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January 21, 1970 1969

TO: Board of Governors

FROM: Charles Molony

SUBJECT: Part I of Board's Annual Report; first instalment

CONFIDENTIAL (FR)

The urgency of clearing the material for Part I of the Board's Annual Report for 1969, the volume of material to be included in that Part, and the lack of staff time available to prepare certain parts have made it seem advisable to send the draft in instalments.

The first instalment is attached. It includes 81 pages and covers the following sections:

Credit Markets and Financial Flows
Demands, Resource Use and Prices
International Payments and Reserves.

The section entitled "Monetary Policy and the Economy" will probably not be more than 10 pages. We plan to send that instalment to you by early afternoon on Thursday, January 22.

The Digest of Principal Federal Reserve Policy Actions will not be available until the Board's records are available. We will plan to forward draft of the Digest to you at the time we send the galley proof of Part I for your final approval.

Inasmuch as all of the material has been prepared under considerable pressure, a substantial amount of further revision and editing will be necessary. The figures must still be checked, and new data will be incorporated as they become available.

In order to expedite the further editing and preparation of this material for the printer, we would appreciate having your suggestions as soon as possible. We plan to send final copy to the printer by Tuesday, January 27, 1970, if possible.

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CREDIT MARKETS AND FINANCIAL FLOWS

Demands for credit remained heavy in most sectors of the economy in 1969 as economic activity continued to expand, price increases accelerated, and business capital investment rose to new record levels. In view of the inflationary character of the economy, and of the widespread expectation of further inflation to come, the Federal Reserve pursued a policy of monetary restraint throughout the year. The resulting constraint on the supply of lendable funds relative to demand led to further sharp increases in interest rates, which were at postwar highs by the year-end. Expansion of total bank credit slowed substantially during the year, even after allowance for expanded use of nondeposit sources of funds, and the money supply grew at only a 2-1/2 per cent rate.

During the year rising interest rates on market securities, in conjunction with regulatory restrictions on rates payable at depositary institutions, progressively limited the availability of institutional credit as investors shifted funds out of deposit-type instruments and into higher-yielding market securities. Commercial banks were particularly affected by such shifts and their share of the total flow of credit extended to nonfinancial borrowers dropped sharply in the first half, and then turned negative in the second half as bank credit declined. Other depositary institutions were better able to maintain their share of total credit supplied--even though their

deposit inflows slowed progressively during the year--by increased reliance on other sources of funds; for example, savings and loan associations borrowed heavily from Federal home loan banks. Credit supplied to borrowers directly through the security markets also became more costly and more limited as the year progressed.

During the first half of the year, funds raised by nonfinancial sectors from all sources declined substantially as compared with the total for the latter half of 1968; but this reduction represented a shift from borrowing to repayment of debt by the U.S. Government as the budget moved into surplus. Borrowing by private sectors increased. In the second half of the year, however, funds raised by private sectors declined substantially in response to the increased cost and reduced availability of credit and to the slower growth in economic activity. And even though the U.S. Government was again a net borrower of funds in the second half, total funds raised by all sectors decreased further during this period.

FIRST HALF OF YEAR

During the first half of 1969 the Federal Reserve continued to pursue the more restrictive monetary policy initiated in December 1968. Total reserves of member banks rose at an annual rate of less than 1 per cent as compared with nearly 11 per cent in the latter half of 1968. Nonborrowed reserves--those reserves provided through Federal Reserve open market operations--actually declined at an annual rate of almost 4 per cent, in sharp contrast to a rate of rise amounting to more than 10 per cent in the preceding half year. In addition to

the pressure exerted on banks through open market operations, the Federal Reserve in April raised the discount rate from 5-1/2 to 6 per cent and increased reserve requirements by 1/2 of a percentage point on demand deposits at member banks.

Consequently, individual banks sought to supplement their reserves by increased borrowing at the discount window, in the Federal funds and Euro-dollar markets, and in other ways. Borrowings from Federal Reserve Banks rose rather steadily over the first half to an average of about $1.4 billion in June; this was almost double the highest monthly level reached in the latter part of 1968. In the Federal funds market--where excess reserves of banks are bought and sold on a day-to-day basis--the volume of funds traded through New York rose to a daily average of around $9.0 billion in the second half of 1968. The cost of these funds also rose, reaching an average of 8.90 per cent in June, well above the maximum of around 6.00 per cent that banks had paid for such borrowings in the second half of 1968.

Banks also increased sharply their borrowings in the Euro-dollar market--mostly through foreign branches. The total of such borrowings--the great bulk through foreign branches--doubled in the first half, rising to almost $14.3 billion by the end of June. Banks had to pay increasingly higher rates to obtain these funds; Euro-dollar rates generally ranged from 10 to 12 per cent in June, depending on the maturity, as compared with 6 to 7 per cent in December 1968.

Moreover, funds were acquired through the sale of commercial paper by bank holding companies, affiliates, and subsdiairies, the proceeds of which were transferred to banks by purchases of bank loans. By midyear, about $1.2 billion of such paper was outstanding. Banks also borrowed through the sale of loans to the nonbank public, subject to repurchase agreements; by June 30 such outstandings had reached about $850 million.

In order to correct certain situations that had arisen in connection with borrowing in the Euro-dollar and Federal funds markets, the Board of Governors proposed several amendments to its regulations during the first half of the year, most of which were effectuated later in the year. On May 29 the Board proposed an amendment to Regulation D (governing reserves of member banks) designed to ensure that checks resulting from transfers involving foreign branches were not used to effect reductions in required reserves. Moreover, in order to remove a special advantage to U.S. member banks of using Euro-dollars for adjustment to domestic credit restraint--and hence to moderate the inflow of Euro-dollars to U.S. banks from their foreign branches and also from foreign banks--it was proposed on June 26 that a 10 per cent reserve requirement be established on borrowings of U.S. banks from their foreign branches to the extent that these borrowings exceed the daily-average amounts outstanding in the 4 weeks ending May 28, 1969. On June 27 the Board issued a proposal to narrow the

category of "Federal funds" transactions that is exempt from Regulation D and Q (governing payment of interest on deposits by member banks).

Deposit Flows of Intermediaries Decline

The availability of deposit funds at commercial banks was sharply limited during the first half of 1969. As market yields became more attractive relative to the maximum interest rates that banks were permitted to offer on their time and savings deposits, funds began to be withdrawn or diverted from these instruments for investment in higher-yielding market securities. During the first half of the year total member bank deposits declined at an annual rate of 3.5 per cent, as compared with a rate of increase exceeding 13 per cent in the second half of 1968. Nonbank depositary institutions in the first half were affected to a much lesser extent by such shifts out of their instruments; deposit inflows at these institutions slowed to an annual rate of 5 per cent from the more than 6 per cent prevailing in the latter part of 1968.

The decline in commercial bank deposits during this period reflected largely the reduction in time and savings deposits, which consisted mainly of sizable outflows of negotiable time certificates of deposits (CD's) in denominations of $100,000 or more. By early December 1968, short-term market rates had risen to the extent that maximum offering rates on CD's allowable under Regulation Q ceilings were no longer competitive, and sizable CD attrition ensued. Over the

first half of 1969, outstanding CD's at large commercial banks declined by $7.5 billion, seasonally unadjusted, or by about one-third of the amount outstanding at the end of December 1968. The bulk of this attrition took place at large banks in the major financial centers where depositors tend to be more interest sensitive; banks in New York City and Chicago, which held about 35 per cent of the outstanding CD's at the end of December 1968, accounted for 60 per cent of the run-off of CD's during the first half. Toward midyear, however, banks outside of New York and Chicago began to account for an increased share of the attrition.

Time and savings deposits other than CD's were also influenced by rising market rates of interest. At large banks, savings deposits and time deposits held by individuals, partnerships, and corporations (other than their holdings of large negotiable CD's), grew during the first quarter at about one-half of the rate for the last half of 1968, and then declined on balance over the second quarter. At country banks net inflows of total time and savings deposits dwindled fairly steadily over the first half, and for the entire period the inflow was only half that in the latter half of 1968.

Rising market rates of interest and the growing squeeze on the availability of borrowed funds also induced private holders to economize on their cash balances. During the first half the money stock--currency and privately held demand deposits--grew at an annual rate of 4.3 per cent, down sharply from the 7.0 per cent rate in the

second half of 1968. Privately held demand deposits rose at an annual rate of 3.7 per cent, about half the rate of growth in the latter part of 1968, whereas currency in the hands of the public continued to expand fairly rapidly--at an annual rate of 6.5 per cent. Demand deposits held by the Federal Government remained essentially unchanged over the first half.

Credit Restricted at Depositary Institutions

With their lendable funds becoming more limited in the face of continued strong demands for credit, depositary institutions--mainly banks--undertook substantial adjustments in their investment portfolios. Banks reduced their liquidity, cut back sharply on acquisitions of longer-term U.S. Government, Federal agency, and municipal securities, sold loans outright, and generally tightened their terms and conditions of lending. Total loans and investments at commercial banks expanded at an annual rate of only 4 per cent during the first half, well below the 15 per cent rate of rise in the previous 6 months.

Banks reduced their holdings of U.S. Government securities by more than $5 billion during the first half--largely Treasury bills and short-term notes and bonds--and virtually ceased their acquisitions of other securities. Large banks, in fact, made substantial reductions in their holdings of municipal issues over the first half. Consequently, by midyear the total of liquid assets held by banks had dropped sharply, and the ratio of these assets to deposit and other liabilities had fallen lower than at any time during the period of monetary restraint in late 1966. In addition, the accommodation of new loan demands was partially satisfied by the outright sale of existing

loans by banks; such sales to other than banks and bank-related affiliates and subsidiaries amounted to about $750 million by midyear.

Banks also tightened their lending terms and conditions in this period. The prime rate, for example, was raised three times--from 6-3/4 per cent to 7 per cent in early January, to 7-1/2 per cent in mid-March, and to 8-1/2 per cent in early June. The increase in bank loans over the first half--at an annual rate of about 10 per cent--was substantially less than the 15.5 per cent increase during the second half of 1968. Inclusion of loans sold to bank holding companies, affiliates, and subsidiaries would bring the increase in bank loans to an annual rate of 11 per cent in the first half, which still would be well below the pace in the prior 6 months.

Although expansion of total bank loans slowed during the first half, loans to businesses continued to expand at about the rapid pace prevailing in the latter part of 1968--and even picked up somewhat if loan sales are included--as corporate demands for funds intensified and banks continued to make a large volume of new loan commitments to businesses. Growth in most other major loan categories began to slacken, however. A moderation in the advance of real estate loans began in the second quarter, accompanied by a decline in housing starts, and expansion of consumer loans slowed, as did growth of total consumer credit. And security loans, which had expanded rapidly in the autumn of 1968, fell, on balance, during the first half of 1969 as

dealers reduced their positions, in response to the high cost of carrying inventories of securities and to expectations that interest rates would rise further.

Nonbank thrift institutions were able to increase substantially their net acquisitions of credit market instruments in spite of somewhat reduced inflows of funds to savings accounts. Savings and loan associations--the dominant residential mortgage lender--relied heavily on borrowings from the Federal home loan banks in order to increase their takings of mortgages. At mutual savings banks net acquisitions grew less rapidly than in 1968, and there was some contraction in the volume of mortgage lending, but this was moderated by reduced acquisitions of corporate bonds. Moreover, the growing pressure on available funds resulted in a slowing of new-commitment activity in the mortgage area as the year progressed. After April, the backlog of outstanding mortgage commitments began to decline.

