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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

September 8, 1966

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SUMMARY AND OUTLOOK

Outlook for GNP

Gains in GNP in this and the next quarter are still likely to be appreciably larger than in the second quarter with a deepening of the decline in residential construction but with an acceleration of the increase in defense outlays. We are now projecting GNP expansion at about $14 billion in the third quarter and $15 billion in the fourth quarter, as compared with $11 billion in the second quarter and $17 billion in the first.

The level of business plant and equipment outlays projected earlier for the third and fourth quarters has been confirmed by the latest Commerce-SEC survey, and the second quarter was raised moderately. An increase of 17 per cent is still in prospect for the year 1966. Order and output trends remained strong in the machinery and equipment industries through July.

A rapid run-down in the Federal cash balance and upward revision of recent defense orders suggest that defense spending is rising faster in the third and fourth quarters than was projected earlier--at a $3.5 billion rate rather than a $2.5 billion rate. Also, with new evidence showing a further step-up in the rate of stock building by manufacturers in July, our earlier prljection of business inventory accumulation has been raised to show somewhat less decline from the exceptionally high second quarter rate.

The third quarter rise projected in consumer spending on goods and services--about double the small second quarter increase--is about in line with the rise projected for disposable income. Increases are expected to be higher because of the rise in Federal salaries, Medicare and other transfer payments, and a smaller increase in the personal tax take. Sales of new domestic autos rose appreciably in late August, and for the month were apparently at an 8.5 million annual rate--our projected rate for the current and next quarter. The recovery in auto sales following the decline in the spring accounts for much of the sharp pick-up in the rate of increase in consumption expenditures from the second to the third quarter.

Resource-use and prices

With the rise in economic activity now in prospect, pressures on resources are likely to be maintained. Expansion in industrial activity since midyear--even with auto production down--has equaled or exceeded the estimated growth in capacity. Use of manufacturing capacity has remained above 92 per cent, and unemployment has remained at about 4 per cent of the civilian labor force. That rates of resource use will be at least maintained in coming months is suggested by prospects for recovery in auto production and for further expansion in output, not only of business and defense equipment but also of materials for current use and for inventory. Only in the residential construction area is there clear evidence of declining activity.

Price developments in the months ahead, as has been stressed before, will be strongly influenced by the response of participants in labor contract negotiations to the developing business and financial situation. The very low level of unemployment for prime labor force groups, increases in consumer prices and wage escalation in some industries, large profits in most industries, and the waving influence of the guideposts for wages and prices have already led to increasing labor demands. Moreover, after many years of stress on fringe benefits, the emphasis has been shifting back toward money wage increases and escalator clauses, which tend to have a more certain and often more prompt effect on unit labor costs. In the first half of this year, however, the increase in labor costs per unit of output in manufacturing was small, and was caused mainly by the January increase in social security taxes.

While price prospects continue to be dominated by the wage and labor cost response to strong demands, prices of sensitive materials, which contributed so much to the earlier rise, have declined somewhat in recent months. A general easing in supplies for the major nonferrous metals, including copper, has brought sharp price declines in the more volatile markets. Consequently, the rise in the index for all industrial commodity prices since midyear has been considerably less rapid than the 3.5 per cent annual rate of the first half. Whether the supply situation for sensitive materials will remain easier, or whether it will tighten again and renew upward pressures on the price structure will depend primarily on two factors: the military effort in Vietnam and the seriousness of any strikes or other interruptions to production.

For other industrial materials and finished products prices have continued to rise in recent months although the pace has been slower than in the first half of the year. Expansion and activity at the projected rate will sustain the rise, and the rate of increase will be strongly influenced by what happens to wages and labor costs per unit of output.

Bank credit outlook

Growth in bank loans is likely to be much larger in September than in August, but probably will fall appreciably short of the unusually high levels of June and July. Some of the temporary factors which tended to dampen loan demands in August will no longer be operative or will be of reduced importance: (1) corporation payments on withheld income and social security will be about normal in September again after having been at a much reduced level in August as a result of the recent acceleration program; (2) large corporate income tax payments are due in September; and (3) finance companies will need to borrow heavily again to redeem commercial paper over the tax period after having made unusually heavy bank loan repayments in July and August.

In addition to these temporary influences, corporate cash flows are continuing to fall short of expenditures, and corporate needs for outside financing will be continuing large. The extent of actual rise in bank loans, however, might well be moderate compared with earlier this summer by two possible developments--a reduction in the rate of business inventory accumulation from recent high levels and a further tightening of lending policies at the banks, particularly in the light of the Board's discount policy statement of September 1.

Bank efforts to accomodate expected loan demand will be complicated by a record level of CD's maturing in September, an amount in excess of $5.2 billion. In New York City alone, $2.2 billion of CD's will mature in September--31 per cent of their total outstandings. Current rate relationships suggest that banks, in the aggregate will be unable to roll-over all of these certificates. Banks in major money market centers particularly are likely to face CD attrition as holders of maturing certificates shift to other short-term assets or use the proceeds for tax and transaction purposes; for the banking system as a whole net CD run-offs could amount to $1.5 billion or more. The banks likely to be most adversely affected by CD attrition are also the institutions that will be most affected by this month's increased reserve requirements on time deposits in excess of $5 million and the September 1 reclassification of promissory notes as deposits.

In anticipation of the resultant reserve pressures, large banks appear to have increased their holdings of short-term liquid assets in August; for example, New York banks became Federal funds sellers late last month. This preparatory accumulation of liquid assets, however, will not eliminate the necessity for banks to make other adjustments--in both assets and liabilities--in meeting September loan demands.

Securities markets prospects

The abrupt recent turn-around of yields in the bond market is attributable chiefly to some abatement in fears of an approaching credit availability crisis, fears which were being accorded increasing credence during the latter half of August. Short-term rates, by way of contrast, have contined to advance as bank reserve positions have remained under pressure and the money market has had to digest a $3.0 billion addition to the supply of Treasury bills. The advent of fall seasonal loan demands, combined with continuing reserve pressures and the prospect of unusually large shifts in deposit funds, can be expected to maintain upward pressure on shorter-term rates.

In long-term markets, easing in investor concern developed following reports of increased prospects for near-term fiscal action. With the possibility thus raised of some shift in the monetary-fiscal policy mix, the extreme yield mark-ups of late August were quickly reversed. Also, reports that the contemplated September sale of FNMA participation certificates would be postponed or reduced in size, and the Federal Reserve statement on use of the discount window suggesting that banks would be under less pressure to liquidate securities, reinforced the downward tendency in yields. At the same time security dealers scrambled to cover short positions and, in the case of municipal securities, to replenish depleted bond inventories.

At this juncture, the likely extent and duration of the yield down-swing are uncertain. As the current down-turn in rates is extended, it increasingly reflects expectations about future events which still have to be confirmed. In particular, the course which the Administration actually takes on fiscal policy, and the extent to which either new fiscal actions--or monetary actions already taken--will moderate business spending and financing plans are the major determinants of whether recent yield declines are sustained and extended, or simply prove to be temporary as was the case last spring. In the absence of a significant cut-back in spending plans, business needs for financing will remain heavy and, with bank credit further constrained, should continue to weigh more heavily on capital markets.

In the municipal bond market, the steep run-up of bond yields during late August was attributable more to actual and expected bank selling in the secondary market than to the calendar of new offerings, which has recently been running below a year ago. To some extent, however, the reduced calendar has reflected both voluntary and involuntary withdrawals of planned offerings--the latter due to statutory rate limitations. Hence, any sizable decline of yields would be likely to encourage some enlargement of the new issue calendar.

Balance of payments

A continuing large inflow of foreign liquid funds kept the U. S. payments position in surplus on the official settlements basis, seasonally adjusted, in August, and may have averted some pressures that might otherwise have developed on the U. S. gold stock and on Federal Reserve swap lines. But balance-of-payments relief from this source on the August scale should probably be viewed as temporary. The underlying payments position continues to be one of substantial deficit. On the liquidity basis of calculation, there was a deficit in July-August on the order of $3 billion at an annual rate.

The inflow of foreign liquid funds came through the foreign branches of U. S. banks, which continued to bid aggressively for Euro-dollars in August. The liabilities of U. S. head offices to their foreign branches increased further by about $350 million during the month, after an increase of about $750 million in July. As the run on sterling abated, the supply of Euro-dollars from that source apparently diminshed sharply, while transfers (presumably covered forward) out of Continental European currencies into Euro-dollars apparently increased. The latter development is suggested by market reports and by the behavior of exchange rates and official reserves.

The merchandise trade balance continued to deteriorate in July. From the first quarter to June-July--a fairly representative period--imports shot up at an annual rate of more than 20 per cent; i.e. about three times as fast as GNP, while exports advanced at an 8 per cent rate. There are reasons to expect some acceleration of the export advance and some slowing of the import expansion in the months ahead. These developments, together with minor net changes on other current transactions, may halt the shrinkage of the current account surplus, but seem unlikely to reverse it.

New favorable developments on capital account also seem unlikely. In particular, reflows of U. S. bank credit are already large, and the outflow of U. S. direct investment capital, net of amounts borrowed abroad, had already declined in the first half year to about the $2-1/2 billion annual rate expected for the full year.

Thus the outlook for the remainder of the year is for continuation of the liquidity deficit at roughly the recent $3 billion rate, and for reemergence of a deficit on the official settlements basis as inflows of foreign private liquid funds diminish.

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 years Ago*
Civilian labor force (mil.)	Aug'66	77.4	77.1	75.8	2.1	4.2
Unemployment (mil.)	"	3.0	3.0	3.4	-10.4	-20.1
Unemployment (per cent)	"	3.9	3.9	4.5	--	--
Nonfarm employment, payroll (mil.)	"	64.3	64.1	61.0	5.4	9.9
Manufacturing	"	19.3	19.1	18.1	6.4	11.3
Other industrial	"	8.0	8.0	7.8	1.8	4.4
Nonindustrial	"	37.0	36.9	35.0	5.6	10.4
Industrial production (57-59=100)	July'66	157.5	156.2	144.2	9.2	18.2
Final products	"	155.2	154.7	141.7	9.5	17.3
Materials	"	160.0	157.9	146.4	9.3	19.0
Wholesale prices (57-59=100)1/	"	106.4	105.7	102.9	3.4	6.0
Industrial commodities	"	104.6	104.5	102.1	2.4	3.8
Sensitive materials	"	106.3	106.6	102.3	3.9	7.3
Farm products and foods	"	109.8	107.7	103.7	5.9	11.9
Consumer prices (57-59=100)1/	"	113.3	112.9	110.2	2.8	4.6
Commodities except food	"	106.7	106.4	104.7	1.9	2.3
Food	"	114.3	113.9	110.9	3.1	6.6
Services	"	122.6	122.0	117.8	4.1	6.3
Hourly earnings, mfg. ($)	Aug'66	2.72	2.71	2.62	3.8	6.7
Weekly earnings, mfg. ($)	"	112.22	111.60	107.53	4.4	7.9
Personal income ($ bil.)2/	July'66	579.7	577.2	535.4	8.3	16.6
Corporate profit before tax ($bil.)	QII'66	82.9	82.7	74.5	11.3	24.1
Retail sales, total ($ bil.)	July'66	25.5	25.4	23.7	7.7	16.1
Autos (million units)2/	"	8.3	8.3	8.9	- 7.1	12.1
GAF ($ bil.)	"	6.1	6.0	5.4	12.7	19.6
Selected leading indicators:						
Housing starts, pvt. (thous.)2/	July'66	1,064	1,273	1,473	-27.8	-29.1
Factory workweek (hours)	Aug'66	41.3	41.1	41.1	0.5	1.0
New orders, dur. goods ($ bil.)	July'66	24.2	24.6	22.2	8.9	13.8
New orders, nonel. mach. ($ bil.)	"	3.4	3.6	3.1	8.4	17.0
Common stock prices (1941-43= 10)	Aug'66	80.65	85.84	86.49	- 6.8	- 1.6
Manufacturers' inventories book val. ($ bil.)	July'66	72.9	71.9	65.4	11.5	20.6
Gross national product ($ bil.)2/	QII'66	732.3	721.2	672.9	8.8	16.7
Real GNP ($ bil., 1958 prices)2/	"	643.5	640.5	607.8	5.9	11.3

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

SELECTED DOMESTIC FINANCIAL DATA

	Week ended Sept. 2	Four-Week Average	Last six months High	Last six months Low
Money Market 1/ (N.S.A.)				
Federal funds rate (per cent)	5.35	5.45	5.88	3.00
U.S. Treas. bills, 3-mo., yield (per cent)	5.07	5.00	5.09	4.33
Net free reserves 2/ (mil. $)	- 422	- 385	- 94	- 477
Member bank borrowings 2/ (mil. $)	691	731	827	508
Security Markets (N.S.A.)				
Market yields 1/ (per cent)				
5-year U.S. Treas. bonds	5.72	5.57	5.89	4.76
20-year U.S. Treas. bonds	5.04	4.97	5.12	4.59
Corporate new bond issues, Aaa	5.98	5.77	5.98	4.84
Corporate seasoned bonds, Aaa	5.43	5.35	5.48	4.74
Municipal seasoned bonds, Aaa	4.02	3.97	4.04	3.42
FHA home mortgages, 30-year 3/	6.51	6.51	6.51	6.00
Common stocks S&P composite index 4/				
Prices, closing (1941-43=10)	76.52	79.72	92.42	74.53
Dividend yield (per cent)	3.77	3.63	3.77	3.13

	Change in July	Average change last 3 mos.	Annual rate of change (%) 3 mos.	Annual rate of change (%) 1 year
Banking (S.A., mil. $)				
Total reserves 5/	6/ - 253	- 32	- 1.8	3.2
Bank loans and investments:				
Total 7/	2,800	2,200	6.5	9.2
Business loans	1,800	1,700	27.4	18.9
Other loans 7/	1,300	800	7.2	10.8
U.S. Government securities	- 400	- 600	-12.2	- 6.6
Other securities 7/	100	300	8.6	11.3
Money and liquid assets:				
Demand dep. & currency	6/ - 200	- 100	- 0.5	4.1
Time and savings dep. 7/	6/ 1,700	1,600	12.6	12.6
Nonbank liquid assets	- 900	- 100	- 0.5	5.1

N.S.A.--not seasonally adjusted. S.A.--Seasonally adjusted.
1/ Average of daily figures. 2/ Averages for statement week ending August 31. 3/ Latest figure indicated is for month of July. 4/ Data are for weekly closing prices. 5/ Based on revised series. 6/ Change in August. 7/ Comparisons have been adjusted for definitional changes in June and July.

