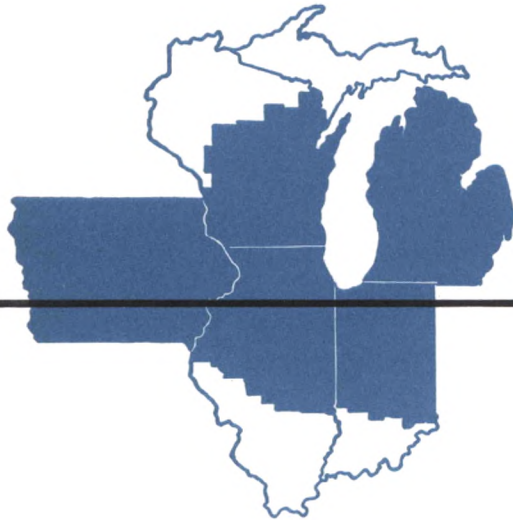


A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1957 December



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THE Trend OF BUSINESS

Although upward price pressures continued in evidence during the first eight months of 1957, general business activity, measured in physical terms, charted an uneven plateau. Appreciable changes occurred in various lines but they tended to be offsetting. In September and October, however, some softening became apparent in industrial production, employment, and salary and wage income, although production of a few non-durable lines such as paper, printing and leather goods, together with the auto industry, showed strength.

Despite these developments over-all activity remains at a very high level, and utilization of the nation's manpower resources has remained relatively full. Nonfarm employment dropped about 300,000 on a seasonally adjusted basis between August and October. Nevertheless, a new record was established for the latter month, somewhat above a year ago and 1.8 million more than two years ago—the high for the month up to that time. Unemployment, estimated at 2.5 million, was 400,000 over a year ago and somewhat higher than two years ago, but equal to only 3.7 per cent of the civilian labor force.

Although the drop in activity has affected many lines it is closely related to two major developments. These are, first, the order cancellations and slowdown in new orders for military hard goods, and, second, the ending and reversal of the two and one-half year capital spending boom of business firms.

The major impact of the first probably is

past. New orders for military goods and services presumably will continue to reflect shifts in emphasis on various programs, but further over-all reductions do not appear likely. Recent announcements have featured upward adjustments in planned outlays for research and development and for total military expenditures relative to the earlier target of 38 billion dollars for fiscal 1958.

The magnitude of the increment in arms outlays is uncertain, as is the general impact of spending which may be concentrated in the area of research and development. It is evident, however, that defense spending will have less of a repressing effect than had been indicated a few months ago, and possibly could become an expansive force.

The drop in capital outlays

Meanwhile, the capital expenditure picture has clarified somewhat. A survey of business firms concerning their plans for investment in new plant and equipment was released by McGraw-Hill in mid-November. The tabulations point to a 7 per cent drop in business capital spending between 1957 and 1958. The three previous years had witnessed substantial increases.

Manufacturing firms expect to cut their outlays by 16 per cent, and railroads plan a 27 per cent reduction. Only the public utilities, among the major industrial groups, expect an appreciable increase.

The fact that capital spending will still be very large in 1958—only a shade behind

1956 which was by far the highest year up to that time—does not mitigate the fact that the principal causative factor behind the 1955-57 boom has turned downward. Through the current year capital outlays had been quite stable at a 37 billion dollar rate.

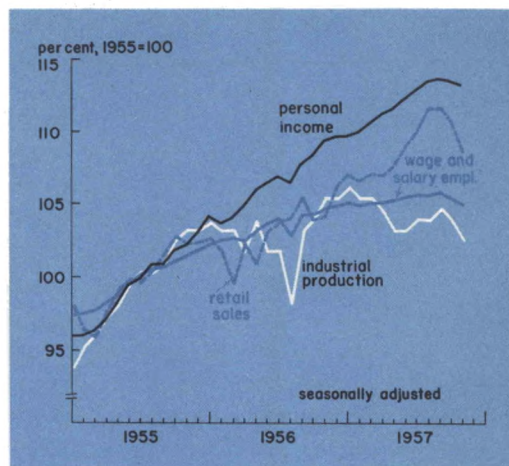
The McGraw-Hill survey also indicated that American manufacturing firms were operating at only 82 per cent of capacity this fall as compared with a desired rate of 90 per cent. Mainly because of the growing margins of industrial capacity many economists expect that the decline in capital outlays will be greater than 7 per cent next year, as some plans previously formulated are revised downward. The importance of capital spending to the Seventh Federal Reserve District, which provides close to 30 per cent of the total output of the nation's producers' durable goods, is readily apparent.

The indicated decline in capital spending does not come as a surprise. Rather, it confirms earlier evidence of a slide in capital goods activity based upon new orders for machinery and equipment as well as production and employment in these lines. Changes in output of capital goods ordinarily precedes spending by many months because of the long production period. Output of selected capital goods has drifted downward since the early months of 1957 (see chart). Recent layoffs in Midwest plants producing construction machinery, machine tools and diesel engines show that some of the impact has already been felt, despite the maintenance of current spending on finished goods.

