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CONFIDENTIAL (FR)

# CURRENT ECONOMIC AND FINANCIAL CONDITIONS

By the Staff
Board of Governors
of the Federal Reserve System

September 15, 1971

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## SUMMARY AND OUTLOOK

### Nonfinancial

At mid-summer economic activity was expanding quite modestly, while upward price pressures were strong, according to the latest economic statistics (most of which relate to the period prior to the new economic program announced at mid-August). According to current staff estimates real GNP is increasing at an annual rate of only 2 per cent in the current quarter following a rise at an upward revised rate of nearly 5 per cent in the second quarter.

In August industrial production declined almost 1 per cent further, though this was mainly because of continued cutbacks in steel following the earlier precautionary build-up of stocks. The labor market continued weak; nonfarm payroll employment changed little after two months of decline, and the unemployment rate returned to a level above 6 per cent as the labor force rose sharply.

Retail sales have shown strength in the last few weeks, rising 1.7 per cent in August on the basis of the advance estimate. For July and August combined, retail sales averaged about 1 per cent over the second quarter. Automobile sales--both domestic-type and imports--were exceptionally strong in the last 10 days of August and the first 10 days of September, probably in part because of expectations of a retroactive rebate of the excise tax and higher prospective prices for imports.

New orders for durable goods increased considerably in July, with defense orders up sharply. Capital equipment orders changed little and were 4 per cent above the first quarter average. The August Commerce-SEC survey (with most returns in before August 15) scaled down slightly the already modest increases in business plans for plant and equipment spending this year.

Wholesale prices of industrial commodities, seasonally adjusted, increased markedly further in the month ending at mid-August, continuing the sharp stepup of the past several months. Increases were widespread, with metals and lumber accounting for much of the overall rise. Prices of farm products and foods also rose sharply.

Outlook. Beginning in the fourth quarter, the President's new economic program is expected to impart a strong upward push to the economy and to hold down wage and price increases. For the three quarters ending at mid-1972, real GNP is projected to increase on average at an annual rate of around 7 per cent, with the first half of 1972 expected to be somewhat stronger than the fourth quarter of this year. Before the President's announcement, we had projected an average rate growth in real GNP of a little over 5 per cent for these three quarters. A summary comparison of old and new staff projections is shown in the table below.

GNP PROJECTIONS

| | Change in Nominal GNP $ billion | | Increase in per cent per year: Real GNP | | GNP deflator | | Unemployment rate | |
|---|---|---|---|---|---|---|---|---|
| | Old | New | Old | New | Old | New | Old | New |
| 1971-III | 19.0 | 16.0 | 2.7 | 2.0 | 4.5 | 4.1 | 6.2 | 6.1 |
| 1971-IV | 27.5 | 22.8 | 5.0 | 6.4 | 5.3 | 2.2 | 6.4 | 6.0 |
| 1972-I | 28.0 | 30.5 | 5.1 | 7.3 | 5.1 | 3.9 | 6.3 | 5.8 |
| 1972-II | 27.5 | 25.4 | 5.6 | 7.5 | 4.2 | 1.6 | 6.1 | 5.5 |

The sharp increase in growth in real GNP anticipated for the fourth quarter reflects mainly expected strength in consumer spending, a shift from a decline to increase in inventory investment, and further advances in residential construction. Consumer spending in real terms is expected to accelerate, with total auto sales rising appreciably from their average thus far this year and with a shift away from imports toward domestic-type units.

In the first half of 1972, strength is projected to extend to business fixed investment--in response to both rising levels of output and the investment tax credit. Also the new program is expected to result in a shift from deficit to surplus in net exports of goods and services. Consumer spending is likely to continue strong, as disposable income is enlarged, effective January 1, by some tax relief in the form of higher personal exemptions and the volunteer army pay increase partly offset by the postponement of the Federal pay raise. With a more typical cyclical recovery under way, inventory accumulation is projected to increase appreciably further in the first half of next year.

We are assuming a reasonably effective post-freeze wage price program, with wage rates rising at an annual rate of about 5 per cent over the three quarters to mid-1972. Productivity is expected to respond favorably to sizable increases in output, and the rise in unit labor costs is expected to slow appreciably. With such diminished cost pressures, the private GNP fixed-weight index is projected to increase at an annual rate of around 2-1/2 per cent price over the next three quarters, down from a rate of over 5 per cent in the first half of this year.

Industrial capacity is projected to become more fully utilized, and the unemployment rate to be trending down, reaching about 5.5 per cent in the second quarter.

Financial

In recent days, market interest rates generally retraced part of the decline that followed the President's mid-August speech. With the Federal funds rate at or near a new high for the year, private short-term rates began to edge upwards in late August, and by mid-September most were only 1/8 to 1/4 of a percentage point below their mid-August level. The three month Treasury bill rate had increased by 30 basis points since late August but--reflecting previous declines associated with large official foreign demand--remains 50 basis points below its mid-August level. With respect to bond yields, in the first week or two after the President's announcement, bond yields declined about 75 basis points. Subsequently, with new issues moving very slowly in early September, the corporate calendar building, and the money market remining tight, several underwriting syndicates were terminated with large unsold balances at mid-month; under the circumstances, new issue yields rose about 25 basis points.

Commercial bank deposits and credit were greatly influenced by international developments in August. Total bank loans increased at a near record rate as foreign and domestic corporations borrowed dollars to pay for imports in advance, to reduce net long--or increase net short--dollar positions, and perhaps to re-lend dollars in the Euro-dollar market. A significant proportion of the proceeds of such loans ended up in deposits of the U. S. Government as foreign central banks purchased special Treasury issues with dollars absorbed by them in support of their own currencies.

Net inflows of consumer-type time and savings deposits at banks and nonbank thrift institutions, taken together, slowed further in August. Despite the August slowdown of inflows to thrift institutions, however, mortgage rates are reported to have eased since the President's new program was announced.

Outlook. The outlook for credit flows and interest rates over the balance of the year is quite uncertain, depending as it does on how the President's economic program seems to be developing. In long-term markets, the lower level of yields resulting initially from the new program stimulated new offerings of both corporate and municipal issues--including some previously postponed--in September, and the forward calendar for October has also begun to build. Despite this bulge in offerings, the staff sees no reason to change its view that--given imporved internal funds flows and the successful completion of a considerable volume of financial restructuring--corporate long-term borrowing in the fall should continue below the record pace of the first half. But long-term rates might come under further upward pressure as investors back off and borrowers accelerate offerings, especially if short-term market pressures tend to cause a change in longer-run interest rate expectations.

In short-term markets, credit demands are likely to be sustained between now and year-end by increased business demands to finance working capital in connection with the accelerated expansion in GNP, by larger consumer credit demands, and by sizable Treasury and Federal agency cash needs.[1/] Part of these demands will fall on banks. With U. S. Government and private demand deposits unlikely to be a significant source of funds, and consumer-type time deposits continuing to grow only modestly, banks can be expected to step up efforts to sustain CD's. Thus, interest rates in short-term markets could come under upward pressure as we move into the fall.

Under the circumstances, there is little reason to expect a significant reversal of the recent slower growth of interest-bearing deposits at nonbank depositary institutions. Mortgage rates, however, are expected to rise little of any this fall because of the existing high level of S&L liquidity, Government mortgage support programs, and the seasonal moderation in mortgage credit demands.

1/ The staff assumes no massive sales of market issues or redemption of special issues by official foreign accounts in the fourth quarter.

Balance of payments

The U. S. balance of payments deficit in August appears to have been of the order of magnitude of \$8 or \$9 billion. The greater part of this occurred before European official exchange markets were temporarily closed during the week of August 16-20, following the President's announcement of the suspension of gold convertibility of the dollar. During that week and thereafter there were large reserve gains by Japan, in particular, until the Japanese yen was allowed to appreciate by 5-1/2 per cent on Saturday, August 28. In the first week of September the Bank of Japan, as well as some other central banks, made further reserve acquisitions.

In July, U. S. merchandise imports substantially exceeded exports for the fourth month in a row. The worsening of the trade balance from a \$2 billion surplus in 1970 to more than a \$4 billion rate of deficit in recent months reflects three types of factors: a strengthening of aggregate domestic demand in the United States relative to that in other countries, reactions to or expectations of work stoppages (at ports and in U. S. industries such as steel), and fears of future unavailability or increased cost of imports that might be affected by quotas, exchange rate changes, or other measures. In the months ahead the trade balance may continue to be adversely affected by the first factor, but the other two may no longer buoy up imports so strongly. As time goes by, the import surcharge will begin to cut down the dollar payments to foreign sellers of those categories of imports for which U. S. import demand is sufficiently responsive to changes in cost. The appreciation of the Japanese yen and other industrial country currencies in recent months will have similar effects on the quantities of imports (but with much less effect on dollar payments to foreign countries), while having the positive effect of favoring U. S. exports and raising their aggregate dollar value.

Projections of U. S. foreign trade and the balance of payments during this period of international reappraisal and negotiation are perforce arbitrary. It seems likely that several months will elapse before the U. S. surcharge and foreign compensatory or retaliatory measures can be cleared away, giving place to multilaterally negotiated exchange rate changes (involving further appreciations against the dollar) and to agreements regarding exchange rate flexibility and regarding the nature and management of international reserve assets in the future.

The worsening of the over-all balance of payments from about \$10 billion in 1970 (on the official settlements basis) to a rate of over \$22 billion in the first half of 1971 reflected a worsening by nearly \$4 billion in the trade balance and very large adverse shifts in recorded and unrecorded capital flows (other than repayments of liabilities to commercial banks abroad, which tapered off after March).

These capital flows were heavily affected by anticipations of exchange rate changes, especially from last April on. It is to be expected that new rounds of speculation on additional appreciations of industrial country currencies will develop in coming months, and there will continue to be a basic deficit in the U. S. payments accounts. Thus governments and central banks of the other industrial countries may be faced with difficult choices between further unilateral appreciations of exchange rates, tighter exchange controls, or further large acquisitions of dollar reserves. Meanwhile, central banks in most of the less developed countries will continue to acquire reserves if their payments positions permit.

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SELECTED DOMESTIC NONFINANCIAL DATA

(Seasonally adjusted)

| | 1971 | | | | Per Cent Change* From | | |
|---|---|---|---|---|---|---|---|
| | May | June | July | Aug. | 1 mo. ago | 3 mos. ago | Year ago |
| Civilian labor force (mil.) | 84.2 | 83.1 | 83.8 | 84.3 | 0.6 | 0.2 | 1.9 |
| Unemployment rate (%) | 6.2 | 5.6 | 5.8 | 6.1 | -- | -- | 5.1 4/ |
| Insured unempl. rate (%) 6/ | 4.2 | 4.4 | 4.0 | n.a. | -- | -- | 3.5 4/ |
| Nonfarm employment, payroll (mil.) | 70.8 | 70.7 | 70.6 | 70.6 | 0.0 | -0.3 | 0.2 |
| Manufacturing | 18.7 | 18.6 | 18.5 | 18.5 | -0.2 | -1.1 | -3.9 |
| Nonmanufacturing | 52.1 | 52.0 | 52.0 | 52.1 | 0.0 | 0.0 | 1.7 |
| Industrial production (1967=100) 6/ | 107.0 | 106.9 | 106.0 | n.a. | -0.8 | -0.2 | -1.4 |
| Final products, total | 104.0 | 104.2 | 104.0 | n.a. | -0.2 | 0.4 | -1.4 |
| Consumer goods | 115.8 | 116.0 | 115.9 | n.a. | -0.1 | 1.1 | 3.3 |
| Business equipment | 94.4 | 94.2 | 93.6 | n.a. | -0.6 | -1.6 | -8.7 |
| Materials | 108.9 | 108.7 | 107.1 | n.a. | -1.5 | -0.4 | -1.3 |
| Capacity util. rate, mfg. 5/ | n.a. | n.a. | n.a. | n.a. | -- | -- | -- |
| Wholesale prices (1967=100) 1/ | 113.8 | 114.3 | 114.6 | 114.9 | 0.3 | 1.0 | 4.0 |
| Industrial commodities (FR) | 113.4 | 113.7 | 114.3 | 114.9 | 0.5 | 1.3 | 4.5 |
| Sensitive materials (FR) | 113.3 | 113.6 | 115.1 | 116.4 | 1.1 | 2.7 | 2.9 |
| Farm products, foods & feeds | 114.3 | 115.4 | 115.0 | 114.6 | -0.3 | 0.3 | 3.1 |
| Consumer prices (1967=100) 1/ 6/ | 120.8 | 121.5 | 121.8 | n.a. | 0.2 | 1.3 | 4.4 |
| Food | 118.2 | 119.2 | 119.8 | n.a. | 0.5 | 1.7 | 3.5 |
| Commodities except food | 116.6 | 117.1 | 117.0 | n.a. | -0.1 | 1.0 | 4.0 |
| Services | 127.5 | 128.2 | 128.8 | n.a. | 0.5 | 1.6 | 5.6 |
| Hourly earnings, pvt. nonfarm ($) | 3.41 | 3.42 | 3.42 | 3.45 | 0.9 | 1.2 | 5.8 |
| Hourly earnings, mfg. ($) | 3.55 | 3.57 | 3.58 | 3.60 | 0.6 | 1.4 | 5.9 |
| Weekly earnings, mfg. ($) | 142.00 | 142.80 | 143.53 | 143.59 | 0.0 | 1.1 | 6.2 |
| Net spend. weekly earnings, mfg. (3 dependents 1967 $) 1/ 6/ | 101.81 | 102.45 | 100.77 | n.a. | -1.6 | -0.3 | 1.0 |
| Personal income ($ bil.) 2/ 6/ | 850.0 | 870.1 | 859.1 | n.a. | -1.3 | 1.7 | 6.7 |
| Retail sales, total ($ bil.) | 32.7 | 33.3 | 33.0 | 33.6 | 1.7 | 2.7 | 9.1 |
| Autos (million units) 2/ | 8.4 | 8.2 | 8.4 | 8.4 | 1.1 | 0.3 | 7.5 |
| GAAF ($ bil.) 3/ | 8.9 | 9.3 | 9.0 | 9.1 | 1.3 | 2.2 | 9.7 |
| 12 leaders, composite (1967=100) 6/ | 124.8 | 124.7 | 126.5 | n.a. | 1.4 | 2.1 | 8.9 |
| Selected leading indicators: | | | | | | | |
| Housing starts, pvt. (thous.) 2/ 6/ | 1,975 | 1,995 | 2,218 | n.a. | 11.2 | 16.0 | 38.4 |
| Factory workweek (hours) | 40.0 | 40.0 | 40.0 | 39.9 | -0.3 | -0.3 | 0.3 |
| Unempl. claims, initial (thous.) 6/ | 304 | 307 | 275 | n.a. | 10.5 7/ | 2.8 7/ | -1.7 7/ |
| New orders, dur. goods, ($ bil.) 6/ | 30.6 | 30.7 | 31.7 | n.a. | 3.3 | 4.8 | 5.3 |
| Capital equipment | 7.9 | 8.2 | 8.2 | n.a. | -0.4 | 6.3 | 16.4 |
| Common stock prices (41-43=10) | 101.64 | 99.72 | 99.00 | 97.24 | -1.8 | -4.3 | 24.8 |

* Based on unrounded data. 1/ Not seasonally adjusted. 2/ Annual rates.
3/ Gen'l. merchandise, apparel, and furniture and appliances. 4/ Actual figures.
5/ To be revised. 6/ Per cent calculated to July 1971. 7/ Sign reversed.

SELECTED DOMESTIC FINANCIAL DATA

| | Averages 1970 QIV | 1971 QI | 1971 QII | 1971 July | 1971 Aug. | Week ended Sept. 8 |
|---|---|---|---|---|---|---|
| Interest rates, per cent | | | | | | |
| Federal funds | 5.57 | 3.86 | 4.56 | 5.31 | 5.57 | 5.73 |
| 3-mo. Treasury bills | 5.35 | 3.76 | 4.26 | 5.40 | 4.94 | 4.56 |
| 3-mo. Federal agencies | 5.50 | 3.78 | 4.43 | 5.56 | 4.19 | 5.80 |
| 3-mo. Euro-dollars | 7.46 | 5.50 | 6.72 | 6.47 | 8.16 | 8.76 |
| 3-mo. finance co. paper | 6.12 | 4.48 | 4.74 | 5.54 | 5.57 | 5.44 |
| 4-6 mo. commercial paper | 6.28 | 4.57 | 5.05 | 5.75 | 5.73 | 5.75 |
| Bond buyer municipals | 5.93 | 5.25 | 5.74 | 6.06 | 5.83 | 5.39 |
| Aaa corporate-new issues | 8.26 | 7.33 | 7.83 | 7.96 | 7.65 | 7.38 |
| 20-year Treasury bonds | 6.57 | 6.00 | 6.24 | 6.38 | 6.27 | 5.99 |
| FHA mortgages, 30-year | 8.76 | -- | 7.67 | 7.97 | n.a. | -- |

| | 1970 QIV | 1971 QI | 1971 QII | 1971 July | 1971 Aug. |
|---|---|---|---|---|---|
| Change in monetary aggregates (SAAR, per cent) | | | | | |
| Total reserves | 6.6 | 11.0 | 6.6 | 0.3 | 15.0 |
| Nonborrowed reserves | 9.4 | 11.0 | 5.3 | -13.1 | 16.3 |
| Credit proxy | 15.1 | 17.0 | 9.6 | 8.8 | 11.5 |
| Credit proxy + nondep. funds | 8.3 | 10.9 | 6.5 | 8.0 | 10.0 |
| Money supply | 3.4 | 8.9 | 11.3 | 10.1 | 2.6 |
| Time and savings deposits | 21.8 | 27.3 | 13.5 | 11.3 | 6.1 |
| Deposits at S&L's and MSB's | 11.6 | 23.3 | 17.3 | 15.8 | 8.4 |
| Bank credit, end-of-month | 8.6 | 12.2 | 7.4 | 7.6 | 13.0 |
| Treasury securities | 6.2 | 19.8 | 11.1 | -20.9 | -3.9 |
| Other securities | 36.5 | 27.9 | 15.7 | 18.7 | -3.7 |
| Total loans | 1.4 | 6.3 | 4.2 | 10.0 | 21.8 |
| Business | -4.9 | 1.4 | 2.5 | 11.7 | 29.4 |

| | 1970 QIV | 1971 QI | 1971 QII | 1971 July | 1971 Aug. |
|---|---|---|---|---|---|
| Commercial paper (SA change, $ mil.) | | | | | |
| Total (SA) | -760 | -2,581 | -874 | -758 | n.a. |
| Bank-related (NSA) | -2,269 | -657 | 41 | 75 | -16 |

| | 1970 H-2 | 1970 QIII | 1970 Aug. | 1971 QII | 1971 July | 1971 August |
|---|---|---|---|---|---|---|
| New security issues (NSA, $ mil.) | | | | | | |
| Total corp. issues | 20,499 | 8,560 | 2,274 | 11,654 | 4,000 e | 2,850 e |
| Public offerings | 16,830 | 7,646 | 2,069 | 9,930 | 3,527 | 2,350 e |
| State and local government bond offerings | 10,327 | 4,465 | 1,359 | 6,050 | 1,928 | 1,828 e |
| Fed. sponsored agency debt (change) | 3,057 | 1,593 | 678 | - 924 | 869 | 210 e |
| Fed. gov't. debt (change) | 16,257 | 7,366 | 2,716 | 1,616 | 4,226 | 6,900 e |

n.a. - Not available. e - Estimated. p - Preliminary.
SAAR - Seasonally adjusted annual rate. NSA - Not seasonally adjusted.

