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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

[redacted]

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CURRENT ECONOMIC AND FINANCIAL CONDITIONS

By the Staff
Board of Governors
of the Federal Reserve System

October 26, 1966

SUMMARY AND OUTLOOK

Outlook for GNP

Department of Commerce preliminary figures show that GNP increased at a faster pace in the third quarter -- rising nearly $14 billion as compared with $11 billion in the second. Larger increases in defense outlays, business fixed investment, and consumer spending contributed to the step-up. Retarding influences in the quarter were declines in residential construction and the rate of inventory accumulation. Sectoral changes -- and the rise in total GNP -- in the fourth quarter are expected to be broadly similar to those in the third quarter.

With rising prices absorbing a large proportion of the increase in consumption expenditures since the beginning of the year, the rise in consumers' real takings has slackened, and output of consumer goods has shown only a small rise since early spring. The sharp step-up in consumer spending in the third quarter came from recovery in durable goods purchases, but only to the first quarter rate. In the current quarter, spending for durable goods is expected to increase only moderately further, with higher prices for autos a factor in the rise. More of the increase in total consumer spending now projected to accompany the large expected rise in income is likely to result from stepped-up purchases of nondurable goods and services, with higher prices also contributing significantly to the increase in current dollar volume.

Future growth in consumer incomes and spending will depend to an important degree on how strong an upward thrust is maintained in defense and business equipment sectors. Recent months have seen a steady escalation of defense spending estimates for the last half of this year. The third quarter increase in defense purchases of goods and services now stands (in the preliminary Commerce GNP figures) at $4.2 billion (as against $2.5 billion in the second quarter), and a further large rise in defense spending is projected for the fourth quarter. Orders for defense equipment spurted sharply in September to a new record level.

Since the beginning of the year, business construction has been easing off -- mainly in the commercial sector -- and an unusually large rise in equipment purchases has accounted for the entire increase in business fixed investment. New orders, the order backlog, and output continued to rise for machinery and equipment through September, and equipment outlays are expected to rise further in the current quarter.

Only a moderate further slowing in the rate of nonfarm business inventory accumulation is now being projected for the current quarter, in part because of the sustained growth in inventory requirements in the defense and business equipment industries. In consumer goods lines the rate of inventory accumulation appears to have tended downward since midyear.

Looking beyond the fourth quarter, it seems reasonable that continued monetary restraint, suspension of the investment tax credit and accelerated amortization, and some moderation of capacity pressures in consumer goods industries will probably result in reduction in overall growth in business fixed investment. Moreover, further downward pressures on the pace of inventory accumulation would tend to follow from any slackening of the rate of increase in activity in equipment industries, as well as from the general influence of restrictive monetary policy. But in the absence of any basis for forecasting the pace of defense spending or of additional fiscal restraints, it has not seemed fruitful to incorporate in the Green Book any quantitative projections of total GNP going into 1967.

Resource use and prices

Utilization of manufacturing capacity remained quite high in the third quarter and the unemployment rate was quite low. Nevertheless, expansion in industrial output and employment has slackened.

Levels of unfilled orders suggest that the deceleration of the rise in output in defense and business equipment industries -- to an annual rate of 14 per cent in the third quarter from about 20 per cent during the preceding 12 months -- was caused largely by limitations of plant or labor resources. For consumer goods, the virtual leveling in output is attributable, in part, to slackening in demands for autos last spring and summer and to a reduction in demand for appliances and other home goods associated with the decline in home building.

Partly as a result of crosscurrents in output of final products, pressures among materials-producing industries have varied. Supplies of major nonferrous metals and some types of textiles have remained short and supplies of some chemicals and paper products also may not be adequate to meet inventory demands as well as production requirements. But for other paper products and chemicals (including synthetic textiles), steel, and building materials, potential supplies are ample, and in certain cases, inventories may have increased to or somewhat above desired levels.

Looking ahead, output of defense and business equipment is likely to continue to press against capacity, but auto production is not expected to expand beyond the relatively high level to which it is recovering in October, and output of other consumer goods and most materials is likely to expand less rapidly than capacity. Although there are prospects for some selective easing in pressures on plant facilities, the expansion projected for GNP is sufficient to sustain increases in aggregate employment in line with growth in the labor force. The unemployment rate will remain below 4 per cent and various skills will remain scarce, but overtime work may be reduced in selected manufacturing industries.

Price developments, over the past year, have been dominated by the direct impact of expanding demands on certain materials and products, by reduction in supplies of a number of foodstuffs, and by rising wages in service industries; labor costs per unit of output have not generally increased by appreciable amounts in commodity-producing industries. In recent months, however, negotiated wage increases have tended to become larger, and with unemployment low, profits high, and the consumer price index up considerably, demands for wage increases are likely to remain large. At the same time, slower expansion in industrial output is likely to be accompanied by a reduction in the rate of gain in productivity. Rising unit labor costs, therefore, may become a greater influence on price developments.

Banking system

Business loans by banks will apparently expand at between a 10 to 12 per cent annual rate in October. While this expansion is greater than the 7-1/2 per cent rate of September, the increase was less than anticipated in light of the further acceleration of corporate payments of withheld taxes in October. Taking September and October together, business loan expansion has been at roughly one-half the pace of the first eight months of the year.

Apparently both supply and demand factors entered into the recent experience. Commercial banks have been forced to reduce their over-all credit growth sharply, and this has been reflected in a further tightening of lending standards to businesses and discouragement of loan applications. But there has also apparently been some moderation in business demand for funds at current loan costs. The cutback in bank loans to business has not been associated with any marked growth in security market financing. And while some business need for funds may have been satisfied by redemptions of outstanding negotiable CD's, at least part of funds withdrawn from CD's appears to have been reinvested in the bill market and helps account for the recent rapid decline in rates there.

Business loan growth over the next few weeks is not likely to be much more rapid than in the recent past, and might even be less so. Corporate tax liabilities will be reduced in November because of the accelerated payments of withheld taxes in October. While loan demands could be held down if inventory accumulation dropped more rapidly than is now projected, in the short-run rising capital outlays should maintain business external financing needs.

Banks may find less pressure on CD's over the next few weeks because of the lower level of interest rates on Treasury bills, especially on very short-term bills. With a possibly more favorable CD experience coupled with less intense bank credit demands, banks would have less need to liquidate securities and their borrowing demands on Reserve Banks would be reduced.

Capital markets outlook

In corporate and municipal bond markets the estimated volume of new financing during October and on the calendar for the period immediately ahead has remained quite moderate, despite the sizable general roll-back of bond yields since early September and the continued slower growth of business loans at banks. While there undoubtedly will be further additions to the November calendar in the weeks immediately ahead, underwriters at the moment report fewer large issues in the gestation stage than was the case last summer.

Offerings of new municipal bonds are expected to continue to run behind a year ago, as they did in the third quarter. Even at currently reduced rates a few recent State and local government borrowers continue to experience difficulty in covering financing needs at acceptable interest costs. And only a few of the issues postponed earlier in the year have as yet been brought back to market, notwithstanding the considerable recent decline in municipal bond yields.

In the U.S. Government securities market, yields have declined rather sharply thus far in October. The Treasury will announce its mid-November refunding by the end of this week. It is expected that this will involve two issues, the longer-term option maturing in 3-5 years with an attractive coupon, perhaps 5-1/4 per cent. In the prevailing market atmosphere such an issue could generate some selling of other securities in order to capture the higher current yield over the life of the new offering.

While the Treasury refunding could lead to some, perhaps temporary, upward yield adjustments, the outlook for the capital markets as a whole does not suggest any substantial upward interest rate movements. And in the absence of any build-up in corporate and municipal calendars, bond yields could drift off somewhat further. Such a development may, however, generate offerings of participation certificates by the Federal Government.

With respect to mortgage markets, under the new maximum rate ceilings and with market interest rates somewhat lower, savings flows to mutual savings banks have maintained their recent improvement in the first half of October; savings and loan associations also appear to be somewhat less hard pressed than earlier, although California S&L's appear little if any better off. Funds available for mortgage lending at life insurance companies may very well be cut back further, however, in view of the combination of heavy prior commitments and the erosion of available cash flows.

Balance of payments

With some abatement of tightness in U.S. money market conditions, U.S. banks made only slight further net drawings in the four weeks through October 19 on the Euro-dollar market, where the call-money and seven-day rates remained near earlier highs. Lacking large inflows of foreign private liquid funds such as occurred in July-September, the U.S. balance of payments has been in deficit so far this month on the official reserve transactions basis, as well as on the liquidity basis.

In the absence of large accretions to Euro-dollar supplies such as those associated with movements out of sterling last summer, it is unlikely that inflows of foreign liquid funds through U.S. banks will resume on the very large scale of July to mid-September. Toward the yearend, seasonal tightness in the Euro-dollar market may produce some return flow to Europe.

The short-term liabilities of U.S. banks to foreign holders of Euro-dollar deposits now constitute a sizable threat overhanging the U.S. net official reserve position. However, if a substantial run-off of these liabilities some time in the future were to be associated with movements of funds from the Euro-dollar market into sterling -- either in response to covered rate differentials or for other reasons -- the resulting addition to U.S. official reserves could hardly be considered an unfavorable development from the U.S. point of view -- even though U.K. repayments of central bank credits (and eventually of IMF drawings) would tend to augment the official dollar holdings of Continental Europe.

Data on U.S. international transactions in September show a further shrinkage in the trade surplus, with merchandise imports at a new high, and on the other hand further net repayments of bank credit by foreigners. Preliminary incomplete data on settlement items suggest the following seasonally adjusted balances for the third quarter: a deficit under $1 billion annual rate on the liquidity basis without special adjustment; a deficit near $2 billion annual rate if adjustment is made for foreign debt prepayments to the United States and foreign shifts into nominally nonliquid U.S. assets; a large surplus on the official reserve transactions basis, amounting in the single quarter to something between $1 and $1-1/2 billion -- so far out of line with other periods that measurement in annual rate terms would be meaningless.

In coming months, official reserve transactions are unlikely to show a surplus for the United States. But even if (as seems likely) there are no further massive inflows of foreign liquid funds, the net outflow of U.S. capital may continue to be restrained. Accordingly, so long as U.S. bank credit remains as tight as in recent months, the liquidity deficit (apart from special transactions) may remain nearer a $2 billion level than the $3 billion level which was feared a few months ago.

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.)	Sept'66	77.1	77.4	75.6	2.0	3.7
Unemployment (mil.)	"	2.9	3.0	3.3	-11.0	-22.9
Unemployment (per cent)	"	3.8	3.9	4.4	--	--
Nonfarm employment, payroll (mil.)	"	64.2	64.2	61.2	4.9	9.2
Manufacturing	"	19.2	19.3	18.2	5.7	10.0
Other industrial	"	8.0	8.0	7.9	2.0	4.8
Nonindustrial	"	37.0	36.9	35.2	5.1	9.9
Industrial production (57-59=100)	"	158.2	158.3	143.5	10.2	18.1
Final products	"	157.2	156.9	143.3	9.7	18.4
Materials	"	159.4	159.6	143.7	10.9	17.6
Wholesale prices (57-59=100)1/	"	106.8	106.8	103.0	3.7	6.1
Industrial commodities	"	104.4	104.5	102.3	2.1	3.7
Sensitive materials	"	103.0	103.9	103.0	0.0	3.5
Farm products and foods	"	111.7	111.3	103.5	7.9	12.5
Consumer prices (57-59=100)1/	"	114.1	113.8	110.2	3.5	5.3
Commodities except food	"	107.0	106.6	104.9	2.0	2.6
Food	"	115.6	115.8	109.7	5.4	7.8
Services	"	123.5	123.0	118.5	4.2	6.9
Hourly earnings, mfg. ($)	"	2.74	2.73	2.63	4.2	7.0
Weekly earnings, mfg. ($)	"	113.33	113.00	107.72	5.2	8.9
Personal income ($ bil.)2/	"	589.5	585.4	552.5	6.7	17.3
Corporate profits before tax ($ bil.)	QII'66	82.8	82.7	74.5	11.1	24.0
Retail sales, total ($ bil.)	Sept'66	25.6	25.7	23.8	7.6	14.4
Autos (million units)2/	"	8.6	8.5	8.9	- 3.1	- 2.6
GAF ($ bil.)	"	6.0	6.1	5.6	7.3	18.6
Selected leading indicators:						
Housing starts, pvt. (thous.)2/	"	1,073	1,102	1,453	-26.2	-25.7
Factory workweek (hours)	"	41.4	41.4	41.0	1.0	2.0
New orders, dur. goods ($ bil.)	"	24.2	23.4	22.2	9.4	21.7
New orders, nonel. mach. ($ bil.)	"	3.6	3.8	3.3	9.7	24.4
Common stock prices (1941-43=10)	"	77.81	80.65	89.38	-12.9	- 6.7
Manufacturers' inventories book val. ($ bil.)	Aug'66	74.1	73.0	65.8	12.6	21.9
Gross national product ($ bil.)2/	QIII'66	746.0	732.3	686.5	8.7	16.9
Real GNP ($ bil., 1958 prices)2/	"	650.7	643.5	618.2	5.3	11.2

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

SELECTED DOMESTIC FINANCIAL DATA

	Week ended Oct. 21	Four-Week Average	Last six months High	Last six months Low
Money Market 1/ (N.S.A.)				
Federal funds rate (per cent)	5.35	5.36	6.13	3.00
U.S. Treas. bills, 3-mo., yield (per cent)	5.36	5.39	5.59	4.33
Net free reserves 2/ (mil. $)	- 297	- 467	- 94	- 583
Member bank borrowings 2/ (mil. $)	790	799	928	547
Security Markets (N.S.A.)				
Market yields 1/ (per cent)				
5-year U.S. Treas. bonds	5.25	5.30	5.89	4.76
20-year U.S. Treas. bonds	4.83	4.88	5.12	4.59
Corporate new bond issues, Aaa	5.86	5.82	5.98	5.12
Corporate seasoned bonds, Aaa	5.40	5.44	5.53	4.93
Municipal seasoned bonds, Aaa	3.83	3.86	4.04	3.47
FHA home mortgages, 30-year 3/	6.63	6.63	6.63	6.32
Common stocks S&P composite index 4/				
Prices, closing (1941-43=10)	78.04	76.40	92.42	73.20
Dividend yield (per cent)	3.73	3.79	3.80	3.13

	Change in Sept.	Average change last 3mos.	Annual rate of change (%) 3 mos.	Annual rate of change (%) 1 year
Banking (S.A., mil. $) 5/				
Total reserves 6/	124	- 18	- 0.9	3.6
Bank loans and investments:				
Total	-2,200	700	2.9	7.9
Business loans 6/	500	800	12.7	16.9
Other loans 6/	-1,100	100	1.2	8.5
U.S. Government securities	-1,900	- 200	- 3.7	- 4.4
Other securities	200	0	- 0.9	8.3
Money and liquid assets:				
Demand dep. & currency 6/	1,000	- 200	- 1.2	4.0
Time and savings dep. 6/	400	1,200	9.6	11.7
Nonbank liquid assets	1,200	600	2.5	4.6

N.S.A.--not seasonally adjusted. S.A. Seasonally adjusted.
1/ Average of daily figures. 2/ Averages for statement week ending October 19. 3/ Latest figure indicated is for month of September. 4/ Data are for weekly closing prices. 5/ Where necessary, comparisons shown below have been adjusted for definitional changes in June and July. 6/ Based on revised series.