Construction strong, over-all

Another look ahead to 1958 which places capital outlays in a broader perspective was released in November and struck a more optimistic note. The Commerce and Labor Departments estimate that the dollar volume

General measures of activity slipped in September and October

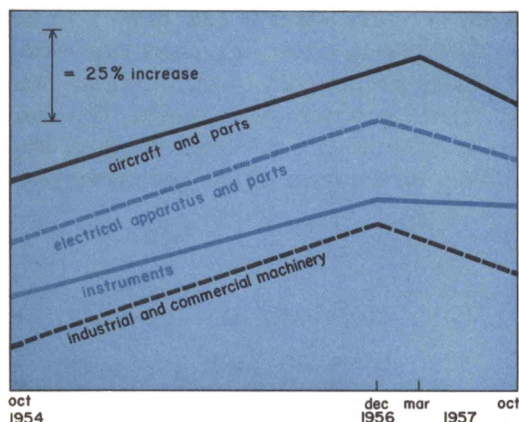


of total construction activity next year will run 5 per cent above 1957. Manufacturing and railroad construction are expected to be off appreciably, but these outlays account for only about 10 per cent of total private construction. Housing expenditures are expected to rise 6 per cent and public works and public utilities 7 per cent. These would more than offset the declining segments.

Much of the optimism over housing activity in 1958 is based on the expectation that a fall in business capital expenditures, and other factors reducing business needs for outside funds, will make more funds available to residential construction. Any falling off of capital issues of corporations would tend to increase the attractiveness of FHA-insured mortgage loans to institutional investors, particularly insurance companies.

Interest yields on municipal issues were easier during October. The decline in yield, along with the fact that many municipalities have been adapting their financial practices

Equipment output began decline at turn of year



to the higher level of interest rates, should make financing less of a deterrent to state and local government projects than in the past year or two.

Retail sales lag

The strong trend of total retail sales throughout the third quarter was not maintained in October or early November. Department store sales in October about matched 1956, which in turn was only equal to the previous year. Thus, general merchandise stores have been operating at about the same level as two years ago despite price increases.

It may be significant that sales of general merchandise stores were considered disappointing in October 1956, but that the Christmas upsurge cast the fourth quarter in a favorable light. This year, however, there is some apprehension about the late date of Thanksgiving, November 28, which, in the minds of some retailers at least, tends to reduce the effective selling period prior to Christmas.

The auto industry's drive to clean up 1957 models may have adversely affected other retailing. Dealer deliveries were almost 900,000 in September and October compared with less than 800,000 last year. Other reasons given for the slowness in retailing during recent weeks include apprehension over international developments, layoffs and shortened work week in certain industries and the effects of flu. In any case, recent buying has slipped relative to income and total employment.

Job market eases

In Michigan, with a new model year under way, the auto industry has increased production sharply, many plants are operating nine-hour days and some are on six-day weeks. In other Midwest states, the employment situation reflects cutbacks in aircraft and electronics, road building equipment and industrial machinery.

Through early September, new claims for unemployment compensation were not much above 1956. Since that time a marked increase has occurred:

	Initial claims for unemployment compensation (change from year ago)	
	Six weeks ending Sept. 8	Nine weeks ending Nov. 10
U. S.	+ 7%	+41%
Illinois	-17	+22
Indiana	-21	+26
Iowa	+ 6	+ 1
Michigan	-17	+62
Wisconsin	+ 9	+38

The Michigan situation, of course, reflects the later date for model changeovers. In most areas, the greater volume of claims probably has continued.

Business loans decline

The sharp drop in business loans at major

Seventh District banks, which began after the mid-September bulge in tax borrowing, continued through October. In the five weeks ending November 13, commercial and industrial indebtedness at the big District banks *dropped* 135 million dollars. This compares with a 130 million dollar gain in the like 1956 weeks. For all weekly reporting banks, business loans were 317 million dollars lower on November 13 than five weeks ear-

lier. During the comparable 1956 period these loans rose 592 million.

The relatively poorer showing in business loans in recent weeks is due, in part, to the slower pace at which new loans were being extended and, in part, to the increased pace at which loans were being repaid. This contrasts with the earlier period in which new extensions had been maintained above year-ago levels.

The job market: easing evident, but unemployment remains low

Last July saw employment in the nation pass the 67 million mark for the first time. The trend has been mostly upward ever since the 1953-54 recession. Despite the appearance of leveling tendencies in some sectors of the economy, the monthly employment figures for the first three quarters of this year averaged slightly higher than in 1956, although small declines from year-ago were registered in both August and September. October showed virtually no change from 1956, while failing to register the customary seasonal pickup.

Although job totals lately have not shown the seasonal increases familiar from earlier experience, this has had no substantial effect on unemployment. In other words, expansion of the labor force—which is made up of persons either working or looking for work—has been slackening. A rapid increase in the labor force occurred in both 1955 and 1956, during an upsurge in economic activ-

ity that kept the labor market under sustained pressure. This year, expansion of the labor force has continued, but at a considerably reduced pace. In 1955 and 1956, and again this year, at least until the last few weeks, the rise in total jobs has roughly matched the labor force gain, with the result that unemployment has held about even.