At life insurance companies, the contractual nature of funds inflows insulated these intermediaries to a significant degree from the type of pressure experienced by depositary institutions. But there was a substantial rise in policy loans at insurance companies--as policy holders faced increased costs and reduced availability of credit from other sources. Hence, the volume of funds available at these companies for other investments could be maintained at the second-half-of-1968 level only by a reduction in cash balances. As a result, life insurance companies became more cautious about making new commitments and about scheduling takedowns of funds.

Pressures in Security Markets Intensify

As economic activity remained strong and bank loans came under increasing restraint, nonfinancial business borrowers turned more and more to the increase of market securities and shorter term paper to obtain needed funds. Plant and equipment expenditures were rising sharply and internal funds generation slowing somewhat, so that total corporate financing requirements were rising on balance. The volume of funds raised through bond and stock offerings in the first half of 1969 was significantly larger than that in the second half of 1968; most of the increase was accounted for by stock issues, despite the lack of buoyancy in average stock prices--which reached a peak in December 1968 and then declined 7 per cent on average through June. Although large industrial firms accounted for a relatively small share of new debt and equity issues, both public utility and communication firms and small to medium-sized industrial firms, issued debt in volume. Corporations borrowed heavily in the commercial paper market as well--raising nearly $5 billion at a seasonally adjusted annual rate, or $2 billion more than in the prior 6 months.

Borrowing by State and local governments was significantly affected by the pressures that developed in securities markets and by the drying up of demand for these securities by commercial banks--the principal institutional purchaser of municipal debt. Rising market rates of interest on long-term municipal securities generated a sizable

cutback in the issuance of such debt in the first quarter; net long-term borrowing in that period amounted to $4 billion (annual rate), less than one-half the rate in the fourth quarter of 1968. Many governmental units were forced to postpone or cancel planned borrowing because of below-market rate ceilings. To a considerable extent, the reduced volume of long-term borrowing was offset by a sharp rise in the flotation of short-term debt by units having authority to enter this market and not subject to restrictive rate ceilings, and total market issues fell only moderately in the first quarter.

Early in the second quarter yields on municipal securities declined, largely as a result of expectational factors, and the volume of long-term debt increased significantly from the unusually low first-quarter rate. At the same time municipal demands on the short-term market dropped from the peak rates of the first quarter, but they were still quite high. However, a renewal of upward pressures on interest rates as the quarter progressed resulted in more cutbacks and postponements of long-term borrowing plans, with short-term or interim financing being substituted in some instances.

Federal Government demands on credit markets were substantially reduced in the first half of 1969 relative to a year earlier. Although the budget showed a deficit of $2 billion in the first quarter, this was less than one-fourth that in the comparable quarter a year earlier. Moreover, in the second quarter the budget swung into

substantial surplus, reflecting a sharp year-over-year gain in revenues--attributable to receipts from the tax surcharge as well as higher incomes--and constraint on expenditures. As a result the Federal Government, on balance, repaid debt in volume, at seasonally adjusted annual rates, there was a turnaround from a net borrowing of $12 billion in the last half of 1968 to a net repayment of $10.5 billion in the first half of 1969.

On the other hand, Federally sponsored credit agencies not included in the budget increased their demands on the securities markets. Net debt issuance by these agencies aggregated $6.3 billion (annual rate) in the first half, more than three times the volume in the second half of 1968. The Federal home loan banks and Federal National Mortgage Association accounted for a substantial portion of this borrowing, as they sought funds to channel to the mortgage market.

Interest Rates Advance

With demands for credit remaining generally in excess of the available supply in nearly all financial markets, most market interest rates rose further. Banks, facing persistent loan demands and reduced availability of lendable funds, not only raised their prime lending rates but also bid up rates paid on Federal funds and Euro-dollars as they aggressively sought funds in these markets.

Other short-term rates also rose substantially. Corporate demands for funds spilled over into the commercial paper market, and bank affiliates began to issue commercial paper, with the result that

rates on 4- to 6-month paper advanced to above 8.50 per cent by the end of June, an increase of more than 2 percentage points during the first half. Whereas yields on Treasury bills and short-term Federal agency issues were relatively unchanged through the spring, by midyear rates on these instruments had risen substantially. Larger sales of Treasury bills by banks were readily absorbed by the market as the demand for bills was increased in large part by the shifting of investor funds out of large CD's and into other market instruments, and also by demands for bills by many investors who wished to increase their liquidity positions because of financial uncertainties. However, continued sales of bills by banks, as well as reduced demands by some institutional investors, resulted in a rise in bill yields to an average in June about 50 basis points above that in December 1968.

In long-term markets, upward pressures on interest rates were substantial as banks withdrew from the market because of reduced availability of funds and other investors remained cautious in anticipation that tighter market conditions might follow. By the end of June the average yield on municipal bonds had risen more than 80 basis points from the level prevailing in December 1968. Rates on corporate Aaa new issues (with 5-year call protection) and on Federal Housing Administration mortgages rose by about 60 and 85 basis points, respectively. Yields on long-term Government bonds, however, increased relatively little, as no long-term debt was issued by the Treasury because of the below-market rate ceiling on such instruments.

SECOND HALF OF YEAR

During the second half of 1969 both total and nonborrowed reserves of member banks declined slightly--at an annual rate of 2.5 to 4 per cent--as the policy of restraint in Federal Reserve open market operations was continued. Moreover, on July 24 and August 13 the Board of Governors of the Federal Reserve System enacted amendments to Regulations D and Q, proposed earlier in the year, that were designed to limit member bank borrowing in the Euro-dollar market (discussed on p.4 above). Also on July 24 the Board took action to narrow the scope of member bank liabilities under repurchase agreements that are exempt from Regulations D and Q. On October 29 the Board announced that it was considering amendment of its rules governing the payment of interest on deposits (Regulation Q) to apply to funds received by member banks from the issuance of commercial paper or similar obligations by bank affiliates.

All of these pressures led banks to maintain their borrowings at the Federal Reserve Banks at about the high level reached in the early summer. They also relied increasingly on the Federal funds market, with about $10 billion of these funds being traded through New York on a daily-average basis during December, or about $1.0 billion more than at midyear. The Federal funds rate in December averaged clost to 9.00 per cent, 10 basis points higher than at midyear.

Total borrowing by U.S. banks in the Euro-dollar market rose sharply further in July, but remained essentially unchanged at an average level of about $15.5 billion during the balance of the second half, probably to some extent in response to System action in late July and early August concerning such borrowing. Rates on Euro-dollars dropped slightly from those prevailing in June and averaged from 10 to 11 per cent in December, depending on maturity.

Outstanding commercial paper issued by bank holding companies or other bank affiliates, however, rose sharply, by an additional $3 billion in the second half. But after borrowing through sales of loans under repurchase agreement became subject to Regulations D and Q in late July, such net borrowings from the nonbank public declined steadily to a level of about $200 million at the end of the year.

Deposit Flows to Intermediaries Curtailed Further

As market rates of interest continued to increase, the availability of deposit funds at the major types of thrift institutions became more restricted. The outflow of total deposits at member banks was somewhat larger than in the first half--at an annual rate of nearly 5 per cent--and funds obtained by banks from nondeposit sources failed to offset fully this decline; total member bank deposits plus nondeposit funds fell at an annual rate of about 1 per cent during the second half. Net inflows at nonbank thrift institutions were cut sharply during the latter half of the year.

Declines in outstanding time and savings deposits at commercial banks--at an annual rate of more than 6.5 per cent in the second half--continued to account for a large part of the reduction in total deposits after midyear. CD attrition began to moderate from the rapid pace of the first half, however, as the volume of maturing issues declined. The run-off in CD's during the second half was approximately $4.5 billion, seasonally unadjusted, or about 60 per cent of that earlier in the year. In contrast to the first half, the bulk of this attrition took place outside of the major financial centers; banks outside of New York City and Chicago experienced more than 90 per cent of the run-off, or more than twice their share earlier in the year. In fact, banks in New York City were able to add to their time deposits of foreign official holders in the fourth quarter. Such deposits are not subject to interest rate ceilings under Regulation Q. Part of the increase however, appeared to reflect a shifting of balances previously held in the form of Euro-dollar deposits with foreign branches of U.S. banks.

Time and savings deposits other than CD's became increasingly important in the decline in total time and savings deposits at banks. At large banks, seasonally unadjusted outflows of consumer-type time and savings deposits were, on the average, about 20 per cent greater than those that had developed during the second quarter. And at country banks the progressively reduced inflows, seasonally unadjusted, of the first half of the year turned to sizable net outflows during the second half.

Banks also lost demand deposits, on balance, during the second half; the decline in privately held demand deposits more than offset the rise in those held by the U.S. Government. Growth in currency in the hands of the public, however, was fairly well sustained, so that the reduction in privately held demand deposits was more than offset in the money supply statistics. The total money stock rose slightly--at an annual rate of less than 1 per cent--during the second half of the year.

Net inflows of funds to thrift institutions continued to decline during the second half of the year, as yields on market securities rose further above the rates paid on savings accounts. Both savings and loan associations and mutual savings banks experienced substantial outflows during the July and October interest-crediting periods, and net inflows remained depressed in other months of the second half. As a result, deposits at these institutions grew at a seasonally adjusted annual rate of only 1.6 per cent, about one-third the rate in the first part of the year.

Restriction of Intermediary Credit Cumulates

With lendable funds becoming increasingly limited and with liquidity already at very low levels by midyear, banks were obliged to curtail their lending activity further. In adjusting their asset portfolios to the reduced supply of funds they continued to rely on security liquidation and intensified loan rationing, and after midyear total bank credit rose only slightly further.

Again the bulk of the liquidation of security holdings of banks, which totaled almost $6 billion, was in U.S. Government securities--mainly Treasury bills and short-term notes and bonds. However, banks did reduce their portfolios of other securities--generally municipal issues--as holdings of short-term U.S. Government securities were probably approaching minimum working balances, needed for pledging requirements and so forth. Outright sales of loans by banks to others than banks or bank-related affiliates and subsidiaries continued, reaching a level outstanding of about $1.3 billion by the year-end, about $500 million more than at midyear.

Banks also reported further tightening in their lending terms and conditions. There were substantial cutbacks in the dollar amount of new commitments made, and total bank loans rose at an annual rate of only about 5 per cent, about half that of the already reduced pace in the first half. Inclusion of loans sold to bank holding companies, affiliates, and subsidiaries would result in an annual rate of increase in bank loans at about 6.5 per cent, still well below the pace of expansion earlier in the year.

The further slowing in bank loans was evident in virtually all major loan categories. Business loans, which had risen rapidly in the last half of 1968 and the first half of 1969, grew at a sharply reduced rate after midyear. Expansion of real estate loans also moderated substantially further--in line with the continued declines

in housing starts and a drop-off in construction activity--and growth in consumer loans remained at about the reduced pace of the first half.

At other depositary institutions, net acquisitions of mortgages declined, but by less than would have been suggested by the reduction in net savings inflows and smaller mortgage repayments--the latter resulting in part from reduced over all real estate activity and a decline in prepayment volume associated with assumptions of outstanding mortgages to facilitate transactions in existing properties. Net extensions of mortgage credit by these intermediaries were financed by reductions in liquidity positions, by record borrowing of savings and loan associations from the Federal home loan banks, and by reduced acquisitions of securities by mutual savings banks. But with new mortgage commitment activity cut back further, the level of outstanding mortgage commitments at the year-end was well below that a year earlier.

Inasmuch as the other primary mortgage-lending institutions--commercial banks and life insurance companies--were also experiencing considerable pressure on lendable funds, growth in total mortgage debt, seasonally adjusted, continued to decline from the record rate reached in the fourth quarter of 1968. However, mortgage credit supplied by FNMA and, to a lesser extent, expanded lending by the Government National Mortgage Association, became increasingly important factors in holding total net residential mortgage lending, for the full year, above the rate in 1968.

