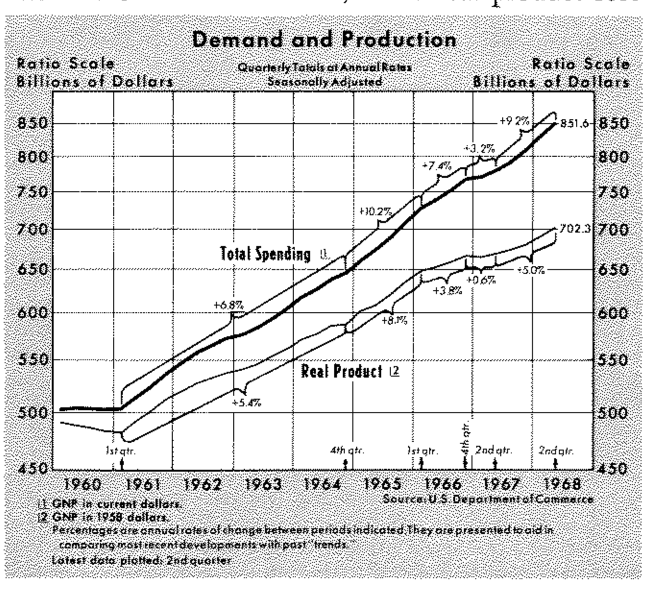
Excessive Demand Slowing?

TOTAL demand for goods and services has continued to expand at an excessive rate, causing price increases to accelerate. There is, however, some expectation of a slowing in the rate of growth in total demand this fall and winter.

Any assessment of the short-term performance of the economy must always be influenced by the impact expected from recent monetary and fiscal measures. The recent rapid increases in the money stock, Federal Reserve credit, bank reserves, and the monetary base may be considered expansive influences on total spending for several months. On the other hand, those observers who expect total demand to moderate focus on interest rates, bank credit, and fiscal developments. Interest rates, although declining since May, have been at historically high levels, and growth in bank credit, although rising sharply in July and August, grew only moderately in the second quarter. The recent 10 per cent surtax and moderation of Federal expenditure growth are also expected by many to produce an immediate and significant slowing of total spending.

Total Demand Remains Vigorous

Total spending increased at a 10 per cent annual rate in the first half of 1968, while real product rose



[1] GNP in current dollars.
[2] GNP in 1958 dollars.
Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."
Latest data plotted: 2nd quarter

at a 6 per cent rate. Most observers agree that such a rapid rate of increase in total demand is excessive and that such a high rate of growth in real product is unsustainable. From 1961 to 1967 total spending rose at a 7 per cent rate and real output grew at a 5 per cent rate. In the early years of this period, unemployment and idle capacity were reduced; in the later years inflationary pressures intensified as excessive claims were placed on available resources.

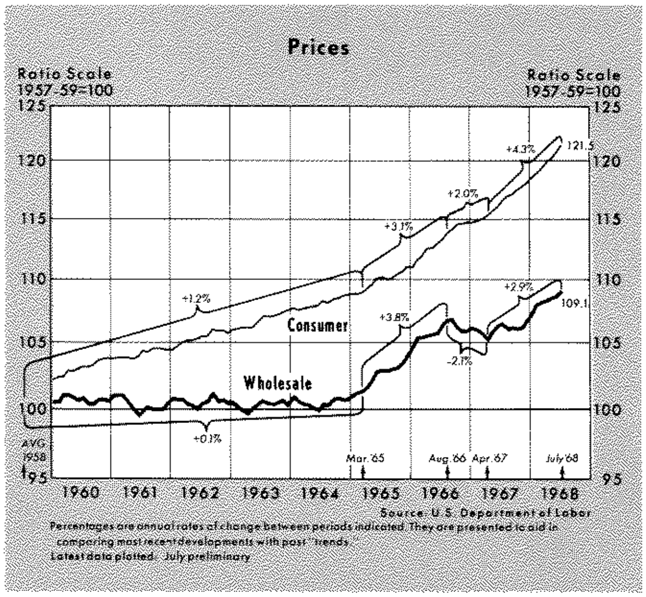
Personal income increased at about a 10 per cent annual rate in the first seven months of 1968. Retail sales grew at a rapid rate of about 15 per cent during this period. Auto sales this year have been exceeding the sales of the last two years and have approached the high level of 1965.