It might appear at first glance that the nation has been singularly fortunate that the upward climb in the number of would-be workers has leveled off somewhat just as growth in the number of jobs has flattened out. The slowdown in the growth of employment opportunities, however, is itself a leading reason for the slackened rate of increase in the labor force. Awareness that jobs have become somewhat less abundant induces some young people to stay in school and thus refrain from entering the labor force and persuades certain of the older members of the work force to withdraw from it, in

favor of full-time homemaking or retirement.

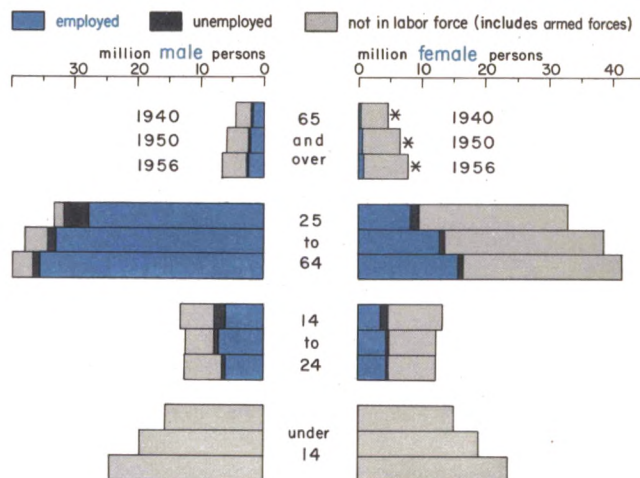
A high degree of flexibility in labor force participation by women, teenagers and men in the older age groups, may well be facilitated by continued prosperity. High wages associated with a boom are a strong inducement to seek employment during periods when activity is expanding and jobs are easy to find. However, when economic activity stabilizes at a high level, with consequent slackening in the growth of job openings, there may be little incentive for other members of the family to engage in a protracted search for employment so long as the head of the household is employed steadily at high wages. The housewife can concentrate on her homemaking chores and the children can continue with their schooling.

Younger job seekers in decline

The "resiliency" recently displayed by the labor force appears to have been due in good part to the impact of population developments.

The low birth rate of the middle Thirties, when most of today's output from the high schools and colleges were born, is taking its toll in the comparatively small numbers of young people passing the threshold into working age. Although the country's total labor force has grown by more than 5.5 million since 1950, the number of young people in the 14-24 age range is today the same as it was then, 24.5 million. Moreover, high school, college and professional school enrollments in 1950 totaled 8.9 million; today they surpass 12 million. Clearly, the nation's

Small number in the 14-24 age group to retard labor force growth for several years ahead



*less than 50,000 unemployed.

employers have had a dwindling stream of young people to recruit from, as school attendance has climbed while the total number in the age group of first-time entrants into the labor force has held steady.

Opportunities for women, the elderly

The relatively small number of young people entering the labor market each year has, of course, spelled a relative abundance of job opportunities for housewives and elderly persons, to say nothing of the continuous employment it has afforded men in the working-age bracket. Since 1950, for instance, the number of women in the labor force has increased by one-sixth; the number of men by about 3 per cent. The fact that labor force growth has so largely depended upon an influx of women means that some slowing of the gains in total employment more likely induces withdrawals from the labor force than it does an outcropping of unemployment.

Industrial, job shifts prominent

Slow growth in the volume of total employment during the past year or so has been marked by some moving about of workers among types of employment. Jobs in manufacturing have been declining gradually but almost uninterruptedly since late last year, and in October stood roughly 500 thousand below the 17.2 million mark for the same month of last year. Employment on the nation's farms likewise has continued its long-term downward trend. Jobs in retail and wholesale trade, government and the service industries have been the principal gainers.

The reallocation of employment among these broad categories has been accompanied by further occupational reshuffling. The total number of persons employed as laborers and machine operatives has remained relatively stable, while jobs of a managerial, clerical, sales, professional or technical nature have increased. The "white collar" designation nowadays applies to 40 per cent of the employed, compared with only 33 per cent a decade ago.

Hours down, earnings up

The average work week of nonsupervisory workers in manufacturing and trade has shortened during 1957, continuing a trend that set in early the year before in the case of manufacturing and as much as five or six years ago in the retail and wholesale trades. Hourly earnings, however, have continued to climb, and average weekly earnings have generally advanced. This would indicate that the shortening of the work week has not been a full offset to the upward march of hourly wage rates.

