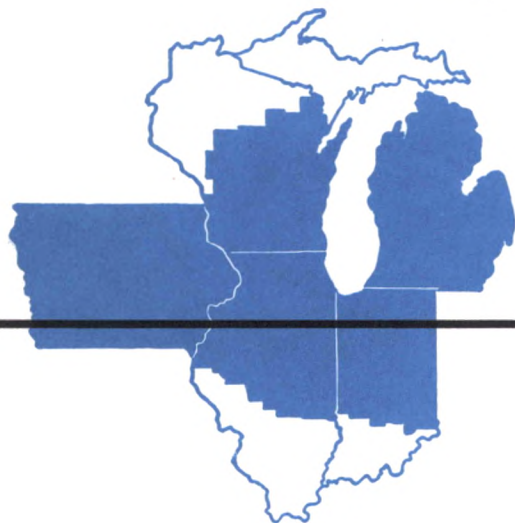


A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1960 December



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THE Trend OF BUSINESS

Business trends continued mixed in the fall. Production and employment slipped further, but personal income continued to rise, retail buying improved and construction contracts for large jobs were in heavy volume. These developments, together with indications of rising government expenditures, were cited by some business observers to support the view that the current adjustment will be short and shallow.

Business investment moving down

A Department of Commerce survey released in late October revealed that most manufacturing firms intended to reduce inventories during the final months of 1960. Efforts to reduce stocks on hand or to keep them from rising have restrained aggregate production all year, but moves to cut stocks appear to have been intensified.

In the first quarter manufacturers' inventories rose 1.9 billion dollars. They increased again in the second quarter but only by 800 million dollars. The third quarter saw liquidation to the extent of 300 million dollars. Plans called for a step-up in this rate of liquidation in the final quarter. Moreover, inventory adjustment programs are now aimed at reducing stocks of finished goods, which have continued to rise, while purchased materials and goods-in-process have declined.

The other important segment of business investment is outlays on new plant and equipment. Preliminary evidence suggests a

moderate decline in capital spending between 1960 and 1961. Various firms have announced that their capital outlays will be reduced next year. The pervasiveness of this trend is indicated by a McGraw-Hill survey released in mid-November which projects a 3 per cent decline in total plant and equipment spending for next year. Steel, transportation equipment (other than autos and parts), building materials, textiles and railroads will cut spending 10 per cent or more according to present plans. These declines are expected to be offset, in part, by increases in electrical machinery, motor vehicles, utilities and a number of nondurable goods manufacturing lines. Final results, of course, will depend heavily upon the vigor

Steel production has remained at sharply reduced level since midyear



of general activity next year. New plants will play only a minor role in next year's capital spending. More than ever before in the postwar period, emphasis is being placed upon cost-cutting innovations and facilities for the production of new products.

Production decline continues

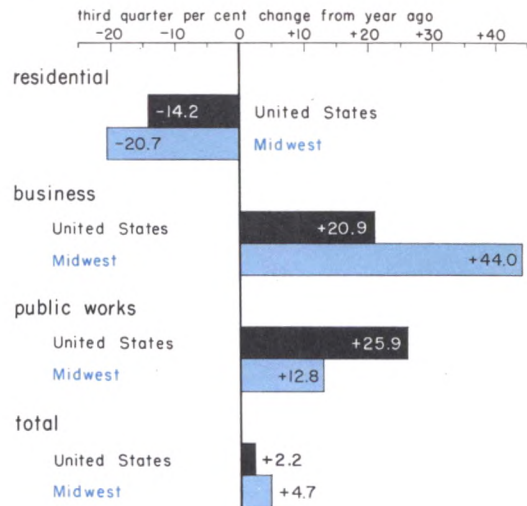
The gradual easing in total industrial production which began in July continued into October and, apparently, November as well. Virtually all types of manufacturing industries have reduced output and employment in some degree.

During November a number of important Midwest industries, including autos, television and construction machinery, announced production cutbacks to reduce stocks of finished goods. Hopes for a stronger trend in machinery demand remained high but machine tool orders declined in the early fall and cancellations of existing orders increased.

A few months ago it was confidently anticipated that steel production would rise substantially in the fourth quarter. However, in late October and early November steel output was declining. It now appears that production in the fourth quarter will not exceed the 20 million tons poured in the third quarter. At the beginning of 1960 it was estimated that steel production this year would exceed the 1955 record of 117 million tons by a wide margin. Now it appears that production for the year will not exceed 100 million tons.

Many steel consumers are counting upon two week delivery from the mills and immediate availability from steel warehouses. The steel industry provides a prime example of the manner in which the inventory burden has been pushed back upon suppliers. It is believed that steel output at the current annual rate of 80 million tons is well below

Total construction contracts rise despite decline in residential work



consumption. However, there is less confidence than formerly in estimates of consumption and the extent to which users can economize on inventory.

