

been rebuilding their liquidity. Other lenders have also tended to favor short-term assets because of the possibility of tighter money, and higher interest rates, in coming months. On the other side of the market, the expectation of even higher rates in the future has stimulated some borrowing in anticipation of need and induced borrowers to issue bonds rather than borrow from banks. It is clear that fears of a possible shift toward tight money have played a major role in producing the abnormally wide spread between short- and long-term interest rates.

In recent weeks the increase in bond yields has begun to affect the mortgage market. In spite of the very large flow of funds to thrift institutions, there have been some increases in mortgage rates. Discounts on FHA mortgages have increased appreciably in the secondary market. Thus far, homebuilding has not been significantly affected, but its recovery could be retarded if high long-term interest rates should cause a substantial diversion of funds from the mortgage market.

OUTLOOK FOR ECONOMIC ACTIVITY

Recent developments have erased the fears and anxieties that the inventory adjustment might cumulate into a recession. It is now evident that businessmen are calmly and steadily adjusting their inventory positions and are maintaining their plans for a high level of plant and equipment spending. Even durable goods manufacturing, which has borne the brunt of the inventory adjustment, turned in an encouraging preliminary report on May performance, with a 6½-percent rise in orders and a 2½-percent gain in shipments. And recent data demonstrate that housing is definitely recovering.

Prospects for the continuing rebound of the economy rest on a solid foundation, although the precise speed and pattern of the resurgence remains uncertain. The improved performance in the current quarter and the prospect of growing momentum in the year ahead can be simply summarized: The recent rate of advance in final sales should be essentially maintained, while the retarding force of the inventory adjustment is losing its punch.

The sustained rise in final sales should be fueled by continued strong advances in State and local purchases, good gains in homebuilding, and significant—though diminishing—increases in Federal purchases. Net exports and business investment should register only small movements, but probably in an upward direction. The incomes generated in these sectors would support strong gains in consumer outlays. Inventory investment may continue downward for some months. But, once inventory investment stops falling, it is most likely to move gradually upward toward a normal level, thus becoming an expansionary force.

These forces will move demand ahead at an accelerated pace. However, the critical question is whether that prospective strengthening of demand could be accommodated without a tax increase, without impairing continued progress toward price stability, and without a credit squeeze. To answer this question we now proceed to review the factors affecting the key sectors of the economy. This discussion assumes that Federal expenditures follow the January budget program. It also assumes that the economy will not be disrupted by major changes in the international situation or by a prolonged strike