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

	1966				1965			1965
	July	June	QII	QI	QIV	QIII	QII	Year (billions)
				Seasonally adjusted				
Current account balance				1,269	1,290	1,527	1,761	6.0
Trade balance 1/	190	350	816	1,118	1,271	1,231	1,317	4.8
Exports 1/	2,425	2,455	7,080	7,121	7,027	6,826	6,798	26.3
Imports 1/ 2/	-2,235	-2,105	-6,264	-6,003	-5,756	-5,595	-5,481	-21.5
Services, etc., net				151	19	296	444	1.2
Capital account balance				-1,604	-1,560	-1,821	-1,426	-6.9
Govt. grants & capital 3/				-955	-881	-743	-949	-3.4
U.S. private direct investment				-630	-731	-569	-859	-3.4
U.S. priv. long-term portfolio				-244	-154	-363	101	-1.1
U.S. priv. short-term				-14	-27	105	412	0.8
Foreign nonliquid				239	233	-251	-131	0.2
Errors and omissions				-228	-80	-240	-109	-0.4
Balances, with and without seasonal adjustment (- = deficit)								
Liquidity bal., S.A.			-163	-554	-350	-534	226	-1.4
Seasonal component			-22	485	-3	-472	-37	--
Balance, N.S.A.	-500	131	-185	-69	-353	-1,006	189	-1.4
Official settlements bal.,			-189	-248	-1,158	236	238	-1.3
Seasonal component			-177	625	33	-508	-184	--
Balance, N.S.A. 4/	142	114	-366	377	-1,125	-272	54	-1.3
Memo items:								
Monetary reserves (decrease -)	190	53	-68	-424	-271	-41	-68	-1.2
Gold purchases or sales (-)	-116	-53	-209	-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 loan repayments.
4/ 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. Gross national product is projected to rise about $14 billion in the third quarter and $15 billion in the fourth quarter -- to reach a year-end level of over $760 billion. Prices are expected to continue to increase about as fast as in the first half of the year; the rise in GNP in real terms in the second half would then be at an annual rate of 4 per cent, the same as in the first half of the year.

The over-all increase indicated for the last half of the year is little changed from that projected three weeks ago. In light of the sharp drop in housing starts through July and of the continuing stringency in mortgage markets, projected levels of residential construction activity have been lowered appreciably in both the third and fourth quarters to show a much larger decline than indicated earlier. On the other hand, defense spending has been raised to show increases of $3.5 billion a quarter, instead of the $2.5 billion projected earlier. This boost in defense spending is suggested by recent evidence of a much more rapid rundown in the Federal cash balance in recent months than had been anticipated, by some upward revisions in the recent level of defense orders, and by the large increase in draft calls for October.

The rate of nonfarm business inventory accumulation is still expected to decline in the last half of the year from the exceptionally high second quarter level -- but by not quite so much as was projected earlier. July book value figures indicated a sustained high rate of accumulation of goods other than autos, particularly in manufacturing, and preliminary August indications for production and final takings show a continued high rate of inventory accumulation. Auto inventories, which increased substantially in the second quarter, are projected to show little change over the current quarter and then to decline somewhat in the fourth quarter.

Farm inventory accumulation has also been revised upward for the current and next quarters -- by small amounts which have been deducted from "other Federal purchases of goods and services." According to information now available, farmers are accumulating inventories rather than putting crops under Federal loan, because of the favorable market price situation.

Large further increases in business fixed investment are still being projected for the last half of this year. The latest Commerce-SEC survey of nonfarm outlays for new plant and equipment (conducted in late July and August) confirmed the third and fourth quarter levels that business had planned three months ago (and which have been incorporated in the GNP projections for the last half of this year) the latest survey also showed a moderate ($.5 billion) upward revision in outlays for the second quarter (not now incorporated in the second quarter GNP estimate). The increase in dollar outlays for the year as a whole remains 17 per cent. It might be significant that business has this time not revised upward its earlier projections; upward revision of initial estimates -- from lower rates -- was virtually the rule from early 1964 to mid-1966. According to a recent NICB survey a moderate decline in new capital appropriations is now expected by manufacturers in the last half of the year; however, the backlog of unspent appropriations also is expected to rise.

Third and fourth quarter consumer income, spending, and savings patterns remain about as projected earlier. The third quarter rise in disposable income is expected to be double the small second quarter increase, largely as a result of a spurt in Federal transfer payments and the Federal pay increases and because of a smaller rise in personal tax payments. In the fourth quarter disposable income is expected to rise as much as in the third quarter. Private wages are expected to increase somewhat faster, and there will be some further increase in transfer payments. Moreover, the increased taxes for the supplementary Medicare insurance plan, which limited somewhat the rise in personal income in the third quarter, will not affect the fourth quarter rise; and the increase in other personal tax payments is expected to moderate further.

Consumption expenditures are projected as rising about $9.5 billion in the third and also the fourth quarters. As in the case of income these gains are about double the small second quarter increase. The reversal from sharp decline to moderate recovery in new auto sales accounts for much of the speed-up in consumer spending in the third quarter. In the fourth quarter sales of new domestic autos are projected as holding at the 8.5 million annual rate estimated for the third quarter, but auto prices are expected to be up, leading to a further rise in the dollar volume of auto sales. In line with recent retail sales developments, the rise projected for nondurable goods is about the same as the second quarter increase. Partly under the expected stimulus of the Medicare program to the volume of medical treatment and partly due to an apparent step-up in price increases, some acceleration in gains in service expenditures is being projected in the last half of the year.

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

	1964	1965	1966	1965	1966			
							Projected	
			Proj.	IV	I	II	III	IV
Gross National Product	631.7	681.2	740.1	704.4	721.2	732.3	746.0	760.7
Final sales	627.0	672.1	729.7	694.0	712.3	720.0	735.8	750.7
Personal consumption expenditures	401.4	431.5	466.1	445.2	455.6	460.1	469.5	479.0
Durable goods	59.4	66.1	68.9	68.0	70.3	67.1	68.5	69.5
Nondurable goods	178.9	190.6	207.3	197.0	201.9	205.6	209.0	212.5
Services	163.1	174.8	190.0	180.2	183.4	187.4	192.0	197.0
Gross private domestic investment	93.0	106.6	116.6	111.9	114.5	118.5	116.7	116.7
Residential construction	27.6	27.8	26.7	27.6	28.6	28.0	26.0	24.0
Business fixed investment	60.7	69.7	79.6	73.9	77.0	78.2	80.5	82.7
Changes in business inventories	4.7	9.1	10.3	10.4	8.9	12.3	10.2	10.0
Nonfarm	5.3	8.1	10.0	9.0	8.5	12.1	10.0	9.5
Net exports	8.5	7.0	4.9	6.1	6.0	4.7	4.5	4.5
Gov. purchases of goods & services	128.9	136.2	152.5	141.2	145.0	149.0	155.3	160.5
Federal	65.2	66.8	76.6	69.8	71.9	74.0	78.5	82.0
Defense	50.0	50.1	59.0	52.5	54.6	57.1	60.5	64.0
Other	15.2	16.7	17.6	17.3	17.4	16.9	18.0	18.0
State & local	63.7	69.4	75.9	71.4	73.1	75.0	76.8	78.5
Gross National Product in constant (1958) dollars	580.0	614.4	647.5	631.2	640.5	643.5	649.8	656.3
GNP Implicit deflator(1958=100)	108.9	110.9	114.3	111.6	112.6	113.8	114.8	115.9
Personal income	496.0	535.1	580.1	552.8	564.6	573.5	585.5	597.0
Wage and salaries	333.6	358.4	391.6	370.8	380.0	387.4	395.5	403.5
Personal contributions for social insurance (deduction)	12.5	13.2	17.5	13.5	16.9	17.1	17.9	18.0
Personal tax and nontax payments	59.4	66.0	73.9	66.7	69.5	73.6	75.6	77.0
Disposable personal income	436.6	469.1	506.2	486.1	495.1	499.9	509.9	520.0
Personal saving	24.5	25.7	26.8	28.5	26.7	26.6	26.8	27.0
Saving rate (per cent)	5.6	5.5	5.3	5.9	5.4	5.3	5.3	5.2
Total labor force (millions)	77.0	78.4	80.1	79.0	79.4	79.7	80.4	80.8
Armed forces "	2.7	2.7	3.1	2.8	2.9	3.1	3.2	3.3
Civilian labor force "	74.2	75.6	77.0	76.2	76.5	76.7	77.2	77.5
Employed "	70.4	72.2	74.0	73.0	73.6	73.7	74.2	74.6
Unemployed "	3.9	3.5	3.0	3.2	2.9	3.0	3.0	2.9
Unemployment rate (per cent)	5.2	4.6	3.9	4.2	3.8	3.9	3.9	3.7

Industrial production. Industrial production in August is estimated to have increased about 1 percentage point further from the preliminary July figure of 157.5 per cent of the 1957-59 average. Gains in output were widespread among both final products and materials.

Auto assemblies in August failed to meet earlier production schedules and, after allowance for the model changeover, were 9 per cent below the reduced July level. Schedules for September indicate a rise in output of about 15 per cent; the level would still be 10 per cent below production at the beginning of the model run a year ago. Production of television sets and furniture, which had declined in July, increased in August, apparently in response to the recovery in retail sales of these goods in July and August.

Continued rapid expansion in output of both business and defense equipment in August is suggested by increases in production worker manhours in the machinery, aircraft, and ordnance industries and by a further rise of unfilled orders in July.

Output of iron and steel, which declined considerably less than seasonally in July, continued strong in August. Paperboard, crude oil, and refined petroleum products were at advanced production levels and August employment data suggest further increases in output of chemical products.

Auto sales and inventories. Sales of new domestic autos in the month of August were at a seasonally adjusted annual rate of 8.5 million, 2 per cent above the two preceding months, but 4 per cent below a year ago. Inventories of new cars on August 31, estimated to be 1.1 million, were down sharply from the extraordinary peak of 1.7 million at the end of June. Stocks are expected to increase rather sharply in the month of September as a consequence of the accelerated September production schedule. Assuming a seasonally adjusted sales rate of 8.5 million in September, ending inventories on September 30 will likely be about 1.3 million units, an unusually high level for the beginning of a model year.

Consumer credit. Consumers added $564 million to their instalment debt in July. The rate of increase in instalment credit in July was up from June and the second quarter but still below the first quarter rate. And, moreover, the pace thus far in 1966 remains well behind that for 1965.

In July a larger share than usual was accounted for by credit purchases of furniture and other home goods. Through the first six months of the year, such credit contributed one-third of the increase in total instalment credit, but in July it accounted for almost 45 per cent. Retail sales of furniture and appliances, and especially color television sets and air conditioners, were strong in July, giving rise to somewhat larger than usual demands for credit.

Repayments on instalment debt have continued to rise, but the increase in the second quarter was the smallest in a year and a half. Meanwhile, credit extensions, which leveled off late last year, turned down a little in the second quarter. The tempo of both extensions and repayments then picked up in July, as the table shows.

CONSUMER INSTALMENT CREDIT
(Seasonally adjusted annual rate, billions of dollars)

	Extensions	Repayments	Increase in outstandings
1965 - Q1	72.5	65.1	7.4
Q2	74.4	66.4	8.0
Q3	76.8	68.5	8.3
Q4	77.8	70.0	7.8
1966 - Q1	78.8	71.7	7.1
Q2	78.6	72.3	6.3
July	80.8	74.0	6.8

Interest charges on consumer loans continue to rise. In some areas, bank lending rates are bumping against statutory limits as, for example, in Chicago where the legal maximum under usury laws is 7 per cent, in Philadelphia where it is 6 per cent, and in Los Angeles where it is 8 per cent. The rates that have reached these limits are, for the most part, those charged on used car and unsecured personal loans. New car loans continue to carry a preferential rate at many banks.

In general, sales finance company rates have risen about as much as bank rates. Most consumer finance companies, on the other hand, have not raised their charges at all, since they already operate at the maximums provided by State small loan laws. Credit unions, too, have changed their rates little. Perhaps the stickiest rates have been those charged by consumer lenders in smaller cities and towns. These seem to have changed little, even where not affected by statutory limitations.

<u>Consumer buying plans</u>. According to the Census mid-July survey, consumer intentions to buy new autos within 12 months were about as numerous as they were in mid-1965, with 9.4 per cent of households expressing such intentions as compared with 9.6 per cent a year earlier. Leveling off over the past year contrasts with a sequence of large increases from 1962 to 1965. Twelve-month buying plans for used cars were up slightly from a year ago; 7.9 per cent as compared with 7.6 per cent in July 1965.

Plans to buy household durable goods, on the other hand, were considerably stronger than a year ago: in the recent survey 18.7 per cent of all households expressed intentions to buy at least one of 7 major items within 6 months as compared with 17.2 per cent a year earlier. Similar large year-over-year gains were recorded in the preceding two quarterly surveys.

In July as in the earlier surveys this year, sizable year-over-year gains were reported in the proportion of households whose current income exceeded year-earlier levels and in the proportion of households expecting higher income a year hence.

<u>Manufacturers' inventories</u>. The pace of inventory accumulation stepped up further at manufacturers in July, when the book value increase totaled nearly $1 billion. Accumulation was about $850 million in June and, for the second quarter as a whole, averaged $767 million. From mid-1965 to last March, the book value of factory stocks was increasing at a rate of about $550 million per month.

MONTHLY AVERAGE CHANGE IN MANUFACTURERS' INVENTORIES
(Book value, seasonally adjusted; millions of dollars)

	1965		1966		
	1st half	2nd half	1st Q	2nd Q	July
Manufacturing, total	280	565	544	767	981
Durable goods	256	395	316	577	799
Business & defense equipment	103	235	194	324	407
Consumer durables (incl. autos)	77	12	32	84	196
Other durables	76	148	90	169	196
Nondurable goods	24	170	228	190	182

The pronounced pick-up in the rate of accumulation in recent months has been concentrated in durable goods industries. Accumulation by nondurable goods producers has fluctuated rather narrowly around a monthly average close to $200 million since mid-1965.

The July book value increase for durable goods of $799 million was over a third above the high second quarter, with increases widespread. Half the rise was in the business and defense equipment industries where inventory increases continued to accelerate owing mainly to a further spurt in work-in-process stocks; order and output gains remain strong in these industries. A large rise was reported for inventories in the auto industry (about $170 million) which may have been an aberration due to problems of seasonal measurement during the model changeover.

Factory inventories of materials and supplies, which had spurted in the second quarter, showed a much smaller rise in July, although accumulation of such stocks continued at a fairly rapid pace in the business and defense equipment industries.

The rise in factory stocks in recent months has exceeded the rise in shipments and the manufacturing inventory-shipments ratio, which was at a low for this expansion period in the first quarter, has increased moderately. For durable goods, this July inventory-shipments ratio was the highest since the beginning of 1963, except for October 1964 which was affected by auto strikes. The inventory-shipments ratio for nondurable goods remains unusually low -- 12 per cent below early 1963.

Retail inventories. The book value of retail inventories declined slightly in July, as stocks held by auto dealers showed a sizable decrease and other trade inventories increased only moderately. The drop in auto stocks was associated with an unusually sharp cutback in production due to the early model changeover, while sales showed only the usual seasonal decline. A reversal of the July decline in auto stocks may come in September, when the early model changeover is bringing an unusually sharp run-up in output for that month.

Thus, July developments are not considered representative of the probable change in retail trade inventories during the third quarter.

