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SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

January 28, 1966

SUPPLEMENTAL NOTES

The Domestic Economy

The consumer price index increased .4 per cent in December to 111.0 per cent of the 1957-59 average. Much of the rise was the result of an .8 per cent increase in average food prices which reached a level 3.5 per cent above a year earlier. Retail prices of pork rose 3.8 per cent in December and reached a level about 30 per cent above a year earlier.

The index for nonfood commodities increased .1 per cent. New cars did not exhibit their usual seasonal decline and apparel was unchanged. Fuel prices rose seasonally, while used car prices continued to decline.

Average prices of services rose .3 per cent in December, and, for the year as a whole, increased moderately more than for the four years previous.

Rental vacancy rates in the fourth quarter of last year returned to the first quarter average (7.7 per cent) after two quarters of moderate decline. While the fourth quarter rise was quite general both by type of area and by region, the average for the year as a whole (7.5 per cent) was the same as in 1964 and under the recent record of 7.9 per cent reached in 1961. Among the individual regions, the rate in the North Central states remained appreciably below earlier advanced levels; in the Northeast and particularly the West, however, the fourth quarter rates were among the highest for the series and the averages for 1965 were at new annual highs.

The Domestic Financial Situation

This week's addition of several large corporate issues to the February calendar and the continued reluctance of investors to acquire bonds at original reoffering yields put more upward pressure on corporate yields. Consequently, when it immediately became apparent that this week's lone competitive issue was not going to move quickly, underwriters terminated syndicate price restrictions. The subsequent yield advance of 6 basis points in free market trading brought yields on Aaa-rated utilities to the highest level since 1959. In the municipal market, the generous yields offered on the \$253 million New York City issue have apparently resulted in a favorable reception. Some other offerings in this week's record new supply, however, were less enthusiastically received.

On January 26 the Treasury announced the terms of a combination refunding and advance refunding operation involving \$13.7 billion of publicly-held securities maturing in February, April, May, and August 1966. Two new issues are being offered in the exchange: a 4-7/8 per cent, 18-month note and a 5 per cent, 4-3/4-year note. The new 4-7/8's are priced to yield 4.96 per cent and the 5's are priced to yield from 4.97 to 5.00 per cent, depending on which eligible security is exchanged. Holders of all the eligible issues may exchange into the new 5 per cent note, but the new 4-7/8 per cent note is available only to holders of the February and April maturities. The market's initial response to the refunding terms has been very favorable.

International Developments

In the U.S. balance of payments table (page I--T - 3) new data and revisions are as follows:

(millions of dollars)

	1965		
	<u>Year</u> P/	<u>IV</u> P/	<u>Dec.</u> P/
Balance on regular transactions S.A.	-1,850 ^{e/}	-500 ^{e/}	
Seasonal component	--	3	
Balance N.S.A.	-1,850 ^{e/}	-500 ^{e/}	-100 ^{e/}
Liquidity balance S.A.	-1,312	-354	
Seasonal component	--	3	
Balance N.S.A.	-1,312	-351	- 16
Official settlements balance S.A.	-1,332	-1,155	
Seasonal component	--	57	
Balance N.S.A.	-1,332	-1,098	-649

	<u>Year</u> (billions)	<u>IV</u>	<u>Dec.</u>	<u>Nov.</u> ^{f/}	<u>Oct.</u> ^{f/}
Trade balance	4.8	1,280	460	430	390
Exports	26.3	7,080	2,350	2,400	2,330
Imports	21.5	-5,800	-1,890	-1,970	-1,940

These trade figures incorporate Census's revised seasonal adjustments, and also balance-of-payments adjustments for the fourth quarter arbitrarily spread out evenly by months. Revisions for earlier quarters will not be entered in this table until published in March.

Corrections:

Page IV - 3: Insert "buoyant" line 17.

Page IV - 4: Footnote "a" applies to third quarter figure for France instead of October.

SUPPLEMENTAL APPENDIX A: THE FEDERAL BUDGET

As had been indicated in the President's State of the Union message, the Federal Budget for fiscal year 1967 shows a smaller deficit in the administrative budget and a turn to a small surplus in the cash budget as compared with fiscal 1966. This smaller deficit is partly the product of accelerated corporate tax payments, restored excise tax cuts, and increased asset sales -- all offsetting higher expenditures, mainly for national defense and Great Society programs.

When the implications of the Budget Document for calendar year 1966 are examined, the various budgets, including the budget on a national income accounts basis, show greater deficits as compared with the full calendar year 1965. In the second half of 1965, however, there had been a sharp increase in fiscal stimulus.

In order to facilitate analysis of the economic and financial impact of the current budget, the fiscal year totals shown in the Document have been projected on a half-year basis for various budget concepts and related financial transactions, as shown in the attached tables.