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

	1966				1965			1965
	Sept.	Aug.	QII	QI	QIV	QIII	QII	Year (billions)
			Seasonally adjusted					
Current account balance			1,084	1,298	1,290	1,527	1,761	6.0
Trade balance 1/	215	294	853	1,118	1,271	1,231	1,317	4.8
Exports 1/	2,460	2,467	7,111	7,121	7,027	6,826	6,798	26.3
Imports 1/ 2/	-2,245	-2,173	-6,258	-6,003	-5,756	-5,595	-5,481	-21.5
Services, etc., net			231	180	19	296	444	1.2
Capital account balance			-1,175	-1,586	-1,542	-1,821	-1,426	-6.9
Govt. grants & capital 3/			-961	-948	-881	-743	-949	-3.4
U.S. private direct investment			-957	-687	-731	-569	-859	-3.4
U.S. priv. long-term portfolio			-94	-219	-154	-363	101	-1.1
U.S. priv. short-term			-53	-2	-27	105	412	0.8
Foreign nonliquid			890	270	251	-251	-131	0.2
Errors and omissions			-66	-268	-80	-240	-109	-0.4
Balances, with and without seasonal adjustment (- = deficit)								
Liquidity bal., S.A.			-157	-556	-332	-534	226	-1.3
Seasonal component			-27	488	-3	-472	-37	--
Balance, N.S.A.	137	-318	-184	-68	-335	-1,006	189	-1.3
Official settlements bal.,			-186	-246	-1,158	232	239	-1.3
Seasonal component			-182	628	33	-508	-184	--
Balance, N.S.A. 4/	--	41	-368	382	-1,125	-276	55	-1.3
Memo items:								
Monetary reserves (decrease -)	-139	-133	-68	-424	-271	-41	-68	-1.2
Gold purchases or sales (-)	37	-94	-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 (+) increases 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 at a seasonally adjusted annual rate of $759.5 billion in the fourth quarter, up $13.5 billion from the third. This rise is about the same as in the third quarter, when, according to the Commerce preliminary estimates, GNP totaled $746 billion. Present estimates for the two quarters -- and the indicated real growth rate of about 4 per cent per year -- are little different from our projections made over the past 2 or 3 months.

The third -- and fourth -- quarter increases represent a step-up from an $11 billion rise in the second quarter, and the step-up comes mainly from larger increases in defense outlays, business fixed investment and consumer spending. Part of the boost represented by these expansive developments has been offset in total GNP by a much larger fall-off after midyear in residential construction activity because of the sharp curtailment of mortgage financing funds and by a moderate decrease in the rate of inventory accumulation.

The main expansive strength in the second half year continues to be centered in defense and business equipment sectors. New and unfilled orders, output, and employment (including the Armed Forces) were rising through September, and large further increases in outlays seem assured during the current quarter. The increase in defense purchases of goods and services amounted to $4.2 billion in the third quarter, according to preliminary Commerce estimates; a similar increase is projected for the current quarter, after allowance for inclusion in the third quarter rise of the one-time stimulus of the Federal pay raise. These figures represent a sharp step-up from earlier increases, and they are having a major influence on the pace of over-all activity.

In the other area of major strength -- business equipment -- order and activity trends also remained strong through September, and outlays are expected to rise sharply further in the current quarter. Business outlays for producers' durable equipment have been rising since the beginning of the year at an annual rate of 17 per cent, as compared with a 13 per cent increase from early 1965 to early 1966. Over-all business construction has shaded off since the first quarter, however, as the effects of restrictive monetary policy have limited commercial building activity, while industrial construction has remained relatively strong. The easing off in business construction has tended to limit the rise in total business fixed investment since early 1966 to an annual rate of around 8 per cent, as compared with a 15 per cent increase from early 1965 to early 1966 -- a period during which business construction rose by a fifth. Looking beyond the next few months, selective suspension of the investment tax credit, as well as some slackening of pressures on capacity in consumer goods lines, may well act to moderate the growth in equipment outlays as well.

Rising prices have been absorbing a large proportion of the increase in consumption expenditures thus far in 1966; the rise in real consumer takings has slackened and output of consumer goods has shown very little increase since early spring. Partly reflecting these developments in consumer buying, increases in nonfarm employment have tended to slow in recent months. However, wage increases have been accelerating and supplements to current income in the form of Federal transfer payments have been boosted since midyear (for Medicare and other purposes) with the result that personal income is continuing to rise rapidly. In the third quarter, despite a boost in social security tax payments (for Medicare) and a further large rise in other personal tax payments, disposable income increased $7.5 billion as compared with about $5 billion in the second quarter. Another large increase in disposable income is projected in the current quarter.

Recovery in durable goods purchases to the first quarter level accounted for the spurt in total consumption expenditures in third quarter, which outran the rise in disposable income and brought the indicated saving rate to the lowest level in three years. For the current quarter we are now projecting as large a rise in consumer spending as in the third quarter and no change in the saving rate. The projection assumes no change in unit (new) auto sales but larger increases than in the third quarter for nondurable goods and services. Evidence on the current reception of the new auto models is still uncertain, however. The different incidence of the auto model changeover this year is preventing accurate determination of seasonally adjusted sales levels.

Present GNP estimates incorporate only a moderate slackening in the rate of nonfarm inventory accumulation during the last half of year. This is in recognition in part of the probable continued growth in inventory requirements in defense and business equipment sectors, which last spring and summer were accounting directly for over 40 per cent of the large accumulation of factory stocks. Moreover, the magnitude of the change in auto stocks -- rapid accumulation of which contributed so significantly to the second quarter bulge in business inventory investment -- are still not firmly set. Some decline in auto stocks is assumed after midyear.

A major question is the extent to which the very high rate of accumulation of factory stocks in July and August may have been "involuntary." With manufacturing shipments showing little change from March on and with inventories rising rapidly, stock-sales ratios moved up rather abruptly and generally, and in the consumer goods, construction material and related sectors particularly inventories probably became too high. In August, manufacturers of durable goods reported intentions to make a very large downward adjustment in the rate of inventory accumulation in the current quarter, but this was predicated in part on an expected pronounced rise in shipments after midyear, which had not developed through September.

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

	1964	1965	1966 Proj.	1965 IV	1966 --- I	II	Projected III	IV
Gross National Product	631.7	681.2	739.8	704.4	721.2	732.3	746.0	759.5
Final sales	627.0	672.1	729.4	694.0	712.3	720.0	735.2	750.1
Personal consumption expenditures	401.4	431.5	466.3	445.2	455.6	460.1	470.0	479.5
Durable goods	59.4	66.1	69.8	68.0	70.3	67.1	70.3	71.5
Nondurable goods	178.9	190.6	207.0	197.0	201.9	205.6	208.3	212.0
Services	163.1	174.8	189.5	180.2	183.4	187.4	191.4	196.0
Gross private domestic investment	93.0	106.6	115.9	111.9	114.5	118.5	116.0	114.4
Residential construction	27.6	27.8	26.2	27.6	28.6	28.0	25.2	23.0
Business fixed investment	60.7	69.7	79.3	73.9	77.0	78.2	80.0	82.0
Change in business inventories	4.7	9.1	10.4	10.4	8.9	12.3	10.8	9.4
Nonfarm	5.3	8.1	10.5	9.0	8.5	12.1	11.3	10.0
Net exports	8.5	7.0	5.2	6.1	6.0	4.7	4.7	5.3
Gov. purchases of goods & services	128.9	136.2	152.5	141.2	145.0	149.0	155.3	160.6
Federal	65.2	66.8	76.5	69.8	71.9	74.0	78.3	81.8
Defense	50.0	50.1	59.5	52.5	54.6	57.1	61.3	64.8
Other	15.2	16.7	17.1	17.3	17.4	16.9	17.0	17.0
State & local	63.7	69.4	76.0	71.4	73.1	75.0	77.0	78.8
Gross National Product in constant (1958) dollars	580.0	614.4	647.9	631.2	640.5	643.5	650.7	657.0
GNP Implicit deflator (1958=100)	108.9	110.9	114.2	111.6	112.6	113.8	114.6	115.6
Per cent change, annual rate								
GNP current dollars	7.0	7.8	8.6	10.4	9.5	6.2	7.5	7.2
GNP constant dollars	5.3	5.9	5.5	8.4	5.9	1.9	4.5	3.9
Implicit deflator	1.6	1.8	3.0	2.2	3.6	4.3	2.8	3.5
Personal income	496.0	535.1	580.2	552.8	564.6	573.5	585.0	597.5
Wage and salaries	333.6	358.4	392.2	370.8	380.0	387.4	396.6	404.7
Disposable income	436.6	469.1	505.0	486.1	495.1	499.9	507.3	517.5
Personal saving	24.5	25.7	25.3	28.5	26.7	26.6	23.8	24.2
Saving rate (per cent)	5.6	5.5	5.0	5.9	5.4	5.3	4.7	4.7
Total labor force (millions)	77.0	78.4	80.1	79.0	79.4	79.7	80.4	80.7
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	77.4
Employed "	70.4	72.2	74.0	73.0	73.6	73.7	74.2	74.5
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	3.8

Industrial production. Industrial production in September was 158.2 per cent of the 1957-59 average, virtually unchanged from the August level. Auto assemblies increased from the reduced August level but production of furniture and some other consumer durable goods declined. Output of defense, industrial, and freight and passenger equipment increased while production of commercial equipment was unchanged. Among materials, output of iron and steel declined further but production of most other durable materials increased. Production of nondurable materials, chiefly some paper, textile, and chemical products, also declined.

Available production data, primarily for autos and steel, are insufficient to estimate the October index. Auto assemblies, so far this month, have advanced substantially, and this increase may account for about .3 to .4 of one point in the total index. Output of steel ingots, however, has declined further.

The rate of increase in industrial production slowed considerably further in the third quarter from the very rapid rate in the first quarter and somewhat lower rate in the second quarter. Among consumer goods, auto assemblies, reacting to a drop in sales and high dealer inventories, declined sharply in July and August but rose moderately in September. Over-all output of household durable goods rose from the first to the second quarter and then declined. Apparel production reached a new high last April and has changed little since then. Output of business and defense equipment increased in the third quarter, but the August-September rise in business equipment was one of the smallest in recent months.

INDUSTRIAL PRODUCTION
(Per cent change)

	1966	
	March-June	June-Sept.
Total	2.0	1.1
Autos	-8.7	-11.4
Home goods	2.9	- 1.7
Apparel	2.0	n.c.
Consumer staples	1.0	2.2
Defense equipment	6.0	6.2
Business equipment	3.3	2.9
Durable materials	1.9	1.0
Nondurable materials	2.9	0.6

n.c. -- No change.

Retail sales. Following sharp recovery in June from the decline in April and May, retail sales edged up somewhat further to August but in September and early October -- according to preliminary indications -- edged down a bit. In the first two weeks of October retail sales were reported to be only 5 per cent above a year earlier, as compared with a 9 per cent year-over-year gain in August. However, the largest part of this narrowing of the margin resulted from a substantial rise in sales between August and October last year. Moreover, year-over-year early October sales comparisons for auto dealers are somewhat ambiguous because of model changes.

Sales for the third quarter as a whole were up nearly 2-1/2 per cent from the second quarter, when auto sales were sharply curtailed, but were only 1 per cent above the first quarter. Sales of nondurable goods stores in recent months have been about 3 per cent above the first quarter average, while sales of durable goods have been somewhat below the first quarter in part because of lower unit sales of new autos.

Unit sales of new domestic automobiles in the first 20 days of October were at an annual rate of approximately 8.2 million, 5 per cent less than the rate in the preceding month but only slightly below a year ago. In the first 10 days sales appeared strong relative to a year ago, reflecting the early introduction of the new models, and in the second 10 days, sales appeared weak relative to the year-earlier period when the last of the new 1966 models were introduced. Dealer inventories of new cars on October 20 remained somewhat high for this time of year and were slightly above both a month ago and a year ago.

Consumer credit. The increase in consumer instalment debt was not as large in September as in August. On the basis of early reports from commercial banks, the September increase (seasonally adjusted, annual rate) is estimated to have been about $6.5 billion, compared with $7.2 billion in August and $6.8 billion in July. This would put the rate for the third quarter as a whole a little ahead of the second quarter but still behind the first, and sharply lower than last year's third quarter.

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

	Increase in outstandings
1965 - QI	7.4
Q2	8.0
Q3	8.3
Q4	7.8
1966 - Q1	7.1
Q2	6.3
Q3	(e)6.8

The tempo of the instalment credit expansion had picked up in July and August along with increases in consumer spending for autos, furniture and appliances, and other consumer durable goods. Similarly, when retail sales edged down in September, so did consumer credit growth.

Credit grantors have continued to pursue restrictive consumer lending policies, according to a special System survey of consumer loans taken three weeks ago. Problems of obtaining desired funds have apparently affected the small finance companies the most, and credit unions and retailers the least. The survey did not include an adequate sample of small retailers, so it is not clear how they have fared, but large retailers have been able to draw upon well-established lines of credit with their banks.

Construction activity. Seasonally adjusted new construction activity was off further in September from the peak reached last March and was at the lowest annual rate ($72.5 billion) in more than a year. Private residential construction accounted for all of the September decline, but private nonresidential construction expenditures were also down further in the third quarter as a whole. Reductions in commercial, educational and related activity were only partially offset by a small further increase in the already sharply advanced outlays for industrial plants and public utilities, Public construction activity apparently leveled off in the third quarter and was below its first quarter peak.

NEW CONSTRUCTION PUT IN PLACE

	3rd Q 1966 (billions)1/	Per cent change from	
		1st Q 1966	3rd Q 1965
Total	$73.1	- 7	+ 2
Private	49.3	- 9	--
Residential	24.1	-12	-10
Nonresidential	25.3	- 6	+11
Public	23.8	- 3	+ 9

1/ Seasonally adjusted annual rates; preliminary.

Developments so far suggest that the first quarter rate of residential construction outlays probably marked the peak in this series, and that the rate over the remainder of the year will not change significantly. In addition to limited availability of mortgage and other types of funds, costs of construction and financing have risen to dampen earlier plans. And although there was an increase in seasonally adjusted Dodge contracts for nonresidential building in September, it followed a period of irregular decline. Moreover, suspension this October of the 7 per cent investment tax credit and elimination of the most accelerated types of depreciation allowances for tax purposes (until early 1968) can be expected to have a contractive influence on speculative types of projects not yet started. While plans for large projects reaching architects' drawing boards are reported by Engineering News-Record to have risen again in the third quarter of the year, many of these plans are still at a stage at which, under the currently altered tax conditions, construction can be postponed.

Seasonally adjusted housing starts declined in September from a revised (upward) August rate nearly to the December 1960 recession low. For the third quarter as a whole, the rate was 1.09 million, more than a third below the recent peak in the first quarter of 1964. Some tendency toward stabilization over the near-term appears likely on the basis of depths already reached and in view of certain potentially ameliorative legislation affecting the flow of loanable funds recently approved by Congress. However, a further slide-off is likely in October, possibly to below 1 million unit rate for the first time since 1946, judging by the continued downward course of seasonally adjusted building permits in September. Although the decline in permits has affected multifamily units and activity in the Northeast and West the most, it has been quite pervasive, as shown in the table.

PRIVATE HOUSING STARTS AND PERMITS

	September (thousands of units)1/	Per cent change from	
		August 1966	Year earlier
Starts	1,073	- 3	-26
Permits	736	-13	-38
1 family	457	- 7	-33
2-or-more-family	279	-21	-44
Northeast	145	-29	-43
North Central	212	- 1	-29
South	237	-17	-37
West	142	--	-43

1/ Seasonally adjusted annual rate; preliminary.