Residential building. The sharpness of the drop -- one-third -- in housing starts from March through July has exceeded initial expectations and has raised further questions about the extent of further cutbacks that may occur in the period immediately ahead. A significant decline in housing starts during the course of the year was anticipated, but at 1.06 million (including farm starts) the seasonally adjusted annual rate in July is one of the lowest since World War II. While the series is inherently volatile and subject to marked revision, it has rarely, as in this instance, declined as many as four consecutive months in a row. Moreover, the three-month moving average at 1.22 million for the May-July period was below the 1.25 million average in 1960, a recession year for housing starts.

Owing to difficulties in seasonal adjustment, some upward fluctuation in the series may occur in individual months immediately ahead. The Census Bureau, for example, does not allow fully for variations in the number of working days in deriving the seasonally adjusted starts series. Consequently, the possibility that a temporary rise in the rate may be reported for August cannot be ruled out mainly because August this year had an unusually high number of working days relative to July. Unlike the situation in the early part of the year, mortgage commitments to builders are now at a low ebb and funds available for mortgage loans from all of the major types of institutional lenders are severely restricted.

While most of the decline in starts of both single and multi-family units may have already been experienced, a really significant upturn cannot occur until basic inflow positions of private lenders are improved and pressures lessen from other types of demands for credit. Pending such a development, it seems most likely that starts over the remainder of 1966 will average at most 1.1 million units and bring the total for 1966 under that for 1960.

The stimulative impact of the new legislation (still to be signed by the President) granting the Federal National Mortgage Association an additional $4.8 billion of purchasing authority, as is explained more fully in the appendix, the magnitude of the direct contribution to starts from this source may be moderate. Altogether the direct contribution may amount to no more than 130,000 new housing units spread over a period of at least 12-18 months.

Of the two programs affected by the legislation (FNMA's secondary market operations and its special assistance functions), the $1 billion special assistance portion potentially offers the speedier and more direct avenue of assistance to builders. In April 1958, FNMA received similar authority under conditions when mortgage discounts were lower than they have been recently and the market for mortgages was generally beginning to ease. Nevertheless, it is estimated that although there was some immediate impact in the month the legislation became effective, there was a lag of some 7 months before starts financed by the special assistance program reached their maximum volume. This suggests that the major impact of the new program will probably not be experienced until some time next year.

Labor market. The labor market showed continued strength in August. Employment gains in manufacturing were impressive -- especially in the metals and machinery industries -- but employment weakness was evident in construction, and trade failed to show its recent strength. Hours of work in manufacturing increased in August following 2 months of decline, in part due to the early start of the auto model year. The over-all unemployment rate, at 3.9 per cent in August, continued virtually unchanged for the fourth consecutive month.

Nonfarm employment. Nonfarm payroll employment continued to move up quite vigorously in August but gains were somewhat more selective. Employment rose by 210,000 to 64.3 million (revised) and was 3.3 million, or 5 per cent, above a year ago. Manufacturing and government accounted for 2 million of the gain.

In manufacturing industries, employment in August continued to increase at the fast pace set so far in 1966, as shown in the table. Gains, however, were increasingly concentrated in the defense and capital goods oriented industries. Especially large increases were recorded in primary metals and electrical machinery. A sharp rise in transportation equipment from July to August is due in large measure to the earlier than usual model changeover in autos this year.

CHANGES IN NONFARM EMPLOYMENT
(Monthly averages, seasonally adjusted, 000's)

	January to July 1966 (monthly average)	August 1966
Nonfarm, total 1/	260	145
Manufacturing 1/	85	85
Durable 1/	55	75
Nondurable	30	10
Construction	- 5	-45
Other industrial 2/	5	-15
Trade	40	--
Finance and service	50	35
Government	85	85
Federal	30	35
State and local	55	50

1/ Because of the effect on seasonally adjusted employment of the earlier model changeover this year than last, the transportation equipment industry has been omitted from the appropriate major groupings.
2/ Includes mining, transportation and public utilities.

In government (Federal and State and local), as in manufacturing, the rise in employment continued at the rapid rate of 85,000 monthly or 1.0 million annually. On the other hand, in the private nonmanufacturing sector, construction employment declined and trade failed to show its recent increase. Since the March peak, the decline in construction employment has amounted to 170,000 or 5 per cent.

Hours and earnings in manufacturing. The workweek rose 0.2 hours from July to 41.3 hours in August, slightly below the February peak of 41.5 hours. Some of the decline in July and the rise in August resulted from the early seasonal shutdown of auto plants. The workweek rose strongly -- by 0.5 hours -- in primary metals. In nondurable goods industries, the workweek has gradually declined from a high of 40.5 hours in February this year to 40.1 hours in July and August.

Average hourly earnings in manufacturing, at $2.69 in August were 10 cents, or 3.9 per cent higher than a year earlier, reflecting in part more overtime work. The rate of increase in earnings has accelerated somewhat; in the first quarter, hourly earnings were showing a 3.4 per cent rise, and between 1964 and 1965 the increase was 3.2 per cent.

Unemployment. The lack of improvement in the over-all unemployment rate -- close to 4 per cent since last January -- reflects some worsening of the unemployment situation for Negroes and less skilled workers in recent months. The unemployment rate for nonwhite workers rose to 8.2 per cent in August, over a percentage point higher than in January. By comparison, the unemployment rate has continued at near frictional levels for married men, white collar workers and skilled blue collar workers. Although the economy appears temporarily to have reached a floor for over-all unemployment at close to 4 per cent, some improvement may be apparent in the fall with the return to school of teenagers and with recovery of auto production.

Between the summers of 1965 and 1966, the number of teenagers in the civilian labor force (16 to 19 years old) was swollen by over 1 million, an increase of 14 per cent. This was 2-1/2 times the average increase of the preceding 3 years. This tremendous surge of new teenage workers -- the heritage of the baby boom that began about 2 decades ago -- was on the whole successfully absorbed into employment (or employed in a Federal work program). But the unemployment rate among youths remains high and accounts for about one-third of all unemployment. Negro youths have not fared as well as whites over the past year; the unemployment rate for nonwhite teenagers this summer was at the same high rate of 27 per cent as last year, while the unemployment rate for white teenagers dropped from 14 to 12 per cent.

Collective bargaining. Major contract negotiations in the first half of this year have affected relatively few workers. Contracts covering only about 835,000 workers were negotiated during the first 6 months -- about half in manufacturing. In manufacturing settlements have been mainly in the lower paying lumber, textile and apparel industries.

From here on the pace of contract settlements will be faster. Already the ariline agreement in August and a comparable settlement in early Setpember at 5 per cent by the telephone installers appear to be establishing a pattern of wage increases well above the guideposts. It is expected that 350,000 telephone workers will receive wage increases in the next two months in line with those of the installers.

Contracts in the electrical products industry expire in October and this bargaining will affect some 135,000 workers. The number of workers directly affected by major contract renegotiations in 1967 will be substantially greater.

CONTRACT NEGOTIATIONS -- SEPTEMBER-DECEMBER 1966

Month contract expires	Industry classification	Number of workers
September	Telephone & Telegraph	90,000
	Leather	13,000
	Electrical products	5,700
October	Electrical products	135,000
	Telephone & Telegraph	102,000
	Leather and textiles	19,000
November	Telephone & Telegraph and miscellanous	135,000
December	Electrical products	19,000
	Ordnance	9,000

NOTE: The BLS calendar is limited to contracts covering 5,000 workers or more.

In contrast to the small number of new contracts, wage increases scheduled for this year in major contracts negotiated in 1965 or earlier are affecting a much larger number of workers than in most recent years. Over 4 million workers were scheduled to receive deferred wage increases in 1966 under major collective bargaining agreements, the largest number since 1957. In September and October alone, deferred increases will raise the wages of 1.2 million workers. For auto workers, a scheduled productivity increase will total 10.5 cents, or an average increase of 3.4 per cent of straight time earnings. In most other industries affected -- mainly farm equipment and aerospace, and metal containers in December -- the rise will be in the 2-1/2 to 3 per cent range.

Over 1-1/2 million of these 4 million workers receiving deferred wage increases are also covered by contracts with cost-of-living clauses. With increased pressure from rising prices, cost-of-living adjustments are having a significant impact on wage rates in these industries. Automobile workers have received 8 cents an hour in wage increases over the past year as a result of the rise in consumer prices. With the 10.5 cents from the annual improvement factor, auto workers by this month will have received 18.5 cents increase in their basic wage rate over the past year -- a rise of about 6 per cent.

The pressure of increasing prices is likely to see a renewal of interest for inclusion of escalator clauses in wage contracts. The agreement by the airline industry to an escalator clause was a key factor in the final settlement of the recent machinist strike. The electrical workers have now made the reinstatement of an escalator clause in their contracts with G.E. and Westinghouse a major goal of their negotiations, and other unions may be expected to follow suit. Popularity of escalator clauses has risen and fallen in the postwar period with the tide of inflationary pressures. Only 800,000 workers were covered by contracts including such clauses in September 1950; within a year the number reached 3 million, and by September 1952, 3.5 million, mainly in autos and related products and in railroads. This total was about one-fifth of all workers covered by collective bargaining contracts at that time. With the end of the Korean War in 1953, interest in escalator clauses diminished, and by the beginning of 1955, less than 2 million workers remained covered. The 1955-57 expansion brought a renewed surge of interest and coverage rose to a postwar peak of 4 million in 1958 and 1959. Beginning in 1960, escalator clauses were dropped from contracts in electrical equipment and the railroads and in the steel, aluminum and container industries. Only about 2 million workers were covered this year, largely in the relatively high wage automobile, aerospace, farm and construction equipment, trucking and meatpacking industries.

Wholesale prices. The monthly wholesale price index for mid-August will show a further rise, but the rise will not be so large as the .7 per cent from June to July. Although increases were widespread among foodstuffs, the average for this group is expected to show only about half the rise of 2.2 per cent in the preceding month.

After mid-August, expansion in livestock marketings brought about declines in prices which apparently halted the rise in the over-all index. Sustained expansion in supplies of meats may now be underway.

As a result mainly of continued decreases among the sensitive materials, the rise in the industrial commodity index in August has probably been at about the reduced pace of July. Prices of hides and lumber, which contributed so much to the rise in industrial commodities early this year, have declined further in recent weeks, and prices of most scrap metals have fallen. Copper prices in the London market have dropped to about 50 cents a pound from 75 cents two months ago and about 95 cents at the high in April; a shift in expectations followed resumption of shipments from Zambia and elimination of a strike threat in Chile reinforced by prospects of a decline in consumption in the United Kingdom. In this country, prices of a few copper products have been reduced as a result of the declines for scrap copper and for refined copper from sources other than the primary producers.

It is likely that the price index for other or "sluggish" industrial materials and the index for finished products continued to rise in August. The announced increases in steel sheet and strip will be reflected in the August index, and increases also are known to have gone into effect for some fabricated metal products, industrial chemicals, petroleum products, paper boxes, and glass containers. Some makers of heavy-duty trucks also announced price increases.

Consumer prices. The consumer price index rose .4 per cent further in July and, as shown in the table, was 2.8 per cent higher than a year earlier. Food prices continued to rise, but the increase was considerably less than seasonal. On a seasonally adjusted basis, while dairy products and eggs increased, fruits and vegetables and meats declined.

Services continued on their rapid upward course. July was the month that the increase in New York City subway and bus fares went into the index, and that contributed much to the rise in transportation services. Medical services continued to rise at a rapid pace.

Nonfood commodities rose somewhat in July, reflecting mainly increases for used cars and cigarettes, with the latter affected by tax increases. Higher prices were reported also for furniture and some nondurable household goods. New autos showed less than the usual seasonal decline, although a larger decrease had been expected in view of the large number of cars in dealer hands at midyear.

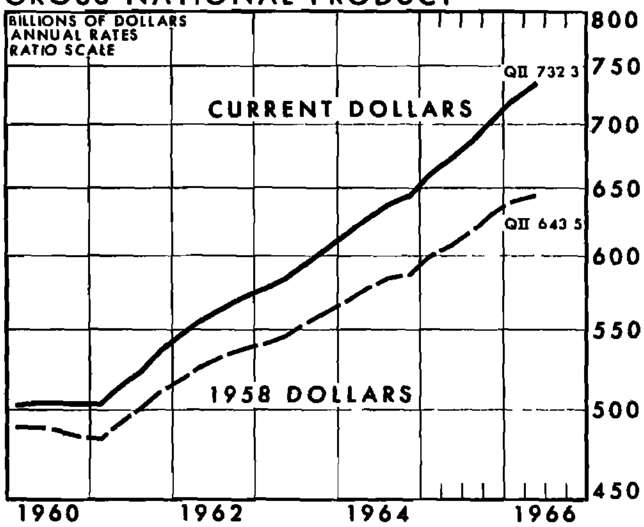
CONSUMER PRICES

	Per cent change to July from:	
	June 1966	July 1965
All items	.4	2.8
Food	.4	3.1
Nonfood commodities	.3	1.9
Apparel	-.2	3.0
Other nondurables	.5	2.4
New cars	-.1	-.5
Used cars	1.8	-2.2
Household durables	.2	.6
Services	.5	4.1
Medical	.7	5.0
Transportation	1.5	5.0
Rent	.1	1.3
Other household	.3	4.4

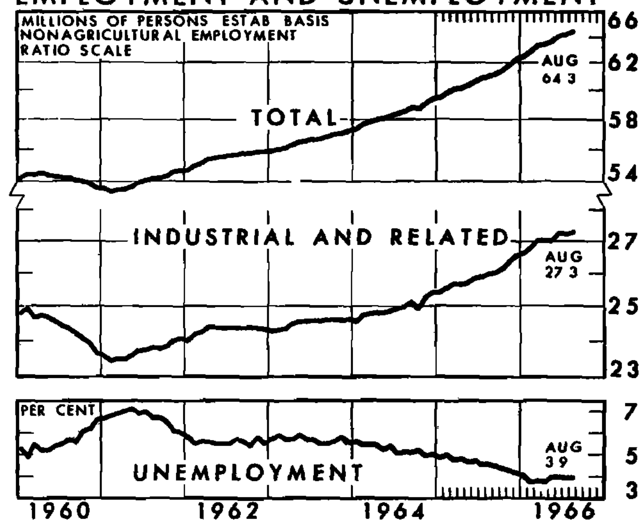
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

