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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

August 17, 1966

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SUMMARY AND OUTLOOK

Outlook for GNP

Despite various domestic and international uncertainties, expansion in GNP is still expected to accelerate in the current quarter and to maintain the stepped-up pace in the fourth quarter. The staff projection is for a rise of around $14 billion in both the third and fourth quarters, about midway between the $11 billion rise of the second quarter and the exceptional $17 billion rise of the first quarter. In real terms this projected growth is at an annual rate of 3.9 per cent, a rate that would be accompanied by continued high levels of resource utilization and strong upward pressures on prices and wages.

There appears to be no abatement in the pace of the increase in defense spending. Both new and unfilled defense orders were very strong in June. Stepped-up draft calls for September and October suggest the likelihood of a continued build-up in the armed services, at least through this year. By midyear, the armed services had already attained the strength originally scheduled for mid-1967.

Business fixed investment is projected to rise much more sharply in the second half of the year than in the second quarter, when strikes curtailed construction. The projected rise is in line with the latest official spring survey of spending plans (a new survey will be available next month).

The rate of inventory accumulation, in contrast, is expected to decline appreciably from the second quarter annual rate of $12 billion,

in part because dealer stocks of autos, which showed a sizable second quarter rise, after seasonal adjustment, are assumed to show little change in the third quarter. And residential building is expected to decline significantly further, as mortgage markets remain tight.

Resumption of a more rapid rate of expansion in GNP is expected in part to reflect renewed strength in consumer buying, stimulated by a much greater rise in disposable income. This, in turn, comes from a projected acceleration in personal income as well as a smaller rise in tax and social security payments. Revised retail sales data for June, now up 3.5 per cent from May, and the moderate further growth now indicated for July are broadly consistent with this view on consumer spending. The bulk of the projected expansion is in nondurable goods and services. The staff has projected sales of new domestic autos at an annual rate of 8.5 million units in the second half of the year, somewhat above the actual sales rate so far this quarter. The 1967 models will have added safety features but also, presumably, higher price tags.

Resource-use and prices

The GNP projection discussed above points to the maintenance of relatively strong demand pressures on industrial resources. Recent expansion in industrial activity, although not so rapid as last winter, apparently has been at least as fast as expansion of capacity. The over-all unemployment rate has held at about 4 per cent, the rate for adult males has remained close to a minimum, and the number of workers

unemployed for long periods has declined further. These conditions, along with high profits, rising consumer prices, and wage escalation in certain industries, increase the likelihood of an acceleration in wage increases as new contracts come up for negotiation--a development which would add upward pressure of labor costs to the existing pull of demand on prices of manufactured materials and prodccts.

The recent rise in list prices for steel sheet and strip may affect attitudes considerably more than costs. The successful chipping away at the guideposts could be taken as a signal that market conditions generally are strong enough to support price increases. The direct effect of the 2 per cent increase in sheet and strip on the industrial commodities index will be negligible, only 2 one-hundredths of 1 per cent. The cost impact is concentrated on the auto and appliance industries; estimates of the impact on the cost of an auto range from $2 to $5.

The steel-price increase was taken as an occasion for predictions of price increases ranging from $50 to over $100 for 1967 autos. Higher prices may affect markets even though the new safety features will account for some part if not all of the increase. In the consumer and wholesale indexes the amount attributable to the safety features will be factored out as quality improvement. In setting prices the auto companies presumably will be keenly aware of cost increases that have occurred but also will have before them a recent record of an appreciable decline in sales.

Bank credit outlook

The member bank credit proxy, on a daily average basis, is expanding considerably less rapidly in August than in July or for the year to date. Security portfolio liquidation and reduced loan demands, the latter reflecting in part the smaller tax withholding payments due from large corporations this month, appear to account for much of the retardation. But with liquidity reduced and time deposit growth slackening markedly at the large banks, increased credit rationing may also be contributing to slower expansion or curtailment in some loan categories. Total bank credit, on a last Wednesday basis, however, is likely to show a sharp increase for August, since banks will probably still have on hand a sizable part of the $3.0 billion of Treasury tax bills to be auctioned this week, with full tax and loan credit, and delivered just 4 days before the end of the month.

Business demands on banks over the remainder of the year--particularly in September--are likely to intensify again, even in the face of the rise in bank loan costs. Not only will the normal seasonal fall loan expansion be underway--with more of business needs likely to be reflected in demands for bank loans due to reduced corporate liquidity--but September tax and dividend needs may also be more difficult for firms to handle given their increased requirements for funds for working and fixed capital.

Large commercial banks will find it increasingly difficult to satisfy the loan demands expected to be placed upon them over the next few months. Their security portfolios have already been sharply reduced, as have their time deposit inflows; New York City banks have actually suffered declines in time deposits since midyear. Money market banks probably will be unable to roll over all of their large September maturities of CD's, under present Regulation Q ceilings, and this may add greatly to the pressure on bank positions. Increased demands for credit, low bank liquidity, reduced time deposit inflows, and the general level and direction of market rates of interest, therefore, suggest a further squeeze on credit availability at large banks, of which this week's increase in the prime rate is one symptom.

These developments should tend to redirect credit demands from large banks to the market, which may push market rates up further and make it even more difficult for banks to sell CD's at present Regulation Q ceilings. Under such circumstances, money market banks can be expected to tap all possible sources of funds. The possibilities include more aggressive bidding for Federal funds and for foreign official deposits and Eurodollars obtained through foreign branches (both exempt from Regulation Q). Most big banks also have room to raise rates paid on consumer-type time deposits further, unless prevented from doing so by regulatory or legislative action. More loan demands are also likely to be directed to banks outside of money market centers, which since late spring have been much more successful in obtaining time deposit money.

Securities markets prospects

The underlying supply-demand influences which have recently been exerting such marked upward pressures on interest rates in securities markets can be expected to persist in the weeks immediately ahead. In fact, they may be intensified by further shifts of credit demands from banks to the capital markets as a consequence of the prime rate increase and the possibility that major banks will be unable to replace heavy September CD maturities.

Depositor reinvestment of the proceeds of CD liquidation would tend to exert a downward effect on some short-term rates. Also new issues of regular Federal agency debt are likely to be in substantially smaller volume over the next month. But these downward rate influences would very likely be offset by additions to market supply resulting from the imminent Treasury cash borrowing, by the bank portfolio liquidation needed to cover the deposit withdrawals, and by the dislocations in existing demand-supply relationships that would result from any abrupt squeeze on bank positions would bring.

Pressure on bank liquidity positions have already exerted a marked recent impact on municipal bond yields, both through a sharp cut-back of bank participation in new debt offerings and through steady city bank liquidation of outstanding municipal bond holdings. The resulting sharp rise in tax exempt yields has caused a few postponements of new issues and has attracted increasing demand from individuals and bank trust departments, but not in sufficient volume to halt the yield advance. Any sizable run-off of CD's at larger banks can be expected

to concentrate bank portfolio liquidation in the municipal bond market, further accentuating recent rate tendencies.

Pressures on bank liquidity positions also may be forcing some business borrowers into new capital market financing, at a time when general business demands for long-term funds and reduced institutional investor interest in private placements are also greatly expanding the volume of publicly offered corporate bonds. The supply of such offerings now estimated for August is about $1 billion, the largest monthly total for the year, and underwriters report that September public offerings are also likely to be unusually large. Since interest rates in the market for public offerings tend to adjust more quickly than those in the private placement market, the heavy volume of public offerings has and can be expected to continue to accentuate the rise in corporate bond yields.

In the mortgage market, the extreme concern which preceded the July reinvestment period at depositary-type financial intermediaries was moderated by the better than expected savings experience of mutual savings banks in New York State and of savings and loan associations in California. But the July savings experience of S&L's in some other parts of the country was considerably less favorable than in California. And with yields on market instruments rising so sharply since July, the attraction of direct market investment for savers is likely to work against any significant rebound in savings flows to depositary-type institutions. With life insurance companies also heavily committed and under pressure from business demands, the availability of mortgage funds is likely to continue very limited.

Balance of Payments

The payments deficit on the liquidity basis was at an annual rate of roughly $3 billion in July and continued large in early August. The contrast with a deficit rate of only $1-1/2 billion for the first half year reflects the fact that that figure was held down by large shifts of funds by foreign official and international institutions from liquid to nonliquid claims on the United States.

The balance on the official reserve transactions basis has behaved differently. From a deficit of nearly $1 billion (annual rate) in the first half year, it swung into very substantial surplus in July, as foreign private liquid funds were attracted to this country in unusually large volume, mainly through the foreign branches of U.S. banks. Much of this inflow was probably the counterpart of the heavy drain on U.K. reserves. Unfortunately, the emergence of an official settlements surplus did not relieve the over-all pressures on U.S. reserves or on the dollar in foreign exchange markets. While the official claims of the United Kingdom on this country diminished, those of other countries continued to increase, partly because of uncertainties about sterling, and the System made extensive use of its swap arrangements.

The outlook for the months ahead is for continuation of a liquidity deficit in the $3 billion range. The merchandise trade surplus recovered a little in June to about the average rate for the

first half year, but no early further recovery from that level is expected. The renewed outflow of U.S. bank credit that developed in the second quarter may be checked again soon; but there may also be some increase in outflows through transactions in foreign securities, which were unusually low in the second quarter (thanks partly to advance redemptions by the Canadian Government).

Given a continued large liquidity deficit, the balance on official reserve transactions is likely soon to swing back into deficit. U.S. banks will doubtless seek to draw further on the Euro-dollar market, but they are unlikely to be able to continue to do so at anything like the July pace, or even at a pace sufficient to match the liquidity deficit, particularly if the new British economic program ultimately succeeds in reversing some of the earlier flight from sterling. Thus, further declines in the U.S. gold stock and further use by the System of its swap lines are to be expected in the months ahead, in addition to U.S. drawings of $350 million from the IMF during August-October (confidential until released).

SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest Period	Amount			Per cent change	
		Latest Period	Preced'g Period	Year Ago	Year Ago*	2 years Ago*
Civilian labor force (mil.)	July'66	77.1	77.1	76.1	1.4	4.0
Unemployment (mil.)	"	3.0	3.1	3.4	-11.9	-18.2
Unemployment (per cent)	"	3.9	4.0	4.5	--	--
Nonfarm employment, payroll (mil.)	"	63.6	63.5	60.5	5.2	9.4
Manufacturing	"	19.1	19.1	18.0	5.9	10.6
Other industrial	"	8.0	8.1	7.8	2.8	5.3
Nonindustrial	"	36.5	36.3	34.7	5.4	9.7
Industrial production (57-59=100)	"	157.5	156.2	144.2	9.2	18.2
Final products	"	155.2	154.7	141.7	9.5	17.3
Materials	"	160.0	157.9	146.4	9.3	19.0
Wholesale prices (57-59=100)1/	"	106.4	105.7	102.9	3.4	6.0
Industrial commodities	"	104.6	104.5	102.1	2.4	3.8
Sensitive materials	"	106.3	106.6	102.3	3.9	7.3
Farm products and foods	"	109.8	107.7	103.7	5.9	11.9
Consumer prices (57-59=100)1/	June'66	112.9	112.6	110.1	2.5	4.5
Commodities except food	"	106.4	106.3	105.1	1.2	2.0
Food	"	113.9	113.5	110.1	3.5	7.3
Services	"	122.0	121.5	117.6	3.7	6.0
Hourly earnings, mfg. ($)	July'66	2.70	2.71	2.61	3.4	6.7
Weekly earnings, mfg. ($)	"	111.46	111.85	107.22	4.0	8.1
Personal income ($ bil.)2/	"	579.7	577.2	535.4	8.3	16.6
Corporate profit before tax ($ bil.)2/	QII'66	82.9	82.7	74.5	11.3	24.1
Retail sales, total ($ bil.)	July'66	25.5	25.4	23.7	7.8	16.7
Autos (million units)2/	"	8.3	8.3	8.9	- 7.1	12.1
GAF ($ bil.)	"	6.0	6.0	5.4	10.5	17.2
Selected leading indicators:						
Housing starts, pvt. (thous.)2/	June'66	1,288	1,295	1,566	-17.8	-20.5
Factory workweek (hours)	July'66	41.2	41.3	41.0	0.5	1.2
New orders, dur. goods ($ bil.)	June'66	24.3	24.3	21.3	14.0	21.4
New orders, nonel. mach. ($ bil.)	"	3.5	3.6	3.2	10.6	16.4
Common stock prices (1941-43=10)	July'66	85.83	86.06	84.91	1.1	3.1
Inventories, book val. ($ bil.)	June'66	126.7	125.5	3/	--3/	--3/
Gross national product ($ bil.)2/	QII'66	732.3	721.2	672.9	8.8	16.7
Real GNP ($ bil., 1958 prices)2/	"	643.5	640.5	607.8	5.9	11.3

* Based on unrounded data. 1/ Not seasonally adjusted. 2/ Annual rates.
3/ Not comparable with current data.

SELECTED DOMESTIC FINANCIAL DATA

	Week ended Aug. 12	Four-Week Average	Last six months High	Last six months Low
Money Market 1/ (N.S.A.)				
Federal funds rate (per cent)	5.72	5.34	5.75	3.00
U.S. Treas. bills, 3-mo., yield (per cent)	4.87	4.82	4.93	4.33
Net free reserves 2/ (mil. $)	- 383	- 423	- 94	- 477
Member bank borrowings 2/ (mil. $)	782	718	827	453
Security Markets (N.S.A.)				
Market yields 1/ (per cent)				
5-year U.S. Treas. bonds	5.35	5.25	5.26	4.76
20-year U.S. Treas. bonds	4.86	4.85	4.88	4.59
Corporate new bond issues, Aaa	--	5.60	5.64	4.84
Corporate seasoned bonds, Aaa	5.25	5.22	5.26	4.74
Municipal seasoned bonds, Aaa	3.87	3.80	3.87	3.39
FHA home mortgages, 30-year 3/	6.45	6.45	6.45	5.70
Common stocks S&P composite index 4/				
Prices, closing (1941-43=10)	83.34	84.06	94.06	82.31
Dividend yield (per cent)	3.49	3.45	3.49	3.01

	Change in July	Average change last 3 mos.	Annual rate of change (%) 3 mos.	Annual rate of change (%) 1 year
Banking (S.A., mil. $)				
Total 5/	181	36	1.9	4.6
Bank loans and investments:				
Total 5/	2,800	2,200	6.5	9.2
Business loans	1,800	1,700	27.4	18.9
Other loans 5/ 6/	1,300	2,300	7.2	10.8
U.S. Government securities	- 400	- 600	- 12.2	- 6.6
Other securities 6/	100	300	8.6	11.3
Money and liquid assets:				
Demand dep. & currency	- 1,500	- 500	3.5	4.4
Time and savings dep. 5/	1,900	1,500	11.6	13.4
Nonbank liquid assets	- 900	100	- 0.5	5.1

N.S.A.--not seasonally adjusted. S.A. Seasonally adjusted.
1/ Average of daily figures. 2/ Averages for statement week ending August 10.
3/ Latest figure indicated is for month of June. 4/ Data are for weekly closing prices.
5/ In comparisons involving July 1966 allowance has been made for the $1.1 billion of balances accumulated for the payment of personal loans which were excluded from time deposits and from loans on June 9.
6/ In comparisons involving July 1966 allowance has been made for the shift of about $1.0 billion of participation certificates from "other loans" to "other securities" beginning in July.

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

	1966				1965			1965
	July	June	QII	QI	QIV	QIII	QII	Year (billions)
				Seasonally adjusted				
Current account balance				1,269	1,290	1,527	1,761	6.0
Trade balance 1/		350	816	1,118	1,271	1,231	1,317	4.8
Exports 1/		2,455	7,080	7,121	7,027	6,826	6,798	26.3
Imports 1/ 2/		2,105	6,264	-6,003	-5,756	-5,595	-5,481	-21.5
Services, etc., net				151	19	296	444	1.2
Capital account balance				-1,604	-1,560	-1,821	-1,426	-6.9
Govt. grants & capital 3/				-955	-881	-743	-949	-3.4
U.S. private direct investment				-630	-731	-569	-859	-3.4
U.S. priv. long-term portfolio				-244	-154	-363	101	-1.1
U.S. priv. short-term				-14	-27	105	412	0.8
Foreign nonliquid				239	233	-251	-131	0.2
Errors and omissions				-228	-80	-240	-109	-0.4
Balances, with and without seasonal adjustment (- = deficit)								
Liquidity bal., S.A.			-163	-554	-350	-534	226	-1.4
Seasonal component			-22	485	-3	-472	-37	--
Balance, N.S.A.	-437	122	-185	-69	-353	-1,006	189	-1.4
Official settlements bal.,			-189	-248	-1,158	236	238	-1.3
Seasonal component			-177	625	33	-508	-184	--
Balance, N.S.A. 4/		115	-366	377	-1,125	-272	54	-1.3
Memo items:								
Monetary reserves (decrease -)	190	53	-68	-424	-271	-41	-68	-1.2
Gold purchases or sales (-)	-116	-53	-209	-68	-119	-124	-590	-1.7

1/ Balance of payments basis which differs a little from Census basis.
2/ Monthly figures tentatively adjusted for changes in carry-over of import documents.
3/ Net of loan repayments.
4/ Differs from liquidity balance by counting as receipts (+) increase in liquid liabilities to commercial banks, private nonbanks, and international institutions (except IMF) and by not counting as receipts (+) increase in certain nonliquid liabilities to foreign official institutions.

