FEDERAL RESERVE BANK OF NEW YORK

MONTHLY REVIEW

JULY 1959

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Volume 41 No. 7

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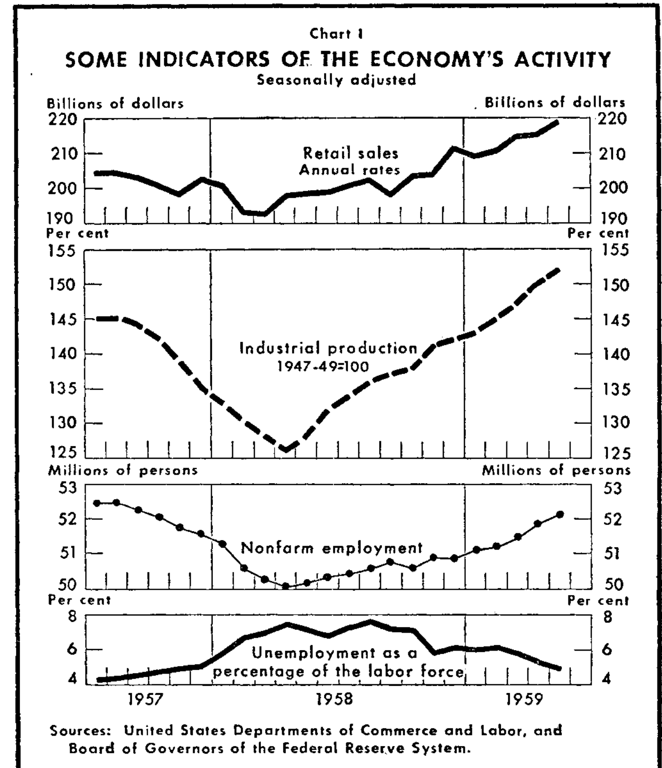
The Business Situation

Rising sales, production, and employment have carried economic activity to new records through the first half of 1959, with no evidence of any general slackening in momentum. Measures of industrial production, personal income, and retail sales all set new highs in May, and these levels appear to have been maintained or improved in June. Employment, which lagged in the earlier portion of the business recovery, has risen briskly in the past several months, while substantial progress has now been made in reabsorbing unemployed workers. Looking ahead, the latest United States Commerce Department-Securities and Exchange Commission survey suggests a firmly rising trend of business capital expenditures over the balance of this year. Broad price aggregates, meanwhile, have held about unchanged in recent months—although there is no ignoring the possibility of stronger upward pressures emerging in some lines as rapid reemployment of industrial facilities and manpower brings economic limits on capacity into sight.



Sources: United States Departments of Commerce and Labor, and Board of Governors of the Federal Reserve System.

GAINS IN OUTPUT, EMPLOYMENT, AND INCOME

The broad measures shown in Chart I dramatically attest to the economy's strength in recent months. The Federal Reserve's index of industrial production climbed another 2 points in May (seasonally adjusted) to 152 per cent of the 1947-49 average, 4 per cent above the pre-recession peak and 21 per cent above the recession low in April 1958. Recent gains have been distributed among a wide variety of industries—chiefly in durable goods manufacturing but in a number of nondurable lines as well and, most recently, in minerals. In May there were significant increases in output of machinery, automobiles, fabricated metal products, and crude oil. Production of primary metals also rose further, although steel output tended to level out after sharp advances in earlier months. This leveling-out, which continued through most of June, seemed to result essentially from economic limits on capacity and occurred despite reports of vigorous efforts by steel consumers to stockpile more of this vital commodity against the possibility of a strike. In the last week of June, steel output decreased because of sporadic work stoppages associated with the approaching contract expiration date (now postponed for two weeks to mid-July). With the sharp rise of output in steel-using industries, some observers have questioned whether stocks would be sufficient to meet an extended shutdown.

Continuing production gains have been matched by fresh advances in employment and further cuts in joblessness. Employment in nonfarm establishments, as measured by the Bureau of Labor Statistics, climbed by over 200,000 persons in May (after seasonal adjustment) following a 400,000 spurt in April (see Chart I). The largest gains recently have been in manufacturing, accompanied by further increases in the length of the workweek, while most other lines of employment have continued expanding, too. At 52.1 million in May, nonfarm employment was more than 2 million above the recession low and only about 350,000 below the pre-recession peak. The more inclusive, and differently derived, estimates of nonfarm employment by the Bureau of the Census also have shown solid increases in recent months.

Even more encouraging are the sharp cuts in unemployment in the past few months. The Census Bureau's estimate for May was that 3.4 million persons were out of work, a decline of more than 200,000 from April and of about 1½ million from the high level of a year ago. The rate of unemployment, seasonally adjusted, was 4.9 per cent in May, down from 5.3 per cent in April and at

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the lowest point since November 1957. Indeed, the level of joblessness in May was not much above the 4 to 4½ per cent range that prevailed over most of the 1955-57 period of business expansion; unemployment remains high, however, in a number of major labor market areas, especially in the Great Lakes heavy industry region, in some New England centers that are dependent on textiles, and in the mining regions of Pennsylvania and West Virginia. Across the country, the number of persons out of work for half a year or more was about 600,000 in May, a drop of 120,000 from April. This group, comprising those hardest hit by the recent business decline, was still considerably larger than before the recession.

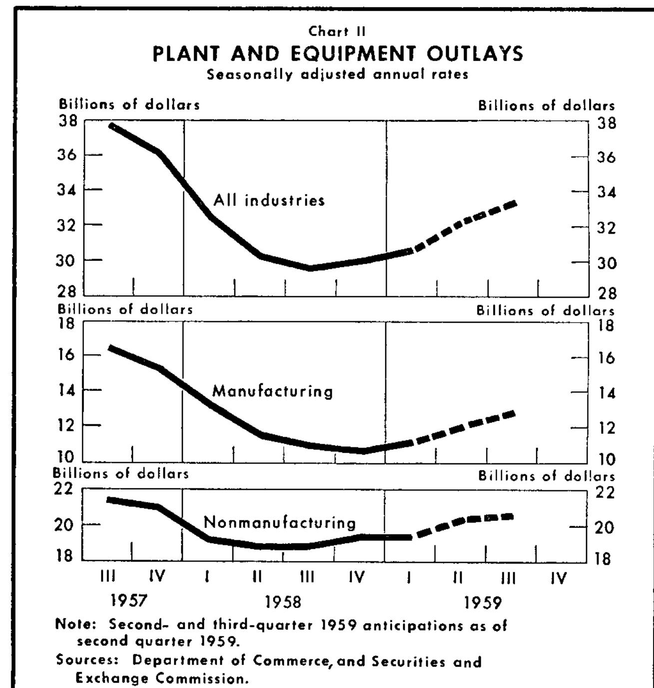
Largely because of expanding employment and longer workweeks, but reflecting higher pay rates and some other income sources as well, personal income has continued a strong upward trend. In May, the seasonally adjusted annual rate was $376 billion, up by $3 billion from April and by nearly $25 billion (7 per cent) from a year earlier. In turn, rising income has furnished the chief impetus behind expanding retail sales. Sales in May reached an estimated $18¼ billion (seasonally adjusted)—or $219 billion at an annual rate, as shown in Chart I. The annual rate of sales in May was up about $3½ billion from April and some $20 billion (10 per cent) from a year earlier. Sales of new domestic cars improved more than seasonally in May, and early reports indicate a continued good performance in June. Active department store trade in early June also points to a favorable showing for total sales in that month. In another area of consumer spending —outlays for housing—activity remains high but has not been rising further. In May, the seasonally adjusted annual rate of private housing starts slipped to 1,340,000 from 1,390,000 in the two previous months. The competing pressures for materials, manpower, and financing in other lines of activity—which have become stronger as business expansion has broadened out—make further increases above this high rate of residential construction unlikely.