The automobile industry, steel's largest customer, currently is reducing production of passenger cars. Assemblies numbered 618,000 in October. Although sales were at record levels in October and early November, ample inventories in the hands of dealers have caused a reduction in production schedules to less than 600,000 cars in December.

Heavy construction a bright spot

Total construction activity was slightly lower in the third quarter than in the second, with a drop in the residential sector more than offsetting a rise in the nonresidential and public categories. But construction contracts tabulated by F. W. Dodge have been in large volume in recent months, indicating

an improvement in activity for the future. In the first six months of 1960, total construction contracts were 7 per cent below last year in the nation and 2 per cent lower in the Midwest. In the third quarter, contracts were 2 per cent *higher* than last year in the nation and 5 per cent *higher* in the Midwest.

There has been little evidence to date indicative of a sustained improvement in the depressed home-building industry. The Commerce Department has forecast an increase of 4 per cent in housing starts nationally in 1961 over 1960. This projection is predicated largely upon a pickup in the second half of next year.

During the third quarter substantially fewer housing permits were issued in most areas than in the same months of last year. Nationally, permits were off 19 per cent: in Chicago, 24 per cent; in Detroit, 29 per cent; in Milwaukee, 18 per cent; and in Indianapolis, 42 per cent. In most smaller centers

housing permits also were lower than last year, but Grand Rapids, South Bend, Kenosha and Racine reported increases.

Recent strength in construction contracts has been concentrated in public utilities and public works. However, awards for manufacturing and commercial construction also have increased. Capital spending plans for next year suggest a tapering in most types of business construction although the utility and public works sectors are likely to show further improvement. Voters approved a large volume of bond issues on November 8.

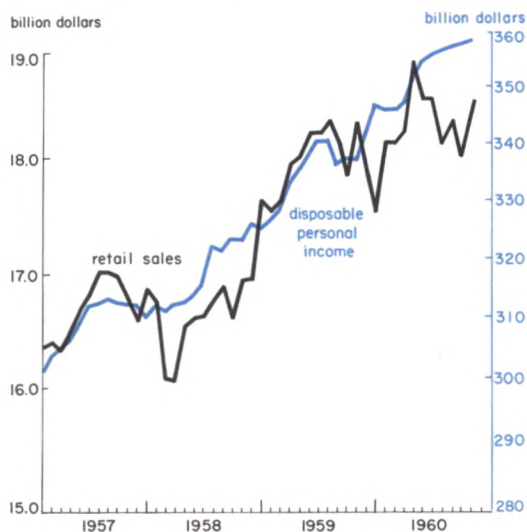
Another record Christmas?

Total retail sales rose to an 18.5 billion dollar monthly rate in October—a marked improvement over the 18.1 billion dollar rate of the third quarter and close to the record level of the second quarter. Strength in retail sales during October was attributable largely to increases at department stores and automobile dealers. The number of new cars delivered to customers in October and early November was a record.

The trend of retail trade in the Christmas season will provide an indication of the seriousness of the current adjustment. Despite the drop in employment, personal income continued to rise through October, and was 7 per cent above last year. The extent to which consumers are willing to spend this income will determine, in large degree, the pace of production in consumer goods industries in the months ahead. Recent evidence indicates reduced buying of such hard goods as appliances and television sets. However, surveys of consumer buying intentions suggest that purchases of some of these items may soon improve.

Total retail sales are generally expected to exceed the year-ago level in November and December. In 1959 these months were

Retail trade has not matched income gains in recent months



depressed, largely because of the steel strike which restricted the availability of new cars. Total retail sales in December of 1959, seasonally adjusted, were at a rate of only 17.5 billion dollars. This was one of the rare occasions in the postwar period when sales in the Christmas month failed to set a record.

Sales during the last two months of the

year will determine the success of the calendar year for many stores. November typically accounts for 10 per cent of the year's sales and December for 16 per cent in Midwest department stores. For some departments the November-December total is much higher—40 per cent or more in men's furnishings, handkerchiefs, gloves, toys and sporting goods.

Farm prospects, 1961

Farm income in 1960 has climbed more than was expected at the beginning of the year, and the total for the year may exceed the 1959 level. With farm output at a record high and prices of agricultural commodities averaging only slightly below last year, cash receipts from farm marketings are now indicated to be 34 billion dollars in the current year. Realized net income of farm operators may total about 11.5 billion. Prospects for 1961 were described recently by officials of the U. S. Department of Agriculture at the Annual Agricultural Outlook Conference as follows.

Demand for food and farm products is expected to be maintained in 1961 as both domestic consumption and exports will continue at high levels.

Cash receipts from farm marketings and realized net income of farm operators in 1961 are expected to remain close to 1960 levels. While the volume of products marketed by farmers may increase further next year if growing conditions are average or better, prices may average slightly below the current year.

Farm costs leveled off in 1960 and little change is expected in 1961. Interest payments and taxes rose sharply this year while expenses for livestock and feed were lower.