THE ECONOMIC PICTURE IN DETAIL

The Nonfinancial Scene

Gross national product. After rising $17 billion and $11 billion (revised) in the first two quarters of 1966, GNP is projected to increase by about $14 billion in each of the last two quarters.

The implicit GNP price deflator is expected to continue to rise at an annual rate of 3.5 per cent. Real GNP is thus projected to grow at an annual rate close to 4 per cent in the second half of 1966, about midway between the first and second quarter growth rates.

Most components are expected to increase in the third and fourth quarters. Only residential construction activity and the rate of inventory accumulation are projected to decline.

In the projection, consumer spending, which expanded very little in the second quarter, is shown as expanding rapidly in the third quarter, although not quite so rapidly as in the first quarter. Changes in nondurable consumption are in accord with anticipated increases in disposable income. Service outlays are shown to increase at a somewhat faster rate than previously because of the beginning of payments under the Medicare program. And expenditures for durable goods turn up again after the second quarter decline.

Sales of domestically produced autos in the second half of 1966 are projected at an annual rate of 8.5 million, up a little from the second quarter and also from July. The greater discounts being offered this quarter will operate to prevent the dollar value of automobile purchases from increasing as rapidly as sales of physical units.

However, these unusually large discounts coupled with widespread expectations of price increases for 1967 models should operate to stimulate sales of remaining 1966 models and possibly to draw some sales away from the normal fourth quarter purchases of 1967 models. In the fourth quarter, prospective price increases -- partly or wholly for new safety features -- will cause the dollar value of auto purchases to rise relative to unit sales. While these new safety features may stimulate sales in the fourth quarter price increases are likely to discourage them. Consumer purchases of other durable goods are projected to show only a modest growth.

Defense spending increases shown in the projection are in line with recent experience and the higher draft calls recently announced. Other Federal purchases are expected to increase sharply from the second quarter level, when exceptionally large CCC sales of agricultural commodities (entering the GNP accounts as deductions from Federal expenditures), resulted in a decline in nondefense Federal purchases. These CCC sales are not expected to be as large in the remainder of the year.

A somewhat greater increase in fixed business investment than in the second quarter is expected for the second half, as indicated by the latest quarterly plant and equipment survey last May. But the prospective continued tightness in availability of mortgage funds is likely to result in continued decline in residential construction expenditures.

The rate of inventory accumulation is projected to decline from the exceptionally high $12.3 billion rate of the second quarter to a level of $9.5 billion in the third quarter. The buildup of dealer stocks of new U.S.-made autos to a record high accounted for $1.3 billion of the second quarter's inventory accumulation.

AUTOMOBILE SALES, PRODUCTION, AND INVENTORY CHANGES
Estimated Third Quarter
(Thousands of cars)

Annual sales rate, s.a.	8,500
Sales in quarter	1,732
Inventory beginning of quarter	1,727
Scheduled production	1,340
Inventory end of quarter	1,335
Seasonally adjusted	
End of quarter stocks	1,615
Beginning of quarter stocks	1,515
Change in quarter	100
Annual rate of change	400

If sales of domestically produced cars in the third quarter are at an annual rate of 8.5 million and announced production schedules hold (see estimates shown in table), there will not be any liquidation, on a seasonally adjusted basis, of the heavy volume of automobile inventories currently in dealer's hands. Thus, roughly $1.3 billion of the $2.8 billion third quarter decline in the change in business inventories

is attributable to the fact that automobile inventories will have stopped increasing.

Other categories of business inventories in general do not appear to be high relative to sales. A decline is assumed, however, in the rate of accumulation of inventories in two areas which have shown the fastest rate of growth, specifically work in process at machinery and transportation equipment manufacturers and materials at durable manufacturers. The second quarter increase in materials at durable manufacturers seems to have brought these inventories in line with sales.

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

	1964	1965	1966 Proj.	1965 IV	1966 I	1966 II	1966 Projected III	1966 Projected IV
Gross National Product	631.7	681.2	739.9	704.4	721.2	732.3	746.0	759.9
Final sales	627.0	672.1	730.1	694.0	712.3	720.0	736.5	751.4
Personal consumption expenditures	401.4	431.5	466.1	445.2	455.6	460.1	469.7	479.1
Durable goods	59.4	66.1	68.8	68.0	70.3	67.1	68.5	69.3
Nondurable goods	178.9	190.6	207.4	197.0	201.9	205.6	209.2	212.8
Services	163.1	174.8	190.0	180.2	183.4	187.4	192.0	197.0
Gross private domestic investment	93.0	106.6	116.9	111.9	114.5	118.5	117.2	117.5
Residential construction	27.6	27.8	27.4	27.6	28.6	28.0	27.0	26.0
Business fixed investment	60.7	69.7	79.7	73.9	77.0	78.2	80.7	83.0
Changes in business inventories	4.7	9.1	9.8	10.4	8.9	12.3	9.5	8.5
Nonfarm	5.3	8.1	9.7	9.0	8.5	12.1	9.5	8.5
Net exports	8.5	7.0	5.0	6.1	6.0	4.7	4.7	4.7
Gov. purchases of goods & services	128.9	136.2	151.8	141.2	145.0	149.0	154.4	158.6
Federal	65.2	66.8	76.1	69.8	71.9	74.0	77.9	80.6
Defense	50.0	50.1	58.4	52.5	54.6	57.1	59.6	62.1
Other	15.2	16.7	17.8	17.3	17.4	16.9	18.3	18.5
State and local	63.7	69.4	75.7	71.4	73.1	75.0	76.5	78.0
Gross National Product in constant (1958) dollars	580.0	614.4	647.5	631.2	640.5	643.5	649.8	656.2
GNP Implicit deflator (1958=100)	108.9	110.9	114.3	111.6	112.6	113.8	114.8	115.8
Personal income	496.0	535.1	580.3	552.8	564.6	573.5	585.7	597.2
Wage and salaries	333.6	358.4	391.9	370.8	380.0	387.4	395.7	404.5
Personal contributions for social insurance (deduction)	12.5	13.2	17.5	13.5	16.9	17.1	17.9	18.0
Personal tax and nontax payments	59.4	66.0	74.2	66.7	69.5	73.6	75.8	77.8
Disposable personal income	436.6	469.1	506.1	486.1	495.1	499.9	509.9	519.4
Personal saving	24.5	25.7	26.6	28.5	26.9	26.6	26.6	26.3
Saving rate (per cent)	5.6	5.5	5.3	5.9	5.4	5.3	5.2	5.1
Total labor force (millions)	77.0	78.4	80.0	79.0	79.4	79.7	80.2	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	71.9	76.2	76.5	76.7	77.0	77.4
Employed "	70.4	72.2	74.0	73.0	73.6	73.7	74.1	74.6
Unemployed "	3.9	3.5	2.9	3.2	2.9	3.0	2.9	2.8
Unemployment rate (per cent)	5.2	4.6	3.8	4.2	3.8	3.9	3.8	3.7

Industrial production. Industrial production in July was 157.5 per cent of the 1957-59 average, 0.8 per cent above the upward-revised June figure of 156.2 per cent and 9 per cent above a year earlier. Increases in output of equipment and materials were substantial, as vacation shutdowns probably were fewer and shorter than usual. Output of consumer goods declined slightly.

Auto assemblies, after allowance for the early model change-over, declined 10 per cent and, at 152 per cent of the 1957-59 average, were almost one-fifth below a year ago. Schedules indicate that output will remain at a reduced rate in August but will increase to 165 per cent in September and be back up to 185 in October, or to an annual rate of 9.4 million units. If these schedules are realized, the August-October rise in auto output will add about .6 of one point to the total index.

The scheduled recovery in output is based mainly on a planned, rapid building up of stocks of the new models, a more rapid build-up than a year ago. The 1967 models go on sale in late September and early October.

Among other consumer goods, output of television sets and furniture also declined in July in what appears to be a temporary move as retail sales of furniture and appliances, which had declined in April and May, rose in June and then advanced further in July to record levels. Production of consumer nondurable goods increased further in July.

Output of both business and defense equipment continued their upward pace and were 17 per cent and 25 per cent, respectively, above a year ago. In May and June, new orders for machinery declined slightly, but they were still higher than shipments and unfilled orders continued to increase.

Production of iron and steel, as well as most other materials advanced further in July. Output of construction materials, however, remained at the somewhat reduced level prevailing since May.

Wholesale prices. The wholesale price index jumped 0.7 per cent from mid-June to mid-July as the average of prices for foodstuffs rose more than 2 per cent and returned to its February peak; industrial commodities rose only 0.1 per cent further. Since mid-July, according to the weekly estimates, indexes for the total and for both industrial commodities and foodstuffs have changed little.

The slowing down of the rise in industrial commodities -- from an average of 0.3 per cent a month in the first 5 months of the year to 0.2 per cent in June and 0.1 per cent in July -- reflects in the main a reversal in sensitive materials. The sensitive index declined 0.5 per cent from May to July after rising 3.5 per cent in the preceding 5 months.

It would be premature, at the least, to interpret the decrease in the sensitive index as indicative of a general easing in demands. The decline was concentrated in lumber and plywood and in hides and leather -- two groups which earlier had risen very sharply in response

to certain actual and threatened supply problems as well as to strong demands.

The metals component of the sensitive group was unchanged in July, after rising more than 4 per cent in the first half of the year. Pressures in copper markets appear to be easing. Prices abroad had been sustained at very high levels by curtailment in shipments from Zambia and a threat of a strike in Chile. But recently, Zambia has yielded to its own need for foreign exchange and has increased shipments through Rhodesia, and a strike in Chile has been averted. The economic program in Britain may also be having an influence -- by creating expectations of lower consumption of the metal and by reducing incentives to hold copper, even at high prices, as a hedge against sterling. Prices of refined copper have declined sharply in most markets abroad, but they remain well above prices in this country. In domestic markets, scrap prices have declined.

Prices of other industrial materials -- which are three times as important in the index as the sensitive materials -- continued upward in July at a pace slightly less than the 3 per cent annual rate of the first half of the year. Prices of plumbing and heating equipment and paper products rose further. In early August, prices of steel sheet and strip, comprising a third of all steel shipments, were raised 2 per cent. In consequence the index for all steel mill products will rise .5 per cent to a level 3 per cent above that of 1959-60.

Prices of finished industrial products rose only .1 per cent in July, after rising 1.3 per cent during the first six months of the

year. Monthly increases for producers' equipment have been erratic; since the beginning of the year they have ranged from .2 per cent (March, April, and July) to .6 per cent (May). Among consumer goods, prices of apparel rose slightly further but gasoline declined while other nondurable goods and major durable goods were stable.

Increases in prices of foodstuffs were widespread in July; indeed, the only exceptions were livestock and meats, which declined slightly. Prices of milk and dairy products continued to increase in response to reduced supplies. Grains rose 9 per cent, partly because of the effect of adverse weather in reducing crop prospects but also as a result of general recognition that carryover stocks of wheat at the end of next season will be extremely low unless actions are taken to reduce exports under foreign-aid programs. In response to the prospective reduction in the carryover and of strong export demands, the Secretary of Agriculture raised the 1967 wheat-acreage allotment by an additional 15 per cent -- a total increase of a third from the original allotment.

WHOLESALE PRICE INDEXES
1957-59 = 100

	Index July 1966	Per cent change to July 1966 from			
		June 1966	May 1966	Dec. 1965	July 1965
Total index	106.4	0.7	0.8	2.2	3.4
Industrial commodities	104.6	0.1	0.3	1.8	2.4
Materials	104.2	0.2	0.3	2.1	2.9
Sensitive	106.3	-0.3	-0.5	3.0	3.9
Other	103.5	0.2	0.5	1.7	2.5
Finished products	104.9	0.1	0.4	1.4	2.0
Producer	108.0	0.2	0.5	2.0	2.6
Consumer	103.3	0.1	0.3	1.0	1.7
Foodstuffs	111.6	2.2	2.1	3.5	6.2
Livestock and products	111.6	1.0	0.8	0.9	6.1
Crops and products	111.4	3.6	3.6	6.5	6.4

Employment. Nonfarm employment continued to expand vigorously in July. The gain would have been about 110,000 higher but for the airline strike and the beginnings of an early shutdown of automobile plants for model changeover. After allowance for these developments, the July seasonally adjusted gain was close to the average monthly increase of 270,000 since January of this year.

In manufacturing, advances in employment were heavily concentrated in the capital goods producing industries, as in other recent months. The average factory workweek has edged down from the first quarter average of 41.5 to 41.2 hours in July.

In services and government employment gains continued to be large and in trade employment moved up moderately further. Construction employment changed relatively little this month, but average weekly hours of work increased somewhat. In transportation and public utilities, employment declined by 67,000, reflecting the effects of the airline strike.

Unemployment. The over-all unemployment rate, at 3.9 per cent in July, was virtually unchanged from the 4.0 per cent rate of May and June, but down sharply from the 4.5 per cent rate of a year ago. Unemployment has shown little change now for about half a year -- ranging between 3.7 and 4.0 per cent -- and stability in unemployment rates has been characteristic of most major groups in the labor force. Unemployment of nonwhite workers, however, has risen almost a percentage point since the beginning of the year to 7.9 per cent in July.

Contrasting changes in the age-sex composition of the civilian labor force, employment and unemployment over the past year are evident in the table below. The net increase in the civilian labor force was entirely teenagers and adult women; the number of adult men participating actually declined, largely because the increase in the adult male population was small and because many of the 400,000 added to the armed forces came from this group.

With these changes in the civilian labor force, increases in employment came largely from the groups of teenagers and adult women, although managements in many cases would have preferred to employ adult men having desired types of skill and experience.

Unemployment of adult men, already approaching a frictional level a year ago, was reduced further and there was also some decline in the number of adult women unable to find jobs. The number of teenagers unemployed did not change but with more of them in the labor force, their rate of unemployment declined somewhat.

CHANGES IN CIVILIAN LABOR FORCE AND EMPLOYMENT,
JULY 1965 TO JULY 1966
(Seasonally adjusted, 000's)

	Civilian labor force	Employment	Unemployment
Total	1,044	1,454	-410
Males 20 years and over	-171	93	-264
Females 20 years and over	452	602	-150
Teenagers	763	759	4
	Percentage distribution July 1966		
Total	100.0	100.0	100.0
Males 20 years and over	58.0	58.8	38.3
Females 20 years and over	31.5	31.6	29.3
Teenagers	10.4	9.5	32.4

Hourly earnings in manufacturing. Average hourly earnings of production workers in manufacturing have increased 3.4 per cent over the past year, with advances for major industries ranging from 1.9 to 5.0 per cent. Increases in hourly earnings reflect, in addition to higher wage rates, increases in overtime and other premium payments and shifts in employment within and among industries; for manufacturing as a whole, overtime averaged 3.7 hours in July as against 3.4 hours a year ago, with hours up more in some industries such as machinery, electrical equipment and textiles but less in some other industries and actually down in the auto industry. Wage rate increases higher than the 3.2 per cent guidepost have occurred mainly in industries in which wage settlements have recently been concluded or which have long-term contracts with CPI escalator clauses. Wage settlements this year have been considerably higher than in the same period last year and for industries individually have been well above those granted in the previous contract.

Gains in hourly earnings have been sharper in nondurable goods industries than in durables. In food, petroleum, textiles and tobacco, earnings have gone up 4.5 per cent or more. The large increase in food reflects in part a substantial rise in the meat-packing industry where wages are tied to CPI. In the rubber and apparel industries, where wage increases so far have been small, wage negotiations are scheduled early next year.

HOURLY EARNINGS IN MANUFACTURING INDUSTRIES

	Per cent increase July '65 to July '66
Total	3.4
Durable	3.2
Nondurable	3.8
Lumber	4.6
Machinery	4.4
Transportation equipment	4.1
Furniture	3.8
Fabricated metals	3.6
Stone, clay and glass	3.4
Instruments	3.1
Primary metals	2.5
Electrical equipment	2.3
Food	5.0
Petroleum	4.9
Textile-mill	4.8
Tobacco	4.5
Paper	4.1
Chemicals	3.8
Leather	3.8
Printing	3.0
Apparel	2.2
Rubber and plastic	1.9

In the durables, an earnings increase of about 4.5 per cent in lumber reflects a recent wage agreement. A similar rise in machinery reflects recent agreements in parts of that industry and also increased overtime and escalator clauses in the agricultural machinery industry. In the transportation equipment industry increases in the CPI were almost immediately reflected in higher earnings. In contrast, wage increases in primary metals and in electrical equipment industries, where contracts do not include escalation clauses, have shown no acceleration. Last year's steel settlement was about in line with the

guidepost. Wage settlements in the electrical equipment industry in 1963 were among the lowest in manufacturing industries; since then increases in hourly earnings there have been well below the average.