The sharper relative rise in retail sales than in consumer income over the past year has been associated with greater use of consumer credit. In the first five months of this year, for example, consumer credit outstanding rose by $2.4 billion on a seasonally adjusted basis, in contrast to a decline of $0.2 billion in the same months of 1958. In May, the latest month for which figures are available, the rise was $545 million, of which $177 million was in automobile paper. The increases so far this year, averaging around $480 million, are still not up to the very rapid pace in the first three quarters of 1955, when the monthly increments averaged about $540 million. Nonetheless, viewed alongside the growth in all other kinds of credit, and particularly in bank credit as described later in this *Review,* these recent magnitudes suggest that the increases may be close to the peak rates that the economy can support if over-all growth is to continue, at a substantial and fairly regular pace.

Business investment spending has also been moving upward. Apparently stimulated by rapidly rising sales, as well as by a determination to hold down cost increases through improved efficiency, businessmen now expect to invest $32.6 billion in new plant and equipment this year, compared with outlays of $31.8 billion anticipated on the basis of a survey several months ago and actual expenditures of $30.5 billion last year. Although actual spending in the first quarter of this year fell slightly short of earlier plans, the survey made by the Commerce Department and the Securities and Exchange Commission in April and May points to a continuing upward trend in the July-September quarter, as shown in Chart II. Anticipated increases in spending center in manufacturing but extend in some degree to other lines as well, including railroads, utilities, and the broad "commercial and other" group. The latest estimate of plant and equipment outlays for the entire year, moreover, implies some further rise through the final quarter; the previous survey had suggested a leveling-off in the latter part of 1959.

Total business inventories rose by $900 million in April, after seasonal adjustment, the largest monthly increase in several years and by far the largest since the rebuilding

Chart II
PLANT AND EQUIPMENT OUTLAYS
Seasonally adjusted annual rates



Note: Second- and third-quarter 1959 anticipations as of second quarter 1959.
Sources: Department of Commerce, and Securities and Exchange Commission.

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of stocks began last November following liquidation during the recession. Most of the April increase was in manufacturers' stocks, and these holdings rose by another $400 million in May. Despite the rather substantial increases in total inventories since the low point was reached late in 1958, the ratio of total inventories to sales has dropped to the lowest point in several years because sales have been rising faster than stocks could be accumulated. Some considerable part of the April and May increases, and also of the rise that very likely occurred in June, no doubt represented a build-up of steel inventories in anticipation of a strike, although as mentioned earlier these accumulations may have been less than the steel users had hoped to achieve.

Money Market in the Second Quarter

Developments during the second quarter tended to confirm that the business expansion had entered a new phase in which credit demands, already strong, would press with sustained vigor against the available supply of loanable funds. Commercial bank loans, after a quite modest showing in the first quarter, began to increase by record amounts and, as credit policy moved into a more restrictive phase, pressures on bank reserve positions intensified. In meeting the mounting demands for new credit, banks both liquidated a large volume of securities and increased their indebtedness to the Reserve Banks. And on May 15, following a round of increases in several short-term money market rates, major banks throughout the country announced an increase to 4½ per cent from 4 per cent in their prime loan rate. The shift in credit policy during the quarter was reflected both in discount rates and in member bank borrowing. Between May 29 and June 12, all twelve Federal Reserve Banks lifted their discount rates to 3½ per cent from 3 per cent, while in June net borrowed reserves averaged close to $500 million.

The Treasury, faced on the one hand with an unusually heavy financing schedule for this period and on the other with strong competition in the market for funds, confined its operations largely to the short-term sector. Interest rates rose sharply and most long-term rates reached their highest levels of the postwar period. By mid-June, however, bond prices steadied, and during the remainder of that month fluctuations were relatively minor.

COMMERCIAL BANK CREDIT

Preliminary data for all commercial banks indicate that the loan increase in May was of record size for the second straight month. The total $3 billion expansion during April and May compares with a previous high for these two months in 1955 that was only about one half as large. Moreover, data for weekly reporting banks suggest that the loan advance has continued in the first three weeks of June, with particular strength in the business loan category which had been relatively sluggish during the first quarter of the year. Business loans, which typically rise sharply during these weeks because of tax borrowing, rose by $1.0 billion at the reporting banks this year (see Table I), compared with an increase of $0.7 billion in the same weeks of June 1955 when the previous business expansion was in a roughly comparable stage.

The sharp expansion in bank loans during the second quarter occurred despite indications that member banks were less liquid than during similar phases of earlier business expansions. One commonly used measure of bank liquidity (or, more accurately, bank illiquidity) is the ratio of loans to deposits, which reached a level in May equal to or slightly higher than the previous postwar high of 53 per cent attained in October 1957.[1] It is possi-

[1] The May 1959 figure is a preliminary estimate, and is here being compared with earlier figures derived from the quarterly *Member Bank Call Report.*

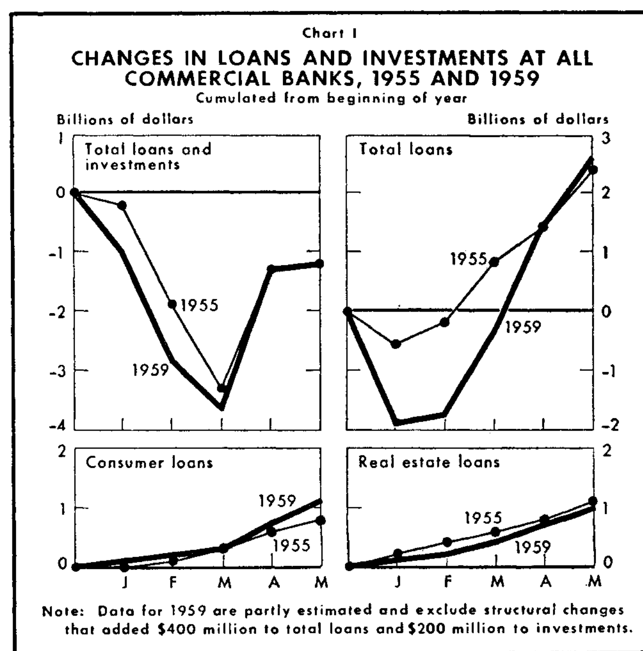


Table I
Changes in Principal Assets and Liabilities of the Weekly Reporting Member Banks
(In millions of dollars)

