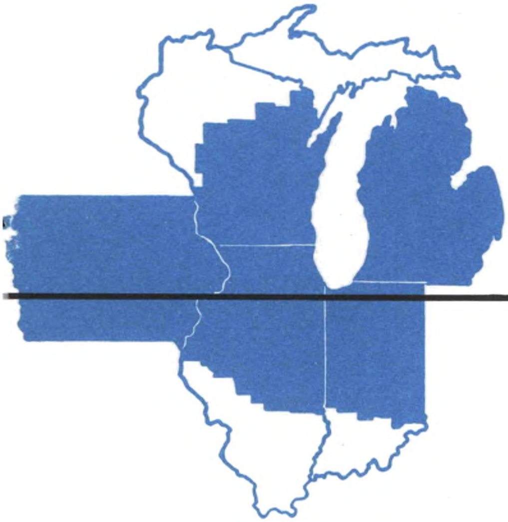
A *review by the* **Federal Reserve Bank of Chicago**

Business Conditions



1956 February

Contents

THE Trend OF BUSINESS

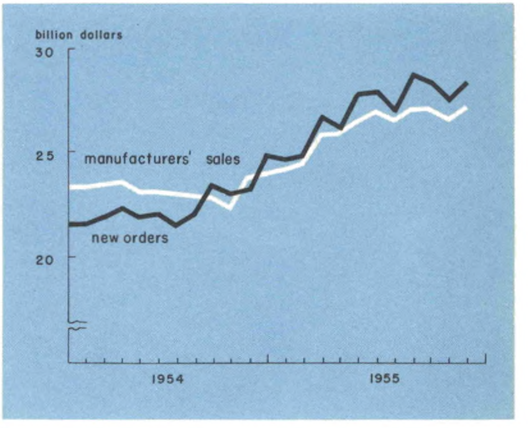
Retail sales reached a new high in December, industrial production maintained November's record high level to year end, and the nation's output of goods and services rose somewhat further in the fourth quarter to an annual rate of 397 billion dollars. Heavy order backlogs at the start of 1956, together with advance indications of spending plans of business, consumers and governments, suggest that activity for the year as a whole will be at a somewhat higher level than in 1955. Nevertheless, there is increasing skepticism that advances will be recorded throughout the year.

There is evidence that the upward curve of general activity was leveling even before the turn of the year. Total construction work in progress was actually being dragged downward by a slowing residential segment.

	Per cent increase by quarters				
	IV 1954	I 1955	II 1955	III 1955	IV 1955
GNP	+2.3	+2.2	+2.5	+1.7	+1.4
FRB index	+3.7	+4.1	+3.2	+2.6	+1.6
Construction	+3.0	+5.1	+3.3	−0.6	−1.9
Retail trade	+2.1	+2.8	+2.7	+2.0	+1.3

The slackening in the rate of rise noted in the second half of 1955 resulted in part at least from the fact that the economy was bumping against capacity ceilings imposed by availability of men and materials. Attempts to serve still greater demands on the nation's productive machine caused a wave of price increases in nonfarm goods. Prices of industrial goods advanced 3 per cent in the July-October period. Since then additional increases have been recorded, but the rate of gain has slowed. Further price advances are being announced, but they are being matched more often by declines in other lines. The apprehension of businessmen a few months ago that a major price inflation was under way has become less evident.

Orders outpace sales, backlogs rise



Spotlight on consumers

Bulging order books of equipment producers and continued gains in contract awards for nonresidential construction are helping to buttress optimistic surveys of business capital spending plans in the current year. Federal spending sights for the fiscal year beginning next July have been raised by 1.6 billion dollars, partly as a result of an expanded missile program to provide the defense establishment with global artillery. State and local governments, also, probably can be counted upon for another moderate rise in outlays despite some hesitation in pushing ahead on proposed toll road projects. Thus, the question mark for the months immediately ahead is the desire of consumers to buy goods and services and invest in new homes. Desire is used advisedly; the ability of individuals to increase spending further is assured by record personal income and the possibility of more intensive use of credit.

Recently, two major sectors of consumer spending—new homes and automobiles—have been slipping. Permits for new building units dropped off by 15 to 30 per cent from year ago in large Midwest cities in the late months of 1955. (See article beginning on page 4.) In November and December new car deliveries dropped to a level more than 20 per cent below that of last spring, although still in excess of late 1954 results. The winter months are seasonally slow, but automobile producers apparently had counted upon a more enthusiastic reception for their new models. Heavy production pushed inventories up rapidly to well over 700,000 units at the start of 1956—double the number on hand a year earlier. Result: output schedules were being cut back sharply in December and January. Elimination of overtime absorbed much of the impact, but a flurry of layoffs of assembly line and parts plant workers also occurred.

Less vigorous demand for supplies on the part of automotive producers will make additional amounts of steel, copper, nickel and glass—all in short supply—available for other lines which have been stinted. Thus, production of other goods will be stimulated for a time at least. But the effect of reduced auto buying does not end at that point. Lower income of auto workers may mean fewer consumption purchases by that group, only partially offset elsewhere. In addition, an easing in the supply of tight materials might uncover substantial duplications of orders and melt widespread desires to build inventories which have been induced by shortages or expected price increases.