Orders for durable goods. New orders for durable goods rose 3-1/2 per cent in September, recovering most of the August decline, and the rise in unfilled orders, which had slackened in August, speeded up again to the high rate prevailing over the period from September 1965 to July 1966.

The September rise in both new and unfilled orders was concentrated in defense products. New defense orders were up a fourth, to a new record level 5 per cent above the preceding high reached in June. Excluding defense, total orders were about unchanged from August, with some industries up and some others down. Orders for machinery and equipment increased somewhat and unfilled orders rose substantially further; new orders for steel recovered half of the large August decline.

New orders in September were somewhat below the peak reached last March, although over that period the backlog of unfilled orders continued to rise at a rapid pace. The decline from the March peak has reflected mainly a fall-off in new orders for construction materials and consumer durable goods. The increase in new orders from early 1965 to date was concentrated in the six months from September 1965 to March 1966.

NEW AND UNFILLED ORDERS FOR DURABLE GOODS
(Per cent change in seasonally adjusted figures)

	New orders			Unfilled orders		
	Mar. 1965 to Sept 1965	Sept 1965 to Mar. 1966	Mar. 1966 to Sept 1966	Mar. 1965 to Sept 1965	Sept 1965 to Mar. 1966	Mar. 1966 to Sept 1966
Total	2	12	- 3	7	12	12
Defense products	40	- 2	15	15	13	14
Total excl. defense	- 3	15	- 5	2	12	11
Iron & steel	-37	65	- 1	-41	15	16
Construction materials	- 1	16	-12a/	3	8	2a/
Motor vehicles	- 1	- 1	-11	(Included in miscellaneous)		
Other consumer dur.	1	13	- 6	7	16	5
Machinery & equip.	3	11	7	10	11	15
Miscellaneous	3	20	- 4a/	12	15	9a/

a/ Based on changes from March to August.

<u>Business inventories</u>. In August, as in July, auto stocks dropped sharply and total trade inventories were about unchanged. Thus, despite further acceleration in the rate of accumulation in manufacturing, the book value increase for total business inventories in August -- at an annual rate of nearly $13 billion -- continued below the exceptionally high second quarter rate of $15 billion. Auto stocks apparently increased in September; thus, for the entire third quarter some rise in trade inventories is expected and the over-all book value increase is likely to be closer to the second quarter rate than indicated by the July-August figures alone.

In the table below, July-August inventory changes are shown in terms of some perspective. The main features of this showing are the marked acceleration in inventory accumulation in durable goods industries in the spring and summer and the shift in retail auto stocks from rapid increase in the spring to marked decrease in the summer. The rate of accumulation by nondurable goods producers and by non-auto distributors has proceeded at a fairly steady pace.

MONTHLY AVERAGE CHANGES IN MANUFACTURING AND TRADE INVENTORIES
(Book value; seasonally adjusted; $ million)

	July 1965 through Mar. 1966	April-June 1966	July-August 1966
Total	861	1,256	1,049
Manufacturing	558	767	1,076
Durable Goods	369	577	885
Iron & steel	24	35	27
Construction materials	23	40	24
Motor vehicles	- 7	2	126
Other consumer durables	26	82	61
Machinery & equipment	109	164	244
Defense products	112	160	220
Miscellaneous	81	94	184
Nondurable Goods	189	190	191
Trade	303	489	- 27
Auto dealers	52	179	- 253
Other	251	310	226

Labor market. Nonfarm employment showed little change in September, highlighting a moderation in the rate of employment growth which has been evident during the past several months. But the manufacturing workweek continued at 41.4 hours in September, close to the highest level since World War II and, at 64.2 million, nonfarm employment was 3 million higher than a year earlier. The unemployment rate was 3.8 per cent in September, virtually unchanged from August's 3.9 rate.

The lack of employment growth in September reflected a number of factors. Employment in trade, service, and Federal Government sectors was apparently affected by the withdrawal of about 3 million youngsters from the labor force to return to school -- about half a million greater than seasonal. The exodus of young persons last month may also have been a factor in the widespread but small declines in manufacturing industries. (In contrast, when young workers were entering the labor force in June, nonfarm employment rose by almost one-half million). The continued decline in construction employment was the result primarily of a further contraction of residential building, but construction employment was still somewhat above a year earlier.

Only two major sectors showed significant employment growth in September -- State and local government and transportation. The substantial gain recorded in transportation reflected in large part the end of the airline mechanics strike following settlement on a new contract after mid-August.

The strength in hours of work also suggests that recent slackening in employment growth may have reflected special factors. Hours of work in manufacturing, contrary to expected movement when employment demand eases, have risen almost half an hour since the summer low. The workweek in electrical equipment, primary and fabricated metals, and machinery all rose in September although employment leveled off or declined.

The increase in nonfarm employment in the third quarter was considerably below the very rapid rate achieved in preceding quarters; employment increased at an annual rate of 2.1 million in the third quarter as compared with 4 million in the first quarter and 3.1 million in the second quarter. The slowing in the rate of gain has been widespread, but the reasons vary. In manufacturing, employment increases in capital goods and defense-related industries appear to have slowed partly because of shortages of skilled workers, and employers as a result have been lengthening workweeks. On the other hand, some slowing in textiles and apparel, curtailment of expansion in automobiles and a decline in construction materials industries all contributed to reducing total growth of manufacturing employment to half the average increase of the previous two quarters. In nonmanufacturing sectors, in addition to the continued decline in construction employment, trade and State and local government employment showed smaller gains than earlier.

INCREASES IN NONFARM EMPLOYMENT
(Seasonally adjusted quarterly averages, in 000's)

	Annual Rates			
	I Q 1966 from IV Q 1965	II 1966 from I 1966	III 1966 from II 1966	Sept. 1966 from Sept. 1965
Total nonfarm	3,980	3,100	2,132	3,001
Manufacturing	1,336	1,288	664	1,038
Durable	1,076	912	584	798
Nondurable	260	372	80	240
Construction	408	- 252	- 140	55
Transportation & public utilities 1/	116	44	56	105
Trade	676	496	360	495
Finance & service	572	508	528	517
Government	868	1,020	660	791
Federal	224	328	308	238
State & local	644	696	352	553

1/ Includes mining.

<u>Wages and collective bargaining</u>. Higher wage increases provided in recent contracts and the impact of cost-of-living adjustments have begun to show up in accelerated increases in earnings in manufacturing. Average hourly earnings rose to $2.74 in September and were 4.2 per cent higher than a year earlier. In the first half of this year, hourly earnings were up 3-1/2 per cent from a year earlier and in 1965, they had increased about 3.0 per cent.

The largest rise last month was in the transportation equipment industry, reflecting a 10.5 cent annual improvement factor increase as well as a further cost-of-living adjustment received by auto workers. As a result, wages of these workers have increased by nearly 6 per cent over the past year. Workers in farm and construction equipment industries also have annual improvement factor clauses in their contracts and their earnings will rise substantially in October.

The recent General Electric and Westinghouse settlements provide for average annual wage and fringe increases (excluding possible cost-of-living adjustments) of somewhat more than 4 per cent. The addition of cost-of-living adjustments could boost the average increase to 5 per cent or more a year.

The G.E. contract provides an average wage increase of 11.4 cents an hour the first year, 9 cents an hour the second year, and 9.1 cents an hour the third year. The escalator clause guarantees at least an additional 3.0 cents an hour increase in wage rates in the second and third year of the contract regardless of the rise in the cost-of-living.

However, benefits from the clause are limited to a maximum of 1-3/4 per cent, or 5-1/4 cents, a year so that the maximum increase can be no more than 10.5 cents over the two year escalator period. Such limitations to price adjustments appear to be characteristic of recent contracts -- something similar was provided in the airline mechanics contract -- and they represent an important limitation of union demands for open-end escalator clauses such as contained in the auto contract.

The agreement also provides a ninth paid holiday, longer vacations, improved pension, health and welfare benefits and more pay for skilled workers.

Since growth in productivity in the electrical industry appears to be well above the average for the economy, much of the additional wage cost could probably be absorbed. But this settlement, coming after the airline mechanics and other recent similar agreements, seems to have crystallized a wage and fringe increase pattern at about 5 per cent -- well above the average productivity gains for the economy. This pattern is likely to spread as other contracts are negotiated in coming months. The limited escalation provided in the new contracts in a fashion represents a favorable development, since in past periods of rising consumer prices open-end escalator clauses tended to become fairly widespread.

Consumer prices. The consumer price index in September continued on its upward course, although the increase of 0.3 per cent was only slightly more than seasonal. The net increase in commodities was only of about seasonal proportions; it resulted from decreases in foods and in new and used cars that were larger than seasonal and increases in apparel and other nondurables that were also larger than seasonal. The rise in services remained rapid, with the increase of 1.1 per cent for medical care extraordinarily large for one month. Since their rise accelerated beginning in March, medical services have increased 5 per cent, or at an annual rate of about 8 per cent. (They have an importance in the total index that approaches 5 per cent.) The 12-month increase in the total index remained 3.5 per cent; foods were up 5.6 per cent, services 4.2 per cent, and commodities other than foods only 2 per cent.

Wholesale prices. The total wholesale price index was unchanged from mid-August to mid-September as foodstuffs showed only a small further increase (0.4 per cent) and imdustrial commodities remained stable (-0.1 per cent). Since mid-September, the total index has declined as a result of substantial decreases in foodstuffs, especially livestock and meats. Little evidence is available on industrial commodities but it is likely that there has been some increase from the mid-September level.

Continued stability in the industrial commodity index in September reflected offsets between additional increases in machinery and equipment and a number of metal products and further declines in sensitive materials (hides and leather, lumber and plywood, copper scrap, and synthetic textiles), seasonal rebates on autos in the final month of the 1966 model year, and decreases for some household appliances. The expectation of a rise in the industrial index in October is based on a slowing in the decline in sensitive materials, a return to full list prices for autos after introduction of the new models, and reports of increases for some types of machinery and consumer durable goods. However, a return of the industrial index to the 3.0 to 3.5 per cent annual rates of increase in the first two quarters of this year, when some of the sensitive materials were rising rapidly, is not likely.

Industrial commodity prices turned stable after midyear; the anatomy of the shift from substantial rates of increase in the first half is illustrated in the table, although no one set of time periods is ideal for all groups. (The sensitive group, for example, reached a peak in May when lumber was at its high.) A large part of the acceleration in the rise that occurred at the beginning of the year and the turn toward stability in the third quarter is accounted for by sensitive materials. Prices of hides, lumber, and copper first rose rapidly as a result of various interruptions to supplies as well as strong demands in industrial countries generally, and they subsequently declined.

A pattern of acceleration and subsequent slowing in the rise is evident to some extent in the other groups of industrial commodities -- especially producers' equipment. For some types of machinery, specifically agricultural and construction machinery, price increases tend to be smaller in the second and third quarters than at other times of the year. A major feature of the shift, however, was the behavior of electrical equipment; this group rose more than 2 per cent in the first half of this year, after having been virtually stable in 1965, and then increased only 0.4 per cent further in the third quarter. As yet there are no indications as to whether the recently negotiated labor contract in the electrical equipment industry will be followed by a renewed acceleration in prices.

WHOLESALE PRICES

	Per cent change from 3 months earlier to			
	1966			1965
	Sept.	June	March	Dec.
All commodities	1.0	0.3	1.2	1.1
Industrial	-0.1	0.9	0.8	0.5
Industrial ex fibers	0.1	0.9	0.7	0.5
Sensitive materials*	-2.1	1.0	2.2	0.3
Hides and leather	-8.8	4.9	9.4	4.1
Lumber and plywood	-2.5	2.3	4.4	-0.1
Metals	-2.6	1.3	3.1	0.4
Textiles*	-0.5	0	-0.1	-0.6
Other materials	0.6	0.9	0.6	0.6
Producers' equipment	0.6	1.0	0.8	0.5
Consumer goods	0.2	0.7	0.2	0.5
Foodstuffs	4.5	-1.4	2.7	2.9
Livestock and products	4.4	-3.4	3.4	4.8
Crops and products	4.5	1.0	1.7	0.8

* Excluding fibers; fibers dropped about a fifth in the third quarter mainly as a result of changes in Federal programs.

Livestock supplies. Expanding livestock production is showing up in sharply larger farm marketings in the fourth quarter. Supplies of red meats and poultry for the quarter as a whole are expected to average from 7 to 9 per cent above a year earlier. Egg supplies are rising too, but milk production continues under a year ago. Reported increases in the pig crop indicate that hog slaughter rates 7 to 10 per cent above those a year earlier may continue throughout 1967. Feedlot operators are also expanding operations and on the first of October they had 8 per cent more cattle on feed than a year earlier. Fourth quarter marketings of fed cattle will be up 7 per cent from last year's high level, if feedlot operators carry out their intentions. Next year, total market supplies of beef may level off as cattlement begin to withhold cows and calves for herd building.

1967 grain crops. With the announcement on October 17 of the terms of the Voluntary Feed Grain Program for the 1967 crop, the Department of Agriculture rounded out plans for bolstering next year's supplies of wheat and feed grains. The wheat program had been announced earlier in the year.

The feed grain program permits farmers to expand land planted to corn and sorghum grain by as much as 15 million acres. Prices support payment rates will be unchanged. Rental payments on diverted land are eliminated except on small farms. Favorable market prices are expected to maintain growers' incomes.

With normal weather, it is hoped that the expanded acreage will lift 1967 production to 175 to 180 million tons, a substantial increase over the 158 million-ton output of 1966. Carryover stocks of feed grains on October 1 this year amounted to 47 million tons, generally considered a desirable level. In the marketing year just ended, feed grains fed to livestock increased 10 per cent to 130 million tons and exports jumped 32 per cent to a record 29 million tons to become the biggest dollar earner among farm products shipped overseas. Further expansion in utilization in 1966-67 is expected to draw down stocks to 25 to 30 million tons by October 1, 1967, the end of the current marketing year.

The wheat acreage allotment for the 1967 crop was increased in May and again in August, for a total increase of 17 million acres, or 32 per cent. With favorable growing conditions, this acreage should produce a 1.6 billion bushel crop, 300 million bushels larger than the crop harvested this year.

Wheat stocks on July 1, 1966 were 550 million bushels, an adequate reserve, but a further drawdown is in prospect during the course of this year to meet overseas commercial and foreign assistance program demands. In fact, exports are expected to be trimmed down somewhat from the record 869 million bushels shipped in 1965-66, largely by substituting grains in ample supply, such as grain sorghums, for part of India's requirement under the foreign assistance program.

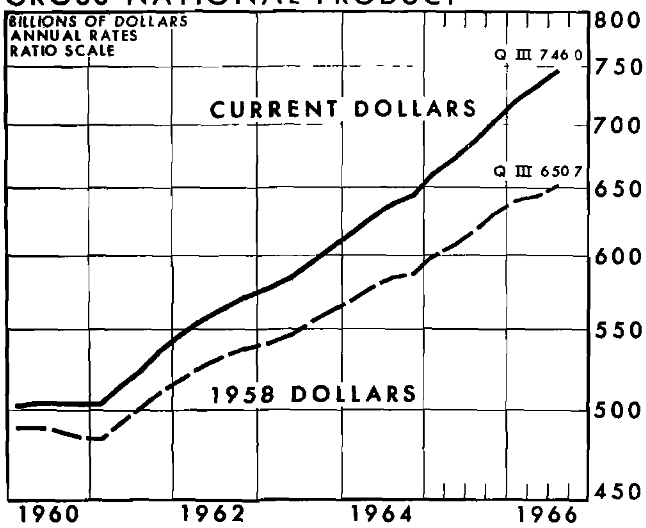
In the meantime, the worldwide wheat supply situation for 1966-67 has improved markedly over the relatively tight prospects that earlier had prompted loosening our acreage controls. Both Canada and Russia have reported record crops, and the European crops are good. The Argentine and Australian crops, which begin to be harvested in December, are expected to be substantially larger than last year.