Assets	Statement week ended 1959 June 3	1959 June 10	1959 June 17	1959 Three weeks ended June 17	1955 Three weeks ended June 15
Loans and investments:					
Loans:					
Commercial and industrial loans	− 40	+ 233	+ 779	+ 972	{+ 714
Agricultural loans	− 10	+ 9	+ 7	+ 6	
Securities loans	+ 71	+ 13	+ 24	+ 108	+ 191
Real estate loans	+ 14	+ 49	+ 59	+ 122	+ 111
All other loans (largely consumer)	+ 48	+ 64	+ 118	+ 230	+ 148
Total loans, adjusted*	+ 83	+ 366	+ 988	+1,437	+1,162
Investments:					
U. S. Government securities:					
Treasury bills	− 53	− 6	− 177	− 236	+ 79
Other	− 127	− 79	− 204	− 410	− 533
Total	− 180	− 85	− 381	− 646	− 454
Other securities	− 55	− 33	− 78	− 166	+ 21
Total investments	− 235	− 118	− 459	− 812	− 433
Total loans, adjusted,* and investments	− 152	+ 248	+ 529	+ 625	+ 729

* Exclusive of loans to banks and after deduction of valuation reserves; figures for the individual loan classifications are shown gross and may not, therefore, add to the totals shown.

ble, however, that loan demands in 1959 have been concentrated at banks with relatively high liquidity. Most measures of liquidity suggest, for example, that the central reserve city banks, which have not participated in this year's loan expansion to any great extent, are less liquid than the reserve city and country banks.

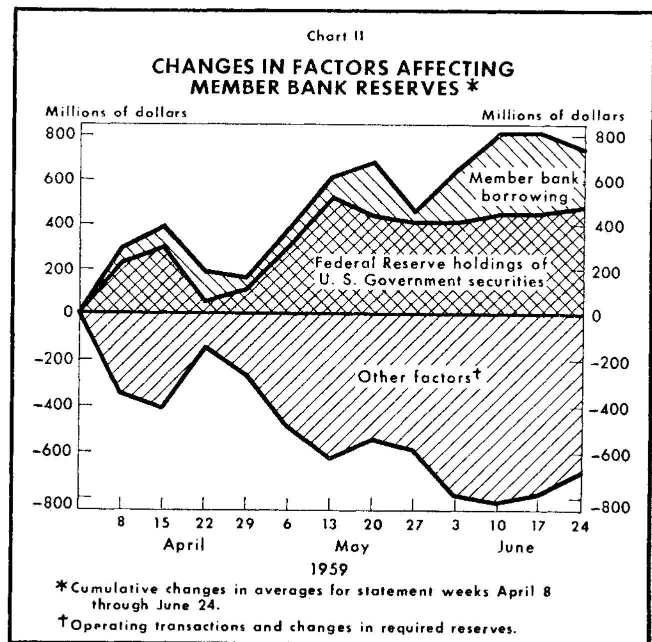
The composition of the loan increase so far this year by broad categories of borrowers has been quite similar to that of the 1955 business expansion (see Chart I). In the first five months of both 1959 and 1955, consumer and real estate loans accounted for a substantial part of the loan expansion, a reflection of the strength in residential construction and purchases of consumer durables during this stage of business upswings. Business loans over the five months did not increase so much in 1959 as in 1955 because of a slow first quarter, but in April and May the advance was about the same as in 1955. However, the seasonal decline in agricultural loans was considerably larger in the earlier period. Data on the weekly reporting banks for the first three weeks of June suggest that these broad tendencies have continued.

Chart I indicates that the pattern of change in total loans and investments also has corresponded closely to 1955. Over the first five months, total bank credit declined by about $1.2 billion in both years. Liquidation of securities, which is normal for this season, was unusually large in these years both because of strong loan demands, which created pressure for liquidation, and a strong nonbank demand for money market investments from corporations with large temporary cash accruals. The decline in bank holdings of securities has not been much greater in 1959 than in the earlier period, even though reserve positions have been statistically tighter this year.

The growth in the seasonally adjusted money supply (demand deposits adjusted plus currency outside banks) during the first five months of 1959 fell within the range of experience in other recent years. The annual rate of increase of about 2.7 per cent compares with increases of 4.1 per cent and 4.4 per cent in 1958 and 1955, and 0.4 per cent and 0.5 per cent in 1957 and 1956. The substantially smaller increase in the seasonally adjusted money supply in 1959 than in 1955, when the change in bank credit was about the same, reflects the relatively larger growth in time deposits this year. Time deposits rose by about $1.4 billion in the first five months of this year, exceeding the increase during any of the years 1953-56 although falling well short of 1957 and 1958.

MEMBER BANK RESERVES

About $0.7 billion of member bank reserves was absorbed on balance during the second quarter by autonomous reserve influences and by increased required reserves (see Chart II). The principal factor draining reserves in this period was an outflow of currency into circulation, which was larger than usual for this season because of the accelerating business recovery. Reserves were also lost



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from an outflow of gold, which was, however, considerably smaller than during the same period last year. Required reserves fluctuated sharply from week to week, absorbing a moderate amount of reserves on balance over the period as a whole. As may be seen in Chart II, about two thirds of the reserves absorbed by these factors was offset by System securities purchases, but the remainder of the loss was reflected in higher net borrowed reserve figures for the banking system. To offset, temporarily, the net loss of reserves, member banks turned increasingly to the "discount window" during the second quarter, and borrowing by banks during the last statement week in June averaged $276 million higher than in the last week of March.

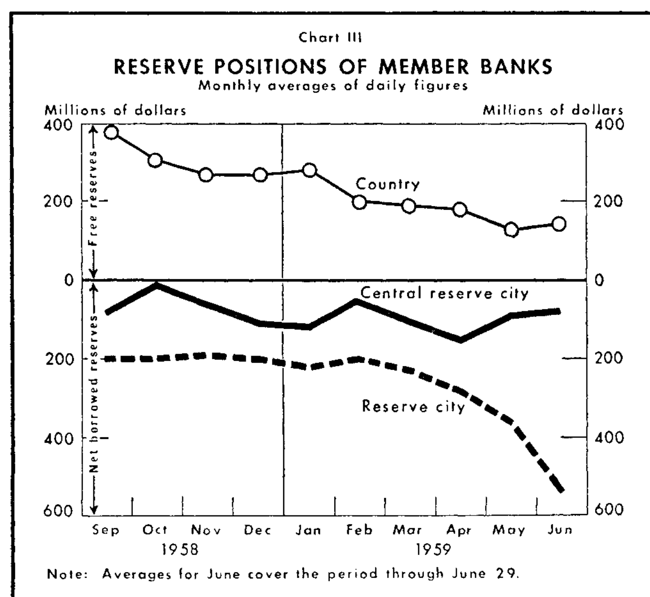
Most of the tightening in reserve positions was concentrated at the reserve city and country banks (see Chart III). Indeed, net borrowed reserves of the central reserve city banks during June were not much larger than last September, when member banks as a group had free reserves. The relatively comfortable reserve position of these banks probably reflects the fact, already noted, that they have not thus far participated in the loan expansion this year to the same extent as banks elsewhere.

