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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

April 25, 1969

SUPPLEMENTAL NOTES

The Domestic Economy

The BLS estimates a rise of only 0.1 per cent in wholesale prices of industrial commodities from mid-March to mid-April and of 0.2 per cent in the over-all WPI. These increases represent a distinct slowdown from the rapid rate of increase in the first three months of the year. The BLS estimates for April are shown below, with indexes for February and March:

BLS WHOLESALE PRICE INDEXES
(1957-59 = 100)

| | February | 1969 March | April ^{e/} |
|---|--------------|---------------|---------------------|
| All commodities | 111.1 | 111.7 | 111.9 |
| Farm products & processed foods & feeds | <u>110.0</u> | <u>110.7</u> | <u>111.0</u> |
| Farm products | 105.0 | 106.5 | 105.6 |
| Processed foods and feeds | 116.3 | 116.4 | 117.5 |
| Industrial commodities | 111.4 | 112.0 | 112.1 |

The abrupt slowing of the rise for industrial commodities in April reflected in large part a reversal of the earlier sharp run-up in lumber and plywood prices. The latter prices declined, on average, 5 per cent, with softwood plywood down 20 per cent. Reduction in these prices took 0.1 point out of the industrial total. Apart from lumber and plywood, industrial price increases continued widespread, with metals up substantially further and with higher prices reported for gasoline, hides and skins (up 15 per cent), and some paper and machinery items.

The Domestic Financial Situation

Bank credit. Business loan growth at weekly reporting banks accelerated sharply during the April tax week, following appreciable expansion earlier in the month. The tax week rise in business borrowing was particularly large at banks outside New York City, with the increase at New York banks about in line with comparable periods in other recent years. Corporations apparently also relied heavily on other sources of funds to meet April tax liabilities, as indicated by the large rise in finance company borrowing and the substantial CD run-off.

CHANGES IN SELECTED BALANCE SHEET ITEMS AT
WEEKLY REPORTING BANKS OVER THE APRIL TAX PERIOD^{1/}
(Millions of dollars)

| Item | 1966 | 1967 | 1968 | 1969 |
|--|-----------|-------------|-------------|---------------------|
| Business loans | 158 | 646 | 683 | 1,214 ^{2/} |
| Government security dealer loans | 274 | -84 | -562 | 193 ^{2/} |
| Finance company loans | 293 | 235 | 514 | 635 |
| Treasury bill holdings of banks | 271 | -287 | -342 | 12 |
| Negotiable CD's outstanding ^{3/} | <u>65</u> | <u>-527</u> | <u>-697</u> | <u>-475</u> |
| Total bank financing | 931 | 1,037 | 990 | 2,529 |
| Corporate income tax payments (1969 estimated) | 2,440 | 4,295 | 4,339 | 5,100 ^e |
| Ratio of business loans to tax payments (per cent) | 7.0 | 15.0 | 15.7 | 23.8 |
| Ratio of total bank financing to tax payment (per cent) | 38.2 | 24.1 | 22.8 | 49.6 |
| ----- | | | | |
| MEMO: | | | | |
| Tax bills outstanding | n.a. | 2,510 | 3,507 | 2,003 |
| Tax bills turned in for taxes | n.a. | 790 | 1,200 | 775 |
| Ratio of bills turned in for taxes to tax payments (per cent) | n.a. | 18.4 | 26.1 | 15.2 |

^{1/} Reporting week including April 15.

^{2/} Adjusted to exclude effect of System matched sale-purchase transactions.

^{3/} A decline in CD's is considered as a source of financing and is added to the other items to obtain total bank financing.

n.a. - Not available.

e - Estimated.