Weekly earnings in durable goods manufacturing, however, have been an exception. The reduction of overtime scheduling by

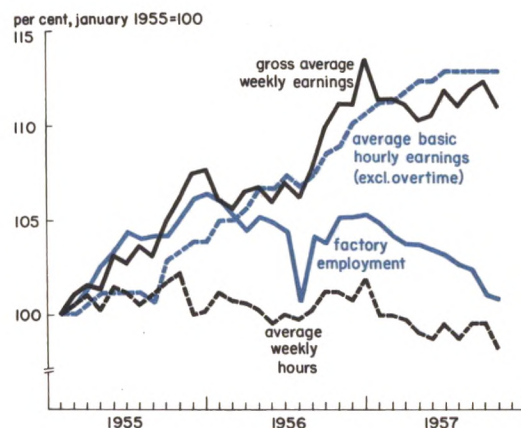
employers in this sector has caused some slimming of weekly pay envelopes since late last year. Compared with the earlier months of 1956, though, weekly earnings of workers in the durables industries are up substantially.

Midwest performance varied

Labor market classifications for most District centers have remained unchanged in 1957. Of the larger areas, Chicago, Milwaukee, and Indianapolis all were in the relatively favorable group B in September, and had been since early 1956 at least. This classification denotes a slight excess of job openings over the number of job seekers, unemployment in a range of 1½ to 3 per cent of the labor force and the expectation of some increase in jobs for two to four months ahead.

Detroit fell in the relatively unsatisfactory group D. This designation applies to markets having an excess of job seekers over job openings, not due primarily to seasonal factors, unemployment at 6 to 9 per cent of the

Weekly pay in manufacturing levels off as shrinking work week offsets continued climb in hourly wages



work force and an expected further decline in employment. Also, during most of 1956, Detroit had been in this group, a reflection of the post-1955 decline in auto assemblies by Detroit-area producers. In the first half of this year, the resurgence of Ford and Chrysler, which predominate in Detroit proper, helped to nudge the area into group C; July, however, marked its return to the lower classification.

Flint, hard hit by production declines in its General Motors plants, has dropped during the year from the C grouping down to E, which is indicative of a considerable non-seasonal excess of job seekers over job openings, an unemployment rate between 9 and 12 per cent and an expected further decline in jobs. As of September, Flint was the only District labor market area so classified. Two other Michigan cities, Grand Rapids and Kalamazoo, both to some degree oriented toward the automotive industry, have fallen from group C to group D in the course of this year; another, Muskegon, has been in group D since May 1956. Two additional areas, Kenosha and Terre Haute, the former a center of automobile production, also were in group D in the September classification.

Other District cities for the most part have held group B classifications during the past year and have experienced a slow uptrend in wage and salary employment and slight declines in factory jobs, paralleling movements in the national totals.

Jobs and autos

Employment prospects for Detroit, Flint and a number of smaller centers, mostly in Michigan, clearly will depend to a good extent upon the reception that will be accorded the 1958 automobile models. The achievement of anything like the production and sales volume reached in 1955 would un-

doubtedly put pressure on the labor supply in those communities, tempt back into the job market some who remain outside it for the time being and result in some reshuffling of the employed labor force. With anything less than a 1955-like year, however, an overall climb in auto production might have a selective impact, benefiting some of the centers much more than others. A great deal will hinge on a present imponderable: how the market will divide among the car makes and models.

Another Midwest community heavily influenced by the automobile, but in an indirect fashion, is Peoria. Employment there has risen substantially over the past three years and in August of this year, it was up some 9 thousand over the year-ago month. Recently announced layoffs by large area employers, however, probably have narrowed the gain. Job expansion in the Peoria area has been due in large measure to stepped-up production of road building machinery, touched off by the new Federal highway program. The failure of the earth-moving stage of that mammoth undertaking to develop as soon as anticipated is cited as the reason for the slowing in production, and the consequent paring of payrolls. This condition may well prove short-lived, though, as 1958 is expected to see a rapid increase in the volume of highway construction activity.

Easing further ahead?

The stringency that has characterized the labor market since the depression may well begin to pass in the next few years. The crowded classrooms of today foretell the steep rise in the number who will be leaving the high schools and colleges just a short time ahead. Only a half dozen or so years from now, young people in the first of the big postwar birth classes will be reaching 18,

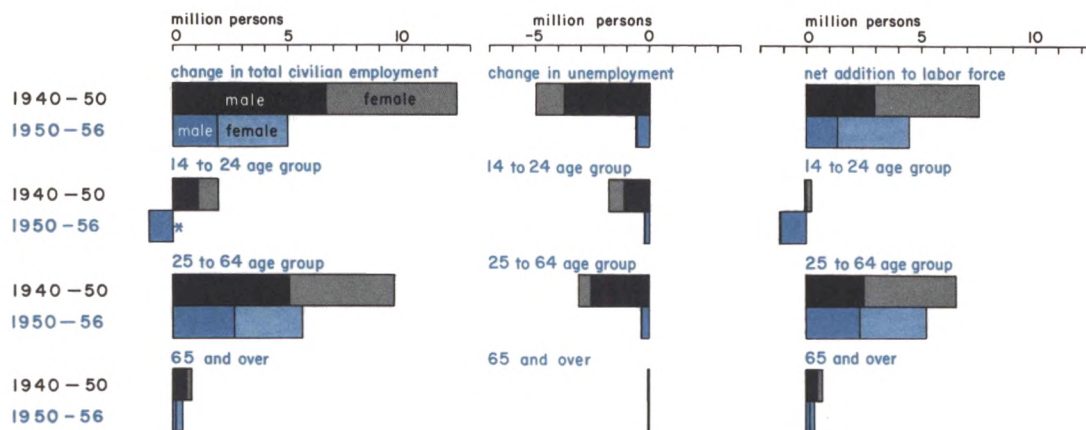
Jobs and the labor force, 1940-56

The previously unemployed provided a major source of added manpower between 1940 and 1950. Employment gains of the past six years have been limited to the growth of the labor force.