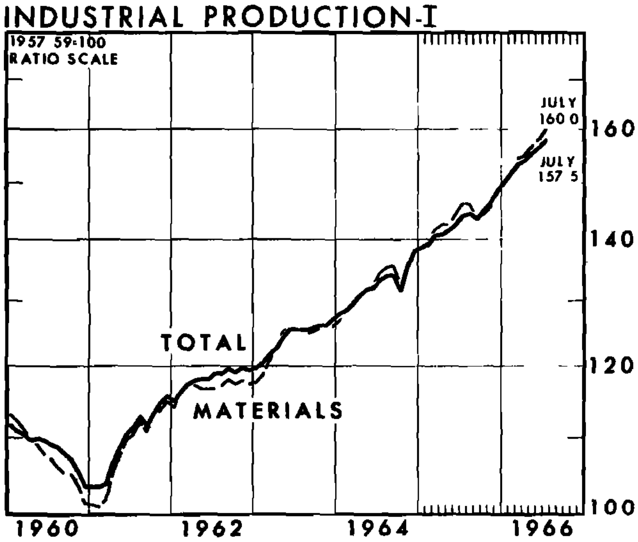
GROSS NATIONAL PRODUCT



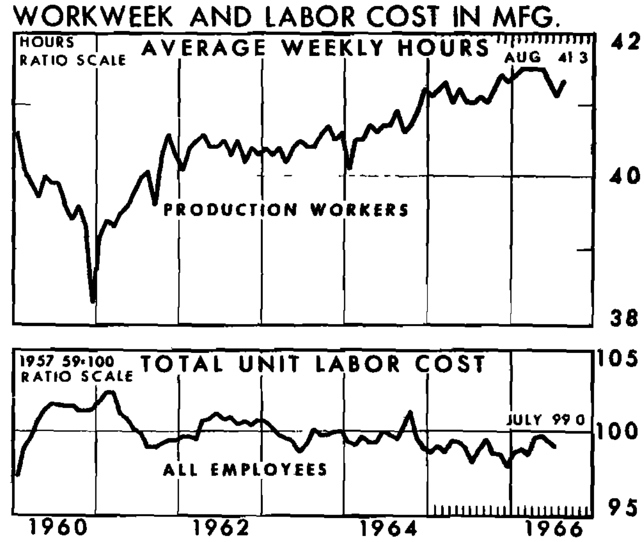
EMPLOYMENT AND UNEMPLOYMENT



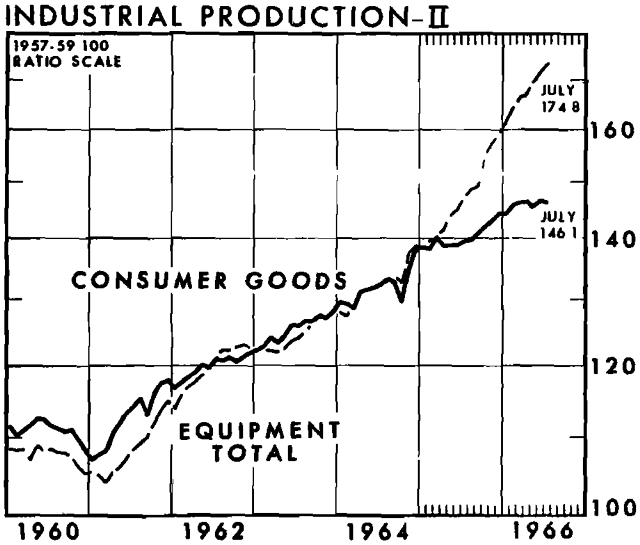
INDUSTRIAL PRODUCTION-I



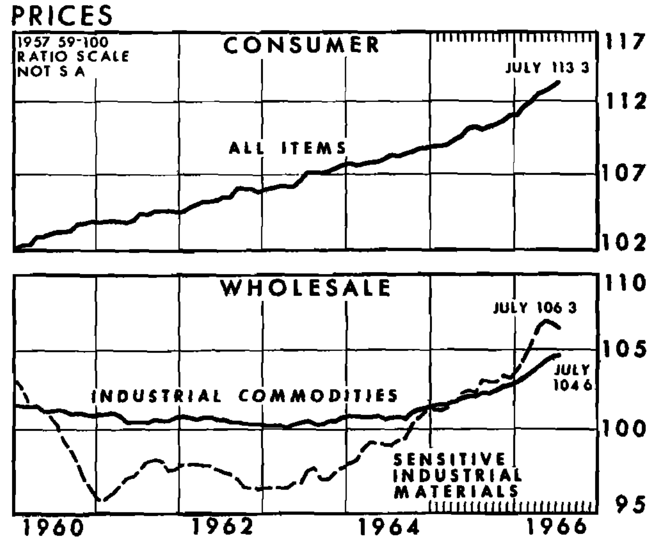
WORKWEEK AND LABOR COST IN MFG.



INDUSTRIAL PRODUCTION-II



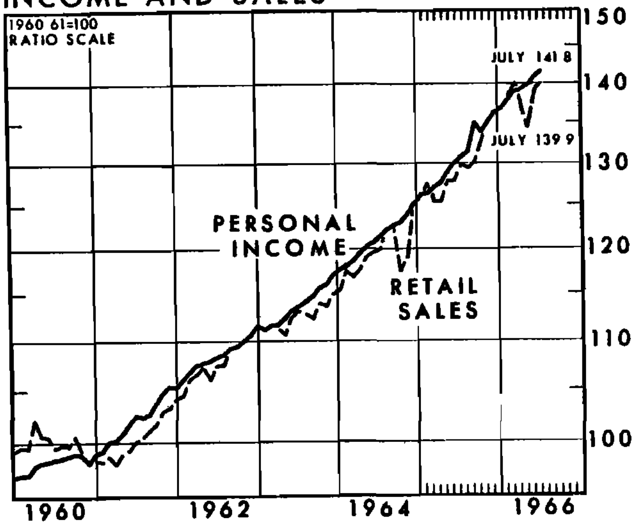
PRICES



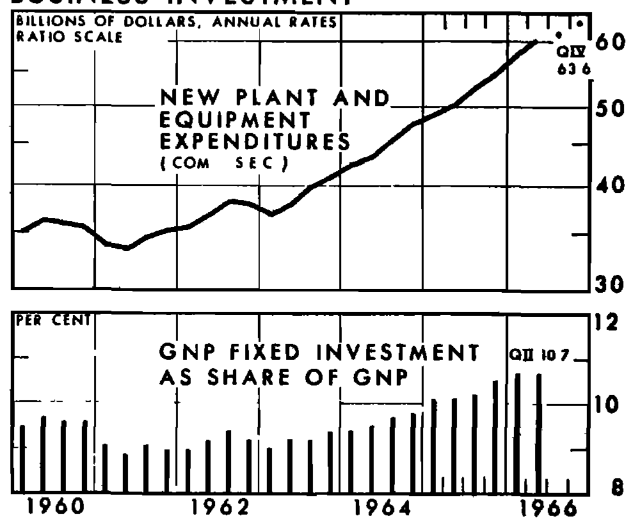
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

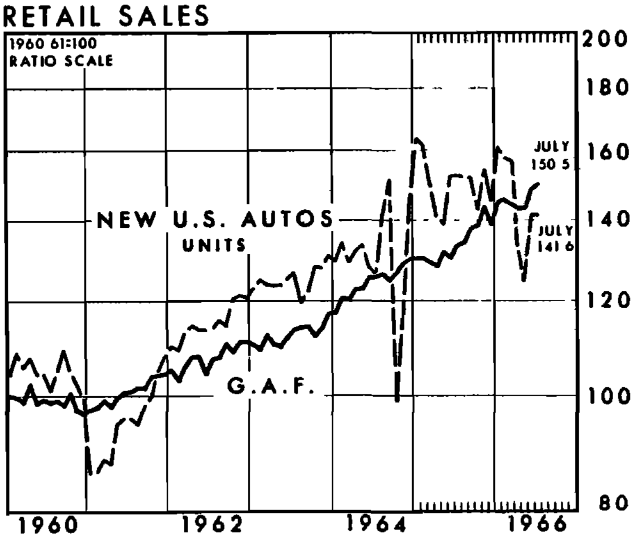
INCOME AND SALES



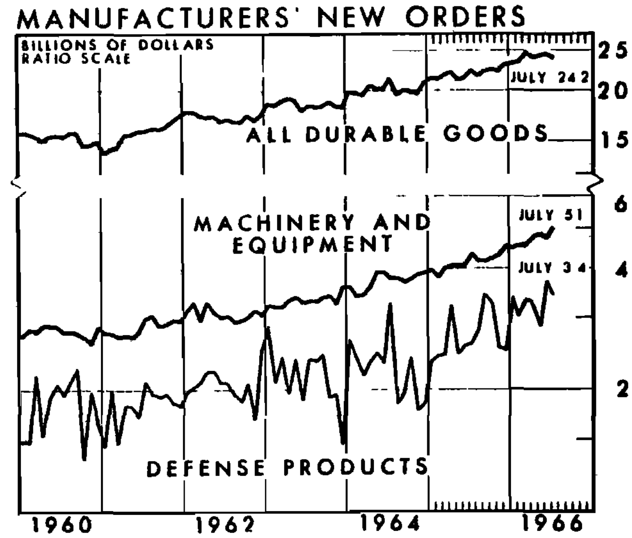
BUSINESS INVESTMENT



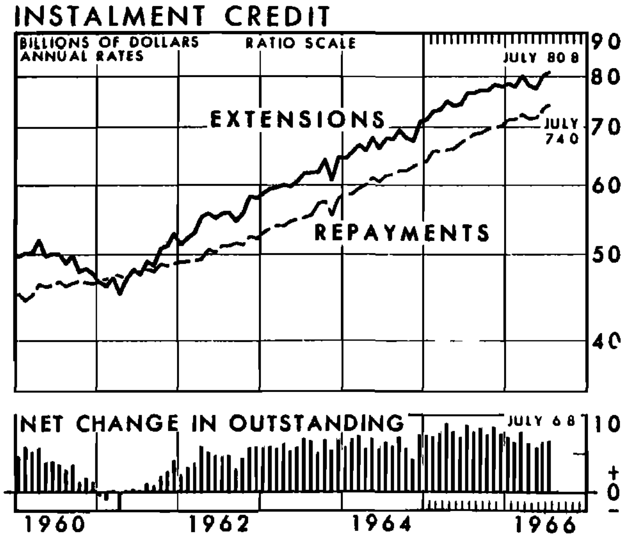
RETAIL SALES



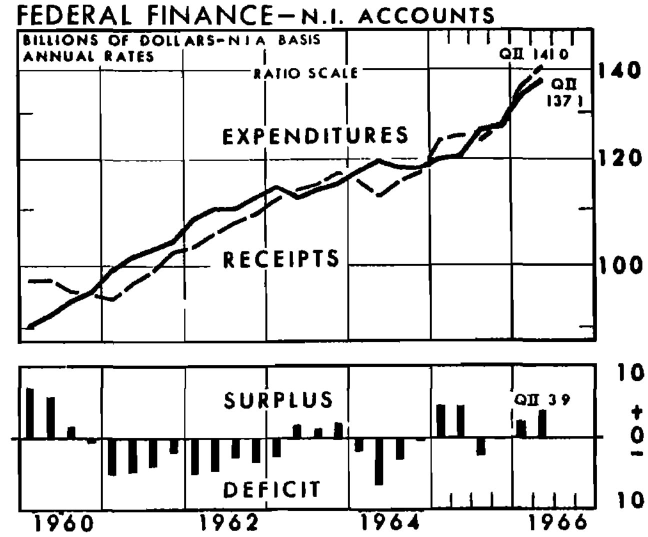
MANUFACTURERS' NEW ORDERS



INSTALMENT CREDIT



FEDERAL FINANCE—N.I. ACCOUNTS



DOMESTIC FINANCIAL SITUATION

Bank credit. Preliminary estimates indicate that total bank credit on a last Wednesday basis increased about $1.5 billion in August, an annual rate of 5.8 per cent. This was a little more than half of the July rate of growth and well below the 8.2 per cent average for the first six months of this year. On a daily average basis, the member bank credit proxy declined at a 2.0 per cent annual rate during the month. The discrepancy between these two measures is accounted for primarily by bank acquisitions of the March and April tax anticipation bills--fully payable by tax and loan account credit--which were delivered late in the month. Of the $3 billion total of these bills sold, practically all to banks, about $2 billion were apparently still in bank portfolios at month-end. In addition, the member bank credit proxy understates bank growth somewhat since it excludes foreign branch borrowing, which has increased recently.

Total loans at commercial banks in August showed little or no change on a seasonally adjusted basis, in sharp contrast with the July increase of nearly a 20 per cent annual rate. In the absence of the large acquisitions of the tax anticipation bills in the last week of August seasonally adjusted commercial bank holdings of Government securities also would have remained virtually unchanged, in contrast with the $2.1 billion increase now estimated. Furthermore, commercial banks liquidated $600 million in other securities, whereas banks were able to make substantial net additions of these securities earlier in the year.

The sharp departure in August from earlier monthly expansions of bank loans is accounted for, in part, by the $650 million decline in loans to finance companies at city banks. These repayments, which were much larger than seasonal, reflected not only a sizable reduction in the need for funds as auto inventories declined from their June peaks, but also a shift in the composition of short-term financing from bank loans to commercial paper. This shift presumably was partly in response to firmer lending policies at banks as well as differences in the relative cost of financing for these borrowers.

The slowdown in total loan expansion in August also was related to the effects of tax payment schedules on business loan demand. Previous tax accelerations in June and July reduced withholding tax payments due during the month by an estimated $1.8 billion. Preliminary seasonally adjusted figures show business loans declined $400 million, or at a 6.2 per cent annual rate, in August, after having increased sharply at a 31 per cent annual rate over the combined June and July period and an 18 per cent rate for the first 5 months of the year. Because of the temporal shifting of tax payments, the growth of business loans over the whole June to August period--an 18.3 per cent increase, at annual rates--may provide a better reflection of real trends than the August figure alone, though the new tax schedule for this 3-month period does include some payments shifted forward from September. The less than seasonal increase in bank loans in August to petroleum and chemical firms and the contraseasonal decline in loans to other manufacturing and mining firms most likely reflected these tax shifts. Loans to wholesale and retail trade concerns were also off sharply, whereas loans to metal and metal products industries remained strong during the month.

In the last 2 weeks in August the basic reserve position of New York banks dramatically improved as they curtailed sharply their borrowing from the Federal Reserve--to zero in the week ending August 31--and shifted to net sales of Federal funds. Earlier in the month, they had been net purchasers of Federal funds. These changes are more indicative of bank preparations for the September pressures rather than of any over-all easing in the money market. In addition to selling Federal funds, the New York banks also put some of the funds they received from the large repayments of business and finance company loans into short-term assets, such as dealer loans, rather than in other securities. Moreover, these banks were able to obtain additional large amounts of funds by borrowing from their foreign branches, as well as by issuing short-term promissory notes early in August. The outstanding volume of promissory notes fell sharply during the week ending August 31, as these notes were to become subject to reserve and interest rate requirements after September 1.

Bank deposits. Growth in commercial bank time and savings deposits in August continued at a pace approximately equal to the July annual rate of 14 per cent. Weekly reporting banks outside of New York City continued to be highly successful in attracting time deposits, though they did experience a contraseasonal decline of about $150 million in savings deposits. Their outstanding CD's rose by about $170 million in the 5 weeks ending August 31, and time deposits other than CD's by more than $530 million, an increase well above that for the comparable period in previous years. As mentioned in earlier Greenbooks, the ability of these banks to continue to attract time deposits may reflect the willingness of their business customers to sacrifice yield to keep their credit lines open, though some switching out of savings deposits may have also been operative. At New York City banks, in contrast, total time and savings deposits declined by $203 million during the month, reflecting a $260 million run-off in CD's and a small contra-seasonal decline in savings deposits. Time deposits other than CD's rose much more than seasonally.

