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MONEY MARKET IN JULY

Money market conditions during the past month were influenced chiefly by the announcement of the Federal Open Market Committee on June 28 that Government security operations of the Federal Reserve System would be governed primarily by the general business and credit situation with the aim of increasing the supply of funds currently available to meet the needs of business and agriculture. Following this announcement, the Reserve System temporarily ceased selling Government securities in the open market and, in the absence of sizable private demand for funds, member banks for a time experienced considerable difficulty in employing the approximately 800 million dollars released by the reduction in legal reserve requirements (effective June 30 for the larger city banks and July 1 for country member banks). As a result, prices of all types of marketable Treasury securities rose sharply in the closing days of June and the first week of July. The pressure of demand became so strong, particularly for the short-term issues, that the System sold large amounts of Treasury bills and certificates in order to restore orderly market conditions, thereby eliminating most of the increase in excess reserves. The higher price level for Government bonds, however, apparently attracted offerings of such bonds from private sources, particularly the life insurance companies. As a consequence of these various offerings and the alternatives afforded for purchase of corporate issues, the pressure of demand declined, prices of both long and short-term Government securities receded gradually, and sales by the System diminished sharply during the last half of the month.

The decline early in the month in Government security yields spread into the corporate and municipal bond markets, stimulating the sale of new issues and enabling security dealers to dispose more readily of unsold portions of previous offerings. The rise in prices of seasoned corporate and municipal bonds, however, lagged behind that of Government issues. On July 5 acceptance dealers lowered the rates on bankers acceptances of all maturities.

Over the period as a whole, yields on Government and corporate securities moved to levels ranging generally from 5 to 15 basis points below those prevailing at the end of June. The rapid deterioration in rates which occurred during the first week of the period was checked, and orderliness restored to the markets, primarily by Federal Reserve System redemptions and sales of short-term Treasury issues in excess of a billion dollars from June 29 to July 27.

GOVERNMENT SECURITY MARKET

The change in open market policy immediately gave an impetus to the demand for all types of marketable Treasury obligations, and subsequently to the demand for corporate issues as well. Treasury issues were sought principally by the member banks, whose free funds had been substantially augmented—almost simultaneously with the policy change—by a reduction in legal reserve requirements. Demand for short-term Treasury securities was particularly strong, since the larger member banks confined their purchases primarily to short-term issues. The medium-size and smaller banks generally sought to expand their holdings of Government bonds.

With Treasury bills and certificates not available from the Federal Reserve System, yields fell sharply. Early in the month, most of the supply came from the portfolios of Government security dealers, as indicated by a decline of 350 million dollars in their borrowings from the weekly reporting member banks in New York City in the week ended July 6. Inasmuch as the reserves used to purchase these securities were returned to the banks through repayment of dealer loans, the banks' reserve positions remained practically unchanged and their investment problem unsolved, despite the great upward pres-

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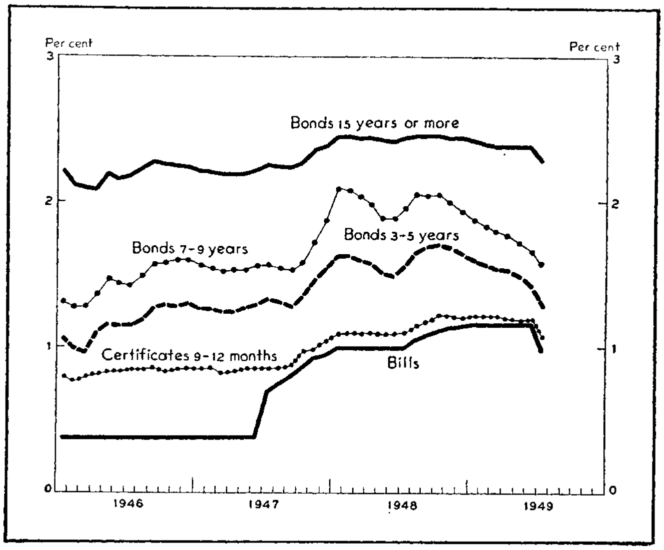
Yields on U. S. Government Securities
January 1946-July 1949*



* Monthly averages of daily figures; taxable issues only. Bill yields are rates on new issues offered within the period.
Source: Board of Governors of the Federal Reserve System. July 1949 estimated on the basis of the data through July 23.

sure upon Government security prices to which their demand had contributed.

Bank demand for short-term Treasury securities became, therefore, even more insistent, and as a result yields fell further. Offerings contracted substantially, and market conditions grew disorderly, with sharp increases in price taking place on a small volume of trading and spreads between bid and asked quotations widening perceptibly.

Confronted by these disorderly conditions, the Federal Reserve System sold substantial amounts of Treasury bills and certificates. The pressure of demand subsided rapidly as this increased supply became available, and yields rose. The new Treasury bill issue offered on July 28 averaged 1.02 per cent discount as against 0.93 per cent for the preceding issue. System sales of short-term issues had repercussions on the long-term bond market, and yields on other Treasury securities firmed somewhat.

At one point, the decline in short-term securities had carried to a level where the return on Treasury tax Savings notes during the first year exceeded that on short-term marketable issues. It was reported in the press that corporate investors and large business corporations made considerable shifts from short-term marketable issues to Savings notes, thus tending to provide some brake on the price advance of short-term issues.

Prices of Treasury bonds also rose sharply (yields fell) in the first half of July, as most sellers (including the Reserve System) withdrew from the market. Buyers were willing to make purchases at higher prices, but did not bid aggressively for fear of accelerating the price advance. The volume of trading in bonds, therefore, was small. While the price increases were substantial, they reflected mainly dealer mark-ups to levels which would attract offerings.

The efforts of the Government security dealers to restore two-way trading in the Government bond market apparently met with some success. The pace of the price advance slowed up noticeably after the first week of July. Life insurance companies sold considerable amounts of bonds for the purpose of financing their purchases of new corporate securities and other investors stepped up their sales. Perhaps the major development tending to reduce the demand for bonds was the general market reaction to the substantial sales of short-term securities by the System.

Prices of medium and long-term eligible bonds, which between June 28 and July 6 had risen by from 5/32 to 1-4/32 for various maturities, advanced by another 2/32 to 10/32 in the following week. Ineligible bond prices rose similarly, with the longest-term issues showing larger increases than the earlier maturities. The advance over the entire period of slightly more than two weeks was somewhat greater for the restricted bonds than for the eligible issues, thus reversing the tendency of eligible bond issues to rise faster than ineligible bonds (a tendency that had prevailed since early November 1948). Prices of corporate bonds moved up more slowly and with a lag. Moody's averages of Aaa and Baa issues rose the equivalent of 26/32 and 11/32 of a point, respectively, between June 28 and July 13.

Most of the demand for eligible Treasury bonds originated from the smaller and medium-size banks, as already noted. Demand for ineligible bonds came principally from the savings banks (which financed a considerable part of their purchases with the proceeds of the sale of eligible bonds), from trust and pension funds, and from individuals. Life insurance companies continued to be the chief sellers of restricted bonds.