The Monsoon rains which largely determine the autumn cereal output in India have turned out to be better than last year, although they were still only 82 per cent of normal. These developments were reflected in substantial declines in cash and future market prices of wheat during September and October. Despite these declines, farmers are continuing to hold a much larger proportion of their current crop than in recent years.

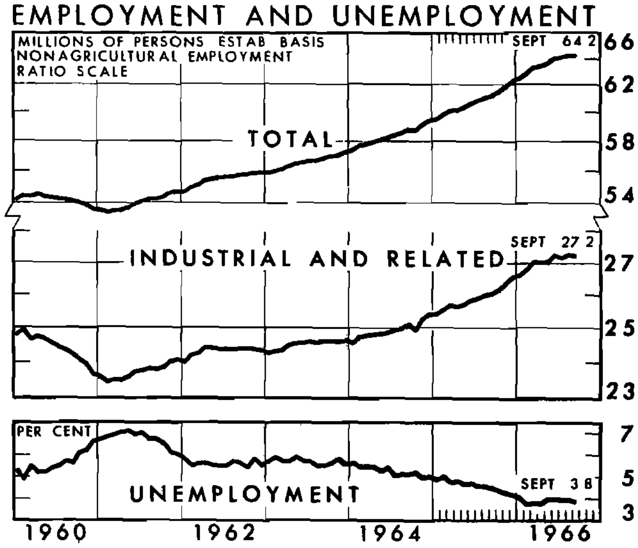
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

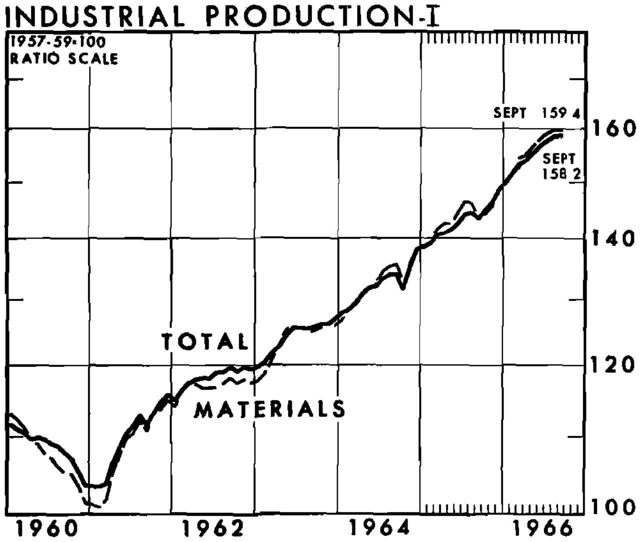
GROSS NATIONAL PRODUCT



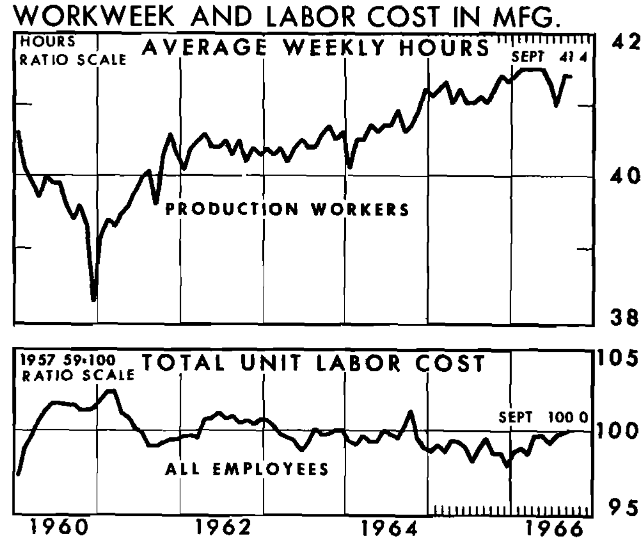
EMPLOYMENT AND UNEMPLOYMENT



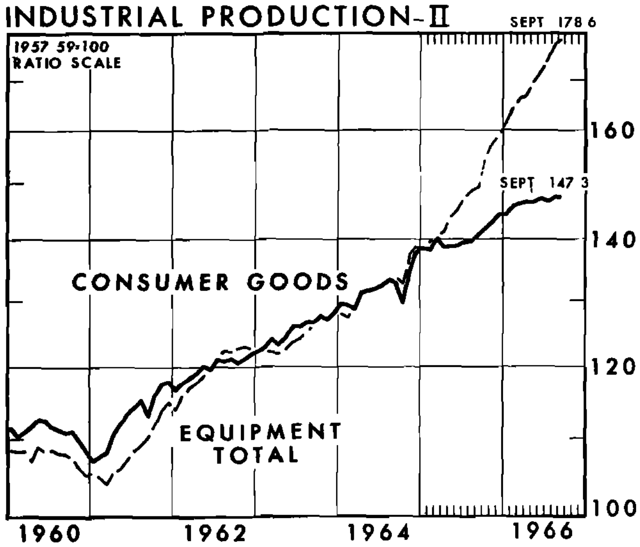
INDUSTRIAL PRODUCTION-I



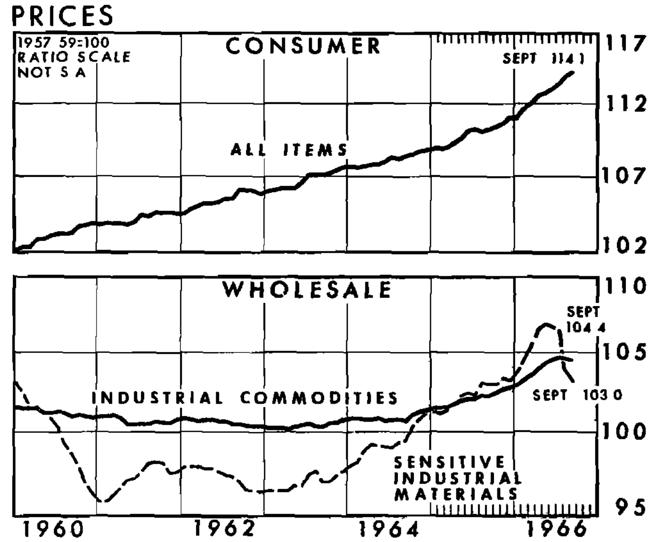
WORKWEEK AND LABOR COST IN MFG.



INDUSTRIAL PRODUCTION-II



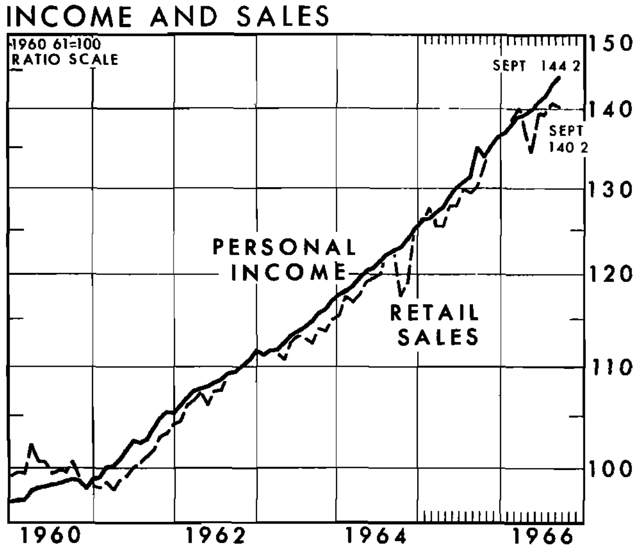
PRICES



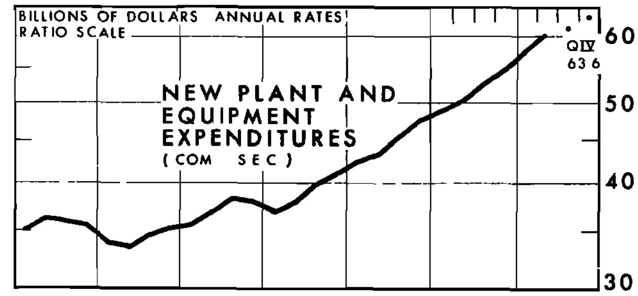
ECONOMIC DEVELOPMENTS - UNITED STATES

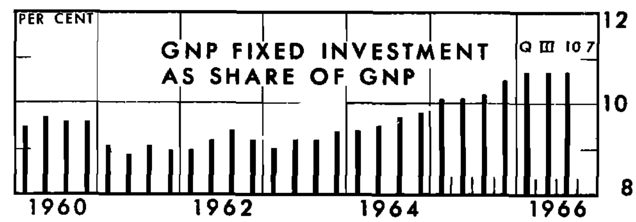
SEASONALLY ADJUSTED

INCOME AND SALES

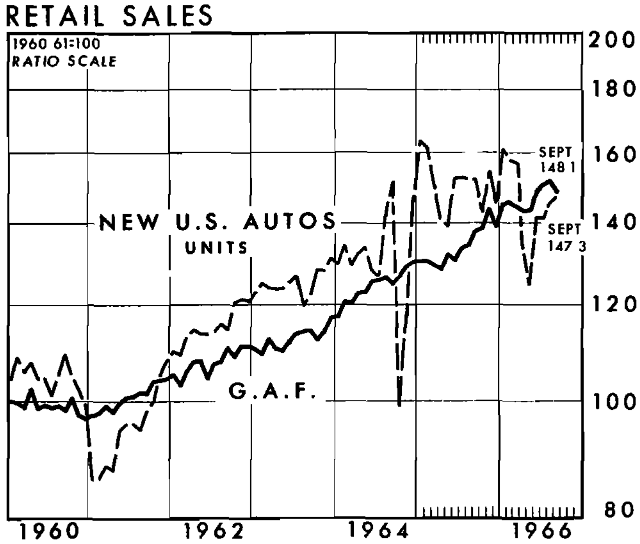


BUSINESS INVESTMENT

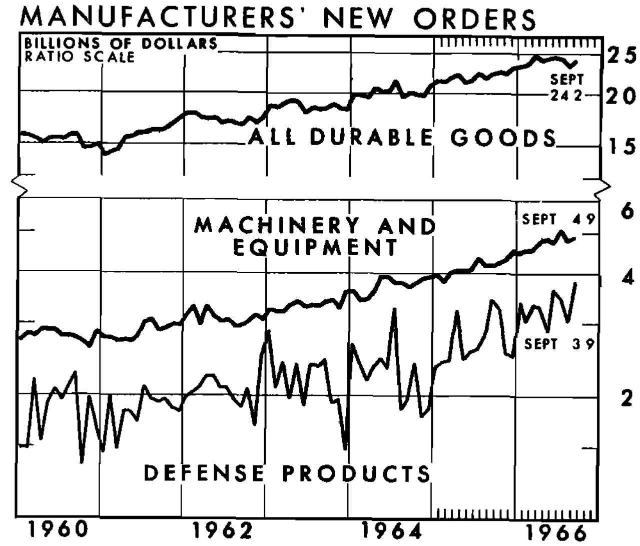




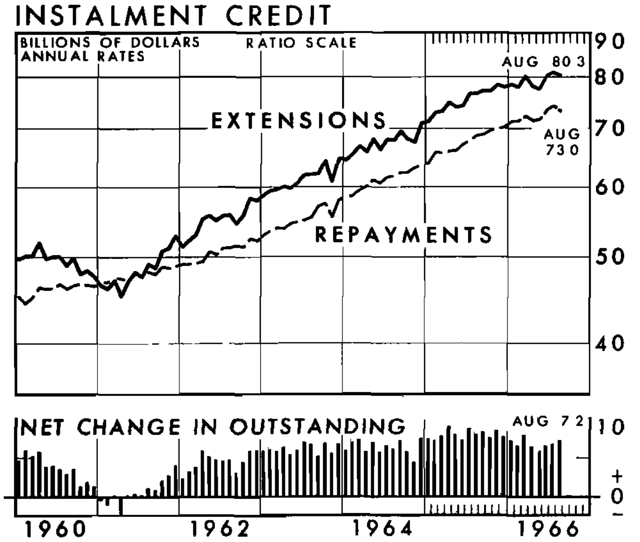
RETAIL SALES



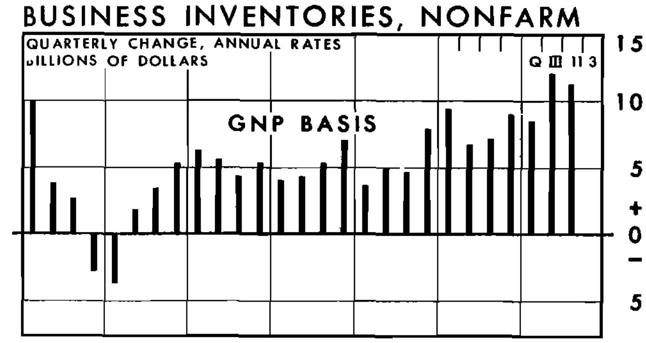
MANUFACTURERS' NEW ORDERS

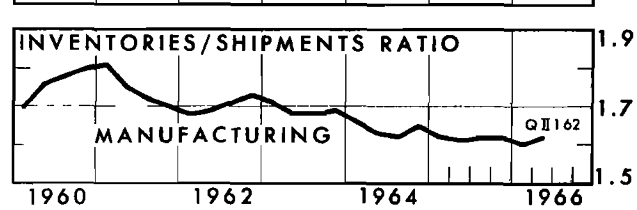


INSTALMENT CREDIT



BUSINESS INVENTORIES, NONFARM





DOMESTIC FINANCIAL SITUATION

Bank credit. In October, for the third month in a row, bank credit growth appears to be relatively weak. This continuing slowdown, coming after the very rapid expansion of the first seven months of the year, reflects mainly CD runoffs and the associated liquidation of Treasury securities. Total commercial bank credit, seasonally adjusted, showed virtually no change on balance in August and September combined. Weekly data thus far available do not indicate any renewed strength in bank credit thus far this fall. During the three-week period ending October 12, total credit at weekly reporting banks declined by about $1.8 billion, a sharp contrast to the $600 million decline in the comparable period last year, after excluding the effects of last year's Treasury financing.

As shown in the table below, U.S. and other security holdings and total loans all declined at weekly reporting banks since the September tax date. The reduction in total loans was associated mainly with a sharp decline in loans to security dealers and slower business loan expansion.

The growth in business loans, which totaled $186 million compared with $415 million in the corresponding period last year, was especially small considering the large accelerated payments of withheld taxes due in two instalments this month. During the tax week there was a substantial runoff of CD's at large banks, and an apparently large volume of maturing commercial paper as well as reflected in a large contraseasonal rise in bank loans to finance companies.

The factors accounting for the slowing in business loan expansion are still not clear, though it is probable that business demand for credit may be moderating somewhat from the pace of the spring and early summer months.

The September 15 System lending practices survey provides some partial evidence of this moderation in business demand. As compared with the four quarterly surveys since September 1965, the most recent survey showed that a small but increasing number of banks were experiencing weaker demand for loans, and a smaller number of banks had stronger loan demands. On the whole however, the majority of survey respondents still reported loan demands to be moderately stronger than in the preceding quarter. The continued rapid expansion in bank loans to machinery and transport equipment firms, associated with the capital goods boom, is one of the areas of strong demand.