Of the 17.4 million increase in jobs between 1940 and 1956 . . .

One third was accounted for by a 5.6 million drop in unemployment . . .

With the addition to the labor force coming largely from the entry of women in the 25-64 age group.



* No change in female employment.

and leaving high school. A record number of them will go on to college and thus be unavailable for work for another four years. But a sizable proportion will head directly for the job market. And the numbers of new entrants will mount successively in the years following, just as births have climbed uninterruptedly since the initial upsurge at the war's end.

The stepped-up inflow of labor force entrants at the lower end of the working-age scale promises to lessen somewhat the resiliency the labor force has displayed in recent experience. Young people getting established as homeowners and parents and heavily committed by their purchases seldom have the option of withdrawal from the labor force

when jobs become scarce and hard to find. They belong to the labor force of necessity, their incomes are pledged to meet the cost of day-to-day living, and when they lose their jobs, they join the ranks of the job-seeking unemployed. Because of this factor, it will be especially urgent in future years to maintain conditions favorable to steady growth of job opportunities. Even small fluctuations in total employment would tend, to a greater degree than in the nation's post-depression experience, to invoke sharp short-term counter movements in unemployment, while failure of the economy to adhere closely to the path of its growth potential could give rise to a longer-term unemployment problem of growing seriousness.

Interest rates here and abroad

Interest rates have increased sharply over the past few years virtually throughout the free world. The latest rise got under way in 1954 and has reflected the surge in economic activity in most countries coupled with the use of monetary restraint to combat inflationary pressures. Today, almost every developed nation counts a flexible monetary policy, and the accompanying interest rate movements, as a part of their tools to dampen business cycles.

Differing levels—differing changes

While interest rates in general have moved up on almost a worldwide basis, both the pace at which they have changed and the level of rates varies considerably from country to country (see table). To a large extent, the movements in long-term rates are a reflection of the relative demand for and supply of capital. Nations with relatively small flows of savings or big demands for investment funds tend to have the highest rates.

In the short-term area, funds flow more freely among nations tending to make these yields more similar. Short-term money rates are also the most sensitive to changes in business activity and monetary policy, with yields generally responding the quickest and entailing larger swings than rates on longer-term investments.

United Kingdom—7%

Interest rates in most countries have continued to rise well into 1957. The steepest increase has been recorded in England, where rates moved up with the 2 per cent hike in the discount rate—or bank rate as

it is called in Great Britain—this past September. This boosted the Bank of England's lending rate to 7 per cent, the highest since 1920 and double the 3½ per cent rate then in effect in the United States.

The British economy in the summer months was subjected to pressures from several quarters. The pace of business activity picked up, the labor market tightened again, wage rates and the cost of living rose.

During the summer, sterling was under considerable strain, despite an increase in Great Britain's "current account" surplus—the excess of exports of goods and services above the value of imports. In part, this was because of a deficit on current account by other sterling countries. Most important, however, many holders of sterling were expecting the pound to be devalued and, hence, sold sterling and purchased other currencies—mainly the U.S. and Canadian dollars and the German mark. The result was to glut foreign exchange markets with available sterling and to depress its price in terms of other currencies.

Instead of altering the exchange rate, however, the British Government took strong steps to halt domestic inflation. In addition to raising the bank rate by 2 full percentage points, it also announced restrictions on the volume of capital spending and the amount of bank loans. The pound quickly responded and within twenty days had increased to \$2.80¼ from the \$2.78¼ level of August and early September.

Rates well above U. S.

Most interest rates moved up with the hike

in the bank rate. The yield on Treasury bills jumped over 2 ¼ points to 6.6 per cent, and the rate on the long-term Governments also rose by a third of a percentage point. As the table indicates, these rates are considerably above the comparable U.S. figures. In addition, the interest paid on savings accounts was increased from 3 to 5 per cent, and the prime rate on bank loans rose from 5½ to 7½ per cent. This compares with 2–3 per cent on savings and the 4½ per cent rate on prime business loans at banks in the United States.

The charges on bank loans in this country and the U.K., however, are not strictly comparable. In England, the customers borrow by drawing overdrafts on their accounts. Instead of crediting a borrower's deposit with the amount of a loan, the banks merely allow their customers to overdraw their accounts. The borrower pays interest due on only the volume of funds he actually uses — the average daily amount of the overdraft. In the U.S., on the other hand, a borrower pays charges on the entire amount of the loan, and, in addition, is often-times required to maintain at least a minimum deposit balance equal to some portion of its outstanding borrowing.

