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

Business Conditions

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THE Trend OF BUSINESS

Although most major types of spending have participated in the business upswing which began in the spring of last year, the most dynamic elements have been: (1) the switch from inventory liquidation to accumulation, (2) the rise in government purchases of goods and services and (3) the increase in home-building activity. These prime movers may already have played their major role in the current boom. In recent months, the continued rise in activity has been drawing more heavily on other sectors—personal consumption spending and plant and equipment outlays.

From the first quarter of 1958 to the first quarter of 1959, the annual rate of total spending on goods and services rose by 40 billion dollars. Of this amount, over 14 billion was accounted for by the change in business investment in inventories—from liquidation at an annual rate of 9 billion to accumulation at the rate of 5 billion dollars. An additional 8 billion was contributed by higher governmental outlays, both Federal and state and local. Expenditures on residential building rose by 5 billion dollars.

Over the same period, the rate of personal consumption spending rose 14 billion dollars, but this is only a 5 per cent gain for that spending category. Expenditures on producers' durable equipment and private construction other than housing, combined, rose only slightly. Thus, these kinds of expenditures, which in the aggregate account for about 80 per cent of total spending, contributed less than 40 per cent of the *rise* in total spending between the first quarter of 1958 and the first quarter of 1959.

If investment in inventories were to make as great a contribution to the rise in total spending in the twelve months beginning with April 1959 as in the preceding year, there would have to be an increase to a 19 or 20 billion dollar annual rate of accumulation. Barring an extremely speculative situation, this is highly improbable.

State and local governments are likely to continue the rise in spending which has been evident in this sector throughout the postwar years. However, attempts on the part of Congress and the Administration to hold down increases in Federal spending are being publicized widely and may be effective.

New housing starts hit a seasonally adjusted annual rate of 1.4 million last November and have remained near that high plateau through April. However, the rate of starts declined somewhat in May, and most experts expect that the high rate of the first quarter will not be maintained for 1959 as a whole. Even if home-building activity were to continue very strong, it is quite unlikely to increase appreciably from present levels.

As the impetus from the factors described above has tended to wane, spending for personal consumption and new plant and equipment has gathered strength. Retail sales were at a record level in March and April and showed another spurt in May. This is traceable to consumers' rising income and

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greater willingness to incur debt now that job prospects have firmed in nearly all areas.

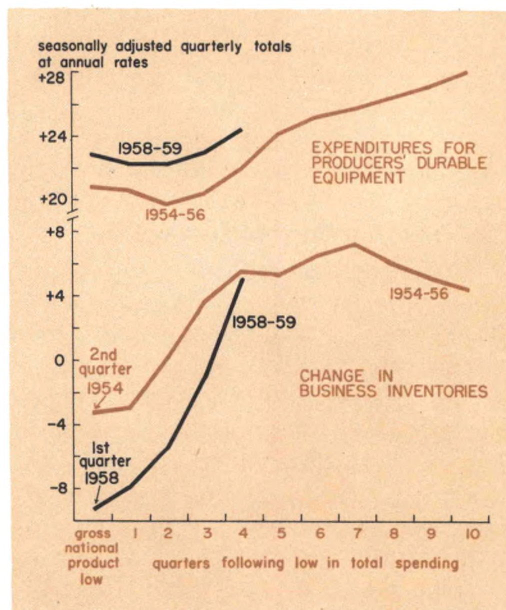
Capital expenditures by business began to rise in the fourth quarter of 1958. The rate of rise accelerated in the first two quarters of the current year. A survey released jointly by the Department of Commerce and Securities and Exchange Commission in June points to at least a 7 per cent increase in capital expenditures for the year 1959 as a whole. Except for public utilities and manufacturers of nondurable goods, all major industry groups have raised their estimates of capital expenditures for 1959 over the amounts reported in surveys made earlier in the year. The iron and steel industry which had projected a small decline in the March survey now estimates a 7 per cent rise.

Comparison with 1955

In the four quarters which followed the low point in business in 1954, total spending rose by 34 billion dollars. However, the sources of the increase were substantially different than in the corresponding period following the 1958 low. Inventories and residential construction played roles comparable to their part in the recent revival. But total government purchases of goods and services did not rise appreciably in the earlier period as Federal outlays declined significantly. The 1954-55 experience also differed from that of 1957-58 in that nonresidential private construction shared in the rise and consumer spending showed a greater increase, mainly through larger purchases of durable goods, reflecting the phenomenal sales of the 1955 model automobiles.

In the second quarter of 1955, after four quarters of rise, the upswing was to continue for nine additional quarters before giving way to recession. However, three of the sectors which had sparked the rise—consumer durables, residential construction and investment in inventory—had already made their maximum contribution. Personal consumption spending for "soft" goods and services, business outlays for new plant and equipment, nonresidential construction, net exports and, later, national defense expenditures were the major additional sectors which carried the economy up to the peaks of 1957.