Private Security Issues Moderate

Private nonfinancial borrowing in security markets declined in the second half from the advanced pace registered earlier. The reduced volume of such borrowing was attributable in large part to the further increase in cost and reduced availability of credit. Net new issues of long-term securities by State and local governments were $1.5 billion below the $5.6 billion total, at an annual rate, for the first half of the year. Many governmental units were forced to defer long-term financing because of below-market rate ceilings. Even some units that had had their ceilings increased earlier in the year were limited in the extent to which they could finance programs by borrowing, as bank reductions in holdings of municipal issues and investor concern over provisions in the proposed tax reform bill--related to the tax treatment of interest income on municipal securities--contributed to a substantial, further increase in rates on these securities. While some governmental units with flexibility borrowed at short-term, or reduced their liquid assets, and/or used other sources of funds, the aggregate growth in State and local government expenditures nevertheless moderated in the second half of the year.

Flotations of corporate securities were slightly below the exceptionally high rate of the first half. While public offerings of bonds by corporations rose somewhat, the increase was offset by the developing tightness in private placements. Equity offerings remained unusually large in view of the continued decline, on balance, in average stock prices. Although gross corporate security offerings

were a record for the full year, maintenance of a high and rising level of net investment during the second half put added pressure on corporate financial positions. Because declining profits were restraining growth in internal funds and it was increasingly difficult to obtain bank loans, corporations relied on substantial reductions in liquid assets and on further issuance of commercial paper.

The Federal Government was a net borrower of funds during the second half whereas it had made net repayment of debt earlier in the year. Three factors in particular caused the budget surplus to decline to a seasonally adjusted annual rate of $5 billion, or roughly one-half that in the first half; these were enlarged Federal expenditures, the absence of make-up payments on 1968 tax liabilities, and the slower growth in incomes--and consequently, tax receipts. Continuing a pattern evident in the first half, Federally sponsored agencies outside the budget offered a sizable volume of debt issues to raise new money, mainly in connection with FHLB and FNMA borrowing in support of the mortgage market. When combined with borrowing in the budget, net funds raised by the Federal sector in total amounted to about $15 billion at seasonally adjusted annual rates, compared with the net repayment of more than $3 billion in the first half of the year.

Interest Rates Rise to Postwar Highs

Interest rates in both short- and long-term markets rose substantially further over the second half of the year. Increased demands for funds by banks pushed rates up in the Federal funds and

commercial paper markets. Treasury bill yields came under substantial upward pressure as the Treasury raised new cash through additional bill sales at a time when commercial banks and other intermediaries were reducing liquidity positions; the yield on 3-month Treasury bills rose to new highs and averaged about 7.80 per cent in December, 140 basis points above the June level.

Interest rates also continued to press upward in capital markets. With commercial banks reducing their holdings of municipal securities and individual investors concerned over tax reform and the future course of interest rates, municipal yields advanced more than 1 percentage point in the second half--reaching a record 6.90 per cent average in December. Corporate Aaa new issues (with 5-year call protection) were also marketed at new highs in the latter part of the year--increasing about 120 basis points to 8.75 per cent in December. Continuing strong demands for construction and the reduced availability of mortgage credit combined to push up interest rates on mortgages continuously in the second half. However, ceiling constraints on conventional and Government-underwritten mortgages tended to limit the over all rise in mortgage rates. Long-term U.S. Government bond yields followed the upward trend and increased about 60 basis points to a year-end level of approximately 6.80 per cent.

DEMANDS, RESOURCE USE, AND PRICES

Expansion of aggregate output in the United States slowed markedly in 1969 and halted in the fourth quarter. For the full year, growth in real GNP amounted to 2.9 per cent, compared with 4.9 per cent in 1968; except for 1967 this was the smallest increase for any year since the recession year of 1961. In large measure the slowing reflected the sustained pressure exerted by the restrictive fiscal and monetary policies that had been adopted in mid- and late 1968, respectively, in order to dampen persistent inflation and inflationary expectations. Nevertheless, inflationary pressures remained strong throughout 1969. Prices, as measured by the implicit GNP deflator, advanced 4.7 per cent, the largest amount since 1951; increases had amounted to 4.0 per cent in 1968 and 3.2 per cent in 1967.

The fourth quarter of 1969 was the first since the spring of 1967 in which real GNP had not shown a significant rise. The GNP price deflator nevertheless increased at an annual rate of around 4.5 per cent. The diminishing strength of demand for goods, particularly in the second half of the year, was evident in the pattern of industrial production. The Board's index averaged about 4.5 per cent higher in 1969 than in 1968, but it declined in every month after July. In December the index was 2 per cent below its summer high and was little more than 1 per cent above a year earlier. Some of the net decline after mid-year was attributable to a major strike in the electrical

equipment industry, but for the most part it reflected weakening demands for consumer goods, particularly automobiles and other durable goods, and declines in output of defense equipment and materials.

As expansion of output moderated in the second half of the year, the capacity utilization rate in manufacturing declined appreciably and signs of easing began to appear in the labor market. Growth in employment slowed perceptibly. In manufacturing, employment in December was smaller than in June, exclusive of those out of work because of the major work stoppage, and the average workweek was also lower. Unemployment claims were rising. But the over-all unemployment rate, which had risen in the second and third quarters, changed little in the fourth quarter and in December was about the same as a year earlier.

Unit labor costs in the private nonfarm economy rose steeply in 1969--about 6-1/2 per cent according to preliminary estimates compared with 4 per cent in 1968. The rise in output per manhour for the year was small while average wage rates continued to rise sharply, although a little less sharply than in 1968. In manufacturing, the gain in output per manhour was appreciably more than for the private nonfarm economy as a whole and unit labor costs rose less.

The persistence of inflationary pressures reflected a number of interacting influences, with special supply situations--as in the case of meats--generally operating on the upside. Even though expansion of output was slowing and labor

markets were beginning to show signs of easing, manpower and industrial resources were fairly well utilized until late in the year and consumer incomes were rising sharply. The preceding--and continuing--increases in consumer prices were serving as a floor in wage negotiations as workers endeavored to catch up with earlier price advances and also to improve their standard of living. Nonlabor costs, including materials, were also advancing, and producers and distributors made efforts to recoup both these and the sharply rising unit labor costs through higher selling prices. The pervasive nature of inflationary expectations--apart from tending to raise businessmen's sights for spending on plant and equipment and inventories--affected labor's wage demands, employer willingness to grant sizable settlements, and business pricing policies.

DEMANDS

Real GNP had increased at an exceptionally rapid annual rate of 6.3 per cent in the first half of 1968, but by the fourth quarter of that year expansion was down to a 3.5 per cent rate. This slowing continued during 1969, and in the fourth quarter (Table A) the expansion halted, with a prolonged work stoppage in the electrical equipment industry forestalling some slight increase. The deceleration of growth in 1969--in both current and constant dollars--reflected successively smaller increases in final sales as the year progressed. The rate of inventory accumulation fluctuated within a relatively moderate range but was larger in the second half of the year than in the first. Even these moderate fluctuations, however, had a perceptible influence on quarter-to-quarter changes in total GNP.

Quarterly changes in current-dollar expenditures for most major categories of final demand were not so expansive in the second half of the year as in the first (Table B). Early in the year sizable increases in consumer spending, business fixed investment, State and local government purchases, and residential construction added up to a large advance in total final sales. In the second half, on the other hand, the rise in consumer spending was much smaller and so was that in State and local government purchases; business fixed investment was not quite so strong as in the first half; and residential construction activity was declining. Federal purchases were

TABLE A: GROSS NATIONAL PRODUCT

Item	1967	1968	1969	1969[1] I	1969[1] II	1969[1] III	1969[1] IV
	In billions of dollars						
Total	793.5	865.7	932.5	908.7	924.8	942.8	953.1
Inventory change	7.4	7.3	8.3	6.6	6.9	10.7	7.8
Final sales	786.2	858.4	924.2	902.1	917.9	932.0	945.3
Private[2]	695.5	758.9	822.0	800.5	817.3	828.8	842.6
Federal	90.7	99.5	102.2	101.6	100.6	103.2	102.7
	Change from preceding period: In billions of dollars						
Total	43.6	72.2	66.8	16.2	16.1	18.0	10.3
Inventory change	-7.4	-0.1	1.0	-3.9	0.3	3.8	-2.9
Final sales	51.1	72.2	65.8	20.1	15.8	14.1	13.3
Private[2]	38.2	63.4	63.1	20.4	16.8	11.5	13.8
Federal	12.9	8.8	2.7	-0.3	-1.0	2.6	-0.5
	In per cent, at annual rates						
GNP in current dollars	5.8	9.1	7.7	7.3	7.1	7.8	4.4
GNP in 1958 dollars	2.5	4.9	2.9	2.5	2.0	2.1	-0.1
GNP implicit deflator (1958 = 100)	3.2	4.0	4.7	4.7	5.1	5.6[3]	4.4

1 Quarterly figures are at seasonally adjusted annual rates.

2 Adjusted to include State and local governments.

3 Excluding Federal pay increase, 4.3 per cent.

Note:--Basic data from Dept. of Commerce.

Table B: GROSS NATIONAL PRODUCT: FINAL SALES
Change from preceding period, in
billions of dollars

Item	1967	1968	1969	1969 I	1969 II	1969 III	1969 IV
Total Final Sales	51.1	72.2	65.9	20.1	15.8	14.1	13.3
Personal consumption expenditures	26.0	44.3	39.4	11.3	10.8	7.0	9.4
Durable goods	2.2	10.3	6.3	2.1	2.2	-0.8	-0.2
Nondurable goods	8.2	15.5	13.2	4.3	3.5	3.0	4.3
Services	15.6	18.6	19.7	4.9	5.1	4.8	5.3
Addendum: Saving rate	7.4	6.5	6.0	5.3	5.3	6.7	6.4
Fixed investment	2.0	10.4	12.5	5.2	1.9	2.0	2.0
Residential structures	0.0	5.2	2.0	1.4	-0.6	-1.3	0.2
Nonresidential	2.1	5.1	10.5	3.8	2.5	3.3	1.9
Net exports of goods & services	-0.1	-2.7	-0.4	0.3	0.1	1.1	-0.1
Govt. purchases of goods & services	23.3	20.2	14.4	3.3	2.9	4.1	1.9
Federal	12.9	8.8	2.5	-0.3	-1.0	2.6	-0.5
Defense	11.7	5.6	1.3	-0.3	-0.5	1.8	-1.1
Other	1.3	3.1	1.3	0.1	-0.5	0.8	0.6
State and local	10.3	11.4	12.0	3.7	3.8	1.5	2.4

Note: Basic data from Department of Commerce.

edging down over the year, except for a rise in the third quarter, when there was a pay increase for both civilian and military personnel.

However, net exports of goods and services--which had been adversely affected in late 1968 and the first half of 1969 by the prolonged strike at East Coast and Gulf ports--gained strength in the second half of the year as merchandise exports increased faster than imports. But for the year as a whole, the merchandise trade surplus barely matched the very small balance of 1968. And the over-all surplus on goods and services was smaller than in 1968 because of the reduction of about $0.5 billion in the surplus on services.

Government

Federal fiscal development contributed in a major way to the slowing of over-all expansion in 1969. A major turn in fiscal policy had occurred with enactment of the Revenue and Expenditure Control Act of 1968 in late June of that year. This Act had imposed, until mid-1969, a 10 per cent surcharge on corporate income taxes, /retroactive to January 1, and on most individual income taxes, retroactive to April 1. In addition, it provided for restraints on some expenditures.