While some dispersion of earnings increases is to be expected even when the terms of the guidepost are being observed, it is apparent that, with more than half the major groups in manufacturing showing earnings increases of 3.8 per cent or more, these terms were being breached in manufacturing prior to the airline machinists dispute. Up-coming contract negotiations in all likelihood will tend to continue to confirm the pattern of high wage increases indicated in the recent settlements in many industries.

Personal income. Personal income rose $2.5 billion in July to a seasonally adjusted annual rate of $579.7 billion, 8-1/4 per cent above a year earlier. The July increase, though smaller than in June, was about the same as the average in the second quarter and reflected small gains in all major types of personal income except dividends (unchanged) and farm proprietors' income (off slightly further).

Wages and salaries, with manufacturing payrolls up only slightly, rise $2.8 billion in July. Contributing to the rise was a $1.1 billion increase in Federal Government payrolls because of higher pay rates. The earlier shutdown of auto production this year for the model change-over and effects of the machinists strike at some airlines and scattered strikes in contract construction limited the rise in wages and salaries.

Personal contributions for social insurance rose by $700 million, with $600 million reflecting the initial payments of the $3 monthly contribution by the 17-1/4 million enrollees in the Medicare voluntary medical insurance plan. Benefits paid in July under the hospital insurance part of the Medicare program increased transfer payments by $100 million. Federal payments for Medicare-covered services received in July lagged as administrative procedures were being worked out to reimburse hospitals concurrently with the provision of the services.

Retail sales. In July, retail sales, after rebounding from a low in May, were 2 per cent above the second quarter rate and 1 per cent above the first quarter rate. June figures were revised to show an increase of 3.6 per cent, rather than the preliminary 1.2 per cent, and July was up .6 per cent further.

Growth in retail sales over the past year has been greater for nondurable goods than for durable goods, partly as a result of sharp increases in food prices. Much of the April-May decline and subsequent recovery, however, was in durable goods, and may have been in part a response to sharp deceleration in the rise in disposable income early in the second quarter and more rapid advance since then. In July and early August, unit sales of new domestic autos remained at the June rate of 8.3 million units, up from 7.9 million in May, and the value of sales of the automotive group of stores rose somewhat further; in July it was only 2.5 per cent below the first

quarter when unit sales of new cars were at an annual rate of 9.3 million. Sales at furniture and appliance stores rose 4 per cent in July, returning to the March peak.

At general merchandise stores, sales remained close to the June level and were 4 per cent above the average level earlier in the year. A shift in composition of sales at these stores toward durable goods and away from apparel may have occurred in July in line with the rise in furniture and appliance stores and a sharp, presumably transitory, decline at apparel stores. Sales at food stores were very little changed.

Consumer credit. Despite some resurgence in June and July, consumer credit growth remains sluggish. An estimate for July (based on incomplete reports) puts that month at about the $7.1 billion annual rate of the first quarter. This would be higher than the second quarter but still well below the $8.0 billion rise in instalment credit for all of 1965. Consumer borrowing in connection with purchases of color television sets and major appliances continued large in July; the protracted heat wave resulted in exceptionally strong demands for air conditioners. Demands for auto credit and personal loans, on the other hand, were apparently little changed from the June level.

Auto credit developments in recent months have varied from the usual seasonal pattern. As the table shows, the proportion of new cars bought on credit usually increases moderately in the second quarter, but this year the rise was sharp. In part, this was probably due to the earlier model changeover which, in turn, advanced the period for the usual close-out sales. But the high inventories of new cars coupled with the reduced sales pace of last April and May seems to have spurred dealers to extra efforts to sell cars. In such situations, it is the marginal buyer and user of credit who is most commonly attracted into the market.

CREDIT SALES OF NEW PASSENGER CARS AS A PER CENT
OF TOTAL NUMBER SOLD
(Without seasonal adjustment)

	Quarters			
	I	II	III	IV
1962	55	61	75	57
1963	57	62	76	59
1964	60	66	74	62
1965	57	65	82	62
1966	61	73		

Repayments on consumer instalment debt have continued to rise this spring and summer, despite the general slowdown in instalment credit use this year. For the most part the rise reflects the fact that the pattern of repayments is governed by the amount of credit extended in earlier periods and by contract terms, but it is also a sign of continued

ability and willingness of consumers to pay their bills. In the second quarter, with disposable personal income rising at the same rate as repayments, the repayments ratio remained at the 14.5 per cent level of the first quarter.

Orders for durable goods. The June preliminary figures for new orders of durable goods tell about the same story as had the advance figures; the total continued to show little change at a level moderately below the March peak. With shipments also relatively stable, unfilled orders rose $1.4 billion or 2 per cent, which is close to the rate of monthly increases earlier this year.

New orders for defense products rebounded to a new high for this period of defense build-up, largely reflecting an increase in aircraft and parts. Orders for machinery and equipment, which had increased more than 5 per cent from March to May, declined 4 per cent in June, with bookings down for construction machinery and electrical transmission and distribution equipment. Orders remained at an advanced level for consumer durable goods other than autos, while those for autos and parts and presumably for stampings declined. For steel, orders fell from the extraordinarily high figure for May but remained relatively high; unfilled orders for steel increased further to a level $1 billion or 36 per cent higher than at the end of January.

Increases in unfilled orders in June were widespread among durable goods, aside from autos and parts. The increase in the total nevertheless was accounted for almost entirely by defense products, machinery and equipment, and steel.

Business inventories. Business inventories rose nearly one per cent further in June and at the end of the month were 10 per cent higher than a year earlier. In the second quarter as a whole the book value of manufacturing and trade inventories rose at an annual rate of $14.3 billion, 10 per cent more than in the first quarter and 50 per cent more than the average for all of 1965. On a GNP basis, which allows for price changes during the quarter, the rise was at an annual rate of $11.8 billion.

Manufacturers' inventories increased $890 million in book value in June, the largest rise in more than six years and a fifth more than the average for April and May. The second quarter annual rate of accumulation was $9.4 billion, considerably more than the $6.6 billion rate in the first quarter of the year and the $7.0 billion rate in the final quarter of last year.

The bulk of the June increase was at durable goods industries, where increases in stocks of producers of defense products, and machinery and equipment and consumer goods, accounted for three-fourths of the increase. Stocks held by producers of textile mill products and paper and paper products also increased in June.

Relatively large increases occurred in inventories of materials and supplies and of work-in-process in June, accelerating the uptrends in these sectors. In the second quarter, materials and supplies increased at an annual rate of $3.8 billion, compared with $1 billion in the first, and work-in-process increased at an annual rate of $4.2 billion, up from $2.9 billion in the first. In the machinery and transportation equipment industries the increases in materials and supplies and in work-in-process have been especially large relative to finished goods.

At retail stores the build-up in June was considerably less than in May but still somewhat more than in earlier months this year. Nearly half the May-June increase in retailers' stocks was at automotive stores and reflects the build-up in auto dealers' new car stocks which was particularly large in May.

August crop prospects. Hot, dry weather during July cut yield prospects for most crops and reduced pasture feeds, especially in the South Central and Atlantic Seaboard states. Over-all pasture conditions on August 1 were the lowest for the date since 1954. Indications are that average crop yields will be 5 per cent below last year's record and that crop output, also at a record level last year, will be down nearly 7 per cent. One major factor in the output decline is a reduction of 28 per cent in the cotton crop, reflecting an even greater decline in acreage in this first year of the new 4-year cotton program.

Feed grain output is likely to be 6 per cent under the 1965 record output. July weather was unfavorable for corn except in the West and in the Northern portions of the Corn Belt and yield prospects declined during the month. The crop is now placed at 4.0 million bushels, down 6 per cent from July 1 prospects, and 5 per cent from last year's crop. Because of smaller yields, the soybean crop is expected to be only 2 per cent above the 1965 crop although acreage planted was up 7 per cent. Combined production of oil crops --

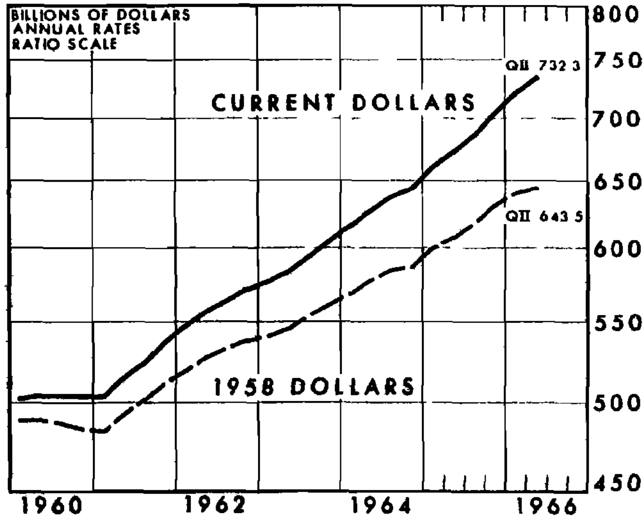
soybeans, flaxseed, peanuts, and cottonseed -- is expected to be 5 per cent below last year.

Food grain prospects improved in July. The winter wheat harvest, now largely completed, turned out better than expected and rice made favorable progress. The combined food grain crop, however, will probably be about 2 per cent under last year's relatively large crop. Supplies of fresh vegetables, potatoes, and sweet potatoes are likely to be below last year and, because of late spring freezes and summer drought, deciduous fruits will also be less plentiful.

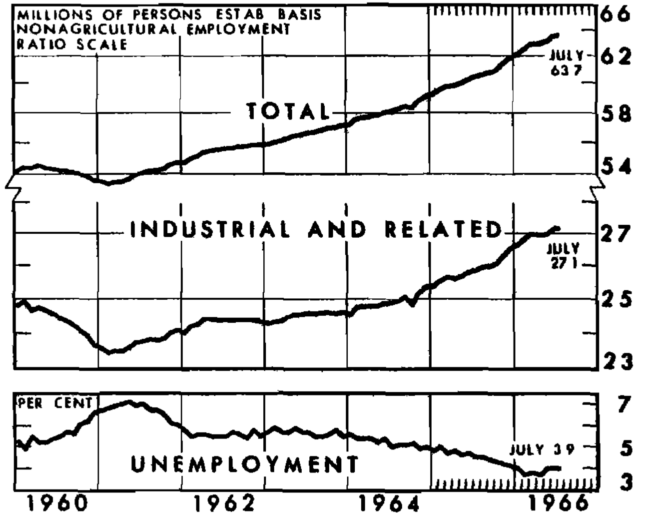
ECONOMIC DEVELOPMENTS - UNITED STATES

SEASONALLY ADJUSTED

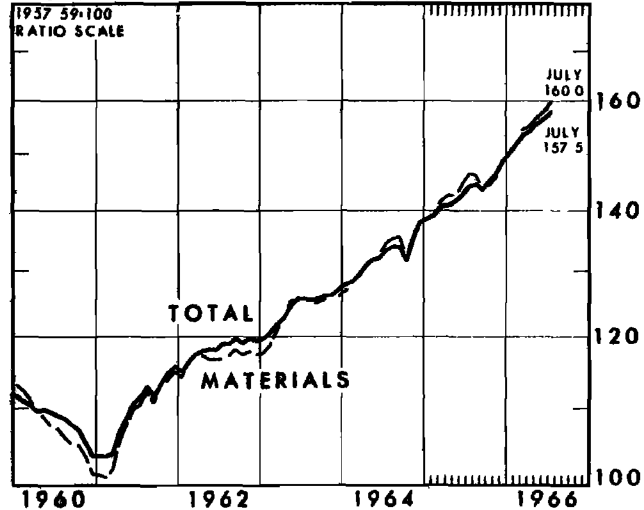
GROSS NATIONAL PRODUCT



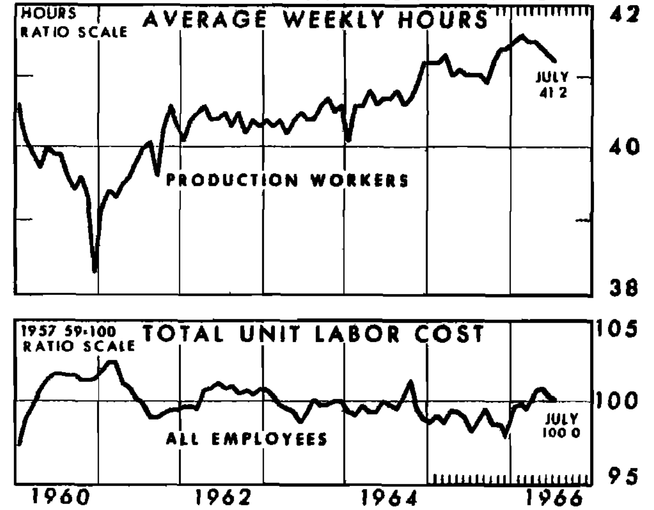
EMPLOYMENT AND UNEMPLOYMENT



INDUSTRIAL PRODUCTION-I



WORKWEEK AND LABOR COST IN MFG.



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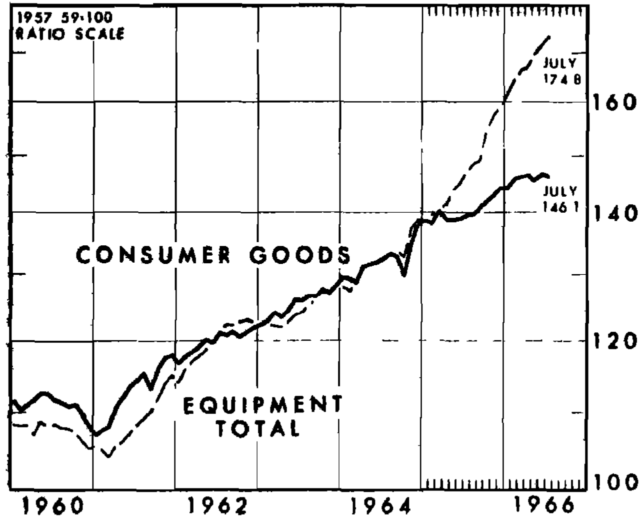
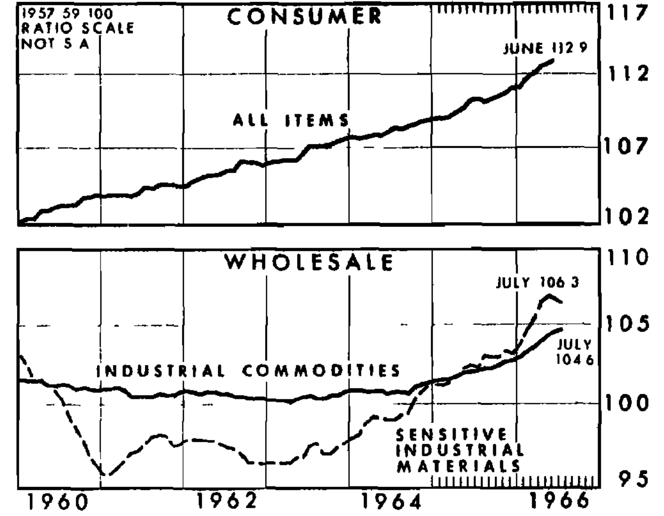