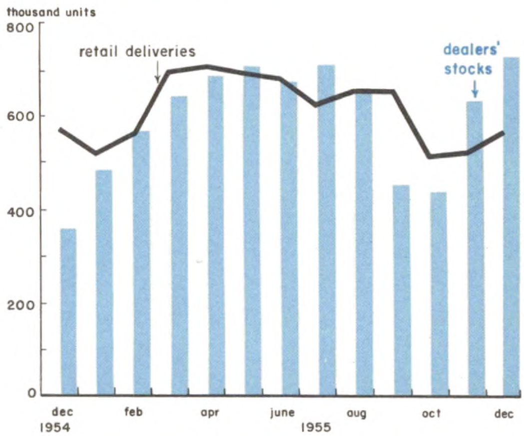
Appliances, TV and furniture

Although a decline in automobile output and sales is expected almost universally, a similar degree of certainty does not prevail in the case of other consumer hard goods which contributed heavily to the upswing in consumer buying during 1955. Auto industry executives anticipate a 12-15 per cent year-to-year decline in factory sales of their product. Spokesmen for the appliance and furniture industries, however, hope for further gains in 1956. Television representatives generally look for some decline in 1956 production of black and white sets but vary in their evaluation of the extent to which a pickup in color sales will offset such a development.

Yearly sales of all of the major household durables added together fall short of the amount spent on purchases of automobiles by about one-third. Nevertheless, these items comprise an annual market in the neighborhood of 10 billion dollars. Moreover, analysis of the demand for these items must consider factors similar to those involved in evaluating the automobile situation. The goods are long lasting; they bear rather large price tags and many purchases are dependent upon the use of consumer credit.

Most types of consumer hard goods fared very well in 1955—a record year for air conditioners, TV sets, washers and furniture. Retail sales information on these items is scanty, and inventories grew in most lines during the year. Nevertheless, the following table on fac-

High output, year-end sales slump boost car inventories



SOURCE: *Ward's Automotive Reports*

tory shipments provides an indication of last year's market strength:

	1954	1955	Per cent change
	(thousands)		
Air conditioners	1,230	1,290	+ 5
Freezers	990	1,100	+11
Electric ranges	1,350	1,600	+19
Refrigerators	3,600	4,025	+12
TV sets	7,347	7,905	+ 8
Washers	3,610	4,387	+22
Automobiles	5,510	7,943	+44
Furniture[1]	1,965	2,300	+17

[1]Millions of dollars
SOURCE: *Electrical Merchandising, Ward's Automotive Reports* and the National Association of Furniture Manufacturers

Total consumer purchases of durable goods increased by about 22 per cent in 1955 to 36 billion dollars. This rise was more than matched by the growth in the use of instalment credit. Extensions increased 28 per cent over 1954 in the first eleven months of 1955. But year-to-year gains were falling moderately in the fourth quarter, as new credit for car purchases declined sharply. In January, the head of Sears Roebuck, largest credit seller, saw signs of lesser use of credit for household goods during 1956.

About half of the record volume of instalment credit extensions in 1955 were for the purchase of automobiles, but this segment accounted for more than two-thirds of the year-to-year gain. Instalment credit extensions used for the purchase of consumer goods other than automobiles accounted for one-fourth of total extensions but only 17 per cent of the rise.

Obviously, a significant decline in automobile sales would reduce total extensions of consumer credit. While other consumer durables need not be affected similarly, it cannot be supposed that the income and credit used to buy cars will be automatically available for other lines. Repayments on the credit extended during 1955 are mounting and affect the ability of individuals to take on new obligations.

Home building settles down

By any standard, 1955 was an outstanding year for the home-building industry. Private housing starts topped 1.3 million units—only a shade under the peak volume reached in 1950. Outlays for residential building were up 23 per cent from 1954 and far above any earlier year. Buyer interest, although more selective than in some past periods, generally continued strong, enabling most builders to pass on cost increases encountered during the year. Finally, inventories of unsold houses at no time assumed sizable proportions, despite a flood of completions in the summer and fall.

There was, however, a discordant note in the 1955 building picture. Although activity for the year as a whole was very high, indicators of future volume have been pointing persistently downward since midyear. Slowly, but steadily, seasonally adjusted monthly housing starts tapered off. By year end, starts were at a 1.2 million annual rate, as compared with a high of more than 1.4 million units a year earlier. Residential contract awards, as reported by F. W. Dodge for 37 eastern states, also lost steam in late summer and have generally run below the 1954 dollar volume since September.

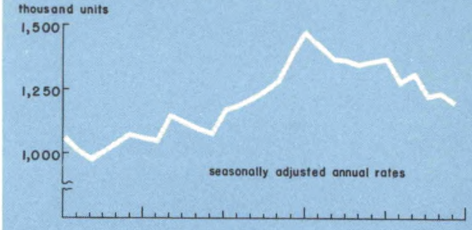
In the current setting, moderation of the fast pace of new building has been a desirable development. Reflecting high levels of business and public construction as well as home building, resources available to the industry have been fully utilized and some materials, such as cement, glass and structural steel, have been in short supply. Wholesale prices of building materials have advanced 8 per cent since mid-1954, while over-all construction costs increased about 4 per cent over the same period. In addition, asking prices for land—both developed lots and raw sites for subdividing—have soared in most metropolitan areas. Moreover, anticipated further boosts in nonresidential building will maintain substantial pressure on construction labor and material supplies, even with a lower level of residential building.

The question remains, of course, of how far the current down-drift in home building will go in the months ahead. Builders generally are more cautious than was the case a year ago and may well elect to go more slowly with spring building programs until the character of the market is clarified. This attitude has been fostered, in part, by the increased choosiness of prospective buyers noted in recent months and also by the tighter mortgage market which developed as 1955 progressed.