As a result of these actions, the Federal fiscal position as measured in the national income accounts (NIA) turned from stimulating general economic activity to restraining it. In the first half of calendar 1968, the Federal deficit had amounted to about $9.5 billion, annual rate, but by the fourth

quarter, the Federal fiscal position (NIA basis) was in balance. In calendar year 1969, the surcharges on both corporate and individual income taxes were extended at 10 per cent to the end of the year, and a surplus of about $10 billion emerged. Total receipts for the year increased by $25 billion while total expenditures rose by $10 billion.

Also a striking development in 1969, as well as the over-all fiscal position, was the virtual cessation of growth in direct Federal demands on resources. Federal purchases of goods and services rose by less than $3 billion for the calendar year 1969, a far smaller increase than in either of the two preceding years. Moreover, the rise in Federal purchases from late 1968 to late 1969 amounted to less than $1 billion (annual rate), even including the sizable pay increase in the third quarter (Table A). Apart from this pay increase, defense spending was drifting down throughout 1969--reflecting the beginning of disengagement from Vietnam.

Federal expenditures other than for goods and services increased by about $8 billion in the calendar year 1969, only a little less than in 1968. About half of the increase was in transfer payments, mostly social security payments. Most of the remainder was in interest on the public debt and in grants-in-aid to State and local governments.

State and local government purchases of goods and services increased by $12 billion, or 12 per cent in the calendar year 1969--a little less than in 1968. But growth in

the second half was only about half as large as in the first half (Table B). A major reason for this slowdown was the congestion in capital markets and record interest rates. Many States and municipalities were impelled to trim borrowing and capital spending either because legal interest rate ceilings were below prevailing market rates or because they were unwilling to borrow at the current market rates.

Business Fixed Investment

Business spending on fixed investment was a major stimulus to over-all expansion in 1969. The increase for the year--12 per cent--was double that for 1968 and was the largest for any broad category of final demand. Moreover, such spending maintained its upward momentum much better in the second half of 1969 than did other major sectors of demand, and year-end surveys indicated plans for a substantial further rise in 1970, particularly in the first half of the year. It should be noted that more than half of the 1969 increase represented higher prices, both for structures and for producers' durable equipment.

Spending on plant and equipment turned out to be somewhat smaller than indicated by an official survey of intentions early in the year. But the shortfall represented mainly the failure of actual spending to match anticipations in the first two quarters and probably resulted primarily from delays in construction schedules and in equipment deliveries, given the high rate of resource use in these industries. Tight financial markets and less buoyant views about prospects undoubtedly

contributed to some cutbacks, but in the aggregate these cutbacks appear to have been marginal. The President's recommendation, enacted toward year-end, that the investment tax credit be repealed as of April ___ apparently exerted only a limited effect on spending in 1969.

Broad influences stimulating the sizable expansion in fixed capital spending included optimism about future sales prospects, rising prices of plant and equipment, and sharply increasing unit labor costs. Profits after taxes totaled about [$51 billion], up slightly from the $50 billion of 1968, but in the second half of the year these profits were declining. In some basic industries--for example, electric utilities--existing capacity was clearly being pressed. In others, technological advance was a major stimulus. Altogether, about half of 1969 capital spending was for expansion of capacity and half for modernization, including cost cutting.

Nevertheless, the large further rise--12 per cent--in manufacturing outlays was somewhat surprising in view of the rather moderate rate of capacity utilization in that sector. The rate for 1969 averaged less than the 84.5 per cent rate of 1968, and by the end of the year it had declined to about 81 per cent. Only three years earlier, in 1966, manufacturing industries had been using their capacity at an average rate of more than 90 per cent. From the end of 1966 to the end of 1969, manufacturers had increased their capacity about ____ per cent. Meanwhile, output had risen by only _____ per cent.

Business Inventory Accumulation

Businessmen accumulated inventories at a relatively moderate rate in 1969, about in line with the historic average relationship of inventory investment to GNP. Nevertheless, by the end of the year--as sales and new orders slowed--inventory levels appeared to be more burdensome than they had been at the beginning of the year.

Producers of consumer goods began to reduce output in the second half of the year in an effort to adjust to weaker consumer demands. The declines were not sufficient to bring inventories back into line with sales, however, and by late 1969 the inventory/sales ratio for retail establishments had risen to the highest level in many years. Auto stocks in particular were at record levels relative to sales. Inventories of other major consumer goods also remained fairly high, despite the cuts in production and a strike at a major producer. Nevertheless, such inventories were declining.

High levels of demand for business and defense equipment resulted in sizable additions to durable goods manufacturers' inventories--particularly work-in-process--during most of the year. In the second half, however, growth in orders for these goods was also slowing, and the backlog of unfilled orders leveled off.

Residential Construction

About 1.5 million private housing units were started in 1969, virtually the same number as in 1968. The number of

starts had risen irregularly in 1968 but in 1969 the peak annual rate--an exceptionally high 1.7 million units--was reached in the first quarter; after that the rate declined. The fourth-quarter rate of 1.3 million units was down nearly 25 per cent from the first quarter.

Following the course of starts, residential construction expenditures declined after the first quarter, but for 1969 as a whole they were about 7 per cent larger than in 1968. Inasmuch as the number of starts was about the same in both years, the increase reflected primarily higher costs per unit, and to some extent, a larger volume of additions and alterations--which, along with nonhousekeeping units, account for about one-fourth of the residential total. Indeed, an increase in additions and alterations in the fourth quarter offset a further decline in outlays for new dwelling units.

The persistent decline in starts in 1969 resulted primarily from the limited availability of mortgage financing. Over-all demands for funds were very strong, and monetary policy was restrictive. The inability of the thrift institutions--savings and loan associations and mutual savings banks--to compete for funds in a period of rising and record interest rates resulted in greatly reduced inflows of funds, as described in detail elsewhere in this Report. Considerable support to mortgage markets, however, was provided through FNMA's free market commitment auctions and by a record volume of advances to the savings and loan associations by the Federal home loan banks.

Mainly reflecting such support, the rate of starts of single-family units tended to stabilize in the fourth quarter at the reduced third-quarter rate.

One important feature of the year as a whole was a further increase in the number of multifamily units started. These totaled 44 per cent of all housing starts, compared with the previous high of 40 per cent in 1968. In general, investors in multifamily units were more willing and better able to compete for financing than purchasers of single-family units, particularly since such financing often incorporated various forms of equity participation and also was generally less restricted by the usury ceiling limits imposed in some States. Late in the year, however, the number of multifamily starts declined sharply.

Demands for housing continued very strong despite high prices and record interest rates, and vacancy rates were the lowest in over a decade. The supply of new housing was below actual needs and below official goals for the decade ahead, even though it was augmented by a sharp further expansion in mobile home shipments to a total for the year of about 400,000 units. (It should be noted that mobile homes are not included in the statistics on housing starts or residential construction expenditures.)

Consumer Expenditures and Income

Consumer spending on goods and services increased 7.5 per cent from 1968 to 1969, compared with an increase of 9 per

cent the year before. But prices advanced more rapidly in 1969 than in the earlier period, and the physical volume of consumer takings was up only 3 per cent following an increase of more than 5 per cent in 1968. Real takings of durable goods increased by 5 per cent for the year; of nondurable goods, by only 1.3 per cent, and of services, by 3.8 per cent. In all three cases, the 1969 advances were significantly smaller than in 1968.

Consumer spending was relatively strong in the first half of the year, but growth in such spending slowed considerably in the second half, with the third quarter particularly sluggish. Employment gains were large early in the year, and wages and salaries and total personal income continued to increase rapidly. Growth in disposable (after-tax) income slowed in the first quarter, however, when large final settlements began to be made on 1968 income tax liabilities, including retroactive payments on the surcharge for the second quarter of 1968. Nevertheless, the increase in consumer spending was sizable, and was made possible in part because consumers reduced their saving rate to 5.3 per cent from the 6.0 per cent level maintained in the second half of 1968. In the second quarter of 1969 consumer spending again increased by a sizable amount, as a large rise in disposable income provided support to consumer demands while the saving rate was unchanged from its first-quarter level.

The third-quarter increase in consumer spending was the smallest of the year even though disposable income--bolstered by the Federal pay raise and by the earlier ending

of large tax payments on 1968 liabilities--showed an exceptionally large rise. The saving rate increased sharply to 6.7 per cent, from the 5.3 per cent of the first half of the year. (This increase of 1.4 percentage points in the saving rate represented almost $9 billion, annual rate, of disposable income and an equivalent amount of consumer spending at the 5.3 per cent saving rate.) The weakness in consumer spending in the third quarter is indicated not only by current dollar figures but also by the fact that there was virtually no rise in real takings. Takings of durable goods were off a little, those of nondurable goods were unchanged, and growth of services was not so rapid as earlier.

Expansion of both personal and disposable income slowed considerably in the fourth quarter, largely because gains in employment and in wages and salaries were much smaller than they had been earlier in the year. But the increase in consumer spending was somewhat larger than in the third quarter, as the saving rate declined a little. For the second half of 1969 as a whole, consumer demands can best be characterized as sluggish. Real takings of durable goods were down, with weakness evident in demands for furniture and appliances and particularly for new automobiles late in the year. Although about 8.5 million new domestic autos were sold in 1969, only slightly less than the 1968 total, the sales rate declined from about 8.5 million units in the first half to about 8.1 million in the fourth quarter; in December sales were down to an annual rate of 7.7 million units.

Sluggishness of consumer demand in the second half of 1969--as evidenced by the sharply higher saving rate, the more or less nominal increase in real takings, and the decline in physical volume of takings of durable goods--appears to reflect a combination of influences. Perhaps most important was the pervasive effect of the steep rise in consumer prices; such rapid price increases not only provoked some resistance to purchases but also completely offset income gains for many employees--in fact, average weekly earnings in manufacturing declined slightly over the year. Growing concern about employment and income prospects in 1970, as indicated in various surveys of consumer attitudes, also tended to encourage more saving. And a decline in the volume of housing units completed and/or transferred adversely affected demands for furniture and other household durable goods.

LABOR MARKET

Demands for labor were very strong early in 1969, in part because of the vigorous expansion of final demand generated by the investment boom. Increases in employment in the first quarter were the largest since the 1965-66 period, and the unemployment rate hit a post-Korean-war low of 3.3 per cent. As the year progressed, however, growth of employment moderated, and insured unemployment rose as manufacturing employment declined.

CHANGES IN NONFARM PAYROLL EMPLOYMENT
(Thousands of persons)

	Total	Manufacturing	Nonmanufacturing
Six months ended:			
December 1968	1,059	168	891
June 1969	1,425	240	1,185
December 1969	339	-210	549

Note: Adjusted for seasonal variation.

Manufacturing employment rose at a rapid pace in the first 6 months of 1969, but declined between June and December as consumer purchases of autos and other goods softened, defense-related employment edged down, and strikes in the electrical equipment industry interrupted production. Reflecting the lessening of demand, the average factory workweek declined to about 40.5 hours in the last quarter of the year, a reduction of 0.3 hour from the same period a year earlier.

Employment also declined after mid-year in construction activities and the Federal Government, but neither sector recorded

a large reduction. Growth in employment in trade, services, and State and local government slowed after midyear, but the slowing was moderate and followed a period of relatively large increases.

There were marked differences in the incidence and pattern of unemployment changes in 1969. Easing demand for labor was most noticeable in the industrial sector -- where employment is dominated by men. The jobless rate for all adult men (aged 25 years and over) rose from a post-World-War-II low of 1.5 per cent in the first quarter to 1.8 per cent in the fourth quarter. Reflecting both more layoffs and longer spells of unemployment, the number of persons drawing unemployment insurance rose after midyear and in December reached the highest level for that month since 1964.