Interest rates show sharp increase in most major countries over past three years

	United Kingdom	France	Germany	Canada	United States
Discount rates					
September 1957	7.0 ¹	5.0	4.0 ²	4.1	3.5
September 1954	3.0	3.3	3.0	2.0	1.5
Short-term market rates					
September 1957	6.6 ⁴	7.4 ³	3.8	3.8	3.6
September 1954	1.6	3.8	2.3	1.2	1.0
Long-term market rates					
September 1957	5.3	6.1 ³	5.9 ³	4.4	3.6
September 1954	3.6	5.4	5.5	3.0	2.5
Bank prime loan rates					
September 1957	7.5 ⁴	n.a.	6.0	5.8	4.5
September 1954	3.5	n.a.	5.0	4.5	3.0

n.a. Not available.

¹Effective September 19.

³August data.

²Effective September 18.

⁴Rates after September discount rate increases.

Note: Short-term rates: Day-to-day money rates in France, 1957 figure rate on private bills, 3-month Treasury bills for other countries; long-term rates: 5½ per cent mortgage bonds in Germany, Treasury issues with maturity over 12 years for other countries; bank prime loan rates: in U.K., rate on overdrafts, in Germany, Land Hesse rate on discounts of DM 20,000 or over.

On the continent

France, plagued by both inflation and balance of payments difficulties, has also witnessed a sharp advance in interest rates. In 1954 and 1955, both output and real wages rose while prices were relatively stable. French holdings of gold and dollars increased in 1955, but the 275 million dollar foreign account surplus in that year was transformed into a 900 million dollar deficit during 1956. The situation has continued to worsen as the deficit in the first six months of this year almost equaled the figure for all

of 1956. At the same time, prices have risen rapidly. Wholesale prices are now 10 per cent above the level at the end of 1955.

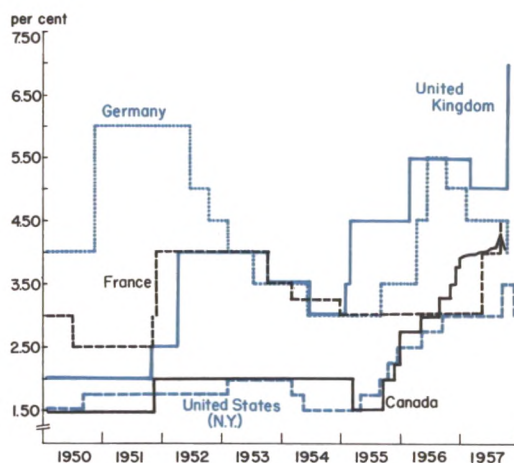
Several causes are evident. First, after bountiful crops in both 1954 and 1955, the 1956 harvest was extremely poor, with the result that imports of foodstuffs were boosted. Increased welfare outlays, expanded investment in housing, agriculture and utilities, the extra burden of additional military spending and higher costs of fuel as a result of the Suez crisis, together with large-scale expenditures in North Africa all added to both inflationary pressures and the demand for imports.

With the increase in the price level and the deterioration of the balance of payments, the general level of interest rates also moved up. Twice this year the Bank of France has raised its discount rate, each time by a full percentage point. The latest increase was in August when the rate was boosted to 5 per cent. Short-term rates increased from their 1956 low of 3.5 per cent to their present 4 per cent. Yields on long-term Government securities have shown an even steeper climb, gaining $1\frac{3}{4}$ percentage points, and recently exceeded the 7 per cent level.

These measures, however, were grossly inadequate to correct the severe balance of payments problems. As a result, the French instituted a selective devaluation later in August, raising the official exchange rate of the franc for specific transactions from 350 to 420 to a dollar. The new rate had already been essentially in effect on a limited group of exchanges. This move, which put the rate at about the point at which unofficial exchange operations were taking place, was recently extended to all foreign transactions.

The movement toward higher rates has been important in most other European countries as well. Belgium, the Netherlands,

Discount rates changed frequently over past several years



Switzerland and Sweden, for example, have all increased their discount rates this year and have been experiencing rising market yields.

Two exceptions: Germany . . .

While the trend toward higher interest rates continues in most foreign nations, there are two outstanding exceptions. In both Germany and Canada, interest rates, while still well above those prevailing in the past few years, have been declining. Short-term rates in Germany have been dropping from their previous high level for more than a year. The yield on 3-month Treasury bills has fallen more than $1\frac{1}{2}$ percentage points since June, to about $3\frac{3}{4}$ per cent.

This decline has in large part been due to the heavy influx of funds into Germany. First, the return on short-term investments during 1957, and for several months about mid-1956, topped that of most other countries and tended to attract outside funds. In addition, however, a large volume of "specula-

tive" funds were transferred from pounds and francs into German marks in anticipation of an upward revaluation of the mark. Germany had been accumulating larger and larger reserve balances as its exports to other European countries were far above the volume of imports from its European neighbors. Many speculators poured their funds into Germany, taking the position that only by an exchange rate revaluation could this situation be corrected.

