the call money rate from exceeding 4-7/8 per cent at most times.

In Italy, the monetary authorities have aimed to keep credit conditions easy in order to facilitate the resumption of economic expansion. Long-term bond yields have come down substantially, in spite of the recovery of domestic production and some increase in the annual total of new security flotations between 1964 and 1965. The balance-of-payments surplus, which contributes to monetary ease, has continued large (for the time of year). In the 6 months November 1965 through April 1966, the banks' net foreign asset position increased by \$106 million, while the Bank of Italy's reserve increase of \$377 million was a factor supplying lira reserve funds to the banking system.

In Japan, seasonally adjusted bank credit has continued to expand at a fairly steady annual rate of 13 or 14 per cent. The average interest rate on bank loans and discounts fell further in March to 7.54 per cent. This contrasts with the peak of 7.99 per cent reached in the latter half of 1964. Call loan rates through May 21 remained unchanged from the low levels first reached on October 1 of last year.

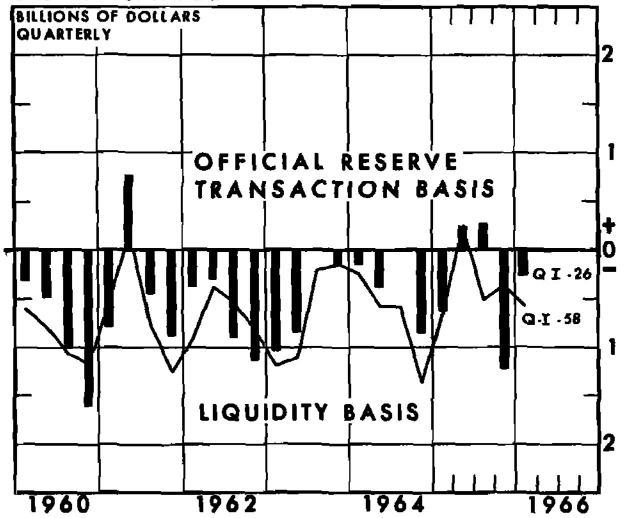
There are signs, however, of a possible mild tightening in monetary conditions. According to the Japanese financial press, the Bank of Japan began in May to shift its easy money policy to a "neutral" policy. Bank of Japan bond sales were increased from the originally scheduled ¥50 billion for May to ¥70 billion. In addition, the monetary authorities will reportedly arrange for an increase in the call loan rate by 0.183 per cent in June. These steps toward mild tightening may have been prompted in part by a rather substantial rise in wholesale prices. In the three-month period ending in February wholesale prices rose 2.1 per cent. After dipping slightly in March, wholesale prices rose again in April to a level 3.4 per cent higher than a year earlier.

Interest rates and commissions on U.S. dollar import acceptance bills now generally exceed the cost of yen financing of imports. In order to avoid too rapid a switch to domestic sources of trade financing, the Japanese authorities have taken steps in recent months to liberalize restraints on the foreign operations of the banks. The foreign exchange reserve requirement (against certain types of short-term foreign liabilities) has been reduced from 25 to 15 per cent. The maximum limit on long positions in foreign exchange has been reduced by about 10 per cent. In addition, moral suasion is used to discourage too rapid a repayment of U.S. credits.

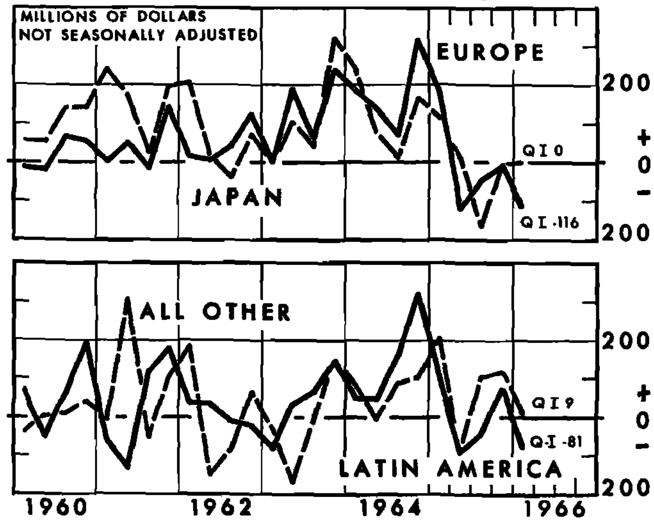
U.S. AND INTERNATIONAL ECONOMIC DEVELOPMENTS

