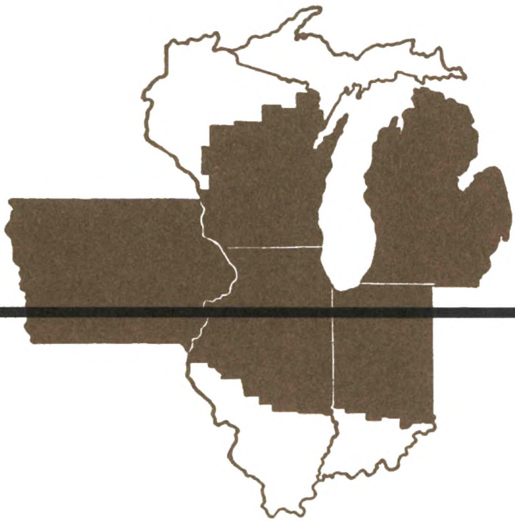
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1963 March

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Trends in banking and finance

Debt rose rapidly in 1962 as consumers, businesses and governmental units borrowed substantially more than they repaid. An expansion of 64 billion dollars in outstanding obligations during the year—more than in any other year except 1959 — pushed total net public and private debt past the trillion dollar mark.[1]

With the exception of Federal Government debt, where wars have accounted for the major increments, all types of debt have shown a gradual secular rise, roughly corresponding to the over-all growth of the economy. Years when private debt has shown the largest increases have generally been years of rapidly expanding business activity such as 1955 and 1959. This pattern reflects the demands for funds generated by consumer purchases of durable goods and houses and business expenditures for plant, equipment and inventories in boom periods.

Although 1962 showed a gain in total production of goods and services of almost 7 per cent over the preceding year, it did not bear the earmarks of a boom year; substantial amounts of unused labor and industrial facilities remained at year-end. Nevertheless, strong activity in certain areas, such as construction and auto buying, was reflected in associated debt forms—mortgages and consumer credit. Nonfarm mortgages accounted for almost a third of last year's total growth in debt. The 21 billion dollar increase in outstanding mortgage debt was by far the largest on record. Consumer debt rose 6 billion—moderately less than in the record years of 1955 and 1959.

Indebtedness of nonfinancial corporations rose 19 billion dollars, about evenly divided between short-term liabilities and long-term borrowing. This was a larger increase than in 1960 or 1961 but smaller than in postwar years of rapidly rising activity. Farm business showed relatively little increase in debt during 1962 after a sharp 13 per cent rise in the previous year.

The public sectors accounted for a quarter of last year's debt expansion. State and local governments continued to spend more than was collected in taxes and other revenues and outstanding obligations of these units rose by a record 7 billion dollars, or more than 10 per cent. Federal Government expenditures also exceeded receipts and outstanding debt (to holders other than Federal agencies) rose 8.7 billion dollars.

For the most part the 1962 increases in major types of debt extended the trends that have persisted since the end of World War II (see chart). While total debt in the economy has risen 80 per cent in the past decade, non-

