

As might be expected where productivity gains are typically small, service prices and retail margins have been driven up by higher wage costs. Unit labor costs have also increased in manufacturing, not only because wages have been rising faster than the productivity trend, but also because productivity gains have been temporarily retarded by the reduction in output and relative stability of employment. A part of the rise in unit labor costs has been absorbed by declining profit margins, but prices of manufactured goods have also moved up in response to rising wage rates.

In summary, the recent behavior of prices gives us some ground for satisfaction but none for complacency. In our annual report, we pointed out that we expected 1967 to bring progress toward restoring price stability, but that it would take time for the distortions introduced into the economy during the last half of 1965 and the first half of 1966 to work their way through the system. Nothing has occurred which would suggest any change in this basic appraisal. Prices will rise more moderately than during the period between the step-up in our involvement in Vietnam and the respite which became evident last autumn. We will be moving in the right direction. But we will not have fully restored the price stability we seek. This means that the need for restraint in wage and price decisions is no less pressing than in earlier years.

FINANCIAL DEVELOPMENTS

As inflationary pressures moderated in the fall of 1966, the Federal Reserve moved quickly toward an easier monetary policy. Since then, the Federal Reserve has continued to supply the banking system with substantial amounts of additional reserves. The active easing of monetary policy lowered the Treasury bill rate by more than 2 percentage points from its peak last fall. Rates on other short- and intermediate-term securities have also fallen sharply. As a result, thrift institutions are once more able to compete successfully against marketable securities. The flow of funds to thrift institutions this spring has exceeded by a wide margin the flow during the springs of both 1965 and 1966. That, in turn, has increased the availability of mortgage funds and contributed to the gradual recovery of the home building industry. The increase in reserves has also permitted banks and other financial institutions to reduce their borrowing and to rebuild their liquidity.

Though bill rates are at their lowest levels since 1964, bond rates are now quite close to their peak 1966 levels. Bond rates had declined significantly during late 1966 and early 1967 but, starting about in April, they began to move back up. It was at that time that the effects of a strong demand for funds were reinforced by fear of a return to tight money.

Throughout 1967 bond markets have been strained by the extremely heavy borrowing of corporations and State and local governments. Corporations have issued large amounts of bonds in order to reduce their reliance on bank loans and to rebuild their liquidity. State and local authorities, who had postponed bond issues during tight monetary conditions of 1966, have had to increase their borrowing in order to finance necessary expenditures.

Expectations of a tightening of monetary conditions later this year have also served to push up long-term interest rates. Banks have