SEASONALLY ADJUSTED

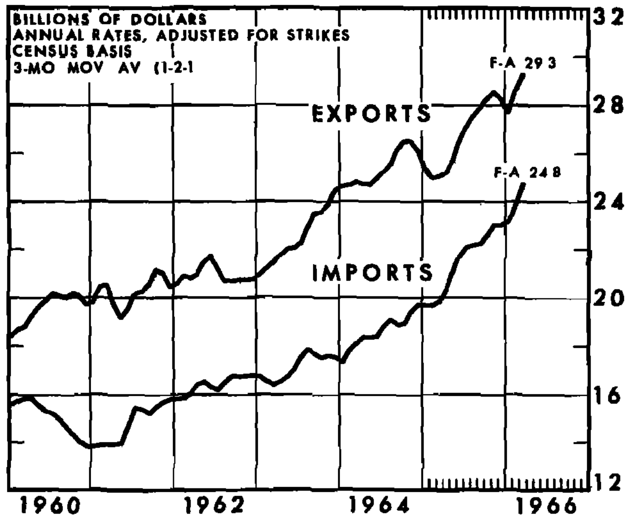
U.S. BALANCE OF PAYMENTS



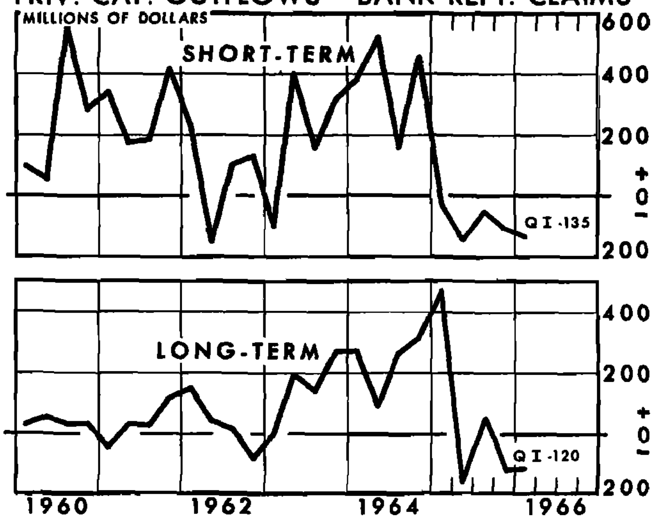
U.S. BANK CREDIT OUTFLOWS



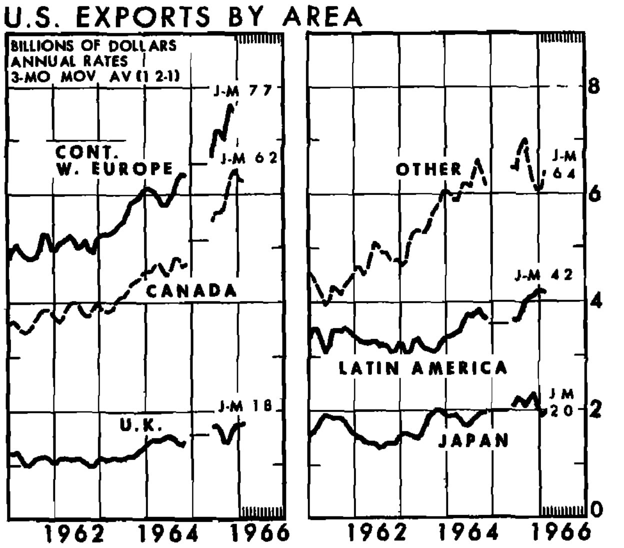
U.S. MERCHANDISE TRADE



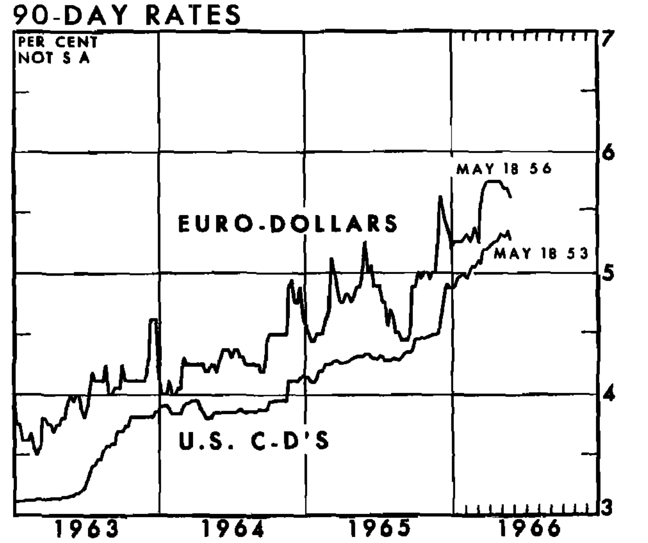
PRIV. CAP. OUTFLOWS - BANK REPT. CLAIMS



U.S. EXPORTS BY AREA



90-DAY RATES



APPENDIX A:
THE EEC: THE END OF THE DEADLOCK OVER AGRICULTURE*

On May 11, the EEC Council of Ministers reached an agreement which represented a major step towards completion of the European Common Market. On July 1, 1968, all import duties among the EEC countries will have been eliminated, the common external tariff will be established, and the common agricultural policy (CAP) will be fully effective.1/

Community activities had been paralyzed for almost one year as a result of a breakdown in the talks on the arrangements for financing the CAP. However, the conflict went much deeper than the mechanics of financing arrangements. The clauses of the Treaty of Rome providing for a common agricultural policy implied that the function of regulating the agricultural sector was to be ceded by the national governments to the EEC institutions. A basic conflict between France and the other members of the Community arose over this matter, which raised the general question of the degree of supra-nationality to be given to the EEC Commission. But even without these political aspects, the CAP was one of the most difficult parts of the Common Market arrangements to reach agreement on because of the great variety in degree and methods of agricultural protection in the member countries.

The aim of the CAP briefly is to:

a) increase agricultural productivity within the EEC;
b) ensure a fair income to EEC farmers;
c) stabilize markets within the EEC; and
d) ensure reasonable prices to EEC consumers.