Hog prices this fall have been more than \$4 per hundredweight higher than last fall, and hog production is apparently turning upward again after a one year decline, the quickest turnabout on record. For the first half of 1961 hog slaughter will be somewhat smaller than this year, but the favorable hog-corn ratio and abundant feed supplies favor an expansion, and farmers have already reported plans to increase the 1961 spring pig crop. While hog prices are expected to drop below 1960 levels next fall, prices for next year as a whole and incomes of hog producers probably will average about the same as this year.

Cattle and calf slaughter in 1961 will increase about 10 per cent next year, with the total meat supply reaching a new high. A severe cyclical break in cattle prices does not appear likely, barring unfavorable weather over large areas of the West, but prices are expected to continue a downward trend.

The lower grades of slaughter cattle may show more price weakness than the other classes. Next year the price decline is expected to average about the same as the reduction during 1960, though the downward pressure on all classes will likely be greater in the last half of the year and could drop significantly if drought conditions develop in the West next summer.

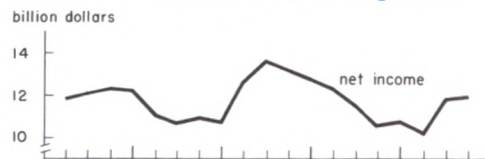
The number of cattle on farms is expected to continue upward next year, but the recent increase in cow and calf slaughter indicates the buildup is easing off. Numbers have been increasing for three years in the current cattle cycle and are now at record levels.

Feed grain production was at a record level this year and with the large carry-over from earlier years the total supply reached a new high for the seventh consecutive year. Prices of feed grains and protein feeds are expected to average a little lower than in 1959-60. The carry-over of feed grains at the end of the 1961 feeding season is expected to increase further.

Soybean production this year, although 4 per cent above last year, is below the record of 1958. Demand and supply are expected to be in close balance. Prices probably will average about the same as in the past year but with larger seasonal changes. The U. S. Department of Agriculture has suggested that larger production may be in order to provide adequate supplies for the expanding demand for soybean oil and meal. With favorable prices next spring, relative to the corn support price, soybean acreage is expected to increase in 1961.

Dairy production will be slightly above levels of recent years. Prices through March 1961 will be somewhat above year earlier. For the remainder of 1961 the level of Government price supports, to be announced before next April 1, may be an important

Net farm income rose during 1960



... as farm prices and cash receipts increased



determinant of milk and butter prices. Even with no increase in support prices, cash receipts from farmers' sales of dairy products in 1961 are likely to increase slightly over 1960 to another new record. However, the cost of producing milk has been rising and may prevent net incomes to dairymen from increasing.

The expected decline in beef cattle prices will likely slow the decline in the number of dairy cows on farms and the increase in milk production in 1961 probably will exceed that in 1960.

The net worth of agriculture, as an industry, is estimated to decline 3 per cent during 1960, the first decline since 1953. A downward trend in farm land values in most states since March is largely responsible though small declines were recorded in other farm assets, and farm debts rose. Farm debt is expected to total 25.7 billion dollars on January 1, 1961, compared with 24.3 billion a year earlier. However, debt will still be less than 13 per cent of the value of farm assets.

The longer-term outlook for agriculture

is dominated by the prospect of continued surpluses of major crops if it is assumed that support prices and major farm programs now in operation will be continued. Expansion of the domestic market for farm products will depend primarily on the growth of population since the effect of rising consumer incomes on food consumption per person is small and seems to diminish as incomes rise. Experts in the Department of Agriculture project an 11 per cent increase in total domestic use of agricultural products from 1959 to 1965. Agricultural exports are estimated to increase 20 per cent by 1965, assuming continued vigorous use of export

subsidies and special Government export programs such as the "Food for Peace" proposal.

Total farm output is expected to continue upward. Even with continuation of subsidies and other special Government export programs, Department economists concluded ". . . that by the mid-1960's, our surplus capacity may be about the equivalent of 15 to 25 million acres of cropland . . ." considering market outlets and productive capacity as a whole. However, these economists noted that in recent years they have tended ". . . to underestimate rather than to overestimate future increases in farm output."

Gold in the American economy

Changes in the U. S. Treasury's stock of gold normally attract very little attention outside the Federal Reserve System and the foreign central banks which hold all or part of their official reserves in the form of gold. Since the end of 1957, however, the Treasury's gold stock has dropped nearly 5 billion dollars to the present level of about 18 billion, reflecting recurring deficits in our balance of international payments. In recent months the gold outflow has accelerated noticeably. This, along with the spectacular gyrations in the price of gold on the London market during the latter part of October, has generated widespread interest in the role of gold in the United States and the world economies and, for a time at least, caused reports on changes in gold holdings and prices to appear on the front pages of many daily newspapers.

The interest in gold has been sharpened further in recent weeks as a result of the Administration's attempts to check the flow of gold and dollars from this country. The President has directed Government agencies to cut down on dollar spending abroad wherever possible; and conferences have been held with the German, French and British Governments on the matter of sharing foreign economic aid and western defense costs.