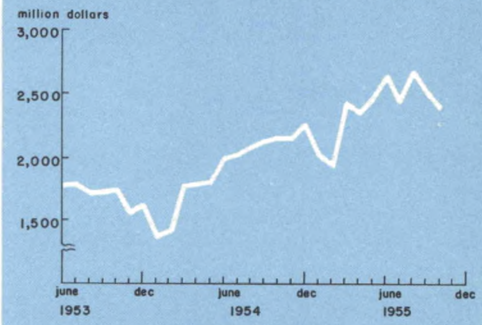
Housing markets, however, should receive some support from the relaxation in FHA and VA loan terms announced January 16. Loan maturities, restricted to 25 years on new applications and requests received by these agencies since last July, may again be written for a maximum term of 30 years. Actually, only a relatively small proportion of new home loans have been subject to the shorter maturity, due to the large volume of approvals already outstanding at the time of the restriction. In November, for example, two-thirds of the VA loans closed on new properties were written with maturities exceeding 25 years. Nevertheless, the relaxation has removed a source of uncertainty and concern for builders and averts the potentially depressing effect of stricter terms on future building.

Moreover, a relatively strong demand for housing in most areas seems assured for some time to come. High and rising incomes, favorable job prospects, relatively liberal financing terms, a vacancy rate which is still very low in most areas and widespread family dissatisfaction with present living accommodations—all combine to provide a basically healthy underpinning for housing markets. Thus, any further decline in activity promises to be of fairly modest proportions. Although home building in 1956 now seems likely to fall appreciably short of the 1955 rate, activity will continue high by comparison with most other postwar years.

National housing starts have dropped gradually but persistently for the past year



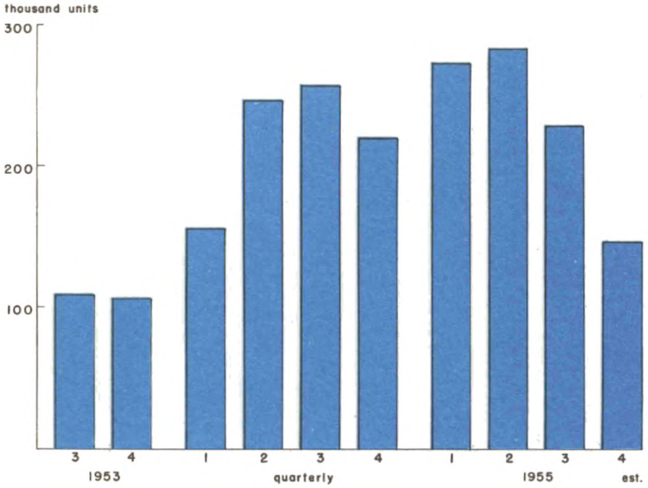
New mortgage loans made on small properties increased until recently



Mortgage market tightens

Probably the most important developments influencing the course of home building in 1955 were the dramatic changes which took place in availability and terms of mortgage credit. The bulge in housing starts during late 1954 and early 1955 stemmed, in large part, from the ready availability of commitments from lenders to provide financing on very liberal terms—often on a 30-year basis and with little or

Home construction proposals submitted for FHA and VA approval off sharply after big bulge from mid-1954 to mid-1955



1954, despite better business and rising personal incomes. Time deposits at commercial banks increased substantially less than in 1954. Even savings and loan associations, accustomed to a strong growth trend, experienced a poor third quarter, with the inflow of funds to share accounts running behind the previous year for the first time since early 1951.

Actions taken by governmental bodies which have tended to restrict the availability of credit have also contributed to the more cautious attitude of lenders. The Federal Reserve System permitted the money market to become increasingly tight through 1955. The rapid growth in bank warehousing of mortgage loans was viewed with concern in some quarters. The Federal Home Loan Banks raised interest rates on loans to members twice during the year and in September restricted further borrowing by the member savings and loan associations — a policy which has since been moderately relaxed. Finally, the FHA and VA made two separate moves to tighten credit terms on insured and guaranteed mortgage loans. Inclusion of closing costs in the amount of new mortgages was prohibited in June. On July 30, down payment requirements were raised two percentage points and maximum maturities reduced from 30 to 25 years on loan applications and appraisal requests submitted for approval after that time. These restrictions continued in effect until mid-January, when the 30-year maximum maturity was restored.

Most important, however, the tightening in the mortgage market last year was in response to the large upsurge in mortgage loan demand. Mortgage credit extensions on small properties in the first ten months were 28 per cent larger than in the same months of 1954. Indebtedness on 1-4 family houses rose an estimated 13½ billion dollars in 1955, almost 40 per cent more than in the year before. Such an expansion

no required down payment in the case of VA loans. In turn, the easing of starts during the year partly resulted from a reversal in the financing situation. As a large backlog of commitments accumulated, lenders became progressively less willing to take on future obligations except on a more selective basis and at higher yields. In addition, funds for current lending became relatively more scarce after midyear, as earlier commitments were drawn upon by builders.

What caused the turnaround in lenders' attitudes? To a substantial extent it resulted from the accumulation of a very large backlog of commitments. Confronted with a heavy inflow of savings and a contraction in alternative investment outlets during 1954, institutions relaxed terms in an effort to obtain additional mortgage loans. This relaxation brought forth a large amount of new business—clearly more than had been anticipated.

Furthermore, the inflow of new savings to many institutions during 1955 did not fully live up to expectations. Additions to balances at mutual savings banks were no larger than in clearly strained the lending capacity of financial institutions, automatically resulting in increasing tightness and greater selectivity by lenders in granting current loans.

In some areas, the combination of record mortgage loan demand, the large overhang of commitments and the disappointing inflow of savings to local institutions led to temporary congestion in the mortgage market in the fall. This condition now appears to have been largely corrected as the result of recent improvement in savings inflow and the working down of commitments to generally manageable levels. Moreover, current and prospective loan demand has diminished somewhat, reflecting a tapering off in the dollar volume of residential construction outlays. Lessened mortgage demand, however, may be more than offset by larger business needs for long-term credit in the months ahead. Thus, significant further easing in mortgage markets does not appear to be in store.