To achieve these aims, special market regulations are applied to a range of basic commodities which currently account for about 85 per cent of the EEC's agricultural production. With the removal of internal trade barriers, agricultural prices will ultimately be unified. Common prices are being set at compromise levels affording a measure of continuing protection to high-cost producers, such as the German farmer, while preventing the appearance of huge surpluses in the lower-cost areas, France in particular. The major instrument of protection

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1/ On July 1, 1968, the formation of the customs union of the EEC countries will have been completed a year and a half earlier than was contemplated in the 1958 Treaty of Rome. However, the transition period towards the full completion of the Common Market is still to run until December 31, 1969. By that time harmonization of national tax policies, common anti-dumping arrangements, control of intra-Community restrictive practices, etc., are to be achieved.

against imports from outside is a system of variable import levies--tariffs which can be changed daily if necessary.1/ Exports to the outside are to be subsidized as necessary. The key levy and support price system is that for grains; similar levy systems apply to pork, beef and veal, eggs and poultry, dairy products, rice, olive oil, and fruits and vegetables. Intra-EEC trade is regulated by temporary levies designed to neutralize the effects of differences in national price levels. These levies are set so as to give intra-Community suppliers a margin of preference over outside suppliers and will have disappeared completely by July 1, 1968.

Grain price controversy

The recent conflict began with the attempts to secure agreement on the unification of grain prices. Germany, with an inefficient but politically articulate agricultural sector, was reluctant to cut its high support level for grain prices; France, on the other hand, feared that agreeing to higher support prices would bring increased production and create a serious surplus commodity disposal problem.