On a weekly basis, the movement to a higher net borrowed reserve level for the member banking system occurred largely in the week of June 3, when reserve drains stemming mainly from currency outflow and a lower level of float were not offset by open market operations (see Table II). In the two following statement weeks, net borrowed reserves averaged $500-550 million but declined to $379 million in the final June week, mainly as a result of an unexpectedly large expansion of float. Changes in Federal Reserve holdings of Government securities were small during these three weeks, since net changes in the other factors influencing reserve balances were partly offset by changes in required reserves. For the four weeks ended June 24, net borrowed reserves rose to an average of $489 million from $318 million the previous month. The average level of borrowing from the Reserve Banks rose from $767 million in May to $920 million, the highest point since September 1957, while average excess reserves declined slightly to $431 million.

Table II
Changes in Factors Tending to Increase or Decrease Member Bank Reserves, June 1959
(In millions of dollars; (+) denotes increase, (—) decrease in excess reserves)

Factor	Daily averages—week ended				Net changes
	June 3	June 10	June 17	June 24	
Operating transactions					
Treasury operations*	+ 2	+ 64	+ 47	+ 16	+ 129
Federal Reserve float	− 87	− 79	+ 255	+ 227	+ 316
Currency in circulation	− 168	− 162	− 74	+ 63	− 341
Gold and foreign account	− 16	− 10	− 4	− 143	− 173
Other deposits, etc.	+ 12	+ 13	− 5	—	+ 20
Total	− 258	− 175	+ 220	+ 164	− 49
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	—	+ 34	+ 5	− 8	+ 31
Held under repurchase agreements	—	—	—	+ 34	+ 34
Loans, discounts, and advances:					
Member bank borrowings	+ 191	+ 130	− 3	− 100	+ 218
Other	—	—	—	+ 1	+ 1
Bankers' acceptances:					
Bought outright	− 1	—	—	—	− 1
Under repurchase agreements	—	—	—	—	—
Total	+ 189	+ 165	+ 3	− 74	+ 283
Total reserves	− 69	− 10	+ 223	+ 90	+ 234
Effect of change in required reserves†	+ 51	+ 113	− 179	− 66	− 81
Excess reserves†	− 18	+ 103	+ 44	+ 24	+ 153
Daily average level of member bank:					
Borrowings from Reserve Banks	849	979	976	876	920‡
Excess reserves†	326	429	473	497	431‡
Net borrowed reserves†	523	550	503	379	489‡

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† These figures are estimated.
‡ Average for four weeks ended June 24, 1959.



GOVERNMENT SECURITIES MARKET

Treasury debt operations during the second quarter added roughly $4½ billion to the supply of marketable obligations, thus contributing to upward pressures on Government securities yields during this period. Moreover, other demands upon the capital markets, particularly by State and local governments and by mortgage borrowers, were sustained at record or near-record levels. In addition, growing statistical confirmation that the pace of the business expansion was accelerating gave rise to expecta-

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tions that credit conditions would tighten further as credit demands by business, which had been relatively slack through the first quarter, were added to the already heavy demands of consumers, home buyers, and all levels of government. The developing strength of business loan demands in the second quarter, and the coincident and related tightening of bank reserve positions discussed above, tended to confirm these expectations.

Between March 19—when the Treasury announced the terms of the first of two major financings which influenced the market during the second quarter—and June 30, prices of coupon-bearing longer term Government obligations declined by about 3½ points and yields rose throughout the entire range of maturities. Over this period, rates rose by about ½ of 1 per cent on Treasury bills and other issues due in five years or less, and by about 20 basis points on long-term bonds. At the end of June, the average yield on long-term bonds was 4.11 per cent, while three- and six-month Treasury bill issues yielded 3.14 per cent and 3.67 per cent, respectively.

During a large part of the period, market yields on many Treasury bonds were above the 4¼ per cent statutory limitation on the coupon rates that can be set on these securities. This circumstance, and the rather unsettled condition of the intermediate and longer term markets as the yield advance took place, made it difficult for the Treasury to undertake anything but short-term financing. The first of two major financing operations, described in detail in the April issue of this *Review,* came at the end of March but its effect on the market carried over into the second quarter. In this financing, the Treasury auctioned $2.0 billion of special 289-day Treasury bills and offered $1.5 billion of 4 per cent four-year notes plus an additional $500 million of the 4 per cent bonds of October 1, 1969, originally issued in October 1957. All three issues were for cash and were eligible for payment by credit to Treasury Tax and Loan Accounts at commercial banks. Although the two coupon obligations were oversubscribed, allotments were relatively high. Allotments of the notes were 50 per cent of the amount subscribed, while on the bonds, which were intended primarily for savings-type investors, allotments amounted to 65 per cent for these investors and an unexpectedly high 35 per cent for commercial banks.

In the other financing operation of the quarter, the Treasury replaced $4.5 billion of securities due on May 15 with roughly $4.8 billion of new securities, all with maturities of one year or less. These included two special bills sold for cash at auction, totaling $3.5 billion, and a one-year certificate offered in exchange for $1.8 billion of maturing certificates. One of the special bills, a 340-day issue carrying the Tax and Loan feature, attracted sizable bidding by commercial banks. However, tenders for the subsequent bill offering, a 221-day tax anticipation issue without the Tax and Loan feature, barely covered the offering. Attrition on the exchange offering amounted to almost one third of the outstanding issue.

The peak for yields on long-term Governments was reached in the first week of June. Subsequently, the market firmed somewhat in response to a modest revival of investment demand and some professional short-covering activity, and over the balance of June these rates fluctuated narrowly and irregularly. On intermediate issues, however, yield increases continued through much of June.

Market rates on both three- and six-month Treasury bills increased sharply in early April after having held generally steady in the first quarter. Following this initial rise, yields on the shorter issues moved down to their former level by mid-May, but yields on longer issues remained higher, reflecting the influence of the additional market supply of one-year maturities resulting from the Treasury's May 15 refunding. During June, rates on shorter bills jumped sharply at the start of the month, in adjustment to the discount rate increase, but declined later in response to a sustained nonbank demand (stemming partly from the reinvestment of the proceeds of cash redemptions of the matured June 22 tax anticipation bills) and the developing scarcities of some issues. In contrast, market rates on longer bills rose less sharply in early June but advanced again toward the end of the month, partly reflecting the approach of the Treasury cash financing in July.

In the regular weekly auctions of June, the three-month Treasury bills were awarded at average issuing rates of 3.149 per cent on June 1, 3.283 per cent on June 8, 3.276 per cent on June 15, 3.281 per cent on June 22, and 3.164 per cent on June 29, compared with 2.878 per cent on May 25. The six-month bills were sold at 3.489 per cent, 3.565 per cent, 3.486 per cent, 3.585 per cent, and 3.703 per cent in the respective auctions, compared with 3.373 per cent in the last May auction.

After the close of the market on Thursday, June 25, the United States Treasury Department announced a $5 billion cash financing for early July. Tenders will be received on July 1 for $3 billion of 258-day tax anticipation bills to be dated July 8 and to mature March 22, 1960, and on July 8 for $2 billion of one-year bills to be dated July 15 and to mature July 15, 1960. Payment for both issues may be made by credit to Treasury Tax and Loan Accounts.