Prices reacted moderately during the second half of the month. The impact upon the market of further sales of short-term issues by the Reserve System led to some profit-taking sales of bonds, while life insurance companies increased their offerings in the Government market in order to finance the purchase of part of a large new corporate security issue. Corporate bond prices, however, generally maintained their smaller gains, as their attractiveness was enhanced by the earlier rise in Government security prices.

Member Bank Reserve Positions

Money market conditions were eased substantially during the first part of July by the reduction in member bank reserve requirements and the inability of the banks to employ the funds so released because the private demand for bank loans and access to the Federal Reserve security portfolio were limited. In addition to the 800 million dollars of reserves released by action of the Board of Governors of the Federal Reserve System, member banks gained funds during the week ended July 6 through net Treasury disbursements, an expansion of Federal Reserve "float," and foreign government disbursements out of accounts with the Reserve Banks; these items were offset only in part by a preholiday expansion of currency in circulation.

Although the member banks, particularly the larger institutions outside New York City, were able to purchase large amounts of short-term Treasury securities in this first week, only a moderate amount of additional bills was acquired direct from the Treasury through subscription to the new issue and indirectly from the System through the market. Most of the purchases by the larger banks were made from Government security dealers, who used the proceeds to retire bank loans; the result was the transfer of large amounts of funds to the New York City banks. In the aggregate, however, the banks' gains of excess reserves were left substantially intact. The increase in the surplus reserves of the country banks was apparently shifted to the larger city banks, where they remained largely uninvested, so that, in the aggregate, excess reserves of all member banks on July 6 rose by an amount only 30 million dollars less than the decline in reserve requirements.

In addition to the funds gained through the Government security operations of the larger out-of-town banks, the New York City banks were also the recipients of roughly 300 million dollars placed on deposit with them by their out-of-town correspondents that had not fully invested their free reserves. Thus, despite the fact that the New York City banks gained only a minor amount of surplus balances from the reduction in their own reserve requirements, the New York money market turned very easy in the week ended July 6. Since the New York banks likewise were unable to employ their gains fully, their excess reserves rose 290 million dollars in this week.

During the next two weeks, transactions tending to provide member banks with reserves were moderately larger than those tending to absorb them. The money market continued subject to the demand pressure arising from the earlier sharp increase of excess reserves which the larger reserve city and central reserve city banks sought to employ in short-term Treasury securities. In the face of unsettled conditions in the short-term issue market, the Federal Reserve System made substantial sales of Treasury bills and certificates. These sales had the effect of more than absorbing the excess reserves, as well as subsequent additions to reserves, of the larger member banks, which consequently had to increase their borrowings from the Federal Reserve Banks. Thus, the reserve positions of the larger banks were considerably tightened. Country member banks, on the other hand, retained (either as deposits with correspondents or as excess reserves with the Reserve Banks) a substantial part of the reserves released by the lowering of their reserve requirements or acquired through subsequent transactions, since the available market supply of intermediate and long-term eligible Treasury bonds, in which they sought to invest their surplus funds, was limited in the absence of sales by the Federal Reserve System.

Thus, a decline of about 500 million dollars in System holdings of Treasury bills and certificates in the week ended July 13 was accompanied by a decrease of almost a like amount of excess reserves. But a decrease of close to 365 million dollars in the Federal Reserve portfolio of short-term issues in the week ended July 20 was accompanied by only a minor change in excess reserves. Commercial bank purchases of short-term Treasury issues in this week were, in the aggregate, financed mainly through borrowing from the Federal Reserve Banks. Since a substantial part of the member banks' investment problem had been passed on to the New York banks, a large part of the decline in excess reserves in the week ended July 13, and of the rise in member bank borrowing in the week ended July 20, occurred among the New York City banks, many of which were reluctant to adjust their reserve positions through sale of short-term securities recently acquired at higher prices.

Reserve positions for the banking system as a whole remained virtually unchanged during the remainder of the month. Bank demand for short-term Treasury securities eased after the week ended July 20. However, early in the week ended July 27 repayment of indebtedness to the Federal Reserve Banks and nonbank investor purchases of short-term Treasury issues brought member bank reserve positions under some pressure, particularly among the banks of New York City, where a sizable deficiency of reserves was incurred. The banks subsequently were compelled to sell Treasury bills and increase their borrowings in order to adjust their reserve positions. Adjustments were more extensive for the New York banks than for the out-of-town banks. Thus while in the aggregate the change in Federal Reserve credit was small, there was a substantial expansion of Reserve credit in use in New York City. As the month ended, the excess reserves of country banks were roughly 150 million dollars higher than they had been on June 30 before the change in requirements, while those of reserve city and central reserve city banks had increased by about 60 and 80 million, respectively.

TREASURY FINANCING IN THE FISCAL YEAR 1949

The fiscal year which ended June 30, 1949 can be viewed as a year of transition. The first half of the year saw the postwar peak in production and income, while its final months witnessed the beginning of a business recession. The decline from the postwar peaks of production and consumption affected private income and expenditure patterns, and the changes in these patterns gave rise in turn to changes in Treasury income and outgo.

The first half of the fiscal year was marked by rising corporate and personal income, personal saving, production, and consumption. The turning point came in the first months of calendar 1949 as income, production, and consumption began to shrink while saving continued to increase. As about three quarters of the Treasury's total cash receipts are derived from income taxes, the magnitude of personal and business income directly affects Government income. However, most of the Government's income tax receipts in the fiscal year 1949 were derived from the high personal and corporate incomes of the calendar year 1948, and thus were fairly well sustained. Although personal income has been declining since the fourth quarter of 1948 (when it was running at the peak annual rate of 220 billion dollars), in the full fiscal year 1949 personal income was higher than in fiscal 1948, and Government receipts from the personal income tax would undoubtedly have been larger in fiscal 1949 than in fiscal 1948 had it not been for the reduction in personal income tax rates which became effective January 1, 1948.

Federal expenditures are attuned more closely than receipts to the current economic changes, since various automatic "adjusters" of Government spending come into play as soon as such changes are manifest. The most important of these adjustment factors is unemployment insurance, which causes Federal expenditures to increase with only a short lag as unemployment rises. Old age benefit payments also rise as lessened employment opportunities cause an increase in the number of older people drawing insurance benefits. The farm price support program is, of course, an additional element which makes the budget responsive to changing economic conditions.

The Treasury finished the fiscal year 1949 with a cash operating surplus of not quite one billion dollars, or less than half the cash surplus estimated by the President in his Budget Message in January. Compared with the cash surplus of almost 9 billion dollars in fiscal 1948, the 1949 surplus reflects not only the reduction in personal income tax rates but the changes in economic conditions that have taken place in the past year. Total cash income from budgetary and trust fund accounts in fiscal 1949 was 41.6 billion dollars, or 3.8 billion less than the postwar high of 45.4 billion dollars in 1948. Cash expenditures, on the other hand, increased by over 4 billion dollars, to 40.6 billion dollars.