I -- T - 3
U.S. Balance of Payments
In millions of dollars; seasonally adjusted

| | 1971 p/ | | | | |
|---|---|---|---|---|---|
| | I | II | May* | June* | July* |
| Goods and services, net 1/ | 1,147 | -22 | | | |
| Trade balance 2/ | 269 | -1,040 | -306 | -424 | -360 |
| Exports 2/ | 11,030 | 10,716 | 3,670 | 3,594 | 3,435 |
| Imports 2/ | 10,761 | -11,756 | -3,976 | -4,018 | -3,795 |
| Service balance | 878 | 1,018 | | | |
| Remittances and pensions | -342 | -357 | | | |
| Govt. grants & capital, net | -1,026 | -1,094 | | | |
| U.S. private capital (- = outflow) | -2,230 | -1,967 | | | |
| Direct investment abroad | -1,370 | -1,315 | | | |
| Foreign securities | -353 | -396 | -126 | -150 | -70 |
| Bank-reported claims -- liquid | -72 | 38 | -481 | 437 | -103 |
| " " " other | -53 | -317 | -507 | 139 | 109 |
| Nonbank-reported claims -- liquid | -225 | 66 | -64 | 76 | n.a. |
| " " " other | -157 | -43 | | | |
| Foreign capital (excl. reserve trans.) | -2,241 | -110 | | | |
| Direct investment in U.S. | 92 | -24 | | | |
| U.S. corporate stocks | 78 | 1 | 10 | -11 | -4 |
| New U.S. direct investment issues | 317 | 264 | | | |
| Other U.S. securities (excl. U.S. Treas.) | 164 | -59 | | | |
| Liquid liabilities to: | -2,693 | -59 | -693 | 1,025 | -613 |
| Commercial banks abroad | -3,042 | -85 | -617 | 1,134 | -632 |
| Other private foreign | 78 | -148 | -118 | -86 | -59 |
| Intl. & regional institutions | 271 | 174 | 42 | -23 | 78 |
| Nonliquid liab. to banks and others | -199 | -233 | | | |
| Foreign official reserve claims | 4,856 | 5,047 | 4,806 | -1,515 | 2,229 |
| Liquid | 5,067 | 5,216 | 4,821 | -1,455 | 2,287 |
| Other | -211 | -169 | -15 | -60 | -58 |
| U.S. monetary reserves (increase, -) | 862 | 838 | 496 | 307 | 221 |
| Gold stock | 109 | 456 | 357 | 61 | 54 |
| Special drawing rights 3/ | 125 | 196 | 196 | -- | 100 |
| IMF gold tranche | 255 | 252 | 4 | 250 | -5 |
| Convertible currencies | 373 | -66 | -61 | -4 | 72 |
| Errors and omissions | -1,026 | -2,335 | | | |
| BALANCES (deficit -) 3/ | | | | | |
| Official settlements, S.A. | -5,718 | -5,885 | | | |
| " " , N.S.A. | -5,440 | -6,444 | -5,302 | 1,208 | -2,450 |
| Net Liquidity, S.A. | -2,728 | -5,930 | | | |
| " , N.S.A. | -2,604 | -6,572 | -4,064 | -330 | n.a. |
| Adjusted liquidity, S.A. 4/ | -3,025 | -5,826 | | | |
| " " , N.S.A. | -2,927 | -6,548 | -4,609 | 183 | -1,837 |

* Monthly, only exports and imports are seasonally adjusted.
1/ Equals "net exports" in the GNP, except for latest revisions.
2/ Balance of payments basis which differs a little from Census basis.
3/ Excludes allocation of $717 million of SDRs on 1/1/71.
4/ Measured by changes in U.S. monetary reserves, all liabilities to foreign official reserve agencies and liquid liabilities to commercial banks and other foreigners.

## THE ECONOMIC PICTURE IN DETAIL

### Domestic Nonfinancial Scene

Gross national product. GNP projections in this Greenbook are a revision and extension of those presented in the Supplement to the last Greenbook which incorporated our tentative conclusions with respect to the impacts of the President's new economic policies through the end of this year. Since many important aspects of the new policies remain uncertain, the projections require an unusually large number of major assumptions, particularly in regard to the post-freeze period.

We have assumed that Congress will enact the President's new proposals quickly and that the 90-day price freeze will be generally effective. Following the freeze, we expect that average wage rate increases will be kept to about 5 per cent annual rate and price increases to about 2 - 2-1/2 per cent. Some post-freeze catch-up is expected to accelerate increases in wages and prices temporarily in the first quarter of 1972. We have also assumed that the 10 per cent job development tax credit and the 10 per cent supplemental duty on imports, or equivalent foreign exchange rate adjustments, will remain effective throughout the projection period. With respect to monetary policy, we assume that interest rates will remain approximately at present levels through early 1972. Additional important assumptions involving fiscal implications are listed on the following page.

ASSUMPTIONS

The 7 per cent manufacturers excise tax on automobiles will be repealed retroactive to August 15, 1971.

Personal income tax exemptions will increase by $100, to $750 per individual on January 1, 1972.

Social Security benefits will be increased by 5 per cent on January 1, 1972, but without any other liberalization.

No minimum wage increase will go into effect until after July 1, 1972.

Welfare reforms and revenue sharing will be postponed until after July 1, 1972.

Regular Federal civilian and military pay increases will be postponed from January 1, 1972 to July 1, 1972.

The special military pay increase in connection with the volunteer army program will be postponed from October 1, 1971 to January 1, 1972.

Federal employment will be reduced by 5 per cent by June 30, 1972.

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Our reappraisal suggests the likelihood of a distinctly stronger tone to the economy over the next several quarters than was anticipated prior to the President's announcement. Many of the sectors which had remained relatively weak are now expected to grow at an accelerating rate. Improved consumer demand, particularly for autos, a higher rate of inventory investment, and--beginning early next year--an improvement in the net export position combined with a turnaround in capital spending, are expected to raise real GNP growth to an annual rate of about 7 per cent in the next three quarters--not usually high for a period of cyclical recovery.

GNP AND RELATED ITEMS 1971 - III THROUGH 1972 - II
(Changes in seasonally adjusted annual rates)

| | 1971 | | 1972 | |
|---|---|---|---|---|
| | Q III | Q IV | Q I | Q II |
| | -----Billions of Dollars------- | | | |
| GNP | 16.0 | 22.8 | 30.5 | 25.4 |
| Final sales | 17.9 | 21.1 | 28.3 | 20.6 |
| Personal consumption | 10.9 | 14.4 | 16.7 | 13.4 |
| Residential construction | 1.1 | 1.4 | 1.4 | .7 |
| Business fixed investment | 1.0 | - .2 | 1.7 | 2.5 |
| Net exports | - .5 | - | 1.5 | 1.5 |
| Federal purchases | 1.8 | 2.5 | 3.0 | - .5 |
| State & local purchases | 3.5 | 3.0 | 4.0 | 3.0 |
| Inventory change | -1.9 | 1.7 | 2.2 | 4.8 |
| | -------Per Cent Per Year------- | | | |
| Real GNP | 2.0 | 6.4 | 7.3 | 7.5 |
| GNP deflator | 4.0 | 2.2 | 3.9 | 1.6 |

Relatively little impact from these policy changes is likely to be evident in the current quarter. We now expect a GNP increase of only $16 billion almost $6-1/2 billion less than the rise last quarter.1/ This reflects in part a slower increase in prices as a result of the freeze, but the gain in real GNP is also expected to fall far short of that in the second quarter, 2.0 per cent as compared with 4.8 per cent.

1/ We have revised up second quarter GNP to reflect new figures which suggest a net export total of $-0.5 billion instead of $-2.2 billion. Commerce plans to make a similar adjustment.

However, the surge of auto sales in the last ten days of August and the first ten days of September suggests that the proposed elimination of the 7 per cent excise tax on new autos and the freeze on prices of 1972 models may already have had some effect. We expect a high rate of sales of domestic type autos to continue through September, with the average for the quarter at 8.6 million units. Substantial demand for foreign cars is also likely to be sustained temporarily by inventory clearances of autos exempt from the import surcharge. Nevertheless, total retail sales fell in July, and the rebound in August was modest outside of the auto sector. As a result, we still anticipate a significantly smaller gain in consumer expenditures in the third quarter than in the seoond.

Among other sectors, construction activity continues to post impressive gains. We now expect 2.1 million residential housing starts, annual rate, in the current quarter, about 150,000 more than last quarter. But relatively little evidence of strength has been evident elsewhere in the economy. The net exports situation is expected to show no imporvement in the current quarter. Capital outlays should rise only modestly and a decline of about $2 billion is expected in the rate of inventory investment largely as a result of the runoff of steel stocks.

The impact of the new economic program is projected to be more clearly evident in the fourth quarter. We expect an increase in current dollar GNP of $23 billion; in real terms this would be an annual rate of 6.4 per cent, as compared with 5.0 per cent we had projected in July, preceding the announcement of policy changes. Domestic auto sales are expected to continue at an advanced level, in small part at the expense of foreign models once the current inventory, not affected by the import surtax, is sold off. An annual sales rate of 9-1/4 million is anticipated for domestic cars, up from a projected rate of 8.6 million this quarter. Relative stability in prices should have a salutary effect on consumer attitudes generally, resulting in stronger real takings for other durables and nondurables as well. In total, consumer outlays are projected to rise by over 6 per cent in real terms, and the saving rate is projected to drop to around 7 per cent.

With improved business sentiment, the rate of inventory investment is also likely to rise in the fourth quarter accompanying a recovery in demand and the attainment of a better balance of steel stocks. However, the rather moderate production schedules announced for October and November, in conjunction with the high sales rate we foresee, suggests some rundown of auto stocks.

Even larger gains in GNP are projected for the first half of 1972--an average of about $28 billion per quarter, nearly 7-1/2 per cent, annual rate, in real terms.

Consumer demand is projected to continue up at a brisk pace with income benefitting from significantly larger employment increases and a series of fiscal stimuli: a $2.4 billion military pay increase and a $100 increase in personal income tax exemptions plus other liberalizations.

Business investment should also be gaining considerable strength through this period. Encouraged by improved sales and higher utilization rates, business is expected to take increasing advantage of the 10 per cent tax credit, with capital spending rising at an annual rate of about 8 per cent in current dollar terms during the first half. A substantial further rise in inventory investment should also accompany the increase in sales, with accumulation averaging about $10 billion a quarter, about double that during 1971. Residential construction activity is expected to continue at a high rate with housing starts leveling off at slightly over 2.1 million, and as a result of the surcharge and exchange rate adjustments, net exports of goods and services are expected to swing to a positive total of about $2 billion by the second quarter.

The higher rate of real growth which we are now projecting should mean a sizeable expansion of nonfarm employment--1.7 million in the next three quarters. The growth of the civilian labor force is also expected to accelerate, and the unemployment rate should drop moderately, to a 5-1/2 per cent rate in the second quarter.

We anticipate a substantial recovery in productivity gains, to almost 4 per cent, annual rate, to accompany improved output performance, and this should contribute significantly to the success of efforts to keep price increases in check. The rise in prices, as measured by the fixed weight GNP price index is expected to moderate to about a 2 - 2-1/2 per cent rate in the second quarter following the post-freeze catch up early in the year.

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

| | 1970 | 1971 Proj. | 1971 I | 1971 II | 1971 III (Projection) | 1971 IV (Projection) | 1972 I (Projection) | 1972 II (Projection) |
|---|---|---|---|---|---|---|---|---|
| Gross National Product | 974.1 | 1051.2 | 1020.8 | 1043.1r | 1059.1 | 1081.9 | 1112.4 | 1137.8 |
| Final purchases | 971.3 | 1046.7 | 1017.6 | 1037.4r | 1055.3 | 1076.4 | 1104.7 | 1125.3 |
| Private | 751.9 | 813.0 | 789.4 | 807.2r | 819.8 | 835.4 | 856.7 | 874.8 |
| Excluding net exports | 748.3 | 812.5 | 785.2 | 807.6 | 820.8 | 836.4 | 856.2 | 872.8 |
| Personal consumption expenditures | 615.8 | 665.9 | 644.6 | 660.9 | 671.8 | 686.2 | 702.9 | 716.3 |
| Durable goods | 88.6 | 101.9 | 97.6 | 100.8 | 103.0 | 106.0 | 109.4 | 111.9 |
| Nondurable goods | 264.7 | 281.2 | 272.0 | 279.8 | 283.0 | 290.0 | 298.0 | 303.5 |
| Services | 262.5 | 282.9 | 275.0 | 280.4 | 285.8 | 290.2 | 295.5 | 300.9 |
| Gross private domestic investment | 135.3 | 151.2 | 143.8 | 152.4 | 152.8 | 155.7 | 161.0 | 169.0 |
| Residential construction | 30.4 | 39.9 | 36.4 | 39.7 | 41.0 | 42.4 | 43.8 | 44.5 |
| Business fixed investment | 102.1 | 106.8 | 104.3 | 107.0 | 108.0 | 107.8 | 109.5 | 112.0 |
| Change in business inventories | 2.8 | 4.6 | 3.2 | 5.7 | 3.8 | 5.5 | 7.7 | 12.5 |
| Nonfarm | 2.5 | 4.1 | 3.0 | 5.2 | 3.0 | 5.0 | 7.5 | 12.5 |
| Net exports of goods and services | 3.6 | 0.4 | 4.2 | -0.5r | -1.0 | -1.0 | 0.5 | 2.0 |
| Exports | 62.9 | 66.5 | 66.1 | 66.4r | 66.9 | 66.5 | 71.0 | 72.7 |
| Imports | 59.3 | 66.1 | 61.9 | 66.9 | 67.9 | 67.5 | 70.5 | 70.7 |
| Gov't. purchases of goods & services | 219.4 | 233.7 | 228.2 | 230.2 | 235.5 | 241.0 | 248.0 | 250.5 |
| Federal | 97.2 | 97.5 | 96.7 | 95.7 | 97.5 | 100.0 | 103.0 | 102.5 |
| Defense | 75.4 | 72.0 | 73.0 | 71.8 | 71.5 | 71.5 | 73.5 | 73.5 |
| Other | 21.9 | 25.5 | 23.7 | 23.9 | 26.0 | 28.5 | 29.5 | 29.0 |
| State & local | 122.2 | 136.3 | 131.5 | 134.5 | 138.0 | 141.0 | 145.0 | 148.0 |
| Gross national product in constant (1958) dollars | 720.0 | 741.1 | 729.7 | 738.4r | 742.2 | 754.1 | 767.8 | 782.2 |
| GNP implicit deflator (1958 = 100) | 135.3 | 141.9 | 139.9 | 141.3 | 142.7 | 143.5 | 144.9 | 145.5 |
| Personal income | 803.6 | 858.7 | 834.3 | 854.8 | 866.5 | 879.3 | 900.2 | 916.7 |
| Wage and salary disbursements | 541.4 | 576.0 | 562.3 | 572.4 | 580.2 | 589.2 | 604.7 | 616.0 |
| Disposable income | 687.8 | 743.4 | 721.6 | 740.8 | 750.2 | 760.9 | 781.0 | 795.2 |
| Personal saving | 54.1 | 58.4 | 58.4 | 60.9 | 59.2 | 55.2 | 58.3 | 58.8 |
| Saving rate (per cent) | 7.9 | 7.9 | 8.1 | 8.2 | 7.9 | 7.3 | 7.5 | 7.4 |
| Corporate profits before tax | 75.4 | 82.9 | 79.1 | 83.3 | 82.5 | 86.5 | 92.5 | 98.0 |
| Corp. cash flow, net of div. (domestic) | 69.8 | 82.8 | 77.2 | 81.2 | 83.7 | 89.2 | 94.1 | 98.6 |
| Federal government receipts and expenditures (N.I.A. basis) | | | | | | | | |
| Receipts | 191.5 | 198.8 | 195.6 | 198.3 | 199.4 | 202.0 | 207.6 | 213.3 |
| Expenditures | 205.1 | 222.0 | 213.2 | 220.9 | 224.5 | 229.2 | 237.0 | 238.9 |
| Surplus or deficit (-) | -13.6 | -23.2 | -17.5 | -22.6 | -25.1 | -27.2 | -29.4 | -25.6 |
| High employment surplus or deficit (-) | 0.9 | 1.7 | 2.5 | 0.9 | 2.4 | 1.1 | -3.4 | -0.7 |
| Total labor force (millions) | 85.9 | 86.8 | 86.5 | 86.5 | 87.0 | 87.3 | 87.6 | 88.0 |
| Armed forces " | 3.2 | 2.8 | 3.0 | 2.8 | 2.8 | 2.7 | 2.6 | 2.5 |
| Civilian labor force " | 82.7 | 84.0 | 83.6 | 83.7 | 84.2 | 84.6 | 85.0 | 85.5 |
| Unemployment rate (per cent) | 4.9 | 6.0 | 5.9 | 6.0 | 6.1 | 6.0 | 5.8 | 5.5 |
| Nonfarm payroll employment (millions) | 70.6 | 70.7 | 70.4 | 70.7 | 70.6 | 71.0 | 71.6 | 72.3 |
| Manufacturing | 19.4 | 18.6 | 18.7 | 18.6 | 18.5 | 18.6 | 18.8 | 19.0 |
| Industrial production (1967=100) | 106.7 | 106.4 | 105.5 | 106.7 | 105.8 | 107.8 | 110.0 | 112.5 |
| Capacity utilization, manufacturing (per cent) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Housing starts, private (millions A.R.) | 1.43 | 2.00 | 1.81 | 1.96 | 2.11 | 2.13 | 2.13 | 2.13 |
| Sales new autos (millions, A.R.) | | | | | | | | |
| Domestic models | 7.12 | 8.63 | 8.39 | 8.29 | 8.60 | 9.25 | 9.25 | 9.25 |
| Foreign models | 1.23 | 1.58 | 1.50 | 1.57 | 1.75 | 1.50 | 1.40 | 1.30 |

NOTE: Projection of related items such as employment and industrial production index are based on projection of deflated GNP. Federal budget high employment surplus or deficit (N.I.A. basis) are staff estimates and projections by method suggested by Okun and Teeters.

n.a. - not available.

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CHANGES IN GROSS NATIONAL PRODUCT
AND RELATED ITEMS

| | 1970 | 1971 Proj. | 1971 I | 1971 II | 1971 III | 1971 IV (Projection) | 1972 I (Projection) | 1972 II (Projection) |
|---|---|---|---|---|---|---|---|---|
| | Billions Of Dollars | | | | | | | |
| Gross National Product | 45.0 | 77.1 | 32.4 | 22.3r | 16.0 | 22.7 | 30.6 | 25.4 |
| Inventory change | -4.6 | 1.8 | -0.5 | 2.5 | -1.9 | 1.7 | 2.2 | 4.8 |
| Final purchases | 49.6 | 75.4 | 32.9 | 19.8 | 17.9 | 21.1 | 28.3 | 20.6 |
| Private | 39.9 | 61.1 | 28.4 | 17.8 | 12.6 | 15.6 | 21.3 | 18.1 |
| Excluding net exports | 38.3 | 64.2 | 26.9 | 22.4 | 13.2 | 15.6 | 19.8 | 16.6 |
| Net exports | 1.6 | -3.2 | 1.5 | -4.7r | -0.5 | 0.0 | 1.5 | 1.5 |
| Government | 9.7 | 14.3 | 4.5 | 2.0 | 5.3 | 5.5 | 7.0 | 2.5 |
| GNP in constant (1958) dollars | -4.7 | 21.1 | 13.8 | 8.7 | 3.8 | 11.9 | 13.7 | 14.4 |
| Final purchases | -0.5 | 19.6 | 14.3 | 6.4 | 5.5 | 10.4 | 11.9 | 10.4 |
| Private | 5.7 | 20.3 | 15.0 | 6.9 | 3.7 | 8.3 | 11.1 | 9.5 |
| | In Per Cent Per Year | | | | | | | |
| Gross National Product | 4.8 | 7.9 | 13.8 1/ | 9.0r 1/ | 6.1 | 8.6 | 11.3 | 9.1 |
| Final purchases | 5.4 | 7.8 | 13.4 | 7.8 | 6.9 | 8.0 | 10.5 | 7.5 |
| Private | 5.6 | 8.1 | 14.9 | 9.0 | 6.2 | 7.6 | 10.2 | 8.5 |
| Personal consumption expenditures | 6.2 | 8.1 | 12.7 | 10.1 | 6.6 | 8.6 | 9.7 | 7.6 |
| Durable goods | -1.4 | 15.0 | 59.8 | 13.1 | 8.7 | 11.7 | 50.6 | -25.1 |
| Nondurable goods | 6.9 | 6.2 | 1.6 | 11.5 | 4.6 | 9.9 | 11.0 | 7.4 |
| Services | 8.4 | 7.8 | 9.1 | 7.9 | 7.7 | 6.2 | 7.3 | 7.3 |
| Gross private domestic investment | -1.8 | 11.8 | 18.9 | 23.9 | 1.0 | 7.6 | 13.6 | 19.9 |
| Residential construction | -4.4 | 31.3 | 43.9 | 36.3 | 13.1 | 13.7 | 13.2 | 6.4 |
| Business fixed investment | 3.5 | 4.6 | 13.9 | 10.4 | 3.7 | -0.7 | 6.3 | 9.1 |
| Gov't. purchases of goods & services | 4.6 | 6.5 | 8.0 | 3.5 | 9.2 | 9.3 | 11.6 | 4.0 |
| Federal | -2.0 | 0.3 | 3.3 | -4.1 | 7.5 | 10.3 | 12.0 | -1.9 |
| Defense | -3.8 | -4.5 | -1.1 | -6.6 | -1.7 | 0.0 | 11.2 | 0.0 |
| Other | 5.8 | 16.4 | 17.6 | 3.4 | 35.1 | 38.5 | 14.0 | -6.8 |
| State & local | 10.5 | 11.5 | 11.3 | 9.1 | 10.4 | 8.7 | 11.3 | 8.3 |
| GNP in constant (1958) dollars | -0.6 | 2.9 | 8.0 1/ | 4.8r 1/ | 2.1 | 6.4 | 7.3 | 7.5 |
| Final purchases | -0.1 | 2.7 | 8.0 | 3.5r | 3.0 | 5.6 | 6.4 | 5.4 |
| Private | 1.0 | 3.5 | 10.4 | 4.7r | 2.5 | 5.6 | 7.3 | 6.1 |
| GNP implicit deflator | 5.5 | 4.9 | 5.3 1/ | 4.0r 1/ | 4.1 | 2.2 | 3.9 | 1.6 |
| Private GNP fixed weight price index 2/ | 4.8 | | 5.6 1/ | 5.0 1/ | 4.0 | 1.9 | 3.2 | 2.5 |
| Personal income | 7.1 | 6.9 | 8.6 | 9.8 | 5.5 | 5.9 | 9.5 | 7.3 |
| Wage and salary disbursements | 6.2 | 6.4 | 11.0 | 7.2 | 5.5 | 6.2 | 10.5 | 7.5 |
| Disposable income | 8.5 | 8.1 | 11.5 | 10.6 | 5.1 | 5.7 | 10.6 | 7.3 |
| Corporate profits before tax | -10.5 | 9.9 | 41.9 | 21.2 | -3.8 | 19.4 | 27.7 | 23.8 |
| Federal government receipts and expenditures (N.I.A. basis) | | | | | | | | |
| Receipts | -2.7 | 3.8 | 13.3 | 5.5 | 2.2 | 5.2 | 11.1 | 11.0 |
| Expenditures | 8.2 | 8.2 | 6.5 | 14.4 | 6.5 | 8.4 | 13.6 | 3.2 |
| Nonfarm payroll employment | 0.5 | 0.1 | 1.8 | 1.3 | -0.4 | 2.3 | 3.4 | 3.9 |
| Manufacturing | -4.0 | -4.0 | 0.4 | -0.6 | -3.2 | 2.2 | 4.3 | 4.3 |
| Industrial production | -3.6 | -1.0 | 7.3 | 4.7 | -3.6 | 7.5 | 8.5 | 8.7 |
| Housing starts, private | -2.3 | 39.9 | 8.1 | 32.7 | 29.6 | 5.1 | 0.0 | 0.0 |
| Sales new autos | | | | | | | | |
| Domestic models | -15.9 | 21.2 | 216.1 | -4.7 | 15.1 | 30.2 | 0.0 | 0.0 |
| Foreign models | 16.0 | 28.5 | 60.2 | 18.1 | 46.5 | -57.1 | -26.7 | -28.6 |

1/ At compound rates.