PRICES



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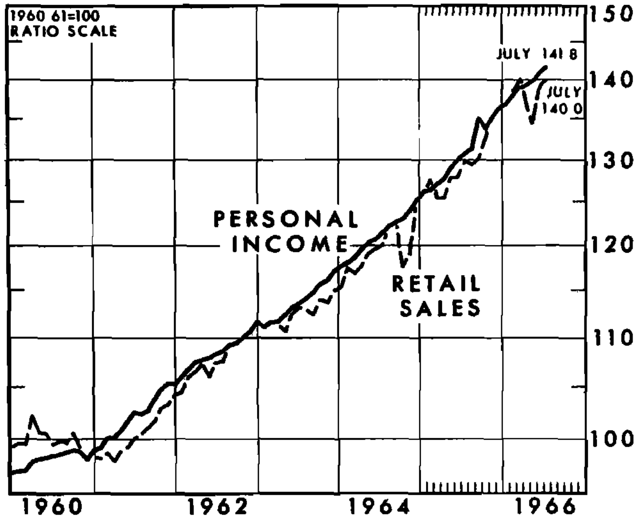
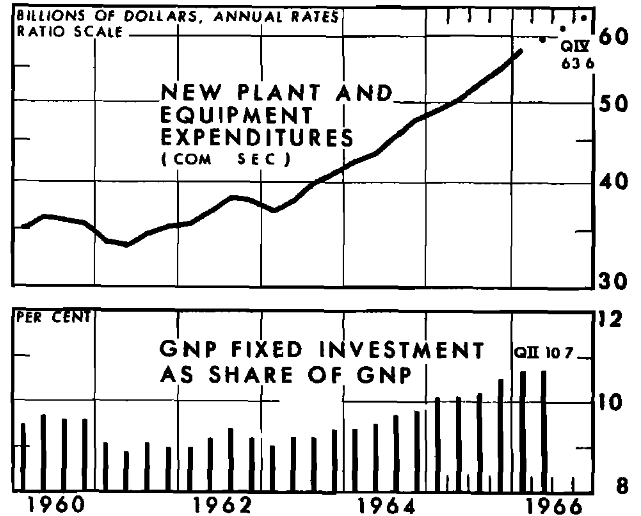
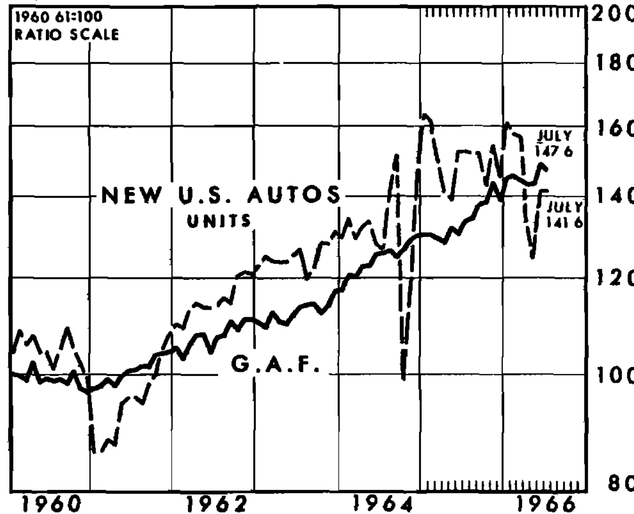
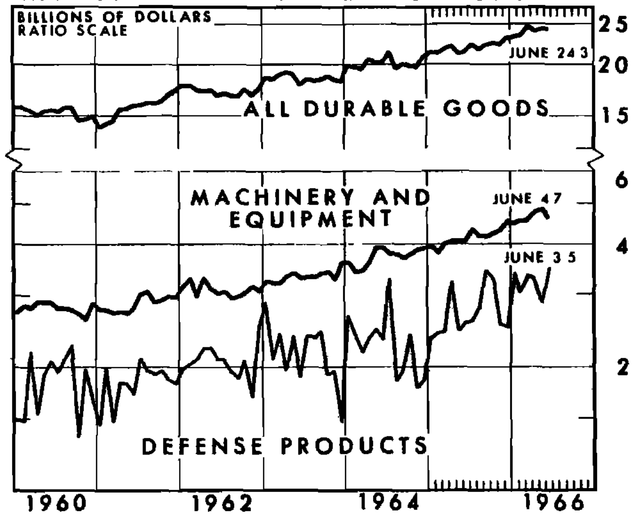
ECONOMIC DEVELOPMENTS - UNITED STATES

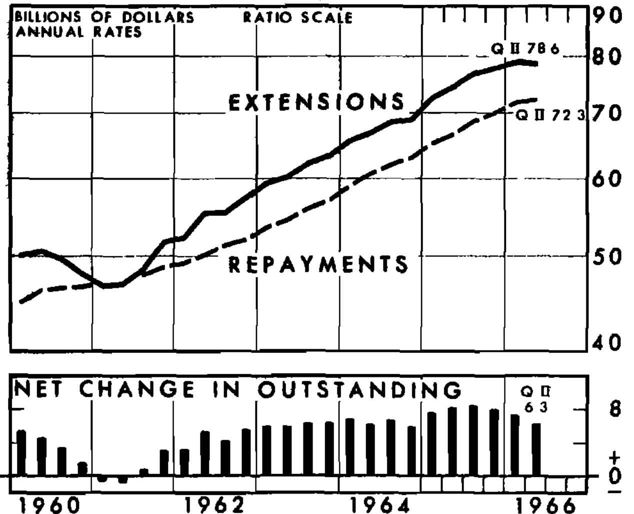
SEASONALLY ADJUSTED

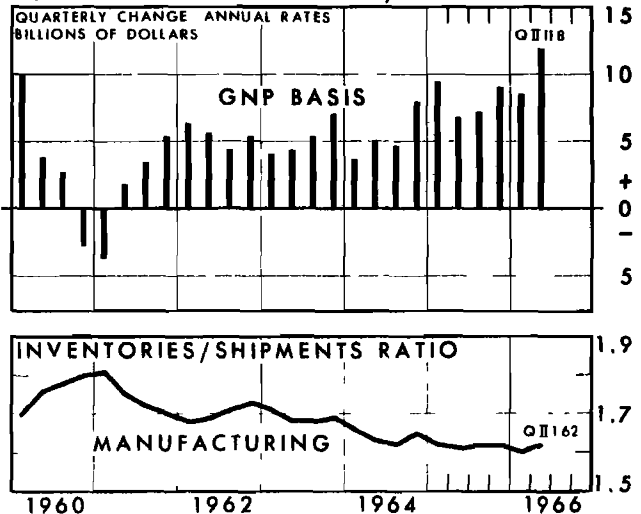












DOMESTIC FINANCIAL SITUATION

Bank deposits. Growth in commercial bank time and savings deposits accelerated to a 14 per cent annual rate in July, and inflows continued at near this pace early in August. While one-time shifts from nonbank depository institutions undoubtedly were contributory factors, continuation of rapid growth after mid-July is attributable in large part to a greater relative success of country banks in attracting time deposits than earlier in the year.

This recent time deposit growth has been of a different pattern than in April and early May, when increasing time deposit rates last expanded time deposit inflows sharply. As indicated in the first table, at weekly reporting banks there has recently been a less rapid increase in time deposits other than CD's and a less rapid decline in passbook savings. While the net effect of these offsetting movements was a larger inflow of total savings and time deposits other than CD's. The July decline in negotiable CD's kept aggregate inflows below the April pace.

New York City banks (middle panel) suffered a relatively large attrition over the July and early August period in the sum of savings and time deposits. On the other hand, weekly reporting banks outside New York (bottom panel) did even better than in April, and estimates for member banks suggest that country bank inflows of total time and savings deposits also have accelerated over the summer. This may reflect recent increases in rates at smaller banks, the less intense interest of small bank customers in market securities, and less active competition from nonbank savings institutions.

Table 1
Composition of Time and Savings Deposit Flows
Weekly Reporting Banks 1/

Class of deposit	July & Early August 2/		April & Early May 2/	
	1966	1965	1966	1965
Total time and savings	+ 791	+1,087	+ 824	+1,082
Savings	-1,017	+ 415	-1,822	- 86
Time other than CD's	+1,881	+ 188	+2,434	+ 383
Total other than CD's	+ 864	+ 603	+ 612	+ 297
CD's	- 73	+ 484	+ 212	+ 785
Weekly reporting banks in New York City				
Total time and savings	- 258	+ 260	+ 200	+ 670
Savings	- 157	+ 65	- 245	- 28
Time other than CD's	+ 62	+ 11	+ 331	- 27
Total other than CD's	- 95	+ 76	+ 86	- 55
CD's	- 163	+ 184	+ 114	+ 725
All other weekly reporting banks				
Total time and savings	+1,049	+ 827	+ 624	+ 412
Savings	- 860	+ 350	-1,577	- 58
Time other than CD's	+1,819	+ 177	+2,103	+ 410
Total other than CD's	+ 959	+ 527	+ 526	+ 352
CD's	+ 90	+ 300	+ 98	+ 60

1/ Revised panel of banks after June 29.

2/ Five-week period, Wednesday to Wednesday.

Net flows of negotiable CD's have also tended to increase inflows at smaller banks and reduce inflows at the large, money market banks. As indicated in the second table, weekly reporting banks experienced only a small inflow of CD funds in the three months ending July--after doing relatively well earlier in the year--and have had a contraseasonal decline in outstandings in early August. Almost all of this reduction in the six weeks of July and early August has been in New York City, where CD's declined 153 million. Even earlier in the year, New York banks had had only moderate increases in CD's. In contrast, weekly reporting banks outside New York and Chicago had sharply increased their CD's earlier in 1966, and, while their CD inflow had decelerated, they have continued to do relatively better than banks in New York and Chicago. The ability of these banks to continue to attract CD's may reflect efforts of their customers to keep their own credit lines open by taking a little lower yield on their liquid investments than is available in the market.

The slowdown in CD sales in New York has occurred despite rates of 5.50 generally available on 30 day maturities throughout most of July. Since midyear, the Regulation Q ceiling has increasingly forced concentration of sales in short CD's by money market banks, and with September maturities already quite large, there is little question that maturities next month will set a record.

With reserve pressures mounting, New York and other large banks turned to a variety of sources of funds in July--including sales of promissory notes, heavy Federal Funds purchases, additional borrowing

Table 2

Changes in Outstanding Negotiable Certificates of Deposit
Weekly Reporting Banks 1/

	Early August 2/		End of April to end of July 3/		End of January to end of April 3/	
	1966	1965	1966	1965	1966	1965
All weekly reporting banks						
Reported change	-70	-18	+763	+1099	+1072	+1108
Change due to series revision 1/	--	--	+525	--	--	--
Adjusted change	-70	-18	+238	+1099	+1072	+1108
Weekly reporting banks in New York City						
Reported change	-75	+121	- 25	+ 644	+ 146	+1152
Change due to series revision 1/	--	--	+ 9	--	--	--
Adjusted change	-75	+121	- 34	+ 644	+ 146	+1152
Weekly reporting banks in Chicago						
Reported change	+77	--	+ 3	+ 54	+ 233	- 52
Change due to series revision 1/	--	--	+ 26	--	--	--
Adjusted change	+77	--	- 23	+ 54	+ 233	- 52
All other weekly reporting banks						
Reported change	+21	- 11	+785	+ 401	+693	+ 8
Change due to series revision 1/	--	--	+490	--	--	--
Adjusted change	+21	- 11	+295	+ 401	+693	+ 8

1/ Revised panel of banks after June 29.

2/ Early August means the one week ending August 3 & 4 for all banks and banks outside of New York and Chicago and the two weeks ending August 10 & 11 for New York and Chicago banks.

3/ End of month refers to last Wednesday of month.

at the discount window, enlarging corporate RP's and borrowing from their foreign branches. In New York City, the sum of these sources increased more than $700 million in July, compared with $60 million last year. Moreover, there were reports of CD sales in New York City above 5.50 per cent to exempted foreign accounts. In the first two weeks of August New York banks increased outstanding CD's other than IPC by $68 million -- possibly reflecting sales to foreign official accounts.

Repayment of loans obtained in June and shifts of private balances to Treasury accounts due to accelerated payments of withholding taxes reduced private demand deposits in July, following the June run-up. Over the June and July period combined, there was little change in either seasonally adjusted private demand balances or the money stock. Since the end of November, the money stock has increased at a 3.5 per cent annual rate, substantially below the 4.8 per cent rate for all of 1965.

Bank credit. Seasonally adjusted loans and investments of banks increased by an estimated $2.8 billion in July on a last Wednesday basis. This was an annual rate of almost 11 per cent, the highest rate of expansion since early spring, and about as rapidly as the rate of increase indicated on a daily average basis. Total loans registered a seasonally adjusted growth of about $3.2 billion -- an annual rate of increase of almost 19 per cent. To finance such loan expansion banks (especially the larger ones) continued to liquidate Treasury issues and to liquidate or reduce their acquisitions of other securities.

Loan demands of nonfinancial firms continued large in July, with business loans showing a very large seasonally adjusted growth for the second straight month -- about $1.8 billion. For the two months, business loans increased at an annual rate of almost 31 per cent (see Table 3), the largest rate of increase for any two consecutive months in the 1960's. In both months, accelerated withholding tax payments -- which increased payment by $1.75 billion in June and $2.7 billion in July -- placed special financial pressures on corporations. However, these special needs merely buttressed a heavy underlying business demand for bank credit and perhaps some anticipatory borrowing based on fear that funds would not be available in the fall. The metal and metal products industries were very heavy borrowers at city banks, as they have been all year. Loan demand of miscellaneous manufacturing and mining, public utilities and trade firms also showed strength in July.

Business loans demands at weekly reporters -- especially in New York City -- were financed mainly by the liquidation of loans to security dealers and finance companies. As the result of both reduced auto dealers needs and increased sales of market paper by finance companies, finance company loans dropped off at all weekly reporters from the very high June level. It also appears that city banks -- through higher rates for dealers, and stiffer rate and nonrate terms for finance companies -- were shifting security dealer and nonbank financial needs to other banks and to the market in order to finance nonfinancial customers.

Table 3

Changes in All Commercial Bank Credit
Seasonally Adjusted
Annual Rate
(Per cent)

	1966					1965
	July 1/	June 2/	2nd Qtr. 2/	1st Qtr.	Year to date 1/ 2/	Year
Total loans and investments	10.9	8.7	8.3	8.0	8.7	10.2
U.S. Government securities	-8.9	-10.9	-10.7	-11.8	-10.7	-5.6
Other securities 1/	2.5	- 2.5	12.3	8.0	9.2	15.8
Total loans 1/ 2/	18.8	17.2	12.7	13.8	14.3	14.7
Business loans	28.3	32.3	21.0	19.1	22.1	18.7

1/ Allowance has been made for the shift of an estimated $1.0 billion of participation certificates from "other loans" to other securities in July.

2/ Allowance has been made for a reduction of loans by $1.1 billion as a result of changes in Federal Reserve regulations regarding balances accumulated for the payment of personal loans.

Nonweekly reporting banks -- with their time deposit inflows higher -- apparently showed a very strong increase in loans in July, accounting for a much larger share of seasonally adjusted total loan expansion than in any previous month of this year. Most of their expansion was probably centered in business and finance company loans -- some of which may have represented loans to customers denied credit at larger banks. Country member banks reduced their borrowings from the Federal Reserve in June and July by almost $90 million, despite their increased loans, while other member banks increased their discounts and advances. In the first five months of the year, most of the increase in member bank borrowing occurred at country banks.

The initial reports for early August indicate a considerable retardation in growth of bank loans and investments, due mainly to a contraseasonal decline in total loans and investments in New York City. Weekly reporters outside of New York in the first week of August also showed less than seasonal increases in total earning assets, although loan demands continued strong. Nonweekly reporting banks probably will continue to show a more rapid increase in loans in August, as their time deposit inflows have remained large.

In assessing what is likely to be a smaller growth in busines loans in August, it must be kept in mind that business demands for credit are now being affected by the lower level of withholding tax payments. Such payments in August will be less than normal by about $1.8 billion due to previous accelerations of payments into June and July.

Savings flows at depositary-type institutions. Using preliminary tabulations of monthly savings flows for 200 representative associations, the Home Loan Bank Board now estimates that share capital at all savings and loan associations contracted $1.3 billion, or 1.2 per cent, in July. This is roughly $300 million more attrition than was indicated by an estimate based on savings experience for the first half of the month. The difference reflects failure of the seasonal pattern of net inflow to develop as expected during the latter half of the month.

While it is possible that the Bank Board sample gives a more bearish view of over-all S & L experience than is justified, the July attrition clearly exceeded both the $750 million net withdrawal of share capital in April and the $490 million net withdrawal in July 1965.

In contrast with April, when California associations accounted for more than 60 per cent of the net shrinkage in total share capital at S & L's, net losses at the California associations in July--apparently no more than $50 million--were less than 4 per cent of the total. While this more favorable California experience was due partly to seasonal influences, recent dividend rate increases and aggressive advertising also helped to minimize net outflows at these associations. On the other hand, losses of share capital at associations in other Home Loan Bank districts were much larger than in April, in part reflecting experience of the larger number of associations in those districts that credit dividends semi-annually.

In sharp contrast with the S & L experience, mutual savings banks in New York State showed a net savings growth of $150 million during July. Net growth for all savings banks is estimated at $175 million or .3 per cent of outstanding deposits--nearly as large as in July 1965. The experience of New York institutions, as for the California S & L's, strongly reflected widespread increases in rates paid.

Looking at institutional savings growth for the first seven months of the year, the more favorable experience of commercial banks becomes evident. The seasonally adjusted growth in savings deposits at commercial banks for the first 7 months of 1966, although less than in the record year 1965, was still larger than in 1964. Growth of savings at mutual savings banks, on the other hand, was less than half the record 1964 rate and at S & L's less than one-fourth the 1964 rate; for both, growth had already slowed appreciably in 1965.