With the gap between the bill rate and discount rate widening, the German central bank has taken steps to bring the discount rate more in line with market rates. In September the rate was reduced to 4 per cent, the second reduction this year. It was also announced that no exchange rate changes were contemplated, a move that dampened the speculative inflow of funds into the country.

Long-term rates in Germany, however, did not begin to level off until late in 1956 and then showed little change through the middle of this year. Since June, yields on typical long-term obligations have declined somewhat.

This reflects in part a slowdown in business activity. Industrial production in the first half of the year was running 7 per cent above the year-earlier level. In the July-September quarter of this year, however, physical output of German factories and mines has just about matched the 1956 performance.

And Canada

The decline in interest rates in Canada began more recently than in Germany, but also reflects a slowdown in the pace of economic expansion. As the table indicates, the rate of growth in industrial production started to slacken in early 1957 and has continued

to slow down through the second quarter of this year.

	Per cent change from previous year	
	1956	1957
First quarter	+9	+4
Second quarter	+6	0
Third quarter	+7	
Fourth quarter	+6	

The major factor behind the plateau in activity has been a leveling in outlays for industrial machinery and equipment. As in the United States, the Canadian boom in the past few years has been supported by sharp gains in such expenditures. Large-scale development of natural resources, together with expansion in plant capacity and machinery, boosted business investment from an annual rate of 3.5 billion in early 1955 to 5.5 billion in the final quarter of last year, a gain of almost 60 per cent. Since then, these outlays have shown little change.

Interest rates reached a peak in Canada toward the end of August. The issuing rate on Treasury bills at that time reached 4.1 per cent and has since moved down to 3.8 per cent. Long-term rates moved down at about the same time, although the decline has been more gradual.

For the past year, the Bank of Canada has tied its discount rate directly to the Treasury bill rate, resetting it each week $\frac{1}{4}$ of a per cent above the issuing rate on bills. Hence, when the bill rate began to fall in August, the discount rate was similarly reduced.

The drop-off in interest rates in Germany and Canada, and the recent decline in the United States, represent adjustments in the credit markets to changes in business activity and monetary authority's efforts to restrain or promote expansion. Fluctuations in these rates must be expected as "free" economies adjust to changing circumstances.

Growth in Treasury trust accounts slows down

A portion of the funds flowing into the U.S. Treasury is earmarked for specific uses. To the extent that the "earmarked" inflow exceeds the current outflow for the special programs financed from such funds, the Treasury's financing problems are eased. The current and accumulated "surplus" can be invested in Treasury debt issues, thereby reducing somewhat the Treasury's dependence on the public market for sale of its securities.

As of June 1957, the Treasury was administering trust funds which totaled 50 billion dollars. Since mid-1947, these funds have increased 23 billion dollars, for an annual average addition in excess of 2 billion. During fiscal 1957, accumulated reserves in Treasury trust funds rose 1.6 billion dollars, and the accumulation during the present 1958 fiscal year is expected to be close to this amount, largely as a result of the creation in 1956 of two new funds—the Federal disability insurance fund and the highway trust fund.

Trust funds have been established in connection with a variety of programs designed to protect individuals and their families against income loss resulting from old age, prolonged disablement, unemployment or death. Included are separate funds serving the Federal old-age and survivors and veterans life insurance programs and the joint Federal-state unemployment compensation system, as well as several other smaller trusts, such as Indian tribal funds. In addition, the Treasury holds under trust agreements funds

administered under the recently expanded Federal-aid highway program and various gifts and bequests for specific purposes.

Under some of the older fund-financed programs, benefit costs have been rising more rapidly than income, with the result that reserves have declined or shown slower growth than in earlier experience. This development has given rise to a good deal of discussion about the adequacy of these funds and their changed impact on Treasury finance.

In the case of the old-age and survivors insurance trust fund, the largest of the Treasury trust funds, receipts have risen steadily since its birth in the middle Thirties. The labor force has grown and the program has been expanded to cover a larger portion of the working population. Nine-tenths of all the gainfully employed are now covered. Also, wages have risen and the combined employer-employee social security tax has been increased over the years from 2 per cent to 4½ per cent. Last year, payroll tax collections rose to 6.2 billion dollars which represented an increase of 8 per cent over collections in 1955.

OASI benefits on the rise

But benefit payments expanded even more, rising during the year by 15 per cent to 5.7 billion dollars. In the third quarter of 1957, moreover, disbursements exceeded contributions, mainly because of the recent extension of social security coverage to farmers, professional persons other than physicians, and certain other groups, and the lowering from

65 to 62 in the age at which women workers become eligible for retirement benefits.

Quite apart from any additional broadening of coverage that Congress may authorize, the cost of old-age and survivors insurance and other Government retirement programs will probably continue to rise, as the number of covered workers reaching retirement age grows and as higher base earnings are reflected in larger benefits. Furthermore, if past experience is a guide, payments will be liberalized further.