In spite of its small operating surplus, however, the Treasury paid off almost 5.3 billion dollars of marketable debt during the fiscal year 1949, in net redemption of Treasury bills, certificates of indebtedness, notes, and bonds. The funds used for debt retirement were derived partly from the cash operating surplus of 1.0 billion; partly from the proceeds (2.8 billion dollars) of net sales of Savings bonds and notes and from various minor sources, including changes in the indebtedness of Government corporations; and partly by drawing down the General Fund by 1.5 billion dollars. In fiscal 1948, debt operations had resulted in the disbursement of 8.7 billion dollars in retirement of marketable debt. The 8.9 billion dollar cash operating surplus in that year, supplemented by the receipt of 1.4 billion dollars from net sales of nonmarketable securities and Government corporation debt, provided more than ample funds for this purpose and the General Fund was increased by the remaining 1.6 billion dollars.

The Federal financial record for fiscal 1949 reflects in various ways the changes which the economy has been undergoing. For example, net receipts from sales of Savings bonds during the year (2.4 billion dollars) were a billion dollars greater than receipts from this source in 1948, evidencing in part the rise in personal saving during the fiscal year. Receipts from Series E Savings bonds alone were about 600 million dollars greater in fiscal 1949 than in the preceding fiscal year. The remainder of the increase in net receipts from Savings bond sales arose from the special offering of Series F and G bonds to institutional investors in July 1948.

Treasury Financing, Fiscal Years 1949 and 1948
(In billions of dollars)

Sources and disposition of funds	1949p	1948
Cash income	41.6	45.4
Cash outgo	40.6	36.5
Net cash operating income	1.0	8.9
Decrease in General Fund*	1.5	− 1.6
Cash borrowing (−) or debt repayment	2.4	7.3
Nonmarketable, total	− 2.8	− 1.4
Savings bonds	*− 2.4*	*− 1.4*
Savings notes	*− 0.5*	*1.2*
Other	*0.1*	*− 1.1*
Marketable, total	5.3	8.7

p Preliminary.
* A minus sign (−) indicates an increase.
Note: Because of rounding, figures do not necessarily add to totals.
Source: *Daily Statement of the United States Treasury* and *Treasury Bulletin*. Partly estimated by the Federal Reserve Bank of New York.

An additional 460 million dollars was obtained by the Government from net sales of Savings notes. This was in marked contrast to the situation in fiscal 1948, when redemptions of Savings notes exceeded sales so that 1.2 billion dollars net was paid out to the public on this account. The increased popularity of Savings notes in fiscal 1949 can be partly explained by their more favorable interest rate position in relation to other Government securities after September 1948. Throughout fiscal 1948, the interest rate on notes was 1.07 per cent as compared with an average interest rate of 1.48 per cent on all 3-5 year taxable issues, 1.01 per cent on certificates, and 1.82 per cent on 7-9 year bonds. In September 1948, the interest rate on notes was raised to 1.40 per cent, putting notes in a more favorable yield position as compared with other Government securities. The average interest rates on all Government securities rose during the fiscal year 1949, but the gap between the yield on notes and the yield on other issues was narrowed. The average rates for fiscal 1949 were: certificates, 1.20 per cent; 3-5 year taxable issues, 1.59 per cent; 7-9 year taxable bonds, 1.90 per cent. At the end of fiscal 1949, the rates on all Government securities were again turning downward, thus increasing the desirability of notes for investment purposes.

Only a small amount, approximately 20 million dollars, was obtained from the public through sales of other nonmarketable issues in fiscal 1949, in comparison with over a billion dollars so obtained in fiscal 1948 (mainly from sales of investment series Treasury bonds). Government corporation debt declined, thus returning to the public almost 75 million dollars, but leaving 2.8 billion in net receipts from sales of nonmarketable securities which could be used to redeem marketable debt.

Marketable securities were reduced by almost 5.3 billion dollars in fiscal 1949, compared with 8.7 billion in the preceding year. Treasury bills in the amount of 2.2 billion dollars were redeemed for cash; one bond issue in the amount of 451 million dollars was paid off entirely; and 2.6 billion dollars in certificates, notes, and bonds which came due during the year were not exchanged for new issues. In fiscal 1949, somewhat less than 3 billion dollars of Federal Reserve-held debt was redeemed, compared with about 5 billion dollars in fiscal 1948. The decline in redemptions of Federal Reserve-held securities is indicative of the fact that the need for such anti-inflationary measures gradually disappeared during the latter part of the fiscal year 1949.

The effects of economic changes on the Government's cash operating income in fiscal 1949 are somewhat obscured by the reductions in personal tax rates, which more than offset the increases caused by the rise in personal incomes (for the fiscal year as a whole). The cash operating income, which most nearly represents the actual amount of money the Government received from the public during the year (whether assigned to a budgetary or to a trust fund account), was 41.6 billion dollars, or 3.8 billion less than in fiscal 1948. This decline can be attributed mainly to decreases in receipts from income taxes and from sales of surplus property. The lowering of personal income tax rates by Congress in the spring of 1948 reduced net tax receipts for the fiscal year by 2.3 billion dollars despite the rise in personal income. Net income tax receipts in 1949 were only 26.6 billion dollars, as compared with 28.9 billion in 1948. A reduction of 1.3 billion dollars in receipts from sales of surplus property made up most of the remaining decrease in total cash income.

Recent changes in economic conditions are clearly reflected in the Government's cash operating expenditures, the sum of all payments from the Government to the public. Government outgo increased from 36.5 billion dollars in fiscal 1948 to 40.7 billion in fiscal 1949. The major changes seem to have been in the "automatic adjusters" and in national defense, veterans' expenditures, and foreign aid expenditures. Among the "automatic adjusters" are increases in expenditures of 1.8 billion dollars by the Commodity Credit Corporation and of 0.5 billion for unemployment and old age benefits. National defense outlay increased by 0.7 billion dollars. Expenditures for veterans showed a net decrease of 0.8 billion if the drop of 1.3 billion in redemptions of armed forces leave bonds and adjusted service bonds is included; regular budgetary veterans' accounts increased, however, by 0.5 billion. Expenditures of the major foreign aid accounts, including the 3 billion dollars expended from the Foreign Economic Corporation Trust Fund, rose by 2.4 billion dollars. This was partially offset by decreases in expenditures by the Export-Import Bank and in redemptions of International Bank and Fund notes, amounting to 525 million and 800 million dollars, respectively; the net increase was therefore only 1.1 billion dollars. Finally, the "clearing account" showed a net decline of 0.9 billion dollars.

The fiscal repercussions of the current economic readjustment and the present low level of the General Fund point to the conclusion that the Treasury will find it necessary to resort to some deficit financing in fiscal 1950, unless very substantial cuts can be made in contemplated Federal expenditures.

WAR LOAN ACCOUNTS

With the growth of the Federal budget and of the public debt, transactions of the U. S. Treasury Department have become one of the dominant factors in the money market. Not only are the amounts currently raised from the public and subsequently returned to the income stream very considerable, but the timing of some Government receipts (such as income taxes) is such as to cause, periodically, temporary drains on bank reserves. Some types of Federal expenditures, on the other hand (such as interest payments on the public debt), add considerable sums to bank reserves in certain weeks.