Some of the questions being asked today are: What is the function of gold in our monetary system? Why has gold been flowing out of the country in recent years? Is the United States gold stock adequate?

Gold and the dollar

Since 1933 the dollar has not been convertible into gold domestically. Gold coin

and gold certificates are not permitted to circulate as a part of the money stock. Americans are prohibited from holding gold in this country, except for small quantities for industrial and various other approved uses. Thus, gold plays no *active* role within the country as a "medium of exchange" or "store of value," the two major functions of money.

The Federal Reserve Banks, however, are required by law to maintain reserves in the form of gold certificates equal to 25 per cent of their combined note and deposit liabilities.¹ The Board of Governors of the Federal Reserve System has authority to reduce or suspend the requirement temporarily.

Since gold or gold certificates do not circulate, some maintain that a reserve requirement in this form is merely a carry-over from an earlier day when gold served as a part of the domestic money stock.² At that time notes and deposits were convertible into gold, and the world's major currencies were linked together through gold. When the Federal Reserve Act was passed in 1913, for example, the United States and most other major nations were on a full gold standard. Their currencies were equated to a fixed weight of gold, defined as gold parity, and were freely convertible into gold. Governments bought and sold gold at established prices, and there were no restrictions on the ownership of gold or its movements across international boundaries.

¹Gold certificates have been issued to the Federal Reserve Banks against most of the gold held by the Treasury. The System's legal reserve requirements approximate 12 billion dollars today, leaving a "free" gold balance of about 6 billion.

²They argue that the System's legal reserve requirements are not an essential part of our present monetary system and should be removed to assure that Federal Reserve actions would never be hampered by the requirement and to make the maximum amount of gold available for international transactions.

This system had the advantage of providing more or less automatic regulation of the money supply in the various countries, and gold movements served as guides to and checks on monetary policy. However, individual countries were subject to "runs" on their gold and consequent pressures on their bank reserves. These "runs" were of both foreign and domestic origin and often one would reinforce the other. As confidence in financial conditions deteriorated during the Twenties and early Thirties, increasing amounts of short-term capital moved from country to country seeking greater safety.

In the summer of 1931, in the wake of banking collapses in Austria and Germany, foreign investors became worried about the safety of their deposits in London and began to demand gold. The ensuing runs compelled the Bank of England to suspend payment in gold in September of that year.

Fears spread that the United States might follow England in abandoning the gold standard. Foreign withdrawals of gold and domestic hoarding of gold and gold certificates increased substantially, helping to precipitate a banking crisis in the winter of 1932-33. In March 1933 the United States suspended the gold standard domestically but retained an international gold exchange standard. Private domestic holdings of gold were called in, and the Treasury was given full authority to license gold exports and imports. Internally the dollar became a "managed paper currency," but it continued to be convertible into gold at a fixed price externally.

Gold and international payments

In the international area gold is used as the ultimate means for settling balances with other nations. The Treasury stands ready to sell and buy gold at \$35.00 per ounce, plus

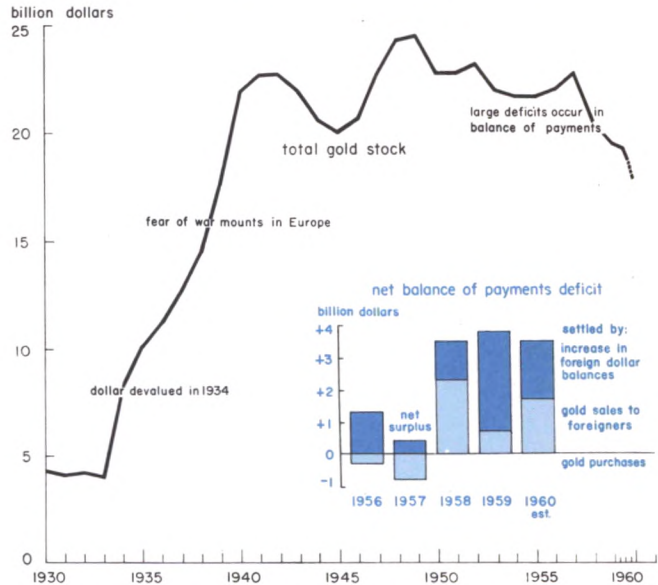
and minus handling charges, to and from foreign governments, central banks and other international institutions “for the settlement of international balances or for other legitimate monetary purposes.” This assures external convertibility of the dollar into gold at a fixed ratio for approved purposes.

Concern about the adequacy of the United States gold stock stems principally from the fact that the 5 billion dollar outflow of gold since the end of 1957 can be directly related to large deficits in our balance of international payments. In both 1958 and 1959 the deficit exceeded 3 billion dollars, and recent estimates indicate a deficit of similar magnitude for 1960. This experience has given rise to opinion both here and abroad that the deficits may be chronic rather than cyclical, reflecting a fundamental disequilibrium in the United States balance of payments position. If this were true, it would indicate need for basic changes in our policies affecting both receipts and disbursements in the international sector.