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OTHER SECURITIES MARKETS

The volume of new corporate and tax-exempt bond issues totaled about $3.1 billion in the second quarter of 1959, higher than the $2.7 billion total for the previous quarter but less than the $3.4 billion in the second quarter of 1958. The shrinkage from year-ago volume occurred entirely in corporate financing. Total corporate bond issues for new capital purposes amounted to an estimated $905 million, compared with $755 million in the first quarter of 1959 and $1.4 billion in the second quarter of 1958. Tax-exempt bond issues, on the other hand, rose to a record quarterly high of $2.2 billion from $1.9 billion in both the first quarter of 1959 and the second quarter of 1958.

Although corporate bond financing fell off, new issues of common stock rose to an estimated $550 million for the quarter, continuing the advance which has taken place since the early fall of 1958. The tendency for offerings of new equity securities to increase may be related in part to the unusually low level of stock yields. The average dividend-price ratio on industrial common stocks has been below yields on the highest quality corporate bonds since August 1958, and the differential has widened almost steadily since that date.

During the second quarter of 1959 the widening of the yield differential between common stocks and high-grade corporate bonds reflected mainly a rise in bond yields. The average yield on Moody's index of Aaa seasoned corporate bonds advanced from 4.15 per cent on March 31 to 4.46 per cent at the end of June, and from 3.06 per cent to 3.39 per cent on Aaa municipals. In the case of tax-exempt obligations, this movement reversed a half year of almost steady decline and, in the case of corporate bonds, six months of relative stability. The yield increases on both types of issues were larger than those on long-term Treasury issues, but yields on the latter obligations had been trending upward since the spring of 1958.

A number of new corporate and tax-exempt bond issues marketed during the quarter were sold out rapidly, but largely as a result of a steady advance in reoffering yields and increasingly large spreads over yields on outstanding issues. Thus, at least three Aa-rated long-term corporate issues in the $50-75 million size-range were enthusiastically received by investors during the period; the first of these was offered on April 1 at a yield of 4.35 per cent, while the other two, sold at the end of May and in early June, provided returns of 5.05 per cent and 5 per cent, respectively. With the prevailing outlook for higher interest rates, corporate offerings priced closely to the market generally were not well received; in many instances in which underwriting syndicates were terminated with unsold balances, substantial price concessions were made. Dealers in tax-exempt bonds also cut prices in order to reduce mounting inventories, especially toward the middle of the quarter. Nevertheless, with the persistent heavy calendar of new offerings, these efforts were only partly successful, and a rather weak tone persisted through most of June.

On short-term debt instruments, rate increases during the quarter were in the neighborhood of ½ of 1 per cent, in line with the rate advance on short-term Treasury issues. Dealers in commercial paper raised their offering rates by ⅛ per cent on four occasions, the first on April 21 and the last on June 9; following the last increase, the offering rate on prime four- to six-month maturities was 3⅞ per cent. Similarly, four successive rate increases of ⅛ per cent on bankers' acceptances between April 14 and June 16 brought dealers' bid and offered rates on 90-day unindorsed acceptances to 3½ and 3⅜ per cent, respectively. Rates on directly placed paper of large sales finance companies were raised in several stages by a total amount of ½ per cent between April 21 and June 18, after which the rate on 60- to 89-day paper stood at 3½ per cent.

International Financial Developments

STOCK MARKET DEVELOPMENTS ABROAD

Rising prices and declining yields have characterized the major stock markets abroad during the past year or so, as public interest in equities has broadened. The timing and the extent of the price advance have of course varied in the different markets. In some of these, price indexes for common stocks in the spring of 1959 were still somewhat below their previous highs, while in others the indexes reached record levels. The rise has been particularly marked in West Germany, where stock prices have almost doubled over the past two years, and in the Netherlands, where quotations have risen some 65 per cent since the end of 1957 (see chart).

In most foreign industrial countries, the 1958-59 rise extended over virtually the entire list. Shares of large concerns with international affiliations and of companies producing consumer durable goods have been particularly

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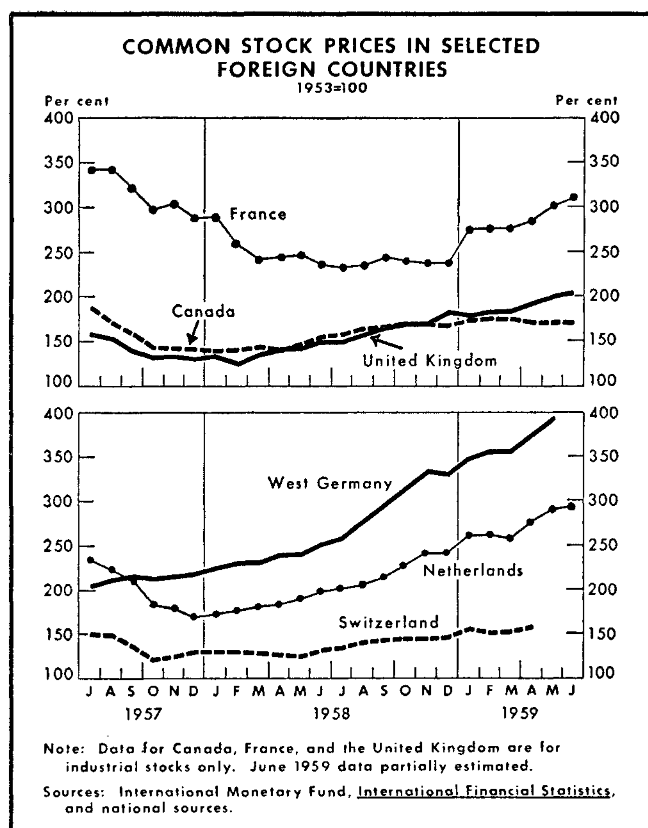

Note: Data for Canada, France, and the United Kingdom are for industrial stocks only. June 1959 data partially estimated.

Sources: International Monetary Fund, International Financial Statistics, and national sources.

strong, along with those of the chemical, electronics, oil, and capital goods industries. In some Continental countries, shares of financial institutions have also been among the leaders. At the same time, stock market turnover has increased markedly, particularly in Germany and France, and in the United Kingdom where postwar records were set in recent months.

Rising prices have generally been accompanied by declining stock yields (i.e., dividend-price ratios), even where dividend payments also have increased. The decline in yields has often been striking. In the United Kingdom, the average yield on industrial stocks dropped from 7.25 per cent in early 1958 to around 5.00 in June 1959; in the Netherlands, the average yield on all common stocks fell from 7.9 per cent at the end of 1957 to 5.3 in April 1959.[1] The decline in stock yields has brought such yields virtually down to, and in some cases even below, those on corporate bonds. In some countries, e.g., France and Germany, where stock yields have been below corporate bond yields for most of the postwar period, the existing spread has tended to widen.

[1] Yields in the United States declined from 4.6 per cent at the end of 1957 to 3.2 at the end of June 1959. For statistical and other reasons, however, stock yield data for different countries are not strictly comparable.