SEASONALLY ADJUSTED RATES OF SAVINGS GROWTH AT
DEPOSITARY-TYPE FINANCIAL INTERMEDIARIES
January-July, 1964-1966 1/
(Per cent)

	Total	Savings & loans	Mutual savings banks	Commercial banks 2/
1966	3.6	1.6	2.3	5.7
1965	5.6	4.6	4.4	7.0
1964	5.8	6.8	5.5	5.0

1/ July data for savings banks and S & L's used in calculating growth rates are still estimates.
2/ Negotiable time CD's at weekly reporting banks were deducted from commercial bank time and savings accounts before calculating seasonally adjusted growth rates.

Home Loan Bank advances showed a net increase of $550 million during July, some $200 million less than in April notwithstanding the considerably larger July attrition in savings capital. The smaller borrowing this year is explained by the new Home Loan Bank Board policy, enunciated in late April, requiring member associations to reduce their own liquidity prior to securing advances. During the first seven months of 1966, advances outstanding at the Home Loan Banks expanded by $1.4 billion, more than in the full 12 months of any previous year. Advances outstanding normally remain at about the end of July level until late December when they show some further seasonal expansion.

<u>U. S. Government securities market</u>. Yields on U. S. Government securities have risen sharply since late July, notably in the short- and intermediate-term maturity areas where the impact of Treasury financings has been concentrated. The recent advances have pushed these yields to new cyclical highs following a short-lived rally during the third week of July. Currently, the Treasury yield curve displays roughly the same type of "humped" pattern as in late 1959 and early 1960, with yields highest in the 2 to 4 year area. But the level of the present curve is well above that of the earlier period, as may be noted in the table.

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	5.09	5.37	5.64	5.49	5.18	4.92
Lows	4.33	4.46	4.78	4.76	4.56	4.49
1965-1966						
Dec. 3	4.12	4.26	4.54	4.52	4.52	4.44
May 31	4.64	4.80	5.10	5.00	4.80	4.73
June 30	4.58	4.76	5.22	5.09	4.97	4.82
July 26	4.77	4.88	5.28	5.18	4.99	4.82
Aug. 16	5.09	5.37	5.64	5.49	5.18	4.92

The Treasury's August refunding, which included a new 1-year certificate and a new 4-3/4 year note, was accompanied by sizable upward yield adjustments in the secondary market for short- and intermediate-term

Treasury obligations. While direct exchanges into the new issues by the public were fairly large -- $1.4 billion into the certificate and $2.7 billion into the note--- secondary market demand for these issues proved decidedly lackluster and by payment date on August 15 the new note had declined nearly 1/2 point below its issue price. In fact, dealers absorbed some net selling of the new note from the public, although dealers' over-all positions in the refunding issues were reduced by Treasury investment account buying. On August 15, the dealers still held $250 million of the new issues, down from $372 million on August 3, when the subscription books were closed.

Apart from the disappointing demand for the refunding issues, the Treasury note and bond market also reacted to rising yields and increased calendars in the corporate and Federal Agency security markets. Another weakening influence was contributed by widespread talk of an increase in the prime loan rate against a background of taut money market conditions and the approach of seasonal expansion in business loan demands. The actual announcement of a prime loan rate increase to 6 per cent by most major banks on August 16 and August 17 occasioned a further sharp adjustment in bond prices and bill yields. It should be added that retail selling of outstanding notes and bonds has been light in recent weeks and dealer holdings of longer-term bonds have remained small, totaling less than $1 million on August 16.

Treasury bill yields rose markedly in the first half of August, especially on the longest maturities which were most directly affected by the announcement of a $3.0 billion auction of March and April

tax bills. The auction is scheduled for August 18 and payment date will be August 26. Commercial banks will bid for the bulk of the new issues to take advantage of the 100 per cent tax and loan credit, but their subsequent sales of the bills to acquire reserves may be larger than usual in view of current tight bank money positions. After this cash financing, the Treasury will be out of the market until mid- or late October.

SELECTED SHORT-TERM INTEREST RATES 1/

	1965	1966	
	Dec. 3	July 15	August 12
Commercial paper 4-6 months	4.375	5.625	5.875
Finance company paper 30-89 days	4.375	5.50	5.625
Bankers' Acceptances 1-90 days	4.25	5.625	5.625
Certificates of deposit (prime NYC)			
Highest quoted new issue:			
3-months	4.50	5.50	5.50
6-months	4.50	5.50	5.50
Highest quoted secondary market issue:			
3-months	4.50	5.65	5.75
6-months	4.59	5.76	6.00
Federal Agencies (secondary market):			
3-months	4.34	5.40	5.29
6-months	4.49	5.70	5.60
9-months	4.58	5.72	5.73
Prime Municipals 1-year	2.65	3.75	4.25

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

Yields on most other short-term debt instruments have continued to rise in recent weeks, although secondary market rates on

shorter-term Federal Agencies declined in the latter part of July and are still somewhat below their mid-July peaks. Generally speaking, yields on these money market instruments are a full percentage point or more above the pre-discount rate action level last December and at new postwar highs.

Federal Agency securities market. Yields have continued to move up in recent weeks on new Agency offerings in the short-intermediate maturity area. On August 10, a $350 million FNMA issue due in about 2 years met with only a fair reception at a yield of 5.91 per cent. And on August 16, a $590 million FHLB offering due in 1-year was also accorded an unenthusiastic reception at a 6.00 per cent yield. The calendar ahead includes several fairly heavy maturities which will have to be refinanced; additionally, some FNMA participation certificates will probably be sold in late summer or early fall.

Corporate and municipal bond markets. Following a short period of relative stability in late July, yields on both corporate and municipal bonds advanced sharply further in the first half of August, in harmony with the mounting pressure in markets for other debt issues. Among other things, a rapid build-up in the August and September calendars of publicly offered corporate bonds and continuing bank liquidation of municipal securities contributed to the further yield advances.

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					
High	5.56(8/5)	5.73(8/5)	5.25(8/12)	3.87(8/12)	4.08(8/12)
Low	4.79(1/7)	4.84(1/7)	4.73(1/7)	3.39(1/21)	3.51(1/21)
Weeks Ending					
July 15	5.49	5.69	5.14	3.77	3.98
July 29	5.47	5.65	5.22	3.78	3.96
Aug. 5	5.56	5.73	5.24	3.79	3.99
Aug. 12	--	--	5.25	3.87	4.08

1/ Issues with and without call protection averaged together.

In the corporate market, even well-known borrowers with prime credit ratings were faced with the highest net interest costs since the early Twenties. The large AT&T debenture issue -- Aaa-rated and protected against call for 5 years -- was priced to yield investors 5.58 per cent, 47 basis points above that on Telephone's similar offering in late March, and the highest since 1923. Although this historically generous yield led to significantly increased takings of the new debentures by individuals and trust funds, only two-thirds of the issue had been distributed when underwriters broke the syndicate a week later. Subsequent trading in the free market resulted in an upward yield adjustment of approximately 10 basis points. While several other recent corporate bond issues were quickly distributed, these were convertible

debentures. Most recently an Aa-rated utility bond with call protection was reoffered to yield 5.85 per cent -- which adjusts to 5.72 per cent on an Aaa basis.

In general, market participants report a decline of institutional interest in new corporate private placements -- due chiefly to the relative scarcity of uncommitted investible funds at life insurance companies. At the same time corporate financing demands on capital markets have grown, with August offerings of corporate debt -- both private and public -- expected to be nearly 75 per cent more than those of a year ago. Although August is typically a seasonally low month, publicly offered corporate bond issues may aggregate as much as $1 billion, the largest monthly volume for the year and the largest for any August on record.

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.	1,942	1,864	2,083	2,259	1,090	920
May	481	694	556	630	69	449
June	832	748	784	980	811	309
July	460e/	542	600e/	780	125e/	122
August	1,000e/	369	450e/	468	200e/	93

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

In the past three weeks, the major municipal bond yield indexes have advanced between 10 and 21 basis points, with most of the increase taking place last week. And the Bond Buyer's index penetrated the 4 per cent level for the first time since 1934. The large New York City issue was successfully distributed as large numbers of small investors -- with purchases of as little as $5,000 or $10,000 -- as well as trust funds were attracted to the record tax-exempt return. A taxpayer in the 36 per cent marginal Federal tax bracket, for example, would need a 7.1 per cent taxable return to be equivalent to the 4.55 per cent yield available on certain of the New York City maturities and, if this taxpayer were a resident of New York City, the tax equivalent yields would be even higher because income on these securities is not subject to the progressive income taxes of either the City or New York State.

Besides shunning new tax-exempt issues, commercial banks -- under conditions of tight money and strong business loan demand -- have continued to liquidate long-term municipals. This behavior, in conjunction with expectations of even higher yields, has supplied much of the upward pressure on yields. The August municipal volume is now estimated at $900 million, about 1/5 more than a year earlier, but would of course be lower if any further postponements should materialize because of current high borrowing costs.

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

	1966	1965
1st Quarter, total	3,006	2,851
2nd Quarter, total	3,216	3,046
Half year, total	6,222	5,897
July	700e/	1,040
August	900e/	733

1/ Data are for principal amounts of new issues.

Stock market. Common stock prices -- as measured by Standard and Poor's composite index of 500 stocks -- dropped to a new 1966 low early this week, down a little over 6 per cent from the recent high reached in mid-July. The longer-run downtrend from the all-time index high of 94.06 reached in early February now ranges to 13.2 per cent, more than the 9.6 per cent market correction experienced in May-June 1965, but still only half as large as the major decline of 1961-62. Recent stock price weakness has reportedly reflected more a drying up of demand for stocks than any significant step-up in investor selling.

Trading activity since mid-July has averaged about 5.9 million shares daily, as compared to averages of 8.2 million and 6.4 million for the months of May and June, respectively. Investor interest and trading in electronics stocks has increased recently.

The decline in stock prices since February has been widespread among individual stocks and industrial groups. For example, since the week of February 9 -- when the Standard and Poor's "500" hit its all-time

high -- the price indexes of 74 of the 82 industrial components of the "500" have declined; 50 groups have registered declines of between 10 and 20 per cent and 10 groups declines in excess of 20 per cent. Only 8 groups -- including such earlier investor favorites as electronics and airlines -- are above their early February levels.

Reduced demand for stocks has reflected historically high yields now available on both bonds and liquid short-term assets, which provide a good current hedge against stock market uncertainty. Since early February, yields on bonds have advanced more than those on stocks despite the downtrend in stock prices; for example, yields on new high quality public utility bonds are up about 75 basis points since February whereas the dividend yield on the 50 stocks in the Standard and Poor's utility index are up only 55 basis points. To cite a specific example of the size of the spread between the yield on the bonds of a given utility and that on its stock, an investor interested in a stable income could currently acquire the new bonds of Consumers Power -- at a yield of 5.80 per cent -- or acquire its common stock at a yield of about 3.90 per cent.

Stock market credit eased $127 million during July, the largest monthly decline since March. Most of this decline took place in customers' net debit balances, but bank loans to other than brokers and dealers also declined, by $28 million.

Mortgage markets. Mortgage markets continued quite tight through July, with savings and loan associations, the dominant type of lender, experiencing substantial losses in savings as noted elsewhere.

Recent scattered informal reports of a mild increase in investor interest in mortgages by savings banks, where deposits rose in July, and life insurance companies cannot yet be verified. Any substantial pickup seems doubtful, in view of other strong competing demands for lenders' available funds.

In July, heavy pressure on home mortgage markets was indicated by a continued active volume of offerings of FHA and VA mortgages to FNMA for purchase under its secondary market operations. Also yields on both Federally-underwritten and conventional home loans increased further, but by less than in June. Applications and requests to FHA and VA for mortgage insurance on home loans continued to decline and were a third below their year-earlier level.

During July, agency field reports and other sources stress the tightness of mortgage credit for both construction and permanent home loans. Faced with a sharp reduction in new mortgage commitments, some would-be builders and buyers are said to be taking growing recourse to other methods of financing, including greater use of installment land contracts. Even so, sales of existing homes as well as new homes have reportedly slowed down in recent months, with some existing homes formerly for sale being taken off the market by owners unwilling to absorb large mortgage discounts or unable to find buyers with the necessary financing.

Mortgage debt outstanding expanded much less than usual in the second quarter, to reach a level of over $355 billion. The net increase in outstandings was an eighth less than a year earlier, and the smallest for the quarter in five years. As tentatively indicated in the

last FOMC report, only insurance companies recorded a year-to-year increase in portfolio growth among the four major types of private lenders, and insurance company takings, more than those for other lenders, reflect take-downs of prior commitments. The sharpest reductions in year-over-year expansion were made by savings banks (down by nearly a half) and by savings and loan associations (down by two-fifths). Further additions to FNMA holdings, smaller than in the first quarter, only partly offset the year-to-year reduction of one-fourth in portfolio expansion by all other lenders combined.

MORTGAGE DEBT OUTSTANDING BY TYPE OF HOLDER
(Billions of dollars, without seasonal adjustment)

	Amount	Increase in second quarter of		
	6/30/66 p	1966 p	1965 p	1964
All holders	355.6	7.0	8.2	8.2
Financial institutions	274.0	4.8	6.4	6.5
Commercial banks	52.0	1.4	1.7	1.4
Mutual savings banks	45.9	.5	.9	1.0
Savings and loan assoc.	113.6	1.6	2.7	3.0
Life insurance companies	62.5	1.2	1.0	1.0
Federal agencies	14.3	.8	.1	--
FNMA	6.2	.6	-.1	-.1
Individuals and others	67.3	1.4	1.7	1.6

Note: Detail does not always add to total due to rounding.

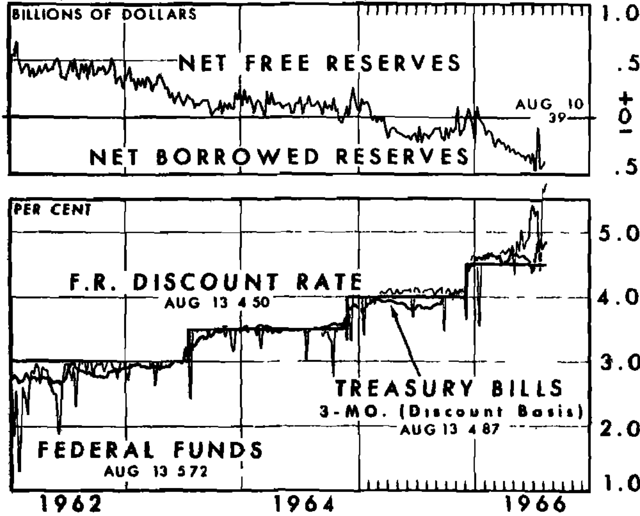
Looking at the distribution of second quarter changes in mortgage debt by type of property rather than type of lender, tentative estimates suggest that the reduced growth was as pronounced for multi-family and commercial mortgages as for home loans.

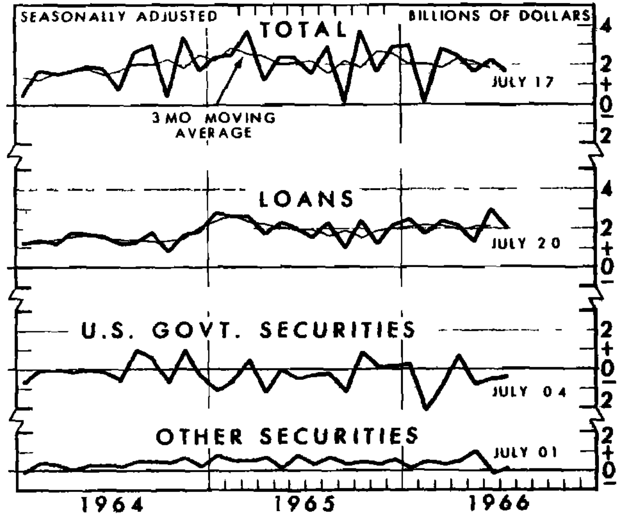
INCREASES IN MORTGAGE DEBT OUTSTANDING
(Seasonally adjusted annual rates in billions of dollars)

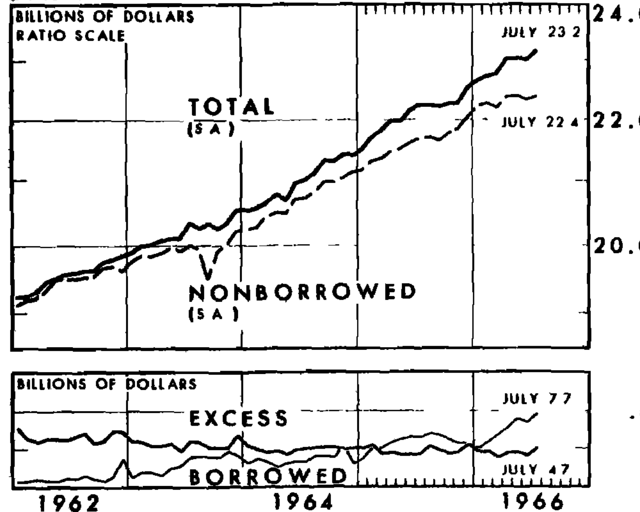
		Total	1-4 family	Multifamily and commercial 1/	Farm 1/
1964	II	29.8	15.4	12.4	2.1
1965	I p	30.4	15.3	13.0	2.1
	II p	30.2	15.2	13.0	2.1
	III p	30.4	15.0	13.2	2.2
	IV p	30.8	16.0	12.0	2.8
1966	I p	31.8	15.9	13.6	2.3
	II p	25.5	12.8	10.4	2.2

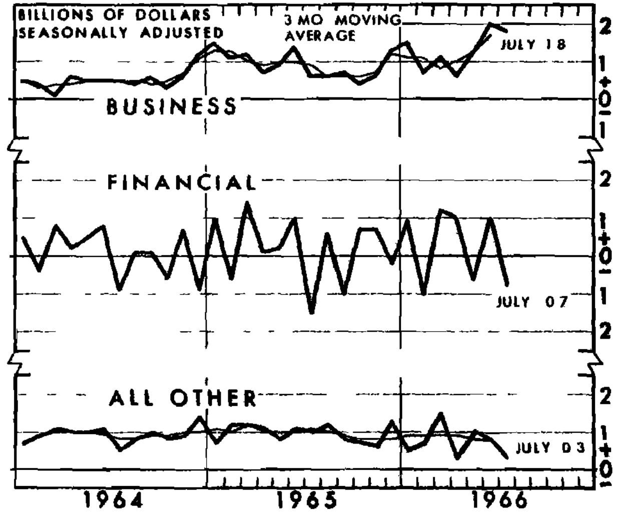
1/ Includes estimates for holdings of individuals and other which are excluded in the flow of funds series.