Inventory investment has increased sharply, capital goods rise beginning



Inventory accumulation continues

Although inventory accumulation during the first half of 1959 was at a very high rate, sales rose even faster. Total business inventories were equal to 1.44 months' sales at the end of April. This was the lowest ratio in recent years, including 1955 when similar conditions prevailed.

Inventories are low relative to sales in

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all major business categories. The situation is especially apparent in retailing. At the end of April, retailers' inventories were equal to only 1.36 months' sales. This was well below the 1955 level. The picture is most impressive in the nondurable goods lines. In fact, the rise in retail inventories in March and April reflected primarily the increase in automobiles.

District employment gains

In May, the Bureau of Employment Security reported that labor markets in ten Seventh District cities had improved. At that time, five out of twelve cities in the entire country with relatively low levels of unemployment and relatively favorable employment opportunities were located in this District, including Aurora, Des Moines, Quad Cities, Kenosha and Cedar Rapids. Chicago, Battle Creek, Lansing and Saginaw moved out of the substantial labor surplus classification. Further improvement was also shown by Muskegon and Grand Rapids. Flint, on the other hand, was downgraded and rejoined Detroit in the class of cities having the heaviest rates of unemployment.

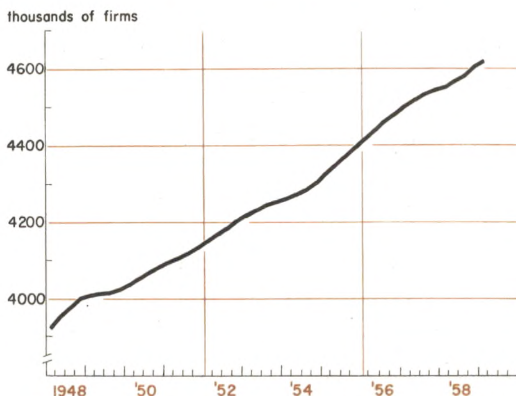
Employers' reports indicate that about three-fifths of the major labor market areas of the nation are expected to show employment gains to mid-July. To a considerable extent, these gains are looked for in seasonal industries such as construction, trade and food processing, but some pickup in electrical machinery, shipbuilding and instruments is also expected.

Reports from District employment security offices show increasing difficulty on the part of employers in finding suitable skilled factory and office personnel. Some workers are reported to be more selective as job opportunities improve. In the South Chicago-Gary area, steel mills were unable to recruit desired numbers of workers in May and June.

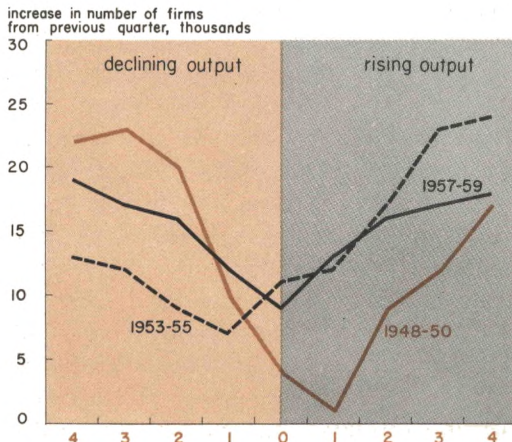
Continued rise in businesses

The number of businesses in operation has shown an average annual increase of about 65,000 during the past 10 years, according to recent Department of Commerce estimates. This rise has tended to keep pace with the increase in population. In 1958, there

Number of businesses in operation



. . . increases less rapidly during business downturns



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were 27 firms per 1,000 persons, about the same as in 1948.

New businesses opened their doors at an average annual rate of 374,000 between 1948 and 1958. For the same period, an annual average of 309,000 firms discontinued operations. By no means do all discontinuances result from unprofitable operations. Only about half close their doors in order to prevent or minimize losses.

On a year-to-year basis, entry and discontinuance rates are closely associated with general business conditions. The slowdown and subsequent acceleration in the growth of number of business firms is seen clearly in the quarterly estimates (see chart). The quarterly increase in number of firms in operation fell from 19,000 in early 1957 to 9,000 in early 1958 and the first quarter of 1959 moved back up to 18,000.

Management of the public debt

On June 8, 1959, the President of the United States transmitted to the Congress a message regarding management of the public debt. On the same day, Chairman Wilbur D. Mills, Committee on Ways and Means, House of Representatives, announced that public hearings would be held on the President's request for legislation to provide for an increase in the public debt ceiling and to remove the statutory ceiling on the interest rate payable on savings bonds and on new Treasury bond issues. On June 11, William McChesney Martin, Jr., Chairman, Board of Governors, Federal Reserve System, appeared before the House committee and made a statement on this important subject, which is reproduced here so that it may be available in its entirety to readers of Business Conditions.

The first thing I want to do, Mr. Chairman, is place the Board of Governors of the Federal Reserve System squarely on the record as endorsing the debt management proposals transmitted to you by the President.

In our judgment they are both necessary and desirable and we are urging their favorable consideration.