President Nixon's tax proposals. With good prospects for legislative action on the investment credit repeal, new orders for producers' durable equipment have become abruptly less attractive beginning April 21. Such a repeal would diminish the average after tax rate of return on new investment in producers' durable equipment by an estimated 1 to 2 percentage points. Its effect can also be looked at as equivalent to a sharp increase in the real price of producers' durable equipment, on average, perhaps the equivalent of a price increase of 5 per cent. These estimates allow for the fact that not all equipment investments had been eligible for investment credits and not all of those that were eligible were getting the maximum 7 per cent credit.

Whatever the magnitude of effect may be on new orders, however, a major part of equipment outlays for the balance of 1969 will still reflect orders and projects to which businessmen were already committed prior to April 21, 1969. Moreover, to the extent that orders were placed before the cut-off date, the subsequent outlays will still give rise to investment tax credits. An additional factor that moderates the restrictive effect on corporate cash flows is the carry-over of past investment credits that could not be utilized due to ceiling limitations and that can be recouped with the repeal in effect. Hence, the impact on corporate cash flows will be very gradual and the staff estimates of the increase in tax revenues that result from repeal amounts to only \$450 million (on an accrual basis) during calendar year 1969.

By 1970, however, the bite of the investment tax credit repeal will become larger and the Treasury estimates as much as a

\$1.8 billion revenue effect for fiscal year 1970 and a \$3.0 billion revenue effect in future years.

The proposed halving of the surtax in the January to June 1970 period would have the following revenue effects during fiscal year 1970 according to staff estimates:

| | <u>January-June 1970</u> <u>(In millions of dollars)</u> |
|-----------------------------------|---|
| Corporate income taxes | -270 |
| Nonwithheld personal income taxes | -180 |
| Withheld personal income taxes | <u>-1,500</u> |
| | 1,950 |

Additional revenue effects would spill over into fiscal year 1971, due to the normal delays in collections.

Some reforms in tax laws also were proposed mainly in regard to individual income taxes. Only three of these will be discussed here:

(1) Low income relief. This is obtained through a special low-income allowance that would be built into the standard tax tables. The special allowance would be gradually phased out for somewhat higher income earners until it is phased out completely at income levels about \$1,000 above the poverty line, with the spread between the poverty line and the cutoff point depending on the number of dependents. Tax payers at the presently defined poverty income levels would pay practically no income taxes, instead of the \$60 to \$120 now collected from them. The annual cost this proposes is estimated at \$665 million.

(2) Allocation of deductions. This is the second most important reform proposal from the standpoint of size of revenue effect, with the increase in annual tax collections estimated at \$500 million a year when the provision is in full effect. Tax payers with tax preferred income in excess of \$10,000 would have to allocate their itemized deductions proportionately as between taxable income and tax preferred income. Tax preferred income for this purpose includes (a) capital gains, (b) municipal bond interest, (c) income before deduction of depletion in excess of cost and accelerated real estate depreciation in excess of straight line depreciation, (d) income from farming without allowance for losses that arise from the imprecise cash basis of accounting farmers are allowed to use, and (e) appreciation in the value of property given to charity. In short, if a tax payer had half of his income in the form of tax preferred income, he would have to allocate half of his itemized deduction to that form of income and thus could not deduct them from taxable income.

(3) Limit on tax preference. A limit on tax preferences is also proposed, somewhat similar to the minimum tax plan proposed by the Treasury Department in the Johnson Administration. The portion of tax preferred income that exceeds half of a taxpayer's total income would be made subject to tax at regular tax rates. A \$10,000 exemption is allowed, and of the list of types of tax preferred incomes given under item 2, capital gains and municipal bond interest would be excluded from consideration under this proposal, so that only the last three items of the list would constitute tax preferred income for the purpose of computing the 50 per cent limit. The eventual revenue effect is estimated at \$80 million.