The restrictive monetary policy of the past few months, which has helped to keep banks under pressure, presumably has been transmitted to some potential business borrowers who in turn have reduced outlays. For example, loans by weekly reporting banks to retailers, which have been weak since midyear after allowing for fluctuations in dealer financing of new car stocks, may reflect the reported efforts by retailers to consolidate their inventories. The weakness in bank loans to the construction industry this year, both because of the slide in home building and since the spring, because of a softness in nonresidential construction, also reflects the effects of a restrictive monetary policy.

On the other hand, the reduced growth in loans to food processors and commodity dealers since midyear does not appear to be related significantly to monetary policy, but rather appears to be mostly associated with farmers' holding on to their crops in anticipation of higher prices.

In addition to the slower expansion of business loans, and the decline in loans to security dealers -- whose inventories were declining -- weekly reporting banks also liquidated securities as their CD's dropped sharply. For the three weeks ending October 12, they reduced their holdings of U.S. Government securities by $880 million and other securities by a contraseasonal $230 million. New York City banks, in the week ending October 19, picked up about $550 million in U.S. Government securities, but practically all of this increase was in the new tax anticipation bills, payable through tax and loan credits, which these banks presumably have been disposing of very quickly. One indication of the continued tightness of New York City banks in the week of the new tax financing was that they also reduced their holdings of other securities by more than $100 million. These liquidations, especially of other securities, reflect in large part attrition in negotiable CD's due to their noncompetitive rates.

CHANGES IN BANK CREDIT
Weekly Reporting Banks
(In millions of dollars, not seasonally adjusted)

	Late September to mid-October[1]		
	1966	1965[2]	1964
Total loans and investments	-1,846	+1,660	- 470
U.S. Govt. securities	- 881	+1,260	- 175
Other securities	- 228	+ 6	+ 194
Loans	- 737	+ 394	- 489
Business	+ 186	+ 415	+ 253
Security	- 648	+ 24	- 930

1/ Includes the last reporting week in September and the first two reporting weeks in October.
2/ This figure includes a $2.3 billion expansion in bank credit at weekly reporting banks associated with the October 11 Treasury financing.

<u>Bank deposits</u>. In sharp contrast to the first eight months of the year, when time and savings deposits on a daily average basis at commercial banks rose at a seasonally adjusted annual rate of 11 per cent, the estimated rise in September was only at a 3.0 per cent rate, and preliminary data for October appear consistent with a projected decline in time and savings deposits at a 2.3 per cent annual rate. This decline is concentrated at reserve city banks, which have had large CD runoffs. Country banks have been able to continue to add to their time deposits at a more than 11 per cent annual rate thus far in October, about in line with their third quarter rate of increase, although preliminary data for the third week in October indicate some apparent moderation of this rate of increase. Perhaps the closer customer

relations these banks have with their depositors, less interest sensitivity among their customers, and fewer accessible alternative investment outlets, help to explain their relatively better performance.

At weekly reporting banks the main source of weakness in time deposits following the September interest crediting period and since the change in the Q ceiling on time deposits under $100,000, has been the inability of these banks to replace maturing CD's as shown in the table below. This table also indicates a marked slowing in the pace at which these banks have been able to attract time deposits other than CD's. This slowdown presumably reflects the September rollback to 5 per cent in the maximum amount that banks can pay on these deposits, the more attractive rates on other financial assets, and the more moderate switching by depositors out of savings accounts into savings certificates and savings bonds.

CHANGES IN TIME AND SAVINGS DEPOSITS
Weekly Reporting Banks
(In millions of dollars, not seasonally adjusted)

	Late September and early October 1/		Late June and early July 2/		Late March and early April 3/	
	1966	1965	1966	1965	1966	1965
Total time and savings	-535	1,295	1,274	779	1,081	521
Savings deposits	-140	489	-616	509	-1,225	120
Time deposits	-395	806	1,890	270	2,306	401
CD's	-571	634	455	221	581	303
Time other than CD's	176	172	1,435	49	1,725	98
Consumer savings	36	661	819	558	500	218

1/ Three weeks ending October 12, 1966, and October 13, 1965.
2/ Three weeks ending July 13, 1966, and July 14, 1965. Data for 1966 have been adjusted for coverage changes.
3/ Three weeks ending April 13, 1966, and April 14, 1965.

In September outstanding CD's of large banks declined by $1.2 billion, with all but $100 million of this decline occurring at banks with total deposits of $1 billion or more, where the interest sensitivity of depositors is apparently very high. All weekly reporting banks lost $350 million in CD's through the two weeks ending October 12, with New York City banks losing slightly more than half of this amount. In the week ending October 19, New York City banks lost an additional $475 million in CD's, of which about $380 million was associated with the Consolidation Coal-Continental Oil merger. Of the $5.2 billion of CD's scheduled to mature in October it is now estimated that runoffs will total between $1.2 and $1.5 billion, though the recent declines in the yields on short-term market assets, including Treasury bills, should help to keep these runoffs on the low side of this estimate. Moreover, under present rate relationships, a large portion of the remaining CD's rolled over probably will be put in short maturities, as they were in September. Nearly half the CD's sold in September mature in October and 80 per cent will mature by yearend. For New York City banks the comparable figures are roughly 70 per cent and 93 per cent, respectively.

Because of September's large CD runoffs, a record number of banks had declines of 10 per cent or more in their outstanding CD's during that month. However, since CD's were not important to many of these banks, only 5 banks had CD losses equal to more than 3 per cent of their total deposits. Four of these banks had total deposits of $1 billion or more, which would indicate the difficulties that some money market banks have been having in replacing their maturing CD's.

Reflecting liquidation by banks of their securities, payment of accelerated withholding tax payments, and the continued attraction to the public of yields on market instruments, the private money stock is expected to decline by $400 million in October, or at a 2.8 per cent annual rate. With the money stock showing no growth since April, its rise for the first 10 months of the year, will be at a 2.3 per cent annual rate, well below the 4.1 per cent rise for the comparable period last year.

In large part because of these CD runoffs, reserve city banks have come under more reserve pressure in recent weeks relative to country banks. In October, through the week ending October 19, the weekly average of reserve city bank borrowing from the Federal Reserve has been more than $600 million, $120 million higher than in September and $220 million above August's weekly average. Furthermore, in both September and October, the weekly average of Federal funds purchased by net-purchasing banks has been running about $300 million higher than in August. Over this same period, country bank borrowing from the Federal Reserve has declined from a $360 million weekly average in August to around a $240 million average for the first three weeks in October, in part because of their success in attracting time deposits.

U. S. Government securities market. Since early October, yields have declined in all maturity sectors of the U. S. Government securities market. Long-term bond yields currently are at their lowest levels since June, while Treasury bill rates have fallen well below their peaks reached around the third week of September.

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	5.59	5.98	6.22	5.89	5.51	5.12
Lows	4.33	4.46	4.78	4.76	4.56	4.49
1966						
June (lows)	4.33	4.46	4.95	4.88	4.75	4.68
Aug. 29	5.02	5.51	6.22	5.89	5.51	5.12
Sept.21	5.59	5.96	5.90	5.53	5.21	4.97
Oct. 4	5.44	5.69	5.56	5.32	5.06	4.90
Oct. 25	5.23	5.51	5.40	5.24	4.94	4.73

The recent strength in the U. S. Government securities market has reflected a growing conviction that the boom in the private sector of the economy could be tapering off and that in any event a tax increase will be requested if needed to temper any inflationary impact from further acceleration in military expenditures. Debt markets also have been bouyed in recent weeks by growing acceptance of the view that monetary authorities would not permit another escalation in short-term interest rates.

In the note and bond sector of the market, trading has continued to be dominated by the dealers who have built up positions in longer-term bonds to their highest level since September 1965. On October 25, the dealers held $208 million of bonds due in more than

5 years. This compares with small net short positions in this maturity category in late August when bond yields reached their peaks. Recently, activity has been quiet as the market has awaited the Treasury announcement of its mid-November refunding.

Treasury bill rates have been influenced in recent weeks by generally strong demand and scarcities in most maturities. Dealer positions in longer bills have risen, however, as dealers absorbed sizable sales of bills by banks following the $3.5 billion auction of April and June tax bills on October 11.

Yields on most short-term debt instruments other than bills also have shown some tendency to edge down recently from their peaks, as the table shows. However, rates on commercial paper and finance company paper remain at their highs set in late September and mid-October, respectively, and new issue CD rates at major New York banks are still at the 5-1/2 per cent ceiling.

SELECTED SHORT-TERM INTEREST RATES[1/]

	1965	1966		
	Dec. 3	June 30	Sept. 23	Oct. 21
Commercial paper 4-6 months	4.375	5.625	5.875	6.00*
Finance company paper 30-89 days	4.375	5.50	5.625	5.875*
Bankers' Acceptances 1-90 days	4.25	5.50	5.75	5.625*
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
Secondary market:				
3-months	4.49	5.55	5.90	5.875
6-months	4.57	5.60	6.30	6.125
Federal Agencies (secondary market):				
3-months	4.34	5.29	5.76	5.58
6-months	4.49	5.53	6.04	5.80
9-months	4.58	5.64	5.96	5.86
Prime Municipals 1-year	2.65	3.50	4.25	3.75

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.

* Rates on October 25.

Federal Agency securities. The recent declines in yields on Federal Agency securities have been influenced by developments in the U.S. Government securities market and also by continued reductions in the amount of Agency issues held by private investors. Since early September, Federal Agencies have raised about $465 million of new money, but the Treasury trust accounts have absorbed $895 million of such securities, as the table shows. As a result, holdings of private investors have been reduced by $430 million.

The general improvement in debt markets during recent weeks has given rise to rumors of a possible offering of FNMA participation certificates in December. The January Budget Document projected sales of $4.2 billion participation certificates in fiscal 1967, including sales of nearly $1.0 billion by the Export-Import Bank. None of these securities have been sold in the fiscal year to date.

RECENT OFFERINGS OF FEDERAL AGENCY SECURITIES
(Amounts in millions)

Offering Date	Agency	Maturing issue	New issue	Placed with Treasury Trust Accounts	New money (public)	Maturity and Yield
Sept. 7	FLB	219	302	83	--	10-mo. at 6.05%
15	FHLB	500	650	250	-100	1-yr. at 6.20%
21	Coops.	230	305	125	- 50	6-mo. at 6.25%
23	FICB	312	230	75	-157	9-mo. at 6.20%
Oct. 14	FHLB	506	700	250	- 56	1-yr. at 6.05%
18	Coops.	151	269	111	7	6-mo. at 5.95%
21	FICB	372	298	--	- 74	9-mo. at 5.95%
Totals		2,290	2,754	894	-430	

<u>Treasury finance</u>. The Treasury is expected to announce the terms of its November refunding on October 27. Maturing issues total about $4.1 billion, including a moderate $3.2 billion held by private investors. The terms of the new offering will be described in the Green Book supplement.

On October 22, the Treasury auctioned $1.4 billion of 9-month and 1-year bills to replace a $1.0 billion maturity and raise $400 million of new money. A similar auction was held in late September and the new cycle of such auctions initiated then is expected to be continued in the months ahead. Over the balance of the year and again in the early weeks of 1967, the Treasury will need to raise a sizable amount of cash in addition to these auctions. On current Board projections, the total would approximate $5 billion through January, not counting the monthly auctions. Some of this money may be obtained in conjunction with the November refunding, if a cash refinancing is undertaken, but additional amounts will probably have to be raised by late November or early December.

Corporate and municipal bond markets. Yields on corporate and municipal bonds have continued to decline since late September, reflecting the further modification of market expectations that has also been affecting yields on U.S. Government securities. The decline in October therefore amounts to as much as 10 basis points and has extended the total rate roll-back from the late August highs to more than 30 basis points in some series.

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
Sept. 2	5.98*	--	5.44	4.02	4.24
Sept. 30	5.80	--	5.47	3.88	4.03
Oct. 7	--	5.81	5.44	3.86	4.00
Oct. 21	5.82	--	5.41	3.83	3.93

1/ Issues with and without call protection averaged together.
* Includes issues with 10-year call protection.

Current demands for funds by corporations in the capital markets appear moderate in relation to earlier months this year. Flotations of publicly-offered bonds in October are estimated at $525 million, large relative to prior Octobers, but the lowest monthly volume since July. And projected volume of public bond offerings in November -- at $575 million -- is less than a year earlier. Thus, despite the slower rate of growth in business credit at banks, the forward bond calendar has not evidenced any unusual build-up.

Moreover, total corporate financing in the capital markets, including public and private issues of bonds, and stocks, is estimated to have declined in October to about the low monthly levels registered in July and May. Preliminary estimates also suggest that the seasonal increase in total corporate financing may be less than usual in November. Life insurance companies are reported to be expecting smaller take-downs of corporate bonds over the next few months than in the like period a year ago. The sharply reduced volume of gross cash flows currently available for investment at life insurance companies, together with the over-all decline in new life company commitments made since the first quarter, lend support to the view that takedowns of corporate private placements will remain at a reduced level in the period ahead.

CORPORATE SECURITY OFFERINGS[1/]
(In millions of dollars)

	Bonds				Stocks	
	Public offerings[2/]		Private placements			
	1966	1965	1966	1965	1966	1965
1st Qtr.	1,774	905	2,586	1,673	734	429
2nd Qtr.	1,941	1,864	2,083	2,259	1,090	920
3rd Qtr.	2,280	1,575	1,573	1,955	251e	383
September	700e	664	550	706	75e	168
October	525e	287	450e	574	125e	124
November	575e	613	450e	529	150e	257

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

The volume of long-term financing by State and local governments in October ($750 million) will be nearly $100 million less than a year ago. The 30 basis point point drop in yields since late August has not produced significant additions to the calendar of previously postponed issues, and even current yield levels continue to lead to a few postponements. Beyond the current week in which yields are being tested by an outsized level of offerings -- including New York City's $123 million issue -- the forward calendar is not congested and shows a fairly even weekly distribution of scheduled issues. November volume is estimated to rise to $850 million, but this would be one-fifth below the high total a year earlier.

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

	1966	1965
1st Quarter, total	3,006	2,851
2nd Quarter, total	3,243	3,046
3rd Quarter, total	2,394	2,781
Total	8,643e	8,678
September	975e	1,008
October	750e	844
November	850e	1,043

1/ Data are for principal amounts of new issues.

Mortgage market developments. Although recent legislation on a variety of fronts as well as the downtrend in interest rates on market securities since September has eased the position of nonbank depository institutions somewhat, mortgage markets generally appear to have remained very tight. Contract rates for conventional first mortgages on homes rose 5 to 10 basis points further in September, to 6.65 per cent for loans to purchase new homes and 6.70 per cent for loans on existing homes. These levels are about 80 basis points above those a year earlier when upward pressures on interest rates first began to appear.

The advance in yields has been even sharper for Government-underwritten mortgages, with secondary market yields on FHA-insured, 30-year mortgages in September up 117 basis points from a year earlier to an average of 6.63 per cent. To reduce the unusually high discounts demanded by lenders, the Department of Housing and Urban Development raised the regulatory maximum contract rate on such mortgages from 5-3/4 to 6.0 per cent effective October 3. This marked the third 1/4 point increase this year and brought the regulatory maximum to its statutory limit for the first time in the history of the program. A comparable adjustment for VA-guaranteed home mortgages was also made by the Veterans Administration.