In order to sell new CD's within the 5-1/2 per cent ceiling, it appears that the larger banks have had to offer mainly short maturities. Consequently, 30 per cent of all CD sales made in August will mature in September with another 21 per cent falling due in October. For New York banks more than 60 per cent of their August sales will mature in these 2 months. September maturities, which already amounted to $4.0 billion at the end of July, rose to a new record level of almost $5.3 billion by the end of August. The magnitude of these maturities was clearly a factor in the evident preparations for September run-offs.

At country banks, time deposit growth slowed down in August on average, with rapid expansion in July and the early weeks of August giving way to a decline in flows as August progressed. These banks were apparently under some pressure during August as their borrowing from the Federal Reserve resumed the upward course it had followed prior to June and July, during which months time deposit inflows at country banks had accelerated.

The private money stock declined again in August though by much less than in July. For the two months combined, the reduction amounted to 7.0 per cent (annual rate), and for the year to date the annual rate of increase now amounts to only 1.5 per cent. Treasury deposits dropped $1.6 billion in August following a July rise of similar size, but loan repayments and attractive yields on money substitutes prevented this development from greatly influencing the level of private demand balances.

Corporate and municipal bond markets. Yields on recently offered corporate bonds, after rising steeply--by as much as 30 basis points--in the latter part of August, have since been marked down abruptly erasing most of the preceding rise. In the municipal bond market the pattern of yield changes has been similar, but the magnitudes of the rise and fall are more difficult to pin-point because of the greater variation in maturity and quality among recently offered issues. Because the published yield series shown in the table are weekly averages for outstanding issues on which yield changes typically lag behind those for recently offered issues, the averages do not fully reflect the steepness of either the late August rise or the most recent decline. The reoffering yield on the one new corporate bond with 5-year call protection scheduled for sale this week is expected to adjust to about 5.90 per cent.

BOND YIELDS
(Per cent per annum)

	Corporate Aaa			State and local Government	
	New		Seasoned		
	With call Protection	Without call Protection		Moody's Aaa	Bond Buyer's (mixed qualities)
1965					
Low	4.33(1/29)[1]		4.41(3/12)	2.95(2/11)	3.05(2/11)
1966					
Low	4.79(1/7)	4.84(1/7)	4.73(1/7)	3.39(1/21)	3.51(1/21)
Weeks Ending					
July 29	5.47	5.65	5.22	3.78	3.96
Aug. 19	5.65	--	5.31	3.94	4.17
Aug. 26	5.92	--	5.37	4.04	4.24
Sept. 2	5.98	--	5.43	4.02	4.24
Sept. 9	5.90 est.	--	n.a.	n.a.	n.a.

1/ Issues with and without call protection averaged together.

The down-turn in bond yields during the past week has been chiefly attributable to changed market expectations, following press leaks indicating the possibility of an Administration proposal for near-term fiscal action to combat inflation and higher interest rates. As a result, some of the rather extreme fears of an approaching credit availability crisis that had developed in late August were moderated. Reports that sales of Federal participation certificates might be deferred or reduced in size, and the Federal Reserve statement on discounting, which was taken to suggest that banks would be under less pressure to liquidate securities, further accentuated the yield reversal.

The impact of the Federal Reserve statement was most pronounced in the secondary market for municipal bonds where continued bank liquidation of holdings had begun to create trading conditions which many market participants were characterizing as disorderly. The yield on one large new issue of municipal bonds brought to market at about the time of the statement was subsequently marked down more than 30 basis points, and dealers moved quickly to cover short positions. By early September the "blue list" of dealers advertised inventories had dropped to about $250 million, the lowest level reported since August 1960.

In the corporate bond market one might have expected the Federal Reserve statement to buttress expectations of an enlarged corporate bond calendar and thus to create upward pressures on yields. But corporate bond yields in fact moved down with those in other markets, apparently reflecting the more important influence on expectations of the reports of imminent Federal fiscal actions. Thus, the Aaa-rated AT&T debentures which were reoffered in early August at 5.58 per cent, with 5-year call protection, and then rose to 5.93 per cent on August 29, have since been marked down about 20 basis points. Similarly, the Aaa-rated Southern California Edison bonds, offered at 6.05 per cent on August 24, which then rose to 6.28 per cent, have since dropped back below 6 per cent.

Looking beyond the immediate psychological factors influencing expectations immediate business demands for long-term financing remain heavy. The calendar of publicly-offered corporate issues already scheduled for September exceeds $800 million and ultimately seems likely to run to at least $1 billion, nearly as large as the record $1.2 billion August volume. On the other hand, the restricted availability of funds among institutional lenders is likely to keep the volume of private placements at a reduced level. While there are some reports of businesses deciding to cancel or defer spending and financing plans, it is difficult to measure the quantitative significance of these changes.

CORPORATE SECURITY OFFERINGS 1/
(In millions of dollars)

	Bonds					
	Public Offerings 2/		Private Placements		Stocks	
	1966	1965	1966	1965	1966	1965
1st Qtr.	1,774	905	2,586	1,673	734	429
2nd Qtr.	1,942	1,864	2,083	2,259	1,090	920
3rd Qtr.	2,685e/	1,575	1,550e/	1,954	325e/	383
June	832	748	784	980	811	309
July	460e/	542	600e/	780	125e/	122
August	1,225e/	369	450e/	468	100e/	93
September	1,000e/	664	500e/	706	100e/	168

1/ Data are gross proceeds.
2/ Includes refunding.
e/ Estimate.

In the municipal bond market, volume for both September and the third quarter is expected to run behind a year ago. To some extent, the year-to-year reduction in volume reflects recent postponements or cancellations of new issues--due largely to the limitations of interest rate ceilings. In addition, announcements of new listings on the forward calendar have slowed somewhat in recent weeks. More general pressures to finance State and local government expenditure programs appear to be continuing, however, and any significant yield decline would very likely bring back some of the borrowers held out of the market recently.

STATE AND LOCAL GOVERNMENT BOND OFFERINGS
(In millions of dollars) 1/

	1966	1965
1st Quarter, total	3,006	2,851
2nd Quarter, total	3,216	3,046
3rd Quarter, total	2,325e/	2,781
Total, 1st 3 Qtrs.	8,547e/	8,678
July	700e/	1,040
August	750e/	733
September	875e/	1,008

1/ Data are for principal amounts of new issues.

Flows to financial intermediaries. Final data on savings flows to mutual savings banks and savings and loan associations indicate that the S&L's lost $1.5 billion in savings capital during July, whereas deposits at the mutuals rose a near record $200 million. Both numbers are larger than previously estimated.

NET SAVINGS FLOWS
(Millions of dollars)

	1966	1965	1964
		January through July	
S&L's	608	3,747	5,443
MSB's	972	1,896	2,218
	Months with Quarterly Reinvestment Periods		
S&L's			
January	-47	241	463
April	-772	-94	317
July	-1,509	-434	38
October	?	610	750
MSB's			
January	227	358	382
April	-341	-22	87
July	195	212	284
October	?	170	233

No firm data are yet available on net savings flows for August, but preliminary estimates for New York State indicate that mutual savings banks continued to experience near record net inflows, as in July, while net inflows at S&L's in New York were reportedly no more than half the already reduced inflow of last August. Preliminary reports from S&L's in some other areas indicate a roughly similar experience. In August a year ago net inflows at all S&L's totaled $550 million.

S&L industry analysts are now looking ahead to the next quarterly reinvestment period in October with some concern, wondering whether that month too will show a net loss of savings capital, as in the three previous quarterly reinvestment periods. Industry apprehension about October is heightened by the sharp further advance of yields on competitive market instruments since July. Also there is some concern that commercial banks will begin to compete more aggressively for savings with their consumer-type CD's if these institutions begin to experience a sizable run-off of large negotiable CD's.

As the table shows, October has not been a typical quarterly reinvestment period, since neither seasonal nor semi-annual dividend pressures are present. January, April, and July have built in seasonal pressures such as Christmas, Tax or vacation payments and both January and July experience the coincident termination of quarterly and semi-annual interest accrual periods. Consequently, during the past 20 years S&L's have not experienced any net outflows within the last 5 months of the year and mutual savings banks have had net losses on only a few occasions during this period.

Since July, S&L's have been pressed by the Home Loan Bank to repay advances from net gains of savings capital. This policy has been dictated by the need to conserve lending power within the Home Loan Bank system preparatory to expected expansion of advances during October. For this reason, outstanding advances have declined more than seasonally. At the same time, S&L's have also apparently added to their own liquidity, raising the average liquidity ratio (without Governments or a per cent of their control) from the record industry low of 8.94 per cent reached in July.

Mutual savings banks, virtually all of which credit interest quarterly, have also placed a large part of their July and August savings inflows in short-term investments, presumably in preparation for their own October reinvestment period. For this reason, deposits at mutuals have not been reflected in an equivalent increase of new mortgage loan commitments.

Mortgage market developments. Reflecting the sharp cut-back in availability of mortgage funds this summer, July mortgage debt held by the major types of institutional lenders grew only about half as much as in July a year ago. The availability squeeze was most pronounced at savings and loan associations--traditionally the major lenders on homes where July mortgage originations and purchases barely exceeded the reduction in portfolios from normal amortization and other factors. Other types of private lenders, with the possible exception of life-insurance companies, also continued to show their net acquisition of mortgage debt.

NET CHANGE IN MORTGAGE HOLDINGS FOR SELECTED GROUPS
July
(Millions of dollars)

	1963	1964	1965	1966
Total, incl. FNMA	2,255	2,151	2,204	1,370
Private only	2,346	2,176	2,199	1,134
Savings and Loan Associations	1,127	1,045	819	54
Mutual Savings Banks	314	436	413	280
Commercial Banks	600	400	700	500e/
Life Insurance Companies	305	295	267	300e/
FNMA	-91	-25	5	236

The net increase in holdings by FNMA in July offset roughly one quarter of the year-to-year shortfall in debt growth among the private lenders. In August, however, although offerings to FNMA by mortgage holders were being maintained at about the July level, purchases by FNMA were below those in July and other recent months, reflecting steps taken earlier to conserve buying power. Implementation of the new legislation expanding FNMA's purchasing authority potentially could permit an increase in FNMA's net acquisition of mortgages by $600-750 million per quarter over the next two years.

With mortgage credit generally constrained and with interest rates in other sectors of the capital market rising sharply further during August, there is little question that mortgage rates increased further in August. In July, the latest month for which data are available, the secondary market yield series for 30-year, FHA-insured mortgages reached an average of 6.51 per cent--6 basis points higher than in June and 105 basis points above the plateau prevailing a year ago just before mortgage yields began their steep climb. While the increase in contract rates for conventional first mortgages for home purchase has also been substantial since early last autumn, the amount of rise through July was less pronounced than for FHA-insured yields.

Conventional interest rates (FHA series) reached 6.45 per cent on loans for new home purchase and 6.55 per cent on loans to purchase existing homes, both 65-70 basis points higher than a year earlier.

Stock market. Stock prices as well as bond prices have risen on balance from the two year low reached in late August. Very recently, however, they have been edging lower again. In the Standard and Poor's composite index, the net advance from the August low amounts to about 2-1/2 per cent, following an earlier net decline of 21 per cent from February. The table shows how this decline compares with other major stock market breaks in the post-war period.

MAJOR STOCK MARKET DECLINES SINCE WORLD WAR II

Period of Decline (high to low)	Standard & Poor's 500 Stock Index (Percentage change)	Months from high to low	Average monthly rate of decline (Per cent)
1966 - Feb. to date	-18.8	--	--
- Feb. to August low	-20.8	7	3.0
1965 - Spring	- 9.6	2	4.8
1961-62	-28.0	6	4.7
1959-60	-13.9	14	1.0
1956-57	-21.6	14	1.5
1948-49	-20.6	12	1.7
1946-47	-23.0	12	1.9

The late August rally developed despite reports of a possible suspension of the investment tax credit. While some temporary rise in prices had been anticipated on technical grounds--because of the sustained earlier price decline and the resulting general drop in price-earnings ratios to levels below those reached at the bottom of the stock market break in 1962--the price improvement apparently developed partly because of the rumored change in the tax credit. Some of the earlier downward pressure on stock prices had reflected concern that the likely severity of an increasingly restrictive monetary policy might trigger serious financial dislocations.

Perhaps the most significant factor contributing to the general down-trend of stock prices this year has been the deepening belief among market participants that corporate profits and profit margins are likely to shrink in the period ahead. This would reduce earnings below those on which price-earnings ratios are currently being calculated and would limit opportunities for capital gains. Given this market expectation, the historically high yields available on fixed income securities have attracted increased investor interest vis-a-vis stocks.

The market outlook on corporate profits is, of course, partly a reflection of uncertainties concerning the chance of more stringent tax and wage-price policies. In addition, it apparently reflects expectations that the developing tight money and cost-push squeeze will be similar to those that occurred prior to the top of the boom in earlier post-war cycles.

U. S. Government securities market. The Treasury bond market registered its sharpest rally in many years at the end of August and in early September. The rally served to erase 50 to 60 per cent of the unusually large price decline of the previous five weeks. Treasury bill rates, on the other hand, continued to move to new highs in the recent period.

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	5.19	5.67	6.22	5.89	5.51	5.12
Lows	4.33	4.46	4.78	4.76	4.56	4.49
1965-1966						
Dec. 3	4.12	4.26	4.54	4.52	4.52	4.44
July 25	4.78	4.89	5.27	5.17	4.99	4.82
Aug. 29	5.02	5.51	6.22	5.89	5.51	5.12
Sept. 7	5.19	5.67	5.79	5.55	5.20	4.94

An atmosphere of unrelieved pessimism in the Treasury bond market gave way in late August and early September to a somewhat more optimistic outlook for bond prices, reflecting the same influences at work in other bond markets. The main thrust of the rally in the Treasury bond market appeared to be provided by dealer demand, including purchases to cover short positions. Dealer holdings of bonds due after

5 years rose from a small net short position in late August to a net long position of over $60 million on September 7.

Treasury bill rates continued to rise in the latter part of August and in early September, following the Treasury's $3.0 billion auction of March and April tax bills on August 18. Sizable bank sales of the new bills were reported and dealer bill positions increased as a consequence. Tending to moderate the run-up in bill yields and dealer positions were large System purchases in the market totaling nearly $925 million between August 24 and September 2. Public demand for bills remained relatively light, however.

The recent advance in bill rates has been accompanied by only selective yield increases on short-term debt instruments other than bills, as the accompanying table indicates.

SELECTED SHORT-TERM INTEREST RATES 1/

	1965	1966		
	Dec. 3	June 30	Aug. 19	Sept. 2
Commercial paper 4-6 months	4.375	5.625	5.875	5.875
Finance company paper 30-89 days	4.375	5.50	5.625	5.625
Bankers' Acceptances 1-90 days	4.25	5.50	5.625	5.75
Certificates of deposit (prime NYC)				
Highest quoted new issue:				
3-months	4.50	5.50	5.50	5.50
6-months	4.50	5.50	5.50	5.50
Highest quoted secondary market:				
3-months	4.50	5.56	5.80	6.00
6-months	4.59	5.65	6.05	6.25
Federal Agencies (secondary market):				
3-months	4.34	5.29	5.43	5.54
6-months	4.49	5.53	5.77	5.85
9-months	4.58	5.64	5.91	5.92
Prime Municipals 1-year	2.65	3.50	4.25	4.25

1/ Rates are quoted on the offered side of the 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 cash position. Despite a $3.0 billion cash financing in late August, the Treasury's cash operating balance is being drawn down sharply in the current quarter. The $6.0 billion balance now projected for the end of September is below the corresponding 1965 figure of $7.5 billion and well below the 1961-64 average of $8.8 billion.