2/ Using expenditures in 1967 as weights.

Industrial production. Industrial production declined 0.8 per cent further in August and at 105.1 per cent was 6.1 per cent below the 1969 high and 2.4 per cent above the low last November. Steel production was cut back very sharply in August, accounting for almost all of the decline in the total index. In the first 11 days of September, however, raw steel production increased 28 per cent from the low August average.

Auto assemblies, after allowance for the model changeover period, were at annual rate of 8.5 million units in August, the same as in July. Production schedules for September and preliminary plans for the fourth quarter indicate little change from the August rate. Output of room air conditioners, television sets, and some appliances was reduced in August. Production of business equipment declined slightly (-0.4 per cent) because of a 1.5 per cent reduction in industrial equipment. Output of defense and space equipment rose slightly.

INDUSTRIAL PRODUCTION
1967=100, seasonally adjusted

| | 1969 | 1971 | | | Per cent change | |
|---|---|---|---|---|---|---|
| | Sept 1/ | June | July | Aug | Sept 1969 to Aug 1971 | July 1971 to Aug 1971 |
| Total index | 111.9 | 107.0 | 106.0 | 105.1 | -6.1 | -.8 |
| Consumer goods | 112.3 | 115.9 | 115.8 | 115.5 | 2.8 | -.3 |
| Autos | 116.6 | 107.9 | 107.9 | 108.5 | -6.9 | .6 |
| Home goods | 111.6 | 112.7 | 113.1 | 110.8 | - .7 | -2.0 |
| Apparel & staples | 111.3 | 116.0 | 115.9 | 115.8 | 4.0 | -.1 |
| Business equipment | 110.3 | 95.0 | 95.4 | 95.0 | -13.9 | -.4 |
| Defense equipment | 102.1 | 76.6 | 76.6 | 77.0 | 24.6 | .5 |
| Intermediate products | 112.1 | 111.4 | 112.9 | 111.3 | - .7 | -1.4 |
| Construction products | 111.9 | 114.2 | 115.7 | 112.6 | .6 | -2.7 |
| Materials, total | 114.4 | 108.7 | 105.8 | 104.2 | -8.9 | -1.5 |
| Durable | 114.9 | 103.0 | 98.7 | 96.4 | -16.1 | -2.3 |
| Steel | 117.0 | 105.3 | 99.3 | 73.0 | -37.6 | 26.5 |
| Nondurable | 113.8 | 114.4 | 113.5 | 113.3 | - .4 | - .2 |

1/ Pre-recession peak of the total index.

Retail sales. Sales in August increased 1.7 per cent from July, with much of the additional strength in the automotive group following the mid-August announcement by the President of major policy changes. Sales of durable goods rose 3.4 per cent, largely reflecting a 4.5 per cent increase in the automotive group; furniture and appliance sales gained 0.8 per cent. Sales of nondurable goods increased almost 1 per cent, with general merchandise up about the same amount and mixed gains and losses in other major store types. Excluding the automotive group and nonconsumer items, sales in August were also up about 1 per cent.

Beginning in March, retail sales have moved sharply upward, and in August were 6.3 per cent above the level six months earlier. This gain far exceeds the rise in retail prices over that period, which amounted to about 2 per cent, and appears to represent the best sustained rate of increase in real terms since mid-1968.

RETAIL SALES, 1971
(Seasonally adjusted)

| | June | July | August | June | July | August |
|---|---|---|---|---|---|---|
| | (Millions of dollars) | | | (Per cent change) | | |
| Total retail | 33,310 | 33,029 | 33,576 | 1.9 | - .8 | 1.7 |
| Durable | 10,518 | 10,531 | 10,884 | 2.9 | .1 | 3.4 |
| Furniture & appliance | 1,487 | 1,450 | 1,461 | 4.1 | -2.5 | .8 |
| Automotive | 6,267 | 6,353 | 6,640 | 2.2 | 1.4 | 4.5 |
| Nondurable | 22,792 | 22,498 | 22,692 | 1.4 | -1.3 | .9 |
| Food | 7,121 | 7,167 | 7,144 | -1.3 | .6 | - .3 |
| General merchandise | 5,975 | 5,790 | 5,841 | 4.4 | -3.1 | .9 |
| Total, less auto & nonconsumer goods | 25,163 | 24,822 | 25,041 | 1.6 | -1.4 | .9 |
| Total real, deflated by all commodities CPI | 28,272 | 27,910 | n.a. | 1.4 | -1.3 | n.a. |

Unit auto sales and stocks. Sales of new domestic type autos in the last 10 days of August were at an annual rate of 9.5 million units and in the first 10 days of September were at an annual rate of 10 million; for the 20 days combined, sales were a fourth above a year earlier. For the month of August, sales were at an 8.5 million unit rate, about the same as the 8.4 million average in the first 8 months of 1971. During this period, most domestic producers either had cash discount programs on 1971 models or had sales incentive programs. Moreover, dealers were permitted to sell the new 1972 models, whereas in the corresponding interval of last year they were not allowed to sell the then new 1971 models.

August sales of foreign cars were in record volume. At an annual rate of 1.8 million units, they were up 43 per cent from a year earlier. Strength of import sales in August may have reflected an attempt to avoid the increased import surcharge which is not applicable to dealer inventories or to vehicles in sea transit by August 15. Foreign sales for the first 8 months of the year were at an annual rate of 1.6 million units.

The import share of the U. S. auto market amounted to 22 per cent in August compared with 18 per cent in July and also in August 1970. However, the rise in the import share over the past two summer months is partly seasonal as domestic type sales are relatively low in the period. Low priced vehicles accounted for most of the import increase, and their share of total sales in the U. S. market rose to 19 per cent from 15 per cent in both July and last August. The market share of domestic small cars was unchanged from last month at 21 per cent but was up from 16 per cent a year earlier.

Due to the earlier and more rapid production change-over for this new model year, seasonal factors for dealer inventories of domestic-type autos have been changed substantially back to April. With the new factors, stocks of domestic type cars were placed at a 61 days supply, up 2 per cent from last year (old seasonal factors) but down 1 per cent from July.

DISTRIBUTION OF U. S. AUTO SALES
(In percent 1/)

| | 1970 August | June | 1971 July | August 3/ |
|---|---|---|---|---|
| Domestic | | | | |
| Total | 82.5 | 83.9 | 81.9 | 78.3 |
| Large | 66.3 | 63.5 | 61.1 | 57.2 |
| Small 2/ | 16.2 | 20.4 | 20.8 | 21.1 |
| Imports | | | | |
| Total | 17.5 | 16.1 | 18.1 | 21.7 |
| Low-Priced | 15.0 | 13.7 | 15.6 | 18.6 |

1/ Based on not seasonally adjusted data.
2/ Compacts and sub-compacts.
3/ Preliminary.

DEALER INVENTORIES OF DOMESTIC TYPE AUTOS, 1971
Days Supply

| | Old Series | New Series |
|---|---|---|
| April | 57.5 | 57.5 |
| May | 56.6 | 58.2 |
| June | 57.5 | 61.8 |
| July | 55.4 | 62.4 |
| August | 72.5 | 61.2 |

Consumer credit. Comsumer instalment credit outstanding during July recorded the largest monthly advance in two years. At $9.1 billion, seasonally adjusted annual rate, the increase was still well below gains reported in most months of the first half of 1969 and the last half of 1968. But in the first half of this year, the increase averaged only $4.7 billion at an annual rate.

Extensions of instalment credit declined slightly in July for all types of credit except personal loans; repayments were lower in all categories, and, in total, were below any month since February. Automobile credit extensions virtually leveled off between March and July after a sharp rise in early months this year that was mainly associated with recovery in sales from last fall's strike. Extensions of nonautomotive consumer goods credit reached a new high of more than $40 billion (SAAR) in the second quarter and remained at an advanced level in July.

Two major factors account for a large part of the increase in nonautomotive consumer goods credit; bank credit card volume has continued to expand and shipments of mobile homes--the credit financing of which is in this category--are running well above year-earlier levels. A new series indicates that the average mobile home contract at commercial banks during June and July was close to $6,800, more than double the average new car loan of $3,200.

CONSUMER INSTALMENT CREDIT EXTENSIONS
(Billions of dollars, seasonally adjusted annual rate)

| | Total | Automobile | Other consumer goods | Personal loans |
|---|---|---|---|---|
| 1970 - QI | 102.2 | 30.0 | 35.5 | 34.6 |
| QII | 104.7 | 31.0 | 35.8 | 35.7 |
| QIII | 106.9 | 31.4 | 37.5 | 35.9 |
| QIV | 102.1 | 26.6 | 38.0 | 35.4 |
| 1971 - QI | 110.1 | 32.2 | 38.7 | 36.9 |
| QII | 116.6 | 33.9 | 40.6 | 39.7 |
| July | 116.1 | 33.3 | 40.8 | 39.4 |

Manufacturers' orders and shipments. New orders for durable goods increased 3.3 per cent in July, according to preliminary data. About half of the increase reflected a jump in defense orders, but excluding both defense and the primary metals group, the value of orders in July was 2 per cent above June and 4 per cent above the first-quarter average. Orders increased in July for motor vehicles and parts, which returned to the first-quarter level, and for the construction- and investment-related "all other" durables group which was 6 per cent above the first quarter. Capital equipment orders changed little at a level 4 per cent above the first-quarter average.

MANUFACTURERS' NEW ORDERS FOR DURABLE GOODS
Seasonally adjusted monthly averages

| | 1971 | | | | |
|---|---|---|---|---|---|
| | Q I (rev.) | Q II (rev.) | June (rev.) | July (prel.) | Change, July from June |
| | -------Billions of dollars-------- | | | | --Per Cent-- |
| Durable goods, total | 31.4 | 30.5 | 30.7 | 31.7 | 3.3 |
| Excluding primary metals | 26.1 | 25.8 | 26.1 | 27.2 | 4.0 |
| Excluding primary metals and defense | 24.1 | 24.2 | 24.5 | 25.0 | 2.2 |
| Primary metals | 5.3 | 4.7 | 4.5 | 4.5 | -.8 |
| Iron and steel | 2.7 | 2.1 | 1.9 | 2.1 | 9.5 |
| Motor vehicles and parts | 4.9 | 4.7 | 4.6 | 4.9 | 6.0 |
| Household durables | 2.3 | 2.4 | 2.3 | 2.3 | - |
| Defense products | 2.0 | 1.6 | 1.7 | 2.2 | 30.3 |
| Capital equipment | 7.8 | 7.9 | 8.2 | 8.2 | -.4 |
| All other durables | 9.0 | 9.2 | 9.3 | 9.6 | 3.2 |

NOTE: Detail may not add to total because of rounding.

Factory shipments of durable goods fell 2.4 per cent in July: defense products shipments dropped back from the unusually high June level, and shipments of primary metals other than iron and steel, of capital equipment, and of household durables also contributed to the decrease. Unfilled orders declined only 0.2 per cent, as the expected decline in primary metals backlogs was largely offset by increases among other major groups.

Inventories. Book value of manufacturing and trade inventories increased at a $5.0 billion annual rate in July, according to preliminary data. This was slightly higher than in June but was below the first and second quarter averages, in part because of the slowing of pre-contract metals stockpiling.

CHANGE IN BOOK VALUE OF BUSINESS INVENTORIES
(Seasonally adjusted annual rate, billions of dollars)

| | 1971 | | | |
|---|---|---|---|---|
| | Q I (rev.) | Q II (rev.) | June (rev.) | July (prel.) |
| Manufacturing and trade | 6.8 | 6.2 | 3.8 | 5.0 |
| Manufacturing, total | .1 | .1 | -1.3 | -2.1 |
| Durable | - .3 | -1.0 | -3.0 | -1.0 |
| Materials* | .9 | 1.3 | - .4 | - .1 |
| End products | -1.2 | -2.3 | -2.7 | - .8 |
| Nondurable | .4 | 1.2 | 1.7 | -1.2 |
| Trade, total | 6.7 | 6.0 | 5.2 | 7.2 |
| Wholesale | .7 | 2.2 | 2.3 | 5.8 |
| Metals & metalwork | .3 | .4 | .5 | .9 |
| Retail | 6.0 | 3.9 | 2.8 | 1.4 |
| Durable | 4.4 | 2.7 | 1.2 | .8 |
| Automotive | 5.0 | 2.8 | 2.6 | .6 |
| Nonautomotive | - .6 | - .1 | -1.4 | .2 |
| Nondurable | 1.6 | 1.1 | 1.7 | .6 |

NOTE: Detail may not add to total because of rounding.
* Including finished and in-process inventories of primary metals manufacturers.

Manufacturers' stocks declined at a $2 billion rate in July as durable materials holdings were little changed and other inventories, both durable and nondurable, declined. When surveyed in July and early August, manufacturers anticipated building stocks at a $1.6 billion rate for the third quarter as a whole, and accelerating to a $4.8 billion rate in the fourth quarter. Attainment of the anticipated third quarter rate (if the July figures are not revised) would require a rate of increase of $3.5 billion in August and September. This would probably have to take place outside the durable materials sector, since steel stocks are expected to be worked down from a July level which was relatively high, even by comparison with other pre-contract periods.

While manufacturers' stocks were declining, trade stocks increased at a $7.2 billion rate--mainly at wholesale, especially automotive goods and metals dealers.

Sales declined in July and the business inventory-sales ratio rose, returning to the May level--which was still well below a year earlier. The inventory-unfilled orders ratio for durable goods manufacturing was unchanged from the high June level.

INVENTORY RATIOS

| | 1970 | | 1971 | |
|---|---|---|---|---|
| | June (rev.) | July (rev.) | June (rev.) | July (prel.) |
| Inventories to sales: | | | | |
| Manufacturing & trade | 1.58 | 1.59 | 1.52 | 1.54 |
| Manufacturing, total | 1.78 | 1.79 | 1.70 | 1.73 |
| Durable | 2.13 | 2.14 | 1.99 | 2.03 |
| Nondurable | 1.36 | 1.37 | 1.36 | 1.35 |
| Trade, total | 1.36 | 1.37 | 1.33 | 1.36 |
| Wholesale | 1.22 | 1.23 | 1.20 | 1.23 |
| Retail | 1.46 | 1.46 | 1.42 | 1.44 |
| Durable | 2.08 | 2.08 | 1.98 | 1.98 |
| Automotive | 1.72 | 1.73 | 1.68 | 1.66 |
| Nonautomotive | 2.58 | 2.57 | 2.42 | 2.47 |
| Nondurable | 1.18 | 1.19 | 1.17 | 1.18 |
| Inventories to unfilled orders: | | | | |
| Durable manufacturing | .799 | .806 | .867 | .868 |

Cyclical indicators. The preliminary Census composite leading indicator rose 1.4 per cent in July. The June change is now reported as a decline of 0.1 per cent, instead of the 0.5 per cent decline indicated by the preliminary index. Series improving in July were initial claims for unemployment insurance, new orders for durable goods, housing permits, and the ratio of price to unit labor cost. Series declining were the manufacturing workweek, contracts and orders for plant and equipment, industrial materials prices, and common stock prices, with all declines relatively small.

The coincident composite declined 1.3 per cent and the lagging composite declined 0.8 per cent.

COMPOSITE CYCLICAL INDICATORS
(1967=100)

| | | 12 Leading Trend Adjusted | 5 Coincident | 6 Lagging |
|---|---|---|---|---|
| 1971: | January | 118.6 | 121.3 | 125.7 |
| | February | 119.6 | 122.2 | 124.0 |
| | March | 122.2 | 122.7 | 124.5 |
| | April | 123.9 | 123.4 | 123.7 |
| | May | 124.8 | 124.2 | 123.3 |
| | June | 124.7 | 126.1 | 123.9 |
| | July (prel.) | 126.5 | 124.4 | 122.9 |

Construction and real estate. Seasonally adjusted expenditures for new construction edged higher in August and, at an annual rate of $105.0 billion, slightly exceeded the previous record reached last June. Outlays for private residential construction--still the dominant factor in the over-all advance--continued upward for the thirteenth consecutive month, to a rate 50 per cent above the low in July of last year. Expenditures for private nonresidential construction in August remained somewhat below the peak registered last June when outlays for commercial buildings, hospitals and some other types of structures had been particularly strong. Outlays for public construction in August appeared to be holding at about the relatively advance second quarter rate, although they were also down from earlier highs this year.

Just before the President's general "wage-price" freeze, construction costs, as measured by the Census Bureau's composite cost index, were advancing at a pace very near the 9 per cent annual rate last year. As a result, higher costs in August accounted for almost half of the year-to-year rise in current dollar outlays. Except for the residential sector, in fact, higher costs continued to account for all of the year-to-year rise in current dollar terms.

NEW CONSTRUCTION PUT IN PLACE
(Seasonally adjusted annual rate)

| | All | Private | | | Public |
|---|---|---|---|---|---|
| | | Total | Residential | Non-residential | |
| | | | Billions of dollars | | |
| 1970 - Annual | 91.3 | 63.1 | 29.3 | 33.8 | 28.3 |
| 1970 - IVQ | 94.8 | 65.3 | 31.9 | 33.4 | 29.5 |
| 1971 IQ (r) | 101.3 | 70.7 | 35.4 | 35.3 | 30.6 |
| IIQ (r) | 104.2 | 74.7 | 38.7 | 36.0 | 29.5 |
| 1971 | | | | | |
| June (r) | 104.8 | 75.6 | 39.0 | 36.6 | 29.3 |
| July (r) | 104.1 | 74.3 | 39.3 | 35.0 | 29.8 |
| August (p) 1/ | 105.0 | 75.5 | 40.4 | 35.1 | 29.5 |
| | | Per cent change in August from a year earlier | | | |
| In current dollars | +17 | +23 | +47 | +3 | +4 |
| In 1957-59 dollars | +9 | +14 | +36 | -5 | -3 |

1/ Data for the most recent month (August) are confidential Census Bureau extrapolations. In no case should public reference be made to them.

In view of the exceptional pace of housing starts so far this year, concern about the possibility of "overbuilding" has already begun to be expressed in some quarters. As reported earlier, however, residential vacancy rates through the second quarter had generally remained quite low. Also, while the mix of sales was apparently shifting toward lower-cost units again in July--the latest month for which data are available[1/]--the seasonally adjusted rate of new homes sold by speculative builders reached a record high. Although builders' stocks of such homes increased further in July, they remained comparatively low in relation to sales even after allowance for the volatility of the sales series. Sales of used homes also showed appreciable strength in July, according to the National Association of Real Estate Boards, at a median price of $25,400--7 per cent more than in July of last year. In the case of apartments, 68 per cent of all new privately financed apartment-units finished in the first quarter of this year were occupied within three months after completion, at a median asking rent of $183 per month, according to the Census Bureau. This contrasted with a 65 per cent absorption rate for comparable apartments in the fourth quarter of last year when--because of a greater incidence of luxury-units in the mix of completions--the monthly rental required was $192.

1/ Confidential until release this Thursday.