What is a balance of payments?

A balance of payments is a record of a nation’s total economic transactions with the rest of the world over a given period of time. Compared with conventional accounting statements, it is more like an income or flow of funds statement than a balance sheet. It does *not* show a nation’s total assets abroad or total foreign claims on assets in the United States, but it provides a summary of our total receipts from other countries and international institutions and our total pay-

Decline in total U. S. gold stock since 1957 reflects large deficits in our balance of international payments



ments to them. If all transactions are taken into account, total receipts will equal total payments during any given period. It is customary, however, to refer to increases or decreases in both our total gold stock and foreign holdings of liquid dollar assets as balancing items—measures of the deficit or surplus in the balance of payments.

If, for example, during the course of the year our payments to foreign countries for goods and services, loans and investments, military expenditures and Government aid exceed our receipts from exports of goods and services, foreign loans and investments in this country and our earnings on overseas investments, the difference or deficit will be reflected in one or more of the following: (1) an increase in foreign liquid dollar holdings including bank deposits and short-term

investments; or (2) a decrease in the U. S. Treasury's holdings of gold. On the other hand, if our total receipts exceed total payments, there will be a net transfer of dollars or gold to this country.

What causes a gold outflow?

In the first instance a deficit in the United States balance of payments is reflected in an increase in the deposits that foreign individuals, commercial banks and corporations maintain with American banks. Foreigners may retain these deposits as working balances to support trade and other activities or invest them in short-term United States securities.

At times they may convert part of their dollar holdings into their domestic currency or other foreign currencies for investment abroad. In the process the bulk of these dollars are acquired by foreign central banks and become part of their official reserves. These banks, in turn, may instruct the Federal Reserve Bank of New York to purchase gold from the Treasury for their account, causing a *gold outflow*. As the Treasury's gold stock has declined since the end of 1957, the gold stocks of other industrial nations such as Italy, France, the Netherlands, Germany and United Kingdom have risen by a roughly comparable amount.

Several European central banks traditionally use the bulk of their net foreign exchange receipts to buy gold because they prefer to maintain their official reserves in that form. Other central banks that maintain both gold and dollar reserves may use only a part of their net foreign exchange receipts to buy gold when they have sizable reserve gains arising out of balance of payments surpluses. They have the option of acquiring gold from the Treasury at the established price of \$35.00 per ounce or in the London market

where the price is determined by supply and demand forces.

Payments deficit has increased

Although recent estimates indicate that our balance of payments deficit increased to an annual rate of 4.3 billion dollars in the third quarter of 1960, from a 2.6 billion annual rate in the first quarter and 2.9 billion in the second quarter, at least one factor points to a basic strengthening in the United States international position. That is the substantial improvement in our trade surplus since mid-1959.

The United States is currently running an export trade surplus reminiscent of the Marshall Plan aid period and the Suez-generated export boom of 1956-57. Since the second quarter of 1959, our exports have increased more than 5 billion dollars to a current seasonally adjusted annual rate of 20 billion dollars. Our imports, however, have tapered off slightly to an annual rate of 15 billion. The improvement in the export picture has been one of the main areas of strength in our economy during the past year.

Chiefly because of the rise in the export trade surplus, this country in the third quarter of 1960 had a surplus on current account with the rest of the world equal to 4.5 billion dollars, annual rate. In the second quarter of 1959 we were running a deficit at the rate of 1.3 billion. A current account surplus means the United States is earning more than enough in its two-way trade in goods and services with the rest of the world to cover its military expenditures and private remittances and pension payments abroad.

If the current account surplus has shown such a considerable improvement, why has the deficit in our over-all balance of payments actually increased since the first quarter? The answer rests with a substantial

U. S. balance of international payments, 1956-60

	1956	1957	1958	1959	1960 (est.)
	(billion dollars; receipts [+], payments [-])				
Current account:					
Exports of goods and services	+23.7	+26.7	+23.3	+23.5	+27.1
Imports of goods and services ¹	-19.8	-20.9	-21.0	-23.6	-23.4
Private remittances and pensions (net)	-0.7	-0.7	-0.7	-0.8	-0.8
Balance on current account	+3.2	+5.1	+1.6	-0.9	+2.9
Capital account:					
Government loans and grants (net)	-2.4	-2.6	-2.6	-2.0	-2.7
Private U. S. capital (net):					
Long-term	-2.5	-2.9	-2.5	-2.2	-2.0
Short-term	-0.5	-0.3	-0.3	-0.1	-1.4
Foreign long-term capital (net) ²	+0.5	+0.4	—	+0.5	+0.5
Balance on capital account	-4.9	-5.4	-5.4	-3.8	-5.8
Errors and omissions	+0.6	+0.7	+0.4	+0.8	-0.6
Over-all balance: surplus (+) or deficit (-)	-1.0	+0.4	-3.5	-3.8	-3.5
Balancing items:					
Gold sales to foreigners (+); purchases (-)	-0.3	-0.8	+2.3	+0.7	+1.7
Increase in foreign liquid dollar holdings (+); decrease (-)	+1.3	+0.4	+1.2	+3.1	+1.8
	+1.0	-0.4	+3.5	+3.8	+3.5

¹Includes military expenditures abroad of approximately \$3.1 billion annually.