Among women and younger workers, unemployment changes were more uneven during the course of the year, and joblessness among such "secondary" workers was not appreciably higher at year-end than in the first quarter. The return to relatively low unemployment rates among women and younger workers, after a large rise in September (which reflected in part some difficulty in seasonal adjustment), was instrumental in lowering the reported unemployment rate to 3.4 per cent in November and December after it had risen from 3.3 per cent in the first quarter of the year to 3.7 per cent in the third.

The labor force increased by 2.0 million between 1968 and 1969 -- the largest increase since 1947. The larger rise was probably

a function of strong demands early in the year, buttressed by the desire of secondary workers to maintain or raise family income at a time of rapid price increases. Reflecting in part the latter factor, nearly 1.2 million adult women entered the labor force in 1969; this number accounted for nearly two-thirds of the net rise in the civilian labor force. Continuing the large increases of the prior 2 years, another half a million adult men were added to the labor force in 1969. Although moderation of military needs contributed to the expansion of the male civilian labor force, the bulk of the rise was a result of the continued flow into the labor market of young men born during the post-World-War-II baby boom. The teenage labor force rose by 350,000, the largest increase since 1966 when 650,000 youngsters entered.

WAGES AND COSTS

Hourly earnings rose slightly less rapidly in the 12 months ending in December 1969 than over the preceding year. However, increases were still very large at 6.5 per cent for all production and nonsupervisory workers on private payrolls and 5.5 per cent for manufacturing production workers. Despite these large current-dollar wage increases, the "average" production and nonsupervisory worker was no better off in 1969 than in 1968 after allowance for the rise of consumer prices. In fact, average weekly earnings in constant dollars -- that is, adjusted for increases in consumer prices -- has increased only slightly since 1965, and all

such gains have been offset by higher Federal income and social security taxes.

There was a strong emphasis on large and immediate wage increases in collective bargaining settlements during 1969. To some extent, the renewed emphasis on wage rates was attributable to efforts of skilled workers to regain former wage differentials, to past increases in the minimum wage, and to the growing influence of younger workers, who tend to be more interested in current income than retirement pay or other deferred benefits. But the main factor behind, and the rationale for, large wage boosts was the continued and, indeed, accelerated rise of consumer prices. Supported by strong demands in both product and labor markets, wage settlements were large for both union and nonunion workers and for both public and private employees.

Union contracts signed in 1969 provided a median first-year wage boost in excess of 8 per cent. In some of these contracts, of course, wages had lagged behind price increases in earlier years of extended contracts, and workers were bargaining for a "catch-up" in wages. Here it should be noted that collective bargaining activity was a relatively low level in 1969; the number of workers covered by contracts negotiated in 1969 was only 2.4 million workers, compared with coverage of 4.6 million in 1968 and an estimated 5 million in 1970. In part reflecting this reduced level of bargaining activity in 1969, there was a slight drop in the rate of

growth of compensation per manhour (which includes both wages and fringe benefits). For the private nonfarm economy, compensation per manhour rose by about 7 per cent between 1968 and 1969 compared with nearly 7.5 per cent in the prior year.

Normally, a decline -- however slight -- in growth of compensation per manhour provides an opportunity for pressures on unit labor costs to subside. In 1969, however, presently available statistics suggest that there was less than a 1 per cent increase in output per manhour in the private nonfarm economy whereas in 1968 there had been a 3.3 per cent rise. Inasmuch as productivity increased only slightly, most of the rise in compensation costs was reflected more fully in higher costs per unit of output. Such costs are estimated to have risen 6.2 per cent in 1969 -- the largest increase since 1956. The poor productivity performance was confined in large part to the nonmanufacturing industries. In manufacturing, output per manhour rose by about 2.5 per cent in 1969, or about as much as in 1968. Consequently, the rise in unit labor costs in manufacturing was smaller than in the nonfarm economy as a whole.

PRICES

Inflationary pressures were strong throughout 1969, even though expansion of real output was moderating (and at a standstill late in the year) and despite signs of easing in the use of manpower and industrial resources. Broad measures of prices all showed substantially larger increases over the year than over 1968. Indeed, the increases were the largest since 1951 for both consumer prices and the implicit GNP price deflator and the largest since 1956 for wholesale prices of industrial commodities. For farm products and processed foods and feeds, the increase was the largest since 1950 with the single exception of 1965. Moreover, the advance in key comprehensive measures of prices was not much different over the fourth quarter than either the average for the year or the pace early in the year (Table C).

Numerous influences contributed to the rapid rise of prices in 1969. Consumer dollar incomes were rising rapidly much of the year and demands in important sectors remained strong, indeed strong enough to put pressure on available resources. These sectors included machinery and equipment, overall construction, and--in the consumer sector--such services as medical care for which demands continue acute in the face of still limited supplies.

A major pervasive factor operating to raise prices was the steep use in unit labor costs for the private nonfarm economy as a whole and the lesser--but still significant--

Table C: PRICES
(Percentage Changes)

Index	Dec. 1965-Dec. 1966	Dec. 1966-Dec. 1967	Dec. 1967-Dec. 1968	Dec. 1968-Dec. 1969	Annual rates 1969 Dec.-March	March-June	June-Sept.	Sept.-Dec.
Wholesale prices, total.....	1.7	0.8	2.8	4.8	6.9	5.4	1.4	5.3
Industrial commodites.....	2.2	1.8	2.6	4.0	6.5	0.7	3.6	4.9
Farm products, & processed foods & feeds.	0.2	-1.8	3.4	7.4	8.5	17.3	-4.2	7.3
Consumer prices, total.....	3.3	3.1	4.7	6.1	6.1	6.4	5.3	6.2
Foods.....	3.8	1.2	4.3	7.2	4.0	10.1	6.4	7.5
Other commodities.....	1.9	3.2	3.7	4.4	5.6	4.1	2.4	5.4
Services.....	4.9	3.9	6.1	7.4	8.1	6.8	7.5	6.3
GNP implicit deflator[1/]	3.5	3.5	4.0	5.1	4.8	5.1	5.3	4.6

1/ Quarters compared rather than months.

increase in unit labor costs in manufacturing, as described earlier in this Report. Over-all costs were also raised by rising costs of materials and of transportation. Booming economies in Western Europe and Japan contributed to upward pressure on the prices of internationally traded materials.

Further, a number of special factors emerged in 1969, most of which tended to raise prices. The most important of these related to supplies of farm products and foods. In the spring, an unexpected shortfall of cattle marketings relative to demand boosted prices of beef precipitously, and retail prices remained high for the remainder of the year. In the fall, pork was in very short supply as a result of an unexpectedly small spring pig crop and wholesale and retail prices of pork moved up sharply. Over the year ending December, wholesale prices of livestock were up 16 per cent. In addition to meats, eggs and some fresh vegetables were also in short supply late in the year. Another special factor--of an altogether different nature--was the steep climb in mortgage interest rates, which raised the housing component and hence somewhat the total consumer price index.

Wholesale Prices

Over the year from December 1968 to December 1969 average wholesale prices of industrial commodities rose about 4 per cent, with materials rising at a rate of about 4.2 per cent and finished goods excluding foods, about 3 per cent. Increases over the year were widespread among commodities, with

only a few reporting declines. Prices of producers' goods rose faster than those of consumer goods, reflecting in large part continued strong demand for business equipment. Costs of producers' goods were also affected more by the increase in prices of metals which rose much more rapidly than those of other materials. The price of metals rose about 10 per cent over the year, by far the largest increase among the 13 major groups of industries. Within the broad metals group, nonferrous metals rose 19 per cent and iron and steel and their products over 7 per cent. The metals group price increase compares with 4.9 per cent for nonmetallic minerals, which registered the second largest increase of the major industry groups. Prices rose in 1969 in all of these major industries except lumber and plywood (which fell about ____ per cent) but some of the increases were relatively small. For example, furniture and household durables, textiles and apparel, chemicals and allied products, rose less than 2.5 per cent, as did passenger car prices.

Within the year, industrial prices, as well as those of the normally more volatile farm products, rose at uneven rates. In the first quarter, the rise in industrial prices was very rapid--about 6.5 per cent at an annual rate--reflecting exceptional increases for nonferrous metals, steel and steel products, and a record rise in lumber and plywood prices arising from a rapid rise in demand coupled with strikes and other supply bottlenecks. In the second quarter the increase slowed to a rate of less than 1 per cent, as plywood and lumber

prices plummeted, and steel and nonferrous metals rose more slowly. The rise in average wholesale prices was sustained, at a rate of about 5.5 per cent, however, by a surge in prices of foodstuffs.

In the third quarter there was another general round of steel price increases, nonferrous metals rose more briskly, and the decline in prices of lumber and plywood was smaller than in the second quarter. As a result, industrial commodity prices rose at an annual rate of 3.6 per cent. But wholesale prices of foods and foodstuffs declined from the very high June level as beef marketings increased. Wholesale prices of all commodities thus rose at a rate of only 1.5 per cent, perhaps conveying a misleading impression of a decline in inflationary pressures. In the fourth quarter, a rapid pace of price increase was resumed. Wholesale prices of farm products and foods were also up considerably over the quarter, with pork, eggs, and fresh vegetables all moving up sharply. Wholesale prices of all commodities rose at an annual rate of over 5 per cent, the fastest since the first quarter. The industrial commodity price rise accelerated, as finished goods prices--including those of passenger cars and machinery and equipment--moved up faster.

Consumer Prices

Consumer prices rose more than wholesale prices in 1969 largely because of exceptionally big increases in the price of services, which make up almost one-third of the

total weight of the consumer price index, and of foods. Prices of services were up about 7.5 per cent over the year from December to December, reflecting sharp increases in costs of mortgage finance, medical care, insurance, and housekeeping services and home-maintenance. Rents and utility costs rose less sharply.

Among commodities, food prices rose faster than other groups, and in December were 7.2 per cent above a year earlier, with prices of meat, poultry and fish up 11 per cent. Apparel and shoe prices also rose rapidly over the year, by more than 5 per cent.

As in other recent years, prices of durable commodities rose less than of nondurable goods in 1969. Passenger car prices rose about 1.3 per cent and household durables about 1.5 per cent, reflecting in part slacker demand for furniture and appliances.

DRAFT
January 16, 1970

INTERNATIONAL PAYMENTS AND RESERVES

Progress was made in 1969 toward establishing economic conditions in the United States and other countries that would help to reduce imbalances in international payments while fostering economic growth at sustainable rates. Toward the same end, changes in the exchange parities of certain important currencies were made. At the same time there was further development of international arrangements relating to gold, SDRs, and the traditional operations of the International Monetary Fund, and there was also continuing international discussion of whether a better working of the international monetary system might be promoted by some increase in the flexibility of exchange rates.

U.S. BALANCE OF PAYMENTS

Despite the fact that persistent and widespread expectations of continuing price inflation in the United States were not yet dissipated, the slackening of demand expansion in this country during 1969 was an important factor in the moderate improvement that occurred after midyear in the balance of U.S. transactions in goods and services with the rest of the world. The volume of net exports, however, was still much too small to support the flow of resources to developing countries and the growth of U.S. private investments abroad. Balance in the country's international accounts was

maintained by a further massive inflow of private foreign capital, the major part of which in 1969 came through the channel of short-term investments by foreigners in the Euro-dollar market linked with borrowings by U.S. banks from their foreign branches operating in that market. The underlying imbalance between the current and the long-term capital transactions of the United States with the rest of the world still remained to be overcome.

The current account of the U.S. balance of payments was adversely affected in the first half of 1969 by a prolonged dock strike at East Coast and Gulf ports, but in the course of the year merchandise exports showed considerable strength and income on foreign investments rose considerably. These gains were offset, however, by a persistent albeit slackening rise in imports, and by large interest payments on the increasing total of U.S. liabilities to the rest of the world.