NEW SINGLE FAMILY HOMES SOLD AND FOR SALE

| | Homes sold[1/] | Homes for sale[2/] | Median price of: Homes sold | Median price of: Homes for sale |
|---|---|---|---|---|
| | (Thousands of units) | | (Thousands of dollars) | |
| 1969 - Annual | 448 | 228 | 25.6 | 27.0 |
| 1970 | 485 | 227 | 23.4 | 26.2 |
| IIQ | 457 | 219 | 24.4 | 27.0 |
| IIIQ | 518 | 215 | 23.0 | 27.1 |
| IVQ | 571 | 227 | 22.6 | 26.2 |
| 1971 | | | | |
| IQ | 661 | 220 | 24.3 | 26.1 |
| IIQ | 628 | 245 | 25.8 | 26.4 |
| 1971 | | | | |
| April | 661 | 224 | 25.8 | 26.5 |
| May | 595 | 232 | 25.5 | 26.5 |
| June | 629 | 245 | 26.1 | 26.4 |
| July[3/] | 717 | 250 | 25.0 | 26.7 |

1/ SAAR.
2/ SAAR, end of period.
3/ Data for July confidential until release this Thursday.

Anticipated expenditures for new plant and equipment. The August Commerce-SEC survey indicates that business plans a 2.2 per cent increase in 1971 spending for new plant and equipment. (The survey was completed before the President's statement of August 15.) This is a slight downward revision from the 2.7 per cent gain reported in the May survey.

The downward revision is attributable to manufacturers who now plan to reduce outlays by 5.8 per cent rather than the 4.2 per cent reported earlier. Within manufacturing, large downward revisions were reported in the primary iron and steel, nonelectrical machinery, aircraft, stone, clay, and glass, and paper industries. Nonmanufacturing, as a whole, indicates a 7.5 per cent gain for the year--up slightly from earlier reported expectations.

The overall investment picture for 1971 is one of relatively widespread weakness in manufacturing with only the textile, petroleum, other durable goods, and other nondurable goods industries expecting to increase outlays this year. The strength in investment is in the nonmanufacturing sector where electric utilities, communications, mining, and commercial and other firms plan large increases over last year's spending.

Actual spending in the second quarter was about $800 million less than anticipated with the shortfall concentrated in durable goods manufacturing--especially primary iron and steel, electrical and nonelectrical machinery, and motor vehicles. Some rise is expected in the third quarter due to a sharp increase in electric utility and commercial and other spending. In the fourth quarter, the slight pick-up expected in manufacturing spending is just offset by a projected drop in nonmanufacturing.

PLANT AND EQUIPMENT EXPENDITURES
(Per cent change from prior year)

| | 1969 Actual | 1970 Actual | 1971 Plans Dec. '70 | Feb. | May | Aug. |
|---|---|---|---|---|---|---|
| Total | 11.5 | 5.5 | 1.4 | 4.3 | 2.7 | 2.2 |
| Manufacturing | 11.7 | .9 | -2.7 | - .3 | -4.2 | -5.8 |
| Durable goods | 13.0 | -1.0 | -3.1 | -2.5 | -7.2 | -9.4 |
| Nondurable goods | 10.3 | 2.7 | -2.4 | 1.9 | -1.4 | -2.2 |
| Nonmanufacturing 1/ | 11.4 | 8.8 | 4.1 | 7.4 | 7.3 | 7.5 |
| Railroads | 28.3 | -4.3 | -14.8 | 2.3 | -2.8 | -7.9 |
| Other transportation | 1.0 | 1.7 | -17.7 | -12.0 | -23.2 | -25.8 |
| Public utilities 1/ | 13.8 | 13.2 | 14.3 | 17.5 | 16.6 | 18.1 |
| Electric | 16.7 | 19.1 | 18.7 | 22.4 | 21.0 | 23.2 |
| Communications | 21.5 | 21.7 | 14.0 2/ | 10.3 2/ | 11.2 2/ | 8.8 2/ |
| Commercial and other | 6.0 | 3.4 | -2.0 2/ | 3.8 2/ | 6.8 2/ | 8.1 2/ |

1/ Includes series not shown separately.
2/ Confidential, not published separately.

The latest Conference Board survey of manufacturers' capital appropriations suggests continued weakness through the remainder of 1971. (This survey also was largely completed prior to August 15.) Appropriations were reduced about 6 per cent in the second quarter--the seventh such reduction in the last eight quarters--and expenditures and backlogs also declined.

QUARTERLY PATTERN OF EXPENDITURES FOR
NEW PLANT AND EQUIPMENT
(Billions of dollars, seasonally adjusted
annual rates)

| | 1970 | | 1971 | | | |
|---|---|---|---|---|---|---|
| | III | IV | I | II | III | IV |
| | (Actual) | | (Actual) | | (Anticipated) | |
| Total | 81.9 | 78.6 | 79.3 | 81.6 | 82.4 | 82.4 |
| Addendum: Totals as shown in May 1971 survey | 81.9 | 78.6 | 79.3 | 82.4 | 82.8 | 82.7 |
| Manufacturing | 32.2 | 31.0 | 30.5 | 30.1 | 29.7 | 30.2 |
| Durable goods | 15.7 | 14.9 | 14.2 | 14.1 | 14.5 | 14.5 |
| Nondurable goods | 16.4 | 16.1 | 16.3 | 16.1 | 15.2 | 15.8 |
| Nonmanufacturing 1/ | 49.7 | 47.7 | 48.9 | 51.5 | 52.6 | 52.2 |
| Railroads | 2.0 | 1.6 | 1.5 | 1.9 | 1.8 | 1.5 |
| Other transportation | 4.5 | 4.3 | 2.6 | 3.7 | 2.9 | 3.4 |
| Public utilities 1/ | 13.8 | 13.7 | 14.6 | 14.9 | 16.1 | 16.4 |
| Electric | 11.3 | 11.2 | 12.2 | 12.6 | 13.7 | 13.8 |
| Communications | 10.6 | 10.2 | 10.7 | 11.2 | 11.2 2/ | 10.9 2/ |
| Commercial and other | 17.0 | 16.0 | 17.4 | 17.7 | 18.6 2/ | 18.0 2/ |

1/ Includes series not shown separately.
2/ Confidential, not published separately.

MANUFACTURERS' NEW CAPITAL APPROPRIATIONS
(Seasonally adjusted, quarterly rates)

| | 1971 | 1970 | | | | 1971 | |
|---|---|---|---|---|---|---|---|
| | II p | I | II | III | IV | I r | II p |
| | Millions of $ | Per Cent Change from Preceding Quarter | | | | | |
| All manufacturing | 5,432 | -13.4 | -1.1 | 1.6 | -9.3 | -4.0 | -5.7 |
| Durable goods | 2,514 | -10.6 | -2.2 | 3.8 | -18.9 | .2 | -7.4 |
| Nondurable goods | 2,918 | -15.9 | .0 | - .5 | .5 | -7.5 | -4.1 |

SOURCE: Conference Board.

Labor market. The labor market has been relatively weak for several months. The unemployment rate rose by 0.3 percentage points in August to 6.1 per cent, with widespread increases for most groups except prime age job seekers (25-54 years). As was anticipated, seasonal forces which led to a sharp decline in the June rate proved temporary. Thus, the unemployment rate in August was the same as in April and only 0.1 percentage point below the high of last May. Nonfarm payroll employment was little changed in August but down 200,000 from May.

The unemployment rate for males of prime working age--the group least affected by seasonal fluctuations--was 3.6 per cent in August about the same as the rate prevailing since the beginning of the year. Looked at by type of occupation, joblessness among white-collar workers remained virtually unchanged in August, while the rate for blue-collar workers jumped 0.5 percentage points to 7.6 per cent largely reflects the layoff of steel workers following contract settlements at the end of July. Both the white-collar and blue-collar rates are 0.7 points higher than a year ago.

The civilian labor force rose sharply in August. In the last two months the labor force has grown by almost 1.2 million, but this followed a decline of over 1 million in June. Compared to a year ago the civilian labor force is up by over 1.5 million and the total labor force by 1.2 million--in both cases a somewhat smaller amount of growth than might be expected from population growth and projected participation rates.

SELECTED UNEMPLOYMENT RATES
(Per cent, seasonally adjusted)

| | 1970 | 1971 | | |
|---|---|---|---|---|
| | August | April | July | August |
| Total | 5.1 | 6.1 | 5.8 | 6.1 |
| Men aged: | | | | |
| 20 to 24 years | 8.7 | 10.5 | 10.1 | 10.5 |
| 25 and over | 3.0 | 3.5 | 3.4 | 3.6 |
| Women, aged 20 and over | 4.8 | 6.0 | 5.7 | 5.8 |
| Teenagers | 15.8 | 17.2 | 16.2 | 17.0 |
| White-collar | 2.8 | 3.8 | 3.6 | 3.5 |
| Blue-collar | 6.9 | 7.4 | 7.1 | 7.6 |
| White | 4.8 | 5.6 | 5.3 | 5.6 |
| Negro | 8.4 | 10.0 | 10.1 | 9.8 |

Nonfarm payroll employment failed to increase in August and has shown very little growth over the past year. Manufacturing employment dropped 30,000 further in August and the average factory workweek also edged down 0.1 hours--reflecting, in part, curtailments in steel production. Over the past year the manufacturing work force has declined by about 700,000 and is 1.8 million below the peak reached in July 1969. Employment has continued to rise in trade and services, but at a much slower rate than earlier. Gains in State and local government have also moderated.

Earnings. Although the overall rate of increase in wages continued high prior to the wage freeze, the growth rate of average hourly earnings of production workers on private nonfarm payrolls in July and August was somewhat below the rates posted in the first half

NONFARM PAYROLL EMPLOYMENT, AUGUST 1971
(Seasonally adjusted, in thousands)

| | Change from: | | |
|---|---|---|---|
| | August 1970* | May 1971 | July 1971 |
| Total | 131 | -217 | -14 |
| Goods-producing | -809 | -275 | -33 |
| Manufacturing | -702 | -201 | -29 |
| Mining | -10 | -12 | 11 |
| Construction | -97 | -62 | -15 |
| Service-producing | 940 | 58 | 19 |
| Transportation & P. U. | -71 | -65 | -24 |
| Trade | 274 | 35 | 33 |
| Finance and services | 386 | 52 | -10 |
| Government | 351 | 36 | 20 |
| Federal | 3 | -29 | -5 |
| State and local | 348 | 65 | 25 |

* Not seasonally adjusted.

of the year. Much of the slowing in the rate of increase occurred in manufacturing. Overtime declined, and the growth of straight time earnings in manufacturing (adjusted for inter-industry shifts), also has edged downward steadily since the beginning of the year. But outside of manufacturing there has been little indication of easing except in services.

AVERAGE HOURLY EARNINGS OF PRODUCTION
AND NONSUPERVISORY WORKERS
(Per cent change from year earlier;
not seasonally adjusted)

| | 1970 | | 1971 | | |
|---|---|---|---|---|---|
| | III | IV | I | II | July-August |
| Private nonfarm | 6.2 | 5.6 | 6.4 | 6.7 | 5.9 |
| Manufacturing | 5.5 | 4.4 | 6.5 | 6.4 | 5.9 |
| Adjusted for overtime and inter-industry shifts | 6.6 | 6.4 | 7.1 | 6.8 | 6.5 |
| Mining | 6.5 | 6.6 | 5.9 | 6.2 | 6.1 |
| Construction | 9.8 | 9.1 | 9.0 | 9.4 | 8.5 |
| Transportation & P. U. | 6.2 | 6.6 | 7.6 | 7.4 | 7.3 |
| Trade | 6.2 | 5.5 | 5.9 | 6.2 | 5.7 |
| Finance | 5.2 | 5.6 | 6.0 | 7.7 | 7.3 |
| Services | 7.9 | 8.0 | 7.7 | 7.2 | 6.0 |

Industrial relations. The 90-day wage-price freeze effective August 16 will affect contract renegotiations in a number of key industries. In the construction industry apparently relatively few of the 480,000 workers covered by major contracts expiring this year had been renegotiated and submitted for approval to the Construction Industry Stabilization Committee before the freeze. Also underway at the time of the freeze was the West Coast shipping strike.

Major contracts covering workers at Atlantic and Gulf Coast ports, in bituminous coal, aerospace, the smaller steel companies and various machinery industries also expire in September. In all, about 420,000 workers are covered by contracts expiring in September, and in October another 230,000 workers, mainly in aerospace, steel and glass industries, will be renegotiating contracts. Wage increases (excluding cost-of-living adjustments) that would have been effective during the period of the wage freeze include 5 per cent for about 400,000 railroad workers, about 3 per cent for 640,000 postal workers, nearly 7 per cent for 60,000 meatpacking workers, and 5 per cent for 50,000 teamsters in Chicago. Cost-of-living wage adjustments affected by the freeze included adjustments for about 200,000 electrical equipment workers at G.E. and Westinghouse and 50,000 Chicago truckers due in October. Annual improvement factor and cost-of-living adjustments for auto and related workers fall after the 90-day freeze--in late November and early December.

Wholesale prices. Wholesale prices rose at a seasonally adjusted annual rate of 9.0 per cent from July to August, reflecting large increases for both industrial commodities and farm and food products. Practically all commodities were priced before the President's wage-price stabilization program was announced.

WHOLESALE PRICES
(Percentage changes, seasonally adjusted annual rates)

| | June '70 to Dec. '70 | Dec. '70 to Mar. '71 | Mar. '71 to June '71 | June '71 to July '71 | July '71 to Aug. '71 |
|---|---|---|---|---|---|
| All commodities | 2.2 | 5.4 | 4.7 | 2.4 | 9.0 |
| Farm and food 1/ | - .4 | 11.3 | 3.2 | -11.9 | 18.4 |
| Industrial commodities | 3.4 | 2.9 | 5.3 | 8.8 | 6.6 |
| Crude materials 2/ | .8 | 2.4 | 7.1 | 6.0 | -3.8 |
| Intermediate materials 2/ | 1.8 | 4.0 | 6.9 | 9.9 | 10.9 |
| Finished goods 2/ | 5.4 | 2.8 | 1.9 | 4.7 | 3.6 |
| Producer | 6.0 | 3.9 | 2.8 | 3.1 | 6.3 |
| Consumer | 5.1 | 2.2 | 1.5 | 5.5 | 2.2 |

1/ Farm products, and processed foods and feeds.
2/ Excludes food.

The rate of increase in industrial commodity prices has accelerated sharply in the last few months; increases over the last three months and the last six months were the largest in the current inflation. Intermediate products increases have been substantially larger than those of finished products.

In August, increases for metals and metal products and lumber and wood products accounted for about two-thirds of the increase in industrial commodities. The first stage of price increase recently set by the steel industry became effective on August 5 and containers, fabricated products and non-ferrous metals also rose. The textile products group also moved up again as prices of cotton and manmade fiber textiles and men's and boy's apparel increased substantially.

Seasonally-adjusted prices of farm and food products increased sharply following last month's decline as prices of fresh and dried fruits and vegetables rose contra-seasonally, reversing their dramatic decline in July, and eggs rose nearly one-fourth in price. Meats, poultry, and fish declined, but less than seasonally. Grains, however, declined more than seasonally on prospects of a bumper crop.

# THE ECONOMIC PICTURE IN DETAIL

## Domestic Financial Situation

Monetary aggregates. Growth in the narrowly defined money stock ($M_1$) dropped sharply during August to an annual rate of about 3.0 per cent. Some slowdown had been anticipated, with the amount of money demanded expected to moderate in lagged response both to the earlier higher level of market interest rates and the greatly increased public holdings of liquid assets, but the falloff--for reasons that are not yet clear--was more abrupt than expected. While no firm evidence is available, it is possible that the massive shifts by private holders out of dollars and the subsequent purchases of special Treasury issues by foreign central banks both before and after the President's mid-month announcements were a contributing factor. Indeed, the outflow of dollars during August was so large that even if only a small part had been held previously in demand balances rather than in interest-bearing assets, the impact on the rate of expansion in $M_1$ could have been significant. Growth in $M_1$ has continued slowly in early September, however, even though dollar outflows have diminished sharply. Thus, even if such outflows did contribute to the slow growth in $M_1$ during August, other factors also would appear to have been at work.

Expansion in $M_2$ also slowed during August, to a rate of about 5.0 per cent from about 7.0 per cent in July. This slowdown is accounted for by the reduced growth in $M_1$, with time and savings deposits other than large CD's expanding at a somewhat more rapid pace than during July.

MONETARY AGGREGATES
(Per cent changes, seasonally adjusted annual rates)

| | 1970 QIV | 1971 QI | 1971 QII | 1971 July | 1971 Aug. |
|---|---|---|---|---|---|
| 1. $M_1$ (Currency plus private demand deposits) | 3.4 | 8.9 | 11.3 | 10.1 | 3.2 p |
| 2. $M_2$ ($M_1$ plus commercial bank time and savings deposits other than large CD's) | 9.2 | 17.8 | 12.6 | 7.2 | 5.0 p |
| 3. $M_3$ ($M_2$ plus savings deposits at mutual savings banks and S&L's) | 9.7 | 19.0 | 14.8 | 10.1 | 7.2 p |
| 4. Adjusted bank credit proxy | 8.3 | 10.9 | 6.5 | 8.0 | 10.7 p |
| 5. Other aggregates | | | | | |
| a) Total time and savings deposits | 21.8 | 27.3 | 13.5 | 11.3 | 6.5 p |
| b) Time and savings deposits other than large CD's | 15.4 | 27.2 | 13.7 | 4.3 | 6.9 p |
| Memo: Average monthly change in: | | Millions of dollars | | | |
| a) Negotiable CD's (SA) | 1,437 | 606 | 242 | 1,579 | 172 p |
| b) U.S. Government deposits at Member Banks (SA) | -24 | -469 | -283 | -208 | 2,365 p |

p - Preliminary.

Despite the small pickup in the growth rate for these time and savings deposits, the expansion was still much less rapid than during the first and second quarters of the year. $M_3$ also increased less during August than during July with growth in nonbank thrift institution deposits, as well as $M_2$, slackening somewhat during the period.

The volume of large CD's outstanding at commercial banks increased moderately on a seasonally adjusted basis during August, following a large increase during July. Despite a sharp expansion in business loans, banks' willingness to bid for time deposits was reduced as the month progressed by the large increases in Treasury deposits that resulted from foreign central bank purchases of special Treasury issues with dollars absorbed during the exchange crisis. As a result, CD offering rates dropped following the President's termination of the gold-dollar link and continued to move downward until late in the month. With other private deposit inflows remaining low and large amounts of CD's scheduled to mature over the forthcoming tax date, offering rates again were bid up somewhat in early September. However, this resulted in little increase in the amounts outstanding.

The large increase in U.S. Government deposits was reflected in the adjusted credit proxy which expanded at an annual rate of 10.5 per cent during August. This increase over the rates of recent months occurred despite the slowdowns in the demand deposit and CD components and a drop of almost $400 million on average in liabilities to foreign branches.

Bank credit. End-of-month commercial bank credit, like the adjusted credit proxy, showed an increased rate of growth during August, rising at an annual rate of 13.0 per cent, almost double the rate for July. All the growth took place in loans, as bank holdings of both U.S. Government and other securities edged off. The decline in holdings of other securities, mainly tax-exempts, was the first in 18 months and was centered at large banks, although holdings were weaker than seasonal at smaller banks as well. Net sales of Treasury issues also were concentrated at larger banks and reflected the liquidation of both low-yielding bills and longer-term securities as well.

COMMERCIAL BANK CREDIT ADJUSTED FOR LOANS
SOLD TO AFFILIATES 1/
(Seasonally adjusted percentage changes, at annual rates)

| | 1970 | 1971 | | | | |
|---|---|---|---|---|---|---|
| | 2nd half | 1st half | QI | QII | July | August |
| Total loans & investments 2/ | 11.4 | 10.0 | 12.2 | 7.4 | 7.6 | 13.0 |
| U.S. Treasury securities | 16.3 | 15.7 | 19.8 | 11.1 | -20.9 | -3.9 |
| Other securities | 29.3 | 22.3 | 27.9 | 15.7 | 18.7 | -3.7 |
| Total loans | 5.6 | 5.2 | 6.3 | 4.2 | 10.0 | 21.8 |
| Business loans 3/ | -1.6 | 1.8 | 1.4 | 2.5 | 11.7 | 29.4 |
| Real estate loans | 4.8 | 9.4 | 8.3 | 10.3 | 12.8 | 11.1 |

1/ Last Wednesday of month series. Data for 1971 are preliminary.
2/ Includes outstanding amounts of loans reported sold outright by banks to their own holding companies, affiliates, subsidiaries, and foreign branches.
3/ Includes outstanding amounts of business loans reported sold outright by banks to their own holding companies, affiliates, subsidiaries, and foreign branches.

The strength in loans during August was concentrated primarily in business, real estate and security loans, although all types of loans showed at least some increase. The expansion in real estate loans extended for another month the string of large increases that began to develop late in 1970, while the sharp increase in security loans was the first recorded this year. The rise in security loans was primarily against issues other than direct Treasury obligations, and probably reflects aggressive pricing by corporate and municipal dealers of recent new issues--and the consequent lag in their distribution--as well as an increase in dealer inventories in anticipation of a continued decline in rates in the immediate future.