²Excludes purchases of U. S. Government securities.

Note: Based on Department of Commerce figures. Estimates for 1960 compiled by Federal Reserve Bank of Chicago. Military supplies and services financed by grants which average about \$2.3 billion annually are excluded from exports and Government grants for all years. Data for 1959 excludes \$1.4 billion additional U. S. subscription to the International Monetary Fund, of which \$0.3 billion was paid in gold. Components may not balance due to rounding.

pickup in recorded net outflows of private short-term capital, apparently in response to the pull of high interest rates abroad, and in *non-recorded* capital transactions. (Rather

sizable movements of capital escape the official reporting systems and show up only as a shift in the residual "errors and omissions" item in the balance of payments. Normally

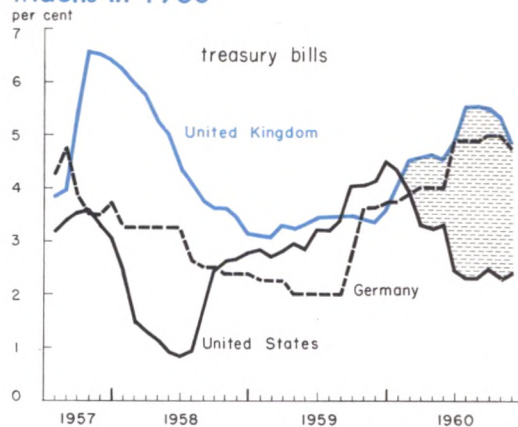
this residual has shown net receipts, but in the first half of 1960 it showed net payments and probably included sizable capital outflows.) Recorded net outflows of long-term capital, including investment in overseas facilities by American firms, purchases of foreign long-term securities and U. S. Government loans and grants abroad, have remained essentially stable.

As can be seen in the accompanying chart, the spread between short-term interest rates in the United States and principal European countries widened steadily in the first nine months of 1960. This reflected a leveling off in economic activity in this country on the one hand and a continued rise in the European business boom on the other. During this period the outflow of short-term capital from the United States accelerated as both foreign and domestic investors converted dollar balances to foreign currencies in order to take advantage of the more attractive rates abroad. United States industrial corporations and investment funds were reported to be heavy buyers of United Kingdom Treasury bills at yields approaching 5½ per cent. In the process the dollar balances of foreign central banks rose substantially. The banks have used a portion of these funds to purchase gold in London and New York, with the latter being reflected in a decline in the Treasury's gold stock.

It is interesting to note that less than a year ago interest rates in this country were higher than in most European financial centers. U. S. Treasury bills and prime short-term finance paper offered investment yields approaching 5 per cent. These yields not only induced foreigners and Americans to keep their dollar balances invested in this country but also attracted foreign funds to New York.

The above should emphasize that the re-

Spread between U. S. and European short-term interest rates widens in 1960



Note: Monthly average market yields for 3-month bills, except Germany which reflects end-of-month yields.

cent increase in our balance of payments deficit is primarily attributable to non-trade items — recorded net outflows of private short-term capital and unrecorded capital transactions. These, in turn, reflect the effects of such unpredictable factors as interest rate differentials between the New York and European money markets and the attitudes of businessmen and investors.

Outlook encouraging

On balance, our present international payments position represents an improvement over the situation in 1958-59 when the deficits could be directly related to a shrinkage in our export trade surplus. If the current export surplus holds, we can expect some improvement in our balance of payments, as a result of the recent easing of short-term interest rates in France, Germany and United Kingdom. This should help to moderate the outflow of short-term funds.

Further areas of encouragement are: (1) the demonstrated ability of domestic business firms to make their goods more competitive with foreign merchandise and (2) the Administration's efforts to relieve the strain on our balance of payments. The President has directed Government agencies to cut down, where feasible, on overseas dollar spending, and major Western European nations have been urged to assume a greater share of the cost of extending economic aid to underdeveloped areas and maintaining the free world's defense position. Success in these areas is essential to correcting the fundamental problem.

The Detroit-built compact cars are a striking example of how American industry can meet foreign competition. This country, moreover, has a considerable reserve of surplus productive capacity to support further expansion of exports. In sharp contrast some leading export nations, notably Germany, have been losing potential export business because heavy backlogs and shortages of plant capacity and skilled labor preclude prompt delivery on orders.

The German Government has proposed a substantially increased foreign economic assistance program for 1961. A fund of nearly 1 billion dollars will be established

with monies from Government and private sources to provide loans and credits to underdeveloped countries. It is understood the aid recipients will not be compelled to purchase German goods, but may use the funds to procure goods in the cheapest markets. The sharing of mutual defense costs is being reviewed with our allies, and the President has stated that discussions on this subject will be continued. Germany recently announced that it would contribute more to the cost of maintaining NATO defense installations.