In December 1964 agreement was reached on a uniform grain price to go into effect July 1, 1967, set about half-way between the then current French and German price levels. At that time it was also agreed that intra-Community tariffs on pork and poultry will be removed at the same time as grain-price unification is to take effect, because national differences in these prices largely reflect differences in feed prices. As part of this agreement, France was promised rapid completion of permanent arrangements for Community financing of the Common Agricultural Policy.

Basic conflict

Under the original interim financial arrangements, the European Agricultural Guidance and Guarantee Fund (known by its French initials as FEOGA) was established to receive funds from the member countries and to disburse them for eligible expenditures.2/ Member countries' contributions were based in part on the value of net imports from outside the Community and in part on a burden-sharing formula. In the proposals for permanent arrangements, the proportion of national price support payments and export subsidies borne by the FEOGA was to

1/ A more detailed description of the CAP can be found in T. M. Klein, "The EEC's Common Agricultural Policy and Its Impact on U.S. Exports": R.F.D. #569, January 18, 1966.

2/ Eligible expenditures fall into two categories: a) the "Guarantee Section" which reimburses the cost of price supports and export subsidies and b) the "Guidance Section" which finances capital improvements.

be expanded gradually until 1970, when it would pay 100 per cent of these expenses. France was particularly anxious to have such an arrangement established because her outlays for these purposes are likely to be very large.

However, the EEC Commission linked to this course of action some proposals which would make the Community organizations financially independent of the Governments of the member states. Rather than secure part of FEOGA's resources from contributions from member governments through the EEC Council of Ministers, the Commission proposed that all customs receipts, on industrial as well as agricultural products, be turned over to the Community. In addition, responsibility for the EEC budget was to be shifted from the Council of Ministers to the European Parliament (which might ultimately be responsible directly to a European electorate).

It was these proposals to which France objected strongly because she regards the Common Market strictly as an organization of member states and not as a potential "superstate". Because France found herself isolated on this issue, the French Government boycotted the Council of Ministers meetings from July 1965 through mid-January 1966. Thus, the conflict over financing the CAP reflected not just the inherent difficulty in substituting a Community-wide program for the existing national schemes for protecting agricultural incomes, but it also brought to the surface a fundamental difference of opinion between France and her EEC partners as to the nature of the Common Market itself.

The agreement

The agreement reached on May 11th provides for financial arrangements for agriculture until the end of the transition period, that is until December 31, 1969, only. Thus, the Community is still governed by interim arrangements on agricultural financing. However, it is expected that permanent arrangements for the period from 1970 onward will be less difficult to establish than were the present interim agreements.

The current agreement gives France satisfaction on all the vital issues. On agricultural financing, the Six agreed that, commencing July 1, 1967, FEOGA will reimburse member governments for all national outlays on export subsidies and price supports for those products governed by market regulations. For the period mid-1965 to mid-1967, FEOGA will reimburse member governments for a rising portion of their expenses. Between July 1967 and December 1969, each country will pay into FEOGA 90 per cent of the receipts from levies on agricultural products imported from non-member countries. This, however, is estimated to bring in little more than half the required amount; the balance will be raised according to a burden-sharing scale.1/

The new financial arrangements do not provide for turning over to the EEC receipts from the common external tariff, as had been proposed in March 1965. Also, the role of the European Parliament in the budgetary process will not be expanded. Thus, France has managed to postpone any progress towards political integration in the Common Market.

Germany, in return for agreeing to the agricultural financing proposals, secured a commitment for the completion of the common market for industrial products. The remaining intra-EEC duties on industrial products will be reduced by one-quarter (5 per cent of the end-1957 rates) on July 1, 1967, and the remainder will be abolished on July 1, 1968. The common external tariff will also come into effect at that time.