Business loans were by far the strongest component in the expansion of bank credit during August, growing at an annual rate of almost 30 per cent, the highest rate for any month since the mid-1950's. This extremely rapid expansion probably is attributable in large part to borrowing both by foreign and domestic corporations associated with the foreign exchange developments during the month.[1/] This is suggested both by statistical evidence and by Reserve Bank conversations with commercial banks, and there seems to be little basis in the real sector for expecting a large increase in domestic business borrowing for other purposes. It should be noted, however, that this assessment may over-emphasize the influence of foreign-related demands for loans, and that some of the August increase in business loans, as well as the relatively rapid expansion of such loans in July, reflects the emergence, after a year of essentially no growth, of stronger business loan demand.

Nonbank depositary institutions. Deposit inflows to the non-bank thrift institutions declined further during August. Because of difficulties with seasonal adjustment that have affected both July and August, however, combining the data for both months probably provides a better measure of recent experience. The combined figure shows a modera-

1/ Most of the foreign borrowing was by Japanese corporations. Japanese banks also were very large borrowers during the month, as reflected in the rise of almost $1 billion in loans to foreign commercial banks at weekly reporting banks. Such borrowing is not included in the end-of-month bank credit data, which are computed, as in the call report, net of loans to both domestic and foreign banks. Some of this large increase in loans to foreign banks was reversed in early September.

tion in inflows from the second quarter pace far less pronounced than that suggested by the August figures taken alone. Evidence on deposit behavior in early September is still very limited, but flows to the sample of large New York City mutual savings banks suggest a continuation of the more moderate pace observed during July-August.

DEPOSIT GROWTH AT NONBANK THRIFT INSTITUTIONS
(Seasonally adjusted annual rates, in per cent)

| | Mutual Savings Banks | Savings and Loan Associations | Both |
|---|---|---|---|
| 1970 - QI | 2.7 | 2.3 | 2.5 |
| QII | 6.4 | 7.2 | 7.0 |
| QIII | 6.9 | 10.6 | 9.3 |
| QIV | 10.5 | 12.1 | 11.6 |
| 1971 - QI | 17.7 | 26.0 | 23.3 |
| QII p/ | 15.0 | 18.4 | 17.3 |
| 1970 - 2nd half | 8.8 | 11.5 | 10.6 |
| 1971 - 1st half p/ | 16.7 | 22.8 | 20.8 |
| May* | 12.7 | 15.1 | 14.3 |
| June | 12.9 | 16.1 | 15.1 |
| July* p/ | 8.8 | 19.0 | 15.8 |
| August * p/ | 6.6 | 9.3 | 8.4 |
| July and August | 7.7 | 14.2 | 12.1 |

* Monthly patterns may not be significant because of difficulties with seasonal adjustment.

p/ Preliminary. August is based on sample data.

The moderation in deposit growth in recent months had been associated with the rise in alternative market yields that had developed before the mid-August wage and price freeze. So far, there is little evidence as to the possible impact on deposit growth of the freeze and the coincident drop in market yields. The few data available on intra-monthly patterns reveal no significant difference from past years. But effects of the drop in market yields may have been offset by what appears to have been an increase in consumer spending during the latter half of August and the first part of September.

Savings and loan associations borrowed a modest net amount from the FHLB Banks during August as they had in July. Although complete data for August are not yet available, this borrowing does not seem to imply any particular pressure on S&L's in their takedowns of outstanding commitments. The FHLB Board, in a move designed to provide some easing in home mortgage interest rates, lowered the minimum liquidity requirements for S&L's from 7.5 to 7 per cent of the sum of deposits plus borrowed funds due within one year. The industry's aggregate liquidity ratio was considerably above even the higher required minimum, however, and no more than the usual relatively small number of associations were operating close to that ratio. It is therefore not likely that this easing in liquidity requirements would provide a significant release of funds for mortgage acquisitions.

<u>Mortgage market</u>. Since the President's new program was announced, yields to lenders on home mortgages have edged down somewhat, according to field reports and trade opinion. However, many private

originators and investors in FHA and VA mortgages have continued to curtail their activities pending a clearer understanding about the operation and impact of the new GNMA special assistance programs that subsidize a portion of the discounts on such loans. Through early September--one month after the programs were initially announced--GNMA had executed more than $400 million in new purchase commitments under Programs 21 and 22, and had sold off about an eighth of them at its first commitment sales auction.[1/]

A further decline through the early part of this month in yields required by home-mortgage lenders on Government-underwritten loans in the secondary market was confirmed by the results of the latest FNMA auction, which continued to be limited to forward purchase commitments of 3 months. By September 7, yields on these 3-month commitments, at 7.88 per cent, were down 19 basis points from the 1971 high in late July.

1/ Under its new discount-subsidy Program 21 (multifamily loans) and Program 22 (home loans) which generally apply to mortgages of no more than $22,000, GNMA executes purchase commitments at fixed prices of 95 (existing homes) or 96 (new properties) per cent of par. It may then resell these commitments at lower prices by (a) auctioning them off to the same mortgage originators from whom it agreed to purchase the loans at the fixed prices (in GNMA's first sales auction of September 9, GNMA accepted $48 million out of a total of $155 million in bids submitted by these buyers, at prices ranging upward from 93); or (b) selling them to the same originators at a uniform GNMA-determined interim selling price (ISP), initially established at 93-1/2. In the event GNMA does not sell all of its purchase commitments before the loans are presented to GNMA for takedown, GNMA may then sell the mortgages to FNMA or may auction them off to any eligible buyer.

FNMA PURCHASE AUCTIONS

| | Amount of total offers: Received | Amount of total offers: Accepted | 3-month commitments: Discount | 3-month commitments: Private market yield |
|---|---|---|---|---|
| | (Millions of dollars) | | (Points) | (Per cent) |
| 1971 - High | 1,168 (5/10) | 314 (4/26) | 8.5 (7/26) | 8.05 (6/1) |
| June 14 | 638 | 191 | 7.4 | 7.91 |
| 28 | 539 | 263 | 7.4 | 7.92 |
| July 12 | 606 | 241 | 7.8 | 7.98 |
| 26* | 686 | 183 | 8.5 | 8.07 |
| Aug. 25* | 635 | 154 | 7.8 | 7.97 |
| Sept. 7* | 445 | 189 | 7.1 | 7.88 |

NOTE: Average secondary market yield after allowance for commitment fee and required purchase and holding of FNMA stock, assuming prepayment period of 15 years for 30-year Government-underwritten mortgages. Implicit yields shown are gross, before deduction of fee paid by investors to servicers of 38 basis points.

*Auctions of 3-month commitments only. The September 7 auction was confined to mortgages too large for GNMA discount subsidy.

Over the entire month of August, average interest rates on conventional home mortgages virtually stabilized, with only a slight increase reported for new-home loans and no change for used-home loans. In the more sensitive secondary market for FHA mortgages, yields edged down. Although gross returns on both conventional and Government-underwritten mortgages improved somewhat relative to the reduced yields on new issues of high-grade corporate bonds, they continued to offer no net investment incentive for diversified lenders after allowance is made for the higher servicing costs on mortgages.

AVERAGE RATES AND YIELDS ON NEW-HOME MORTGAGES

| | Primary market: Conventional loans | | Secondary market: FHA-insured loans | | |
|---|---|---|---|---|---|
| | Level (per cent) | Yield spread (basis points) | Level (per cent) | Yield spread (basis points) | Discount (points) |
| 1970 | | | | | |
| Low | 8.30 (Dec.) | -56 (June) | 8.40 | 1 (May) | 3.1 (Nov.) |
| High | 8.60 (July, Aug.) | 50 (Dec.) | 9.29 | 99 (Feb.) | 6.0 (Feb.) |
| 1971 | | | | | |
| March | 7.60 | 14 | 7.32 | -14 | 2.7 |
| April | 7.55 | -2 | 7.37 | -20 | 3.1 |
| May | 7.65 | -36 | 7.75 | -36 | 6.1 |
| June | 7.70 | -20 | 7.89 | -1 | 7.2 |
| July | 7.80 | -16 | 7.97 | 1 | 7.8 |
| August | 7.85 | 20 | 7.92 | 27 | 7.4 |

NOTE: FHA series; interest rates on conventional first mortgages (excluding additional fees and charges) are rounded to the nearest 5 basis points. On FHA loans carrying the 7 per cent ceiling rate in effect since mid-February 1971, a change of 1.0 points in discount is associated with a change of 12 to 14 basis points in yield. Gross yield spread is average mortgage return, before deducting servicing costs, minus average yield on new issues of high grade corporate bonds with 5-year call protection.

August data confidential until released on Friday, September 17.

Net flows of credit to the residential mortgage market continued large in July, judging from fragmentary data. Net acquisitions by S&L's were at a record pace, inflated partly by an unusually large volume of loans in process. Net market takings by this dominant lender group, plus support from federal credit agencies, had already reached a new high in the second quarter, accounting for a combined share of more than four-fifths of total seasonally adjusted net credit extensions on all residential mortgages.

S&L AND FEDERAL CREDIT AGENCY SHARES
OF NET RESIDENTIAL MORTGAGE LENDING

| Period | Net Lending by all Types of Lenders (Billions of dollars) | S&Ls | Federal Credit Agencies | Both |
|---|---|---|---|---|
| | | (Per cent of total) | | |
| 1968 | 19 | 44 | 8 | 53 |
| 1969 | 20 | 44 | 19 | 63 |
| 1970 | 19 | 48 | 28 | 76 |
| 1970 - I | 14 | 29 | 41 | 70 |
| II | 16 | 40 | 33 | 73 |
| III | 23 | 52 | 27 | 79 |
| IV | 23 | 63 | 17 | 81 |
| 1971 - I | 22 | 66 | 7 | 73 |
| II | 35 | 65 | 18 | 82 |

NOTE: Flow of Funds accounts, with quarterly averages based on seasonally adjusted data. Federal credit agencies include mortgage pools backing GNMA-guaranteed securities. S&L net acquisitions partly reflect loans in process. Details may not add to totals because of rounding.

The quality of home mortgage debt deterioriated slightly during the second quarter, according to the Mortgage Bankers Association after-the-fact delinquency series, which is heavily weighted with FHA and VA loans. The average delinquency rate edged up to a new second-quarter high of 3.27 per cent, partly reflecting the growing volume of loans under FHA's Sec. 235 program that subsidizes interest rates down to 1 per cent for eligible lower-income homeowners. In the MBA series, delinquencies on these subsidized loans were more than twice the average rates indicated for other mortgages.

Corporate and municipal securities markets. After some adjustment from their initial sharp decline, yields on both corporate and municipal bonds continued to fall in the weeks following the Presidential message in mid-August. By September 10, long-term corporate bond rates had dropped 76 basis points and municipal rates were down 67 basis points. However, the decline seems to have run its course for the present. Corporate syndicate positions built up as investors, still uncertain about the course of inflation and sensing an upturn in the new issue calendar, bought sparingly of the aggressively priced new utility offerings. A more generous pricing policy on the most recently issued industrial bonds resulted in quick sellouts.

In mid-September, with the market facing an unusually large weekly calendar, the unsold portions of several slow-moving utility bonds were released from syndicate, and their yields adjusted upward about 25 basis points. Buying appears also to have slackened somewhat in the long-term municipal market in recent days. Dealer inventories of municipals rose significantly, resulting in the termination of syndicates holding several recently issued, high-quality issues.

Since the rapid run-up during the first few days after the President's announcement, stock prices have remained relatively stable with the NYSE, AMEX, and NASDAQ indexes having returned to approximately their June 1 closing levels.

BOND YIELDS
(Per cent)

| | | New Aaa Corporate Bonds 1/ | Long-term State and Local Bonds 2/ |
|---|---|---|---|
| 1970 | | | |
| Low | | 7.68 (12/18) | 5.33 (12/10) |
| High | | 9.30 (6/9) | 7.12 (5/28) |
| 1971 | | | |
| Low | | 6.76 (1/29) | 5.00 (3/18) |
| High | | 8.23 (5/21) | 6.23 (6/24) |
| Week of: | | | |
| August | 6 | 8.02 | 6.07 |
| | 13 | 7.97 | 6.03 |
| | 20 | 7.33 | 5.49 |
| | 27 | 7.48 | 5.71 |
| September | 3 | 7.38 | 5.39 |
| | 10 | 7.21 | 5.36 |

1/ With call protection (includes some issues with 10-year protection).
2/ Bond Buyer (mixed qualities).

Public offerings of corporate bonds amounted to about $1.4 billion in August, but a series of new announcements and reschedulings in late August raised the September calendar to $2.3 billion. At this time it is estimated that the October total may be about $1.9 billion. There have been several announcements of large new issues in recent days, and underwriters report that they have a number of corporations anticipating issues over the next six months or so that might accelerate their offerings if it appeared that interest rates were trending upward again. Prospective offerings in other sectors of the long-term securities markets are expected to remain close to the monthly averages for the first half of the year. It is estimated that takedowns of private placements will continue at a monthly rate of about $550 million during the latter part of the year, after the usual end-of-the-quarter upswing in September. New equity volume, while varying somewhat from month to month because of the timing of rights offerings, is expected to average $800 to $900 million a month.

CORPORATE SECURITY OFFERINGS
(Monthly or monthly averages in millions of dollars)

| | Bonds | | | |
|---|---|---|---|---|
| | Public | Private | Stocks | Total |
| 1970 - Year | 2,099 | 403 | 713 | 3,245 |
| First half | 1,929 | 424 | 721 | 3,074 |
| 1971 - First half | 2,486 | 546 | 948 | 3,980 |
| QI | 2,790 | 505 | 769 | 4,063 |
| QII | 2,182 | 586 | 1,128 | 3,896 |
| QIII e/ | 1,677 | 596 | 1,382 | 3,655 |
| August e/ | 1,400 | 500 | 950 | 2,850 |
| September e/ | 2,300 | 750 | 1,000 | 4,050 |
| October e/ | 1,900 | 550 | 750 | 3,200 |

e/ Estimated.

Long-term offerings by State and local governments were about $1.8 billion in August, and the September total is estimated at $1.9 billion, since a few previously postponed offerings apparently were drawn back into the market by the rapid fall in rates since mid-August. On the basis of current schedulings, the staff expects a slight decline in long-term tax-exempt volume in October.

STATE AND LOCAL GOVERNMENT OFFERINGS
(Monthly or monthly averages, in millions of dollars)

| | Long-term | Net Short-term |
|---|---|---|
| 1970 - Year | 1,514 | 393 |
| First half | 1,306 | 291 |
| 1971 - First half e/ | 2,123 | 481 |
| QI | 2,229 | 540 |
| QII e/ | 2,017 | 421 |
| QIII e/ | 1,809 | 261 |
| August e/ | 1,828 | 265 |
| September e/ | 1,900 | 200 |
| October e/ | 1,700 | n.a. |

e/ Estimated.
NOTE: Long-term offerings are gross. Short-term offerings are Federal Reserve Board estimates of net sales.

Net additions to short-term tax-exempt debt in recent months have been at their lowest level in almost a year. Legal restraints on roll-over of bond anticipation notes, as well as the lower level of long-term interest rates in 1971, have encouraged State and local units to fund much of the short-term debt incurred in 1970.

Government securities market. Yields in the Treasury bill market have risen in the latest week, more than erasing the declines registered in the first two weeks following the August 24 Committee meeting. Nevertheless, bill yields at their current levels are 1/4 to 1/2 per cent below those prevailing just prior to the President's mid-August economic statement. The key 3-month bill, for example, was bid at 4.87 per cent on September 14, down 28 basis points from its August 13 level, but 12 basis points above the level prevailing at the time of the August Committee meeting.

MARKET YIELD ON U. S. GOVERNMENT AND AGENCY SECURITIES
(Per cent)

| | 1971 | | Weekly average for week ending | | | |
|---|---|---|---|---|---|---|
| | Daily highs 1/ | Daily lows 1/ | Aug. 24 | Aug. 31 | Sept. 7 | Sept. 14 |
| **Bills** | | | | | | |
| 1-month | 5.33 (7/19) | 2.07 (3/12) | 4.66 | 4.62 | 4.49 | 4.53 |
| 3-month | 5.53 (7/19) | 3.22 (3/11) | 4.66 | 4.58 | 4.54 | 4.71 |
| 6-month | 5.84 (7/27) | 3.35 (3/11) | 4.77 | 4.84 | 4.84 | 5.00 |
| 1-year | 6.01 (7/28) | 3.45 (3/11) | 5.16 | 5.15 | 5.14 | 5.22 |
| **Coupons** | | | | | | |
| 3-year | 6.91 (7/28) | 4.27 (3/22) | 5.99 | 5.91 | 5.82 | 5.94 |
| 5-year | 7.03 (8/10) | 4.74 (3/22) | 6.22 | 6.16 | 6.04 | 6.16 |
| 7-year | 7.11 (8/10) | 5.15 (3/23) | 6.37 | 6.31 | 6.14 | 6.21 |
| 10-year | 6.95 (8/28) | 5.38 (3/23) | 6.38 | 6.34 | 6.15 | 6.14 |
| 20-year | 6.56 (6/15) | 5.69 (3/23) | 6.16 | 6.15 | 6.02 | 6.04 |
| **Agencies** | | | | | | |
| 6-month | 6.20 (7/23) | 3.67 (3/16) | 5.48 | 5.43 | 5.35 | 5.37 |
| 1-year | 6.56 (7/28) | 3.93 (3/16) | 5.91 | 5.90 | 5.80 | 5.79 |
| 3-year | 7.33 (8/12) | 4.70 (3/24) | 6.68 | 6.59 | 6.44 | 6.37 |
| 5-year | 7.45 (8/13) | 5.12 (3/23) | 6.90 | 6.86 | 6.73 | 6.63 |

1/ Latest dates of high and low rates in parentheses.

The most recent upward yield adjustment in the bill market reflects several factors. There has been a substantial reduction in foreign demand as the combination of floating rates and foreign exchange restrictions has greatly reduced the volume of dollar inflows to foreign central banks. In addition, the cost of dealer financing has remained relatively high as the Federal funds rate has been typically over 100 basis points above the rate on 3-month bills. Furthermore, overall yield declines for other short-term money market instruments have been less pronounced than for bills and have helped to generate market sentiments that bill rates had been initially driven unrealistically low in the wake of the President's message.

In the coupon sector of the Treasury market, yields have also increased in the last week but on balance remain 10 to 25 basis points below the levels preceding the last meeting and 50 to 60 basis points below levels prevailing August 13. The results of the Treasury auction on August 31 of a $1.25 billion 5-year 2-month note generated considerable optimism in the market. In view of the provision for full tax and loan account credit the new issue was largely taken by banks at an average yield of 5.98 per cent, considerably below earlier market expectations. The recent upward adjustment in yields may reflect, in part, some caution on the part of investors as a result of the persistent tightness of the federal funds market, the cool reception accorded a number of recent new issues in the corporate and municipal markets, and the upward movements of bill yields.

DEALER POSITIONS IN GOVERNMENT AND AGENCY SECURITIES
(In millions of dollars)

| | August Daily average | Aug. 23 | Aug. 30 | Sept. 3 | Sept. 13 |
|---|---|---|---|---|---|
| Treasury securities | | | | | |
| Total | 2,898 | 2,766 | 3,167 | 3,636 | 3,784 |
| Treasury bills (total) | 2,244 | 1,949 | 2,369 | 2,489 | 2,604 |
| Due in 92 days or less | 1,089 | 825 | 1,132 | 1,148 | 1,119 |
| 93 days or over | 1,155 | 1,125 | 1,237 | 1,341 | 1,485 |
| Treasury notes and bonds (Total) | 654 | 816 | 799 | 1,147 | 1,181 |
| Due within 1-year | 228 | 199 | 217 | 274 | 298 |
| 1-5 years | 345 | 509 | 503 | 401 | 429 |
| over 5 years | 81 | 108 | 79 | 472 | 454 |
| Agency securities | | | | | |
| Total | 690 | 689 | 971 | 981 | 859 |
| Due within 1-year | 359 | 373 | 467 | 495 | 414 |
| Over 1-year | 331 | 316 | 504 | 486 | 445 |

New issue activity in the Federal Agency market was dominated by a $1 billion FNMA offering on August 26 that raised $552 million of new money. The offering consisted of a $450 million 3-year 3-month issue priced to yield 6.45 per cent, a $300 million 6-year issue yielding 6.88 per cent, and a $250 million 10-year issue yielding 7.25 per cent. The total package was well received, with each issue moving to a premium on subsequent days. The Farmer's Home Administration raised $300 million of new cash on September 10 through a $150 million 5-year issue yielding 6.62 per cent, and a $150 million 15-year issue yielding 7.50 per cent. This financing was also well received. The FHLB announced that it would issue a 14-month bond on September 15 that would result in a $90 million net pay down. Yield movements on outstanding agency securities have generally paralleled those in the market for direct Treasury obligations.