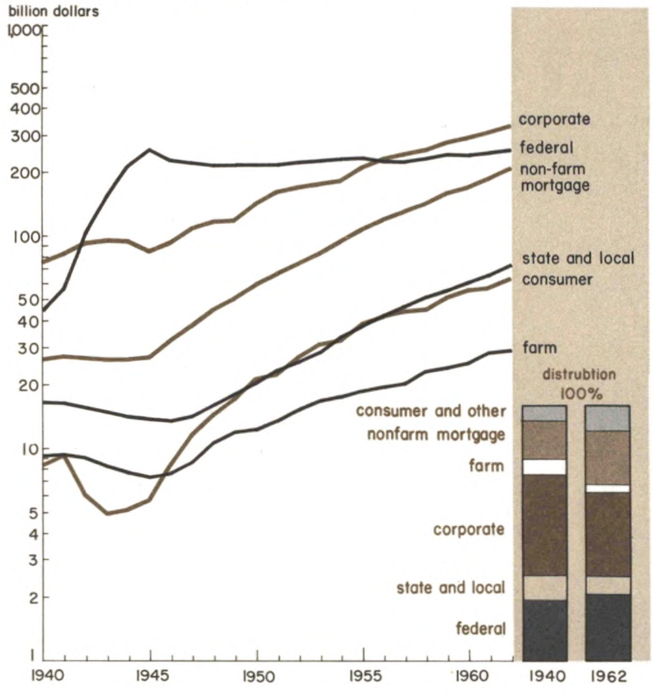
[1]Debt figures used here are based on the net public and private debt series published in the recent *Annual Report of the Council of Economic Advisers*. "Net debt" excludes certain types of duplicating governmental and corporate debt. For the Federal sector, which includes agencies and trust funds, Federal holdings of Federal obligations are eliminated. For the state-local sector, debt is net of obligations held in sinking funds or by other state-local units. Net corporate debt excludes obligations owed to other members of an affiliated system.

farm mortgages and state-local obligations have nearly tripled. Farm and corporate business debts have almost doubled. Consumer credit rose 130 per cent, following an even faster expansion in the early postwar years.

Federal debt grew 15 per cent in the last 10 years after the modest decline from the wartime peak. Cyclical swings in Federal borrowing have tended to move inversely with business and consumer debt as revenues reflect changes in personal and business income, and expenditures show the effects of unemployment and other recession-sensitive programs.

Despite the rapid growth of state-local obligations in recent years, the debt of these governmental units is a smaller proportion of the total than it was in 1940, prior to World War II. Personal debt, including mortgages and consumer credit, has increased in relative importance while the debt of business firms has declined relative to the total. Federal debt, outside that held by Federal agencies and trust funds, accounts for about a fourth of the total, the same as in 1940.

Growth rates for major types of debt in 1962 continue postwar trends



Treasury attracts long-term funds

An active demand for U. S. Government obligations with maturities beyond five years has enabled the Treasury to continue to lengthen the average maturity of the debt without boosting long-term interest rates. This was demonstrated in both the auction sale of 250 million dollars of 25-30 year bonds in January and demand for the five and one-half year issue offered in the February refunding.

The winning syndicate announced a sellout of the long-term bonds within an hour after they were awarded, with orders filled on a 60 per cent allotment basis. Roughly half of these bonds were taken by insurance companies, pension and retirement funds and mutual savings banks—typically long-term holders. Commercial banks took 19 per cent and dealers and brokers 16 per cent.

Results of the refunding of 9.5 billion dollars of February 15 maturities showed that of the publicly held portion (other than Federal Reserve and Treasury accounts) 45 per cent was exchanged for the five and one-half year, 3¾ per cent bonds. This was surprisingly large, particularly since holders of the maturing securities had already been offered the chance to extend into the five-year area in the Treasury's September advance refunding.

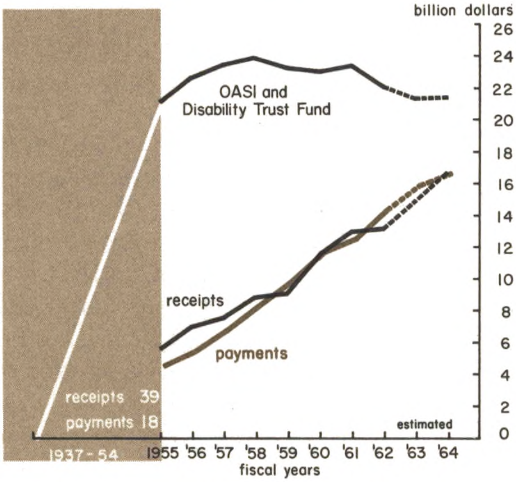
The Treasury has created a new nonmarketable bond designed to fill the needs of persons who set up retirement pension plans under the Self-employed Individuals Tax Retirement Act of 1962. These bonds carry a 3¾ per cent return, similar to the regular series E and H savings bonds. However, the retirement bonds cannot be redeemed before the owner reaches the age of 59½ years except under certain hardship circumstances.