KEY INTEREST RATES

| | 1969 | | | |
|-----------------------------------|-------------|-------------|-------------|-------------|
| | Lows | Highs | April 2 | April 24 |
| Short-Term Rates | | | | |
| Federal funds (weekly average) | 5.95 (1/1) | 7.63 (4/16) | 6.66 (4/2) | 6.48 (4/23) |
| 3-months | | | | |
| Treasury bills (bid) | 5.91 (3/24) | 6.25 (1/7) | 6.09 | 6.10 |
| Bankers' acceptances | 6.38 (2/17) | 7.00 (4/23) | 6.62 | 7.00 |
| Euro-dollars | 7.14 (1/2) | 8.51 (3/19) | 8.41 | 8.38 |
| Federal agencies | 6.08 (3/26) | 6.59 (4/16) | 6.13 | 6.49 |
| Finance paper | 6.25 (2/6) | 6.50 (4/23) | 6.50 | 6.50 |
| CD's (prime NYC) | | | | |
| Highest quoted new issue | 6.00 | 6.00 | 6.00 | 6.00 |
| Secondary market | 6.45 (2/13) | 7.00 (4/16) | 6.65 | 6.90 |
| 6-months | | | | |
| Treasury bills (bid) | 6.04 (3/25) | 6.42 (1/7) | 6.12 | 6.09 |
| Bankers' acceptances | 6.50 (2/17) | 7.12 (4/23) | 6.75 | 7.12 |
| Commercial paper | 6.25 (1/7) | 7.12 (4/23) | 6.88 | 7.12 |
| Federal agencies | 6.32 (1/16) | 6.60 (2/28) | 6.44 | 6.58 |
| CD's (prime NYC) | | | | |
| Highest quoted new issue | 6.25 | 6.25 | 6.25 | 6.25 |
| Secondary market | 6.50 (1/30) | 7.00 (4/23) | 6.85 | 7.00 |
| 1-year | | | | |
| Treasury bills (bid) | 5.86 (1/16) | 6.39 (2/27) | 6.15 | 5.94 |
| Prime municipals | 3.90 (1/2) | 4.55 (3/20) | 4.50 | 4.05 |
| Intermediate and Long-Term | | | | |
| Treasury coupon issues | | | | |
| 5-years | 6.11 (1/20) | 6.45 (3/11) | 6.32 | 6.28 |
| 20-years | 5.91 (4/14) | 6.32 (3/18) | 6.17 | 5.96 |
| Corporate | | | | |
| Seasoned Aaa | 6.56 (1/2) | 7.00 (3/28) | 6.99 | 6.81 |
| Baa | 7.26 (2/3) | 7.64 (3/28) | 7.59 | 7.49 |
| New Issue Aaa | | | | |
| With call protection | 7.05 (1/9) | 7.45 (4/9) | -- | 7.06 |
| Without call protection | 6.90 (2/20) | 7.57 (3/21) | 7.28 | -- |
| Municipal | | | | |
| Bond Buyer Index | 4.82 (1/23) | 5.30 (3/26) | 5.25 | 5.09 |
| Moody's Aaa | 4.57 (1/2) | 5.08 (4/9) | 5.00 | 4.95 |
| Mortgage--implicit yield | | | | |
| in FNMA weekly auction <u>1/</u> | 7.66 (1/9) | 8.17 (3/3) | 8.11 (3/31) | 8.05 (4/21) |

1/ Yield on 6-month forward commitment after allowance for commitment fee and required purchase and holding of FNMA stock. Assumes discount on 30-year loan amortized over 15 years.

International Developments

The March trade data, scheduled to be released by the Bureau of the Census on April 23, will record a sizable trade surplus for the month both on the Census and balance of payments bases as exports increased more than imports. For the first quarter, the trade balance on a Census basis was a deficit at an annual rate of about \$1/4 billion. On a balance of payments basis the trade deficit is now estimated to be about \$1-1/4 billion. Exports were a little higher and imports somewhat lower than we had expected.

The March figures would indicate that both exports and imports were somewhat above "normal" in that month, and as the heavier backlog of exports than of imports is moved out, a sizable export surplus in the second quarter can be expected.