Thus, corrective measures are being taken to restore equilibrium to the United States balance of payments. In the meantime, our present gold stock of 18 billion dollars (nearly one-half of the free world supply) should serve to cushion possible additional drains resulting from capital movements and other unpredictable transactions.

Future policies

The international economic situation has changed dramatically since the end of World War II. With the help of United States foreign aid, the weak, disrupted economies of Western Europe have been rebuilt and are now productive and strong. Markets are no longer dominated by worldwide shortages of goods and services. Purchasers, freed increasingly from dependence upon American aid, shop for price, credit terms, quality and service. The dollar shortage, which plagued many countries in the early postwar period and was confidently predicted by some experts to be a permanent situation, has largely disappeared. Most major industrial countries today possess sizable gold and dollar reserves. Reflecting this, their currencies are strong and freely convertible and invite foreign investment when interest rates are at attractive levels. Meanwhile, many underdeveloped and primarily raw materials ex-

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porting nations are still handicapped by low reserves and recurring balance of payments deficits.

With the change in world conditions now clear to all, the United States is in the process of reshaping its policies. It appears that more emphasis will be placed on extending aid to low income countries and that other lead-

ing industrial nations will be urged to play a greater part in this task as well as in maintaining the free world's defense position. These new policies should help to achieve the essential goals of restoring equilibrium to the United States balance of payments and fostering continued healthy growth of the free world economy.

Large "holiday" reserve needs supplied

The nation's banks are currently experiencing the usual heavy demand for currency and credit associated with the holiday season. Every year, between Thanksgiving and Christmas, currency in circulation increases by more than 600 million dollars, reflecting the public's greater use of "pocket" money for Christmas shopping, gifts of money and other holiday expenditures. Commercial banks obtain this additional currency from the Federal Reserve Banks. Payment for it reduces the reserves of the commercial banking system unless offset by Federal Reserve action.

The season also brings increased demand by bank customers, both businesses and individuals, for short-term financing. As loan volume expands, deposits rise, and banks need more reserves to meet their legal reserve requirements against the additional deposits. The pre-Christmas increase in required reserves normally amounts to at least 400 million dollars, but may be greater if business is expanding rapidly.

Thus, the absorption of bank reserves due to currency outflow and deposit expansion usually amounts to between 1.0 and 1.5 billion dollars. Besides these seasonal factors, however, there are other developments that may cause declines in bank reserves. The most important is an outflow of gold. Bank reserves decline when the Treasury sells gold, because buyers pay for the gold by writing checks against their deposits at commercial banks. As these checks are presented for payment through the clearing process, the reserves of the banks are reduced. This year the gold outflow caused a heavy drain on bank reserves. From mid-September until Thanksgiving this outflow averaged more than 100 million dollars per week.

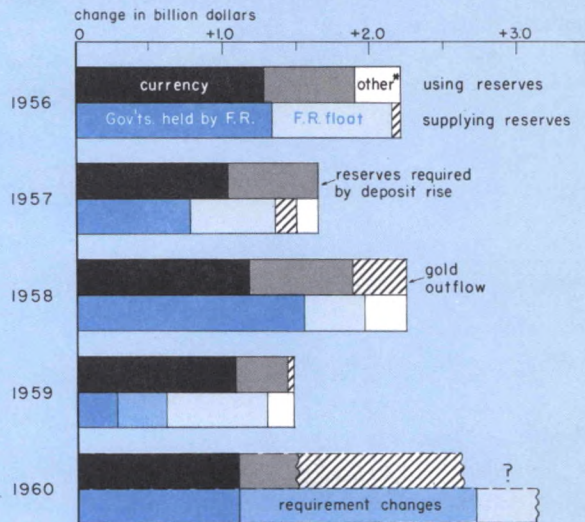
One function of the Federal Reserve System is to provide banks sufficient reserves to assure their ability to satisfy purely seasonal cash and credit demands. At the same time, System operations may offset the reserve effects of gold outflows to the extent these are incompatible with the monetary needs

of the domestic economy.

The volume of reserves provided by System action may, of course, be either larger or smaller than the total amount being currently absorbed, depending on general economic conditions. During times of rapid business expansion and full employment of resources, the System may provide a somewhat smaller amount of reserves in the interest of restraining possible inflationary pressures. This fall, on the other hand, there has been slack in some segments of the economy, and uncertainty has dominated the business outlook. In this environment reserves have been provided to assure that banks are able to meet the credit needs that would be associated with a faster pace of business, as well as to offset those absorbed by seasonal forces and gold outflows (see chart).