Financing implications. As shown in Table 1, the budget figures imply a cash surplus in the current half year -- January-June 1966 -- somewhat smaller than a year ago, to be followed by a July-December deficit that is slightly smaller than last year but above 1964. However, net cash debt repayment by the Treasury in the current half year is projected to be larger than a year ago, \$3.4 billion as compared with \$2.4 billion. This projection of somewhat higher debt repayment assumes that the Treasury does not build up its cash operating balance by mid-1966 to more than the level of \$7.6 billion indicated in supporting tables to the Document. This would imply a less-than-usual rise of \$2.4 billion in the cash balance in the current half-year period.

As a corollary, with a smaller cash balance available at the beginning of the new fiscal year to meet July-December 1966 operating needs, net cash borrowing in that period would be well above such levels of recent years. Past experience suggests, however, that this borrowing could be distributed more evenly through the year, with some advance borrowing taking place before midyear, if market conditions

indicate the possibility. No matter how it is spaced, though, cash borrowing for calendar year 1966, projected at \$6.5 billion, will be much larger than in calendar 1965, when it was \$2.8 billion.^{1/}

The budget's impact on credit markets is not fully indicated by the figures for net cash borrowing, because some of the cash obtained by the Government comes from selling financial assets or participations against such assets (which appear as negative expenditures in the cash budget). The addendum item in Table 1 shows the magnitude of these and other Federal Credit programs affecting domestic credit markets.

Sales of participations in Federally-held assets (such as mortgages and Export-Import Bank paper) are projected in the Budget at \$2.6 billion for fiscal year 1966 and \$4.2 billion in fiscal 1967. Thus far in fiscal 1966, participation sales have amounted to about \$900 million, so that \$1.7 billion are scheduled over the next five months, including \$1 billion of Export-Import Bank paper to be sold presumably mostly to commercial banks.

Data on other credit transactions affecting domestic markets are not readily available by semiannual periods. The Budget Document does indicate stepped up Federal lending in fiscal 1966 as compared with fiscal 1965, which would be a factor tending to reduce pressure on private credit markets. Practically all of this increase in lending represents greater net mortgage purchases in FNMA secondary market operations; after taking account of purchases made so far this fiscal year, about \$1 billion of purchases remain to be made.

In fiscal 1967, credit programs, other than participation sales provide less funds to private credit markets. With participation sales absorbing more funds in that period, the net effect of Federal credit programs is to add rather sharply to credit market pressures as compared with earlier periods.

^{1/} Borrowing in calendar 1966 is projected at about \$1.5 billion lower than it otherwise would be because the Treasury has been increasing the production of new coins that now have no silver content (dimes and quarters) and on which the seigniorage (or difference between face value and production costs) therefore is now larger. The seigniorage level will return to more normal proportions once the coin shortage is alleviated and production returns to more normal levels.

Budget in GNP terms. Translation of the cash budget to the national income account concepts shows a smaller budgetary deficit in those accounts in fiscal 1967 than in fiscal 1966. However, on a calendar year basis, the national income accounts budget moves from a surplus in 1965 to a deficit in 1966, the same direction of movement as in the cash budget. A GNP estimate of \$722 billion for calendar 1966 underlies the budget estimates.

In January-June 1966, the budget in the national income accounts is projected to show a deficit of about \$2 billion, continuing at about that level in July-December. Such a deficit would be slightly smaller than obtained in the second half of calendar 1965. However, expansion in Federal expenditures during the current half year is projected to be quite large -- almost \$9 billion above July-December 1965 (with not quite half in defense) -- but is offset mainly by expanding receipts, especially from social security taxes.

When the Federal budget in the national income accounts is put on a constant "high-employment" basis,^{1/} it shows a slight deficit in calendar 1966. This deficit, as currently estimated in the Government, changes little between the first and second halves. In 1965, the high-employment budgetary balance declined from a \$7 billion surplus in the first half of the year to virtual balance in the second half, as increased social security benefits and the excise tax cut provided a substantial fiscal stimulus. The emergence of a slight high-employment deficit over the coming year stems from a rise in expenditures that is almost, but not quite, offset by the higher revenues generated in a growing economy and from increased social security tax rates.

It should be noted, however, that one of the problems in calculating a high-employment budget is that the constant rate of economic growth -- 3-3/4 per cent per year in real GNP -- assumed necessary to maintain unemployment at 4 per cent could be in the process of shifting downward in view, among other things, of the absorption of manpower into the armed services. In other words, changes in the structure of labor force use suggests that given reductions in unemployment may be accomplished with a slower rate of economic growth than was assumed earlier. If the high employment budget were then calculated on the basis of a somewhat lower growth rate, the high-employment deficit for calendar 1966 would be larger -- that is, closer to the actual deficit projected in the national income accounts.