In line with these developments, the Federal National Mortgage Association lowered its price on 5-3/4 per cent mortgages to sellers in the secondary market by another 2 points effective October 4. Also, under the expanded secondary market program authorized by Congress late last summer, FNMA announced an upward adjustment from $15,000 to $25,000 in the size of mortgages eligible for purchase for new homes provided final certification of underwriting of such mortgages had been made by FHA or VA on or after October 19. While this change was made mainly to stimulate starts of new housing, some increase in the purchase-limit to $17,500 was also authorized for loans on existing homes. For budgetary and other reasons, activation of the $1 billion special assistance authorization, which was also initiated by Congress last summer, has been deferred for the time being. In recent months, overall purchases by FNMA have moved downward appreciably from the record highs reached last March.

Savings flows. In September, savings flows to the major depositary-type institutions showed a further year-to-year shrinkage, dropping more than 40 per cent behind September 1965. This compares with a year-to-year short-fall of 35 per cent in net flows to these institutions over the first 9 months of 1966.

As in August, the further shrinkage in combined savings flows was chiefly accounted for by the slower growth of time and savings deposits at commercial banks. Even when negotiable CD's are excluded, savings flows to banks were 50 per cent smaller than in September a year ago, compared with the 14 per cent reduction in flows experienced for the first nine months as a whole.

At mutual savings banks, September savings flows continued the more favorable experience shown in July and August and were only 15 per cent smaller than in September 1965, much better than the 40 per cent year-to-year shrinkage experienced over the first nine months. While flows to savings and loan associations were still 40 per cent below those in September 1965, this too represented an improvement, since the shortfall for the first nine months was 75 per cent. It is too early to assess the importance of the recent rate legislation to the improved flows in September at these two types of institutions.

SAVINGS FLOWS TO MAJOR DEPOSITARY-TYPE INSTITUTIONS
(Billions of dollars)

	Total 1/	Commercial 1/ Banks	Savings and Loan Assn's	Mutual Savings Banks
September				
1966	1.8	.8	.6	.36
1965	3.1	1.7	1.0	.43
1964	2.8	1.3	1.1	.47
Year to Date				
1966	13.1	10.3	1.3	1.5
1965	19.9	12.0	5.4	2.5
1964	18.4	8.1	7.3	3.0

1/ Excludes negotiable time CD's at weekly reporting member banks.

On the basis of a sample survey, staff of the Federal Home Loan Bank Board estimate that the S & L industry experienced a net loss of share capital amounting to $350 million (excluding interest credited) during the last three days of September and $260 million in the first week of October--the two periods in which quarterly withdrawals are concentrated. Nearly 90 per cent of the outflow occurred in the San Francisco district. Some of the $260 million loss in October will, of course, be offset by net inflows during the remainder of the month. Though, for seasonal reasons, the large net outflows which occurred in April and July will not be repeated in October, the ultimate result for the month will fall well below the $610 million net gain of share capital experienced for the full month of October a year ago.

While no October estimate is available for all mutual savings banks, the New York State mutuals, which have recently accounted for well over half of industry flows, experienced a net deposit inflow of $30 million during the first two weeks. This was larger than in the comparable period of 1965, but smaller than in July when most New York City institutions first raised their rates to 5 per cent.

Stock market. A sharp further decline of common stock prices in late September and early October carried the major indexes of stock prices to their lowest levels since President Kennedy's assassination in November 1963. At the early October low, Standard and Poor's composite index was 73.20, down 22 per cent from its early February peak. But since October 7 the index has advanced about 8 per cent.

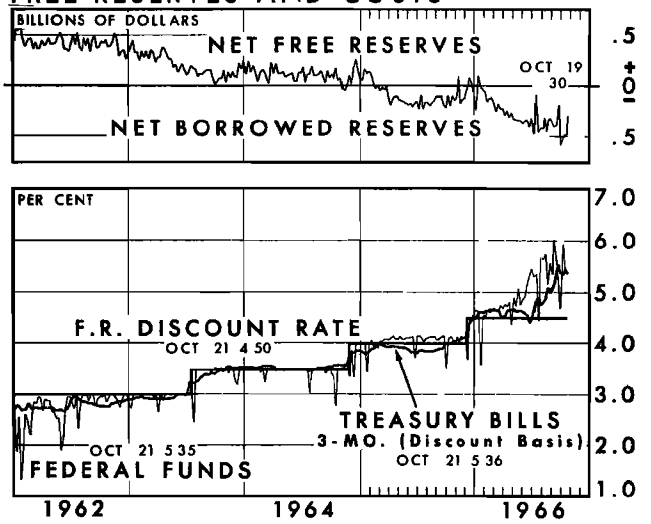
While virtually all stocks participated in the price retreat from spring to fall this year, with declines in excess of 30 per cent fairly general for individual issues, recovery since early October has been quite selective. There seems to have been some tendency for selected conservative stocks to show the largest recent gains. A number of these are typically viewed as defensive stocks, attractive to investors in periods of slower business activity because of the greater relative stability of their income and dividends.

Among stock groupings in the defensive category that reached their lows in August rather than in October, prices of New York City bank stocks have advanced about 22 per cent, those of electric utilities are up almost 14 per cent and those of oils are up over 9 per cent. In the case of stocks that reached their lows in early October, food issues have since gained in excess of 7 per cent, issues of telephone companies more than 8 per cent, and issues of cigarette manufacturers 9 per cent. In contrast to these advances, stock prices in some industry groupings considered to be more sensitive to cyclical swings--such as auto and building material companies--have declined further on balance since early October.

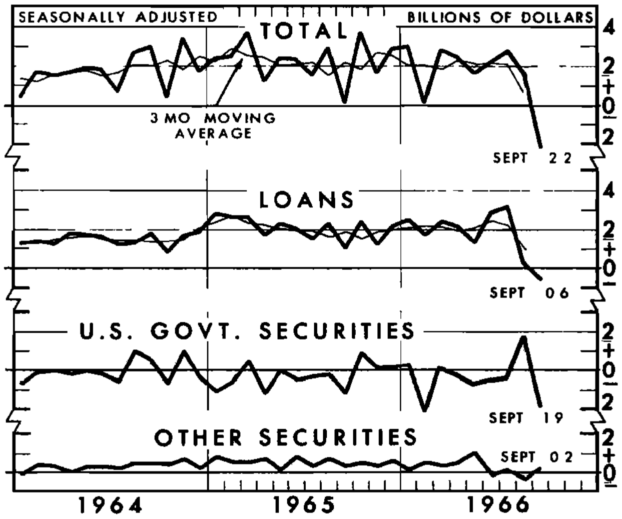
As one would expect with stock prices declining on balance, stock market credit also showed some further contraction in September. At the end of the month, total customers' net debit balances reported by NYSE firms were about $250 million below their month earlier levels. Preliminary estimates by the Exchange staff suggest, however, that less than half of this reported decline actually represented a reduction in margin account debt (as measured in the Exchange's margin panel statistics). In the view of the Exchange staff, lower trading volume around the end of September--relative to August--accounted for part of the decline, because it reduced debits associated with the clearance of cash transactions, and a large increase in short positions in September generated credit entries of a bookkeeping nature which accounted for a further offset to outstanding debit balances. Making a rough allowance for these statistical idiosyncracies, the cumulative decline in margin debt through September, from the April 1966 high of $5.8 billion, probably amounted to $350 million, or roughly 6 per cent.