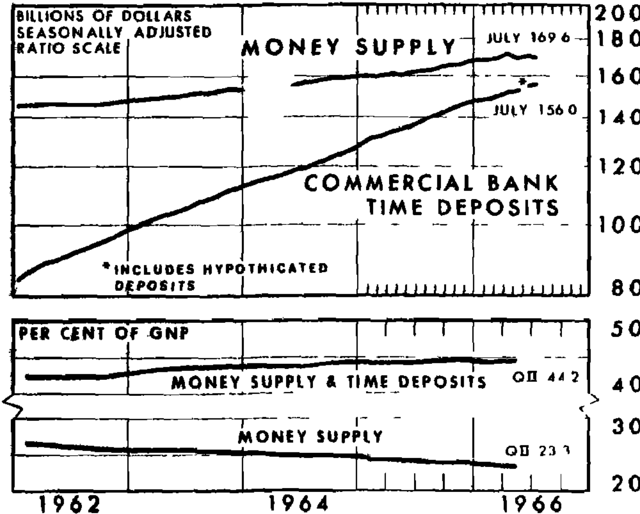
FINANCIAL DEVELOPMENTS - UNITED STATES

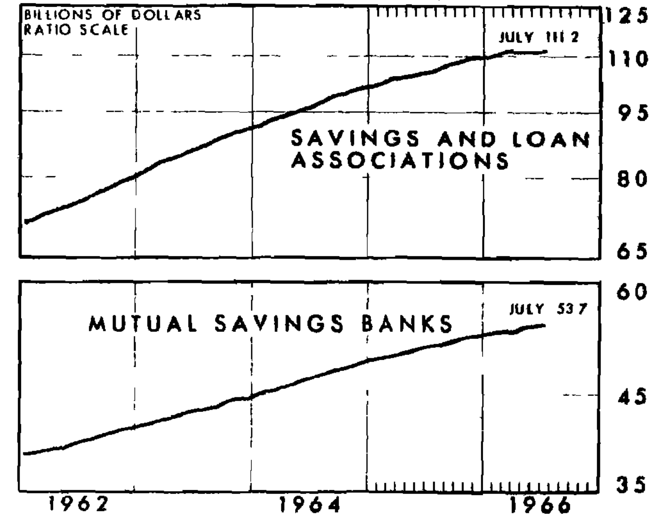




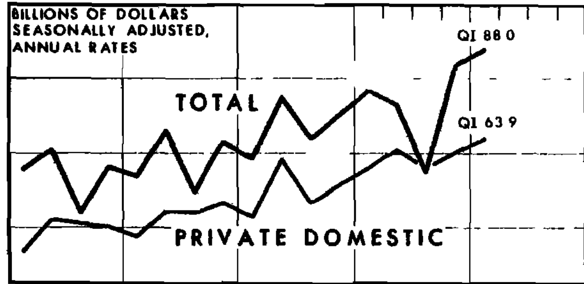


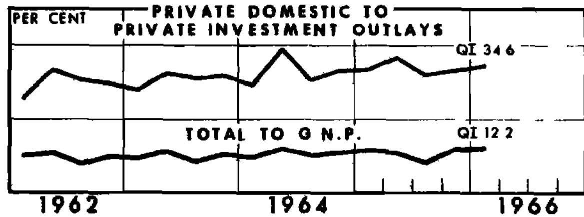


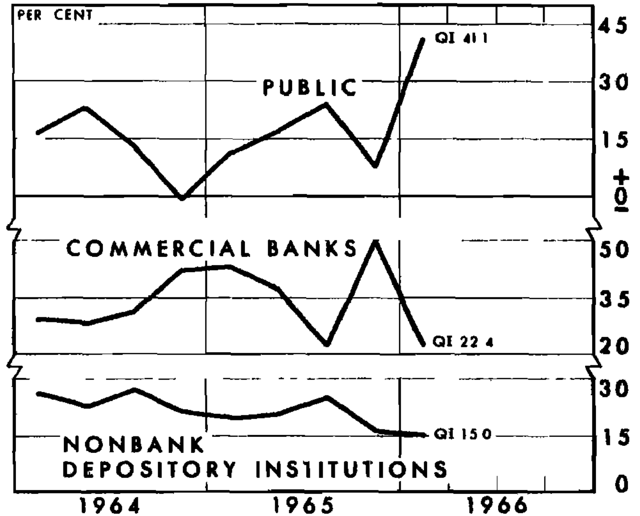


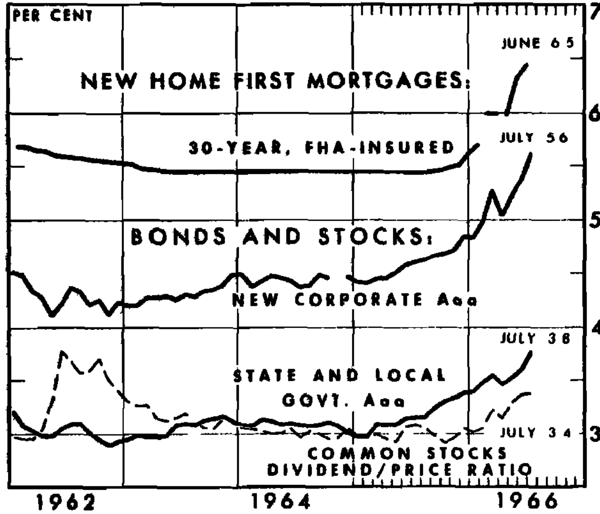


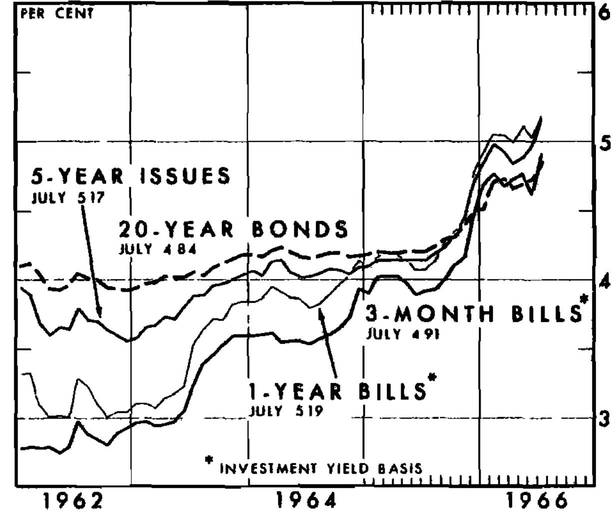
FINANCIAL DEVELOPMENTS - UNITED STATES

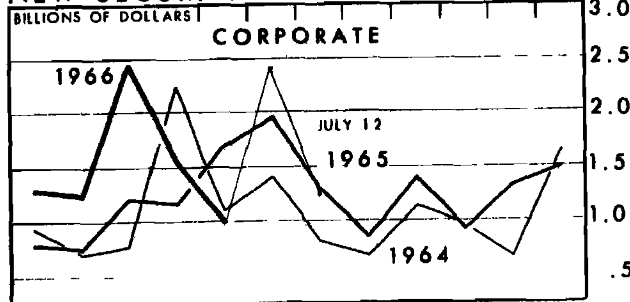


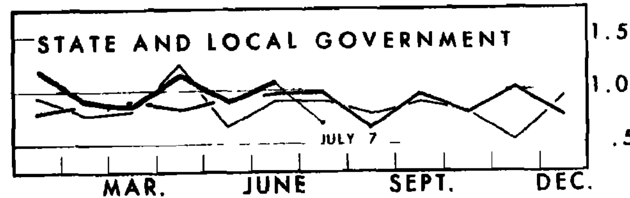


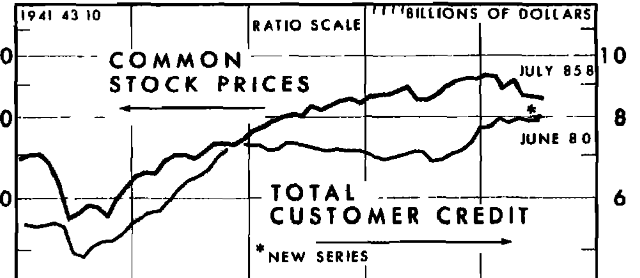


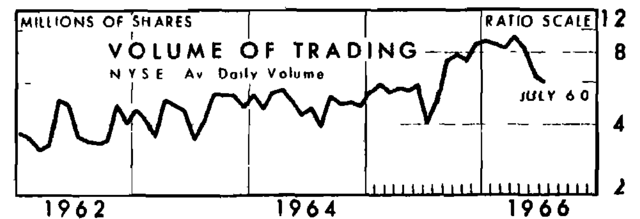












INTERNATIONAL DEVELOPMENTS

U.S. balance of payments. The liquidity deficit in the second quarter fell sharply to $163 million, seasonally adjusted, from $554 million in the first quarter. The reduction resulted from very large shifts of funds held in the United States by foreign official and international institutions from liquid to nonliquid assets. Apart from these shifts (and also from the postponement of Canadian security issues from 1965 into 1966, less advance Canadian redemptions), the liquidity deficit would have increased further in the second quarter and would have averaged about $2-1/2 billion at an annual rate during the first half of the year, as shown in the table on the next page. Some of the shifts of foreign funds into nonliquid claims might have occurred in response to market interest-rate incentives, but U.S. official persuasion is believed to have been an important element in most.

On the official reserve transactions basis, the seasonally adjusted deficit diminished only moderately from $248 million in the first quarter to $189 million in the second. This balance was less affected by the changing liquidity of foreign assets since it is not changed either by shifts in the portfolios of international institutions or by shifts of central bank funds into long-term time deposits. It was, however, held down in both quarters by inflows of foreign private liquid funds totaling more than $500 million during the half-year.

SELECTED ELEMENTS IN THE U.S. BALANCE OF PAYMENTS, 1966
(In millions of dollars)

	Q1	Q2	1st Half
Net shifts from liquid to nonliquid assets			
Foreign monetary authorities:			
Increase in "long-term" time deposits	47	245	292
Purchases of U.S. Government Agency bonds	--	166	166
International institutions	84	296	380
Net U.K. sales of U.S. corporate stocks	-63	-217	-280
Canadian security transactions			
Issues deferred from 1965 to 1966	-150	--	-150
Official repurchases by Govt. of Canada	40	68	108
Liquidity balance (seas. adjusted) on all other transactions	-512	-721	-1233

Preliminary and incomplete data for July show a liquidity deficit of $440 million before seasonal adjustment, or roughly $3 billion at an annual rate. Net shifts of foreign official and international institutions' liquid funds into nonliquid assets are thought to have been small. Weekly indicators through August 10 show continuing large deficits on the liquidity basis.

On the official reserve transactions basis, however, there appears to have been a substantial surplus during July. The wide divergence between this balance and the liquidity balance reflected unusually large inflows of foreign private liquid funds, of the order of $800 million for the month. These inflows were channeled mainly through the foreign branches of U.S. banks, which have been bidding

aggressively for Euro-dollar funds. Much of the July inflow probably had its counterpart in heavy British reserve losses, as foreigners shifted from sterling to dollars. Also, Italian banks continued to place dollar funds in London, and other investors were probably also attracted by the high yields there.

In the past, very large inflows of foreign private liquid funds into the U.S. have occurred mainly during short periods of intense pressure on sterling, notably in late 1964 and in the summer of 1965. It seems unlikely that inflows could continue at anything like the July pace in the absence of such pressure, although they might continue on a significant scale. The average increase in U.S. liabilities to foreign commercial banks (including head office liabilities to foreign branches) was $800 million a year in 1963-65, and $1,450 million in the peak year 1964.

The trade surplus fell sharply further in the second quarter to a seasonally adjusted annual rate of $3-1/4 billion, a seven-year low. There were strong increases in almost all categories of imports while exports fell off a little.

The broadly based strength in imports is shown in some detail in the following table. Imports of industrial supplies increased sharply after falling off a little in the first quarter. Releases from U.S. stockpiles of $280 million in the first quarter had contributed to the decline in imports at that time, but the second quarter increase occurred despite further stockpile releases.

U.S. MERCHANDISE TRADE: STRUCTURE AND RECENT CHANGES[1/]
(In billions of dollars; at seasonally adjusted annual rates)

	1965 2nd half	1966 1st half	Change from preceding quarter IV	I	II
EXPORTS	27.71	28.40	.80	.38	-.16
Agricultural	6.74	6.64	.13	-.17	.03
Other	20.97	21.76	.68	.54	-.19
Canada	5.96	6.34	.46	.09	.12
United Kingdom	1.60	1.76	--	.20	-.08
Continental Europe	7.37	7.59	.40	.13	-.23
Japan	2.18	2.16	.01	-.22	.39
Australia, New Zealand, and South Africa	1.30	1.15	-.45	.09	-.04
Latin America	3.96	4.10	.29	.14	-.30
Other less developed areas	5.22	5.25	-.10	.02	.12
Unallocated	.12	.05	.21	-.08	-.14
IMPORTS	22.70	24.54	.64	.99	1.04
Industrial supplies	10.88	11.42	.88	-.34	.87
Capital equipment	1.70	2.10	.28	.14	.26
Consumer goods	4.32	5.42	.81	.65	.12
Foods and beverages	4.08	4.32	.73	.22	.11
Miscellaneous	1.72	1.28	-.12	.32	-.32
Special adjustment 2/	--	--	+2.18	--	--
TRADE BALANCE	5.00	3.87	.16	-.61	-1.21

1/ Total exports and imports are on balance of payments basis which differs slightly from Census Bureau reports on components; this discrepancy and differences between seasonally adjusted totals and sums of seasonally adjusted components are shown as final component in each group. "Special category" exports, for which destinations are not available, are shown in "Unallocated" part of export detail table. Import detail for second quarter of 1966 partly estimated.

2/ For revision of statistical procedures at Census Bureau; this revision cannot be distributed among the components.

The decline in exports in the second quarter reflected lower sales to Europe and Latin America partly offset by sharply higher sales to Japan and shipments of wheat to India. Sales to Canada also increased further.

The prospects of sharply higher cotton exports in the marketing year which is just beginning, together with strong demands for U.S. jet aircraft, may prevent further erosion of the trade surplus later this year, but the surplus is unlikely to show significant growth during the remainder of the year.

Those flows of U.S. private capital for which second-quarter data are available did not show large net changes from the first quarter. Claims on foreigners reported by U.S. banks--mainly covered by the VFCR but including also customer items--increased moderately, by $130 million, seasonally adjusted, in the second quarter. This renewed outflow represented a substantial shift from reflows which averaged $270 million a quarter during the three preceding quarters. Reflows from Japan continued, but there were renewed outflows to Western Europe and Latin America.

On the other hand, transactions in foreign securities shifted almost as sharply in a favorable direction, from large outflows to a small and exceptional net inflow, seasonally adjusted. New issues of foreign securities in this country fell to less than $200 million, and this flow was offset by redemptions (including advance redemptions by Canada) and higher than usual net U.S. sales of outstanding issues.

Financial markets abroad. Financial markets in most industrial countries have continued to tighten in recent months. The widespread rise of long-term and short-term interest rates, which began about three years ago, now has carried them in many countries not only to postwar highs, but even above the levels reached in the late twenties. The notable exceptions are France, Italy, and Japan, and in France rates have recently been rising again.