In order to minimize the disruptive effects that Treasury operations might have on the money market, the Federal Reserve System and the Treasury Department cooperated during the Second World War in making extensive use of a technical device, the War Loan account system, which had originally been employed to facilitate the financing of the first World War. Instead of permitting funds to flow directly into and out of the Treasury accounts at Federal Reserve Banks, thus alternately decreasing and increasing bank reserves in direct response to the time pattern of Government receipts and expenditures, the War Loan account system permits banks to retain temporarily a certain part of Treasury receipts, thus easing the pressure on reserves. Reserves can thus be withdrawn from the banking system at times when the net effect of Treasury operations would otherwise be to return funds to the money market, rather than to withdraw them. The War Loan account system has thus gradually evolved into a useful and flexible tool for facilitating control of the money market. The system makes it possible not only to distribute more evenly over time the impact of the bunching of Treasury receipts and expenditures, but it can also be used to a certain extent as a means of monetary control by increasing and decreasing bank reserves. While the manipulation of War Loan accounts has definite limitations, it can nevertheless be applied effectively, even in periods of budgetary deficits.

War Loan accounts are Treasury accounts at commercial banks that qualify as "special depositaries." Upon pledging certain specified securities as collateral and upon recommendation of the Federal Reserve Bank in its district, any incorporated bank or trust company may be designated by the Secretary of the Treasury as a special depositary. On June 30, 1948, there were 10,722 special depositaries in the United States. They were divided into two classes, depending on the amount of deposits held.[1] At present, deposits in War Loan

[1] "Group A" banks are those having War Loan account balances of $100,000 or less, and "Group B" those carrying more than $100,000 (as of the close of business September 25, 1948). Calls on banks in Group B are made on relatively short notice, and more frequently than the calls on banks in Group A. Withdrawals are expressed as a percentage of the total balances at a given date.

accounts are built up from the sales proceeds of Savings bonds and Savings notes and from withheld tax collections, to the extent that commercial banks do not transfer receipts from these sources directly to the Federal Reserve Banks.

This system of "special depositaries" originated during the first World War. The First Liberty Loan Act of 1917 authorized banks purchasing Government securities (issued under terms of that Act) for their own or their customers' accounts to make payment for such securities by crediting the amount of the subscriptions to special accounts designated "War Loan accounts." Several provisions made the holding of War Loan deposits attractive to commercial banks. From the time of their inception until 1935, War Loan deposits were exempt from reserve requirements. While the banks holding War Loan account deposits were originally required to pay interest to the Treasury, the stipulated rate of 2 per cent was considerably lower than prevailing market rates. The interest rate was lowered in the early 1930's and was eliminated entirely, along with interest payments on other demand deposits, under the provisions of the Banking Act of 1933. War Loan accounts were not very active during the thirties, as receipts from the sale of marketable securities were then relatively small. During the interwar period the number of depositary banks declined sharply.

At the beginning of the national defense program (in 1941), in order to encourage more banks to apply for special depositary status, the Treasury made available to War Loan account banks a special issue of nonmarketable bonds, the 2 per cent depositary bonds, whose yield was higher than that of many other Government securities available to the banks. As the Treasury's needs for banking facilities expanded greatly during the war, a further encouragement to banks to open War Loan accounts was given in 1943 by suspending again, for the duration of the war plus six months, reserve requirements against War Loan deposits and insurance assessments on such deposits for the Federal Deposit Insurance Corporation. Thus when banks subscribed to Government securities for their customers' accounts, their regular deposits decreased and their reserve requirements declined, although their total deposits remained unchanged.

Even though reserve requirements and insurance assessments have been reimposed, banks have continued to maintain War Loan accounts. It is still profitable to retain such accounts, although the advantages accruing to depositary banks are not so marked as during the war period. The War Loan deposits are not drawn down and reserves are not lost until the Treasury withdraws funds to meet its current expenditures. When banks subscribe for their own account, they receive interest from the time of the purchase of securities and do not lose funds until the Treasury makes withdrawals from the War Loan account.

During both World Wars the use of the War Loan accounts in paying for new issues of Government securities provided an effective mechanism for smoothing the impact of Government financial operations in the banking system. To the extent that this method of payment for Government securities was utilized, total bank reserves were not immediately reduced when new Government securities were issued. As calls for repayment of the War Loan deposits were issued to provide the Treasury with funds to meet expenses, roughly corresponding amounts of Government checks were deposited with the banking system. The amount of War Loan withdrawals and of new deposits did not necessarily balance, even roughly, for each individual bank. Nevertheless, if the banks made adequate use of this procedure, they could to a large extent prevent any unusual disturbances to their reserve positions during times when the Government sold securities in large volume, as during the War Loan drives of World War II.

If the special depositary system had not existed, there would have been periodic, heavy drains on bank reserves during times of heavy Government financing, followed by large gains of reserves, with disruptive effects on the economy and particularly on the Government bond market. If the banks had had to pay for securities purchased for their customers' and their own accounts by drawing down their reserves, the Federal Reserve System would have had to extend credit to them in order to prevent widespread liquidation of Government securities. Then, as the proceeds of the securities were spent by the Government, they would have been deposited in the banks by the latter's customers, and thus bank reserves would have been built up again. The Federal Reserve System would then have had to sell securities to the banks in order to absorb the resulting excess reserves.

Since the end of World War II the Treasury has not been a net borrower in the market, but it has continued to sell substantial amounts of Savings bonds and notes. Most of the receipts from the sale of these securities are channeled through War Loan accounts. Disruptive effects on deposits and reserves resulting from seasonal movements in sales of Savings bonds and Savings notes that are unrelated to the needs of either the Treasury or the money market are thus ironed out through the operation of the War Loan accounts. The Treasury still maintains a large portion of its balances in commercial banks throughout the country in order to keep the flow of reserves and deposits out of and into the banks as smooth as possible. In fact, the Treasury has been expanding the use of the War Loan accounts. Starting in March 1948, banks were permitted to credit to the War Loan accounts their receipts of withheld income taxes, which formerly they had had to turn over to the Federal Reserve Banks as soon as the amount in their (separate) withheld tax account reached \$5,000.[2] This change added almost 5 billion dollars in 1948 to the credits to War Loan accounts arising from book credit sales of Savings bonds and notes (amounting to 7.8 billion dollars). In the first six months of 1949, deposits from withheld taxes were almost half of the total credits to the War Loan accounts. Another source of funds for War Loan accounts

2 For a discussion of the operation of withheld tax accounts, see the *Review* of August 1, 1943.

will be added in the early part of 1950, when banks will have the option of crediting Social Security tax receipts to these accounts.

The planned timing of withdrawals from the War Loan accounts has been used extensively in recent years in connection with the anti-inflation and debt retirement programs. In making calls on these accounts, the Treasury considers not only its needs for funds, but also the effect such withdrawals have on the money market. Depending on the policies the monetary authorities are pursuing, the amount of calls can be increased or decreased, and the dates of payment can be postponed or advanced in order to regulate the time distribution of net Treasury cash receipts or expenditures. Rising Treasury balances at the Federal Reserve Banks, of course, cause a drain on bank reserves, as does the retirement of Federal Reserve-held debt through the use of War Loan account withdrawals. On the other hand, net Treasury expenditures add to bank reserves unless they are made for the retirement of System-held securities. If other money market factors are likely to cause pressure on the market, a contemplated withdrawal from the War Loan accounts might be postponed so as not to drain away still more reserves from the banks. Rather than schedule a call that might cause a severe tightening of the money market, the Treasury may permit its balance at the Federal Reserve Banks to fall.