There are only a few points that I want to make and while this isn't necessary before a group such as this, nonetheless I think it is important to emphasize that I am before you today not as a spokesman for the administration, but as Chairman of the Federal Reserve Board.

We are living today in a country of unprecedented wealth. It is wealthy in part because of abundant natural resources, and in part, because of the energy and initiative of our people.

An even more important distinction between the United States and most other countries is the size and quality of the accumulated stock of capital goods in the hands of producers and consumers. Due to past saving —I emphasize the word "saving"—we enjoy the benefits which flow from a reservoir of housing and durable goods in the hands of consumers, of public facilities, such as highways, school buildings, and waterways, and

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of industrial plant and equipment.

The society in which we live has been popularly characterized as affluent, and despite our proper concern for certain depressed areas, both economic and geographic, I am sure that we can all agree with this characterization.

One consequence of affluence is exposure to instability in the pace of general activity and also in interest rates which rise in periods of boom and decline in periods of recession.

In a primitive economy, where everyone must work as hard as he can to eke out a bare living, additions to stock of capital are largely made by diverting effort directly to production of capital goods. Such borrowing and lending as does take place is effected at interest rates which we would regard as fantastically high. In this type of economy, there is little threat of instability except from natural causes.

A drought or an unusually good season may produce relative poverty or plenty. But the range of economic fluctuation will tend to be fairly small.

The greater the accumulation of wealth the greater are the possibilities for economic fluctuation. These may stem from shifts in the peoples' preferences among the wide range of expenditure opportunities open to them, from changing attitudes toward saving and investment, from overspeculation which undermines the solvency of financial institutions, or, perhaps on some occasions, simply from the arrival at a point where even a high rate of technical innovation fails to induce investment decisions adequate to sustain capital expansion.

It is not surprising then that, in a free and wealthy economy, we are unable to counterbalance perfectly, through changes in public policy, the wide shifts that can take place. We always have had, and I think always will have, changes in the pace of our economic progress. We can and should work to reduce these fluctuations and strive for the goal of stable growth. At the same time, however, we must recognize that it is highly unlikely that we shall ever achieve perfection.

Fluctuations in our economy express themselves in various ways, and we attempt to gauge them by various statistical measures.

If we look at the movements in any of the broad measures of economic activity and compare them with fluctuations in interest rates, the conclusion is inescapable that interest rates tend generally to move upward in periods of prosperity and downward in times of recession or arrested growth. Hence, concerned as we may be about the impact of rising interest rates on the burden of the public debt or on necessitous borrowers, we must recognize that rising interest rates are, in fact, a symptom of broad prosperity and rapid economic growth.

I might insert here, Mr. Chairman, that I have been coming up to the Congress for a number of years now and I would much rather come up to explain high interest rates as a byproduct of prosperity than I would to be up here when interest rates were declining as a result of a deflation.

Since the stabilization of monetary systems in key countries after World War II, interest rates in most other industrial nations of the free world have been higher than in the United States. This has been a period of great economic growth, very active demands for credit, further monetary expansion, and continuing, though perhaps abating, inflationary pressures. This past year's rise in interest rate levels here, accompanying economic recovery, has been in contrast to some decline in interest rate levels in Western European countries, where a modest recession came somewhat later than in the United States and

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Canada.

In the United States, the rise in interest rates has affected all types and maturities of debt instruments. Yields on long-term securities have generally risen by about 2 percentage points since the low point reached shortly after the end of the war. Yields now range from 4 to 4½ percent on U. S. Government securities of long- and medium-term, over 4½ percent on many outstanding Aaa corporate bonds, and average over 5 percent on outstanding Baa corporate bonds. New issues necessarily have to be offered to investors at higher rates.

Despite their recent upward movement, interest rates in the United States are still at levels comparable with those prevailing during much of our history.

Long-term rate movements since last summer have been within the range of the period from the early part of this century through 1930. The level is still substantially lower than during most of the nineteenth century. From a historical viewpoint, the present level of rates can hardly be regarded as "out of line" for a period of wide prosperity and growth.

In comparing present rate levels with those of past periods, one of the most important things sometimes overlooked is the effect of our necessarily high tax structure on the effective rate of interest. For example, if both the borrower and lender are subject to the 52-percent tax on corporate profits, the borrowers' net cost and the lenders' net return is a little less than half of the expressed rate. Thus a market rate of, say 4 percent, implies for both parties a net rate of a little less than 2 percent. On its own taxable bonds, the Federal Government, through the income tax, recaptures a substantial share of the interest it pays. When we look at interest rates in long-term perspective, we must bear in mind that net yields after taxes are lower today than a comparison of market rates would suggest, because of the fact that taxes are higher.

Aggressive demands for financing, which, as I have said, are characteristic of prosperous times, represent efforts to attract resources away from current consumption in return for the payment of interest. In a free economy, no matter how affluent, it follows that, when borrowers attempt to attract a larger share of the total product for their purposes, they will have to pay for doing it.