Other short-term credit markets. Total commercial and finance company paper outstanding dropped by about $200 million to $29.2 billion in August, following much sharper declines, averaging nearly $700 million, in June and July. About a third of the August decline was accounted for by a reduction in bank-related paper. Of the non-bank paper, dealer-placed commercial paper fell by $200 million over the month on a seasonally adjusted basis, but this was partly offset by an increase of around $70 million in finance company paper.

Interest rates on commercial paper and finance company paper fell by 1/8 to 1/4 of a percentage point in the two weeks following the President's mid-August announcement of his new economic program, but have been about unchanged since then, with the 3-month commercial paper rate remaining 1/8 per cent below the 6 per cent bank prime rate. Yields on bankers' acceptances have changed little during the past several weeks. Most new issue CD rates fell by 1/2 of a percentage point over the third and fourth weeks of August, but more recently have moved up slightly, possibly to counteract seasonal runoffs of such deposits.

SELECTED SHORT-TERM INTEREST RATES
(Wednesday Quotation-Discount Basis)

| | 1970 | | 1971 | | | | Net change |
|---|---|---|---|---|---|---|---|
| | Highs | Lows | Aug 11 | Aug 18 | Aug 25 | Sept 8 | Aug 11--Sept 8 |
| **1-month** | | | | | | | |
| Commercial paper | 9.25 | 5.50 | 5.75 | 5.63 | 5.50 | 5.63 | -.12 |
| Finance paper | 9.00 | 5.00 | 5.50 | 5.25 | 5.25 | 5.25 | -.25 |
| Bankers' acceptances | 9.00 | 5.50 | 5.75 | 5.88 | 5.75 | 5.75 | -- |
| Certificates of Deposit--new issue 1/ | 7.75 | 5.00 | 5.50 | 5.25 | 5.00 | 5.25 | -.25 |
| Treasury bill | 7.84 | 4.58 | 5.17 | 4.81 | 4.69 | 4.45 | -.72 |
| **3-month** | | | | | | | |
| Commercial paper | 9.25 | 6.00 | 6.00 | 6.00 | 5.88 | 5.88 | -.12 |
| Finance paper | 8.25 | 5.50 | 5.50 | 5.50 | 5.38 | 5.38 | -/12 |
| Bankers' acceptances | 9.00 | 5.50 | 5.88 | 6.00 | 5.88 | 5.88 | -- |
| Certificates of Deposit--new issue 1/ | 6.75 | 5.50 | 5.75 | 5.50 | 5.25 | 5.50 | -.25 |
| Treasury bill | 7.93 | 4.74 | 5.22 | 4.78 | 4.73 | 4.60 | -.62 |
| **6-month** | | | | | | | |
| Bankers' acceptances | 9.00 | 5.50 | 6.00 | 6.13 | 6.00 | 6.00 | -- |
| Treasury bill | 7.99 | 4.78 | 5.67 | 4.84 | 4.95 | 4.89 | -.78 |
| **12-month** | | | | | | | |
| Certificates of Deposit--new issue 1/ | 7.50 | 5.50 | 6.25 | 5.88 | 5.75 | 5.75 | -.50 |
| Treasury bill | 7.62 | 4.74 | 5.91 | 5.22 | 5.21 | 5.15 | -.76 |
| Prime municipal notes | 5.80 | 2.95 | 3.60 | 3.00 | 3.20 | 3.00 | -.60 |

1/ Investment yield basis. Highs for certificates of deposit are ceilings effective as of January 21, 1970.

Source: Wall Street Journal's Money Rates for commercial and finance paper and bankers' acceptances; all other data from the Federal Reserve Bank of New York.

COMMERCIAL AND FINANCE COMPANY PAPER
(End-of-month data, in millions of dollars)

| | 1971 June | 1971 July | 1971 August 4/ |
|---|---|---|---|
| Total commercial and finance paper 1/ | 30,080 r/ | 29,397 | 29,203 |
| Bank related 2/ | 1,733 | 1,808 | 1.744 |
| Nonbank related 3/ | 28,347 r/ | 27,589 | 27,459 |
| Placed through dealers | 11,577 | 11,459 | 11,261 |
| Placed directly | 16,770 r/ | 16,130 | 16,198 |
| Total commercial and finance paper 1/ | -650 r/ | -683 | -194 |
| Bank related 2/ | - 15 | + 75 | - 64 |
| Nonbank related 3/ | -635 r/ | -758 | -130 |
| Placed through dealers | -845 | -118 | -198 |
| Placed directly | +210 r/ | -640 | + 68 |

1/ Combines seasonally adjusted nonbank-related paper and seasonally unadjusted bank-related paper.
2/ Seasonally unadjusted.
3/ Seasonally adjusted.
4/ Based on data for the week ending September 1, 1971.
r/ Revised.

Federal finance. Estimates budget receipts and outlays for fiscal year 1972 are quite tentative at the moment, since the Congressional response to the President's fiscal package is not yet clear, but assuming the President's proposals to be adopted the staff has estimated that the deficit for fiscal year 1972, on a unified budget basis, would be about $27 billion. The likely effects of the fiscal changes recommended by the President are analyzed in detail in an Appendix to the Greenbook supplement.

Briefly, in making estimates of tax receipts the staff has assumed, as it also did for the last Greenbook, that the investment tax credit, the automobile excise repeal and the acceleration of personal tax relief will each be passed in the form proposed, although estimates of the initial impact of these measures on receipts have been revised downward slightly. On the other hand, the estimate of receipts from the import surcharge has been increased by about $1 billion because the staff is now assuming that the surcharge will remain in effect for the full fiscal year. The staff estimates that the President's package of requests would result in a net reduction of $4.2 billion in its estimate of receipts for the current fiscal year.

On the outlays side of the unified budget, staff estimates for fiscal year 1972 are somewhat below those of the Administration. Unlike the OMB, the staff assumes a 5 per cent increase in Social Security benefits starting in January, but general revenue sharing, which is now included in the Administration estimate as of January, is entirely excluded from the staff estimate for the current fiscal year. Also the staff estimate of outlays has been lowered somewhat since the last Greenbook, mainly because Social Security reform measures that were previously projected to because effective in January 1972 are no longer expected to affect fiscal 1972 outlays. Other expenditure adjustments proposed by the President are incorporated in the staff estimates, including the six month delay of the Federal pay raise and the 5 per cent reduction in Federal employment, which would reduce fiscal 1972 outlays by $1.3 billion and $.8 billion, respectively. The President's package of requests would reduce staff estimates of outlays by $3.9 billion, on net, in fiscal year 1972.

Staff estimates of the high employment budget on a national income accounts basis, show an approximate balance in fiscal year 1972, even with the proposed fiscal changes. However, computation of the high employment budget on a unified budget basis shows a deficit of about $5 billion for this fiscal year; on the same basis the Administration calculates a deficit of around $8 billion in its official high employment budget estimate. The revision of the staff's high employment budget estimates and the difference between the staff and Administration figures are explained in the Appendix to the supplement.

Congressional actions could alter the outlook significantly. Some changes in the President's package are being suggested that would cut revenues further, such as making the investment tax credit retroactive to April 1, 1971, extending it to used as well as new equipment, and increasing the minimum standard deduction for the personal income tax. On the other hand, there are also press reports that Congressman Mills favors a straight 7 per cent rather than a 10 per cent-falling-to-5 per cent investment credit, and reversal of the recently adopted liberalized depreciation regulations.

Projections of the Treasury cash balance and of Treasury borrowing are quite uncertain because it is not known to what extent the recent special foreign issues will be redeemed in coming months. The balance at the end of September is estimated to be $8.6 billion, assuming no further foreign redemptions and full repayment of special Treasury certificates sold to foreign branches as they mature. No new borrowing is expected until mid-October, when $3 to $4 billion of new money might be needed. Further borrowings and increases in the size of weekly bill offerings are projected from mid-October to mid-December, as the cash balance falls to a seasonal low in early November. The projected $8 to $9 billion in net new cash borrowing between now and the end of the year would be greater if there were substantial redemptions of special foreign securities.

Table 1
FEDERAL BUDGET AND FEDERAL SECTOR IN NATIONAL INCOME ACCOUNTS 1/
(In billions of dollars)

| | Fiscal Year 1971* | Calendar Year 1971 F.R. Board | Fiscal Year 1972e/ Adm. Estimate 2/ | Fiscal Year 1972e/ F.R. Board | F. R. Board Staff estimates, Calendar Quarters, 1971 II* | 1971 III | 1971 IV | 1972 I | 1972 II |
|---|---|---|---|---|---|---|---|---|---|
| **Federal Budget** | | | | | | | | | |
| (Quarterly data, unadjusted) | | | | | | | | | |
| Surplus/deficit | -23.2 | -26.6 | -27.5 | -27.6 | 1.6 | -8.7 | -11.3 | -10.6 | 3.1 |
| Receipts | 188.3 | 193.5 | 204.5 | 202.9 | 56.7 | 48.9 | 43.8 | 48.5 | 61.7 |
| Outlays | 211.6 | 220.0 | 232.0 | 230.5 | 55.1 | 57.6 | 55.1 | 59.1 | 58.6 |
| Means of financing: | | | | | | | | | |
| Net borrowing from the public | 19.4 | 20.3 | n.a. | 24.2 | 1.6 | 8.5 | 8.6 | 8.1 | -1.0 |
| Decrease in cash operating balance | -.8 | 2.8 | n.a. | 2.6 | -4.3 | .2 | 3.2 | .8 | -1.7 |
| Other 3/ | 4.5 | 3.4 | n.a. | .7 | 1.1 | -.1 | -.5 | 1.7 | - .4 |
| Cash operating balance, end of period | 8.8 | 5.3 | n.a. | 6.2 | 8.8 | 8.5 | 5.3 | 4.5 | 6.2 |
| Memo: Net agency borrowing 4/ | 1.1 | 1.6 | n.a. | n.e. | -.9 | 1.5 | 2.0 | n.e. | n.e. |
| **National Income Sector** | | | | | | | | | |
| (Seasonally adjusted annual rate) | | | | | | | | | |
| Surplus/deficit | -19.0 | -23.1 | n.a. | -26.8 | -22.6 | -25.1 | -27.2 | -29.4 | -25.6 |
| Receipts | 193.6 | 198.8 | n.a. | 205.6 | 198.3 | 199.4 | 202.0 | 207.6 | 213.3 |
| Expenditures | 212.7 | 222.0 | n.a. | 232.4 | 220.9 | 224.5 | 229.2 | 237.0 | 238.9 |
| High employment surplus/deficit (NIA basis) 5/ | 1.3 | 1.7 | n.a. | -.1 | .9 | 2.4 | 1.1 | -3.4 | -.7 |

* Actual e--projected n.e.--not estimated n.a.--not available

1/ Reflects effects of total additional depreciation allowable under Treasury's newly-approved "accelerated depreciation range" guidelines, which are effective as of the beginning of 1971.

2/ In testimony before the House Ways & Means Committee on Sept. 8, 1971, Secretary Connally disclosed the current Administration budget deficit estimate of $27.0--28.0 billion and the updated outlays estimate of $232.0 billion. These figures would imply a receipts estimate ranging from $204.0--205.0 billion.

Footnotes continued

FEDERAL BUDGET AND FEDERAL SECTOR IN NATIONAL INCOME ACCOUNTS[1/]
(In billions of dollars)

3/ Includes such items as deposit fund accounts and clearing accounts.
4/ Federally-sponsored credit agencies, i.e., Federal Home Loan Banks, Federal National Mortgage Assn., Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives.
5/ Estimated by F.R. Board staff.

Table 2

PROJECTION OF TREASURY CASH OUTLOOK
(In billions of dollars)

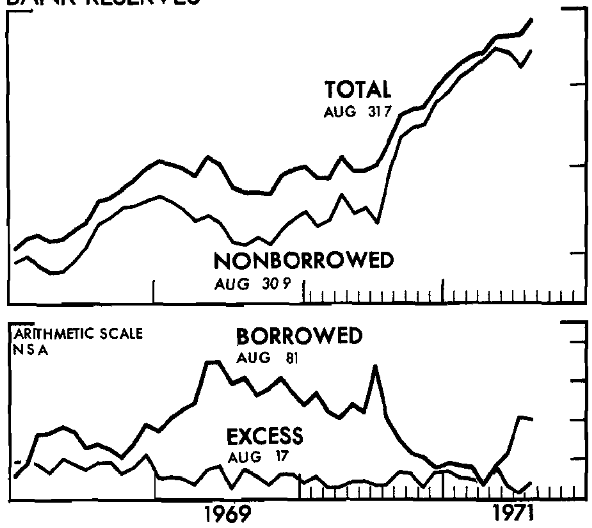
| | Aug. | Sept. | Oct. |
|---|---|---|---|
| Total net borrowing | 6.9 | -2.6 | 2.8 |
| Weekly and monthly bills | .6 | .6 | .4 |
| Tax bills | -- | -- | -- |
| Coupon issues | ·2.7 | 1.2 | -- |
| As yet unspecified new borrowing | -- | -- | 3.5 |
| Other (debt repayments, etc.) | 3.6 | -4.4 | -1.1 |
| Plus: Other net financial sources a/ | -.9 | 1.2 | 1.1 |
| Plus: Budget surplus or deficit (-) | -3.7 | .4 | -6.6 |
| Equals: Change in cash balance | 2.3 b/ | -1.0 | -2.7 |
| Memoranda: Level of cash balance, end of period | 9.5 b/ | 8.5 | 5.8 |
| Derivation of budget surplus or deficit: | | | |
| Budget receipts | 16.0 | 19.7 | 12.8 |
| Budget outlays | 19.7 | 19.3 | 19.4 |
| Maturing coupon issues held by public | 4.1 c/ | -- | -- |
| Net agency borrowing | 0.2 | 0.4 | 0.8 |

a/ Checks issued less checks paid and other accrual items.
b/ Actual.
c/ The August refunding fell short of its goal by $1.4 billion.

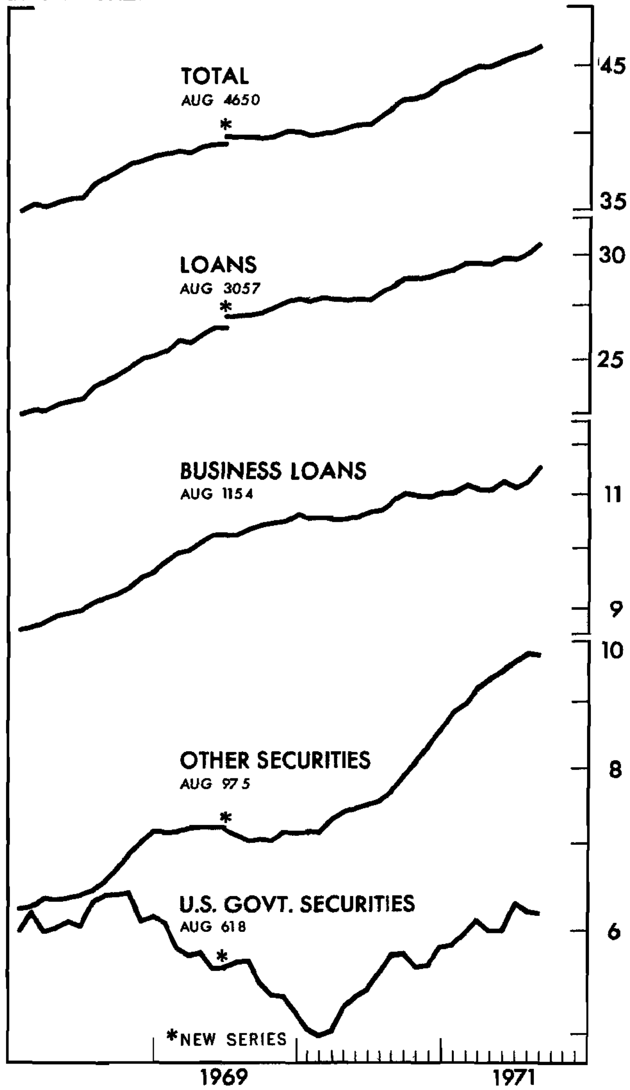
# FINANCIAL DEVELOPMENTS - UNITED STATES

**BILLIONS OF DOLLARS, SEASONALLY ADJUSTED, RATIO SCALE**

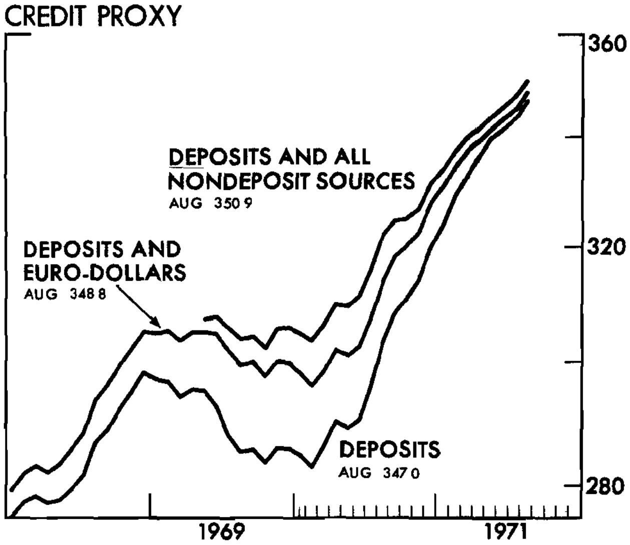
## BANK RESERVES



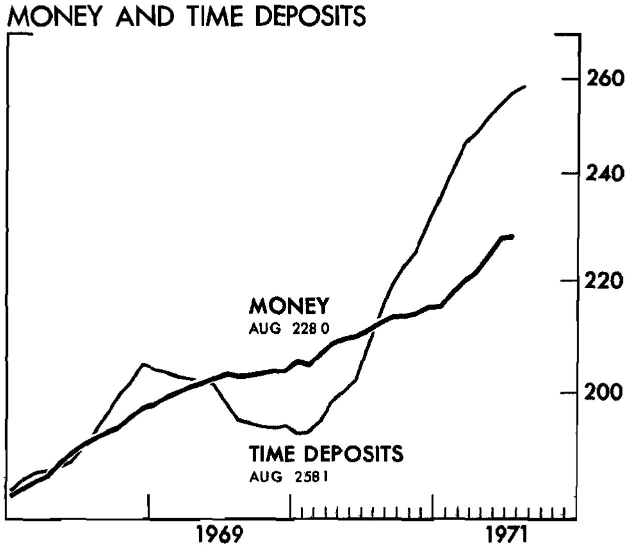

## BANK CREDIT



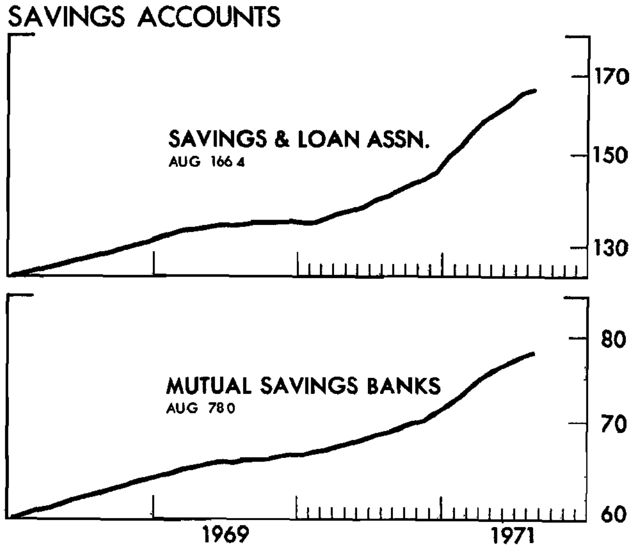

## CREDIT PROXY



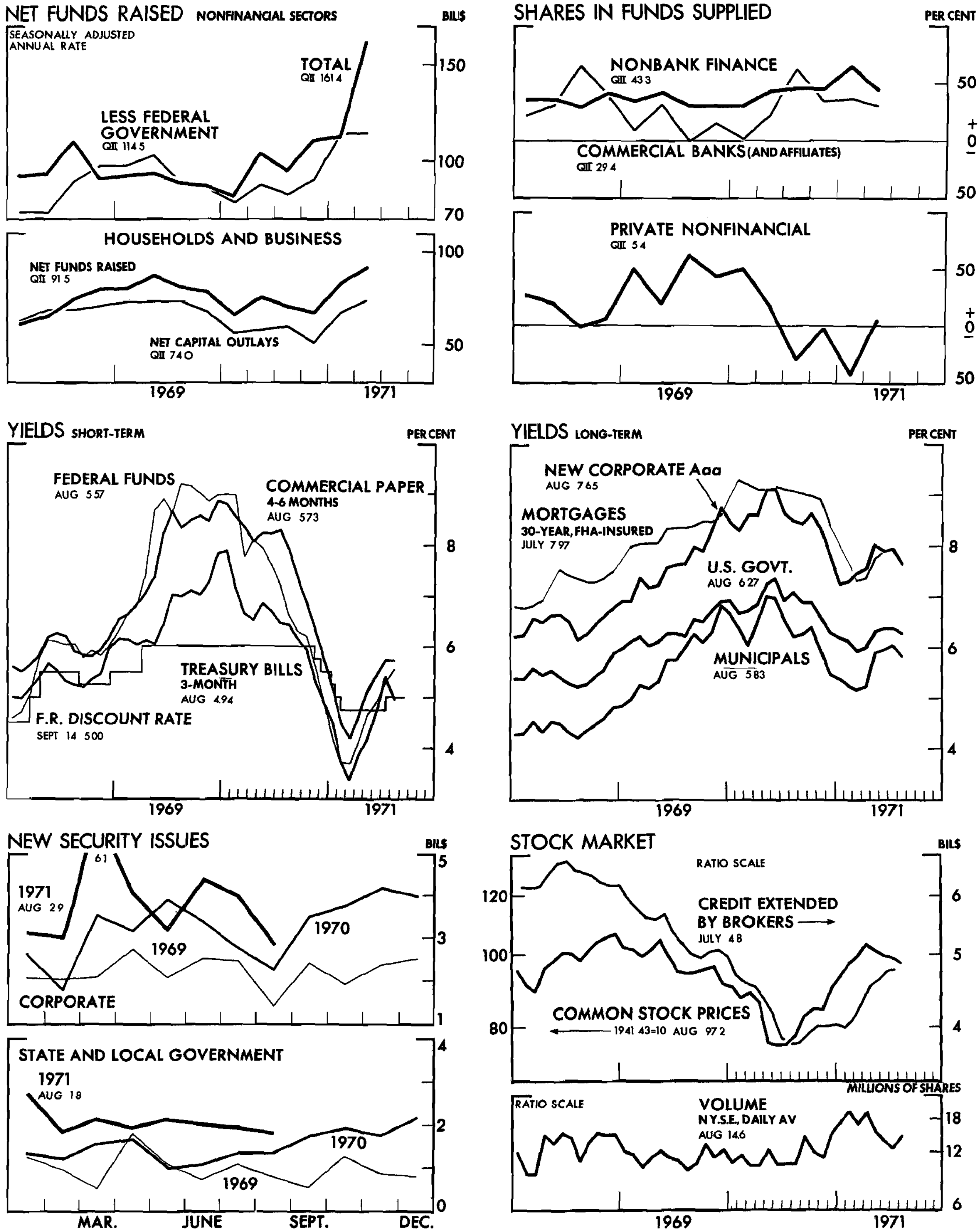

## MONEY AND TIME DEPOSITS




## SAVINGS ACCOUNTS



# FINANCIAL DEVELOPMENTS - UNITED STATES



## THE ECONOMIC PICTURE IN DETAIL

### International Developments

Foreign exchange markets. Following the re-opening of official foreign exchange markets in Europe on August 23, trading volume gradually returned to near pre-crisis levels, though activity in the New York market remains depressed. Bid-offer spreads narrowed substantially as traders became more accustomed to dealing with floating currencies and as fluctuations in the levels of the rates moderated. Forward markets in European currencies were re-established, but volume in those market remains substantially reduced, mainly because of a reduction in short-term capital movements brought about by the institution of a variety of exchange control measures in a number of countries.