The level around which the Treasury's balance at the Reserve Banks is maintained obviously affects the commercial banks' reserves. By maintaining more than a comfortable working balance (say, between 1.5 and 2 billion dollars), some reserves are in effect frozen. If the other money market factors are expected to supply banks with excess reserves, the Treasury may schedule a call larger than actually needed to cover its expenditures. In this way, net Treasury receipts drain away some of the gains from other factors.

In 1948 almost 12 billion dollars was withdrawn from the War Loan accounts, and over 7 billion was called during the first six months of 1949. Starting in early 1949, calls were timed to help the monetary authorities maintain a policy of neutrality in regard to the money market. They were scheduled so as to counteract the effect on the market of changes in the amount of float, currency circulation, required reserves, and net foreign account operations.

Now that total Treasury balances have fallen to such an extent that deficit financing will have to be resorted to in fiscal 1950, the possibilities for using calls as a device controlling money market conditions will be more restricted. The Treasury may have to withdraw funds from the War Loan account rather continuously in order to meet current expenditures, without much regard to the effect of such withdrawals on the market. Currently, the limiting factor on calls is the level of balances in War Loan accounts. It is unlikely that calls would be made that would draw total War Loan account balances below 500 million dollars. If the total War Loan balances fell below half a billion dollars for a considerable period, it is probable that many banks would no longer consider it profitable to maintain the accounts. The Treasury would, therefore, lose depositaries and be deprived of the conveniences derived from them.

PROGRESS OF ECONOMIC RECOVERY IN ITALY

Almost two years have now passed since an Italian governmental committee under the chairmanship of Signor Einaudi, then Deputy Prime Minister of the Italian Government and Governor of the Bank of Italy, and now President of the Italian Republic, promulgated the stringent credit restrictions that played a major part in bringing postwar inflation to a sudden halt and thus laid the foundation for monetary and financial stability in Italy. Under these restrictions, which became effective on September 30, 1947, the banks were compelled to set aside 20 per cent of their deposits in excess of ten times their capital and reserves, or an amount equal to 15 per cent of their total deposits, whichever was smaller. These funds had to be either invested in government (or government-guaranteed) securities or deposited in an interest-bearing blocked account at the Bank of Italy or the Treasury. Moreover, 40 per cent of any increase in deposits that occurred after October 1, 1947 had to be similarly set aside, so long as the total of such "frozen" funds did not exceed 25 per cent of total deposits.

There is no doubt that since the Einaudi reform Italy's economy has made remarkable progress. Industrial activity during the winter of 1947-48 fell approximately 20 per cent as a result of the severe and painful slump that immediately followed the implementation of the credit restrictions, but by the fall of 1948 it had risen above both the prewar level and the peak level reached during the speculative boom of the preceding year. Italy's national income was about 7 per cent higher in 1948 than in 1947.

The high degree of price and wage stability in Italy during 1948 contrasted sharply with the rapid advance during most of the preceding postwar period. Following the pronounced decline in the winter of 1947, prices fluctuated within a narrow range, and after a moderate rise owing to the elimination of agricultural and other subsidies in the summer of 1948, remained during the rest of the year at a level that was about 8 per cent below the 1947 peak. Similarly, the cost of living index, after rising 55 per cent in the first ten months of 1947, fell 7 per cent during the last two months of the year and then remained remarkably stable during most of 1948. Industrial wages increased 85 per cent in 1947, but only 6 per cent in 1948.

Much of the progressive stabilization of the Italian economy during 1948 must of course be attributed to the large influx of ECA-financed goods. Italy was allotted 158 million dollars for the first three months of ERP and 510 million dollars for the fiscal year 1948-49. In 1948 actual imports of ERP goods, largely wheat, cotton, and coal, amounted to 185 million dollars.

The arrival of ECA aid brought about also a rapid improvement in Italy's international economic position; in fact, Italy was able during 1948 to add considerably to her foreign exchange reserves. This was due partly to the reduction of demand for foreign goods resulting from the ending of the inflationary boom and partly to the devaluation and de facto stabilization of the lira towards the end of 1947. Under the exchange control system in force in Italy up to November 27, 1947, all Italian recipients of foreign exchange had been required to sell half of their receipts to the exchange control authorities at a very unfavorable official rate (350 lire to the dollar beginning August 2, 1947); the other half could be sold to importers through authorized banks in a nominally free market where substantially higher rates prevailed, or could be directly used for the purchase of licensed imports within a specified period. On November 28, 1947 this system was modified to the extent that the official rate was to be adjusted each month to the average of the previous month's free market rates. Since January 1948, the government has been able, without apparent difficulty, to stabilize the "free market" rate for the dollar within a range of 572 to 575 lire, or about 20 per cent below the average of the official and free rates immediately prior to the November 1947 devaluation. Gradually the lira rates for most European soft currencies have been adjusted to the lira-dollar rate, a process that culminated in the Italo-British agreement of November 26, 1948, under which the lira-pound sterling rate was pegged to the dollar on the basis of the official pound-dollar parity of 4.03.

At the new rate, which is believed to undervalue the lira relative to most other European currencies, Italian exports expanded rapidly in 1948, their volume rising 56 per cent over the previous year and their value in dollar terms 60 per cent. Largely as a result of this expansion and of a sharp increase in emigrants' remittances and freight earnings, Italy's foreign deficit on current account fell to the equivalent of 273 million dollars, or little more than one third of the 1947 deficit.

Owing to a large trade surplus with nondollar countries and the fact that, while dollar exports rose sharply, most of the imports from the Western Hemisphere were covered by ERP and other United States aid, a striking increase in Italian gold and foreign exchange holdings occurred during 1948. Gold holdings rose 36 million dollars, dollar balances 142 million, and holdings of other currencies the equivalent of 104 million dollars.

The rapid progress in Italy's economic affairs was also reflected in a sharp decline in the budget deficit, which fell from 787 billion lire in 1947-48 to an estimated 450 billion for fiscal 1948-49. For the current fiscal year, a further reduction of the deficit to 174 billion lire is anticipated; such a deficit would represent about 2 per cent of the estimated total of goods and services available for consumption or investment in 1948.

In spite of these genuine achievements, the basic problems of Italy's economy—overpopulation, unemployment, rural poverty, and the structural unbalance in industry—remain acute. Moreover, numerous signs of economic stagnation, if not regression, have begun to appear in Italy. Industrial activity, which fell substantially during the first quarter of this year, in part because of an exceptional drought and consequent power shortage, has failed to recover significantly despite the removal of restrictions on the use of electricity. The index of industrial production of the Central Institute of Statistics dropped in April to 106 (1947=100) from 109 in March and 119 in September 1948. Italian prices during the first half of this year were soft, the wholesale index falling during the first five months about 6 per cent below the relatively stable level of the August-December 1948 period. There has also been a sharp decline in stock exchange quotations.