The advance in stock prices abroad got under way against the background of a substantial easing of credit restrictions in most foreign industrial countries. It likewise coincided with reduced fears of possible international repercussions of the 1957-58 United States recession, and with this country's subsequent economic recovery. At the same time, the external positions of most foreign industrial countries improved steadily and their gold and foreign-exchange reserves rose impressively. More recently, the rise in share prices paralleled a marked pickup in economic activity in the foreign industrial countries themselves.

In this setting, investor interest in equities was spurred by various tax measures in several countries. In the United Kingdom, these included cuts in income taxes and in the purchase tax on certain consumer durables. And in Germany a reduction was made in the corporate tax on distributed profits, along with an increase in the tax on undistributed profits. Finally, the recent strength in equity prices in some countries may be attributed in part to the thinness of their stock markets. In some of these markets, notably in Germany, new share issues have remained relatively small over the past few years, while increased purchases by institutional investors, including banks, have further accentuated the shortage in the floating supply of stocks.

Two additional factors—largely absent in earlier booms —have also influenced the recent rise in stock markets in Western Europe. One has been the investor optimism engendered by the gradual dismantling of external payments controls, the advent of convertibility, and the inauguration of the Common Market. The resultant closer linking of the major European markets has led to an increased volume of intra-European stock transactions and to the "cross-listing" of the stocks of major Common Market firms on the exchanges of other member countries. Moreover, a number of new investment trusts have been formed, e.g., in Germany and Switzerland, which will acquire shares of companies in Common Market and other European countries. American buying of European shares also has risen sharply; in New York, the first United States mutual fund to invest exclusively in Common Market securities was launched early in May 1959.

A second new factor is the general broadening and popularizing of stock ownership through the development of new methods for channeling small savings into equities. Mutual funds, which are a much more recent phenomenon in Western Europe than in this country, are currently active in at least six Western European countries, including the United Kingdom. In the latter country, additional ways of encouraging the flow of such savings into equities

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have also been introduced, including profit sharing through stock distribution to employees, the direct sale of company shares to employees in bearer form, and the extension of credit by finance companies for instalment purchases of stock. In Germany and Austria, the interest of the small investor likewise has been stimulated by the sale of "people's shares", i.e., capital stock in government-held concerns.

EXCHANGE RATES

The principally traded currencies in the New York foreign exchange market generally appreciated against the dollar during June. Spot sterling advanced, except for a brief interval on June 10 when it declined to $2.8104, and at the month end stood at $2.8132. The Canadian dollar advanced to $1.04 53/64 on June 29, the highest since September 1957, primarily as the result of offerings of new securities by Canadian municipalities in the New York market and the acquisition by a United States motor company of stock of its Canadian subsidiary; at the month end the rate was $1.04 51/64. The Swiss franc generally advanced during the month and reached $0.2321⅞ on June 30, the highest since last January.

Growth Without Inflation in Britain[1]

The problem of achieving reasonably rapid economic growth, without generating an inflation that jeopardizes prospects for further growth, has confronted not only the United States but virtually the entire world, both primary-producing and industrial countries alike. In Britain, where the problem has been given increasingly close attention in recent years, the Chancellor of the Exchequer recently observed that the reconciliation of growth with price stability is "one of the most important and intractable economic problems with which the modern world is faced". This article reviews Britain's problems in attempting to achieve this reconciliation in the past and the views of British observers as to how it might better be achieved in the future.

To an American, one of the most significant aspects of these views is the absence of any serious suggestion that "creeping inflation" holds an answer to the problem of economic growth. The pitfalls of a prolonged—even though gradual—rise in prices have become painfully clear to British observers. Price inflation has obviously not been the only factor in Britain's postwar difficulties, but it contributed to the 1949 devaluation of sterling, to the squeeze on pensioners and others with fixed incomes, to ever-increasing wage demands as workers sought to maintain the purchasing power of their incomes, to complications in the management of the government debt and consequently in the maintenance of monetary control, and to periodic bouts of speculation against sterling. The last of these speculative attacks, in August-September 1957, gained such intensity that it was stopped only by drastic fiscal and monetary measures, including the increase in September 1957 in the Bank of England's discount rate to 7 per cent, the highest since 1921. Out of this experience and the subsequent strong revival of confidence in sterling, accompanied as it has been by a degree of price stability unknown in Britain since the thirties, has come a sober discussion of the problem of achieving growth without setting off inflation. It is accepted that there is need for deeper understanding of the workings of the economy, for re-examination of existing policies, and perhaps also for the development of new techniques by which existing policies could be strengthened. The public has been encouraged to discuss the issues and to face up to hard decisions. Above all, there has come a growing recognition that the problem is tough, and persistent, and that in dealing with it there can be no easy or single answer.

BRITAIN'S EXPERIENCE BEFORE WORLD WAR II

The problem, of course, is not wholly new for Britain. Although upward pressure on prices was by no means as persistent in the interwar years as it appears to have been since World War II, the tendency for Britain's rate of economic growth to lag behind that of many other countries has long been a subject for comment. In part, this lag merely reflected a catching-up process in which other countries were covering ground already traversed by Britain in the eighteenth and early nineteenth centuries. It also reflected the inevitable adjustment of the British economy to the rest of the world's economic growth, which had been fostered by heavy British foreign investments.

[1] This is the second in a series of articles that will appear from time to time in this *Review* on the interrelations between economic growth, the general behavior of prices, and public economic policy—particularly monetary policy. The first article, entitled "Creeping Inflation", appeared in the June issue.

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Helped by these investments, foreigners adopted the techniques on which Britain's early industrial supremacy was based. The exportation of British machinery and technical know-how gradually put many of Britain's major customers in a position to supply for themselves products that formerly had been imported. Frequently the development of such competing industries overseas was fostered by tariffs and other protective devices. It thus became increasingly difficult for Britain to sell its traditional exports, and while economic growth abroad opened up new market possibilities, Britain could take advantage of these only if its management and labor remained alert and progressive in their industrial and commercial techniques.

The pace of Britain's adjustment to overseas economic change was given a serious setback by World War I and its aftermath. Overseas countries, whose access to British supplies was curtailed during the war, accelerated the development of their own resources. The need for Britain to adjust was thus increased during a period when its ability to do so was severely limited by the overriding requirements of the war and, after the end of hostilities, by the heavy taxation that was the legacy of war finance. Moreover, British industry:

> came out of the war and postwar boom in poor financial condition, and demand for its products was weak. Excess capacity, overcapitalization, heavy fixed charges made it difficult for iron and steel, cotton, coal, and shipbuilding even to set aside sufficient reserves for depreciation, let alone to finance a comprehensive program for scrapping and rebuilding. The credit of these industries was low. . . . Here was a vicious circle of competitive weakness, because of their failure to reorganize, bringing financial weakness, and financial weakness in turn making it impossible to attract the capital necessary to effect reorganization.[2]

The adjustment problem was aggravated and the resumption of growth delayed during the twenties because the authorities—being determined to restore sterling to an exchange rate at which it was overvalued in terms of other major currencies—were obliged to pursue a deflationary credit policy of a kind that has not been experienced in the United States. Only after 1931, when Britain left the gold standard, was credit policy eased. However, by that time the flexibility of the economy was being hampered by a proliferation of restrictive practices which had been adopted by both management and labor as a defense against the difficulties of the twenties, and which were to complicate further the process of growth and adjustment in the years ahead.