The presence of strong demands on the credit markets from borrowers of all kinds does create a difficult financial problem. Recently credit demands have been pressing on the banking system, and the banks have been accommodating a growing volume of loans.

As borrowers have sought accommodation, banks have raised their prime rate from 4 to 4½ percent. This is the interest rate that banks charge top-quality customers on short-term loans.

More recently, the discount rate of the Federal Reserve Banks has been raised from 3 to 3½ percent. The discount rate, as you know, is the interest rate that is charged by a Federal Reserve Bank when a member bank borrows money from it. This money is often called high-powered money. It is high powered because it is credited directly to the reserve account of a member bank, and unless used to finance a payment of currency into public circulation or an outflow of gold or some other development which drains the member bank reserve base, it forms the basis for a multiple expansion of bank credit and money.

For some months we have been having rapid expansion of bank credit and money, based largely on borrowed reserve funds. The seasonally adjusted money supply—demand

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deposits at banks plus currency in circulation—has increased by more than $2 billion in the last four months, an annual rate of growth of about 5 percent. In the face of developing high-level prosperity and the potential threat of inflationary boom, the Federal Reserve should not be in the position of encouraging an undue expansion of bank credit and money. Hence, the appropriate discount rate under present circumstances is one that does not encourage member bank borrowing and is generally above current rates on short-term market obligations, such as bills.

It is sometimes asserted that the Federal Reserve System should step in and halt the upward trend of interest rates resulting from active demands for loans by supplying sufficient Federal Reserve credit in one form or another to keep interest rates from rising. This cannot be done without promoting inflation—indeed without converting the Federal Reserve System into what has been called an engine of inflation.

When such a program was adopted during and following the war, it did succeed for a time in actually pegging interest rates on Government obligations. But at the same time it promoted and facilitated the dangerous bank credit and monetary expansion that developed under the harness of direct price, wage, and material controls. The suppressed inflation that resulted, we are now well aware, burst forth eventually in a very rapid depreciation of the dollar and even threatened to destroy our free economy itself.

This experience is very recent and the effects are widely and well remembered. It is now very doubtful whether the Federal Reserve System could, in fact, peg interest rates on Government obligations under today's conditions even if we accepted the inflationary costs, which would be high and would eventually, in my judgment, lead to severe collapse. It is certain that the Federal Reserve could not extend interest rate stability to all markets.

The trouble is that the world has learned from wartime inflationary experience. It now knows that inflation follows any effort to keep interest rates low through money creation as the night follows the day. Any attempt on the part of the Federal Reserve to peg rates today would be shortly followed by an acceleration of the outflow of gold in response to demands from abroad, by further diversion of savings from investment in bonds and other fixed interest obligations into stocks and other equities, and by a mounting of demands for borrowed funds in order to speculate in equities and to beat the higher prices and costs anticipated in the future.

Those familiar with the investment markets will confirm to you that such developments would inevitably follow a Federal Reserve attempt to peg interest rates. A simply tremendous volume of bank reserves would have to be thrown into the market through Federal Reserve open-market purchases in the attempt to stem the upward pressure on interest rates.

As these reserves enhanced inflationary pressures even further, the rush from money and fixed obligations into gold and physical property as well as the mounting demands for credit to reap speculative profits and to hedge against future inflation would overwhelm even the most heroic efforts to hold interest rates down. Ultimately, if the gold reserve requirements to which the Federal Reserve is now subject were eliminated, the System might acquire a large proportion of publicly held Government debt of over $200 billion in this way.

True, the interest rate on Government obligations might be said in some distorted

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sense to have been stabilized by such an operation. Interest rates generally, however, would spiral upward as they always have in every major inflation.

People who save will be unwilling to lend their money at low interest rates even when they expect the depreciation in the value of their dollars to be limited. This is understandable. Take for example, a corporate financial institution subject to a 52-percent tax. The aftertax income from a bond yielding 4¼ percent interest would amount to just a little over 2 percent with the dollar stable in value. If this potential investor had reason to fear that the value of the dollar would depreciate even 1 percent a year, his real return would be very low. If the investor had reason to expect a price rise of just over 2 percent a year, his real return would become negative. Investors, I am convinced, are alert today to this way of figuring interest returns.

It might be added that to suggest that holding interest rates down by supplying the banking system with reserves through Federal Reserve open-market purchases of Government securities, on the one hand, and taking them away with higher reserve requirement increases, on the other, represents a fundamental misunderstanding of how the credit system functions. Obviously, if the net effects on the credit base are, in fact, offsetting, they make no net addition to the total supply of bank credit, nor do they reduce the demands of borrowers. If they are not fully offsetting, the net result would be inflationary. We are all acutely aware of the gigantic size of the publicly held debt that is outstanding and available to provide a basis for such monetary inflation. Much as we would like it, there is no magic formula by which we can eat our cake and have it, too.