Reflecting the build-up of stocks of steel and automobiles, the rate of accumulation of business inventories increased in the second quarter after having been reduced by unexpectedly high sales in the first quarter. The inventory-sales ratio was essentially the same at the end of the second quarter as at the end of the first. Industrial production has grown at a 5 per cent annual rate during 1968. Housing starts in May, June, and July were at a 1.4 million annual rate, compared with 1.3 million in 1967 and 1.2 million in 1966.

Total civilian employment has risen at more than a 2 per cent annual rate since the beginning of the year, while payroll employment has grown at about a 3 per cent rate. By comparison, the population of working-force age has been rising at a rate of about 2 per cent a year. Unemployment in the first seven months of 1968 averaged 3.6 per cent of the labor force. While unemployment increased slightly during the summer, it is still low by historical standards. From 1962 to 1967 the unemployment rate averaged 4.8 per cent. The rate this year has been the lowest since the inflationary period of 1953.

Price Increases Accelerate

Prices have continued to reflect the rapid growth of total demand and the high rate of resource utilization. More than two-fifths of the increase in total expendi-



tures in the first half of 1968 was manifested in higher prices.

Consumer prices increased at a 4.8 per cent annual rate in the first seven months of 1968 compared with a 3 per cent average rate from 1965 to 1967, and a 1.3 per cent trend rate from 1961 to 1965. Wholesale prices increased at about a 3.7 per cent annual rate in the first seven months of 1968, compared with a 1.7 per cent rate from 1965 to 1967 and less than a 1 per cent rate from 1961 to 1965.

Unanticipated inflation causes redistribution of wealth and income and alters the productive process. A rise in prices reduces the purchasing power of those who have a claim to a fixed future income or repayment of debt. Inflation affects the country's competitive position in international trade. Because rising prices discourage the acquisition of certain financial assets and increase the relative desirability of real assets, nominal interest rates are driven up.

Impact of the New Fiscal Program

The fiscal program enacted in late June — a 10 per cent income surtax and cuts in planned Government outlays — was motivated by a desire to relieve some of the inflationary pressures on the economy. The high-employment budget is expected to move from a $16 billion annual rate of deficit in the second quarter of 1968 to near balance by the fourth quarter, and further to about a $13 billion surplus in the first half of next year. It is estimated that the high-employment budget would be in near balance in the third quarter of 1969 if the surtax were to expire on schedule. During the current fiscal year, however, the program is expected by many observers to have a dampening effect on total spending.

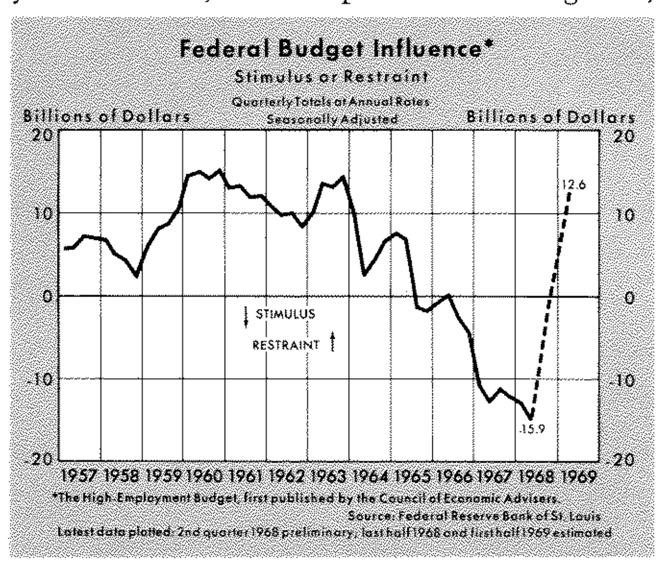
The restraining effects of the fiscal package depend in part on the extent to which the fiscal measures are implemented. During the first 2 months of fiscal 1969, July 1 through August 31, tax and other receipts of the Government amounted to $29.3 billion, or $5.8 billion more than in the corresponding period a year earlier, according to the Daily Treasury Statement. Expenditures in the same period amounted to $36.2 billion, or $3.9 billion (12 per cent) above the like period last year. Spending by the Defense Department went up $0.8 billion and all other outlays rose $3.1 billion. The resulting deficit was $7.0 billion compared with $8.8 billion in the corresponding period last year.