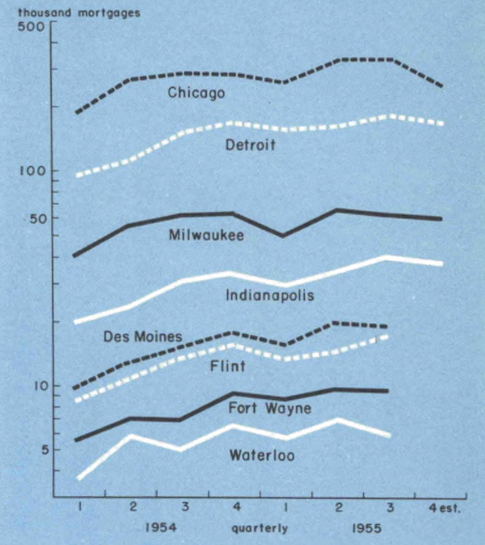
Mixed trends in Midwest centers

Despite the sizable increase in housing starts nationally last year, major District metropolitan areas showed widely divergent movements.

Continued high-level building has substantially boosted the supply of housing in District metropolitan areas

	Total housing units March 1950	New building, 1950-55	
		Number	Per cent of 1950 Census
	(thousands)	(thousands)	
Chicago	1,650	252.0	15.3
Detroit	858	207.0	24.1
Milwaukee	253	52.0	20.5
Indianapolis	172	31.0	18.2
Flint	81	18.0	22.5
Des Moines	72	8.0	11.1
South Bend	61	11.6	19.0
Lansing	51	8.8	17.3
Madison	48	8.9	18.6
Cedar Rapids	33	4.9	15.0
Waterloo	30	4.1	13.7
U. S.	39,625	7,270.0	18.3

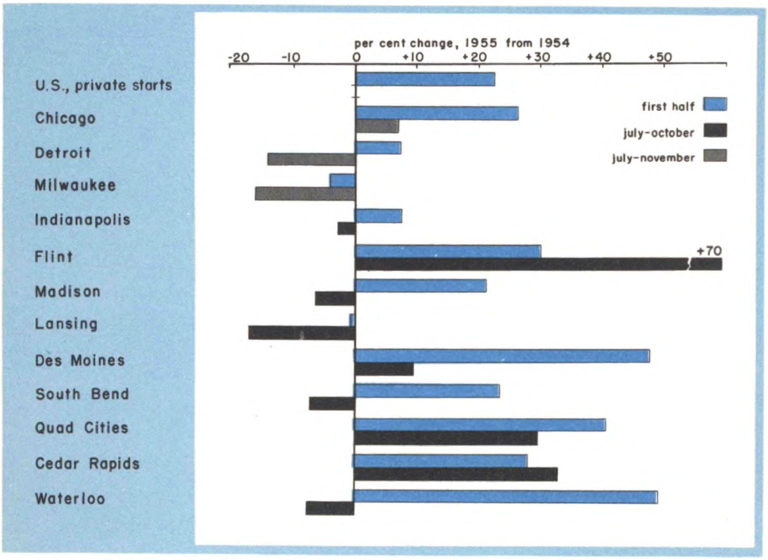
Mortgage recordings on small properties higher last year in most Midwest centers



As measured by building permits issued, activity for the first eleven months of the year was up a substantial 17 per cent in the Chicago area, showed only a modest gain in Indianapolis, witnessed a small decline in Detroit and a 10 per cent decline in the Milwaukee area. Many of the other major centers experienced an appreciable increase in activity for the first ten months—led by an advance of nearly 50 per cent in Flint. But some areas did not fare so well. Building in Lansing, for example, was off 8 per cent.

Year-to-year gains in permit volume narrowed, or gave way to declines, in almost all centers during the latter part of 1955, reflecting the general easing in building activity last year in contrast with the pickup during 1954. In seven of the 12 major cities for which data are available, year-ago comparisons after midyear showed modest to substantial declines from the 1954 volume. Five cities continued

Home-building permits, up sharply in early 1955, generally compared less favorably as the year progressed



to show gains, but only in Flint and Cedar Rapids were they larger than in the first half. Such uniformity is explained, in large part, by the widespread character of the shift in mortgage market conditions.

All Midwest centers have added substantially to their housing supply through new building in recent years, as has the nation as a whole. As might be expected, the relative size of these additions varies widely among metropolitan centers, reflecting largely differing rates of population growth and intensities of local demand to improve housing standards and quality of the housing stock. As a proportion of the March 1950 census of housing units, total new residential building from 1950 through 1955 ranges from a high of 24 per cent in Detroit and 22½ per cent in Flint to a low of 11 per cent in Des Moines.

No over-all population estimates are available for these areas beyond the 1950 Census. Labor force or employment totals, published for some centers, however, provide an indication of the growth in physical requirements for additional living accommodations. With a very few exceptions, such as Flint, the labor force in major Midwest centers appears to have grown substantially less over the past five or six years than the proportion of new building to the 1950 housing inventory. Additions to the number of housing units available for use have been considerably smaller than the number of housing starts during this period, of course, since some dwellings have been demolished, destroyed by fire, converted into larger apartments or nonresidential uses, or otherwise withdrawn from the housing supply.

Vacancy rates, in fact, have remained very low in the Midwest generally. Vacancies of nondilapidated dwellings available for rent or sale in the Midwest amounted to only 1.7 per cent of the total housing inventory last fall, according to estimates of the Bureau of the Census. This is only moderately above the early 1950 proportion of 1.1 per cent and is far removed from the 5 per cent vacancy rate considered normal before the War. Nevertheless, the *improvement* in housing quality resulting from the large volume of new building and withdrawal of the less desirable accommodations from use must have diluted the intensity of demands for additional housing in many communities.