If the Federal Government should substitute artificially created money for savings in an effort to prevent interest rates from rising, it would have a reverse effect. It would worsen the very situation that the action was intended to relieve.

If you really want to encourage rising interest rates, you have only to follow the prescription of those who argue that interest rates on Government or any other obligations can be pegged by inflating the money supply.

In connection with this discussion, it should be re-emphasized that the Federal Reserve System does not "like" high rates of interest. I have testified on many occasions that we would like to see as low interest rates as it is possible to have without producing inflationary pressures. Interest is just a governor on the flywheel of the economy which, if you prevent it working, leads to distortions and maladjustments in the economy from which we all suffer.

We are anxious, always, that interest levels be as low as is consistent with sustained high levels of economic activity, with a steady rise in our national well-being, and with reasonable stability for value for the dollar. We cannot, moreover, put interest rates where we would, whatever our "likes."

Federal Reserve policies can, of course, and do, influence interest rates to some extent through their influence on the rate at which the banking system can add to the credit and money supply. The effectiveness of Federal Reserve policies is always subject, however, to the reaction of borrowers and savers as expressed through the market.

In an economy in which people are alert and sensitive to price changes, the only way to bring about a lower level of interest rates is to increase the flow of real savings or to decrease the amount of borrowing. One important way to do this is to reduce substantially the deficit at which the Government is

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operating. This will not only relieve immediately some of the demand pressures that are pushing interest rates up in credit markets, it will also reassure savers as to the future value of the money they put in bonds and savings institutions and thus increase the flow of savings into interest-bearing obligations.

The proposals before you do not relate to the levels of rates which will prevail in the market, but rather to whether or not the Government shall be able to use savings bonds and marketable bonds effectively as parts of its program of debt management. The forthright management of the public debt is an essential part of any program to encourage savings and lower interest rates. We should not force the Treasury to resort to undesirable expedients in order to comply with arbitrary ceilings on either the size of the debt or the rate of interest it pays.

International levels of interest rates among industrial countries are now more closely aligned than in earlier postwar years. This realignment, together with removal of most restrictions on the movement of capital, reflects progress toward a closer relationship among international money markets, which is the financial counterpart of progress toward sustained growth in output and trade in the free world generally; exactly what we have been striving to attain for a long time.

It also signifies a state of affairs in which capital demands are becoming international in scope and in which they will converge rapidly on the market that is cheapest and most readily prepared to accommodate them. Under these circumstances, interest rates in this country must increasingly reflect worldwide as well as domestic conditions.

We need to remember that today the dollar is the anchor of international financial stability. That anchor must be solid. Realistic financial policies of Government are essential to that end as well as to the end of a wealthy and strong domestic economy.

At this juncture of world development, the least evidence of an irresponsible attitude on the part of the United States toward its financial obligations or of its unwillingness to face squarely the issues which confront it in meeting greater demand pressures on resources and prices, would have very serious repercussions throughout the free world.

Consumer saving, debt and spending for durables

Consumer spending on durables, at an annual rate of 40.1 billion dollars in the first quarter, had all but regained the ground lost during the recent recession. In the third quarter of 1957, as the downturn in business began, outlays for autos, furniture, household appliances and other consumer hard goods were running at a yearly rate of 40.4 billion. Even this, however, was a billion dollars short of the rate scored two years earlier, at

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the crest of the big splurge of consumer buying in 1955.

A volatile component of consumer expenditures, purchases of durables shrank by nearly 5 billion dollars, or 12 per cent, between the summer of 1957 and the spring of 1958. Spending on "soft" goods, on the other hand, dipped by less than 2 per cent and was well on the way upward again as 1958 opened. Outlays for services, moreover, suffered not at all during the course of the recession, repeating the 1948-49 and 1953-54 pattern and preserving intact a record of regular quarter-to-quarter gains ever since the war.

Rising income helps

The upturn in durables doubtless reflects in part the strong showing made by personal income in the early stage of recovery from the recession. Cushioned by a stepped-up outflow of unemployment insurance and social security payments and a fall in personal taxes more than proportionate to the dip in income, consumers' after-tax income declined less than 1 per cent under the impact of the downswing. By the second quarter of 1958, disposable income had reached a yearly rate of 309 billion dollars, or a shade above the high mark set on the eve of the recession three quarters earlier. The remainder of 1958 and the opening months of 1959 have seen the total push upward to substantially higher ground, with the rate in the first quarter in excess of 320 billion.

Consumer morale improves

More important, perhaps, has been the turnaround in consumer attitudes and expectations. When income is faltering and particularly when unemployment is spreading, consumers are prone to "hold the line." Building up cash balances and rehabilitating the family's credit standing come to appear more urgent than making purchases which can be postponed or bypassed altogether.