In most cases, the rise in interest rates has reflected the deliberate tightening of monetary policy by the authorities in efforts to contain inflationary pressures. Seven major countries have raised their official discount rates since the beginning of May 1966:

Date	Country	from	to
May 2	Netherlands	4-1/2	5 per cent
May 27	Germany	4	5
June 2	Belgium	4-3/4	5
June 10	Sweden	5-1/2	6
July 6	Switzerland	2-1/2	3-1/2
July 14	United Kingdom	6	7

The countries continuing to pursue a restrictive monetary policy can be divided into two main groups: those where economic expansion continues at a fairly rapid rate (Canada, the Netherlands, the United States, and to some extent, Germany) and those where the rate of expansion, at least of output, has slackened considerably (Belgium, Sweden, the United Kingdom, and Switzerland). The reason that monetary policy remains restrictive in the latter group lies mainly in the fact that price and wage advances continue strong despite the fact that output has stopped rising. The persistence of inflationary

pressures reflects the chronic labor shortages experienced by most countries since the late fifties, enhanced in some cases by labor hoarding and reductions in the work week, and continually rising public sector demand with little or no restraint of private demand through fiscal policy. Thus the burden of demand management has largely fallen to monetary policy, and the desired restoration of relative price stability so far has not been achieved in most countries.

In Britain, the authorities took new steps in July to restrict domestic demand. On the monetary side, Bank rate was increased from 6 to 7 per cent, special deposit requirements of the commercial banks were raised, and consumer credit terms were tightened, as were over-all ceilings on bank lending.

Through the first half of the year net borrowings by the private sector had expanded fairly rapidly despite monetary restraints. Increases in outstanding bank advances and mortgage loans and net new security issues of private corporations all were at a more rapid rate than in the preceding year; only the rise in consumer credit outstanding was more moderate. The Chancellor announced on July 12 that the ceiling on bank advances--105 per cent of the March 1965 level--would remain in effect beyond March 1967, and that, contrary to earlier promises, no special arrangements would be made for commercial banks to help business firms to meet their liabilities under the new Selective Employment Tax, which begin to fall due on September 5. Thus the private sector will be making a forced loan of about

£250 million to the Government between September and December 1966, when the Government will begin to make refunds and bonus payments under the SET. Since banks in aggregate had reached the credit ceiling in July, the SET payments are expected to exercise a powerful squeeze upon the liquidity of the corporate sector in the fall.

Mortgage funds also may be coming under further pressure. For more than a year the spread between deposit and lending rates of the building societies has been unusually narrow, and the societies have had difficulties in maintaining adequate reserves. An increase in lending rates from 6-3/4 to 7-1/8 per cent, voted last May, has been held up pending a decision of the Prices and Incomes Board. (In Britain, increases in lending rates affect both new and outstanding loans.) The Bank rate increase of July 14 has aggravated the position of the building societies, which now may have to raise deposit rates in order not to lose funds to higher yielding investments.

In <u>Germany</u>, financial markets have continued to be generally tight, but the re-emergence of balance-of-payments surpluses recently is beginning to ease the commercial banks' liquidity positions.

Money market rates in Frankfurt rose above 6 per cent in early June after the increase in the Bundesbank's rediscount rate. Thereafter, seasonal demand tended to push rates up further and by mid-July day-to-day money was quoted at 6.6 per cent, but since then the rate has declined to 5.9 per cent on August 5. The major reasons for this easing were the large improvement in the trade balance in

recent months, some inflows of hot money connected with the speculation against sterling last month, and large cash advances by the Bundesbank to the Federal Government. As a result of the lessening strain on their liquidity positions, banks reduced their indebtedness to the Bundesbank from a high of DM 8.5 billion in early July to DM 6.9 billion on July 29, the lowest point in several months.

In capital markets, there appears to have been some restoration of investor confidence as high yields have begun to attract some cautious buying, but yields still remain near their 1966 highs. Thus 6 per cent public authority bonds on August 5th yielded 8.34 per cent as compared with a high of 8.60 per cent on July 15 and 8.00 per cent at the end of May just before the discount rate was raised. But the bond market remains generally weak and the German authorities have decided to continue indefinitely the issue pause for public authorities which had previously been announced for the period May-June 1966, only. Net new issues during the first half of 1966, at DM 3.5 billion, amounted only to 41 per cent of the volume raised a year earlier. Borrowers have been turning to sources outside the bond market. The Federal Postal Authorities are now raising funds from their major suppliers at a reported 8 per cent cost; a large German city has borrowed in Switzerland against a promissory note yielding 10.2 per cent; at the beginning of August Farbenfabriken Bayer raised DM 50 million from domestic sources against a promissory note yielding 9.7 per cent, a new high for a prime borrower.

The demoralization of the capital market has contributed to rising criticism of the Bundesbank's restrictive policies. It is argued that the private sector is made to pay for fiscal irresponsibility and that the choking off of funds at a time when business is cautious about its investment anyway may endanger future growth possibilities. In this connection, an easing of export credit facilities by the monetary authorities on July 22, through an increase in the rediscount facilities of the Export Credit Corporation and a reduction in the share of financing to be put up by the exporter, has been interpreted as an indication of a general softening of the Bundesbank's strict policy line.

For longer-run stabilization, the Federal Government puts its faith in the General Economic Stabilization Bill now before Parliament. This bill calls for coordination of Government financing plans on local, State and Federal Government levels, possible limitation of public and private borrowing, the establishment of a cyclical equalization reserve to be set aside from tax funds, cyclical use of certain taxing powers, and longer-range planning of budgetary needs.

In Canada, the continued pressure of demand upon resources is the primary cause of tight credit conditions. This tightening is being reflected in a slowdown in the pace of bank loan extensions. In fact, the amount of bank loans outstanding (after seasonal adjustment) fell fractionally in May and June, the first decline after a series of uninterrupted month-to-month increases which had been registered since June 1963.

Banks find themselves in an increasing squeeze for funds, partly because the Bank of Canada's cash management policy has seen to it that the banks' ratio of "more liquid" assets to total assets is remaining at slightly below the 30 per cent level considered minimal by the banks, and partly because deposits are growing more slowly than in the preceding year. Banks find it difficult to compete for deposits because the 6 per cent limit set to their lending rates puts an effective ceiling on the deposit rates they can pay. With rates in the United States and yields on short- and long-term paper in Canada rising, deposit flows into banks are diminishing. Although mortgage banks have no limits set upon the rates they can pay or charge, they also find themselves in a liquidity squeeze because the relatively low yield on outstanding loans does not allow them to raise deposit rates to competitive levels.

Canadian interest rates have increased significantly, though unevenly, since the discount rate increase in March. The rate on three month finance paper has moved from 5-3/4 per cent in March to 6 per cent at the beginning of May and to 6-1/4 per cent in early August. The Treasury bill rate rose from 4.7 per cent in March to 5.1 per cent in April, and has since been fairly steady at 5.0-5.1 per cent. Long-term bond yields which changed relatively little between March and June have been rising since. On August 15 a new 26-year bond was issued by the Government of Canada at 5.94 per cent. Even then initial reception was not enthusiastic, as investors had expected at least a 6 per cent coupon.

In _France_, the authorities have sharply raised the yields on new issues of public sector bonds. In early June the Finance Ministry announced that future issues would bear a 6-1/4 per cent coupon instead of the former 5-3/4 per cent rate. Effective yields to maturity on two new issues in June were 6.72 and 6.79 per cent, respectively, compared with an average yield of 6.26 per cent on the eight new public issues floated in January-May, and market yields on outstanding public sector bonds have risen about half as much. Rising interest rates abroad, expanding credit demands at home, and the poor reception given by the market in France to some new issues during the spring, appear to be the causal factors behind the authorities' decision.

Short-term rates in July have been seasonally high and the day-to-day rate against private paper has been at the 4-7/8 per cent ceiling set by the Bank of France in April 1965 in order to prevent undesirable inflows of capital from abroad. For August, expectations are that conditions will remain tight, in part because banks will have to cope with a 34 per cent _coefficient de tresorerie_ in August, substantially higher than the 31 per cent coefficient prevailing in June and July.

In _Italy_, long-term yields, as reflected by the composite bond index, remained quite stable during the first half of 1966 after the sharp declines which had occurred during the 18 month-period ending December, 1965. The relatively low rates available at home as compared with those prevailing in the rest of Europe, have led firms to repay foreign debts and refinance at home. This has been the main cause

of the Italian deficit on private capital account which developed during the past year. Thus there was a net outflow of private capital from Italy of $229 million during the first six months of 1966 as compared with a small net inflow a year earlier. Mainly for this reason the over-all balance of payments surplus declined from $512 million in the first half of 1965 to $278 million in January-June, 1966. Nevertheless, the surplus still is large and is contributing to the liquidity of the banking system. Bank loans have been rising slowly but the increase has been accelerating lately. In May, 1966 outstanding loans were 10 per cent above the preceding year's level.

In Japan, business demands for credit have generally remained slack in recent months and the rate of credit expansion has declined a little. Interest rates have been stable to declining. These developments have been due in part to the moderate rate of economy recovery and the existence of substantial excess capacity.

The average interest rate on all bank loans and advances was 7.49 per cent in June, down from the previous high of 7.99 per cent in December of 1964. Most of the decline occurred in 1965, with the rate dropping only slightly in recent months. Call loan rates have remained unchanged since October, 1965, at less than 6 per cent.

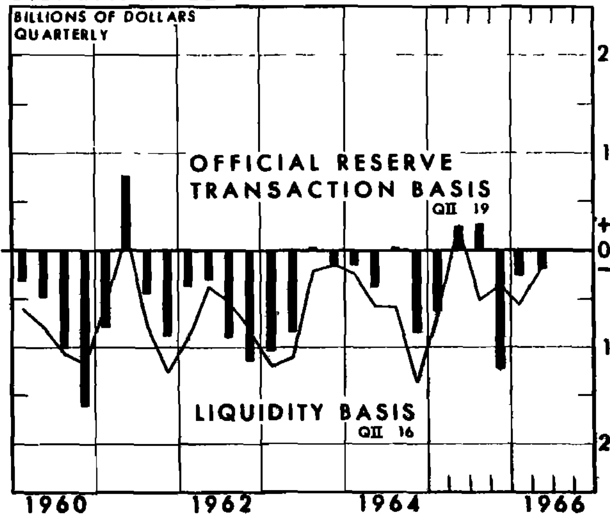
The Japanese authorities are attempting to prevent rapid repayment of foreign borrowings as a result of the lower interest rates in Japan and higher rates abroad. In line with the steady rise in the U.S. interest rate for acceptances, Japanese banks have steadily

increased their rates for dollar import acceptances. Effective July 20 the Japanese authorities abolished the system of interest rate ceilings applied to Euro-dollars borrowed by Japanese foreign exchange banks, which had been in effect since mid-1962. The move gives the Japanese banks more flexibility in the adjustment of the interest rates paid for Euro-dollars.

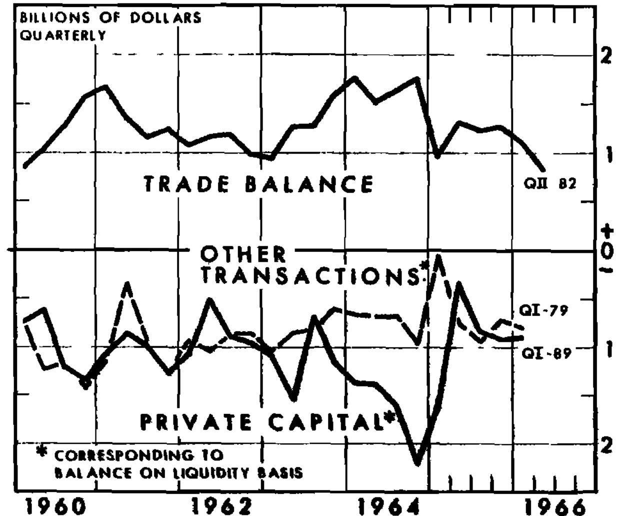
U.S. AND INTERNATIONAL ECONOMIC DEVELOPMENTS

SEASONALLY ADJUSTED

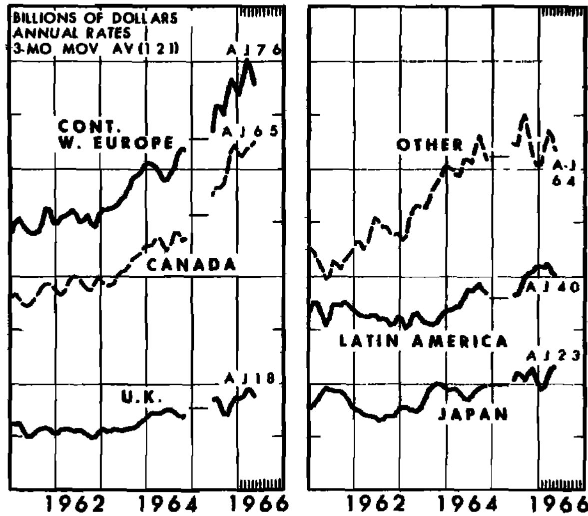
U.S. BALANCE OF PAYMENTS



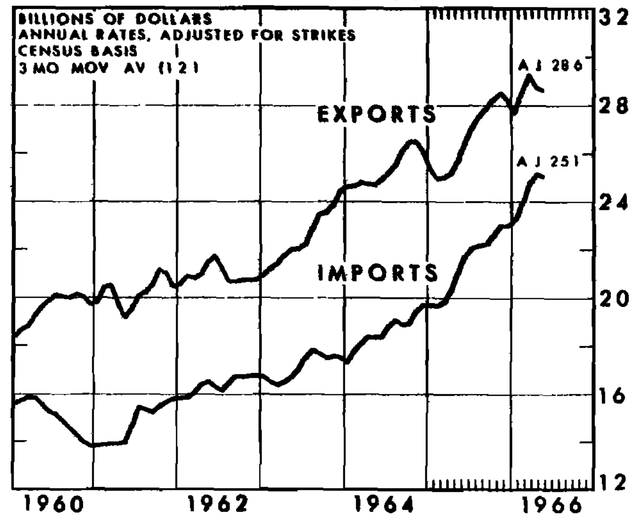
U.S. BALANCE OF PAYMENTS - CONT.



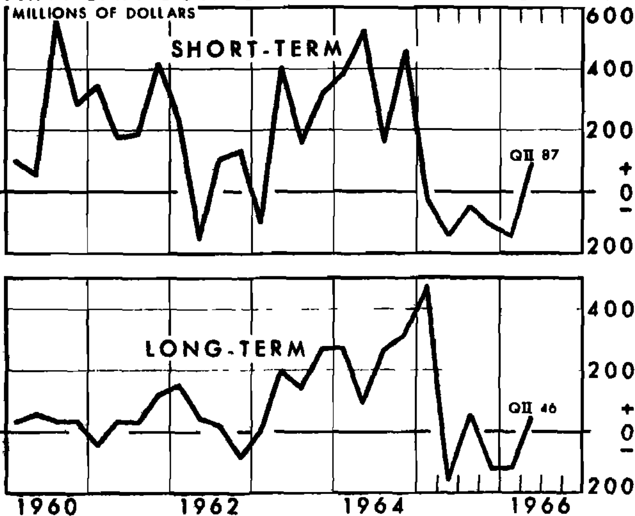
U.S. EXPORTS BY AREA



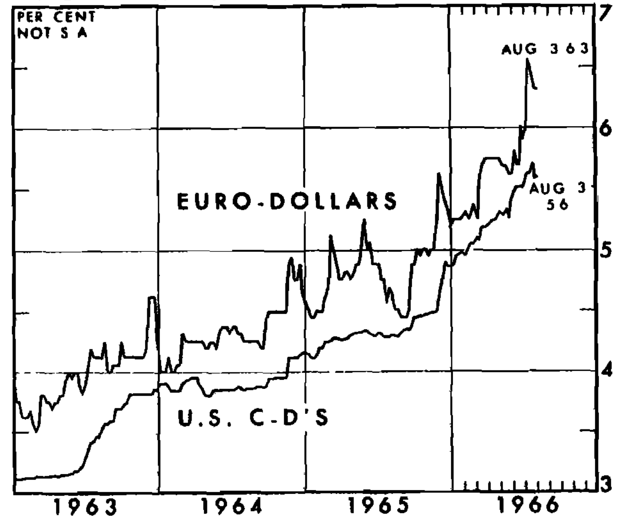
U.S. MERCHANDISE TRADE



PRIV. CAP. OUTFLOWS - BANK REPT. CLAIMS



90-DAY RATES



APPENDIX A: UNEMPLOYMENT IN CONSTRUCTION*

There has been no evidence of any easing in supply of construction workers so far this year despite the decline in housing starts and in construction expenditures. In July, unemployment in the construction industry declined more than seasonally to the lowest rate for the year and a level one-third below a year ago.1/ Unemployment in all industries fell only about one-fifth. In each month this year, the unemployment rate in the construction industry has been lower than the comparable month for all years since the Korean conflict (Table 1). According to official Labor Department figures, unadjusted for seasonal changes, unemployment in construction was down to 4.6 per cent in July. Historically, this is a very low and largely frictional rate and one which is associated with intensive pressure on skilled construction workers. Many of the unemployed are transitory workers.

