

gress later in the year—to limit excessive competition for savings funds.

Nevertheless, in the absence of greater fiscal restraint, the basic economic situation continued to oblige the Federal Reserve to maintain an overall posture of monetary restraint. Prices were continuing to rise rapidly; in the second quarter of the year, the GNP price deflator increased at over a 4-percent annual rate. Successive surveys of business plans for capital spending indicated that the exceptionally strong advance in business capital outlays was likely to continue. Pressures on financial markets mounted as businesses sought credit at banks and in capital markets to finance current needs and prospective capital spending programs, and enlargement of the Federal Government's financing requirements added to these pressures.

To limit expansion of bank credit and moderate bank competition for savings, the Federal Reserve raised reserve requirements against time deposits in June and again in August, and reduced the maximum rates banks could pay on certain maturities of time deposits. Commercial banks found it increasingly difficult to compete effectively for large blocks of corporate liquid funds, as market rates on competitive instruments rose to—and subsequently above—the ceiling rates on large denomination certificates of deposit.

Some banks with branches abroad were able to compensate, in part, for reduced availability of domestic sources of loanable funds by borrowing through their branches in the Eurodollar market. This absorbed dollars that might otherwise have flowed to foreign monetary authorities, and as a result, the U.S. balance of payments on an official settlements basis moved into substantial, though temporary, surplus in summer.

But not many banks had direct access to foreign sources of funds. The Federal Reserve's general policy of restraint on domestic credit expansion, as well as its specific attempts to diffuse the impact of restraint, were evidenced in a declining share of total credit flows passing through commercial banks. By the third quarter of 1966, commercial banks were able to supply only 7 percent of the funds raised by consumers, corporations, and governments, down from about 25 percent of the total in the first half of the year, and over 40 percent of the total in all of 1965.

Viewing credit flows in broader perspective, all financial intermediaries—banks as well as thrift institutions—were falling behind in the competition for savings flows; investors preferred the higher yields available through direct investment in market securities. Consumers as a group, for example, allocated over one-fourth of their net financial savings flows last year to direct purchases of securities, compared with the less than 3 percent invested directed, on average, from 1961 to 1965. Corporations, too, diverted funds to market instruments, and drew down their holdings of negotiable certificates of deposit and other cash assets as external financing became more costly and less easily obtainable.

The diversion of savings flows away from financial intermediaries severely limited the availability of funds to those borrowers most dependent on institutional sources of financing. Particularly affected were builders and home buyers, since ordinarily the great bulk of the financing of construction and purchase of homes in the United States is supplied through financial institutions.