THE LAG IN GROWTH SINCE THE WAR

Although World War II created new handicaps for the British economy, its aftermath contrasted sharply with that of World War I. The world economy, supported by a heavy flow of United States aid and long-term capital, expanded at a rapid pace, and Britain benefited accordingly. The rise in its national income (measured in constant prices) in the 1948-57 decade was about as large as in the two decades of the interwar period. However, in comparison with most major industrial countries Britain's growth, even on a per capita basis, continued to lag while (judging by the available indexes) the rise in its prices was exceeded only in France and Japan.

The reasons for these postwar difficulties are, not surprisingly, a subject for controversy among British observers. On several points, however, there is no dispute. They agree that the growth lag is to some extent associated with the fact that Britain's industries not only suffered less war damage than those of France, Germany, Italy, and Japan, but had made a good start at reconstruction even before hostilities ended. Britain therefore started the postwar period from a base that was little, if any, lower than in 1938, whereas its major competitors—apart from the United States—started almost from scratch. Thus, as in the earlier period, part of the more rapid rate of growth abroad merely reflected a catching-up process from a very low base. In this process, moreover, another circumstance also contributed to the more rapid growth of the severely war-damaged countries. The latter's growth was closely aligned to the special requirements of the postwar period; production of electrical machinery, machine tools, chemicals, passenger cars, and trucks all surged rapidly ahead of other products that were in less vigorous demand. Output of the newer lines also expanded rapidly in Britain, but the considerable weight that such traditional and relatively declining industries as coal, textiles, pottery, and leather goods still bore in the British economy helped to retard the rise in its over-all industrial production.

While such considerations explain part of the lag in Britain's economic growth, British observers are generally agreed that other factors also played an important role. In particular, Britain has usually invested in its domestic economy a smaller proportion of its gross national product than other major industrial countries in the free world. Essentially this has been because other claims on Britain's resources were given higher priority, especially in the

[2] A. E. Kahn, *Great Britain in the World Economy,* New York, Columbia University Press, 1946, pp. 75-6.

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earlier postwar years. The proportion of Britain's resources devoted to defense has been higher since the war than in any of its competitors except the United States. Moreover, many resources that might otherwise have been utilized for domestic investment were actually employed to repay overseas indebtedness and increase foreign investment. Finally, the proportion of output devoted by Britain to personal consumption (including government services) has been generally higher than in other major industrial countries. It is true that in recent years the authorities have at various times taken steps to stimulate domestic investment and that the proportion of the gross national product devoted to this purpose has in fact increased significantly. Nevertheless, the other heavy demands made upon Britain's resources continued until the 1957-58 recession severely to limit the scope for domestic investment, which was consequently kept subject to more or less strict official guidance until as late as February of this year.

THE UPWARD PRESSURE ON PRICES

As regards the factors behind the persistent upward pressure on British prices since the war, there also is a wide, though by no means complete, range of agreement among British observers. Since Britain is considerably more dependent on imported raw materials than most other major industrial countries, it was more affected by the postwar rise in international commodity prices. These prices rose sharply immediately after the war and again at the time of the Korean conflict. The impact of the "Korea" price rise was especially severe because it aggravated the upward thrust that had been given to prices in Britain by the September 1949 devaluation of sterling.

Little pressure on British domestic prices has emanated from imports since 1951, but it is generally agreed that the gradual removal of the controls and subsidies, that had partially suppressed the symptoms of inflation during the forties, contributed to the price rises shown in the published indexes during the fifties. Thus the 1952 removal of certain food subsidies is estimated to have raised retail prices by around 2 per cent. The abolition of the bread subsidy and the reduction of the milk subsidy in 1956, and the relaxation of rent control in 1957, seem to have had a similar impact. Moreover, these measures, like the earlier rise in import prices, doubtless had secondary repercussions since wage and salary earners sought—more aggressively than in certain other European countries—to increase their earnings to compensate for the higher cost of living.

Beyond this area of agreement, however, differences begin to appear in British diagnoses of the factors behind the upward pressure on prices. The opposing views fall into two broad categories that have become familiar in the United States. The first category places the prime emphasis on the extent to which powerful economic groups—representing both labor and management—have levered up wages and profits. The second emphasizes that, in attempting to achieve too many objectives at once, Britain has expanded its spending faster than domestic production, and that the resulting imbalance has led not only to recurrent balance-of-payments difficulties but to a rising wage-price spiral.

The first—or cost-push school, as it is often called—maintains that in certain key industries competitive conditions have so weakened as to give management and labor significantly increased control of profits, prices, and wages. Management—it is argued—has been able to maintain its selling prices even in the face of falling raw material costs, or to pass on to the consumer increases in labor costs, or to raise its prices in order to finance internally the acquisition of new plant and machinery. Firms are also said to be reluctant to reduce their labor force even in periods of relatively slack demand because of fears of labor shortage when prosperity returns. At the same time, labor unions are held to exert continuous upward wage pressure with little more than token resistance by management.

The second—or demand-pull school—accepts much of the foregoing analysis, but places the major responsibility for Britain's postwar price inflation on an abnormally high level of aggregate demand for goods and services maintained for an abnormally long period of time. In this view, which finds its most authoritative expression in the reports of the Council on Prices, Productivity, and Incomes, Britain has pursued a number of objectives which, taken by themselves, are desirable but which have made greater demands on the industry and thrift of its citizens than they have had the power or the will to satisfy. The translation of these demands into a persistently high rate of spending, it is argued, was facilitated in the early postwar period by the abnormally large holdings of liquid assets with which both firms and individuals emerged from the war, as well as by the relatively low levels at which interest rates were maintained, and by the related expansion of the money supply. Even during the fifties when monetary policy came into more active use and the increase in the money supply was curbed, the government's "full employment" commitment acted both to limit the vigor of the authorities' anti-inflation measures and to sustain public optimism and spending. Businessmen in particular are said to have taken this commitment as an

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indication that there would be no serious weakening of demand for their products, and were thus encouraged to maintain levels of capital expenditures that—while still relatively low, compared with other major countries—were in excess of the economy's voluntary savings.

The demand-pull school finds support for its views in two significant labor market developments. First, throughout most of the postwar period the number of reported vacancies in industrial employment has considerably exceeded the number of registered unemployed, the excess having been greatest when spending rose to its peaks in the "Korea" and the 1954-55 booms. Secondly, in periods of rapidly expanding demand, the rise in average earnings has tended to exceed the rise in wage rates set in national agreements and awards. The reasons for this admittedly include increased overtime but among the numerous other factors involved is the tendency for certain firms, in periods of high demand, to attract labor by bidding up wages to levels well above the agreed rates.