FINANCIAL DEVELOPMENTS - UNITED STATES

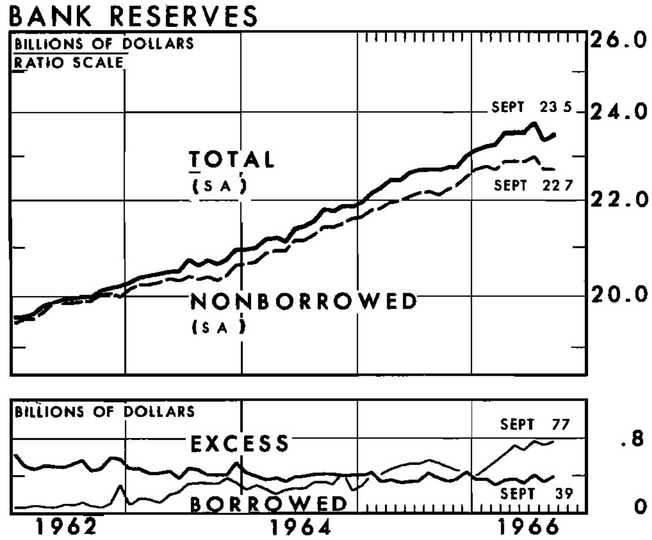
FREE RESERVES AND COSTS



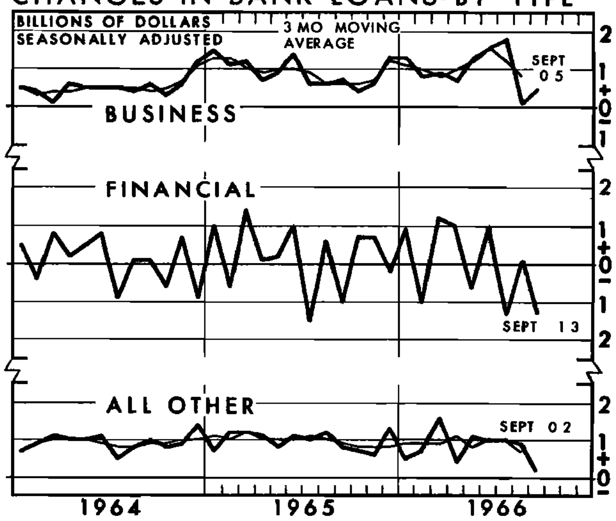
CHANGES IN BANK CREDIT



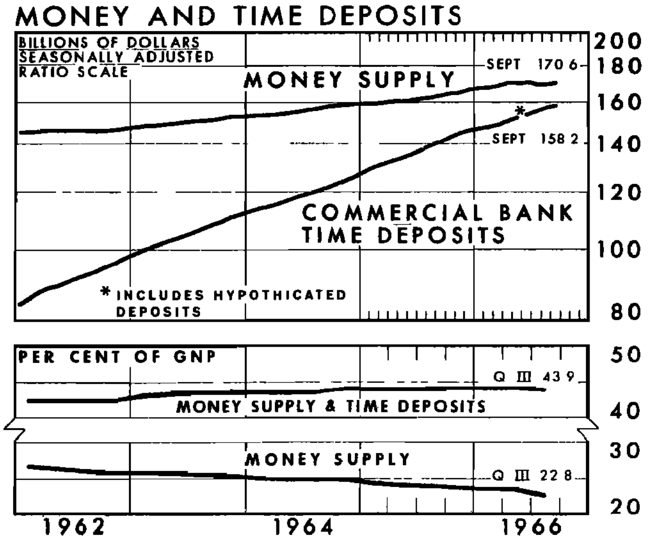
BANK RESERVES



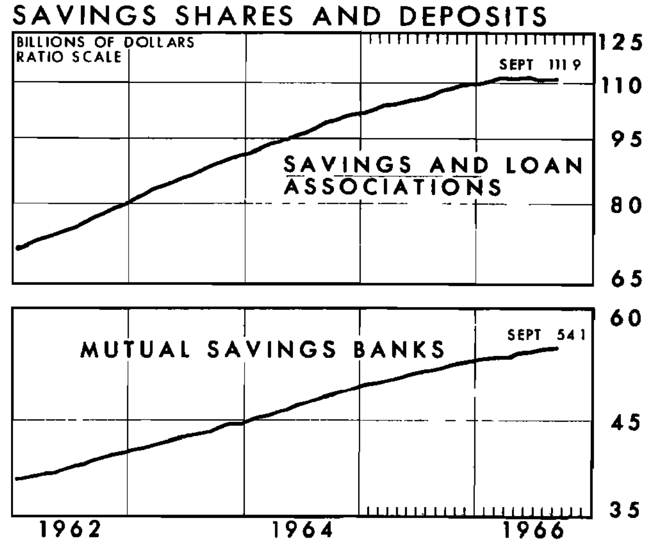
CHANGES IN BANK LOANS-BY TYPE



MONEY AND TIME DEPOSITS

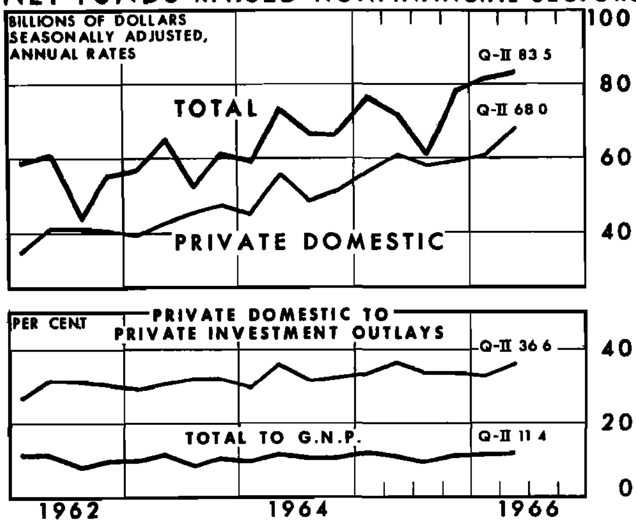


SAVINGS SHARES AND DEPOSITS

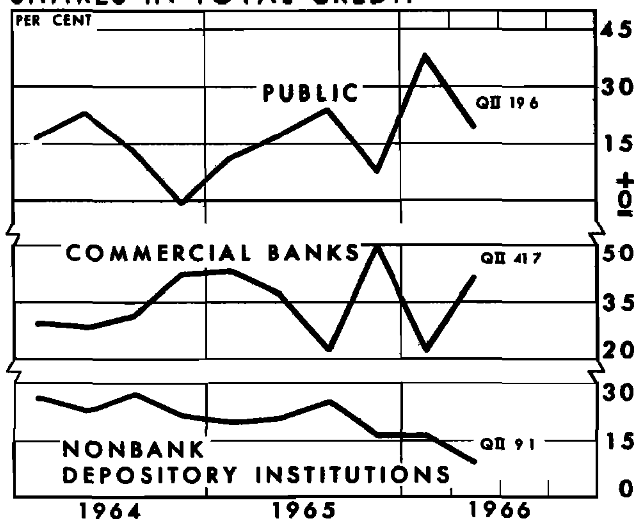


FINANCIAL DEVELOPMENTS - UNITED STATES

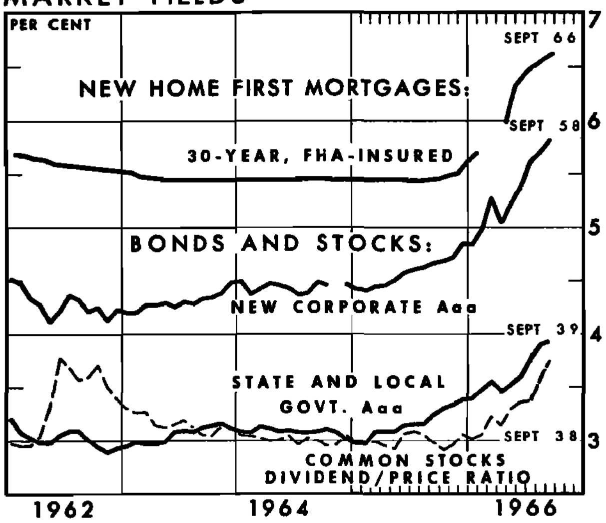
NET FUNDS RAISED-NONFINANCIAL SECTORS



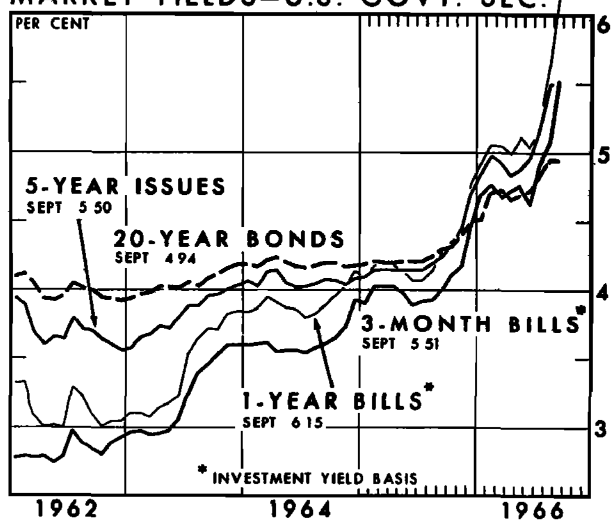
SHARES IN TOTAL CREDIT



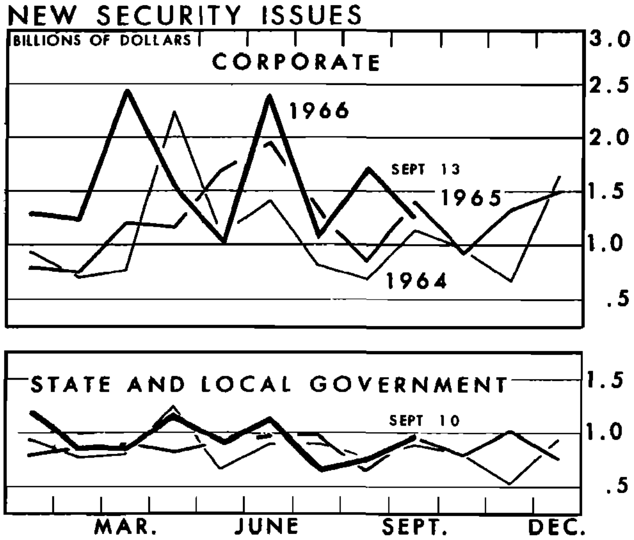
MARKET YIELDS



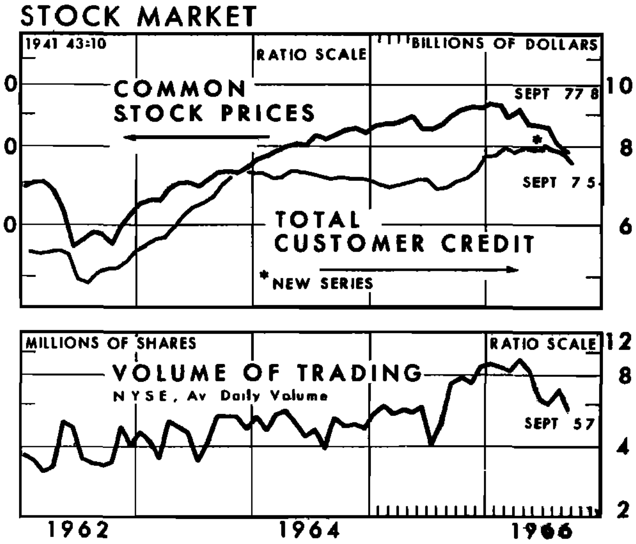
MARKET YIELDS—U.S. GOVT. SEC.



NEW SECURITY ISSUES



STOCK MARKET



INTERNATIONAL DEVELOPMENTS

U.S. balance of payments. Weekly indicators show a sizeable payments deficit on the liquidity basis for the first 19 days of October -- probably in excess of $500 million. October has regularly accounted for a major share of the total fourth quarter deficit.* Thus, while these preliminary and partial October results represent a sharp deterioration from the rate for the third quarter, and for the year to date, they do not necessarily represent a deterioration if we exclude for these periods the favorable effects of debt prepayments and of known shifts of foreign official and international funds into non-liquid forms.

For the third quarter, there was a deficit on the liquidity basis of around $200 million seasonally adjusted, down from the estimate given in the last Green Book primarily by reason of $250 million of special receipts at the end of September (representing debt prepayments and foreign official purchases of U.S. Govt. agency bonds.) Apart from special receipts, the liquidity deficit in the third quarter was at an annual rate of around $2 billion, roughly the rate for the first 9 months on a similarly adjusted basis.

* In 1962 and 1963 the deficit in Ocotber exceeded the fourth quarter deficit on the liquidity basis; in 1965, October accounted for essentially all of the fourth quarter deficit; and in 1964, when there were large outflows late in the year associated with uncertainties concerning the forthcoming U.S. payments program, the October deficit was 60 per cent of the total for the quarter.

Exports in September were at the July-August level (revised, with all figures adjusted for carry-over of documents), and for the third quarter exports were at an annual rate of $29-1/2 billion, up 4 per cent from the second quarter. However, despite the sharp growth of exports, the trade surplus in the third quarter narrowed (falling to an annual rate of less than $3 billion, compared to $3-1/2 billion in the preceding quarter) as imports rose by nearly 7 per cent to an annual rate of $26-3/4 billion.

U.S. EXPORTS
(billions of dollars, seasonally adjusted annual rates)

		1965		1966		
	1964 1/	1st Half 1/	2nd Half	1st Half	July-Aug.	3rd Qtr.
Agricultural	6.4	5.8	6.8	6.8	7.4	n.a.
Non-Agricultural	19.3	19.1	21.2	22.0	22.7	n.a.
Total, Census basis	25.7	24.9	28.0	28.8	30.1	29.8
Total, Balance of payments basis	25.3	24.9	27.7	28.5	29.7	29.5

1/ Distorted by longshoremen's strike early in 1965.

The rise in exports through July-August (latest detail available) consisted of both agricultural and non-agricultural commodities. Agricultural exports were stable from mid-1965 to mid-1966, but in July-August they advanced sharply.

The bulk of the rise in exports in July-August over the second quarter was to primary producing countries, particularly to Australia and Latin America. Among the industrial countries Japan continued to increase purchases of U.S. exports, but shipments to Canada in July-August were little changed from the second quarter, and shipments to the United Kingdom and to Continental Western Europe were somewhat lower.

The adverse effects on the payments position of the cyclically low trade surplus and of high, and doubtless rising, military expenditures have continued to be partly offset by reduced net outflows of U.S. private capital. Net repayments of bank-reported claims on foreigners occurred in the third quarter after seasonal adjustment, in contrast to a small outflow in the second-quarter. At the beginning of October, banks' claims as reported under the VFCR were below their target ceiling for the end of 1966 by $1-1/4 billion, unadjusted; there is normally a seasonal outflow of bank credit of about $300 million in the fourth quarter, so that the VFCR leeway might be estimated at less than $1 billion on a seasonally adjusted basis.

A massive inflow of foreign private liquid funds in the third quarter resulted in a surplus of more than $1 billion on the basis of official reserve transactions (preliminary estimate); for the first 9 months of the year the surplus on reserve transactions exceeded $1/2 billion. As noted in earlier Green Books, the surplus resulted from very large shifts of foreign private funds from European currencies -- and principally from sterling -- into Euro-dollar assets. This market is doubtless the only Euro-currency market that could readily absorb an influx of the size represented by the run on sterling, and probably the only market in which such a volume of funds could readily be invested in liquid, interest-bearing assets. Although the actions of U.S. banks in bidding for Euro-dollars through their branches played a part in producing the inflow of foreign liquid funds, the U.S. surplus on reserve transactions must be regarded as heavily dependent on decisions of foreign residents to move out of sterling and into Euro-dollar assets.

Despite the surplus on the basis of official reserve transactions, there was a decline totaling $940 million in our gold stock and IMF position in the first 9 months (no figures in this paragraph are seasonally adjusted). There was a net increase of $370 million in U.S. official holdings of convertible foreign currencies, for the most part reflecting increased holdings of sterling under swap arrangements. Liquid liabilities to foreign central banks and governments declined more than $1-1/2 billion, while non-liquid liabilities rose $1/4 billion.

Current economic situation and prospects in industrial countries. Over the summer months, economic trends among industrial countries were becoming even more clearly differentiated than earlier in the year. On the one hand, economic activity in Britain was definitely turning down, the slowdown of expansion in Germany and Belgium was continuing, and there were signs that the Dutch and Canadian booms might be cooling off. On the other hand, the recoveries in France, Italy, and Japan became broader and now appear to be firmly rooted.

In recent unpublished forecasts, the OECD Secretariat puts the rate of growth in real GDP of the European countries as a group at 3.9 per cent from 1965 to 1966 and again from 1966 to 1967, about equal to the 4.0 per cent rate achieved from 1964 to 1965. The OECD Secretariat foresees a beginning of recovery in the United Kingdom in the course of next year, and a quickening in the rate of growth not only in France and Italy but also in Germany. Further slowdowns are looked for in Canada, the Netherlands, and the Scandinavian countries. Rapid expansion of output is expected to continue in Japan.

In Britain, signs suggesting that the succession of deflationary measures taken by the Government early in the year and again in July have taken hold are accumulating. Automobile sales in August-September were 20 per cent below those of the same months in 1965. A further drop in instalment credit outstanding in August brought consumer credit to its lowest level since April 1965. The wage freeze, initially voluntary, has been made compulsory.

Private investment demand is weakening sharply; expenditures may have turned down in the second quarter. Latest investment intention surveys, conducted by the Board of Trade and by the Confederation of British Industry, show a sharp deterioration in the investment climate. The CBI reported that 60 per cent of its respondents in August-September expected to invest less next year than in 1966. The drop in confidence about future developments in the order, output and employment situation between the preceding survey and this one was steeper than any recorded in the eight-year history of the survey.

Demand for bank loans has fallen off. Seasonally adjusted outstanding advances of the clearing banks fell sharply from mid-July to mid-September, putting the banks 3 per cent below their credit ceiling. Since then demand for bank loans has reportedly remained weak despite business use of funds to make selective employment tax payments.

Weakening domestic demand was not yet reflected in a fall in industrial output through August. In fact industrial production increased in both July and August. The labor market, however, has clearly begun to ease. Unemployment, which had been rising slightly since June, jumped sharply in September and October.

In September the foreign trade deficit on the balance-of-payments basis virtually disappeared, with both imports and exports down from August. However, the fall in imports may reflect anticipation of the removal of the import surcharge scheduled for November. The drop in exports may reflect tapering off of the bulge in shipments delayed by the seamen's strike.

In Germany, demand pressures have continued to ease. Expansion of private investment demand has been moderating since the fall of 1965, and private consumption demand is now also growing more slowly.

Final domestic expenditures for goods and services in the first six months of 1966 were only 7 per cent higher (valued at current prices) than in the corresponding period of 1965; this compares with year-to-year increases of 11 per cent and 9 per cent for the first and second halves of 1965, respectively.

With domestic demand easing, inflationary pressures have diminished noticeably. The labor market remains tight, but since March unemployment has been rising, albeit fractionally. Job vacancies have been falling steadily since the beginning of the year, and the number of vacancies per unemployed worker has declined from 5.6 in March (seasonally adjusted) to 3.1 in August. One reason unemployment remains very low is that the number of foreign workers in Germany has begun to decline. Labor hoarding is said to have diminished and labor mobility has increased.

Wage increases are slowing. New contracts are being written with average increases of 6 per cent a year rather than the 7 per cent which had been standard until recently, and the gap between increases in contract rates and effective earnings also appears to be narrowing. As a result, disposable incomes from wages and salaries have been recording steadily decreasing year-to-year growth rates since the third quarter of 1965.

Prices for industrial producers' products remained virtually stable between May and July and decreased in August. Declines were confined to prices of basic materials, but prices of investment and consumer goods also stopped rising and were stable during the summer months. Retail prices stabilized for the first time in many months; they were unchanged in June and July and declined seasonally in August. While the decline was mainly in food prices, price increases in the non-food sector appear to be moderating.

Smaller domestic order books and the easier labor situation have put German industry in an excellent position to take advantage of rising external demand. Exports have in fact been increasing strongly, and it is expected that by next year this development will have significant repercussions on domestic investment demand. From March through August, however, total new orders to German industry were falling; in July-August they were at their year-earlier level, even though foreign orders were up 13 per cent. Industrial production, too, has shown no net increase since the beginning of this year.

Imports, reflecting easier domestic investment demand, more cautious inventory policies, and smaller deliveries of military goods, have leveled off since early this year. As a result, the German trade surplus averaged about $150 million a month during April-August, comparable to its size in 1963 and 1964.

In <u>France</u>, the recovery which began last year has broadened in 1966. Private investment demand, which leveled off in 1965, has turned up this year; the latest INSEE survey shows that outlays should increase substantially over the next twelve months. This development, combined with a slight quickening in the growth of consumer expenditures and strongly expanding public investment, is the main factor underlying OECD Secretariat expectations that the growth of real GDP may reach an annual rate of 5-1/2 per cent by the second half of 1967 (change measured from the preceding half year) as compared with 3.8 per cent for the first half of 1966.

So far, the quickening expansion has not generated new inflationary pressures. Residential construction, which had continued to expand gradually through 1964 and 1965, has been relatively stable. The steady growth in industrial output -- up 8 per cent from mid-1965 to mid-1966 -- has been achieved with only fractionally rising employment. Productivity has been growing quite fast -- as expected in the early stages of an upswing -- and wage pressures have remained relatively moderate. The age distribution of the population is such as to produce sizable additions to the labor force over the coming year.

Price increases are remaining relatively moderate: retail prices continue to rise at an annual rate of 2-1/2 to 3 per cent, with non-food prices rising by about 3 per cent; wholesale prices for finished goods have remained fairly stable since early this year.

Imports in July-August were up 14 per cent in value from a year earlier. French exports, after rising strongly to last March, leveled off in April-August and apparently declined in September. A substantial balance of payments surplus nevertheless continued to be expected for coming months; the French reserve losses in September and early October were probably due in considerable part to movements of interest-sensitive funds and to increased confidence in sterling.

In Italy, exports and government expenditures are still the mainsprings of expansion, but reviving private investment and expanding consumer demand give further buoyancy to economic activity. A recent upturn in residential construction permits suggests that recovery is now spreading to this lagging sector. If OECD Secretariat projections are borne out, the annual rate of growth of real GDP will accelerate to about 7-1/2 per cent in the second half of 1967 (change measured from the preceding half year) as compared with 5.4 per cent for the first half of 1966.

As in France, industrial output has easily accommodated expanding demand. Italian industrial production at mid-year was up 10 per cent from a year earlier. The major part of the rise was achieved through increases in productivity; manufacturing employment was up only 2 per cent

Price developments reflect the fact that the Italian expansion is going forward without strain on resources. Consumer prices are rising at an annual rate of only 2 per cent, less than in any other industrial country except Austria. Wholesale prices of investment and consumption goods have been very stable. Export prices, too, have remained stable, in contrast to the upward trend exhibited in other countries. This price stability, combined with the fact that delivery periods have remained short in Italy, helps to explain the continued rise in Italian exports, which in July-August were 11 per cent higher than a year earlier.

In Canada, a number of weak spots are appearing in the economy, suggesting that the rate of expansion may be slowing. The inflow of new orders to industry declined from March to July (latest), residential construction demand has weakened considerably, and automobile sales in April-July (seasonally adjusted) averaged 11 per cent less than in the first quarter. Some uncertainties regarding private investment demand are developing. The June intentions survey indicated a 21 per cent increase in equipment outlays for 1966 over 1965, but recent data on equipment imports, which generally correlate closely with investment spending, suggest that this large rise may not fully materialize.