Between the end of September and Thanksgiving, Federal Reserve open market purchases of Government securities supplied more than a billion dollars of bank reserves. As sellers of these securities deposit the proceeds in their bank accounts, reserves increase. In addition, changes in the reserve requirements of member banks, as provided in legislation adopted in July 1959, have been timed to supply a large amount of reserves during this period. As a result of the most recent amendment to the reserve regulations, an estimated 1.3 billion dollars of reserves became available in two steps: (1) effective

The Federal Reserve System has provided large amounts of bank reserves to cover fourth-quarter needs this year



*Includes changes in Treasury currency, Treasury cash and deposits with the Reserve Banks, member bank borrowing, all other Federal Reserve accounts not shown separately and excess reserves.

Note: The changes shown in the upper bar for each year absorb bank reserves, and those in the lower bar supply reserves. Individual factors may have different effects in different periods depending on the direction of the change, e.g., gold inflows supply reserves while gold outflows absorb them. The data for the years 1956-59 are changes in weekly averages from the last week in September to the last week in December. Changes for 1960 are estimates based on actual changes through mid-November plus normal seasonal changes and projected gold outflow. No allowance is made for possible changes in Federal Reserve holdings of Government securities during December.

November 24, all vault cash became reserve eligible, but at Country banks, which hold most of the vault cash, the reserve effect was partially offset by a concurrent increase in the percentage of demand deposits which must be held in reserves; and (2) effective

December 1, reserve requirements against demand deposits of Central Reserve City banks were reduced to make them equal to those of Reserve City banks.¹ These changes, as they affect the three classes of banks, are summarized below:

	(million dollars)	
At Central Reserve City banks, through:		
Additional vault cash allowable	150	
Reduction in reserve requirements on demand deposits from 17½ to 16½ %	<u>250</u>	400
At Reserve City banks, through:		
Additional vault cash allowable	380	
At Country banks, through:		
Additional vault cash allowable	900	
Less, increase in reserve requirements on demand deposits from 11 to 12 %	<u>-380</u>	<u>520</u>
Total reserves made available		1,300

This is likely to be augmented by some rise in the total amount of currency in bank vaults during the holiday period. Based on

¹This amendment to the Board's Regulation D, governing member bank reserve requirements, constitutes the final step in the implementation of legislation enacted by Congress in July 1959 for the purpose of making reserve requirements more equitable among individual banks. The law provided, among other things, that the Federal Reserve Act be amended to (a) fix identical reserve requirements for Central Reserve and Reserve City banks and (b) eliminate any formal distinction between Central Reserve and Reserve City banks by July 28, 1962. The law also authorized the Board of Governors to make vault cash eligible for inclusion in required reserves. The first step in carrying out this legislation was taken in December 1959, when member banks were allowed to count part of their vault cash as reserves. A further step was taken in August to increase the amount of allowable vault cash.

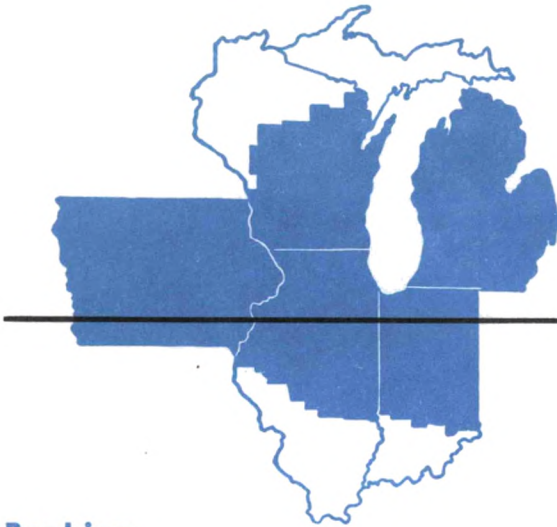
the experience of other recent years, the reserves already provided appear ample for the pre-Christmas needs, especially when the probable expansion in Federal Reserve float is taken into consideration. (Float represents an automatic extension of Federal Reserve credit as banks clearing checks through the Federal Reserve are given credit for cash items still in process of collection from the drawee banks.) Float always rises over the holiday period with the higher volume of checks and occasional mail delays. However, there are a number of factors which may cause the current season to differ from other recent years.

First, deposit expansion may absorb a larger volume of reserves than usual. Deposits were slow to respond to easier monetary policy in the summer and early fall, but have been showing larger gains recently. The net effects, however, will depend on how the deposit growth is distributed among banks. Compared with last year, fewer reserve dollars will be required to support the same volume of deposit growth at New York and Chicago banks due to lower requirements; but Country banks will need more reserves per dollar of deposits. In addition, gold outflow may continue to cause a heavier drain on reserves than usual.

Finally, because of the large and widespread initial impact of reserve requirement changes, the resulting reserves may be used less rapidly than those provided by open market purchases. If reserves should appear redundant for current needs, they can, of course, be absorbed by Federal Reserve actions. Changes in reserve requirements are frequently supplemented with open market operations since the latter are capable of achieving greater precision in the amount and timing of the release or absorption of bank reserves.

Business Conditions

*a review by the
Federal Reserve Bank of Chicago*



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