POLICIES FOR GROWTH WITHOUT INFLATION

Just as there is some common ground in the diagnoses of Britain's problem of achieving growth without inflation, so there is a considerable range of agreement on how to deal with this problem. Already much is being done to increase understanding of the economic system and to supply data on its operations previously either lacking or published only after considerable delay. Practices on the part of management that tend to limit competition are being dealt with by the Monopolies Commission and the Restrictive Practices Court, and there is considerable discussion on the means of dealing with various rigidities that have grown up among the trade unions. Labor mobility is being increased through the retraining of unemployed workers from lagging industries for transfer to expanding industries. Frequently, firms are officially urged, as regards pricing policy, to seek enlarged profits by expanding the volume of their sales rather than by increasing their margins; and, as regards dividend payments, to take account of the tendency of the trade unions to use increases in such payments as a basis for enlarging their wage claims beyond the rate of increase in average productivity. In addition, as part of its policy of economic liberalization, the government has for some years been cutting restrictions on imports and this has acted to stabilize domestic prices, to stimulate efficiency in domestic industry, and to subject the economy generally to the salutary disciplines of the balance of payments.

As the weight of British opinion in favor of price stability has increased, the implications of such stability for the structure of wages have been spelled out and, at least in principle, widely accepted. It is clearly recognized that, if Britain is to maintain price stability as well as an adequate balance-of-payments surplus, total income can increase no faster than total output. Within this framework, it is held that needed shifts in the distribution of the labor force would be facilitated by incentives in the form of larger-than-average wage increases in expanding industries, coupled with wage stability or smaller-than-average increases elsewhere in the economy. Such differential rises in wage rates need not be tied to changes in output per man in particular occupations. Rather, it is argued that labor could be attracted to those sectors, such as manufacturing, where output per man increases most rapidly even though their wage rates were to rise less rapidly than productivity. By the same token, labor could be drawn away from those sectors—such as the service industries—in which the increase in productivity is small, even though wages increased more rapidly than productivity. Such a pattern of wage increases, it is held, would be compatible with declining prices, for example, of manufacturing products and rising prices for services—the different trends averaging out to over-all price stability.

Having recognized that price stability can be maintained in the long run only if output expands as rapidly as income, it is hardly surprising that virtually all British observers go on to stress the need for increased investment as a means of enlarging productive capacity. But, while there is agreement on this need, the means of attaining it are subject to debate. Some members of the cost-push school hold that, given a relatively high level of income and employment, a policy of rapidly expanding investment would require a correspondingly rapid increase in savings, which in turn would require fairly severe restraints on personal consumption at least in the initial stages. Since there is doubt whether such restraints would be accepted voluntarily, it is held that fiscal policy—or, bluntly, increases in taxation and/or reductions in government expenditure—should be brought into play to achieve the necessary balance between savings and investment. Moreover, it is argued that this policy could get off the ground only with the active cooperation of all segments of the economy and especially of the trade unions, which would be asked to accept a "lull" in wage increases for a period set by one commentator at not less than two years. By thus holding costs stable during a period when productivity per man would be rising rapidly, the economic base for further growth would be expanded and workers could thereafter expect to obtain wage increases that might otherwise have been inflationary. Thus, according to this view, progress would be made toward the recon-

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ciliation of a rapid rate of economic growth with the price stability needed to sustain further growth on into the future.

This approach is generally rejected by the demand-pull school, apparently on the ground that, if severe restraints were placed on consumption, market indicators as to the appropriate direction of investment would be lacking and that, if the needed rise in investment were to be attained at all, it would only be by the government itself or as a result of extensive official intervention. Since most members of the demand-pull school favor maximum reliance on the mechanisms of the market, they hold that ordinarily an increased rate of investment cannot precede but only follow a rise in consumption. This is said to be especially true at present when many British industries have considerable excess capacity; output in many lines would have to rise significantly before firms would undertake new investment to expand capacity further. As to the means by which to provide the additional savings to finance the rise of investment, the demand-pull school, while by no means eschewing fiscal policy as an instrument for maintaining economic balance, gives existing monetary policy instruments a major role.

While most commentators rely on an acceleration of investment to achieve the reconciliation of growth with price stability, a few start, as it were, from the opposite direction. They hold that the government should commit itself to keeping a suitably constructed index of the prices of domestically produced goods from rising above a precisely defined ceiling, and that this new obligation should constitute a limitation on the government's existing commitment to maintain aggregate demand at a "full employment" level. To control spending and thus prevent the pressure of demand from pushing the price index above the ceiling, the government would subject all incomes to a new levy, the rate of which could be varied frequently and promptly, as circumstances might require, by a stabilization committee responsible to the Chancellor of the Exchequer. In addition, an independent expert body would publish periodic estimates of the average increase in per capita earnings that it considered compatible with the preservation of full employment with stable prices, while various arbitration boards (with a view to maintaining an appropriate distribution of labor) would settle disputes as to whether workers in a particular industry should obtain increases appreciably above or below that average.

One essential feature of this proposal is, of course, the variable levy on incomes that would serve as a regulator of aggregate demand. Apart from the numerous political and administrative problems surrounding such a device, a levy on income is subject to the economic criticism that, insofar as its impact is absorbed merely through changes in savings, it has little or no effect on spending. Hence, some observers hold the view that a variable tax on expenditure would be more effective both in exercising general control over inflationary or deflationary tendencies and in securing an appropriate distribution of resources between consumption and investment. In this view, the entire existing tax system would be replaced by two new taxes, one on personal expenditure, the other on capital expenditures. Variations in the latter would limit or encourage investment as circumstances might require, while variations in the former would keep spending for consumption within the limits imposed by the requirements of both investment programs and price stability.

CONCLUSION

As this is being written, Britain is emerging from a mild recession. The lifting of controls on instalment credit in the autumn of 1958 and the reduction in income and purchase taxes in the April budget have stimulated personal consumption. The investment programs of the public authorities have been accelerated, and special tax incentives for private investment have been strengthened. House building has been rising, and exports have not only recovered all the ground lost in the 1957-58 recession but have climbed to a new peak. The pace of economic activity is consequently quickening. At the same time, the rise of wages and prices has been checked partly because of declines in British import prices. This spring, indeed, the retail price index dropped for the first time since the war below the level of a year earlier. Morever, the conditions exist for continued price stability. The rise of investment in recent years has greatly increased both the capacity and the efficiency of industry. Hence, there is room for a considerable rise in total output and in productivity per man, which would in turn act to stabilize or perhaps even to reduce unit costs of production.

The stage may thus be set for Britain to reap some benefits from the clarification of methods and objectives that has resulted from the postwar discussion of its most "intractable" economic problem. With the government already having used drastic means to demonstrate its determination to maintain the value of sterling, labor and management may now be in the process of modifying some of the wage, price, and other practices followed in the past. And, having achieved the requisite price stability, the government has moved rapidly toward facilitating economic re-expansion. Actually, Britain should now have much less trouble in supporting levels of spending for

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personal consumption, public welfare, and defense, which in earlier years had acted as a limitation on capital formation and as a threat to its balance of payments. Today, with its enlarged productive capacity, such spending should not be incompatible with the maintenance of an adequate balance-of-payments surplus and with a further substantial rise in the proportion of its gross national product devoted to domestic investment. There is therefore firm ground for hope, if the lessons of the postwar years have been learned as well as now seems indicated, that Britain may in fact be on the threshold of a period of sustained growth without inflation.

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