Governmental restrictions on major types of U.S. private capital outflows were somewhat eased in April, and further changes were made in December. The predominant influence on private capital flows, however, was exerted by higher interest rates which attracted foreign liquid funds to the United States and also influenced the flow of longer-term capital.

Recorded outflows of U.S. private capital were not much changed from the previous year, but the extremely large negative residual item in the over-all accounts in the first three quarters

probably resulted from large unrecorded capital movements, and these were not entirely offset by return flows in the last weeks of the year. Some of the recorded and unrecorded outflows, subsequently reversed, were induced by speculation on a revaluation of the German mark, but a larger part probably was drawn by high Euro-dollar interest rates. While such flows from the United States added to the supply of funds available to U.S. banks borrowing in the Euro-dollar market, far more important in this respect were the movements of foreign short-term capital provided through this channel. Weakness in the U.S. equity markets, combined with the enhanced advantages of holding investible funds in more liquid forms providing high yields, resulted in a reduction in foreign purchases of U.S. corporate stocks and of the corporate securities sold abroad to finance U.S. direct investments. These inflows of capital to acquire securities nevertheless remained very high by the standards of the years before 1968.

Liabilities to foreign monetary authorities were significantly reduced in 1969. In particular, acquisitions by foreign governments of non-liquid claims on the U.S. Treasury and of long-term deposits, which had served in 1968 to reduce the deficit as conventionally measured on the "liquidity" basis, were reversed in 1969, and this shift in direction of transactions contributed a large part of the deterioration in the liquidity balance for the year.

Transactions in Goods and Services

The balance on goods and services increased after the middle of 1969, reaching an annual rate of about $3 billion in the second half. For the year as a whole, net exports of goods and services were only $2 billion, about $0.5 billion less than in 1968. This result fell far short of the average surpluses of the earlier 1960's.

Merchandise exports in 1969 continued to perform reasonably well, advancing by nearly 9 per cent over 1968, despite some loss of sales occasioned by the dock strike, and in the last half of 1969 exports of goods were nearly 13 per cent higher than a year before. The year-to-year gain occurred despite a marked reduction in exports of agricultural products during the first half. As the year progressed, exports of machinery were especially strong and exports of coal and steel also advanced sharply. Exports of automotive products to Canada continued to rise as they have since the 1965 U.S.-Canadian automotive pact. Most of the export rise was in response to demands generated by advancing economic activity in the industrial countries.

On the import side, there was a marked slowing in the rate of intake of foreign goods as compared with the hectic pace of 1968, but the rise of nearly 9 per cent still exceeded the rate of growth of current U.S. GNP. Imports were rising in many major categories, most notably in capital goods, autos from Europe and Japan as well as from Canada, and other consumer goods. Imports of industrial

materials and of foods were little changed from the already high levels of 1968. Thus, the momentum of import demand generated by the cyclical upswing appeared to be yielding, but only slowly, to efforts to stability the economy. The trade surplus for the year showed scant change from the $0.6 billion of 1968, though by the second half the annual rate had recovered to about $1.3 billion.

The decline in the balance on goods and services from 1968 to 1969 occurred principally in investment income flows. Income on U.S. private investments and assets abroad rose by $1 billion to about $8 billion, mainly reflecting higher earnings by foreign affiliates of U.S. firms. However, income paid to foreign holders of U.S. assets rose by $1.5 billion, as interest rates rose and holdings increased. Net changes in receipts and payments for other services were relatively minor. Military expenditures abroad rose somewhat faster than receipts from military sales, leaving the net payments balance on these military transactions at well over $3 billion.

Transfers and U.S. Government Credits

Private remittances, net, and U.S. Government pensions and other transfers were little changed in 1969, resulting in net payments of a little over $1 billion. U.S. Government grants (other than military) held at close to $1.7 billion. Disbursements under Government credits (including changes in related currency holdings)

were down slightly for the year. Scheduled repayments on outstanding credits were about $0.2 billion higher, partly because the United Kingdom was able to resume repayment of postwar credits on schedule, but there was a negative shift of some $0.3 billion in non-scheduled receipts from foreign governments.

Private Capital Flows

In 1969, as in the year before, the net flow of private capital was inward to the United States, marked by striking changes in both size and composition. The net inflow in 1969 reached some $3 billion, far exceeding the nearly $5 billion of 1968, and unparalleled, of course, in any earlier experience.

U.S. direct investors maintained a keen interest in expanding their productive facilities abroad, as evidenced by projections of expenditures for foreign plant and equipment rising into 1970. The financing of this investment through capital outflows from the United States, or from earnings retained abroad, has been limited by mandatory regulations since the beginning of 1968, but a great deal of leeway has been built up by the companies which stayed under their ceilings, and there was some loosening of the restraints in April 1969. Net corporate capital outflows associated with direct foreign investments (that is, capital outflows intended for direct investment less funds borrowed abroad) appear to have risen by about $0.5 billion in 1969, to about $1.7 billion. The gross outflow for direct investment was about $0.5 billion higher than in 1968. Related

sales of new issues abroad were cut in half -- from $2.1 billion to about $1 billion -- but the companies made up for this difference by no longer adding to balances held abroad out of the proceeds of such new issues, which they had done in 1968 to the extent of $1 billion. However, there was some net loss to the balance of payments as U.S. companies tended to accumulate other short-term assets abroad rather than reduce them as they had been required to do in 1968.

U.S. banks subject to the Federal Reserve's foreign credit restraint program (see pages _____) increased their claims on foreigners in the first half of the year, when the program was eased somewhat, but reduced these assets for the year as a whole, though by much less than in the previous year. Firm credit conditions in the United States were the primary restraining influence on banks, who ended the year with $_____ of leeway under their regular guidelines, plus $1.3 billion for export financing provided by changes in the program in December.

U.S. net purchases of foreign securities amounted to about $1.5 billion in 1969, slightly more than in 1968. New foreign bond issues sold here (very largely by Canadian borrowers and international institutions) remained at about $1.6 billion, but redemptions were lower. There was also some increase in U.S. purchases of foreign stocks.

While the outflow of U.S. private capital -- influenced primarily by restrictions and tight credit conditions in the United

States -- did not shift significantly in 1969, there was a dramatic shift in the behavior of foreign private investors. These investors were affected in several ways by the tightening of credit conditions in the United States and in most other countries during the year. One result was the greater difficulty encountered by U.S. companies seeking financing abroad for direct investments, as mentioned above. Similarly, after the early months of the year there was a reduced inflow into U.S. corporate stocks, resulting in a drop from a $2.1 billion inflow in 1968 to about $1.5 billion in 1969. This rate of investment was still very high, and the inflow held up in the winter when U.S. equity markets declined, indicating a persistent underlying demand. One type of long-term foreign capital inflow that grew significantly in 1969 was direct investments, which were at a record high of $0.8 billion, about double the previous high of 1968. Taking into account all forms of foreign private investments in U.S. long-term assets, the inflow in 1969 was about $4.5 billion, down by $1.5 billion compared with the extraordinary inflow in 1968.

The decline in inflows of long-term private foreign capital was far more than offset by an acceleration of the increase in liquid liabilities to private commercial banks and other residents of other countries reported by U.S. banks. The inflow building up such liabilities exceeded $8-1/2 billion in 1969, compared with an already-high $3.8 billion in 1968. About $7 billion of the inflow took the form of an increase in liabilities of U.S. banks to their foreign branches, since

this is the primary channel through which they obtained funds in the Euro-dollar market. Liabilities to all commercial banks abroad, including these branches, rose by $9.3 billion through July, then rose more moderately until the final weeks of the year, when they dropped back to about the mid-year level. Some part of the funds borrowed in the Euro-dollar market may have represented deposits placed by U.S. residents attracted by the much higher deposit rates paid there than on deposits in banks in the United States. Another small part may have been derived from transfers of private nonbank foreign funds previously held in U.S. banks, which were reduced by $.5 billion during the year. However, the major supply factor in the market was the accumulation by private foreigners of dollar-denominated assets, typically purchased from foreign central banks, as an alternative to holding short-term investments or deposits denominated in other currencies.

In the first quarter of the year borrowing in the Euro-dollar market by U.S. banks was facilitated by a reflow of funds previously placed in German mark assets, and Euro-dollar rates moved up only moderately. By late April, however, renewed speculative flows into German marks, coupled with strong U.S. demand, were rapidly driving up Euro-dollar rates to unprecedented highs. Although the speculative pressures were reversed in May, after the German authorities reiterated their intention not to revalue the currency upward, the demand by U.S.

banks became intense in June. By that stage the pressure on reserves of a number of countries had become acute. In the United States there was some concern that banks using Euro-dollars to adjust to domestic credit restraint had a special advantage with respect to reserve requirements. To remove this advantage, and to moderate the flow of funds between U.S. banks and their foreign branches, on June 27 the Federal Reserve Board proposed changes in Regulations M and D, which became effective in September. These have the effect of imposing a 10 per cent reserve requirement on borrowings from foreign branches and branch loans to U.S. residents in excess of amounts held in a specified base period; the banks were required to establish the necessary reserves in October. Borrowings by U.S. banks through the Euro-dollar market moved within a relatively narrow range from about the end of July until near the year end. At that time there was an extraordinarily large flow of funds to the United States, producing a sharp drop in U.S. banks' liabilities to foreign branches. At the year end liabilities to foreign branches were almost $13.2 billion, showing -- as noted earlier -- an increase of almost $7 billion for the year.

As a result of the year-end inflows, which apparently included also a considerable movement out of German marks, there was a surplus on the liquidity basis in the fourth quarter, in contrast to very large deficits in the first three quarters when liquid liabilities accumulated. The deficit for the year on the liquidity basis amounted

to about $6-3/4 billion. This was a major shift from the small surplus for 1968, but the deterioration can be traced in large part to such transient features as the reversal of "special" intergovernmental transactions, which shifted by $3-1/2 billion, and a net increase of over $2 billion in unrecorded outflows. As noted above, this probably included a circular flow of U.S. funds to the Euro-dollar market and back to U.S. banks, not entirely unwound at year-end. Apart from these two kinds of transactions the deficit increased almost $1.5 billion.

Official Reserve Transactions

As measured on the official settlements basis the U.S. balance of payments registered a surplus of about $2-3/4 billion in 1969, up from $1.6 billion in 1968. The principal factor in the difference between the liquidity deficit and this surplus was the very large inflow of private foreign funds described above, which had the effect of reducing U.S. liabilities to foreign official accounts and, at a further stage, of increasing U.S. reserve assets.

During the year U.S. international reserve assets increased by $1.25 billion, including nearly $1 billion of gold purchased by the U.S. Treasury from foreign monetary authorities, and $1 billion added to the reserve position in the IMF. There was a reduction of $.75 billion in holdings of convertible foreign currencies as a result of

net repayments of earlier swap drawings, notably by the United Kingdom. The increase in U.S. gold holdings resulted primarily from purchases from France in the first half of the year and from Germany at the year-end. Developments in 1969 affecting gold markets are discussed below (Pages _____).

The net reduction in U.S. liabilities to foreign monetary authorities was $2-1/2 billion, compared with a fall of $3/4 billion in 1968. Almost $1 billion of the decline occurred in certain non-liquid claims on the U.S. Treasury and on U.S. commercial banks held by foreign monetary authorities; in 1968 such claims had increased by $2.4 billion.