The slackening of the tempo of economic activity is the more regrettable since, apart from emigration, the principal means of reducing the underutilization of Italy's labor force is a sustained increase of domestic output, particularly in industries that use a relatively large amount of labor. To assimilate her fast growing manpower, Italy must expand her plant and equipment at a rapid rate. In the opinion of many observers, the present rate of capital formation in Italy is not adequate to this need. The view is widely held that Italian industry, long sheltered from competition by tariffs and by the restrictive practices that grew up during the Fascist period, and suffering from severe structural maladjustments, with a large number of units dependent on government subsidies, is not now able to produce cheaply for a mass market. Accepting this diagnosis of the position of Italy's industrial economy, a recent ECA study of Italy concludes that vigorous public action is needed to increase production and that the Italian Government should launch a coordinated public investment program in order to accelerate the expansion of industrial capacity. This view is not generally held in Italy, where influential groups feel that private initiative in this direction will become adequate and fear that any major public investment effort at this time might undermine financial stability.

Judging from the long-term program presented by the Italian Government to the Office for European Economic Cooperation, top Italian policy-makers, although not in favor of large-scale government participation in the investment effort, agree that vigorous action is needed toward improving and expanding plant and equipment. The government's plan of action for 1948-52 provides for a 40 per cent increase of industrial production over the 1938 level. The plan's industrial investment program projects a large rise in the output of electric power and substantial increases in the output of iron and zinc ores, as well as steel and pig iron. Refining capacity for mineral oils is to treble that for 1948. In the agricultural sector the plan proposes to secure by 1952-53 a 15 per cent increase in the volume of output compared with the 1934-38 level. Large irrigation and drainage schemes are to be executed within the framework of the program. Total investment requirements will be on the scale of 7½ billion dollars.

These projections are, of course, nothing more than a very tentative outline of the anticipated development of the Italian economy during the next four years. However, the sluggish performance of the economy during the last few months and the virtual absence of administrative machinery for the execution of the program raises a question as to the government's ability to achieve its ambitious targets. Certainly very little has yet been done under this program.

Quite apart from the elaboration of long-term development plans, the Italian Government is beginning to take action in special fields where the need for far-reaching reform is particularly pressing. The problem of agricultural poverty is to be tackled by a land-reform program, which was outlined by Premier de Gasperi last April. This provides for the surrender of parts of large estates to the government, which in turn will allot the land to poor peasants lacking land of their own. The 7,700 landowners likely to be affected by the redistribution measure, if it becomes law, are to be compensated partly in cash and partly in government bonds. According to tentative plans, the beneficiaries of the reform would pay in installments for the land allotted to them, and would be granted credit facilities and technical assistance for its development.

The Italian Government has also approved a law for the allocation of 70 billion lire (122 million dollars) out of the ECA counterpart fund for land reclamation, irrigation, and other improvements of Italian agriculture.

Another major weakness of Italy's economy about to be attacked is the antiquated tax system, which is highly regressive, fails to provide adequate revenue, lends itself to evasion, and, where effective, exerts disincentive effects on private investment outlay. A tax reform program, scheduled to go into effect by January 1, 1950, will reportedly provide for a more even distribution of the tax burden between rich and poor, for greater simplification and acceleration of tax assessment and collection procedures, and for unification of the various types of existing taxes on income.

Constructive though these reform programs are, substantially greater efforts towards the solution of Italy's basic economic problems appear to be necessary if political stability is to rest on more solid foundations than in the past. Existing plant and equipment and available supplies of fuel and raw materials are adequate to give work to many thousands of men who, because they are now unemployed or underemployed, are unable to cover even their most basic needs. Large amounts of labor could, for instance, be absorbed if capital were made available for the reactivation of the building industry and the provision of adequate housing—one of the most frequently cited needs of the Italian public. There is also urgent need to reorganize and rationalize the heavy industries, many of which were overexpanded in the interest of Fascist self-sufficiency. Equally urgent is the provision of modern means for raising crop yields, including better seed, insecticides, fertilizers, and machinery. Much remains to be done, by government and private enterprise alike, if Italy is to achieve the expanding economy for which the monetary reforms of 1947, and the flow of postwar aid from this country, have prepared the way.

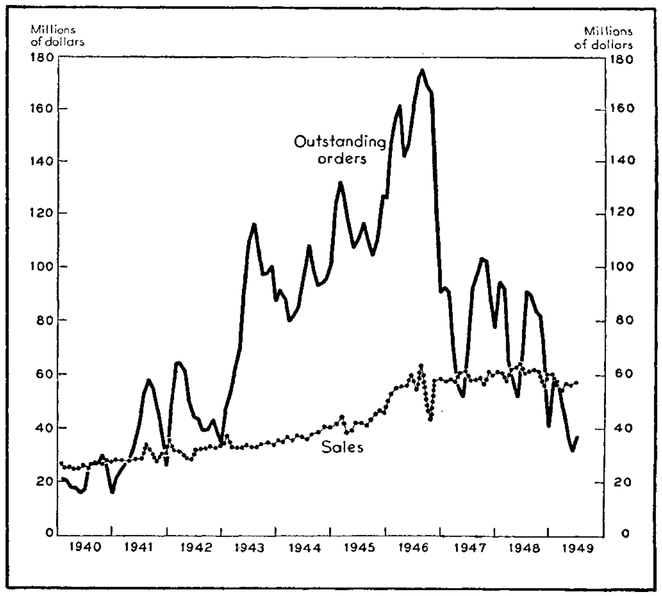
DEPARTMENT STORE TRADE

The seasonal July drop in sales at Second District department stores was greater this year than usual. According to a preliminary estimate, seasonally adjusted sales were roughly 6 per cent lower in July than in June, bringing this bank's adjusted index down to about 224 per cent of the 1935-39 average. As compared with year-ago figures, further ground was lost in July, the daily average dollar volume of business falling off as much as 14 per cent, or perhaps slightly more, whereas for the six-month period ended in June, the loss in dollar sales from last year was only 6 per cent and for June alone, 9 per cent. Since there was one more shopping day in July last year, the drop on the full month's basis was apparently in the neighborhood of 17 per cent.

Results of special sales seem, however, to indicate consumer readiness to buy even the large price tag durable goods when prices are trimmed. In the week ended July 16, for instance, coinciding with intensified promotional efforts, the floor coverings and radio-television-musical instruments departments in New York City department stores marked up sales increases of 20 and 26 per cent, respectively, from the year before. In the larger department stores in the United States as a whole, radio department sales were up 22 per cent in the same week.

The stores do not hesitate to make purchases of promotional merchandise which they can pass on to consumers at

Outstanding Orders and Sales of Second District Department Stores*
(Monthly, 1940-June 1949)



* For a group of stores whose 1948 sales equaled more than half of the estimated Second District total. Sales are seasonally adjusted monthly totals, orders are actual end-of-month data.

"bargain" prices, and consumers in turn stand ready to buy the specially priced lines. By and large, however, stores and customers alike seem to be waiting for lower prices all around.