Recession then tends to have a double-edged effect in paving the way to a subsequent pickup in purchases of durables. For one thing, it prompts people to accumulate liquid holdings if need be by deferring purchases they would otherwise make. Furthermore, payments on outstanding debt contracts usually continue (in mild recessions, with little serious interruption), while the volume of new borrowing falls off. The outcome is that consumer indebtedness tends to flatten out or fall somewhat. This, in turn, means that when prospects improve a sizable reservoir of unused borrowing capacity is on tap to draw upon.

Willingness to borrow increases

Instalment borrowing by consumers held roughly to a plateau during the latter half of 1957 and underwent some decline in early 1958. Reflecting the big backlog of past borrowing, repayment volume built up all through 1957 and then flattened out. By early 1958, loan extensions had begun to run below the volume of credit repaid, and outstandings turned downward. Toward the end of 1958, as the new model cars made their appearance, borrowing picked up; since that time, extensions have appreciably exceeded repayments and the total of instalment debt once again has been on the rise.

Liquid savings are used

The evident willingness of consumers to take on a bigger volume of instalment obligations once the economic skies began to clear is matched by the apparent decision of some consumers to draw down liquid balances. Although total personal holdings of savings and loan share accounts, and time deposits

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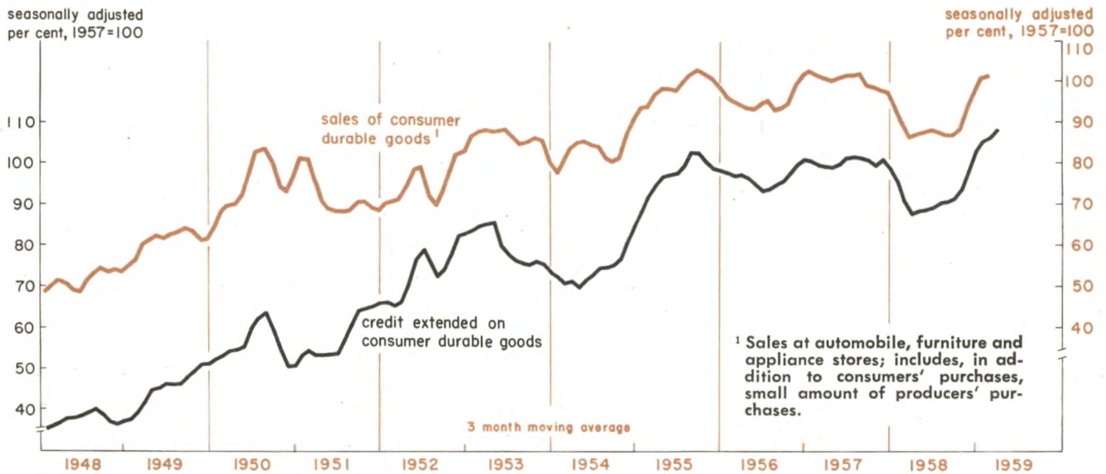
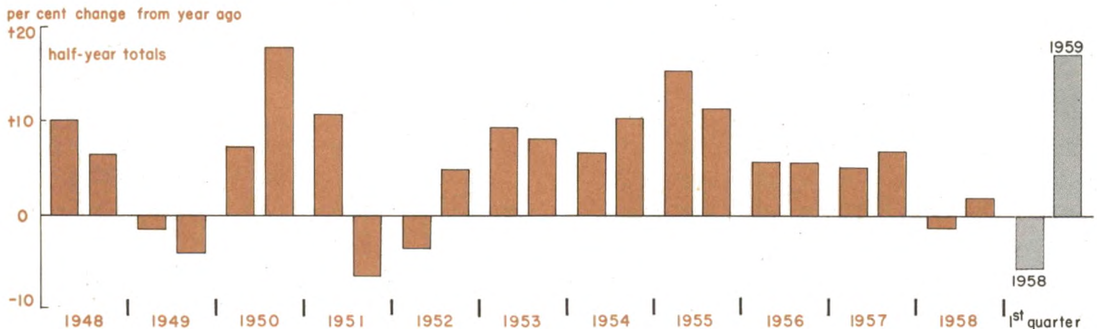
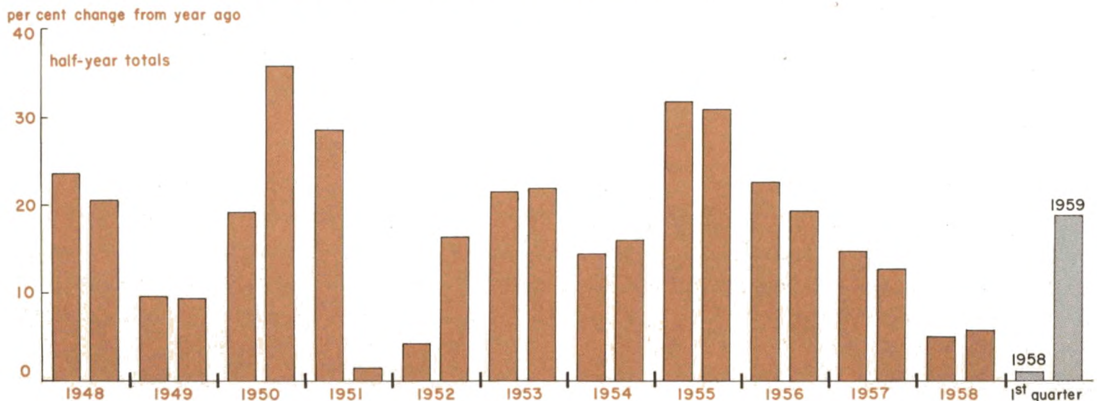
Sales of consumer durables, credit extensions and savings withdrawals show similar cyclical movements