To conclude, when looked at from the point of view of the national income and high-employment budgets, the current Budget seems to suggest a little additional fiscal stimulus over the coming year as compared with the second half of 1965. With private outlays rising

^{1/} This was formerly termed the full-employment budget.

and the margin of unutilized economic resources narrowing further, the question does arise whether the budget should not be showing some move toward fiscal restraint.

Some possible restraint on the economy might develop out of the speed-up in corporate tax payments. This proposed speed-up is reflected in the cash budget but not the national income budget. However, it is not clear yet how corporate spending plans would be affected by a one-time need to obtain more funds to pay taxes. In any event, the main impact of the speed-up, if passed by Congress, would be in the spring of 1967.

On the other hand, the expansionary potential of the budget could be enlarged if the Vietnam situation is not contained within the bounds projected by the Document. The budget as presented implies a bunching of defense outlays in the current half year, and then a leveling off. Any rise in Government expenditures would enlarge the fiscal stimulus (and already sizable borrowing requirements) unless, of course, tax rates also were to be raised.

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Table 1

Estimated Treasury Cash Transactions and Balances
(In billions of dollars)

	Half Year						Fiscal Year			Calendar Year	
	1964	1965		1966		1967	1965	1966	1967	1965	1966
	July-Dec.	Jan. -June	July-Dec.	Jan. -June	July-Dec.	Jan. -June					
Cash deficit (-) or surplus (+)	-10.2	+ 7.5	-12.0	+ 5.1	-11.4	+11.9	-2.7	-6.9	+0.5	-4.6	-6.3
Increase (+) or decrease (-) in total cash balances	- 3.4	+ 5.1	- 6.6	+ 2.5	- 1.1	+ 1.1	+1.7	-4.1	--	-1.4	+1.4
Seigniorage	--	+ 0.1	+ 0.2	+ 0.7	+ 0.8	+ 0.8	+0.1	+0.9	+1.6	+0.2	+1.5
Net cash borrowing (+) or repayment (-) of debt	+ 6.7	- 2.4	+ 5.3	- 3.4	+ 9.9	-12.0	+4.3	+1.9	-2.1	+2.8	+6.5
Cash operating balance outstanding (end of period)	6.4	11.5	5.2	7.6	6.5	7.6	11.5	7.6	7.6	5.2	6.5
Addendum:											
Domestic credit transactions ^{1/} net, contained in cash payments ^{1/}							- .9	- .5	3.1		
Participation sales	.8	0	.9	1.7	1.5	2.7	.8	2.6	4.2	.9	3.2
Other domestic credit transactions ^{2/}							-1.7	-3.1	-1.1		

^{1/} Asset sales and repayments of loans made by the Government are indicated by a plus sign; asset purchases and loans extended by a minus. All credit transactions with foreign borrowers are excluded.

^{2/} Includes asset purchases, such as mortgage purchases by FNMA, and net extensions or repayment of loans made by the Federal Government (other than loans to foreigners).

Note: Breakdown of credit transactions, other than participation sales, not readily available except on a fiscal year basis. Distribution by half-years are Federal Reserve estimates based on totals shown in the Budget document. Data are not seasonally adjusted.

Table 2
 Various Federal Budgets by Half Years
 (In billions of dollars)

	1964	1965		1966		1967	Fiscal Years			Calendar Years		
	II	I	II	I	II	I	1965	1966	1967	1965	1966	
		<u>Actual</u>			<u>Estimated</u>							
Cash: Not Seasonally Adjusted												
Receipts	51.4	68.3	55.0	73.1	61.8	83.7	119.7	128.2	145.5	123.4	135.0	
Payments	61.5	60.9	67.0	68.0	73.2	71.8	122.4	135.0	145.0	127.9	141.2	
Surplus/Deficit	-10.2	7.5	-12.0	5.1	-11.4	11.9	- 2.7	- 6.9	.5	- 4.6	- 6.3	
National Income Accounts				<u>Seasonally Adjusted at Annual Rates</u>								
Receipts	115.7	124.0	124.0	133.5	139.5	144.9	119.6	128.8	142.2	124.0	136.5	
Expenditures	118.1	120.3	126.6	135.3	141.5	144.0	118.3	131.0	142.7	123.5	138.4	
Purchases of Goods & Services	64.6	65.3	68.1	73.3	74.7	74.2	65.0	70.7	74.5	66.7	74.0	
Surplus/Deficit	- 2.4	3.7	- 2.6	- 1.8	- 2.0	.9	1.2	- 2.2	- .5	.5	- 1.9	
High-Employment												
Receipts	123.8	127.2	126.5	135.0	140.8	144.6	125.5	130.8	142.7	126.9	137.9	
Expenditures	118.1	120.0	126.3	135.3	141.6	144.2	119.1	130.8	142.9	123.2	138.5	
Surplus/Deficit	5.7	7.2	.2	- .3	- .8	.4	6.4	--	- .2	3.7	- .6	