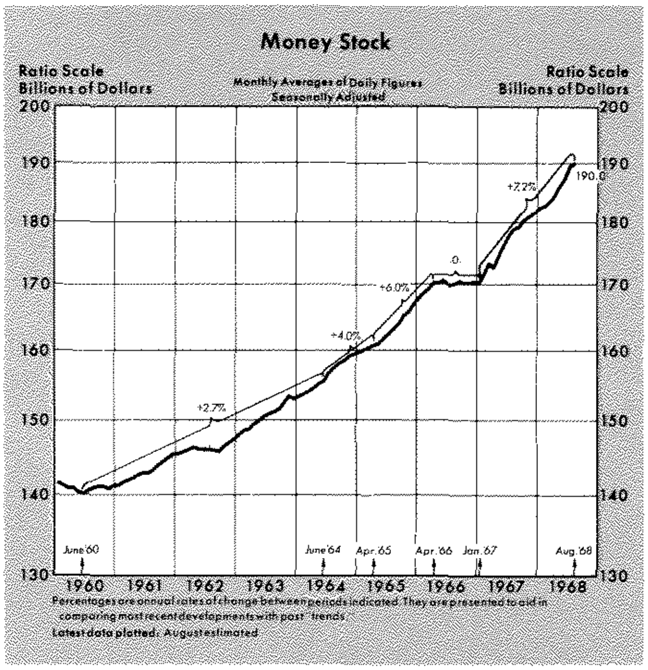
The initial impact of the budget on the economy may be moderated by other developments. In the first half of 1968 savings amounted to 7.3 per cent of income after taxes, compared with a 6 per cent average rate from 1961 through 1967. If the relatively high saving rate in the first half were in anticipation of the tax hike, this aspect of the program would have already exerted much of its influence on the consumer.

In addition, some of the effects of the fiscal actions may be felt only with a lag, and thus their influence on spending and prices may be spread over a longer period with less immediate impact. This impact may also be diminished to the extent that consumers and businesses expect the surtax to last only for the stipulated period. The fiscal program will reduce Federal deficits and borrowing and may lower inflationary expectations, placing downward pressures on interest rates. Lower interest rates may, in turn, stimulate some offsetting consumer and business spending.

Recent Monetary Developments

Monetary expansion has been very rapid in the past year and a half, and it is possible that this growth,





because of lags, will continue to have effects later this year. The money stock has increased at about a 7 per cent annual rate since the beginning of 1967, three times the 2.4 per cent trend rate from 1957 to 1966. Whenever money holdings of the public exceed the amount of money people desire to hold, given incomes, wealth, interest rates and other strategic factors, spending for goods, services, and investments rises. The monetary base[1] has shown a pattern similar to the money stock. Since January 1967 the base has risen at a rapid 6 per cent annual rate, compared with a 3.2 per cent rate from 1957 to 1966.

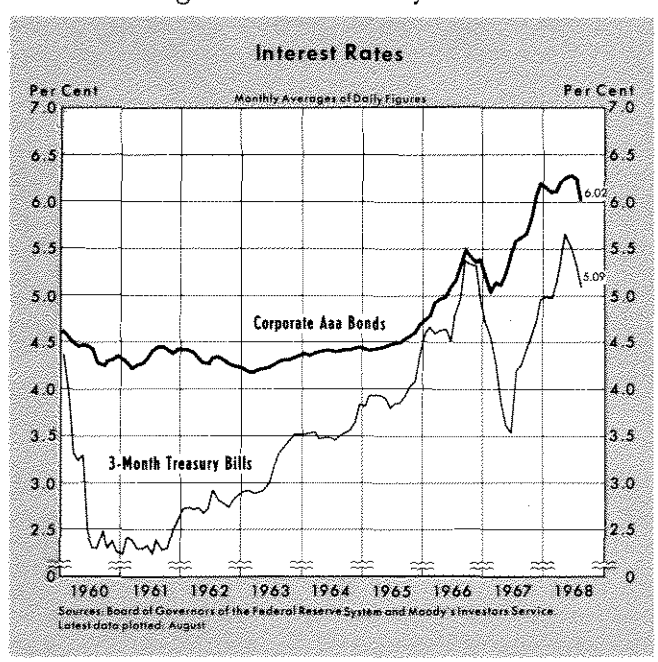
Money supply plus time deposits in commercial banks and total commercial bank credit, two broad monetary measures, have recently shown patterns somewhat different from the money stock, climbing very rapidly in July and August after slowing significantly in the second quarter. These measures usually indicate roughly the same degree of monetary action as the money stock. The two broader measures have been affected by the ability of banks to attract interest-bearing deposits. In the late spring and early summer Regulation Q limits on maximum interest rates banks could offer on time deposits diverted flows of funds around banks. With the recent decline in interest rates, banks have again become more competitive in seeking funds and have resumed their intermediary role.