The easier demand situation was reflected in a decline in industrial production from the April high to July (latest), and an increase in the unemployment rate from 3.3 per cent in April to 4.0 per cent in August. Machinery production has been level, and output of various types of materials, including steel, paper, and construction materials, has declined.

Wage settlements have been very large, averaging between 5 and 8 per cent this year compared with a range of 3-6 per cent in 1965. Prices also are continuing to rise fairly strongly: in August wholesale prices for manufactured goods were 1.2 per cent above the February level, and retail prices had risen by 2 per cent over the six months. This persistence of an inflationary atmosphere, despite tightness of bank credit, explains the Government's announcement in September that an increase in taxes to cover increased social security benefits will be asked for in November.

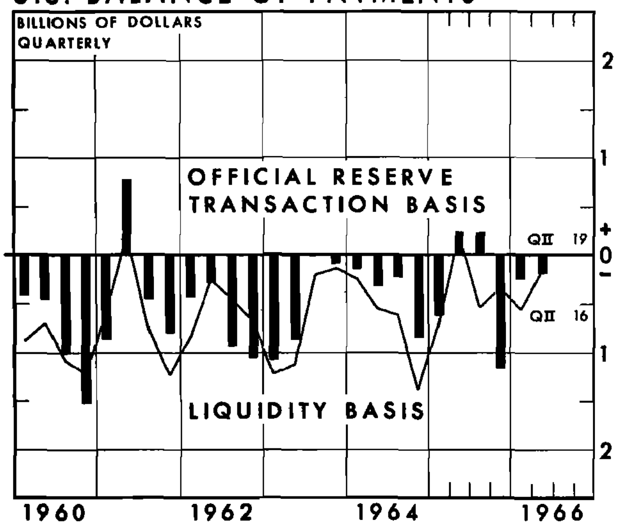
In Japan, industrial production has been increasing steadily, and in August it was 15 per cent higher than a year earlier. Producer goods and durable consumer goods have registered the most rapid rates of increase.

The expansion has outrun official Japanese production predictions made late in 1965. The forecast was that industrial production would be 8 per cent greater in fiscal 1966 (April 1966-March 1967) than in fiscal 1965. This implied, on a straight line basis, a September index of 189 (1960=100). In August, however, the index was already 198.

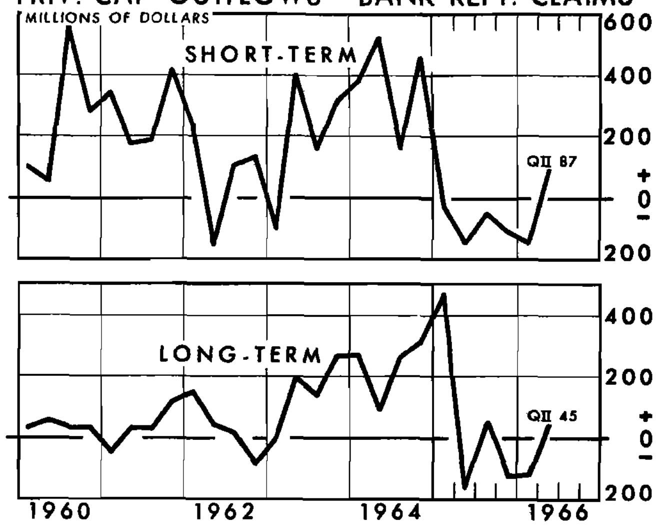
U.S. AND INTERNATIONAL ECONOMIC DEVELOPMENTS

SEASONALLY ADJUSTED

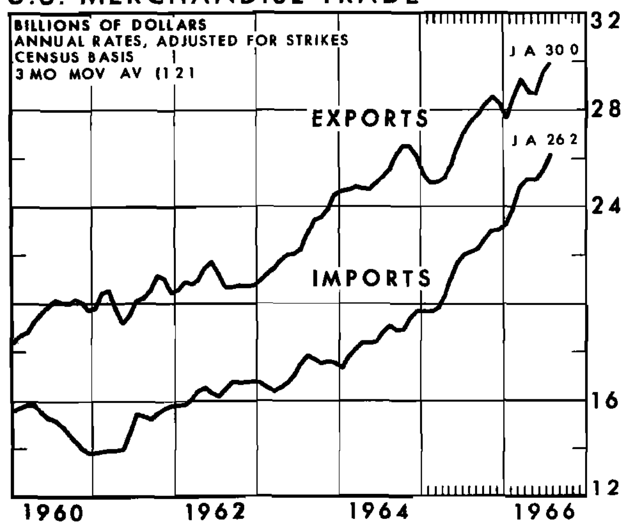
U.S. BALANCE OF PAYMENTS



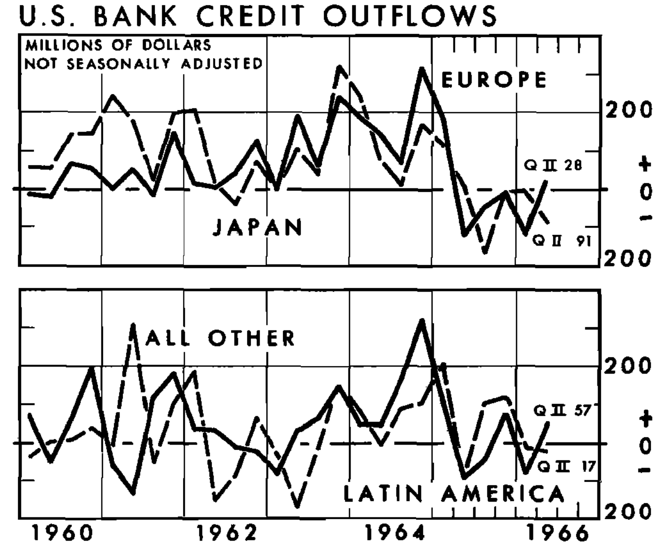
PRIV. CAP OUTFLOWS - BANK REPT. CLAIMS



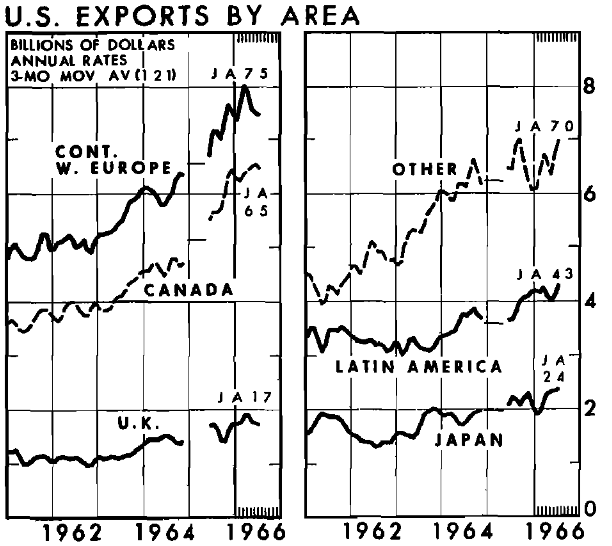
U.S. MERCHANDISE TRADE



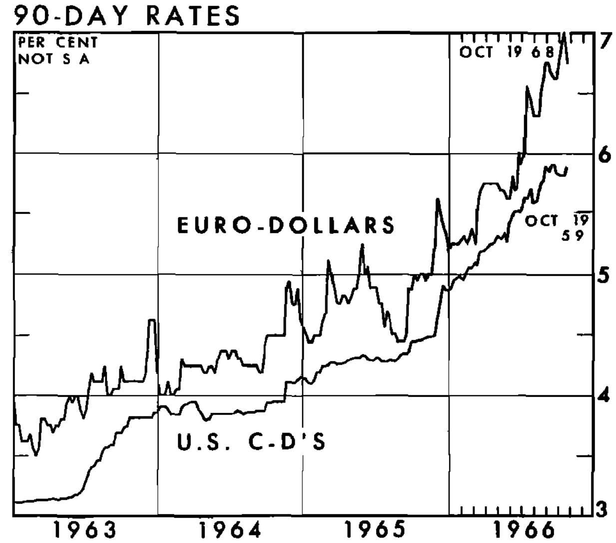
U.S. BANK CREDIT OUTFLOWS



U.S. EXPORTS BY AREA



90-DAY RATES



APPENDIX A: RECENT HOUSING AND RELATED LEGISLATION*

Awaiting the President's signature are two major bills affecting housing and other real estate. One bill (H.R. 17607) -- which suspends the investment tax credit allowance for business machinery and equipment -- also suspends for the next 15 months two methods of accelerated depreciation now permitted on new and reconstructed real estate properties. The other bill (S. 3708), which has longer run implications, authorizes the President's demonstration cities program and other measures.

Tax bill

With one exception, the depreciation provisions of this bill prohibit taxpayers that order, start, or reconstruct properties between October 10, 1966 and December 31, 1967, from claiming for income-tax purposes any accelerated deductions for depreciation at an annual rate greater than 150 per cent of the applicable straight-line method. Exempted from the suspension is construction purchased by a taxpayer during the suspension period for use in his trade or business, to the extent of an aggregate cost of $50,000.

These provisions, in effect, forbid the use of the present forms of accelerated property depreciation -- the double declining balance (200 per cent of straight line) and the sum of the years-digits systems -- for affected properties ordered or constructed during the next 15 months. The prohibition applies over the entire useful life of the new or reconstructed properties. However, the present 150 per cent declining balance and the straight-line systems of depreciation will continue to be allowed for both new and used real estate.

Most market observers feel that the restrictive effect of these changes on starts of new private rental housing or nonresidential structures will be minor during the suspension period, partly because taxes are only one of many factors to be considered. But the precise effect is hard to foretell because we do not know exactly how much the suspended double-declining balance system of depreciation has been used in the past on new properties as compared with other methods of depreciation that will remain in effect. The suspended sum of the years-digits method has accounted for only a very limited number of cases, at least for active construction and real estate corporations

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

filing tax returns for 1960-61 (the latest available year). In that period, the sum of the years-digits method was reported in only about 5 per cent of all outstanding cases for which the method of computation was given for new or used personal or real property.

While the dampening effect on new construction may be small in the aggregate, some contemplated projects will, without doubt, be curtailed. In the past, postponement of income taxes by deducting accelerated depreciation allowances has provided high-leveraged real estate owners with substantial tax shelter and additional cash flow through the early life of new properties. During the first ten years, for example, the double declining method of depreciation -- compared with the 150 per cent method -- can produce an additional cash flow for new structures (with 40-year lives) equivalent to about 6 per cent of the initial cost of the investment. The double declining method may also permit a larger part of any profit realized from the eventual sale of the property to be taxed as a capital gain.

For certain new properties, such as hotels-motels or industrial plants with substantial owner investments in equipment as well as in structures, suspension of the investment tax credit as well as suspension of accelerated depreciation will undoubtedly cause their owners to take another look at their near-term development plans.

Housing bill

The omnibus Demonstration Cities and Metropolitan Development Act of 1966 seems likely to provide little net stimulus to new construction over the next year. Its principal features are actually of a longer-run nature; the fiscal year 1967 authorizations are relatively limited and subject to the usual uncertainties about appropriations and implementation.

A number of the bill's features are designed to alleviate some of the basic problems of modern urban living by widening the scope of Federal assistance to include whole sections of cities or entire metropolitan areas. Among its many provisions are the following: (1) a new $1.2 billion demonstration-city program (through 1969) to eliminate physical and social blight within entire city neighborhoods, to be financed by Federal planning grants and supplemental development grants; $12 million in appropriations is authorized for the current fiscal year; (2) a new $75 million program of supplemental grants (through 1968) to assist public agencies in carrying out area-wide development projects for public facilities; $25 million is authorized this year; (3) a broadened program of FHA-mortgage insurance of land-development loans to include tracts in new communities; FNMA could purchase such loans under its special assistance program; (4) a new program of FHA insurance of loans to finance the construction and equipment of facilities for the group practice of medicine, optometry, or dentistry; (5) new authority for FNMA under its special assistance program to participate in making construction loans on certain FHA-insured cooperative, urban renewal, or below-market-rate housing projects; to date, FNMA's authority has been limited to purchasing permanent loans on completed projects.

APPENDIX B: FARM EXPORTS*

Farm products moved overseas in record volume during fiscal 1965-66. According to Department of Agriculture estimates, dollar earning on farm exports (actual dollar sales plus imputed earning on aid-financed programs) exceeded the value of farm imports by nearly a billion dollars. This favorable balance, and one nearly as favorable in the preceding year, compares with negative balances on agricultural merchandise trade from 1960 through 1963 and a very small plus balance in 1964. Further expansion in the over-all volume of exports is in prospect in the coming year.

The 1965-66 export was valued at $6.7 billion, 10 per cent more than the record export of 1964-65. The big gain was in commercial exports for dollars with sales exceeding last year by 15 per cent. Government-financed sales under P.L. 480 and the AID programs amounted to $1.6 billion, down 5 per cent from the preceding year. Export subsidies were used to bring prices of wheat, cotton, rice and tobacco into a competitive position with world prices on both cash and government-financed transactions.

The commodity "mix" of the 1965-66 export total revealed a substantial reshuffling in relative importance of commodities moving into world trade from the United States. Of the traditional "Big Three" -- wheat, cotton, tobacco -- only wheat retained its top position in 1965-66. As shown in the table, cotton and tobacco ranked below feed grains and soybeans in value in the past year. Wheat owes its retention of top position to subsidies on commercial exports and to large P.L. 480 shipments from surplus stocks only recently brought down to manageable levels from the peak surplus of 1961. In fact, the reduction in wheat stocks has been largely achieved through massive P.L. 480 shipments coupled with moderate cuts in production.

Markets for feed grains, largely dollar markets, have been rising with the fast-growing food livestock industries abroad. However, poor feed crops in many parts of the world gave a fill-up to the 1965-66 market which may not reoccur in 1966-67. Soybeans are benefiting from rising demand for animal feeds abroad and also from a broad shift in consumer tastes away from animal oils to vegetable oils. On the supply side, soybeans have benefitted from the gap in world trade created by the reduced export availabilities in Red China.

*Prepared by Wilellyn Morelle, Economist, Business Conditions Section, Division of Research and Statistics.

New farm programs are expected to encourage expansion in cotton exports in the current year. Cotton exports of 3,065 thousand bales in 1965-66 were 32 per cent below the 4,491 thousand bales exported the year before. Our exports in 1965-66 were held down by larger export availabilities in other net exporting countries and by both lower mill consumption rates in the major importing countries and by importers' reluctance to add to stocks until the new low price of 21 cents per pound on U.S. cotton (the key to the world price) took effect on August 1, 1966.

VALUE OF FARM EXPORTS IN 1965-66
Total, Government-financed, and commercial sales for dollars

Commodity	Value of export in fiscal 1965-66			Per cent change from 1964-65		
	Total	Govt. financed 1/	Dollar sales	Total	Govt. financed	Dollar sales
	(In millions of dollars)					
Wheat and wheat flour	1,403	960	443	13	- 5	91
Feed grains, excluding products	1,351	112	1,239	44	52	43
Oilseeds and products	1,224	138	1,086	10	-16	14
Cotton	386	101	285	-34	-37	-33
Tobacco, unmanufactured	395	92	303	0	166	-16
Other products	1,923	211	1,712	5.6	-17	9.1
Total agricultural exports	6,681	1,615	5,066	10	-5	15

1/ Shipments financed under the four titles of P.L. 480 Title I sales for foreign currency, Title II famine and other emergency relief, Title III donations and barter, and Title IV long-term supply and dollar credit sales--and a small amount, under P.L. 89-195 AIO programs.