The shortened forward buying position of department stores in this District is shown in the accompanying chart. Outstanding orders at the end of June, although seasonally up from the first of the month in view of the approaching fall season, were dollarwise fully 45 per cent less than at the corresponding time last year and amounted to only 17 selling days' supply at the June rate of sales. As a matter of fact, commitments were actually several million dollars smaller than on June 30, 1941, when both prices and sales volume were far below present levels. Thus, the outstanding orders-sales ratio for June 1949 was less than half of what it was for June 1941 and was slightly below the ratio for June 1940 as well. (Data for the years before 1940 are not available.)

Most of the remarkable improvement in the June 1949 ratio from that in 1946 (shown in the table) is of course a reflection of the great improvement in market conditions during the hectic postwar period; the change from 1948, however, is more likely the result, in the main, of deliberate curtailment of forward buying. By June of last year, when sales in the District were at a record level (seasonal factors considered) and practically all business indicators were still moving upward, the stores had already adjusted their forward positions very substantially. Prospects then, however, were for a sustained level of sales, if not a further increase, and hence outstanding orders were still somewhat high. As a result of the past months of lagging sales, however, the stores have brought orders down to an unusually low level, both absolutely and in relation to sales.

Partly as a result of this tightly controlled order level and partly because of lower prices, the dollar volume of stocks in Second District department stores was 9 per cent smaller at the end of June than one year previous. Seasonally adjusted stocks stood at 218 per cent of the 1935-39 average level, the lowest since September 1947.

Orders-Sales Relationships
Second District Department Stores*

June of selected years	As per cent of sales during month	
	Outstanding orders at end of month	New orders placed during month
1940	71	89
1941	158	122
1946	293	128
1947	121	108
1948	110	105
1949	67	84

* For the same group of stores as in the chart.

Indexes of Department Store Sales and Stocks
Second Federal Reserve District
(1935-39 average=100 per cent)

Item	1948	1949		
	June	April	May	June
Sales (average daily), unadjusted	247r	237	230	224
Sales (average daily), seasonally adjusted	262	242	239	238
Stocks, unadjusted	227r	237	227	206
Stocks, seasonally adjusted	241	230	224	218

r Revised.

Department and Apparel Store Sales and Stocks, Second Federal Reserve District, Percentage Change from the Preceding Year

Locality	Net sales		Stocks on hand June 30, 1949
	June 1949	Jan. through June 1949	
Department stores, Second District	− 9	− 6	− 9
New York City	−11	− 8	−11
Northern New Jersey	− 9	− 7	− 8
Newark	−10	− 8	− 8
Westchester County	− 3	+ 6	+ 3
Fairfield County	− 3	− 7	− 6
Bridgeport	− 3	− 8	− 7
Lower Hudson River Valley	− 3	− 5	− 5
Poughkeepsie	− 5	− 3	− 7
Upper Hudson River Valley	− 6	0	−15
Albany	−11	0	−21
Schenectady	+ 1	+ 1	− 5
Central New York State	− 9	− 7	− 6
Mohawk River Valley	−14	− 9	−10
Utica	−15	− 7	−12
Syracuse	− 7	− 6	− 4
Northern New York State	− 6	− 7	−13
Southern New York State	− 6	− 7	− 9
Binghamton	− 6	− 7	−10
Elmira	− 3	− 7	−12
Western New York State	− 6	− 2	− 7
Buffalo	− 3	+ 1	− 6
Niagara Falls	−13	− 2	−10
Rochester	−13	− 7	− 7
Apparel stores (chiefly New York City)	− 9	− 7	− 7

Indexes of Business

Index	1948	1949		
	June	April	May	June
Industrial production*, 1935-39 = 100 (*Board of Governors, Federal Reserve System*)	192	179	174	169p
Electric power output*, 1935-39 = 100 (*Federal Reserve Bank of New York*)	246	256	253	256p
Ton-miles of railway freight*, 1935-39 = 100 (*Federal Reserve Bank of New York*)	206	182	179p	
Sales of all retail stores*, 1935-39 = 100 (*Department of Commerce*)	337	333	332	329p
Factory employment				
United States, 1939 = 100 (*Bureau of Labor Statistics*)	158	148	145	145p
New York State, 1935-39 = 100 (*NYS Div. of Placement and Unemp. Ins.*)	123	113p	110p	108p
Factory payrolls				
United States, 1939 = 100 (*Bureau of Labor Statistics*)	359	336	329p	
New York State, 1935-39 = 100 (*NYS Div. of Placement and Unemp. Ins.*)	283	258p	251p	248p
Personal income*†, 1935-39 = 100 (*Department of Commerce*)	311	310	309p	
Composite index of wages and salaries*‡, 1939 = 100 (*Federal Reserve Bank of New York*)	189r	197	198p	
Consumers' prices, 1935-39 = 100 (*Bureau of Labor Statistics*)	172	170	169	170
Velocity of demand deposits*, 1935-39 = 100 (*Federal Reserve Bank of New York*)				
New York City	96r	103	107	103
Outside New York City	88	88	89	86

* Adjusted for seasonal variation. p Preliminary. r Revised.
† Revised beginning January 1942.
‡ A monthly release showing the 15 component indexes of hourly and weekly earnings in nonagricultural industries computed by this bank will be sent upon request. Tabulations of the monthly indexes, 1938 to date, may also be procured from the Research Department, Domestic Research Division.

NATIONAL SUMMARY OF BUSINESS CONDITIONS

(Summarized by the Board of Governors of the Federal Reserve System, July 27, 1949)

Industrial output declined further in June. Department store sales declined somewhat more than usual in this period, while sales of automobiles were maintained in record volume. Construction contract awards increased further. Prices of basic commodities showed some recovery from mid-June to mid-July; the average level of all wholesale commodity prices showed little change.

Industrial Production

The Board's seasonally adjusted index of industrial production in June was 169 per cent of the 1935-39 average—3 per cent lower than in May and 13 per cent below the postwar peak level reached in October and November 1948. The decline in June reflected mainly further curtailment of output in most durable goods industries and a marked decline in activity in the coal mining industry. Production of nondurable goods as a group was maintained at the reduced levels prevailing in April and May.

Iron and steel production decreased sharply in June and declined further by mid-July. Output of open hearth steel in June was at 85 per cent of capacity, while electric steel output, following a decline of one third from the reduced May level, was at 39 per cent of capacity. Activity in most machinery industries was curtailed further in June. Production of lumber and of stone, clay and glass products remained about 11 per cent below last year's level. Output of passenger automobiles, which had been reduced in May by a labor dispute at the plants of a major producer, increased considerably in June and was at a new high rate in mid-July.

Activity in the textile industries increased somewhat in June from the very low levels reached in May. Output of apparel wool textiles showed a further recovery from the April low point. Production of manufactured foods rose slightly in June. Newsprint consumption, however, decreased from the record May rate, and activity at petroleum refineries and chemical plants also declined somewhat.

Minerals production decreased in June reflecting largely a marked reduction in coal output as a result of a work stoppage and the beginning of the annual vacation period. Coal output remained at a low level in July with most mines operating three days a week. Production of crude petroleum was curtailed slightly in June and somewhat more in early July.