Withdrawals—mutual savings banks' savings deposits



Withdrawals—savings and loan associations' share accounts



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at commercial banks and mutual savings banks continued to increase, withdrawals increased relatively more than inflows. The first and fourth quarters of 1958 present sharp contrasts in this respect. The first was in the trough of the recession; the fourth, at a stage well along the recovery road.

During last year's first quarter, withdrawals from savings and loan share accounts were up a mere 1 per cent from the year before. In the last quarter, share withdrawals were 15 per cent higher than they had been twelve months earlier. At mutual savings banks, deposit withdrawals in the first quarter were 6 per cent lower than in the opening months of 1957, while in the fourth quarter they were up 9 per cent. At commercial banks in Midwestern metropolitan centers, savings account withdrawals in early 1958 were down 4 per cent; in the closing three months of the year, they were greater by 3 per cent than in the same months of 1957.

During the first quarter of 1959, savings and loan association share account inflow was up 15 per cent over a year earlier, but redemptions or withdrawals were up 19 per cent. Similarly, mutual savings banks scored an increase of 6 per cent in inflow but 17 per cent in withdrawals. The commercial bank group in District metropolitan areas reported a 1 per cent gain over 1958 in first quarter savings inflow but a 9 per cent rise in withdrawals.

On balance, it appears that the desire to utilize cash accumulations piled up during the recession and credit resources resulting in part from the net paydown of instalment debt that took place concurrently have both served as strong underpinnings of the recent expansion of spending for durables.

Federal funds study published

"The Federal funds market refers to the borrowing and lending of a special kind of money — deposit balances in the Federal Reserve Banks. . . ."

This statement appears in the opening section of *The Federal Funds Market*, a booklet issued recently by the Board of Governors of the Federal Reserve System. The 111-page report summarizes the findings of a special Federal Reserve committee created to study this market.

The study presents a cross section of the market's structure and operation under conditions of credit restraint. It does not attempt to provide a detailed analysis of the market's behavior over time. The committee relied heavily on information obtained in interviews with banks and dealers who were active participants in the funds market in mid-1956 and on daily reports of Federal funds transactions supplied by about 150 of these banks and several Government securities dealers during the month of November 1956.

A general background section explains why banks need a means for making short-term reserve adjustments and the unique qualities which make operations in Federal funds an appropriate instrument to serve that need. Other chapters describe the growth and structure of the market. Two final chapters are concerned with bank use of the market and the significance of the interest rates paid for Federal funds.

The appendix to the study includes a bibliography of other books and articles dealing with the subject and a statistical summary of the transactions reported by banks and dealers in November 1956.

Copies of the booklet are available from the Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington 25, D. C., at $1.00 each for orders of less than 10 copies and at $.85 each for 10 or more copies in a single shipment.

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Credit flows into expanding cattle business

Activity in the agricultural sector of the economy has been at a high level thus far in 1959. Acreage planted and livestock production have increased. Farmers are using more credit, purchasing more supplies, boosting investment in machinery and equipment and expanding livestock inventories.

Cash receipts from farm marketings in the first quarter were higher, but increased production expenses caused the net income flow to drop below last year's annual rate.

As farmers have stepped up production, their purchases of machinery and supplies have increased. Individual farm machinery manufacturers have reported sales gains over year ago of 10 to 30 per cent. The cattle in-

Increase in farm loans greatest in cattle grazing and feeding areas of the U.S. . . .

per cent increase

black figure: beef cattle inventories
jan 1, 1958 to jan 1, 1959

white figure: loans to farmers
mar 4, 1958 to mar 12, 1959

(non-real estate farm loans of Federal Reserve member banks)

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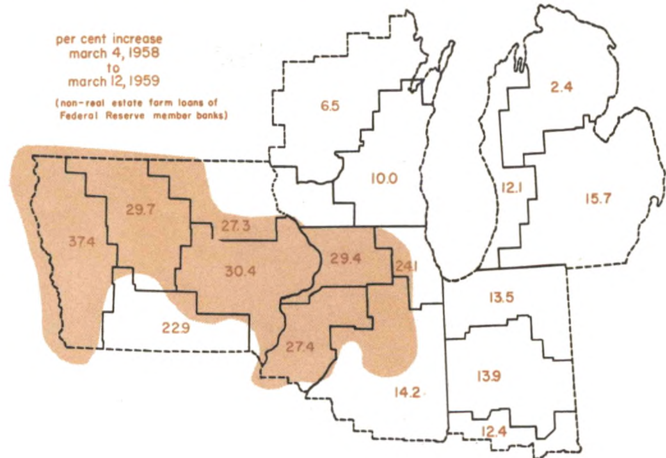
ventory on January 1 reached a new record, and the number of cattle on feed in thirteen major states on April 1 was 8 per cent above a year earlier, a record for that date. Since then, shipments of feeder stock into the Corn Belt have been substantially higher than in the corresponding period in 1958.