Interest rates rose to historically high levels in the early months of this year. In May highest grade corporate bonds were yielding about 6.25 per cent. By comparison, these yields averaged 4.35 per cent in the 1961-65 period. The high rates have reflected primarily the strong demand for credit, based in part on large Federal deficits and expectations of inflation. Since interest cost is a factor in spending decisions, especially for long-term investment, the high interest level may be a dampening factor on economic activity.

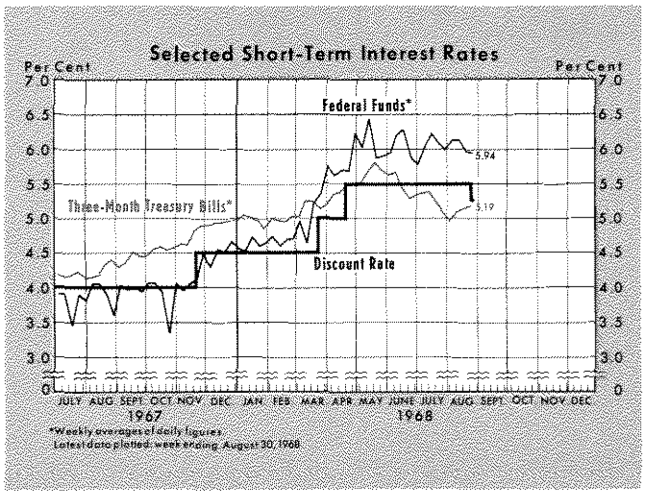
Most interest rates have drifted down from their highs of late spring. The sharpest decline has been in the short-term maturity range. The yield on three-month Treasury bills has declined from 5.65 per cent in May to 5.18 per cent in early September. The yield on highest grade corporate bonds has decreased from 6.27 per cent to 5.95 per cent over the same period. During the period from August 16 to August 30, all Federal Reserve Banks lowered their discount rate charged to member banks from 5½ to 5¼ per cent.

Although most short-term interest rates have declined, the rate on Federal funds, one day loans between commercial banks, has remained high (see chart). This rate increased from roughly 4 per cent a year ago to a 6 to 6¼ per cent range in May and remained near that level through August. The widening spread between the Federal funds rate and other short-term rates may reflect market expectations of further general interest rate declines in the very near future. With such expectations, banks may be willing to borrow on a short-term basis at rates higher than the return on paper of several months maturity.

The decline of interest rates since late last spring may be, in part, a short-run result of the acceleration in the rate of growth of the money stock. Declines in



[1]See "The Monetary Base — Explanation and Analytical Use" in the August issue of this *Review* for a description of this series and a discussion of its usefulness.



interest rates can also be explained in part by the anticipated reduced demand for funds due to the new fiscal program. To the extent that rates have been pushed down farther or more quickly than supply and demand forces in the economy would otherwise have called for, they tend to be expansive. That rates are still high by historical standards may be ascribed in part to the expectations of inflation.

Conclusion

Total spending by the Government, business and consumers has been excessive for many months, causing economic imbalances, inflation, inequities, and a deterioration in the nation's balance of payments. The Government has now taken several actions designed to restrain the ebullient spending.

Most observers anticipate a more moderate rise in spending this fall and winter, but views differ sharply on whether the slowing will be insufficient, appropriate, or excessive. A short-run forecast of the course of the economy is influenced by the weights assigned to the impact of recent monetary and fiscal actions. The recent fiscal actions as well as high interest rates have been cited as a basis for possible sluggishness in the near future. The recent rapid rate of monetary growth, on the other hand, is viewed by some as supplying fuel for continuing excessive growth in total demand.

The goal of stable economic growth will be difficult to achieve in the near future because of continuing inflationary pressures resulting from past excesses, lags in the effect of policy changes, and uncertainty concerning the ultimate impacts of policy actions. Federal budgetary influence on the economy is now essentially fixed until mid-1969, and the major public stabilization tool which is currently subject to short-term control is monetary policy. If it is assumed that monetary developments have their major effect with a lag of 4-to-6 months, then total demand for goods and services in the second half of 1968 is essentially determined by monetary and fiscal actions of the recent past.