Payroll taxes higher

While attention has focused recently upon proposals for income tax reductions, both employees and employers have been paying higher social security taxes since January 1. Under the 1961 amendments, contribution rates rose by ½ of 1 per cent to 3⅝ per cent for both employers and employees. Similar increases are scheduled for 1966 and 1968, thus increasing the combined rate to 9¼ per cent on the taxable portion of payrolls. The rate for the self-employed is one and one-half times that for employees. The figures below show the effects of recent and scheduled increases in rates per worker for those earning the maximum taxable amounts or more.

	Combined rate	Maximum taxable wages	Total payment per worker
	(per cent)	(dollars)	
1957	4½	4,200	189
1959	5	4,800	240
1960	6	4,800	288
1962	6¼	4,800	300
1963	7¼	4,800	348
1966	8¼	4,800	396
1968	9¼	4,800	444

Increased social security taxes will meet expenses under current benefits and coverage by 1964



The rise in Federal receipts due to the most recent boost in payroll taxes is expected to be roughly 4 billion dollars for 1963. Changes in the income tax law proposed by the President were estimated to reduce taxes of individuals about 6 billion per year beginning in the second half of this year. However, the economic impact of the social security program as a whole depends on the relation of tax contributions to benefit payments.

Since 1958, income of the Old Age and Survivors Insurance and Disability trust funds combined has been somewhat less than disbursements; rapidly increasing benefit payments have more than offset higher contribution rates. The 1961 amendment was intended to restore the program as a whole to a self-supporting basis. Latest official Budget estimates anticipate that the new tax rates will produce receipts slightly in excess of the 16.6 billion dollars of benefit payments expected in fiscal 1964. The net effect of this program, therefore, is likely to offset to some extent any tax relief from other sources during the year ahead.

The European business outlook —slower growth?

Growth of economic activity in Europe appeared to be leveling off in 1962, following the very rapid advances in several preceding years. This slackening had become evident in member countries of the European Free Trade Association (EFTA)[1] in 1960 and 1961, long before it affected members of the Common Market.[2]

Accompanying the slowing growth rate of the chief industrial areas of Europe have been substantial declines in common stock prices; mounting pressures on profit margins in some key industries; some easing of demand pressures; and a changing pattern of demand, with a smaller share of output going into new plant and equipment and exports and a larger share going into domestic consumption.

These developments have important implications for the United States. On one hand, any weakening of demand in Europe would likely be reflected in reduced exports from the United States while on the other it would tend to reduce the flow of American dollars to Europe for investment. The probable net effect on the balance of international payments of this country is, of course, uncertain.

Through much of the past year the Common Market has exhibited little sustained growth in industrial production and during the summer months Canada was the only member of the OECD with a sizable gain.

Within the Common Market the economic performance has varied from country to country; since 1960 Italy has shown the most robust rise in activity, followed by France, Germany and the Benelux countries, with the latter falling short of the area's average growth in production.

As it has become increasingly evident that some of the European countries have, in varying degrees, lost some of their earlier push, a number of prominent international economists have advocated the adoption of more expansionary economic policies in Europe. But a general concern over rising costs has led other policy makers to favor greater monetary and fiscal restraint.

Leading examples

The Federal Republic of *Germany* was the first of the six Common Market countries to achieve a vigorous and sustained rate of economic growth. Between 1953 and 1961 Germany's industrial production advanced more than 8 per cent annually; in 1962, however, it rose only about 4 per cent.

Rapid growth prior to 1962 had greatly reduced the country's sizable manpower reserve and by the late Fifties the German economy had begun to rely increasingly on an inflow of workers from Italy and other European countries with labor surpluses. The tightened labor market, accentuated by the cutoff of the supply of East German workers, was accompanied by sharp increases in wage rates which recently have exceeded gains in productivity.