The present prospect is that growth of the old-age and survivors insurance trust fund will be accelerated if the tax increase slated for 1960 is allowed to take effect and no further liberalization of benefits is provided in the meantime. The actual outcome, however, will depend also on the precision of forecasts relating to population and employment developments. During fiscal 1957, reserves in the old-age and survivors insurance fund, which now amount to 23 billion dollars, increased less than 2 per cent. Benefit payments exceeded contributions, but inter-

est earnings enabled the fund to end the year without a deficit.

The rate of accumulation in the railroad retirement fund has also declined. The reserve grew but 1 per cent during the 12-month period ending June 1957, compared with a 3 per cent rise the preceding year and an 18 per cent rise five years earlier.

The rate of disbursement from the second largest of the Treasury trust accounts—the unemployment trust fund—is erratic but tends to follow business conditions. This fund now totals 9 billion dollars. Reserves were drawn down during 1955 but since then have been increasing at an annual rate of about 4 per cent.

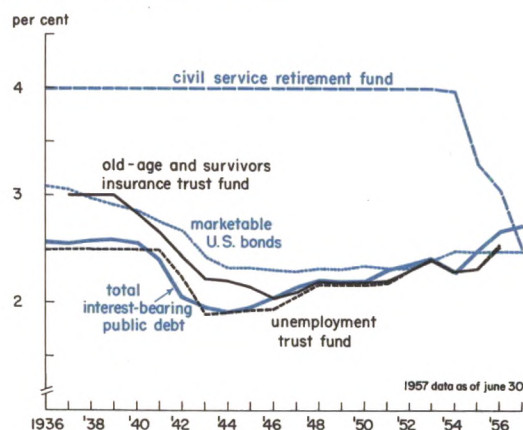
Investment Income

Investment earnings constitute an important supplement to the tax receipts or premium payments which account for the bulk of the fund inflow. With few exceptions, the reserves of Treasury trust funds are invested in United States Government securities. The average yield from Governments held by the two largest funds last year was about 2.52 per cent.

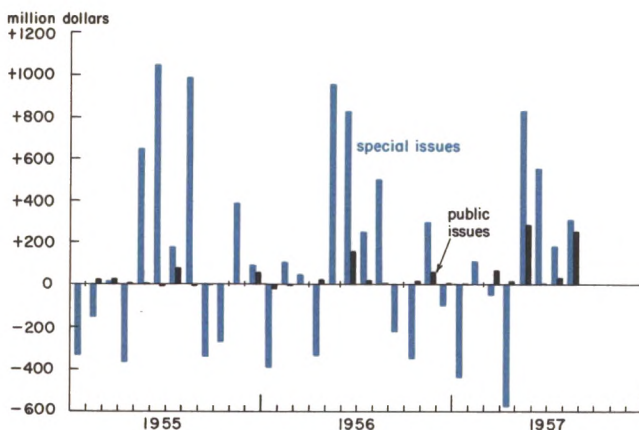
The unemployment trust fund requires that the rate on *special* Treasury obligations held by the fund must be equal to the average rate of interest borne by *all* interest-bearing Governments. The same formula governed the rate on special Treasury obligations issued to the old-age and survivors insurance trust fund for 16 years, until 1956, when it was amended to tie the minimum yield to the rate on securities with maturities of 5 years or more. Confining the rate to longer-term securities is in line with the long-term nature of pension fund obligations.

The 50 billion dollars in Government securities in Treasury trust funds as of mid-1957 were equivalent to 19 per cent of the total

Return on trust fund investments set by earnings requirements, or follows rates on public issues



Treasury trust fund transactions in marketable issues have increased



interest-bearing public debt outstanding. Ten years ago the Treasury trust funds held only 10 per cent of the debt.

Impact on Treasury financing

Special issues, "sold" only to the trust funds, constitute the greater part of the public debt obligations held by the funds, though most of the enabling laws allow investment in marketable issues. The Treasury decides between marketables and specials according to "the public interest." In 1956, for the first time, the Treasury invested 6 million dollars of the railroad retirement fund in marketable Treasury bonds bearing interest ranging from $2\frac{1}{4}$ per cent to 3 per cent. The issues were acquired at a discount presumably sufficient to raise the return to the 3 per cent required by law.

The participation of the Treasury in the market on behalf of trust accounts can have the effect of supporting prices and holding down yields of the securities involved. The effect is likely to be greatest when the volume of market transactions for the trust funds is

relatively high as, for example, in May and August of 1957 (see chart).

Role of reserves

Government pension plans are not fully funded — that is, if contributions were discontinued, reserves would not cover all accrued benefit liabilities. Nor are they on a strict pay-as-you-go basis, that is, without reserves and with benefits paid out of current income. They are rather a mixture of both, for they have sizable reserves, as provided for in the legislation by which they were established. Over the years the tax

schedules have been revised so that current payroll tax contributions are sufficient to pay immediate costs and make some addition to reserves.

If a concerted drive is to be made in coming years to build up reserves enough to "fund" benefit liabilities, the trust accounts will continue to provide a "market" for Treasury issues. Should the decision be to accord reserves a secondary role and place the programs on substantially a pay-as-you-go basis, the trust accounts would have little effect on Treasury finance.

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*a review by the
Federal Reserve Bank of Chicago*



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