FEDERAL RESERVE OPERATIONS IN FOREIGN CURRENCIES

Serious imbalances in international trade and payments kept the international financial system under strain in 1969 -- as in most recent years. Along with the developments in the U.S. balance of payments discussed above, particularly noteworthy were the persistence of large current account surpluses for Germany and Japan, and the continuation during part of the year of a large payments deficit for France. Britain's balance of payments showed marked improvement, as the result of the November 1967 devaluation of the pound and subsequent policy actions restraining the British domestic economy.

By the end of the year important tendencies toward better balance had been set in motion by the devaluation of the French franc

in August, which was accompanied by measures of domestic restraint, and by the revaluation upward of the German mark in October (following a four-week period in which the mark exchange rate was allowed to float upward). But until these currency adjustments were initiated, massive speculative flows occurred, especially into German marks, once in the spring and again in September after the French franc devaluation and before the German elections.

The French franc was under substantial selling pressure in the spring and early summer. Some other European currencies also experienced speculative buying and selling, occasioned by expectations or fears that they might be adjusted along with one or the other of the major currencies. An additional cause of strain on the reserves of many continental European central banks during the first seven months of 1969 was the massive flow of funds to the United States through the Euro-dollar market discussed above.

After the mark exchange rate was allowed to float at the end of September, a reverse flow of funds out of the German mark into other European currencies and the dollar began; this flow continued to be heavy through the rest of the year.

As in earlier years, the Federal Reserve's foreign currency operations were aimed at cushioning the impact of destabilizing flows of international payments, in cooperation with foreign central banks and the U.S. Treasury. Foreign central banks continued to make substantial use of their swap facilities with the Federal Reserve during 1969. Their repayments, however, exceeded their drawings by $1.1 billion,

and total outstanding drawings at the end of the year were reduced to $650 million. The Bank of France drew on the facility during the May speculative crisis, but by the end of June had repaid these and earlier drawings with the proceeds of gold sales and credits from other sources. Drawings were also made at times by the Netherlands Bank, the National Bank of Belgium, the National Bank of Denmark, and the Austrian National Bank, but these were all repaid by October. The Bank of England, which was able to retire a substantial amount of short-term indebtedness to foreign central banks during 1969, reduced its outstanding indebtedness under Federal Reserve swaps from $1,150 million to $650 million, after making new drawings on the facility during the periods of speculation on a mark revaluation in early May and in the summer.

The Federal Reserve, for its part, made less use of its network of swap facilities in 1969 than in any year since 1963, the first full year of System foreign currency operations. This resulted from the fact, noted earlier, that foreign reserve holdings in dollars were in many cases being reduced. The German Federal Bank's reserves of dollars increased sharply on average until the revaluation of the mark, but that bank followed a policy of holding its increased dollar balances without cover.

At the beginning of 1969 the Federal Reserve had about $430 million of swap drawings outstanding in German marks and Swiss francs. The mark drawings were fully repaid by the end of January as funds continued to flow out of marks in the unwinding of the

November 1968 speculative episode. The Swiss franc drawings were sharply reduced in February and were fully liquidated in April with the proceeds of a Swiss franc-denominated Treasury security issued to the Swiss National Bank. In the spring the System drew again on the facilities with both the Swiss National Bank and the Netherlands Bank, but by September it had fully repaid all swap drawings.

In October the Federal Reserve drew $200 million of Swiss francs on the Swiss National Bank to cover increased dollar holdings resulting from repatriations by Swiss banks as credit conditions tightened in Switzerland. It also drew $300 million of guilders on the Netherlands Bank as Dutch residents repatriated funds from Germany and speculative funds moved into guilders. By year-end the outstanding amount of these Federal Reserve swap drawings had been reduced to $330 million.

The Federal Reserve's reciprocal currency arrangements with 14 central banks and the BIS were increased by $475 million during 1969 to total $10,980 million. Facilities with the Bank of Norway, the National Bank of Denmark, the National Bank of Belgium, and the Austrian National Bank were increased and that with the Netherlands Bank decreased.

FOREIGN CREDIT RESTRAINT PROGRAM

ur the Board continued to administer that portion of i 's balance of payments programs that applied to banks and other financial institutions, initially in accordance with guidelines revised on December 23, 1968, and described in the Annual Report for 1968.

In issuing the revised guidelines, the Board indicated its intention to review the program early in 1969, particularly to determine whether additional flexibility for financing U.S. exports might be provided in the guidelines. During the first quarter of 1969, meetings were held in seven Federal Reserve Bank cities with officers of the Federal Reserve Banks and with representatives of banks and other financial institutions reporting to the Federal Reserve Banks under the program.

It was concluded that, while there was adequate capacity for the financing of exports under the existing aggregate ceiling, it would be possible to provide greater flexibility by giving relatively larger ceilings to small and medium-sized banks whose major interest in international lending was the financing of exports. At the same time, larger ceilings for these banks would reduce competitive inequities among reporting institutions. Accordingly, revised guidelines were issued on April 4, 1969.

For about half of the reporting banks, accounting for more than 90 per cent of total foreign assets reported, the ceilings

remained at the level suggested by the guidelines issued in December 1968. The remaining banks, whose foreign assets were a relatively small proportion of their total assets, were permitted to calculate their ceilings as 1.5 per cent of total assets as of December 31, 1968. This provision added $400 million to the aggregate ceiling of the banks.

The guidelines for nonbank financial institutions remained essentially unchanged although the ceiling was increased from 95 per cent of the end-of-1967 base figure to 100 per cent of the base.

A continued restrictive monetary policy, together with a high demand for credit domestically, held down the banks' foreign lending and investment during 1969. In fact, these factors may have had a greater impact than the program in moderating the foreign activities of financial institutions. As described in the Annual Report for 1968, the banks had reduced their foreign claims covered by the guidelines by $612 million in 1968, or by $212 million more than the objective set on January 1, 1968. These assets were reduced further by $125 million during the first quarter of 1969. An outflow during the second quarter was offset by a corresponding inflow during the third. A seasonal outflow during the fourth quarter left the banks with a net ___flow of $_____ million for 1969 as a whole. At the year-end these assets were $_____ million below the December 31, 1964, base figure (Table 1).

Nonbank financial institutions reduced their holdings of foreign assets subject to the guideline ceiling by $_____ million in the first three quarters of 1969 (Table 2). In the full year 1968 such holdings had declined by $240 million, considerably more than the targeted reduction of $100 million. Holdings of foreign assets not subject to the ceiling were increased by $_____ million in the first three quarters of 1969, compared with an increase of $632 million in all of 1968.

On December 17, 1969, in connection with a modest modification of the Government's balance of payments programs, the Board issued revised guidelines for banks and nonbank financial institutions. For the first time, a separate Export-Term-Loan Ceiling was established for credits with a maturity of 1 year or longer extended to finance exports of U.S. goods and services shipped or provided on or after December 1, 1969. Banks also were provided with a General Ceiling, equal to their adjusted ceiling as of November 30, 1969, within which they could make loans of any maturity and for any purpose. However, in using the General Ceiling, the banks were requested to continue to observe an absolute priority for export credits, and among nonexport credits, to meet the needs of the developing countries. The General Ceiling continued to be reduced by repayments of nonexport term loans to residents of developed countries of continental Western Europe. In addition, repayments

of export term loans outstanding when the revision was made were to be deducted from the General Ceiling and added to the Export-Term-Loan Ceiling.

The Export-Term-Loan Ceiling was calculated at 0.5 per cent of a bank's total assets as of December 31, 1968. This formula, which added about $1.25 billion to the aggregate ceiling, distributed the new ceiling more widely among banks. Twenty of the nation's largest banks accounted for about three-quarters of the General Ceiling, which is calculated as a percentage of foreign assets. These banks received slightly more than one-half of the new Export-Term-Loan Ceiling. At the year-end reporting banks were $_____ million below the General Ceiling effective on that date, and also had a leeway of $_____ million within which to make export term loans (Table 1).

The guidelines for nonbank financial institutions contained only one substantive change. In view of Japan's strong reserve and balance of payments position, special treatment accorded to long-term investment in that country was terminated. Long-term loans and investments in Japan after January 1, 1970, were to be counted against the reporting institution's ceiling under the guidelines. Each institution's ceiling was revised to include any such loans and investments held on December 31, 1969.

Table 1 - Foreign Credits of U.S. Banks

Item	End of year				1969			
	1965	1966	1967	1968	Mar. 31	June 30	Sept. 30	Dec. 31
Number of reporting banks.....	161	148	151	161	159	162	167	
	Millions of dollars							
Total foreign credits subject to ceiling.....	9,652	9,496	9,865	9,253	9,127	9,502	9,115	(1/)
Change from previous date.....	+156	-156	+369	-612	-126	+375	-387	(1/)
Ceiling to end of 1969.....	9,973	10,360	10,409	9,729	9,706	10,102	10,135	(2/)
Net leeway for further expansion of credit.....	321	864	544	476	578	600	1,020	(3/)
Export term loans subject to ceiling.....	---	---	---	---	---	---	---	(4/)
Export-term-loan ceiling.....	---	---	---	---	---	---	---	
Net leeway for further expansion of export term loans..	---	---	---	---	---	---	---	

1/ From Dec. 1, 1969, excludes export term loans.
2/ From Dec. 1, 1969, equals to General Ceiling.
3/ From Dec. 1, 1969, equals leeway under General Ceiling.
4/ Foreign credits with maturities of 1 year or longer that finance exports of U.S. goods and services.

TABLE 2: FOREIGN ASSETS OF REPORTING NONBANK FINANCIAL INSTITUTIONS

Amounts shown in millions of dollars

	Amount Sept. 30, 1969	Change from Dec. 31, 1968	
		Amount	Per Cent
ASSETS SUBJECT TO GUIDELINE			
Deposits & money market instr., foreign countries except Canada	16	2	12.9
Short & intermed. credits, foreign countries except Canada 1/	202	- 29	-12.7
Long-term investments, "other" developed countries: 2/			
Investment in financial businesses 3/	123	11	10.2
Investment in nonfinancial businesses 3/	8	*	- 1.4
Long-term bonds and credits	559	- 56	- 9.0
Stocks 4/	379	- 75	-16.5
TOTAL holdings of assets subject to guideline	1,286	-147	-10.2
Adjusted base-date holdings 5/	1,522	- 64	- 4.0
ASSETS NOT SUBJECT TO GUIDELINE			
Investments in Canada:	172	43	33.8
Deposits and money market instruments	163	16	10.7
Short- and intermediate-term credits 1/	600	9	1.5
Investment in financial businesses 3/	44	*	*
Investment in nonfinancial businesses 3/	8,198	285	3.6
Long-term bonds and credits	1,306	- 27	- 2.0
Stocks	1,026	36	3.7
Bonds of international institutions, all maturities			
Long-term investments in the developing countries and in Japan:	26	3	11.7
Investment in financial businesses 3/	12	2	20.5
Investment in nonfinancial businesses 3/	765	- 6	- 0.7
Long-term bonds and credits	400	212	112.9
Stocks	515	144	38.8
Stocks, "other" developed countries 6/	13,227	718	5.7
TOTAL holdings of assets not subject to guideline			

1/ Bonds and credits with final maturities of 10 years or less at date of acquisition. 2/ Developed countries other than Canada and Japan. 3/ Net investment in foreign branches, subsidiaries or affiliates in which the U.S. institution has an ownership interest of 10 per cent or more. 4/ Except those acquired after Sept. 30, 1965 in U.S. markets from U.S. investors. 5/ December 31, 1967 holdings of assets subject to guideline, less carrying value of equities included therein but since sold, plus proceeds of such sales to foreigners. 6/ If acquired after Sept. 30, 1965 in U.S. markets from U.S. investors. *Less than $500,000 or less than .05 per cent.