The projected decline in the balance reflects a higher than usual third quarter cash deficit. Treasury cash payments ran well above projections in August and receipts fell somewhat short of expectations. A detailed breakdown of Treasury expenditures in August will not become available until later in September, but accelerated military expenditures account for most of the higher spending.

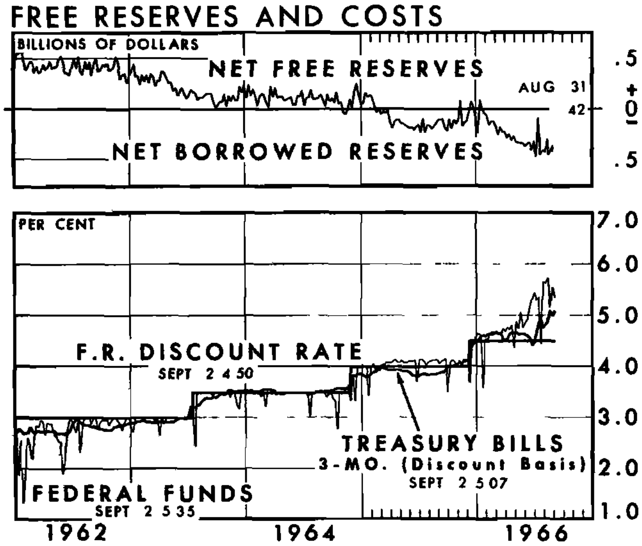
TREASURY CASH BALANCE AND DEFICIT
July - September
(Billions of dollars)

		1964	1965	1966	
Treasury cash operating balance	June 30	10.2	11.5	10.9	
	Sept. 30	9.4	7.5	6.0	proj.
Decline in balance		.8	4.0	4.9	"
Net cash borrowing, July-Sept.		3.2*	- .5*	2.0	"
Other sources of funds		- .2	+ .4	.6	"
Cash deficit		3.9	3.9	7.5	"

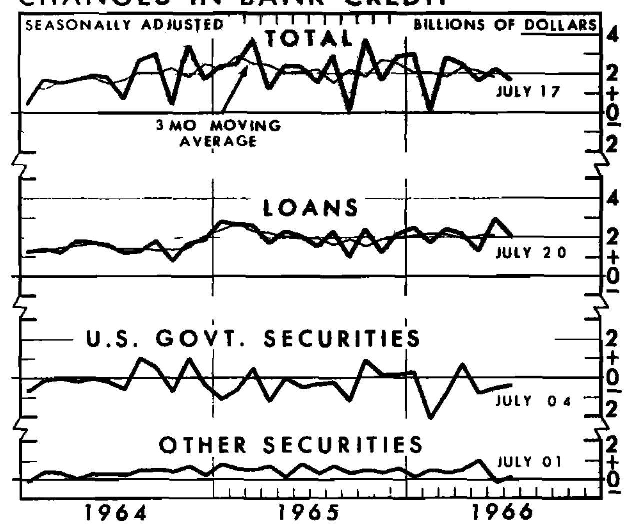
* Includes direct Treasury borrowing, attrition, and net Federal Agency financing.

FINANCIAL DEVELOPMENTS - UNITED STATES

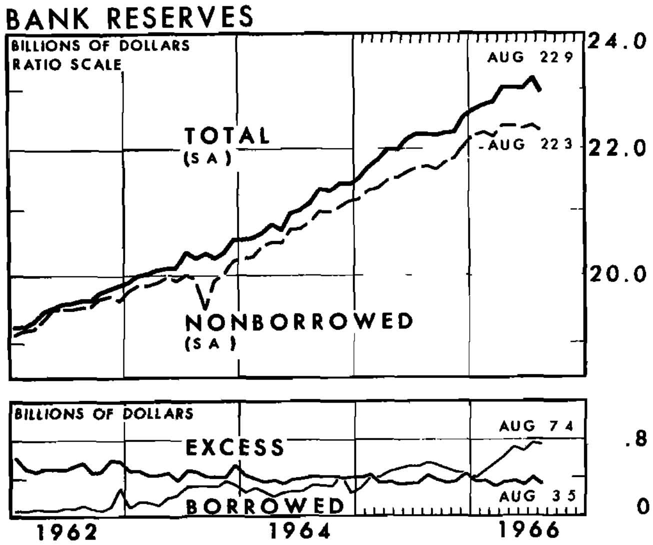
FREE RESERVES AND COSTS



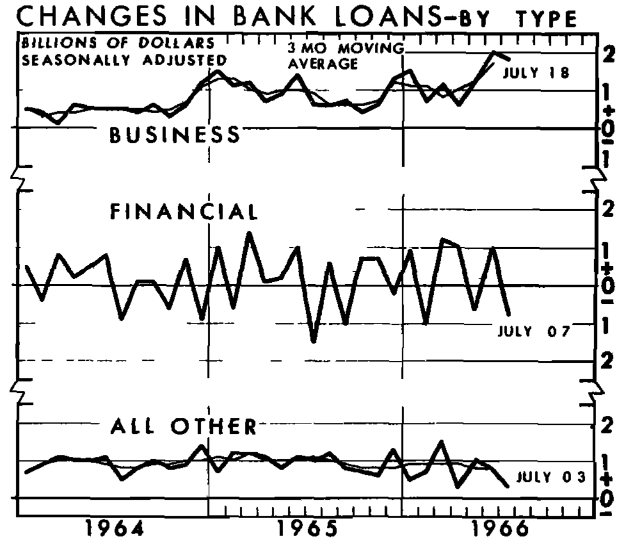
CHANGES IN BANK CREDIT



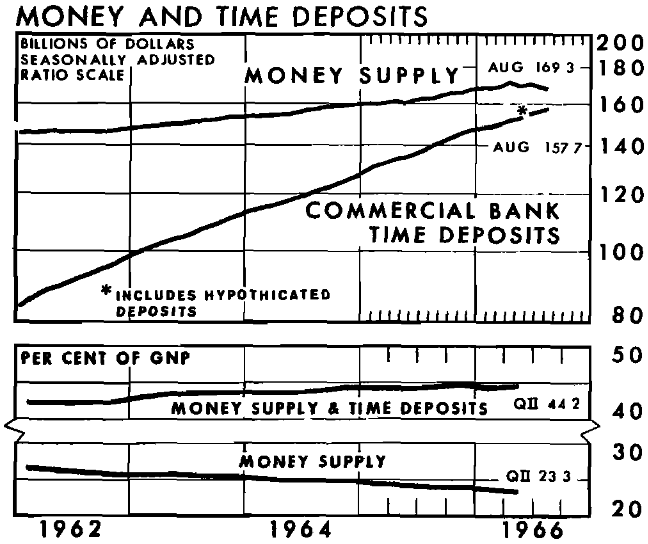
BANK RESERVES



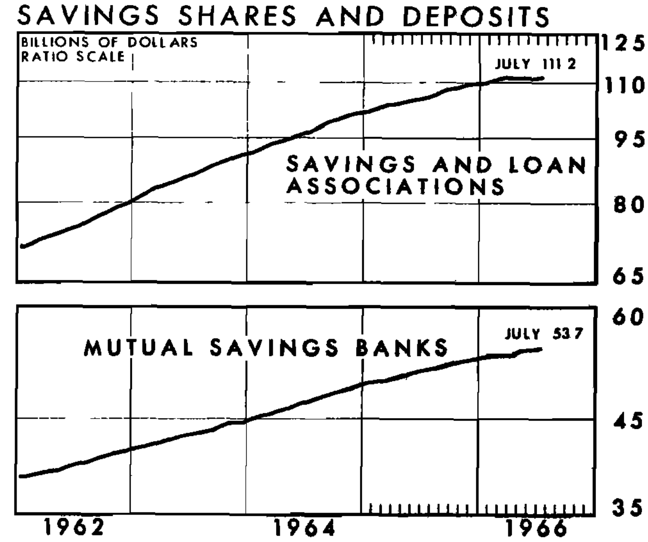
CHANGES IN BANK LOANS—BY TYPE



MONEY AND TIME DEPOSITS

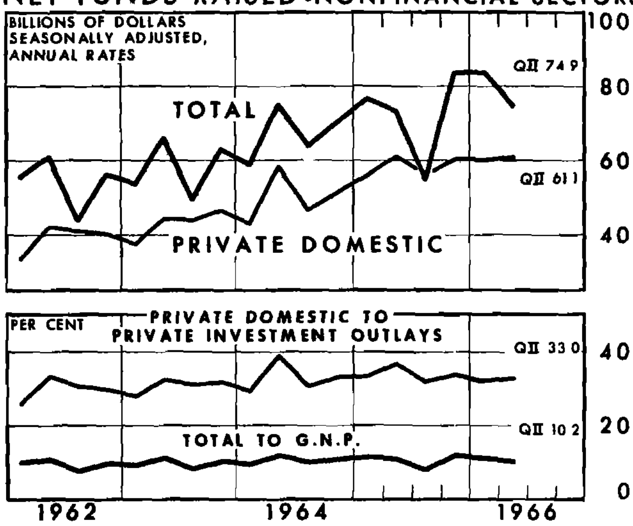


SAVINGS SHARES AND DEPOSITS

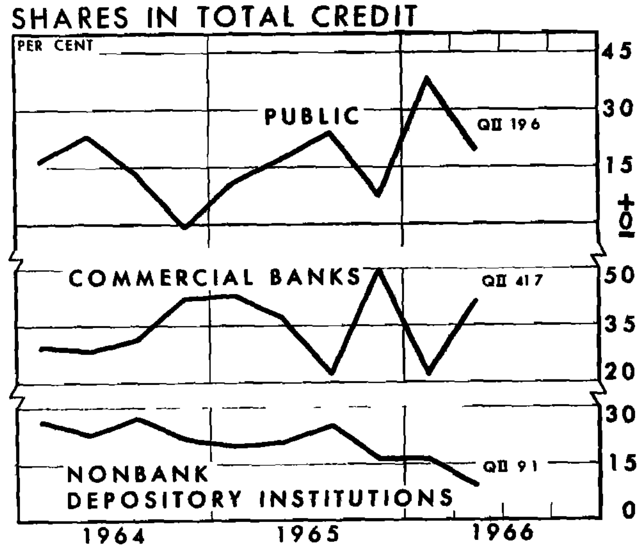


FINANCIAL DEVELOPMENTS - UNITED STATES

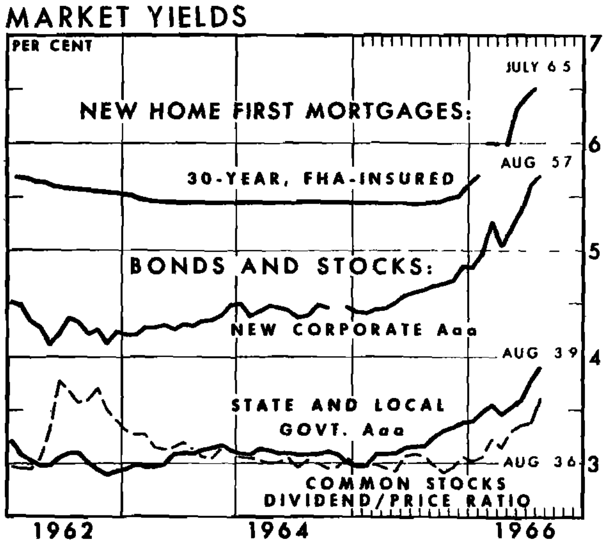
NET FUNDS RAISED-NONFINANCIAL SECTORS



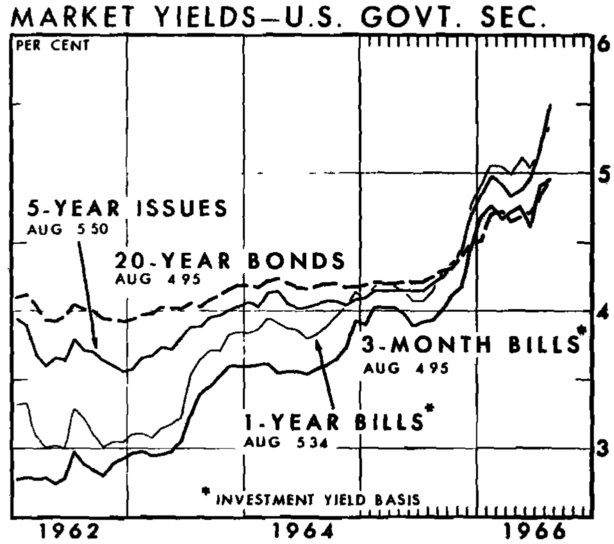
SHARES IN TOTAL CREDIT



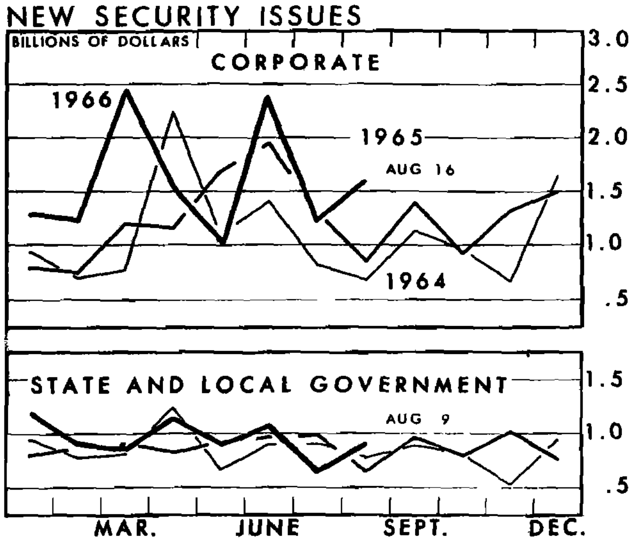
MARKET YIELDS



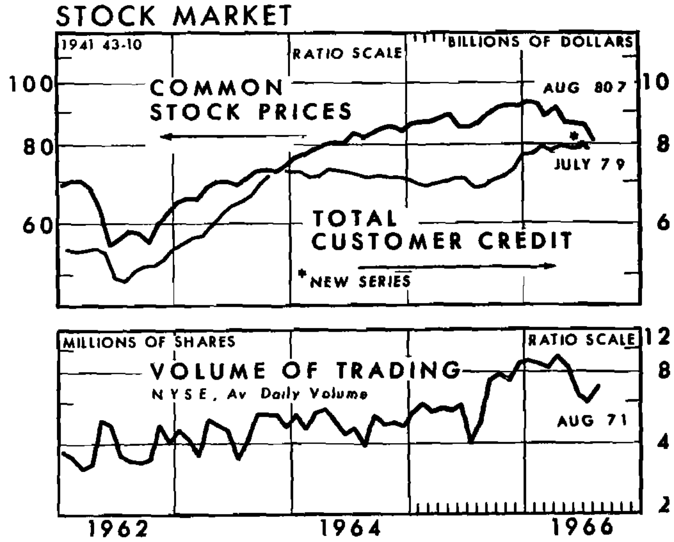
MARKET YIELDS—U.S. GOVT. SEC.