U.S. foreign trade data for March and the first quarter are shown below:

(billions of dollars, seasonally adjusted annual rate)

| | <u>Census basis</u> | | | | <u>Balance of Payments basis</u> | | | |
|---------------|---------------------|-------------|-------------|-------------|----------------------------------|-------------|-------------|-------------|
| | <u>Q-1</u> | <u>Jan.</u> | <u>Feb.</u> | <u>Mar.</u> | <u>Q-1</u> | <u>Jan.</u> | <u>Feb.</u> | <u>Mar.</u> |
| Trade balance | -0.3 | 0.9 | -4.3 | 2.6 | -1.3 | -0.4 | -4.9 | 1.3 |
| Exports | 30.3 | 25.1 | 27.6 | 38.4 | 29.4 | 23.9 | 27.1 | 37.2 |
| Imports | 30.6 | 24.2 | 31.9 | 35.8 | 30.7 | 24.3 | 32.0 | 35.9 |

SUPPLEMENTAL APPENDIX: THE UNITED KINGDOM BUDGET FOR FISCAL 1969-70*

The U.K. budget presented to Parliament on April 15 for the fiscal year which began on April 1 is intended to increase the excess of central government revenue over spending and lending from £281 million in fiscal 1968-69 to £807 million. Tax rate increases in this year's budget are to provide £270 million of additional revenue during this fiscal year, and £340 million a year when fully effective, or a little less than 1 per cent of GNP.

The deflationary effect of the change in total public sector spending and receipts (slated to increase by about 6 and 10 per cent, respectively, in current prices) will be greater than that of the central government alone. Net borrowing by local authorities is expected to be reduced from £678 million in 1968-69 to about £500 million in 1969-70. The nationalized industries and public corporations are expected to show a surplus of over £200 million this fiscal year compared to one of less than £100 million in 1968-69.

The Chancellor said that the application of further restraint in this year's budget is dictated by the failure of the balance of payments to show sufficient improvement. He stated that the basic balance (current and long-term capital accounts) would soon move into surplus but, in view of Britain's huge debts, the surplus in the absence of additional restraint would be too small to be considered satisfactory.

The trade figures for March, released shortly before the Chancellor presented the budget to Parliament, underscored the unsatisfactory nature of Britain's balance of payments position. The trade deficit, on a balance of payments basis, was £52 million in March. This was a slight improvement over the £64 million deficit in February, but was still too large to permit a surplus on the overall current account. Neither exports nor imports changed appreciably from the fourth to the first quarter. The leveling off in total exports was partly due to a 17 per cent decline in shipments to the United States because of the dock strike there, but the growth in British exports to other areas also markedly slackened in the first quarter. Furthermore, the stability of imports was also a consequence of the U.S. dock strike, imports from the United States decreasing by about 15 per cent.

* Prepared by Martin J. Kohn, Europe and British Commonwealth Section, Division of International Finance.

The explicitly stated overriding objective of the budget is to restrain personal consumption, a necessary (though not a sufficient) condition of improvement in the balance of payments. Despite a recent slowdown in the U.K. economy, an early resumption of growth is expected; the government in the official forecast which accompanied the budget predicted a rise in gross domestic product in constant prices of almost 3 per cent from first half 1969 to first half 1970. Without the tax changes, Chancellor Jenkins told Parliament, the projected increase would have been 3-1/2 per cent. Growth is to be export and investment led, with exports of goods and services expected to increase by about 6 per cent and fixed capital investment, private and public, by a little less than 6 per cent. The government foresees the alternative possibility of an increase in exports approaching 10 per cent, an eventuality it predicts would bring about a 4 per cent rise in national income. Imports of goods and services are expected to increase by a little over 3 per cent. The slow growing categories in the official forecast are government current expenditures -- 1.3 per cent -- and, slowest of all, consumer expenditures -- a shade over 1 per cent.