Dissatisfaction an important stimulus

Among the variety of factors influencing the strength of housing markets, three basic sources of demand for additional building stand out. Growth in the number of families requiring separate living accommodations, stemming from the net increase of married couples, the undoubling of families previously living together and formation of other households, is a positive source of additional housing demand. The total of such household formation was very high in the immediate postwar period but has dropped substantially in recent years as marriage rates have declined and doubled-up families have found separate accommodations. Much attention has been devoted to this development as a potentially potent force curbing the demand for housing.

People on the move, however, also tend to create additional housing requirements. During the postwar period, three types of large-scale migration have been taking place. Farm population has declined steadily as people have moved to the towns and cities, families have migrated from central-city apartments to suburban homes, and people have moved, in general, from the Northeast, South and plains states of the nation to the West and Southwest. All these movements are still going on unabated, and all require substantial quantities of new home building.

Another significant and perhaps crucial source of new housing demand stems from the dissatisfaction of families with their present living accommodations. Desire to upgrade housing standards is widely recognized as providing an important segment of the market but constitutes an unknown, largely unmeasurable, quantity. The *Survey of Consumer Finances* for 1955, however, sheds some light on the incidence of family dissatisfaction with their housing arrangements. According to the Survey, 28 per cent of all urban house-owning spending units and 44 per cent of all renters think of their present living quarters as unsatisfactory or only fairly satisfactory. Among both groups, smallness of the accommodation was most commonly cited as the reason for dissatisfaction. Belief that the neighborhood or location was unsatisfactory and expected changes in job location were also common reasons for an adverse vote on present quarters. Among renters, a sizable proportion of families also expressed a desire to own their own homes.

Put in another way, about two-fifths of the nation's spending units either expressed some dissatisfaction with their housing or already had definite plans to move. Nearly one-fifth had some thought of buying in 1955 or 1956, 16 per cent regarded their present residence as a temporary rather than a permanent place to live, and 6 per cent felt that their situation was unsatisfactory but had no near-term expectation of making a change.

Such widespread dissatisfaction certainly is an encouraging sign for housing market prospects but largely represents potential rather than effective demand. Continuance of high incomes, good job prospects and availability of mortgage financing on relatively favorable terms will do much to bring the necessary transition. Even given these favorable conditions, rates of activity may vary rather substantially from time to time and from one community to another, but prospects are good that a relatively large volume of home building by past standards can be maintained for some time to come.

Hard goods spark 1955 retail trade advance

Increased consumer buying during the past year has played a crucial role in boosting the Nation's business activity to record levels. Over half of the 27 billion dollar gain in over-all output last year was directly attributable to increased consumer outlays. In addition, the faster tempo of sales was an important consideration leading business to accumulate inventories, as contrasted with the liquidation of stocks which occurred during most of 1954.

Buying at retail last year gained almost 9 per cent from that of the previous year, a rise unmatched since the Korea-induced buying spree of 1950. Although all major categories scored advances, gains proved far from uniform. Sales of "soft" goods stores rose only 6 per cent, whereas sales at "hard" goods outlets sharply reversed their small decline of the previous year and, sparked by the spectacular upsurge in new car buying, jumped about 16 per cent.

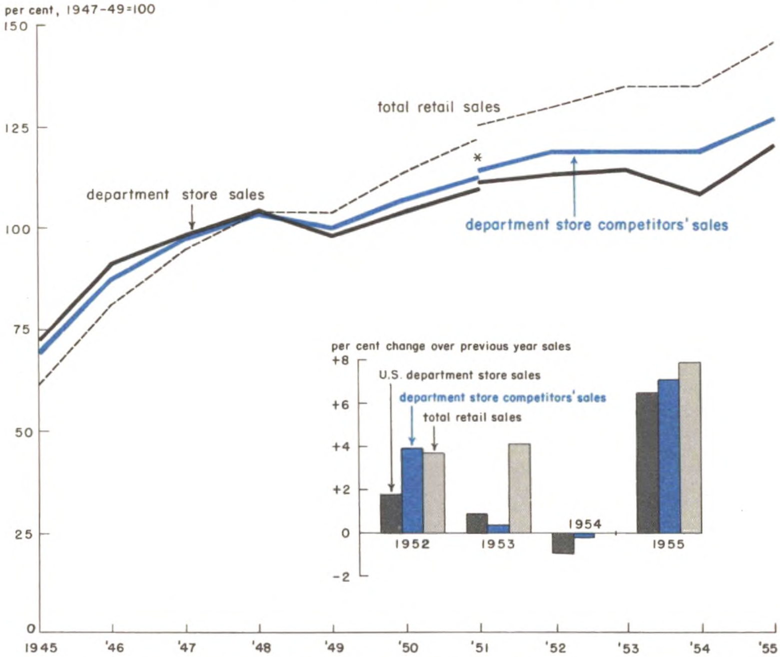
Record Christmas sales, moreover, helped to ring out 1955 on a cheery note. Nationally, retail volume in December topped the year-earlier month by 5 per cent after seasonal adjustment. Although this gain was slightly below that for the year as a whole, it is significant in that retail volume had already picked up considerably by late 1954. Moreover, the December increase was accomplished with a much smaller year-to-year boost from new car sales than had been experienced in earlier months of the year.

Consumers in a buying mood

Obviously, consumers were in a buying mood. Wage increases, longer hours, improving job prospects, relatively stable prices—all contributed to this feeling. Reflecting these developments, personal income after taxes rose almost 6 per cent or 15 billion dollars in 1955. In addition, people generally spent a larger proportion of their income than in earlier years. About 94 per cent of disposable income went to buy goods and services—a proportion unmatched since 1950.