[1]EFTA: Austria, Denmark, Norway, Portugal, Sweden, Switzerland and United Kingdom — also known as the "Outer Seven."

[2]Common Market: Belgium, France, Italy, Luxembourg, Netherlands and West Germany — also known as the "Inner Six."

Consequently, profit margins in important German manufacturing industries have come under increasing pressure and the rate of investment in new plant and equipment has fallen off markedly. The first half of 1962 saw an increase of less than 4 per cent in investment in new facilities, while between 1958 and 1961 such investment had risen at a rate of somewhat over 10 per cent a year.

As a result of the continuing rise in costs and the 5 per cent boost in official value of the German mark in early 1961, the exceptionally large German export trade surplus has declined substantially since the third quarter of 1961. While German exports continue to be very competitive in world markets, imports have risen considerably. Between 1958 and 1960 the consumer price index rose at an annual rate of just over 1 per cent, climbed 2.5 per cent in the ensuing year and an estimated 3.5 per cent in 1962.

Although German economic growth slowed appreciably during the past year, recent monetary and fiscal policies have had the net effect of restraining domestic demand. The maintenance of domestic price and exchange rate stability is a foremost objective of governmental policy. The Bonn Government has hinted that, if unions and employers do not reach "sensible" wage agreements, it will consider adopting tighter procedures for wage negotiations.

Industrial production, selected areas

	Common Market	EFTA	Canada	United States	Total OECD[b]
			(1953=100)		
1958......	144	119	120	102	113
1959......	153	125	129	116	125
1960......	171	134	130	119	132
1961......	182	136	134	120	135
1962[a].....	193	140	146	131	145
Per cent change, 1958-62	34	18	22	28	28

The data in the table indicate that between 1958 and the third quarter of 1962 industrial production rose most rapidly in the Common Market (34 per cent) and less rapidly in the EFTA (18 per cent) and in Canada (22 per cent).

Production in the OECD grew at the same rate (28 per cent) as in the United States although the rise in this country was exaggerated somewhat since activity was rising from a recession level in 1958.

Although not evident in the annual figures, industrial production declined some time during either 1960 or 1961 in all OECD areas except the Common Market. The low in Canada was reached during the third quarter of 1960, in the United States during the first quarter of 1961 and in the EFTA during the fourth quarter of 1961. Also, the recession was most pronounced in the United States with industrial production dropping 7 per cent; but it fell only 4 per cent and 1½ per cent in Canada and the EFTA, respectively.

During the entire period since 1953, industrial production in the OECD increased 45 per cent or at an average annual rate of about 4 per cent. While production in the United States fell significantly short of this, production in the Common Market rose at an annual rate of about 7½ per cent.

[a]Third quarter, seasonally adjusted annual rate.

[b]OECD, the successor of the Organization for European Economic Cooperation (OEEC), includes both the Common Market and the EFTA countries as well as a few other European countries, the United States and Canada—20 countries in all.

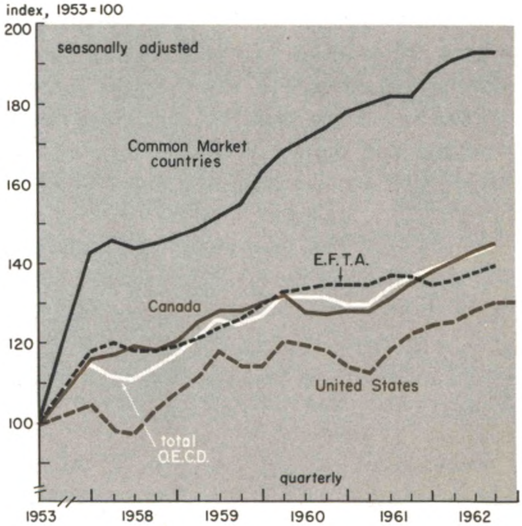
In *France,* pockets of unemployment have emerged in recent months, owing to the influx of a sizable number of refugees from Algeria and the release of servicemen following termination of the Algerian War last spring. These are expected to be absorbed readily if the French economy continues to grow vigorously. An over-all rise of 6 per cent in production is projected for 1963, or slightly more than the increase last year.