Construction

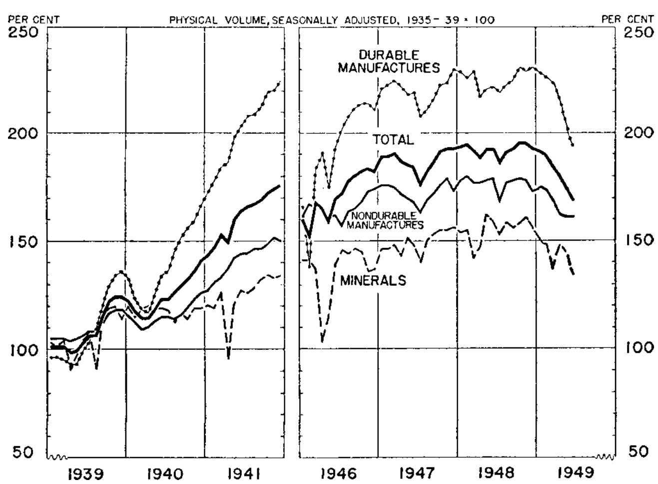
Value of construction contracts awarded in June, according to the F. W. Dodge Corporation, increased further to 946 million dollars as compared with 880 million in May and 935 million in June 1948. The increase reflected chiefly a further rise in awards for private residential work and an expansion in awards for public utility construction. The number of new housing units started in June totaled 100,000, according to the Bureau of Labor Statistics. This was 5,000 more than in May and equal to the postwar high reached in May 1948.

Distribution

Value of department store sales showed somewhat more than the usual seasonal decline in June and the Board's adjusted index was estimated to be 284 per cent of the 1935-39 average, as compared with 292 in May and 307 in June of last year. Sales in the first half of July remained near the June level, after allowance for the usual seasonal changes.

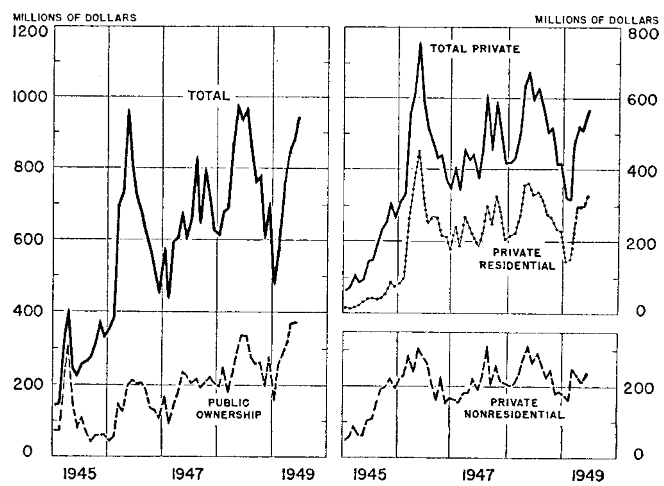
Railroad revenue freight shipments decreased further from May to mid-July. In addition to marked reductions in the volume of coal loadings, shipments of various other industrial goods were in smaller volume than in earlier months.

INDUSTRIAL PRODUCTION



Federal Reserve indexes. Monthly figures; latest shown are for June.

CONSTRUCTION CONTRACTS AWARDED



F. W. Dodge Corporation data for 37 Eastern States. Monthly figures; latest shown are for June.

Commodity Prices

Prices of nonferrous metals and some other industrial materials advanced from mid-June to mid-July, following sharp declines in recent months. Steel scrap prices, however, decreased further by 5 per cent. Prices of hogs and pork showed marked seasonal increases in this period, while prices of worsted fabrics, paints, and some other finished products were reduced.

The average level of consumers' prices increased slightly in June as small advances in prices of foods were partly offset by further declines in clothing and housefurnishings.

Bank Credit

Required reserves of all member banks were reduced by about 800 million dollars on June 30 with the expiration of the temporary reserve requirement authority granted to the Board of Governors by Congress in August 1948. Subsequently, during the first three weeks of July, Government security holdings at the Reserve Banks declined by about one billion dollars, reflecting sales of bills and certificates made in response to a strong market demand for these securities.

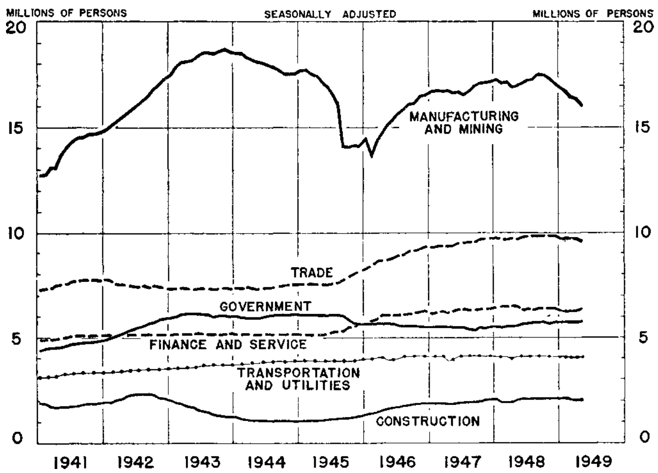
Business loans at banks in leading cities were reduced further during June and the first half of July, but the declines were somewhat smaller than in other recent months. Holdings of Government securities increased by over one billion dollars in the first half of July.

Security Markets

Shortly before the reduction in reserve requirements, the System announced a change in open market policy. These developments were reflected in sharp declines in yields on Government securities early in July. System sales of bills and certificates checked this decline, but the resulting yields were still substantially below previous levels.

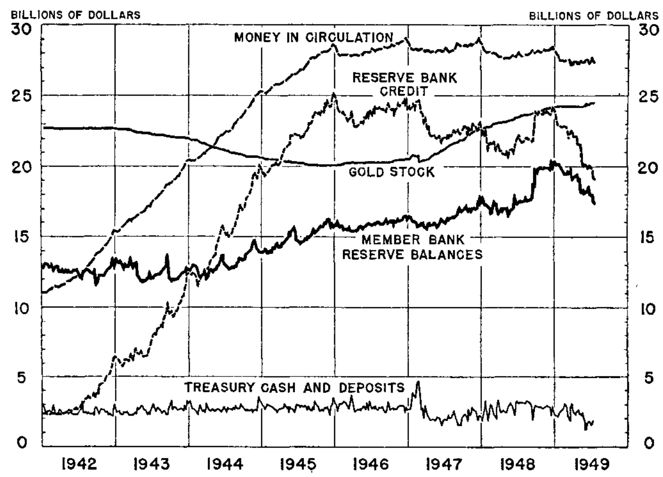
Prices of other securities—bonds and common stocks—advanced steadily in the first three weeks of July.

EMPLOYMENT IN NONAGRICULTURAL ESTABLISHMENTS



Bureau of Labor Statistics' estimates adjusted for seasonal variation by Federal Reserve. Proprietors and domestic servants are excluded. Midmonth figures; latest shown are for May.

MEMBER BANK RESERVES AND RELATED ITEMS



Wednesday figures; latest shown are for July 20.