There are, however, two reasons to question whether the government is taking forceful enough action to limit consumption as planned. One relates to the nature of the tax changes in the budget. The second -- and more important -- cause of doubt has to do with the government's reluctance or inability to keep wage increases in check.

With respect to the budget, some of the increase in taxes directly affect consumer goods. For example, the tax on gasoline was raised. Furthermore, the purchase tax was extended to several goods not previously covered. However, about two-thirds of the anticipated additional revenue from the tax changes is expected to come from a rise in the corporate income tax from 42.5 to 45 per cent and from a 28 per cent increase, effective May 27, in the selective employment tax (SET). The SET is a fixed amount which employers must pay per employee on the payroll. Refunds are made to employers in industries -- mostly in manufacturing -- whose development the government wishes to encourage.

At best, the direct effect on consumption of raising these business taxes is uncertain. At worst, the major impact of boosting business taxes in a period of tight money may be -- incongruously -- to discourage private investment to which the government attaches high priority.

The heavy reliance on business taxes may be to a large extent politically motivated, reflecting the Labor government's efforts to mollify the party rank and file and the public in general. However, there may be some economic justification in making only sparing use of higher indirect taxes on consumer goods, insofar as widespread price rises stemming from such tax hikes could fuel expectations of further price rises and thus cause a flight from money into goods. This consideration may have played a large role in the government's decision to give increased emphasis to voluntary savings schemes (even though the savings ratio did not fall appreciably last year compared to 1967). The new savings plan presented by the Chancellor in his budget speech is a contractual savings arrangement -- scheduled to start in October -- under which persons over 16 can, if they save up to £10 every week, receive a tax-free bonus equal to 20 per cent of their accumulated savings. This would be paid at the end of five years as would an additional bonus of equal amount if the savings are left intact for another two years.

Depending on savings schemes to damp consumption, as the Chancellor himself acknowledged, is hazardous, however, because of the difficulty in predicting how much new savings, as opposed to switching from one form of savings to another, such schemes will stimulate.

The main weakness in the government's efforts to hold consumption in check, however, relates to incomes policy. The Chancellor was sharply critical of the rise in wage earnings last year, asserting that a slower rate of increase would have permitted a less stringent budget this year. However, he also acknowledged the virtual abandonment of a compulsory incomes policy, announcing that the government will allow its current powers to delay price and wage increases for a year to lapse at the end of 1969. Thereafter, the government will revert to the arrangements of 1966, whereby it can delay such increases for only three months.

The Chancellor did promise that some of the suggested reforms in the White Paper on industrial relations published in January would be implemented immediately. However, the legislation proposed by the government last week is a diluted version of the White Paper. It omits the key proposal that a strike ballot by the union be required in the event of an impending major strike. The government is supporting enactment of the recommendation that it be empowered to invoke a 28-day suspension of strikes deemed "unconstitutional" or held to have occurred after inadequate prior negotiation, but with only mild penalties for violations of such temporary bans on work stoppages.

From the end of 1967 to the beginning of 1969, wage earnings increased by about 8 per cent, compared to a 6 per cent rise in consumer prices, a development which contributed heavily to the undesired rise in consumption last year. Given the government's jettisoning of incomes policy and its reluctance or inability to put strong anti-strike laws on the books, the probability that wage increases will again outpace price increases by too wide a margin is high.

While no major changes in monetary policy -- on which a large share of the burden of curtailing consumption appears to rest -- were announced in connection with the presentation of the budget last week, the Chancellor did lay great stress on restricting monetary and credit expansion. He threatened further action against the clearing banks if loans outstanding do not again fall in April, as they did in March. In November, the government directed the banks to reduce loans to the private sector to 98 per cent of the level in November 1967. Despite the directive, loans rose from November through February. The government will also seek to make government bonds more attractive to the nonbank public by exempting them from the capital gains tax. Heavy sales of gilt-edged securities by the public -- and also by the banking sector -- last year led the Bank of England to give heavy support to gilt-edged prices. This contributed to the 6-1/2 per cent growth in the money supply. Finally, in a move designed as much to discourage borrowing by individuals as to raise revenue the Chancellor announced that interest payments will no longer be tax deductible, except for interest on loans for business purposes and on loans for purchase of real estate.