The Japanese exchange markets stayed open throughout, with the Bank of Japan defending the old parity for two weeks after the United States suspended gold convertibility. During those two weeks, Japanese exporters accelerated their conversions of export proceeds and Japanese banks borrowed heavily abroad for conversion into yen, with the result that the Bank of Japan absorbed some $4.2 billion from the market before it suspended the upper intervention limit.

As shown in the table below, major foreign currencies, with the exception of the yen, have appreciated very little since August 13, and are generally at levels well below what we would expect long-run equilibrium rates to be. Meanwhile, LDC's on the average have not changed their rates against the dollar significantly (see below, section on foreign reactions).

Spot Foreign Exchange Rates
New York Market, Sept. 15

| | Per Cent over Par | Per Cent over Aug. 13 Rate |
|---|---|---|
| Sterling | 3.0 | 2.1 |
| DM | 8.7 | 0.5 |
| Dutch guilder | 5.7 | 1.0 |
| Swiss franc | 2.6 | 1.9 |
| French franc | | |
| commercial | 0.8 | 0.0 |
| financial | 4.1 | 4.1 |
| Belgian franc | | |
| commercial | 4.3 | 3.4 |
| financial | 4.3 | 1.7 |
| Italian lira | 1.9 | 1.2 |
| Japanese yen | 6.7 | 5.8 |
| Canadian dollar | 6.6 | -0.3 |
| Swedish krona | 2.1 | 1.7 |
| Danish krona | 2.5 | 2.3 |
| Norwegian krone | 3.4 | 2.6 |
| Austrian schilling | 1.4 | 2.2 |
| Spanish peseta | 0.1 | 0.9 |

Note: These changes do not measure the weighted change of each currency against all other currencies, but only against the U.S. dollar.

The reasons for the absence of greater upward pressure on rates of the industrial countries include (1) the fact that the 10 per cent U.S. surcharge on dutiable non-quota imports is felt as the partial equivalent of changes in exchange rates, (2) the reluctance of speculators -- with large positions already taken -- to plunge deeper until they can see the future more clearly, (3) the continuing restraint exerted by U.S. controls on outward flows of U.S. bank funds and corporate capital, and (4) the actions adopted by various foreign countries to limit the appreciation of their currencies. Such actions have ranged from exchange market intervention (Japan, Italy) to the establishment of two-tier exchange markets (France, Netherlands) to selective exchange controls (U.K., Japan, Switzerland). (For further discussion of the latter measures see below.)

The Bank of Japan continues to intervene in the market, though at rates well outside the former margin. The Bank of Japan no longer reports its intervention activity, but we understand that its reserve gains have exceeded $500 million since the controlled float was begun. The progressive tightening of Japanese exchange controls, notably a freeze on increases in non-resident yen accounts at Japanese banks, has made trading in yen extremely difficult, particularly outside of Japan. The Frankfurt bourse last week suspended an official fixing of the yen rate, on the grounds that it was practically impossible for German banks to deal in yen. On September 10 the German government officially requested the Japanese government to take actions to remedy what has been widely termed a "breakdown" in the yen payments mechanism.

In other official intervention, the Bank of Italy purchased some $200 million the first week after the Italian market was officially re-opened. That bank stopped providing intervention figures after August 27; we know that it has intervened after that date, but we do not have any good indication of the magnitude of such intervention.

The Bank of France purchased $170 million in the first two weeks of operating under its two-tier system, intervening in the commercial franc market at the old upper limit. There was some feeling in the market (and at the Bank of France) that after the Japanese yen was floated the franc would come under great speculative pressures. This did not, in fact, occur, and the Bank of France last week sold $50 million, citing a pickup in payments by French importers as contributing to an easing of the franc.

The Netherlands Bank purchased a moderate amount of Belgian francs, under a bilateral agreement to limit fluctuations in the guilder/franc exchange rate to 1.75 per cent on either side of the old guilder/franc parity. Press reports suggested that the two countries have not been happy with the working of this agreement, but both central banks vehemently denied such reports and again urged that such an arrangement be broadened to include the entire European Economic Community.

Euro-dollar market. Euro-dollar rates, which had risen sharply in early August, have remained at very high levels since mid-August. The movement away from dollar-denominated assets, and the use of dollar borrowings to move into foreign currencies, which largely accounted for the rise in Euro-dollar rates, have not been reversed. Continued uncertainty concerning the exchange value of the dollar makes foreigners hesitant to acquire dollar deposits, and this has led to a thin market in Euro-dollars and sharp daily movements in rates.

SELECTED EURO-DOLLAR AND U.S. MONEY MARKET RATES

| Average for month or week ending Wednesday | (1) Over-Night Euro-$ 1/ | (2) Federal Funds 2/ | (3) (1)-(2) Differ-ential | (4) 3-month Euro-$ Deposit 1/ | (5) 60-89 day CD rate (Adj.) 3/ | (6) (4)-(5) Differ-ential |
|---|---|---|---|---|---|---|
| 1971 | | | | | | |
| Jan.-Mar. | 4.68 | 3.87 | 0.81 | 5.52 | 4.41 | 1.11 |
| April | 5.05 | 4.15 | 0.90 | 5.92 | 4.41 | 1.51 |
| May | 8.52 | 4.63 | 3.89 | 7.04 | 4.97 | 2.07 |
| June | 4.89 | 4.91 | -0.02 | 7.15 | 5.47 | 1.68 |
| July | 5.39 | 5.28 | 0.11 | 6.47 | 5.81 | 0.66 |
| Aug. 4 | 11.54 | 5.57 | 5.97 | 6.84 | 5.92 | 0.92 |
| 11 | 5.82 | 5.59 | 0.23 | 7.43 | 5.92 | 1.51 |
| 18 r | 12.14 | 5.59 | 6.55 | 8.70 | 5.66 | 3.04 |
| 25 | 6.03 | 5.48 | 0.55 | 8.46 | 5.39 | 3.07 |
| Sept. 1 | 28.48 | 5.59 | 22.89 | 9.16 | 5.59 | 3.57 |
| 8 | 5.17 | 5.73 | -0.56 | 8.76 | 5.62 | 3.14 |
| 15 p | 5.84 | 5.66 | 0.18 | 8.09 | 5.62 | 2.47 |

1/ All Euro-dollar rates are noon bid rates in the London market; overnight rate adjusted for certain technical factors to reflect the effective cost of funds to U.S. banks.
2/ Effective rate.
3/ Offer rate (median, as of Wednesday) on large denomination CD's by prime banks in New York City; CD rates are adjusted for the cost of required reserves.
p/ Preliminary.

Potential U.S. suppliers of dollars have apparently been unwilling or unable to take advantage of arbitrage incentives to move funds to the Euro-dollar market in sufficient quantities to lower the Euro-dollar rate structure. The VFCR and OFDI programs limited the potential outflow as banks and non-bank corporations subject to these regulations were near or at their ceilings at month-end. In addition U.S. residents undoubtedly participated in the movement into foreign currencies due to exchange uncertainties. It is possible that U.S. market participants who closely manage their financial assets had switched a substantial share of their available funds into foreign currencies. Meanwhile, less sensitive U.S. investors have not yet responded to higher yields available on Euro-dollars. If the arbitrage advantage exists for an extended period, we would expect U.S. residents to begin to acquire more Euro-dollars, particularly since the opportunity to purchase foreign currency assets has been limited by exchange controls instituted in most major foreign countries.

Japanese banks were heavy borrowers in the Euro-dollar market before month-end and during the first week of September, but this source of demand was probably eliminated by the very severe tightening of Japanese exchange controls on September 7. Additionally, dollars were in demand to roll over short positions taken earlier.

The Euro-dollar yield curve in recent weeks has had an unusual shape, influenced by market views of when some further depreciation of the dollar might occure. Except for unusually high rates at month end, overnight Euro-dollar rates have been easy compared to rates for longer maturities, and at times lower than the

U.S. federal funds rate. This is what might be expected since on any given day the probability of exchange loss to the holder of an overnight dollar deposit is near zero. This is particularly true under current market conditions, since major currencies have already appreciated to some extent, and further appreciation is being resisted by most major foreign countries.

After a net fall in U.S. banks' liabilities to branches during the week ending Wednesday, September 1, of $172 million, such liabilities have risen by $99 million as of Monday, September 13. The Treasury allowed an additional $516 million in special Euro-dollar issues to run off on September 14, bringing the remainder outstanding to a level of $1.5 billion.

U.S. balance of payments. The abrupt worsening of the U.S. balance of payments in the first half of this year was spread throughout the major sectors of the accounts except services (shown in the table below).

After a recovery in June that was probably the result of quarter-end window dressing and perhaps some profit taking after the May appreciation of the DM, the official settlements deficit rose to $2.5 billion in July. Then in August it ballooned to roughly $9 billion (monthly figures). Some countries (mainly Japan) continued to resist appreciations of their currencies after August 15 and to take in dollars, so that sizable U.S. deficits with foreign official reserve holders continued into September.

U.S. INTERNATIONAL TRANSACTIONS
(billions of dollars; seasonally adjusted annual rates)

| | 1970 | | | 1971 | Change 1H70 to |
|---|---|---|---|---|---|
| | Year | 1H | 2H | 1H | 1H71 |
| Trade balance | +2.1 | +2.5 | +1.7 | -1.5 | -4.0 |
| Services, net | +1.5 | +1.4 | +1.6 | +3.8 | +2.4 |
| Goods & services balance | +3.6 | +3.9 | +3.3 | +2.3 | -1.6 |
| Remittances & pensions | -1.4 | -1.4 | -1.4 | -1.4 | -- |
| U.S. Gov't grants & capital 1/ net | -3.8 | -3.6 | -3.8 | -4.4 | -.7 |
| Long-term private capital | -1.5 | -2.5 | -.4 | -5.3 | -2.8 |
| Balance on current account and long-term capital | -3.0 | -3.7 | -2.3 | -8.9 | -5.2 |
| Nonliquid short-term private capital | -.5 | -.5 | -.6 | -1.7 | -1.2 |
| Errors and omissions | -1.1 | -.9 | -1.3 | -6.7 | -5.8 |
| Net liquidity balance (excluding SDR allocations) | -4.7 | -5.1 | -4.3 | -17.3 | -12.4 |
| Private liquid capital | -6.0 | -4.3 | -7.7 | -5.9 | -1.6 |
| Official settlements balance (excluding SDR allocations) | -10.7 | -9.4 | -12.0 | -23.2 | -13.8 |

1/ Includes nonliquid liabilities to other than official reserve holders.
p/ Preliminary. (Confidential until published)

Mounting capital outflows this year, both recorded and unrecorded, were reactions first to the widening of interest rate differentials and then, by April, to growing apprehension about the stability of the dollar. These apprehensions probably also tended to worsen the merchandise trade accounts, adding to other temporary adverse factors such as reactions to actual and potential work stoppages in the United States. The strength of these speculative and temporary factors is, of course, difficult to judge, but they caused overall deficits considerably greater than would have occurred from basic forces alone. On the other hand, the fact that the United States economy was still far below its high-employment potential, while on average other industrial countries were operating with less slack, tended to hold down the size of the possible trade deficit.

Weakness in the trade account carried into July, but during the rest of the year some recovery from the $4.2 billion annual rate trade deficits of the April-July period is expected, as discussed in the next section. On the other hand, the strong showing of the services sector of the current account in the first half of this year resulted largely from lower income payments, and higher income receipts, the latter including some extraordinary direct investment dividends. After mid-year, interest payments will reflect much larger liabilities and higher interest rates than the average of the first half. Consequently, net receipts on services are projected at an annual rate of about $2.0 billion in the second half, down from the $3.8 billion rate of the first half. The combined balance on goods and services is now projected at a minus $1 billion rate in the second half.

A striking feature of the first-half balance of payments was a sharp rise in the net outflow of <u>private long-term capital</u> to an annual rate (seasonally adjusted) of over $5 billion. This was more than double the rate of outflow in the first half of the previous year. In addition, there was a sharp upturn in the outflow of short-term capital apart from outflows classed as "liquid". Nearly half of the $4.0 billion (annual rate) year-over-year increase in recorded outflows of these two classes was connected with U.S. direct foreign investments and other corporate capital flows. While the gross outflow of U.S. corporate capital was only moderately higher than in the first half of 1970, corporate borrowing abroad -- especially short-term financing -- was sharply reduced, so that the net use of U.S.-source funds was much higher than in other recent periods. In fact, it exceeded the total for the year 1970. Some of the increase in net outflow probably reflected exchange rate uncertainties as well as the rising costs of borrowing abroad. However, net outflows in the remainder of the year are likely to be sharply reduced, as they were in the last half of 1970.

Other adverse elements in the first-half recorded capital accounts were a much reduced inflow of foreign capital for direct investments in the United States and to purchase U.S. corporate stocks, and larger outflows of U.S. capital to purchase foreign corporate stocks (mainly Japanese). Movements of "liquid" capital included a further large repayment of liabilities to commercial banks abroad during the first quarter.

In addition to recorded capital flows, unrecorded transactions (probably largely leads and lags on trade and other payments, and capital flows) shot up to over $1 billion in the first quarter and to $2.3 billion in the second. These quarterly amounts compare with a "normal" annual figure of about $1 billion. The massive size of the July-August deficits suggests that in the third quarter these unrecorded flows were even larger than in the second quarter.

Presumably the actions taken by the President on August 15, and the actions taken abroad since that time to allow some appreciations of exchange rates and to raise barriers against further capital inflows, have slowed down the outflow of funds from the United States. However, it appears that exchange market conditions will be unsettled for many months, and that trade and other transactions will be far from normal. While these conditions persist there is unlikely to be any major unwinding of positions taken during the speculative flurries.

U.S. foreign trade. In July the U.S. trade balance showed another large deficit -- for the fourth successive month. For the four months of April-July the trade deficit was at an annual rate of $4-1/4 billion (balance-of-payments basis). This contrasts with a surplus at a rate of about $1 billion in the first quarter, and a surplus of about $2 billion in 1970.

The levels of both exports and imports in July were substantially lower than in June -- 4-1/2 and 5-1/2 per cent respectively -- principally because of the closing of West Coast ports in early July by the longshoremen's strike and because of the selective domestic rail and coal strikes that occurred in July. The shutdown of West Coast ports probably affected imports more than exports since about 15 per cent of total imports arrive by vessel through these ports compared with departures amounting to about 9 per cent of total exports. Imports from Japan were particularly hard-hit by the strike; they were down about 30 per cent from June. Nearly one-half of U.S. imports from Japan arrive by vessel through West Coast ports.

The decrease in the July trade figures also reflected a considerable decline in the seasonally adjusted movement of automobiles to and from Canada. Determination of the appropriate seasonal factor for July is difficult because of variation in timing of the model-year changeover.

It is an unsettled question as to how much of the recent deterioration has resulted from temporary factors such as anticipation of, or the effect of, domestic strikes (longshoremen, steel, aluminum, etc.), anticipation of the imposition of "voluntary" controls by foreign governments on their industries' sales to the United States, and the increasing possibility of changes in currency values. Obviously these factors cannot be fully quantified, and some of them tend to reduce imports as well as exports. We are guessing that these elements may have accounted for about a third to a half of the trade deficit in the past four months. This guess implies an underlying trade deficit (not cyclically adjusted) of between \$2-1/4 - \$2-3/4 billion at an annual rate in the last four months.

While some temporary elements have already ended -- in particular, the coal and railroad strikes, the effect of which was greatest on exports -- others are likely to persist for several more months. The current West Coast dock strike may spread to East and Gulf Coast ports as the labor agreement affecting workers in these ports expires on October 1. The uncertainties regarding the duration of the surcharge imposed by the President on most dutiable imports on August 15, and expectations of currency changes resulting from the floating of the dollar on exchange markets, are likely to result in some hesitation by traders as they attempt to assess the impact of these actions on their export or import positions. Consequently, inventories of U.S. goods abroad, and of foreign goods in the United States, are both likely to be sharply reduced in the next few months.

However, the import surcharge and the changes in parities since August 15 -- small so far, averaging about 3 per cent against the dollar (as measured by several alternative weighting methods) -- should begin to have some effect in reducing the trade deficit before long. Although any estimate of the trade balance for the remainder of this year can only be highly tenuous because of the factors outlined above, we are projecting the trade deficit in the fourth quarter to be close to $3 billion at an annual rate.

Looking a little further ahead, if it is assumed that the surcharge is maintained for a year and that about a third of the impact on the cost of imports is absorbed by foreign exporters or American distributors, the surcharge could reduce dollar payments to foreign suppliers by an annual rate of $1-1/2 billion by mid-1972. This also assumes that there would be no retaliation by foreign countries, either directly in the form of restrictions against U.S. exports or indirectly through subsidies to their export industries.

It is estimated that the import surcharge would have a substantial impact on the domestic economies of Japan and, to a somewhat lesser extent, Canada, among the industrial countries. Its effect would be proportionately even greater on a number of the developing countries, as shown in the table below. For these countries, exports affected by the surcharge are a substantial part both of their total exports and of their GNP. In most major industrial countries other than Japan and Canada the effect of the surcharge will be relatively less significant.