NEW SECURITY ISSUES



STOCK MARKET



INTERNATIONAL DEVELOPMENTS

U.S. balance of payments. Weekly indicators suggest a payments deficit on the liquidity basis for August somewhat below the July figure (revised to $500 million before seasonal adjustment.) For July and August together, the deficit after seasonal adjustment was probably somewhat less than $300 million a month.

On the official settlements basis seasonally adjusted, there were payments surpluses in both July and August, attributable in good part to the run on sterling (particularly in July) but also to shifts of foreign private funds from Continental currencies into dollar assets. Large-scale bidding for Euro-dollars by the European branches of U.S. banks has contributed importantly to upward pressure on Euro-dollar interest rates, particularly for short maturities. In July and August together, these branches provided $1 billion to supplement money positions of head offices. With these rates at high levels, some short-term funds have been attracted out of European currencies into dollar deposits abroad. Thus, since late July in some cases and mid-August in others, Continental exchange rates have weakened against the dollar, and a number of central banks have lost reserves supporting their currencies. French dollar intake of $45 million in August is believed to have been concentrated early in the month, and in early September the French franc was quoted at the lowest level in 5 years.

Stringency in U.S. financial markets has also helped hold down U.S. private capital outflows. Banks reported a net reflow of

$147 million in July under the VFCR, following a moderate second-quarter outflow, bringing the total leeway for expansion within the target ceilings to $1 billion. Preliminary indications suggest that in the summer banks may have been making new commitments on term loans to foreigners at a rate below the $70 million per month average of the first half, which already implied some net reflows on term loans. Reflows of bank credits have reflected not only pressures on U.S. banks, but also changes in the availability of credit abroad. The July reflow was primarily from Japan, and followed sizable reflows from that country as well as from Italy in the first half of the year. In both countries credit markets are relatively easy.

Effects of credit restraint are less evident for other types of U.S. private capital. Direct investment outflows in the second quarter, apart from investments of $280 million financed by sales of securities abroad, were about $650 million (confidential until published at month-end) -- little changed from the average of the three preceding quarters. And new foreign bond issues in the United States in the third quarter seasonally adjusted were up from the low second quarter, mainly reflecting a large IBRD issue early in July.

While money and credit market developments have contributed both to favorable results on the official settlements balance in the past month and to some reflows of U.S. capital, internal demand pressures continue to squeeze the trade surplus, which stands at the lowest level since late 1959.

Imports rose further in July, and the trade surplus declined to an annual rate of $2-3/4 billion. Average figures for June-July show imports at a $26 billion annual rate (up $2 billion from the first quarter) and exports at an annual rate of $29-1/4 billion (up $1 billion from the first quarter.) The $1 billion decline in the trade surplus, to an annual rate of $3-1/4 billion, brings it to less than half the 1964 peak level.

Details on the specific commodities responsible for the rise in imports, or on the particular markets where exports fell off are not yet available beyond June, data for which were presented in the last Green Book.

Payments balances of other countries. The large and persistent payments deficits of the United States and the United Kingdom have inevitably been matched by an excess of surpluses over deficits elsewhere in the world. As will be seen from the table on the next page, a wide variety of countries had substantial surpluses during the 6 or 12 months to mid-1966. The general tendency was for the surpluses of less developed countries to increase, and for those of industrial countries to diminish. For some countries the position swung widely, either from deficit toward surplus, as for Australia and South Africa, or in the opposite direction, as for Spain, Switzerland, and the Netherlands. France and Italy continue to run the largest surpluses, although Italy's surplus has diminished significantly over the past year.

CHANGES IN NET OFFICIAL RESERVES
AND IN COMMERCIAL BANKS' POSITIONS,1/ 1964-66
(In millions of dollars)

Country or area	1964 1st half	1964 2nd half	1965 1st half	1965 2nd half	1966 1st half	Mid-1965 to mid-1966
G-10 Countries other than U.S. and U.K.	-106	+2,836	+797	+1,828	+438	+2,266
European Economic Community	+460	+1,458	+1,370	+1,020	+812	+1,832
Germany	+566	-472	+126	-404	+219	-185
France	+363	+433	+643	+318	+553	+871
Italy	-205	+1,005	+531	+1,046	+257	+1,303
Netherlands	-268	+320	-18	+14	-179	-165
Belgium	+4	+172	+88	+46	-38	+8
Others	-566	+1,378	-573	+808	-374	+434
Sweden	+78	+110	+22	+3	+33	+36
Switzerland 2/	-64	+212	-119	+180	-332	-152
Japan	-530	+420	+29	+381	+37	+418
Canada	-50	+636	-505	+244	-112	+132
Non-G-10 countries	+746	+401	-330	+620	+508	+1,128
Developed countries	+393	+477	-770	+22	+15	+37
Austria	-8	+96	-33	+27	-40	-13
Spain	+117	+249	-61	-43	-217	-260
Other Europe	+71	+320	-256	+186	-109	+77
Australia 3/	+131	-67	-264	-111	+179	+68
South Africa	-22	-40	-202	+78	+186	+264
New Zealand	+104	-81	+46	-115	+16	-99
Less developed countries	+353	-76	+440	+598	+493e/	+1,091e/
Petroleum producing	+83	+32	+344	-102	+278	+176
Others	+270	-108	+96	+700	+215e/	+915e/

1/ Data for Group of Ten countries are changes in net official reserves and commercial banks' net foreign positions; from confidential B.I.S. compilations; net reserves include IMF positions. Data for other countries from IMF; gross official reserves and net IMF positions only.
2/ Change in net official reserves only.
3/ Includes foreign assets of commercial banks.
e/ Partly estimated.

The Common Market countries taken together continued to have a substantial surplus during the first half of 1966 of the order of $1-1/2 billion at an annual rate. After rough allowance for seasonal variations, almost all of that surplus accrued to France and Italy. The French surplus continued at about the same rate as in earlier periods. Italy's surplus, however, has declined significantly, partly as a result of a more rapid increase in imports than in exports, and partly owing to the emergence since mid-1965 of net capital outflows in place of earlier inflows.

Both Germany and the Netherlands had deficits during the year to mid-1966. In Germany, however, a substantial surplus has reemerged since last spring as a result mainly of the strong expansion of exports that got underway towards the end of 1965. And a sharp deterioration in the payments balance of the Netherlands during the first quarter of 1966, both on current and capital account, was partly reversed in the second quarter. Belgian reserves declined during the first half of 1966 as the trade balance weakened and capital inflows were lower than a year earlier.

In Switzerland, the other main European member of the Group of Ten, shifts in capital movements appear to explain the large reserve losses experienced during the first half of 1966. Higher interest rates abroad, especially on the larger volume of long-term dollar-denominated bonds offered in Europe, have attracted funds from Switzerland.

Among industrial countries outside Europe, Canada lost reserves in more than seasonal amount during the first half of 1966, but this was the outcome of a deliberate Government policy of reducing reserves (and net capital inflows from the United States) by redeeming Canadian bonds from U.S. holders in advance of maturity, and did not appear to reflect the emergence of an underlying payments deficit. Japan has remained in substantial surplus (on a calculation including commercial bank positions as well as the official reserve position), although in recent months official reserves have declined as the commercial banks have shifted from foreign to domestic financing of imports and have repaid debt to the United States.

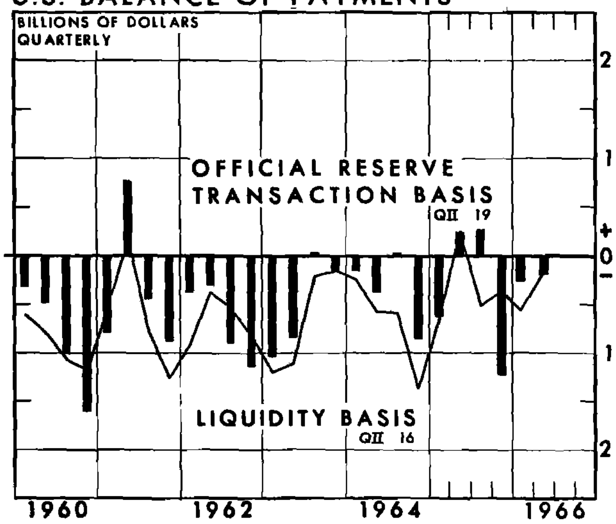
Major developed countries outside the Group of Ten have experienced large payments fluctuations over the past year. Spain has had a very large deterioration in its international transactions, shifting deep into deficit after several years of large surplus. Australia and South Africa, on the other hand, have corrected earlier deficits and moved into substantial surplus. Much of the Australian shift resulted from an increase in capital inflows. South Africa has cut imports sharply by means of direct import controls as well as internal policies of restraint, and capital inflows have increased. Recently, the import controls have begun to be relaxed again.

Incomplete data for less developed countries indicate continued substantial payments surpluses and reserve gains during the first half of 1966. Buoyant economic activity in industrial countries has kept markets for primary commodities generally strong. The surge in reserves of the petroleum producing countries early in 1966 is largely attributable to Libya, which had extra receipts arising from retroactive renegotiation of contracts, as the other countries had a year earlier. The international transactions and reserves of a number of Asian countries, including Thailand, Taiwan, Korea, and the Philippines, have been favorably affected by U.S. expenditures related to the war in Viet Nam.

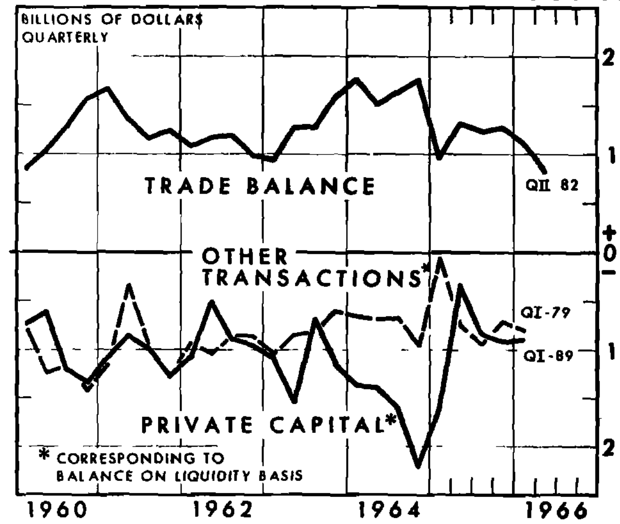
U.S. AND INTERNATIONAL ECONOMIC DEVELOPMENTS

SEASONALLY ADJUSTED

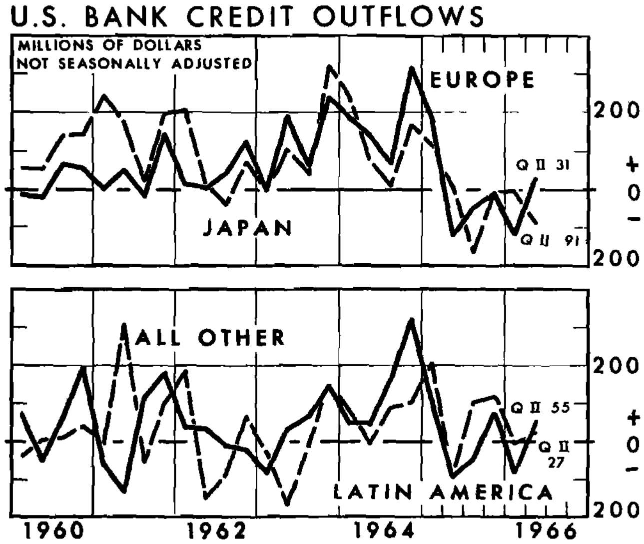
U.S. BALANCE OF PAYMENTS



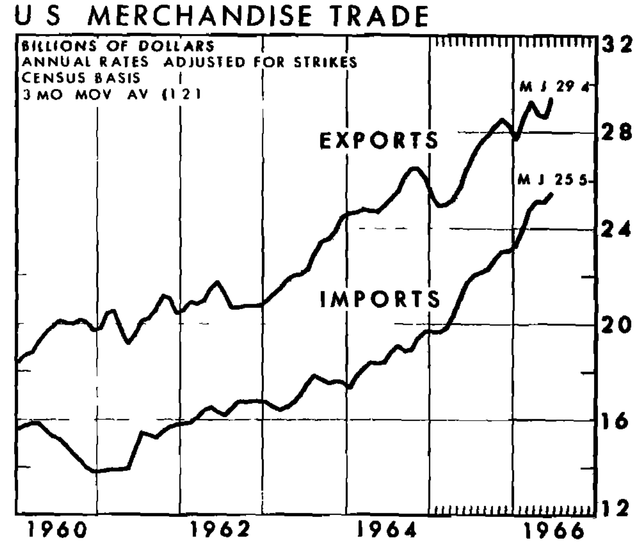
U.S. BALANCE OF PAYMENTS - CONT.



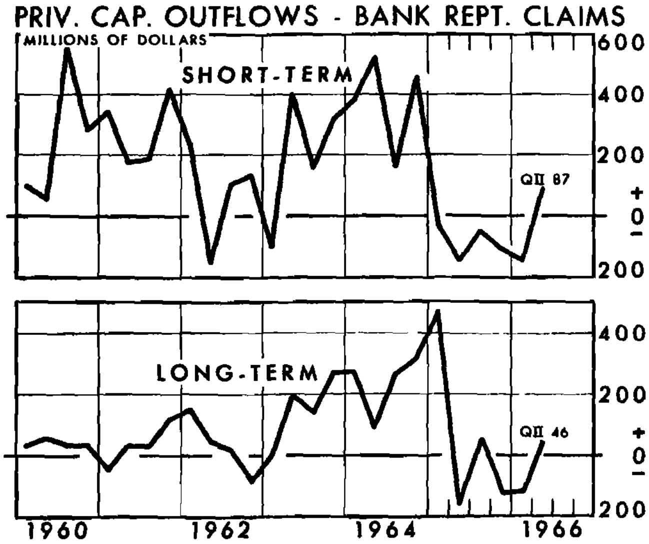
U.S. BANK CREDIT OUTFLOWS



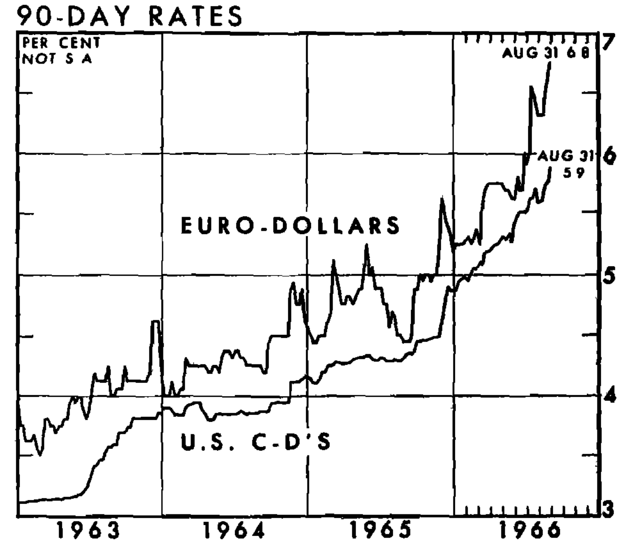
U.S. MERCHANDISE TRADE



PRIV. CAP. OUTFLOWS - BANK REPT. CLAIMS



90-DAY RATES



APPENDIX A: FNMA BILL AND MORTGAGE MARKETS*

Now awaiting the President's signature is a bill (S.3688) to provide the Federal National Mortgage Association with nearly $4.8 billion in additional authority to purchase FHA-insured and VA-guaranteed home mortgages. Of that total, $1 billion would go toward a special assistance program. Almost $3.8 billion would be for FNMA's secondary market operations, as indicated in Table 1. At present, FNMA mortgage holdings acquired under existing legislation exceed $6.3 billion.