Fred Taylor
4/24/69

GREENBOOK SUPPLEMENT

Mortgage market. According to FHA data which have just become available, home mortgage rates continued to rise in March, though at a somewhat more moderate pace. In the primary market, the average contract rate for conventional first mortgages rose only slightly as usury ceilings tended to artificially hold down these rates in a number of States. In the secondary market for Government-underwritten loans, the average yield increase was much smaller than in either of the two previous months when an adjustment was underway for the most recent upward shift in the FHA and VA ceiling rate. Although the yield spread favoring mortgages over new issues of high-grade corporate bonds narrowed sharply in March, it may have widened considerably since then in view of the recent sharp decline in bond yields.

(Rates - Table)

The latest FHA and FNMA field office reports both continue to indicate that at the current high interest rates, adequate funds remain available in most regions to accommodate loan demands. In contrast to the second-half of 1966, lenders have not yet been forced to employ stricter non-rate mortgage terms as a means of rationing available credit.

In March, the backlog of outstanding commitments rose again at all savings and loan associations and New York State mutual savings banks after adjustment for seasonal variation, reaching a level that was a fifth above a year earlier, when average housing prices and loan

amounts were smaller. However, the volume of new commitments approved by these institutions edged down during the month, according to FRB derived estimates. The decline in the volume of new commitments approved apparently resulted, at least in part, from the cautious attitude of lenders prior to the March-April reinvestment period.

AVERAGE RATES AND YIELDS ON SELECTED NEW-HOME MORTGAGES

| | Primary Market: Conventional loans | | Secondary Market: FHA-insured loans | | |
|-------------|---------------------------------------|--------------------------------------|--|--------------------------------------|----------------------|
| | Level (per cent) | Yield spread (basis points) | Level (per cent) | Yield spread (basis points) | Discount (points) |
| <u>1968</u> | | | | | |
| March | 6.80 | 23 | 6.83 | 26 | 7.0 |
| April | 6.90 | 40 | 6.94 | 44 | 7.9 |
| May | 7.15 | 51 | 7.50 ^e | 86 ^e | 6.1 ^e |
| June | 7.25 | 60 | 7.52 | 87 | 6.3 |
| July | 7.30 | 79 | 7.42 | 91 | 5.5 |
| August | 7.30 | 115 | 7.35 | 120 | 5.0 |
| September | 7.30 | 103 | 7.28 | 101 | 4.4 |
| October | 7.25 | 78 | 7.29 | 82 | 4.5 |
| November | 7.30 | 69 | 7.36 | 75 | 5.1 |
| December | 7.40 | 61 | 7.50 | 71 | 6.2 |
| <u>1969</u> | | | | | |
| January | 7.55 | 63 | 7.85 ^e | 93 ^e | 2.8 ^e |
| February | 7.60 | 68 | 7.99 | 107 | 3.9 |
| March | 7.65 | 28 | 8.05 | 68 | 4.4 |

Note: FHA series: Interest rates on conventional first mortgages (excluding additional fees and charges) are rounded to the nearest 5 basis points. Secondary market yields and discounts are for certain 6 per cent, FHA-insured Sec. 203 loans through April 1968. Data for May 1968 estimated by Federal Reserve based on 6-3/4 per cent regulatory interest rate in effect through December 1968. Data for January 1969 estimated by Federal Reserve for 7-1/2 per cent regulatory interest rate, on which a change of 1.0 points in discount is associated with a change of 12 to 14 basis points in yield. Gross yield spread is average mortgage return, before deducting servicing fees, minus average yield on new issues of high grade corporate bonds with 5-year call protection.