Much of the pickup in spending was made possible by a sharp increase in the use of consumer credit. Reflecting a lengthening in debt maturities as well as a sharp increase in new credit extensions, net borrowing rose by almost 6 billion dollars during the year—the largest expansion ever. Funds provided consumers in this way were equal to about one-third of the

Nation's department stores match competition in 1955 though competitors hold edge in recent years



*Series revised. Department store competitors include apparel, homefurnishing, drug, variety and general merchandise stores. All 1955 figures based on ten-month totals.

increase in dollar volume of retail sales.

The bulk of the increase in consumer debt was accounted for by automobile credit as surging auto business served to bolster the pickup in consumer durables. Automotive dealers' sales topped the 1954 dollar volume by 21 per cent. Much of this gain was accounted for by the success of the 1955 models, as the number of new cars sold gained about one-third over the previous year. New car sales gains in most Midwest centers paralleled the national experience, although registrations from January through November in Detroit, Flint, Jackson and Rockford showed increases of 40 per cent or more over 1954.

Other durable lines also showed sizable sales gains during the year even though increases were not as spectacular as in the automotive field. Sales of furniture and appliance stores were up about 10 per cent, while the dollar volume of lumber, building materials and hardware dealers rose by about the same amount, reflecting the record volume of new building and home repair and modernization outlays.

Apparel in the doldrums?

Sales of nondurable goods have not kept pace with over-all retail trade in recent years and, in 1955, this broad merchandising group attracted the smallest proportion of the consumer's dollar since World War II. In part, this reflects the increasing availability and widening variety of durable goods offered for the consumers' consideration. Television sets, room air conditioners, dehumidifiers, automatic washers and dryers — all are largely products of the postwar era. In addition, the steady postwar rise in per capita incomes in real terms has permitted relatively larger outlays for nonessentials and luxuries — more likely to be members of the durable goods family than of the soft goods lines.

Food and beverages, the largest segment of the nondurables category, have claimed a reasonably stable 28-30 per cent of consumer incomes in recent years, reflecting the shift of consumption toward meats, fruits and vegetables and the more expensive packaged items. This, however, has not been true of apparel. Despite a 6 per cent gain in apparel store sales last year, a smaller proportion of the consumer's dollar went for such purchases than ever before. Total sales of clothing and shoes accounted for only about 7½ per cent of personal disposable income as against an average of around 10 per cent in prewar years. Price weakness in apparel lines has both reflected and accentuated this decline. Over the past four years, retail apparel prices have dropped 3 per cent in the face of a 3 per cent increase in over-all consumer prices.

Department stores vs. competitors

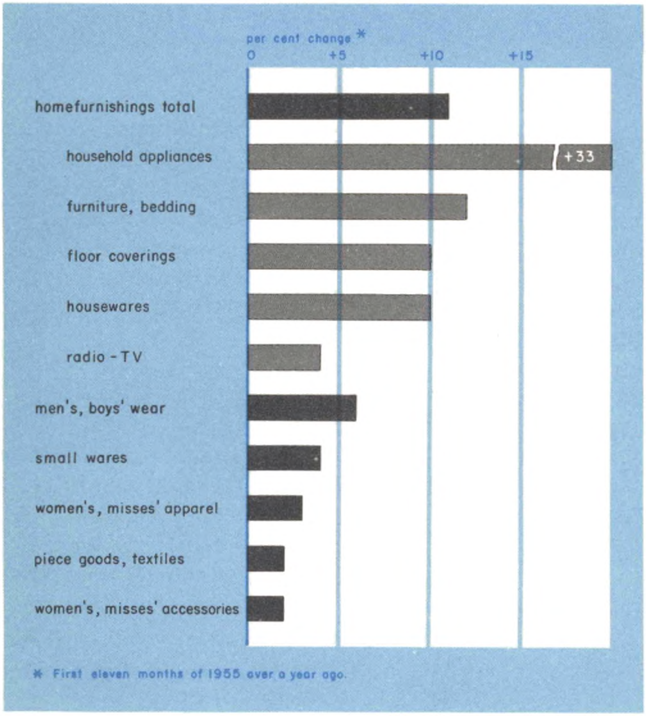
Traditionally, department stores have been primarily merchandisers of soft goods. Despite increased emphasis on appliances, furniture and other durable lines in recent years, this continues to be the case. Apparel sales account for about 55 per cent of department store volume nationally, while homefurnishings make up about one-quarter of the total. These proportions are about the same as before the War. And since apparel has not fared as well as other types of consumer goods in the postwar market, department store sales also have grown less rapidly than total retail sales.

Even in comparison with their direct competitors—apparel, homefurnishing, drug, variety and general merchandise stores—department stores have not fared as well in most recent years (see chart). During 1955, however, over-all department store sales kept pace with those of competing outlets. An increased emphasis placed on durable lines, the opening of additional suburban branches and more vigorous price competition were important in bolstering department store sales.

In the Midwest

The trend of department store sales in the Midwest has paralleled the national pattern for many years. In the past decade, for example, sales totals for the U.S. and the Seventh District have both gained about one-third. In 1955, sales across the nation were up 7 per cent while Midwest department stores gained 8 per cent over the previous year.

Homefurnishing sales out in front at Seventh District department stores



Homefurnishings at Seventh District department stores outpaced all other major merchandising divisions last year, gaining about 12 per cent over 1954 during the January-November period. Major household appliance sales, registering a whopping 33 per cent increase, were instrumental in buoying up the total. Department stores in Chicago, Detroit, Milwaukee and Indianapolis all scored sharp gains in the appliance category, with the Motor City doing especially well.