Benefits and costs

If all the $4.8 billion were directed into new housing, the bill could finance as many as 317,000 housing starts, assuming an average mortgage amount of $15,000 per dwelling. A substantial share of the funds released by FNMA's mortgage purchases, however, will likely leak out into other uses. Unless FNMA concentrates its activity in mortgages on new rather than on existing homes, perhaps somewhat more than half of the funds total will go toward financing existing homes which will stimulate new housing only indirectly.

The full impact of the bill on the availability of mortgage credit and on housing starts will, of course, be considerably delayed; the bulk of the funds ($3.8 billion of the $4.8 billion total) must be obtained by selling new FNMA debentures in a congested capital market. This, as well as high interest costs, dictates financing in moderately-sized individual chunks over a number of quarters -- particularly so if the yield spread favoring mortgages over debentures should narrow further and make it more difficult for FNMA to break even. In addition, the lag may reflect difficulties that building firms encounter in obtaining temporary construction loans from private sources if credit remains tight.

One of the positive results of the legislation will be to facilitate indirectly the purchase of new houses by providing financing for the sale of some older houses. In current markets, many new-home buyers are finding difficulty in meeting required downpayments because they are unable to find buyers for their existing homes who can obtain the necessary financing. Another result will be to ease the currently unsettled state of the mortgage market, thus giving home builders some basis for advance planning. A third effect will be to keep intact some building organizations that might otherwise disband because of inability to finance their operations on even a limited basis.

*Prepared by Robert M. Fisher, Senior Economist, Capital Markets Section, Division of Research and Statistics.

Funds Raised and Used	Mechanics of Operation
Special assistance program:	
$1 billion to be borrowed from the Treasury as required to pay for purchases. Funds would be used to acquire FHA and VA mortgages solely on new homes started after date of Act, in face amounts not exceeding $15,000 each ($17,500 in "high cost" areas and $22,500 in Alaska, Guam, and Hawaii).	Advance commitments to purchase loans would be issued first by FNMA, probably at or near par. This price would be substantially above the current market (in July, FHA reports indicated that secondary market discounts on 30-year loans averaged 6-1/2 points; in August, discounts probably exceeded 7 points). Actual purchases would come later when completed loans were submitted to FNMA. In a similar program (Number 10) in 1958, FNMA commitments were made over a 7-month period and were picked up later with an average lag between date of commitment and date of purchase exceeding 6 months. Altogether, about 85 per cent of the number of commitments issued were taken down by FNMA during a period when the mortgage market was generally easing. More than four-fifths of FNMA's commitments were made at par (then 1 to 2 points above the market); the remainder, closed toward the end of the program, were made at prices slightly above the market.
Secondary market operations:	
$3.76 billion, to be borrowed ultimately from the general public by issuing short-term notes or debentures. Funds would be used to acquire FHA and VA mortgages on new or existing homes.	No advance commitments would be issued. Seller submits offering to FNMA for agency to buy loans under FNMA-posted price schedule. If acceptable, FNMA approves offerings by entering into purchase contract to buy, usually for immediate delivery. The lag between FNMA approval and FNMA purchase generally runs about 45 days. In addition to setting prices, FNMA may impose other conditions, such as age of acceptable mortgage (currently must be no older than 4 months), outstanding balance of loan (currently must not exceed $15,000), amount of FNMA stock that seller must subscribe to when sale is consummated (currently 1 per cent of unpaid balance of mortgages sold), and purchase and marketing fee (currently 1/2 of 1 per cent of unpaid loan balance).

The program seems likely also to provide some early stimulus to housing but with a delayed impact on capital markets for permanent financing. Advance purchasing commitments made by FNMA under its special-assistance program would be taken down, on the average, perhaps no sooner than two quarters later. FNMA purchase contracts executed under its secondary-market operations for immediate loan delivery would ordinarily be taken down more than a month later, and sometimes with a lag of as long as 2-1/2 months. (Table 1) In the interim, of course, short-term construction and/or warehousing credit would have to be obtained from private sources.

On the less positive side of the scale, financing of FNMA's mortgage purchases, under either its expanded regular secondary-market program or the new special assistance program, will require the flotation of additional agency or Treasury obligations, putting further pressure on already congested markets. Also, at a time when construction materials and labor are under strain in many places, additional credit supplied for home building--without further restraint on credit available to other sectors of the economy--may well result partly in still higher construction costs as well as in expanded output. Even now, for example, unemployment in the construction industry as a whole is still low, although the full effects of the sharply reduced rate of housing starts have not yet been fully reflected in construction employment.

Special assistance program. The $1 billion in special assistance funds will go toward loans solely on new housing. A large portion of this total will presumably find its way into financing housing starts that would not otherwise occur in a period of tight mortgage money. This conclusion is based on the assumption that a majority of the additional Treasury borrowing needed to finance these FNMA purchases will draw funds that would not otherwise be used (1) to finance mortgage acquisitions, or (2) as savings deposits in mortgage-lending institutions. But in view of the current high rates on Treasury obligations and the liquidity squeeze on many lenders, some substitution of public for private credit will inevitably occur.

The windfalls (to builders and/or mortgage companies) under this program will be large, since it appears likely that FNMA--following Congressional intent--will make commitments to buy these loans at or very near par, although discounts in the private mortgage market are now perhaps 7 points or more. Because the bill requires that all new-house loans purchased must be originated after the effective date of the legislation, sales to FNMA of loans taken out of existing warehoused inventories or sales of mortgages made under earlier commitments would not be possible.

Secondary market operations. A substantial part of FNMA's authorization for expanded secondary-market operations is likely to go into existing housing, unless FNMA takes offsetting administrative steps to direct the bulk of the aid into new-home loans. One possible change that FNMA might make would be to set a differential ceiling on the unpaid balances of different types of home loans that it stands ready to buy. This ceiling would be set at a substantially higher level for new-home loans than for existing-home loans. At present, the same ceiling of $15,000 applies to both types of loan collateral, although the average amount of loan underwritten by FHA or VA runs a fifth to a sixth larger on new homes than on existing homes.

Other considerations will also influence the stimulus to the housing market provided by the provisions of the bill. They include the willingness and ability of builders and old-house sellers to absorb the unusually large discounts that will undoubtedly be associated with FNMA's secondary-market purchases of loans. These discounts will be substantial even though FNMA does not necessarily have to break even over the short-run in order to fulfill the statutory injunction that its secondary-market activities should be "within its income derived from such operations and that such operations should be fully self-supporting."

Under current conditions in capital markets, FNMA might have to pay as much as 6-1/4 per cent if it floated 1-year debentures to raise needed funds. In addition, FNMA would incur home-office overhead costs of about 20 basis points, and would have to pay its standard servicing costs on the mortgages of 50 basis points. If FHA and VA loans continue to bear a face contract rate of 5-3/4 per cent per annum, FNMA would have to buy the mortgages at an average discount of approximately 10 points (at a price close to 90) in order to break even. If FHA and VA contract rates should be raised by administrative action to the 6 per cent statutory ceiling, discounts charged by FNMA would still average around 8 points. For used-house sellers also paying (in many cases) a fee of 6 per cent to a real estate broker, total selling costs could come to nearly 14 to 16 per cent.

Keeping in mind the long-run statutory objective of breaking even, FNMA could nevertheless buy mortgages in the near future at somewhat higher prices (smaller discounts) that might not fully cover its current costs. This step might be taken in the hope that FNMA could roll over its debentures at some later time at lower rates and so eventually make ends meet. As a practical matter, the step would have to be taken in order to stay at (or close to) going prices in the private market, where discounts now probably average 7 points or more.

Raising funds for FNMA debentures.

One obvious risk of FNMA's secondary market operations is that the agency's financing at prevailing market rates will divert some funds from lenders or from savers that might otherwise have gone into mortgages.

Through the first five months of this year, FNMA outstanding indebtedness expanded by $1.3 billion. Of this total increase, "all other investors" (including bank trust funds) took 64 per cent, and state and local general funds took 22 per cent. Commercial banks acquired nearly 10 per cent, while savings banks, savings and loan associations, and life insurance companies took virtually nothing.

For the "other investors" category--accounting for nearly two-thirds of the total--there is no information as to size of holding or source of funds. Some insight into the behavior of "small savers," however, may be obtained from unpublished, confidential information about the initial reception of FNMA's offerings of August 10. Of the total issue of $350 million, $300 million was offered privately at a coupon rate of 5-7/8 per cent, and reoffered at 5.91 per cent. The following table shows the distribution of private takedowns of debentures by the end of the first day of re-registration:

Denomination	Outstanding		Amount as per cent of total
	Number	Amount (millions)	
$ 1,000	2,200	$ 2	--
5,000	2,180	11	4
10,000	3,535	35	12
50,000	593	30	10
100,000	2,219	222	74
		$300	100

Only one-sixth of the total amount was in the form of debentures in denominations of $10,000 or less.

Assume that "other investors" account for as much as 70 per cent of the future expansion in FNMA debentures and that as much as 30 per cent of this share might be taken by "small savers," possibly out of existing savings or out of savings flows usually routed to traditional mortgage-lending institutions. On these assumptions, perhaps a fifth of the total amount of FNMA debentures might involve a substitution of credit otherwise used for mortgage lending.

Buying mortgage loans.

In recent years, four-fifths or more of all mortgages bought by FNMA under its secondary market operations have been offered by mortgage companies and related institutions. Banks and trust companies have accounted for nearly all the remainder.

Over the recent past, FNMA has maintained a 4-month rule (loans submitted must not be more than 4 months old) on offerings, partly in order to limit the volume of its purchases. It seems likely that this 4-month rule will continue to be imposed, in order to prevent lenders from perhaps unloading a considerable volume of older FHA and VA loans (even at quite large discounts) on FNMA so as to raise funds for liquidity or for other lending purposes.

Continued imposition of the 4-month rule should inhibit the direct substitution of FNMA for private holdings, thus limiting the achievement of FNMA's statutory objective of "providing a degree of liquidity for mortgage investments..." Even so, the maximum potential amount of substantial credit could still be large. In the most recent four-month period (April through July), FHA and VA underwrote a total of $2.8 billion in mortgages on new and existing homes. During the same period, FNMA purchased a total of $700 million under its secondary-market operations.

It seems probable that FNMA will lift its present restrictive $15,000 ceiling on the maximum amount of mortgage that it will buy. If this limit were increased to, say $25,000, nearly all FHA and VA loans would become eligible for submission by this test. Nevertheless, the 4-month rule might well prevent FNMA from buying many FHA and VA loans now in warehouse that may exceed $15,000 in face amount.

The volume of loans now being warehoused by mortgage companies without commitments from permanent private investors probably does not exceed $300 million, according to the best current estimates of the Mortgage Bankers Association of America. This figure probably includes some loans underwritten more than 4 months ago. But even if FNMA took down the entire amount, its action would, in effect, involve a substitution of credit of no more than $300 million.

As long as FNMA purchasing prices remain attractive, a considerable volume of submissions could continue to come from mortgage companies acting, in effect, as FNMA's agent even without advance commitments. Mortgage companies will continue to push FHA and VA loans (despite large discounts) for resale to FNMA in order to build up their servicing volume at an attractive fee (FNMA still pays an annual servicing fee of 1/2 of 1 per cent of the outstanding loan amount; many private mortgage holders now pay only 3/8 of 1 per cent, or less), and in order to derive whatever capital gain may be possible after deducting expenses of interim warehousing (now said to range between 6 and 6-1/4 per cent).

New versus existing homes.

In the first half of this year, about three-fourths of the record volume of FNMA's secondary market purchases were accounted for by loans on existing homes rather than on new ones. This portion was not far out of line with the share of loans then being underwritten by FHA and VA on older houses. Particularly in view of the fact that $1 billion of FNMA's special assistance funds will go exclusively to acquire FHA and VA loans on new houses, it seems difficult to believe that the new-home share of FNMA's total purchases under its secondary market operations will increase in the future, unless offsetting administrative actions are taken, as mentioned earlier.

If FNMA continues to purchase about three-fourths of its mortgages on old houses, most of this credit would be used, in effect to refinance outstanding mortgages on the older houses that are paid off at the time of sale. A reasonable assumption seems to be that between two-thirds and three-fourths of the amount of new loans might go toward replacing outstanding loans. If so, a third to a fourth would go toward expanding the amount of credit secured by the properties.

A crucial question, then, is the extent to which holders of loans that are then paid off will put the funds back into the mortgage market by making new commitments. This is hard to answer precisely, in view of the sharp structural strains being placed on all sectors of the capital market. Certainly, there are attractive--if not compelling--alternatives to mortgage investment.

APPENDIX B: REVISION OF NONFARM PAYROLL DATA*

Data on employment, hours and earnings in August reflect the revision by BLS to March 1965 benchmark levels and recalculation of seasonal factors for the adjusted series. The revision to benchmark levels was carried back to March, 1964 for most series. Unadjusted data on average hours and earnings in manufacturing were little changed by the revision. New benchmarks for religious hospitals and agricultural services, however, result in revised employment levels for service and total nonfarm employment beginning with January 1958. The seasonally adjusted series have been revised starting with January 1955.

REVISED NONFARM EMPLOYMENT
COMPARED WITH UNREVISED
(Seasonally adjusted, quarterly average, 000's)

	II Quarter 1966		
	Revised	Unrevised	Difference
Nonfarm, total	63,617	63,160	457
Manufacturing	19,031	18,958	73
Durable goods	11,136	11,120	16
Nondurable goods	7,895	7,838	57
Mining	618	613	5
Construction	3,290	3,323	- 33
Trans. and public util.	4,130	4,125	5
Trade	13,170	13,037	133
Finance & service	12,594	12,395	199
Government	10,784	10,709	75
Federal	2,532	2,531	1
State & local	8,252	8,175	77

The revised level of total nonfarm employment, seasonally adjusted, was about 450,000 higher in the second quarter this year than the old estimates. The major revisions were in services (up 200,000) and trade (up 133,000). Manufacturing employment was relatively little affected -- up 73,000. The effect of revised seasonal factors for average weekly hours of production workers in manufacturing on the series this year was to eliminate the February high of 41.6 hours and to extend the period of stability at 41.5 hours through May.

* Prepared by Jane Moore, Economist, National Income and Labor Section.