However, there are acute shortages of skilled workers in several key industries, and this has contributed to mounting wage-price pressures. Retail prices have been rising about 4 per cent annually. Incomes, reflecting higher wages and increased social insurance payments, have risen at an even faster pace and, therefore, production is shifting somewhat from the filling of foreign orders to the satisfaction of domestic consumer demand.

Italy has been the fastest growing economy in the European Common Market in recent years. Between 1959 and 1961 industrial production rose at an annual rate of about 13 per cent. For 1962 a further rise of about 10 per cent was anticipated. Moreover, prospects for the current year appear good, although uncertainty in the business sector regarding the outcome of forthcoming national elections could exercise a restraining influence.

While there are still substantial numbers of unemployed in southern Italy, many lack the skills and training required by industrial firms, a problem common to other countries as well. In some industries labor shortages now exist and large wage increases are commonplace. This has intensified pressures on business profit margins and could cause some cutbacks in the rate of business capital investment. From 1959 to 1961 consumer prices increased an average of about 2 per cent annually, but last year the price index moved

Industrial production
has grown rapidly
in the Common Market countries



up at least twice that amount.

(*Spain* has aroused growing interest in the last few years. Beginning in 1959 the country embarked upon an extensive program of dismantling rigid controls over the economy, including many import restrictions, which may succeed in restoring the country to economic health. If her application to join the Common Market is accepted, Spain may achieve vigorous economic growth.)

Britain's economy apparently is expanding less rapidly than those of its chief competitors in Europe. After rising gradually since the early part of 1962, British industrial production declined sharply in October but was followed by a small recovery in November. The over-all gain for the year is believed to be less than 1 per cent, although British consumer prices advanced about 4 per cent. In mid-January the unemployment rate had inched up to 3.6 per cent of the work force—the highest in Britain since 1947. Over the last two years there has been little change in the size of Britain's foreign trade balance.

The reversal of the business advance in Britain followed in the wake of a rather sobering atmosphere in negotiations concerning Britain's bid to join the Common Market. Investment in new plant and equipment has dropped off sharply despite credit becoming more readily available and the government further liberalizing investment and depreciation allowances. An inquiry made toward the end of last year by the Federation of British Industries revealed that a further reduction of capital expenditures by private industry was in prospect.

Conclusion

A slowdown of business activity in several European countries last summer led the Common Market to launch a study of measures to be used, if necessary, to counteract a recession. The proposed actions include tax cuts, heavier government spending and deficit financing. However, most of the member governments apparently believe that prompt implementation is necessary.

For the most part the slowdown has been merely a reduced rate of rise and appears to have resulted largely from labor shortages rather than inadequate demand. European markets for consumer goods are still expanding rapidly. In 1962 private consumption in the Common Market for the first time advanced more rapidly than capital investment.

It would appear that the upward pressures on wages and prices in countries such as Italy, France and Germany could be relieved somewhat by a more plentiful supply of goods. Labor shortages cannot be eliminated quickly, although recourse to more capital-intensive manufacturing processes will tend to relieve this pressure in the long run.

Tariff reductions by the Common Market countries would be one means of providing a prompt increase in supply of goods and would be regarded by their world trading partners—perhaps primarily the United States—as superior to monetary and fiscal restraint as an anti-inflation weapon. Such reductions would not only increase the supply of goods for consumption but also those needed for the further mechanization of production; in addition, this would help the industrial countries with unused labor and plant capacity (for example, the United States and England) to accelerate their own growth of production. It is hoped, therefore, that pending the start of tariff negotiations with the United States, under the Trade Expansion Act of 1962, the Common Market authorities in Brussels will see the possible widespread benefits of helping to bring about a further liberalization of international trade.

Consumer prices rose further in major European countries in 1962