Apparel gains over a year ago at District department stores recorded a markedly less robust showing than hard goods (see chart). Some pickup in clothing sales, however, has been noted in recent months. Men's and boys' wear increased 6 per cent over 1954 while women's apparel and accessories gained about 3 per cent.

As to the over-all retail outlook in 1956, sales trends in the early weeks of the year provide little evidence of which lines will make the greatest headway in the perpetual scramble for the consumer's dollar. Apparel, judging by its relatively "anemic" showing of recent years, seems one possible candidate. The host of recently developed household appliances, including color television, is another.

Tracing the flow of funds*

The turn of the year is typically a time of financial accounting. Accountants and auditors are busily engaged in summarizing receipts and expenses into the year's profit and loss statement and in preparing a balance sheet of assets and liabilities. These reports—awaited by top management, investors and financial analysts alike—serve two major purposes. They act as a means of appraising performance over the period covered and also as an aid in assessing the near-term outlook.

Similarly, systems of accounting on a national scale have been developed to describe the achievements of the nation's economy. The major purpose of these systems, however, is not to provide a historical record, but rather to help lay bare the complex inner working of the economy and by so doing furnish a better understanding of the effects of and relationship between the many diverse forces that determine the future course of business activity.

The national income and product accounts, developed by the Department of Commerce in the 1930's, have become the most widely used form of national accounts. The system focuses on measuring the income generated by the current production of goods and services for consumption and addition to capital and its distribution as wages, profits and rent. In addition, it gauges the proportion of goods and services that are used for personal consumption, capital expenditures and governmental needs.

Missing from this framework, however, is any direct reference to financial forces and their interplay in the economy. To meet the need for such a combined approach, the Board of Governors of the Federal Reserve System has developed a new system of national accounting that is designed to integrate the effect of credit developments with the commercial and industrial influences. The *flow-of-funds* system, as it is called, is concerned with the mutual interaction of the spending patterns, borrowing habits and asset holdings—real and financial—for each of the major segments of the economy. The new system views the nation as a monetary, credit and financial entity, as well as a goods-producing and goods-purchasing economy.

The aim of this framework is exactly what its name implies—to measure and trace the flow of funds through the many channels of our economic structure. All cash and credit transactions are accounted for. Naturally, each transaction involves both a buyer and a seller and, therefore, must be recorded as both an outflow of funds from one of the parties and an inflow of funds to the other. As the accompanying table for consumers indicates, total inflow of funds from (1) the sale of goods and

*The 390-page report entitled *Flow of Funds in the United States, 1939-1953* can be obtained from the Board of Governors, Federal Reserve System, Washington 25, D. C. The cost is $2.75.

The consumer sector in 1954

	Inflow of funds from:	Outflow of funds for:
Wages and salaries	194	3
Investments	65	17
Insurance and taxes	30	63
Purchases and sales of houses, autos and other capital goods	24	66
Purchase and sales of other goods and services	—	155
Total	313	304
Additions to financial assets and liabilities (net):		
Currency and deposits	—	7
Security holdings	—	1
Other financial assets	—	5
Mortgage liabilities	8	—
Other liabilities	2	—
Total	10	13
Valuation and statistical adjustments	—	6

SOURCE: *Federal Reserve Bulletin*, October 1955. Preliminary data.

services (including labor services), either out of current production or from the stock of existing assets, (2) other sources of receipts, such as insurance benefits and tax refunds, (3) increases in outstanding debt and (4) sale or depletion of financial claims—deposits and currency and security holdings, for example—are balanced against a complete enumeration of the use of funds to purchase either consumer or capital goods, to pay for taxes and transfers, to build up financial holdings or to repay debt.

The economy is divided into ten major sectors (consumers, corporations, unincorporated businesses, farmers, banks, insurance companies, other institutional investors, the Federal Government, state and local authorities and, finally, the rest of the world) and the transactions involving each sector are posted separately. As a result, each of the ten sets of accounts presents a complete picture of the flow of funds into and out of the coffers of the individual sector as well as changes in each sector's financial assets and liabilities.

What can these many statistics add to our understanding of the economy? First of all, they can answer what may be called static questions—that is, those concerning developments in a particular period. Thus, the consumers' account for 1954 shows that in order to make outlays of 304 billion dollars and still add 13 billion to their financial assets, consumers as a group supplemented their receipts from wages and salaries, investments, tax refunds and insurance benefits, and the sale of real assets—mainly homes and autos—by increasing their indebtedness to the tune of 10 billion. Furthermore, it also shows the role that banks and other institutions have played in the increased credit supplied to consumers.

In addition, the flow-of-funds system also provides answers to questions of a dynamic nature. For example, are consumers adding to their financial holdings at a faster or slower rate than in the early postwar period? Has the proportion of income derived from wages and salaries changed significantly since 1939? Has the form in which consumers hold their financial assets shifted over the past decade and a half?

These are but a few of the areas on which the flow-of-funds system of national accounting can shed additional light. A new tool of economic analysis, flow-of-funds is still in its infancy. As the framework of the system and the new published data for 1939 through 1953 are given further study and scrutiny, many additional uses undoubtedly will be developed.

As a supplement to the national income system, the flow-of-funds accounts provide economic analysts with an additional tool to help measure and diagnose the operations of our national economy and its various parts.

The seasonal storm conquered

The annual financial upheavals that once plagued the money and capital markets during the fall season have been a thing of the past for some time. Up until the Federal Reserve System was established some four decades ago, the surging demand in the economy during the latter part of the year for currency and credit would habitually outrun the supply of funds, bringing about the threat of, and at times precipitating, a full-fledged money panic.