Characteristically, annual average unemployment in construction has been about twice as high as the total unemployment rate (Table 2). This is true in periods of expansion and periods of recession. Often the higher unemployment rate in the construction industry is quoted as evidence of large available supplies of construction workers and substantially weaker demand in construction than for the economy as a whole. Such comparisons do not represent a fair evaluation of current labor supply-demand conditions in the industry because the higher unemployment rate in construction reflects primarily the seasonal nature of the industry and the large amount of frictional unemployment created by the continual ending of jobs on separate construction projects.

1/ The seasonally adjusted unemployment rates are unofficial Federal Reserve calculations. The unadjusted figures are from the official Labor Department unemployment series which is based on a national survey of households. All wage and salary workers in the construction industry are covered, including those engaged in repair and maintenance. Workers are considered to be unemployed in construction if their last job was in that industry. There is no Government unemployment survey which differentiates unemployed workers last employed in residential or nonresidential construction activity. Unofficial estimates of unemployment in construction are sometimes made for cities by the Bureau of Employment Security, but such estimates are not necessarily consistent from area to area or with the national series.

*Prepared by Susan W. Burch, Economist, National Income, Labor and Trade Section, Division of Research and Statistics.

Table 1

UNEMPLOYMENT RATES IN THE CONSTUCTION INDUSTRY
Selected Years

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC
						Unadjusted 1/						
1953	8.8	8.0	7.5	6.3	4.4	4.3	4.6	3.8	4.8	3.6	4.9	7.9
1955	15.9	14.8	14.5	11.5	7.3	7.1	6.5	6.1	4.3	5.8	7.5	10.1
1956	14.1	14.4	12.4	8.9	7.2	6.2	5.7	5.0	4.8	4.6	7.8	9.9
1961	22.1	23.9	20.4	17.9	14.5	11.6	11.2	8.7	8.9	7.8	10.5	14.4
1963	19.7	22.2	18.4	13.6	9.6	8.7	8.5	6.9	6.6	7.3	10.0	13.2
1965	15.8	16.7	13.7	10.1	7.7	7.4	7.1	5.4	5.8	5.5	6.5	7.9
1966	11.2	11.4	9.9	8.1	5.7	4.9	4.6					

1/ Official data published by Dept. of Labor. No seasonal adjusted data provided.

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC
						Adjusted 2/						
1953	5.4	4.9	5.1	5.3	5.3	5.6	6.2	5.9	6.8	6.2	6.5	7.3
1955	9.9	9.2	9.9	9.6	8.7	9.3	9.0	9.4	6.4	10.0	9.6	9.1
1956	8.9	8.9	8.5	8.4	8.6	8.1	8.0	7.8	7.2	7.8	9.7	8.9
1961	14.3	14.5	14.0	15.8	17.1	15.5	15.3	14.0	14.6	12.4	12.4	12.3
1963	12.5	13.5	12.9	12.3	11.5	11.5	11.4	11.3	11.0	11.4	11.5	11.1
1965	10.0	10.1	9.6	9.4	9.5	9.6	9.4	8.9	9.9	8.3	7.4	6.6
1966	7.1	6.8	7.0	7.5	7.0	6.4	6.1					

2/ By Federal Reserve -- Unpublished.

Table 2

UNEMPLOYMENT RATES
Annual Averages

	Construction	Total	Ratio Construction to Total		Construction	Total	Ratio Construction to Total
1948	7.6	3.8	2.0	1958	13.7	6.8	2.0
1949	11.9	5.9	2.0	1959	12.0	5.5	2.2
1950	10.7	5.3	2.0	1960	12.2	5.6	2.2
1951	6.0	3.3	1.8	1961	14.1	6.7	2.1
1952	5.5	3.1	1.8	1962	12.0	5.6	2.1
1953	6.1	2.9	2.1	1963	11.9	5.7	2.1
1954	10.5	5.6	1.9	1964	9.9	5.2	1.9
1955	9.2	4.4	2.1	1965	9.0	4.6	2.0
1956	8.3	4.2	2.0	1966 - 7 mos.	6.8	3.9	1.7
1957	9.8	4.3	2.3				

The high ratio of unemployment in the construction industry to the average has held even in periods of very tight labor market conditions when there were intensive wage pressures and substantial shortages of construction labor. Although the ratio dropped slightly below the usual 2:1 during the Korean conflict, the average annual unemployment rate in construction never fell below 5.5 per cent. The ratio of construction unemployment to total unemployment is now as low as in 1951 and 1952, and represents a relatively greater decline in construction unemployment since 1963 than for total unemployment.

The seasonal swings in unemployment in construction are extremely large. In the relatively good year of 1963, unemployment was at a high 22.2 per cent in February and a low of 6.6 per cent in August, a decline of more than two-thirds. For total unemployment the seasonal decline was from 6.9 to 5.2 for the same months. As economic expansion progressed, unemployment has declined both at the seasonal highs and lows. In 1966, the unadjusted unemployment rate in construction in February was 11.4 per cent and 4.6 per cent in June.

Two major conclusions can be drawn. First, if the annual unemployment rate in construction is to be brought down to the average for total unemployment, there will have to be a major reduction in winter

unemployment and a change in the employment pattern from relatively short jobs on different projects to steady year-round jobs. Since such basic changes are not likely in the near future, the annual average unemployment rate in the construction industry can be expected to continue to be close to twice as high as total unemployment.

Second, the relatively constant ratios between construction and total unemployment, apart from seasonal shifts, strongly indicate that unemployment in construction is largely influenced by changes in total demands. Even when construction expenditures (residential or nonresidential) show somewhat different patterns of change than overall expenditures, the unemployment ratio apparently is not greatly affected. For example, in 1955 and 1956 sharp reductions in residential activity occurred in a period of strong overall demands and both total unemployment and unemployment in construction dropped significantly. This would seem to imply that when total unemployment is low, laid-off construction workers move relatively easily into other jobs either within or outside the construction industry and hoarding of skilled tradesmen increases.

Past experience suggests, therefore, that if residential activity is reduced further this year the laid-off workers are likely to find other jobs if overall demand continues to expand and total unemployment remains at about current levels. With declining construction activity, however, some cities or geographical areas could experience relatively sharp declines in construction employment. Fortunately, mobility of construction workers is very high and a large number of dropped workers would probably be able to take jobs in other industries or move to other areas with stronger construction activity.

APPENDIX B: REVIEW OF FLOW OF FUNDS IN SECOND QUARTER*

Summary. Accelerated Federal tax collections in the second quarter had a major influence on both total borrowing and the forms of funds advanced in credit markets during the quarter. Primarily because of extra tax receipts from April and June prepayments on 1966 corporate profit tax liabilities, the Federal cash surplus was markedly higher than in the first quarter. This rise was reflected in both reduced Government borrowing and in a sharp rise in Treasury cash balances.

The shift of funds from the private economy to the Government resulted in abnormally low private flows into financial claims, with all forms of private financial investment down from the first quarter except inflows into commercial bank time deposits. Supported by time deposits growth and increases in Treasury cash balances, banks supplied 41 per cent of total funds borrowed during the second quarter, twice the first-quarter proportion and higher than 1965 as a whole. After netting out the build-up in Treasury deposits, however, bank credit supplied about 26 per cent of funds raised during the first six months of 1966 taken together, well below the 40 per cent average for 1965.

Federal finance. Table 1 shows at annual rates the large shifts in Federal fiscal and financial position from the first to the second quarter that affect the subsequent financial-market summary tables. On a national-income basis, the Federal surplus shows little change from the first to the second quarter, primarily because corporate profit taxes in the national-income accounts are credited to the Governments as they accrue rather than as they are paid.1/ Converting the national-income surplus to a cash basis for corporate taxes, as on line 3, suggests the size of impact that the April and June prepayments had on the Federal fiscal position. Further adjustments on lines 4 and 5 toward a cash-budget concept bring the total increase in surplus (at annual rates) to over $27 billion in the second quarter.

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* Prepared by Stephen P. Taylor, Chief, Flow-of-Funds and Savings Section, Division of Research and Statistics.

1/Higher withholding rates on individual taxes are included in the national-income surplus in both the first and second quarters, while accelerated transfers of withheld taxes by large employers are reflected in line 5 of Table 1.

In its financial operations, the Government met this rise in surplus by cutting back borrowing sharply from the high rate of the first quarter and by building up cash balances far more than seasonally. As can be seen in subsequent tables, the rise in Treasury deposits at commercial banks was a major incremental source of bank credit during the quarter.

As shown in Table 2, the $3.8 billion rate of Federal borrowing during the quarter was the difference between a $13.5 billion rate of retirements on direct debt (mainly bills) and a $17.3 billion annual rate of issues in nonguaranteed forms and loan participation certificates. Of the $17.3 billion increase in indirect debt, $8.6 billion constituted borrowing through home loan bank, FNMA, and land bank bonds, and $7.2 billion represented sales of loan participations of all types--FNMA, SBA, CCC, and Export-Import Bank. The $17.3 billion growth in indirect debt was well above the $9 billion rate of lending by the Government and thus supplies funds, at least indirectly, for Federal purposes other than loan programs.

Private borrowing in credit markets. Private borrowing was little higher in the second quarter than in the first, and as Table 3 indicates, the ratio of private funds raised to private net investment expenditures declined in the first half of 1966 and was well below the 1961-65 average. About $10 billion of net funds other than depreciation allowances and credit have been used to finance investment outlays this year. Earlier in this expansion, such internal financing, from net saving and drawdowns of financial asset holdings, had been negligible before the second half of 1965.

Although the total of private borrowing was little changed from the first quarter, there were large shifts in the forms of credit raised. Virtually all of the rise from first quarter rates of borrowing was in business bank loans, while there were declines in mortgage borrowing from $26 billion to $23 billion, in security issues from $12 billion to $8 billion, and in consumer credit from $9.2 billion to $7 billion, all at seasonally adjusted annual rates. The high rate of business borrowing from banks in the second quarter, however, no more than offset the low first-quarter flow of bank loans, and for the half year as a whole, bank loan growth was not significantly different from the 1965 rate. The increment in private credit this year has thus been supplied in other forms, mainly corporate bond issues.

	1965		1966
	1st Half	2nd Half	1st Half
	(Billions of dollars, SAAR)		
Total private borrowing	65.9	65.5	67.5
Bank loans n.e.c. 2/	14.1	13.7	12.4
Corporate securities	5.6	5.8	10.2
Other credit	46.2	46.0	44.9

2/ Bank loans n.e.c. shown here are similar to business loans in other banking statistics, differing mainly in seasonal adjustment procedures used. For business loans in L.4.3 banking statistics, the annual rates of growth for the periods shown above were 18.1 per cent in 1st half 1965, 14.1 per cent in 2nd half 1965, and 20.5 per cent in first half 1966.

Financial investment by the public. The second-quarter shift of funds from the public to the Federal Government reduced sharply the total flow into financial markets from private investors, as shown in Table 4. Although time deposit inflows to commercial banks held up well, investment in cash balances, savings accounts at nonbank institutions, Government securities, and private instruments were all sharply down from the first quarter. Apart from changes in cash holdings, which are characteristically volatile in the short run, the largest relative drop was in flows to nonbank savings institutions, which were more than 60 per cent below the first-quarter rate. This decline was not fully offset in bank time deposits, and the total of bank and nonbank time and savings accounts increased somewhat less than in the first quarter and at about two-thirds the 1965 rate.

The drop in private investment in securities was mainly in direct Federal debt, reflecting the sizable reduction in Federal borrowing during the quarter. Total direct investment in securities was still high by any standard other than the first quarter, however, and of the $16 billion rate indicated, well over $10 billion appears to have been in U.S. Government agency issues.

Within the constraint of reduced funds available for lending, private investors thus shifted from cash to interest-bearing investments, from claims in nonbank institutions to bank time deposits, and from deposit claims as a whole to market securities, mainly nonguaranteed Federal debt issues.

<u>Bank credit in relation to total credit</u>. Inflows of time deposits and the exceptional rise in Treasury cash balances made banks a major direct source of credit to borrowers during the second quarter, supplying 41 per cent of funds raised. The transitory increase in Treasury deposits was the main source of this rise, however. Bank credit from other sources constituted 26 per cent of total credit flows during both quarters of 1966, as indicated in Table 5. This was well below the 40 per cent in 1965 as a whole and the 35 per cent average for 1961-65 and reflects primarily the heavy volume of direct security purchases by the nonfinancial public and the relatively high volume of Federal lending this year.

Table 1 U.S. Government

(Billions of dollars, SAAR)

		1966 I	1966 II	II less I
(1)	Surplus, national income basis	2.3	3.9 e/	1.6
(2)	Excess collections on corporate profit taxes a/	-2.9	11.8	14.7
(3)	National-income surplus adjusted to cash collection of corporate profit taxes [(1) + (2)]	-.6	15.7	16.3
(4)	Lending programs	8.4	9.1	.7
(5)	Other financial uses, net b/	8.6	-3.3	-11.9
(6)	Net need for funds (4) + (5) - (3)	17.6	-9.9	-27.5
(7)	Net financing (8) - (9)	17.6	-9.9	-27.5
(8)	Borrowing in credit markets c/	14.3	3.8	-10.5
(9)	Change in cash balance d/	-3.3	13.7	17.0

a/ Excess of net corporate profit tax receipts over the profit tax accruals included in line (1).

b/ Miscellaneous adjustments to cash budget basis. The large movement from first to second quarter arises mainly from increases in sundry liabilities of the Government: savings and loan association deposit flows to home loan banks, accrued interest payable on public debt, seigniorage, and trade debt to business. Includes sector account discrepancy.

c/ Includes agency issues and loan participation certificates.

d/ Treasury record.

e/ Revised from August 7 flow-of-funds tables for later information.

Table 2 Summary of Credit Market Borrowing

(Billions of dollars, SAAR)

	1965	1966 I	1966 II
Total borrowing	72.3	83.7	74.9
U.S. Government	3.6	14.3	3.8
Direct and guaranteed issues	1.2	9.3	-13.5
Agency issues and loan participations	2.3	5.0	17.3
Foreign	2.9	2.6	2.7
Domestic nonfinancial sectors	65.8	66.7	68.3
State and local governments	7.7	6.7	6.9
Business	30.6	35.1	37.9
Households	27.6	24.9	23.5

Table 3 Business and Households Capital Expenditures and Credit Market Borrowing

(Billions of dollars, SAAR)

		1961-65 Avg.	1965 1st Half	1965 2nd Half	1966 1st Half
(1)	Gross capital expenditures	142.0	167.6	175.8	184.6
	Sources of finance--				
(2)	Capital consumption	97.5	108.0	111.2	114.3
(3)	Credit market borrowing	43.6	58.1	58.0	60.7
(4)	Other sources (1)-(2)-(3)	.9	1.5	6.6	9.5
(5)	Net investment (1)-(2)	44.6	59.6	64.6	70.4
(6)	Percent borrowing of net investment	96.8%	97.3%	89.8%	86.2%

Capital expenditures: outlays for fixed capital, consumer durables, and inventories by nonfinancial business, households, and nonprofit organizations.

Table 4 Sources of Funds to Credit Markets

(Billions of dollars, SAAR)

	1965	1966 I	1966 II
Total borrowing	72.3	83.7	74.9
Funds supplied by private nonfinancial sectors a/	51.0	63.4	34.6
Demand deposits and currency	7.9	9.1	-2.4
Time and savings deposits at banks	20.0	14.4	17.5
Savings accounts at savings institutions	13.1	9.4	3.5
Direct lending	10.0	30.5	16.0
Federal loan programs	4.5	8.4	9.1
Federal cash balances b/	-1.2	-3.9	12.8
Other sources c/	18.0	15.8	18.4

a/ Households, business, State and local governments, and foreign.
b/ Bank record.
c/ Mainly private insurance and pension reserves and internal funds of financial business.

Table 5 Bank Credit and Total Credit

(Billions of dollars, SAAR)

	1965	1966 1st Half	1966 quarters I	1966 quarters II
Total borrowing	72.3	79.3	83.7	74.9
Total bank credit a/	27.8	24.2	17.9	30.6
Percent bank credit of total	38%	31%	21%	41%
Bank credit net of Treasury deposits a/	29.0	20.4	21.6	19.3
Percent net bank credit of total	40%	26%	26%	26%

a/ Net of bank security issues.