The effect of the present limited appreciation of foreign currencies reducing the dollar value of U.S. imports by mid-1972 may be relatively small -- perhaps about $1/4 billion (annual rate) -- but the effect in raising the dollar value of U.S. exports could be considerably greater -- perhaps about $3/4 billion. (See Appendix A for an explanation of the differential effects of a surcharge and a devaluation.) In total, it is quite possible that these factors could result in an improvement in the trade balance of between $2 and $3 billion

SELECTED COUNTRIES AFFECTED BY THE U.S. 10 PER CENT
SUPPLEMENTAL DUTY ON IMPORTS

| | Per cent of total exports affected | Per cent of exports to U.S. affected | Exports affected as per cent of GNP |
|---|---|---|---|
| A. Industrial countries | | | |
| Japan | 29 | 94 | 3 |
| Canada | 16 | 25 | 4 |
| Germany | 9 | 94 | 2 |
| Italy | 9 | 86 | 1 |
| United Kingdom | 8 | 72 | 1 |
| Belgium-Luxembourg | 5 | 84 | 2 |
| France | 4 | 83 | 1 |
| Netherlands | 3 | 75 | 1 |
| B. Less developed countries | | | |
| Mexico | 52 | 60 | 3 |
| Korea | 41 | 95 | 5 |
| China (Taiwan) | 36 | 93 | 11 |
| Haiti | 31 | 37 | 3 |
| Hong Kong | 31 | 83 | 25 |

Note: Exports based on 1970 annual data compiled by U.S. Department of State; GNP based on annual data for latest year available, primarily from various OECD and United Nations sources.

at an annual rate by the second quarter of 1972. On the assumption that the new economic program proves successful, the potential increase in U.S. demand for imports should be blunted by a concomitant improvement in our relative price position vis-à-vis foreign countries.

Even under these optimistic assumptions, and including a strong impact from the "temporary" surcharge, it is unlikely that our trade position will be any better than in balance by the middle of next year. This suggests that a considerable further realignment of currencies --

over and above the appreciation needed to replace the surcharge -- is required if we are to reach the $5 billion-plus U.S. trade surplus estimated to be needed under full employment conditions to achieve some approximate "equilibrium" in our overall payments position.

<u>Official reaction in major industrialized countries to recent U.S. policy moves</u>. The suspension of gold convertibility of the dollar induced most major foreign countries to float their exchange rates. Some central banks, notably Italy and Japan, are continuing to intervene in the market, but at rates outside the usual margins, and France has established a two-tier system, maintaining the old dollar parity for commercial (trade) transactions. Many additional measures have been adopted by foreign countries to mitigate the upward pressures on currencies. These measures and other factors have served so far to limit the extent of dollar depreciation. However, the U.S. measures have also induced financial authorities everywhere to give serious consideration, not only to the much-needed realignment of parities, but also to the future structure of the international monetary system.

Foreign attitudes toward the President's foreign policy measures can be summed up as follows:

1. Most countries now seem willing to accept somewhat greater exchange rate flexibility, at least in the form of wider bands. The EC Council of Ministers has approved a recommendation by the EC Commission that the wider bands with relation to non-EC countries be coupled with progressively narrower bands within the Community.

2. All countries urge the quick removal of the U.S. import surcharge, and of the discriminatory features of the

investment tax credit, either on principle or because, in some cases, they expect serious effects on their exports and thus on domestic employment. Most European countries, however, would probably like to see the U.S. capital controls maintained. Their abolition would enlarge the U.S. capital account deficit, requiring a larger U.S. current account surplus, which could conflict with their own balance of payments objectives. Also, large investments of U.S. capital are sometimes unwelcome as such.

3. There is widespread agreement abroad that the use of the U.S. dollar as an international reserve should be curtailed, so that the United States would no longer be able to finance its balance of payments deficits merely by increasing its liquid liabilities to foreign monetary authorities. This reflects a consensus that the United States should, like other countries, be subject to balance of payments discipline in formulating its domestic policies. How this is to be accomplished has given rise to divergent views. There are some who would like to see the United States return to gold convertibility (presumably accompanied by a funding of existing official dollar balances); but the view is growing that more fundamental changes are needed, and varying schemes of reserve asset consolidation are under consideration.

4. There is strong feeling abroad that the United States should raise the price of gold, if only by a small amount, as a gesture indicating acknowledgment that some of the responsibility for the existing international disequilibrium rests with the United States. Moreover, such a move would enable countries abroad to revalue more relative to the dollar than to gold; this is viewed as a political advantage in many countries. It would also reduce the loss in terms of their own currencies of gold held in international reserves.

A number of press reports, confirmed by confidential conversations with authoritative foreign officials, indicate a fairly widespread expectation that most major currencies will continue their circumscribed floats for some time -- perhaps months -- and, more interestingly, that more than a few foreign officials seem quite resigned to this prospect. In the meantime, the major industrial countries are trying to relieve some of the upward pressures that might otherwise raise the market rates for their currencies. These upward pressures are, in any event, not very strong at present, for the reasons discussed on pp. IV - 2-3 above. The desire to minimize the market appreciation of their currencies partly reflects the uncertainty, on the part of each country, over what other countries might do. (Uncertainties of this kind were diminished a little by Japan's action in allowing an initial appreciation of the yen.) Equally important is the attempt to establish bargaining positions for the possible multilateral negotiation of new parities -- it would be difficult for a country to induce its trading partners to accept a smaller revaluation for its currency than the market had already indicated.

Aside from outright support of the dollar through market intervention, as practiced by France, Italy, and Japan, most countries have intensified earlier efforts to stem the inward flow of capital, primarily by means of exchange controls, but also in a few cases by domestic monetary actions which tend to reduce the incentive for such flows.

A significant portion of the speculative inflow into Japan after August 15 took the form of more rapid conversion by exporters of their foreign exchange receipts. Consequently, the Japanese authorities on September 1 prohibited foreign exchange banks in Japan from purchasing export bills with more than six months maturity unless specific approval is granted.

Regulations concerning the Japanese exchange banks' foreign positions were also tightened; these banks were forbidden to increase their external liabilities to foreign banks above the level at close of business on August 18. This measure, in conjunction with regulations previously in effect which had placed ceilings on the conversion of foreign exchange assets into yen assets at the Bank of Japan, sharply limited the potential for enlargement of the Bank of Japan's dollar reserves. Furthermore, the ceilings on conversions into yen which formerly had to be met at mid-month and month-end only, now (as of September 1) have to be met daily. Also on September 1, the Bank of Japan instructed the foreign exchange banks to freeze their free yen deposit liabilities to nonresidents at the level outstanding on August 27.

The United Kingdom similarly introduced control measures (effective August 31) to discourage speculative inflows. Specifically, banks, discount houses, and other institutions holding sterling accounts for nonresidents of the sterling area may not pay interest on any increase in such balances (although some minor exemptions may be granted). Financial institutions (including building societies and trustee savings banks) and local authorities may not accept further deposits from nonresidents. Nonresidents may not purchase additional holdings of sterling certificates of deposit, Treasury bills, and British Government, British Government-guaranteed and local authority securities having a fixed maturity date earlier than October 1, 1976. Finally, the extent to which authorized banks may convert foreign currency assets into sterling is being restricted.

Switzerland has taken three measures to discourage inflows of capital. First, under a gentlemen's agreement with the banks effective August 16, the banks will not pay interest on Swiss franc deposits owned by any nonresidents in excess of the balance on July 31. Second, under the same agreement, the banks must keep a 100 per cent, non-interest-bearing reserve against any increase in their net foreign liabilities since July 31. Finally, the three largest banks have agreed to block, for three months, additions to foreign customers' Swiss franc balances over and above a daily minimum per customer, if the francs are acquired at a rate showing an appreciation of the franc relative to the dollar of 3 per cent or more from the official parity; so far, such conditions have been present only on the first day.

The Netherlands has acted to reduce foreign purchases of Dutch bonds, which have been a major vehicle for capital inflows. Under regulations effective September 6, nonresidents may purchase bonds denominated in guilders from residents only with new "obligatie guilders," obtainable only from the sale by nonresidents of bonds denominated in guilders. Thus, total holdings of Dutch bonds by nonresidents cannot be increased.

As far as non-exchange rate actions in other countries are concerned, France and Germany maintained their prohibition against payment of interest on bank liabilities to nonresidents; the prohibition is now obligatory in both countries (it had been only voluntary in France). Germany continues to seek legislation enabling the authorities to limit external borrowing by the corporate nonbank sector. Austria intensified its control over capital imports. Italy took no new actions, nor did Belgium or Canada.

In addition to the various control measures just mentioned, some countries have taken domestic monetary actions that may tend to reduce upward pressures on their currencies. It is, of course, difficult to ascertain the extent to which monetary conditions abroad are deliberately kept easier than domestic economic objectives would warrant in an attempt to reduce the inflow of interest-sensitive funds. When the Bank of England, for example, cut Bank rate from 6 to 5 per cent on September 2, it indicated explicitly that the move was consistent with recent exchange control measures to discourage speculative inflows. But an easing of monetary conditions was also consistent with the Government's current reflationary policy. Since, as cited above, nonresidents can no longer receive interest on additions to their short-term sterling assets, it is likely that domestic considerations played a major role in the Bank rate decision. The discount rate reduction in Sweden on September 10, from 6 to 5-1/2 per cent, was based even more clearly on domestic considerations. On the other hand, the decision to decrease the discount rate in the Netherlands on September 15, from 5-1/2 to 5 per cent, was apparently taken mainly to support the measures designed to reduce capital inflows.

Foreign reactions to other aspects of the President's program affecting our foreign trade have been very critical. As to the 10 per cent surcharge, Canada and Japan have been the most vocal complainers, with Canada in particular requesting an exemption; this exemption has not been granted. Strong protests have also been made by the developing countries, many of whose new export industries are affected.

The Germans have also expressed considerable displeasure with the "Buy American" clause in the President's investment tax credit proposal. This measure, coming on top of the surcharge and the mark revaluation, will impose a tremendous burden on the German capital goods industry, which is likely to be hard hit in any case by the expected cyclical down-turn in domestic demand in Germany.

The Canadian government has introduced a bill establishing an Employment Support Board which would seek to maintain employment by granting up to C$80 million in the current fiscal year to firms that can demonstrate that they have been significantly hit by the U.S. surcharge. This would enable those firms receiving aid to charge lower prices on their products, partially offsetting the surcharge. There are pressures to impose similar measures elsewhere, notably in Germany and Japan. But so far there have been no moves to retaliate against U.S. exports.

Exchange market developments in other countries. Among the smaller OECD countries, Austria, Denmark, Finland, Greece, Ireland, Norway, and Portugal have permitted their currencies to float. Iceland, Turkey, and Yugoslavia have maintained the old parity with the dollar. Spain has also maintained the dollar parity, while raising the upper intervention point to approximately 1 per cent. Australia has continued to peg its rate to sterling.

Outside the OECD area, no single currency, to the best of our knowledge, is floating independently. Indeed, in a few cases, countries have devalued against the dollar as well as against the upward floating European currencies. Indonesia devalued by nearly 9 per cent against the dollar on August 23. Israel devalued by 16.7 per cent, and Argentina by 6 per cent, against the dollar on August 25. Virtually all other non-OECD countries have continued to peg their currencies to the U.S. dollar, the pound sterling, or the French franc.

In the Western Hemisphere, Jamaica, Trinidad & Tobago, Barbados and Bermuda have elected to follow the pound sterling and have therefore appreciated against the dollar. Except for Argentina, all the Latin American countries and Surinam are maintaining their old parities with the dollar and thus have depreciated against the harder European currencies.

In Asia, Pakistan, Singapore, Malaysia, Hong Kong, and Burma have maintained parity with sterling, appreciating against the dollar. India, and probably Ceylon, which were previously in the sterling area, have decided to maintain the existing parity with the dollar, depreciating against sterling. All the other Asian countries except Japan and probably Mainland China have maintained the old parities with the dollar.

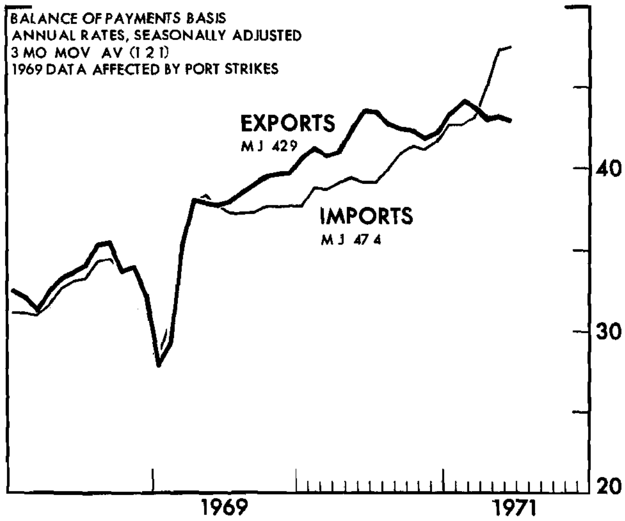
In Africa, former French sub-Saharan colonies have followed the French example, introducing a dual rate for the dollar. Nigeria has also introduced a dual rate for the dollar, maintaining commercial transactions at the old parity. South Africa has retained the existing parity with the dollar, as have the Congo (Kinshasa), Rwanda, Burundi, Tanzania, Ethiopia, the U.A.R. and Liberia. Kenya and Uganda have both moved with sterling, appreciating against the dollar. It is not yet clear what course some of the other former British colonies are following.

In the Middle East, Kuwait has moved with sterling, but most other countries have maintained previous parities with the dollar.

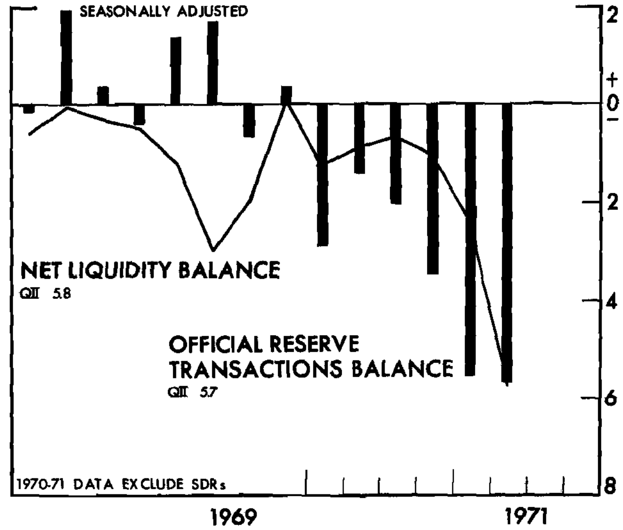
# U.S. AND INTERNATIONAL ECONOMIC DEVELOPMENTS

**BILLIONS OF DOLLARS**

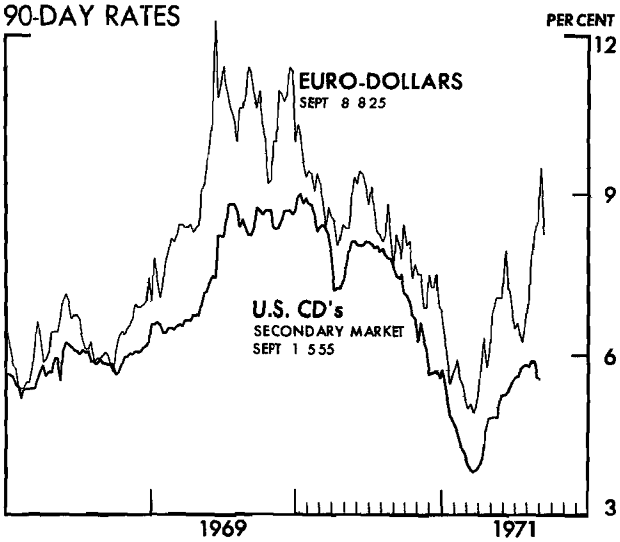
## U.S. MERCHANDISE TRADE



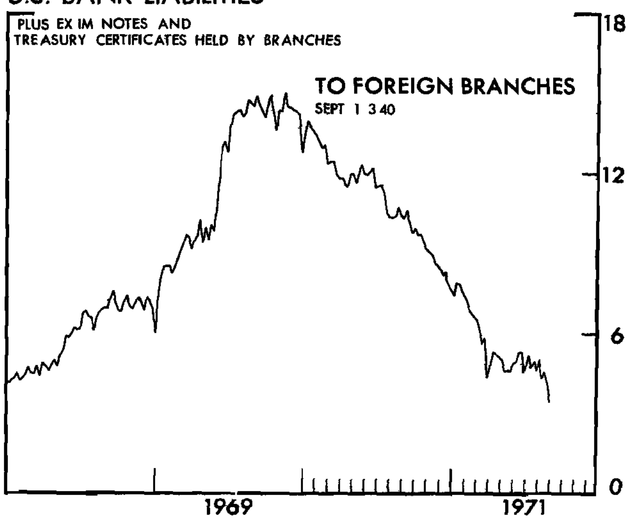

## U.S. BALANCE OF PAYMENTS



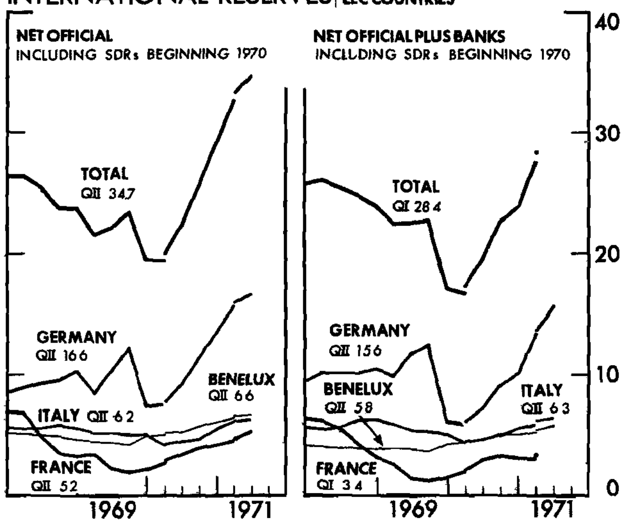

## 90-DAY RATES



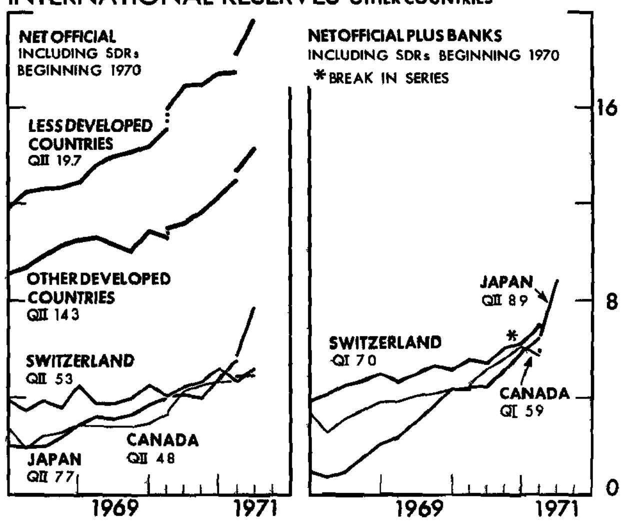

## U.S. BANK LIABILITIES




## INTERNATIONAL RESERVES | EEC COUNTRIES




## INTERNATIONAL RESERVES OTHER COUNTRIES



## APPENDIX A: COMPARATIVE EFFECTS OF SURCHARGES & DEVALUATION

This note describes how an import surcharge may have a greater impact in reducing dollar payments to foreign suppliers of U.S. imports than a devaluation of the same percentage. It is important to observe that no consideration is given to the relative effects of these measures on U.S. exports, and it is assumed that all other economic conditions are held constant; i.e., consumer behavior is unchanged, producers' pricing techniques are unchanged, there is no retaliation by foreign governments, etc.

With either a devaluation or an import surcharge, consumers pay higher dollar prices for the imported goods they do continue to buy. However, with a devaluation all payments go to foreign suppliers, while with an import surcharge a certain percentage of the purchasers' expenditures are siphoned off by the Treasury Department as revenue and the dollar payments going to foreigners are reduced. A surcharge will thus be more effective than a devaluation in reducing the dollar value of imports. It will not, however, necessarily have any greater effect in reducing physical quantities of imports.

To illustrate, we will assume: (1) that the average devaluation and import surcharge are both equal to 10 per cent; (2) that the overall elasticity of substitution is equal to -1.5; (3) that U.S. domestic prices of imports rise by the full amount of the devaluation or the surcharge; i.e., foreign producers raise their dollar prices by the full 10 per cent.

| | Devaluation | Surcharge |
|---|---|---|
| Original payments to foreigners, in dollars | 20 | 20 |
| Purchasers' expenditures on imports with 10 per cent rise in price | 18.7 | 18.7 |
| Payments to Treasury | -- | 1.7 (10% of 17) |
| Payments to foreigners, in dollars, after change | 18.7 | 17.0 |

Our example is not intended to illustrate what will actually happen under the present surcharge and possible revaluations but rather to indicate the possible effect on the value of U.S. imports. Of course, it should be noted that the present 10 per cent surcharge applies only to about one-half of U.S. imports, while a devaluation would affect all U.S. imports. If it is assumed that the items not covered by the surcharge but affected by the devaluation are not sensitive to price changes -- industrial materials, foodstuffs -- then the import bill for these items in terms of dollars may actually rise under a devaluation. If this occurs, a devaluation would appear to be even less effective in reducing imports than the surcharge.

Offsetting this latter effect is the probable improvement in exports with a devaluation while there would be no stimulus to exports under a surcharge. In either case, these illustrations ignore the possible retaliations by foreign governments, which are more likely with a surcharge than with exchange rate changes. They also ignore the actions of exporters and importers in absorbing part of the potential price change -- which would differ to the extent a surcharge is presumed to be temporary while a devaluation is expected to have long-run effects.