INTERNATIONAL MONETARY ARRANGEMENTS AND THE IMF

In 1969 there were important developments in international monetary arrangements. These centered in, or were closely related to, the structure and operations of the International Monetary Fund. The outstanding event, which marked the culmination of years of study and negotiation, was the launching of a system for the deliberate creation of international reserve assets. After completion of the process of amending the IMF Articles of Agreement to establish the legal framework for the system of Special Drawing Rights, the Fund in October made the decision to allocate SDRs for the first period, a period of three years beginning January 1, 1970.

Establishment of the SDR system, and the decision to begin actual creation of SDRs, were of landmark significance for orderly growth of international liquidity. Also important to the sound growth of international liquidity in the years ahead were the Fund's decision to recommend to its members a substantial increase in quotas, and its decision regarding the circumstances under which it will buy gold from South Africa. Toward year-end, expectations of this decision appear to have reinforced other influences which caused a marked easing of free-market gold prices in the last half of the year.

The year was also marked by open discussion of the possible desirability of a limited increase in the flexibility of exchange rates, and announcement by the Executive Directors of the IMF of their intention to continue their study of this subject.

Amendment of the Articles of Agreement

In 1969 the IMF Articles of Agreement were amended for the first time since their entry into force on December 27, 1945. The main purpose of the Amendment was to establish the legal framework for the system of Special Drawing Rights. Certain changes in Fund rules and practices relating to its traditional operations were also made.

An Outline Plan for SDRs had been agreed upon at the annual meeting of the Fund's Board of Governors held at Rio de Janeiro in September 1967. At Stockholm, at the end of March 1968, a consensus on controversial issues had been reached by the Ministers and the Governors of the central banks of the Group of Ten. On these bases, the detailed text of the Amendment was prepared by the Executive Directors, recommended by them on April 16, 1968, and approved by the Fund's Board of Governors on May 31, 1968. The Amendment entered into force on July 28, 1969, following its acceptance--as required under the Articles--by three fifths of the Fund's member countries representing four fifths of the total voting power.

The amended Articles of Agreement establish two separate accounts in the Fund, a General Account and a Special Drawing Account. The traditional operations and transactions of the Fund are carried out through the General Account, while the Fund's functions relating to SDRs are carried out through the Special Drawing Account. In order to become a participant in the Special Drawing Account, a member country of the Fund--and only Fund members are eligible to become participants--has to

deposit with the Fund an instrument setting forth that it undertakes all the obligations of a participant in that Account. But no member could become a participant until instruments of participation had been deposited by members having at least 75 per cent of total quotas in the Fund. This requirement was fulfilled on August 7, 1969.

The main features of the SDR system were summarized in the ANNUAL REPORT of the Board of Governors of the Federal Reserve System for 1968 (pages 329-30).

Allocation of Special Drawing Rights

The main event of the 1969 annual meeting of the International Monetary Fund, held in Washington, D. C., from September 29 to October 3, was the approval by the Governors of the proposal by the Managing Director for the allocation of SDRs for the "first basic period."

SDRs come into existence via "allocation" of them to each member country of the Fund which is a participant in the Special Drawing Account, and which wishes to receive an allocation. Decisions to allocate SDRs are made by the Fund Board of Governors on the basis of proposals of the Managing Director concurred in by the Executive Directors (and any decision to cancel SDRs would be made in the same way). Fund decisions to allocate are made for basic periods of five years (running consecutively), unless the Fund decides that the duration shall be other than five years.

Before making any allocation proposal, the Managing Director "shall conduct such consultations as will enable him to ascertain that

there is broad support among participants for the proposal." In addition, before making a proposal for the first allocation, the Managing Director had to assure himself that there existed a collective judgment that there was a global need to supplement reserves, that a better balance-of-payments equilibrium had been attained, and that there was a likelihood of a better working of the balance-of-payments adjustment process in the future. (All these provisions form part of Article XXIV.)

On September 12 the Managing Director, having conducted the necessary consultations and having assured himself of the existence of the conditions just referred to, made a proposal to the Fund Governors, with the concurrence of the Executive Directors, the essential features of which were as follows: (1) the first basic period to run for three years beginning on January 1, 1970; (2) allocations during this basic period to be made on January 1 in each of the years 1970 through 1972, on the basis of quotas on the day before the allocation dates; (3) the total amounts of SDRs allocated on each of the three allocation dates to be approximately as follows: 3.5 billion, 3 billion, 3 billion (the approximate results of a method of allocation stated more precisely in the actual proposal), or a total of about 9.5 billion for the three years.

On October 3 the Fund Governors, assembled in their annual meeting, approved the Managing Director's proposal. On January 1, 1970, in accordance with this decision and the terms of the Articles of Agreement as amended, the Fund allocated SDR 3,414 million to 104 participants. Of the total amount allocated the United States received SDR 866.9 million.

MIMEO BOND

Proposed Increase in Quotas

Under Sec. 2 of Article III of the Fund Agreement, the Fund is required to conduct periodically a general review of quotas, and to propose an adjustment of them if it deems such action appropriate. Increases made following general reviews in 1958 and 1965 (together with new membership and occasional interim adjustments of particular quotas) raised total quotas from the original $9 billion to the end-1969 level of about $21 billion.

In 1969, with another general review of quotas due in 1970 at the latest, a new factor was present in the weighing of the pro's and cons of quota increases. This was the growing possibility of early activation of the SDR system, which gave rise to new considerations. On the one hand, some countries tended to feel that provision for unconditional liquidity in the form of SDRs (to the extent that SDR use is unconditional) would reduce the need for more conditional liquidity under larger quotas. On the one hand, the fact that SDR allocations are based on the quotas of participants tended to give every participant or potential participant in the SDR system a greater interest in enlarging its own quota (in the forthcoming new round of quota increases) than it would otherwise have had. Among the industrial countries this consideration naturally stimulated interest in selective increases; some of the less-developed countries, on the other hand, urged a relatively larger general increase, and less emphasis on selective increases.

At its 1969 annual meeting the Fund Board of Governors requested the Executive Directors to submit an appropriate proposal by December 31 for the adjustment of members' quotas. In December the Executive Directors, having completed the fifth general review of quotas, submitted their proposal. If each member country were to avail itself of the maximum increase proposed for it, total Fund quotas would rise to $28.9 billion, an increase of ___ per cent from total quotas as of the end of December 1969. The United States quota could rise to $6,700 million from its present level of $5,160, an increase of 30 per cent.

Under the proposal, no increase will take place before October 30, 1970; and members will be able to consent to the proposed increases in their quotas at any time on or before November 15, 1971.

Developments Relating to Gold

Under the two-tier system of gold marketing established two years ago by the communiqué issued in Washington on March 17, 1968, by the central-bank governors of the seven active member countries of the then-existing gold pool, central banks have generally neither sold gold in private gold markets nor bought gold there. (For the text of the communiqué, see the Federal Reserve Bulletin for March 1968, page 254. The two-market system was discussed in the ANNUAL REPORT of the Board of Governors for 1968, pages 331-32.) Since that time, and especially in the closing months of 1969, the question of the appropriate handling of newly-mined South African gold and reserves within the framework of the two-tier system has been

discussed by financial officials of the United States, South Africa, and certain other countries bilaterally, as well as with officials of international financial organizations.

On December 16 the U.S. Treasury issued a statement referring to those discussions, suggesting that a basis for a satisfactory mutual understanding might be emerging, and noting that it was anticipated that the discussions would subsequently be pursued in the framework of the International Monetary Fund. The question was settled before the end of the year by letters from the South African and United States authorities to the IMF, and by an IMF decision. In a letter dated December 23 to the IMF the South African authorities stated their intentions as to the handling of newly-mined gold; and in a letter of December 24 to the IMF the U.S. authorities indicated their willingness to support IMF decisions to buy gold offered by South African under the conditions outlined in the South African letter, assuming that there is an understanding among Fund members generally that they do not intend to initiate official gold purchases directly from South Africa. On December 30 the IMF announced that it would buy gold offered to it by South Africa whenever the latter indicates that the offer is in accord with the South African policy statement (in its December 23 letter). These three documents--the South African letter, the U.S. letter, and the IMF announcement of December 23--were published in the Federal Reserve Bulletin for January 1970, pages _____.

Gold prices in private markets had advanced fairly steadily throughout the first three months of 1969, reaching $43.80 per ounce on the London market in early March--the high for the year on that market. Factors contributing significantly to the first-quarter rise of gold prices were the general absence of new production coming into the market, increased tensions in the Middle East, and purchases by French residents increasingly concerned about the parity of the French franc.

In early June, prices dropped to around $41 per ounce, probably because of the obvious imminence of ratification of the plan for Special Drawing Rights, the rising cost of holding gold as interest rates advanced rapidly in all major European money markets and in the Euro-dollar market, and an increase in the amount of new gold production coming on the market with the waning of earlier strength in the balance-of-payments position of South Africa.

After a temporary firming in gold prices in July to about $42.00, gold prices declined fairly steadily from early August to late October, at which time the price on the London market was about $40.00. The French devaluation in August apparently contributed to the easing, as did the general relaxation of tensions in foreign exchange markets after the revaluation of the German mark in October, and a growing volume of market offerings of newly produced gold by South Africa to finance its worsening balance-of-payments position. By that time, moreover, it had become clear that the principles of the two-tier system would continue to be adhered to by all major nations, and that it was likely that agree-

ment would be reached on an arrangement under which new gold production would be absorbed into official channels only or mainly when the free-market price was at or near the $35 level.

In early November, gold prices began to decline quite rapidly, and by December 9 the price of gold on the London market had fallen to the official level. During the remainder of December it stayed close to that level, ranging between $35 and about $35.30.

Study of Greater Exchange-Rate Flexibility

The possibility that somewhat greater flexibility in exchange rates should be introduced into the exchange-rate system has come increasingly to the fore in recent years. Among the proposals put forward, attention has centered mainly on two: some increase in the margins within which rates for currencies of IMF member countries may fluctuate in spot markets, and a system for parity-rate changes limited in their annual amounts, this system being known variously as the crawling peg, the sliding or gliding parity, the self-adjusting peg, etc. Promulgated initially by some of the academic economists who believe that systems of freely-floating exchange rates (favored by many other economists) are undesirable, or unacceptable to government authorities, or both, these proposals have become of increasing interest to some business men and bankers, as well as to government officials, in many countries.

A major reason for the rise of interest in such systems of greater exchange-rate flexibility has been the growing awareness of the

difficulty of solving some important and chronic international payments imbalances by other means. Another reason, particularly influential among the U.S. businessmen and bankers who have become interested in these proposals, has been the belief that some increase in exchange-rate flexibility might from their point of view be preferable to the increase of direct controls in international transactions which many of them regard as likely to develop if payments imbalances are not solved.

In their annual report for 1969 the Executive Directors of the International Monetary Fund disclosed that in the past year they had discussed extensively the mechanism by which exchange rates can be changed, considering the subject "in the framework of the international adjustment process and with a view to a better working of the international monetary system." They indicated their intention to continue their study of this subject. In discussion of this matter at the 1969 annual meeting the dominant theme, particularly in statements by Governors representing industrial countries, was the need for caution in considering fundamental changes in the exchange-rate system as embodied in the Bretton Woods agreement. But no one opposed the Executive Directors in their announced intention to study the subject further.

Following the Ministerial Meeting of the Group of Ten in Washington on October 1, the participating Ministers and central bank Governors issued a press communiqué in which, among other things, they instructed their Deputies to continue their regular meetings for the purpose of reviewing developments, and possible improvements, in the

functioning of the international monetary system. While this instruction may enable the Deputies to consider, if they wish, possible changes in the exchange-rate system, it is generally assumed that further official study of this question will take place mainly in the IMF.