Germany, supported by the Netherlands, announced that the agreement on agricultural financing is a conditional one, subject to decisions being made on the following:

1) Market regulations for sugar, fruits and vegetables, fats and oils;

2) Common prices for milk, fats and oils, rice, sugar, beef and veal;

3) Negotiating mandates to the EEC Commission for the Kennedy Round; and

4) Restriction of credits on financing the sale of agricultural surpluses to Eastern Europe.

France acknowledged these conditions, and official observers stated that the atmosphere at the May 11 meeting was good despite the hard bargaining that took place. As one Belgian official put it, the agreement was not so much "...a conditional agreement, but rather an unconditional agreement in principle."

1/ Belgium: 8.1%, Germany: 31.2%, France: 32.0%, Italy: 20.3%, Luxembourg: 0.2%, and the Netherlands: 8.2%. France has, for the first time under such arrangements, agreed to pay more than Germany.

Wider implications of agreement

The nearing of the completion of the construction of the common market for both industrial and agricultural products has far-reaching implications for the economies of the Six as well as for third countries.

On the industrial side, the adjustment of national tariffs to the CXT and the full removal of internal tariffs will give inside producers their final preferential margin over outside suppliers. This last step will be of particular significance for outside suppliers to the Benelux countries and Germany, because these countries will have to raise their national tariffs in the last move towards the uniform outer tariff. Concern about the consequences of increased prices of imported goods on their internal economies prompted these countries, and particularly Germany, to press for a Commission mandate to move forward in the Kennedy Round as a condition for agreement on the CAP. Although few people have any illusion that tariff negotiations on the agricultural sector will have meaningful results, there is some hope now that something may be achieved on the industrial side.

Any success in negotiating down tariffs in the Kennedy Round will help to reduce the trade diversion effects of the formation of the Common Market. Various estimates put these effects at around \$1 billion for industrial and at about \$700 million for agricultural goods. The United States would be particularly strongly affected: about \$500 million worth of United States agricultural exports to the EEC are affected by the CAP and it is estimated that the full effect of the CAP may reduce United States exports to the EEC by about \$250 million below what they might have been otherwise.1/

Implications for the six individual countries within the EEC, beyond those of trade relationships with third countries, are equally important and widely divergent. By the time the CAP is in full operation, it is estimated that its levy system on imports and budgetary contributions from the individual countries will yield about \$1.6 billion annually to be used for agricultural price supports, export subsidies and capital improvement expenditures. The largest net beneficiary of the CAP is France, who is estimated to receive in the first full year of operation about \$250 million more from FEOGA than she pays in. In addition, she will derive about \$100-\$150 million more from net sales at above world market prices to partner countries. Most of the cost for these net benefits accruing to France will be borne by Germany, while the other three countries will find themselves in rough equilibrium.

1/ These estimates were based partly on an unpublished manuscript by L. Krause of the Brookings Institution and partly on a U.S. Department of Agriculture internal study.

No estimates, however, have been made for economic costs in terms of re-allocation and possible misallocation of resources either between industry and agriculture or purely within the agricultural sector because of administered market prices for agricultural products. The economic cost to countries (primarily the Benelux countries) which now give little protection to their agricultural sectors may be particularly high.

Policies designed to achieve balanced economic growth and to contain inflationary pressures will be affected by the CAP. Since 1962, when the first moves towards a common agricultural policy became effective, some countries have had to raise their internal prices for certain agricultural goods. The moves toward full completion of the CAP will entail further price increases in that sector, particularly for the Benelux countries; for Germany, in turn, it may bring about a lowering of food prices. To the degree that agricultural prices affect wage and price policies in the entire economy, changes in competitive relationships, both within and outside the EEC, will occur.

The eight-year period (from 1962 to 1970) chosen for the full implementation of the CAP was to help make the adjustment gradual. This gradual adjustment process is particularly important because the latest moves towards integration mean that it now becomes very difficult to use exchange rate changes as a possible adjustment instrument within the Common Market. Alignment of agricultural prices among countries, with the unified price expressed in a common value unit, means that any unilateral change in exchange rates would automatically give rise to an opposite change in the prices of agricultural goods. To the extent that such price changes work through to the general price level, exchange rate adjustments would be offset.