The key to the monetary problems of the pre-Federal Reserve era was inelasticity—both of currency and of the legal reserves needed as a base for deposit expansion. Since then, however, the Federal Reserve has provided the nation with an elastic money supply, one that expands and contracts in accord with the seasonal variations in the need for funds. In fact, the provisions of the original Federal Reserve Act have worked so smoothly that today we frequently take for granted the gains that have been made in solving the problems associated with the fall bulge in the demand for credit and currency.

In the pre-Federal Reserve era, the amount of currency in circulation was limited by the volume of specific U.S. security issues outstanding, and, as a result, could not be expanded adequately to meet the peak seasonal demands. Today, however, the Federal Reserve Banks, for all intents and purposes, have the power to freely convert deposit balances into currency, wherever and whenever cash is needed. Each Federal Reserve Bank can issue a special form of currency—Federal Reserve notes—to member banks at their request. The member pays for this currency by drawing on its reserves on deposit at its Reserve Bank.

In addition, the member banks are given the opportunity to replenish this drain on their reserve accounts by borrowing from the Reserve Bank, on the basis of their eligible customer paper or U.S. securities. Or, the Federal Reserve can add to bank reserves by buying securities in the open market. Reserves thus expand and contract in response to the economy's credit and currency requirements, rather than, as was true before the System was set up, as a result solely of gold shipments into or out of the country. This permits commercial banks to fulfill the legitimate demands for currency and credit of their customers. Then, as seasonal demands wane and the currency flows back into the banks through deposit receipts or loan repayments, the member can repay the credit extended by its Reserve Bank.

The way in which the nation's money markets adjust to the fall surge in demands for credit and currency today are compared with those of the pre-Federal Reserve era in the charts on the following page.

The steps adopted 40 years ago have served remarkably well, despite the many changes that have taken place in the economic structure within which the System operates. Interest rates today still inch up seasonally in the fall and funds become less available. But, the "strait-jacket" conditions that annually gripped the money market in the latter part of the year belong to a by-gone era. As a result, the Federal Reserve has been able to concentrate its attention more fully on the second of its major responsibilities—that of using its powers to alter the flow of credit in order to promote stable, long-run economic growth and progress.

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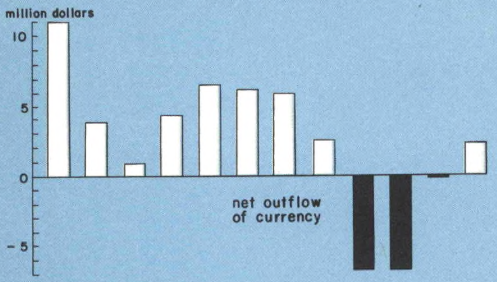
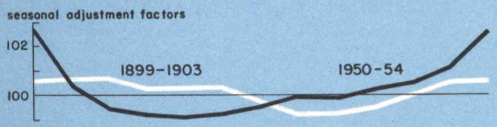
Credit markets during the fall—before and after

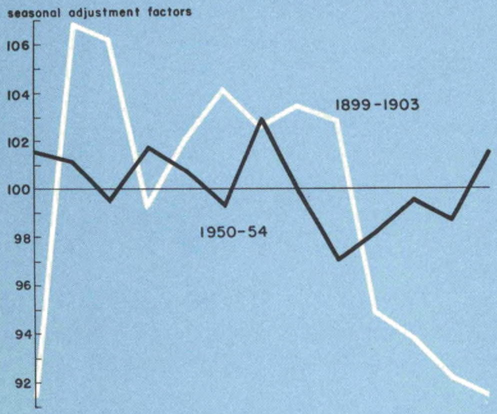
Net flow of currency into New York City banks



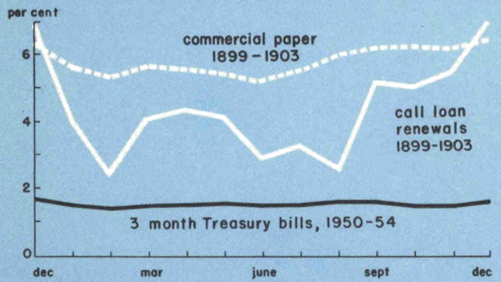
Currency in circulation



Reserves of New York City banks



Short-term money market rates



As was discussed in the article on page 15, before the Federal Reserve was established in 1914, currency generally flowed into New York City banks during the first 7 or 8 months of the year, but this movement was sharply reversed as the autumn began (Chart 1). As the total supply of currency outstanding was relatively inflexible (Chart 2), this outflow, although draining the money centers of their stock of circulating funds, did not fulfill the cash needs of the rural areas. In fact, a shipment of cash to these regions commanded in exchange substantially more in bank deposits than the face value of the circulating money. Today, the volume of currency in use responds to the fluctuations in the need of the economy. Each Reserve Bank is able to freely convert deposit balances into currency whenever and wherever member banks request additional cash.

The withdrawal of currency from the money markets in the years before 1914 put pressure on the city banks' reserve position. Country banks simultaneously began to draw down their balances at their city correspondents, with the result that reserves registered a steep decline (Chart 3). Since the System was set up, however, these drains have been considerably decreased. Too, the System has provided the banking community with additional funds, either through increased discounting or open market operations, to meet the credit needs of the nation. Whereas in the five years from 1899 to 1903, reserves at New York banks fell an average of 12 per cent between the beginning of August and year end, reserves over those five months showed an average gain of 2 per cent in the 1950-54 period.

As a result, the average rate on call loans during the 1899-1903 period soared from 2.5 per cent in August to 7 per cent in December and within the next two months dropped back close to the 2 per cent level (Chart 4). In comparison, the "seasonal" rise in interest rates that has taken place in recent years appears infinitesimal.