. . . and in District cattle feeding areas



To finance this expansion, farmers are using more credit. On March 12, non-real estate farm loans outstanding at member banks in the U.S. were more than 20 per cent above the March 4, 1958 figure. The largest gains were in the Kansas City, San Francisco and Chicago Federal Reserve districts, with increases of 24 to 29 per cent. The Dallas and Minneapolis districts reported increases of 15 per cent. These districts include the important cattle grazing and feeding areas, and much of the increase in credit has been used to finance expansion of the cattle business.

Upswing in cattle numbers

The number of cattle on farms January 1 showed an increase of 3.5 million head, to a total of 96.9 million. This is just over the previous record of 96.8 million head on January 1, 1956. However, the number of dairy cattle had decreased 0.6 million as dairy farmers culled their herds in response to the high beef prices, and this partly offset the increase of 4.1 million in beef cattle. Through April of this year, commercial slaughter of cattle was 6 per cent less than in the same months last year. The reduction was primarily in cows (down 22 per cent), reflecting the "holding" of "she-stock" on ranches to obtain "one more calf." Calf slaughter was down a comparable amount as ranchers withheld young stock to utilize the abundance of grass, and Corn Belt farmers and western feedlot operators bid young stock away from the packers. From January through April, cattle and calf slaughter was 1.2 million less than last year. While slaughter during the remainder of 1959 may be closer to that of last year, there is a strong possibility that the cattle population may increase as much as 5 million head during 1959.

The high prices of feeder cattle and the rapid build-up of the cattle population are reasons for some concern to farmers: the first because of the exposure of farmers and feedlot operators to losses if prices of fat cattle decline while they have large numbers on feed, and the second because of the possibility that a continued rapid build-up will bring a serious price decline for *all kinds of cattle* when marketings increase substantially at some date in the future. Consumers, of course, would benefit from any decline in the price of beef.

Present indications point to a continuation

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of the upswing in cattle numbers, through 1959 at least. While some areas in the Southwest and the northern plains report poor grazing conditions, most of the country has had adequate rainfall to maintain a good growth of grass. Conditions are favorable to continued restocking. The strong urge to expand herds is reflected in the action of cattle ranchers during 1958 and so far this year to withhold cows, heifers and calves. In this situation, any price decline which could bring widespread losses to cattle feeders would seem to depend on the weather in grazing areas or, if the weather remains favorable, the time necessary to bring to market those calves born to cows being withheld now.

Overexpansion in numbers ahead?

Thus, the greatest concern is with the rapid *rate* of build-up in cattle numbers. Analysts at the U.S. Department of Agriculture have made two projections of cattle numbers and slaughter based on (1) a slowing of the herd expansion and (2) continued rapid expansion. Assuming no severe drought, a slowing rate of expansion—say 3½ million in 1960, 3 million in 1961 and 2 million in 1962—would provide about 110 million head on farms by 1963. If the number were to stabilize at that level, the annual supply of beef would be on the order of 90 pounds per person, 4 to 5 pounds more than the 1956 record supply which resulted in severely depressed prices. The other projection, based on a more rapid rate of build-up, would result in about 115 million head on farms in 1964. This assumes increases of 4½, 4, 3 and 2 million head in the years 1960 to 1963. If the number on farms were to level off at 115 million head, the supply of beef would be about 95 pounds per person, or 10 per cent above 1956.

The ideal situation, of course, would be for the total beef supply to increase at about the same rate as consumer demand. This would call for output to rise slightly faster than population. However, build-ups in cattle numbers in the past typically have been quite rapid, with the result that the beef supply proved excessive when the expansion ceased. The accompanying decline in price of cattle, then, has resulted in unprofitable production and reductions of herds on farms, further augmenting the supply of beef. Herein is the root of the so-called "cattle cycle" and much of the instability in that industry.

While demand for beef is rising and presumably could absorb the additional supplies indicated by the slower rate of expansion without a severe decline in price of beef, the increase in supply indicated by the rapid expansion would undoubtedly bring sharply lower prices for cattle and beef. The result will depend almost entirely on the actions of cattle producers in the next few years. The *present* number of cattle on farms is not excessive in terms of current and prospective consumer demand. The danger lies in a continued rapid increase in the number on farms and the probability that the number will not merely level off at some later time but, as in past cycles, will be reduced and thereby lay a basis for the continuation of large fluctuations in supplies and prices.

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