FEDERAL RESERVE BANK OF NEW YORK

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The Business Situation

The economy was revitalized in December by a swelling flow of urgently needed steel. Automobile producers and many other users of ferrous products who had been short of steel were able to recall furloughed employees and start filling back orders. Christmas buying apparently set a new peak, boosting employment in retail trade and certain other fields. And some uncertainties in the economic picture were removed by the settlement of wage negotiations covering many employees of the struck copper industry, the East Coast docks (which had been operating under a Taft-Hartley injunction), the aluminum industry, and the nation's two largest can companies. The settlement of the steel strike in early January, of course, removed another major question mark overhanging the business scene. However, there were still important factors contributing to an uneasy hesitation as to the weeks just ahead. The effects of the various wage settlements upon prices could not as yet be appraised. Numerous firms in need of steel were not yet receiving adequate supplies, and output and employment in many metal-working and machinery industries consequently remained much below pre-strike levels.

THE RENEWED UPTURN

The struck steel mills, which achieved a surprisingly rapid recovery of output following the November 7 reopening, were operating at more than 96 per cent of capacity (rated as of the beginning of 1959) by the second week of December. In actual volume, weekly output reached a record 2.73 million tons of ingots. Output slipped slightly during the final half of the month, but this was a result of the usual holiday closings. Shipments lagged behind the high level of ingot production, because the processing of steel into the various products demanded by the mills' customers requires, in some cases, several additional weeks. Trade sources estimated, moreover, that about one fourth of the December shipments would be absorbed by "in transit" operations and by the rebuilding of the better balanced stocks needed for starting up operations in steel-using enterprises. A survey taken in late November by some 415 purchasing executives in steel-using industries showed that one fourth of those polled thought steel supplies for their companies would be insufficient for normal production until March or later. Unusually heavy demands by automobile and railroad equipment producers in the first quarter of 1960 are expected to aggravate the steel difficulties of other firms.

Total industrial production rose slightly in November and advanced more sharply in December. The October level had been the lowest point in the strike period, 7 per cent below the June record of 110 per cent of the 1957 base now used in the index. (The Federal Reserve's index has recently been extensively revised to use more up-to-date weights and to include output of electricity and gas; the new index is now available with a new base year, 1957, and also with the old base of 1947-49.) The one-point increase to 103 in November reflected primarily the sharp rise in steel production and an expansion in output of the bituminous coal and iron ore required by the reopened steel mills. Despite the increase in steel, the gain in total production was small because of offsetting declines in automobile production and electrical machinery. In December, however, the index is expected to reflect the steep climb that occurred that month in auto output, as well as the further expansion in steel production.

Employment also moved up again, as the wheels of industry started to turn faster. Nonagricultural employment rose by 124,000 between mid-October and mid-November, to a total of 52.1 million, seasonally adjusted (see Chart I). Although unemployment rose over the same period, the increase was less than seasonal and the seasonally adjusted ratio of unemployed to the total civilian labor force receded to 5.6 per cent from the October strike-time high of 6.0 per cent. Later in November, there were additional layoffs of automobile workers, but these had all been recalled by mid-December.

Personal income increased in November to a new all-time high of $384.8 billion (seasonally adjusted annual rate). The previous peak, $1 billion lower, had been reached in June. The $2.5 billion increase in November was the largest of the monthly rises that have occurred since September. Wage and salary payments rose by $1 billion, as sharply higher payrolls in the steel industry and in the dependent mining and transportation industries more than offset declines in steel-using industries. Transfer payments also increased substantially.

The rise in personal income helped push retail sales of nondurables to new heights in November, 2 per cent above the October level on a seasonally adjusted basis (see Chart I). Total retail sales, it is true, declined in November by 1 per cent after seasonal adjustment; but this was primarily attributable to a drop in sales of automobiles, resulting from the depletion of dealers' inventories

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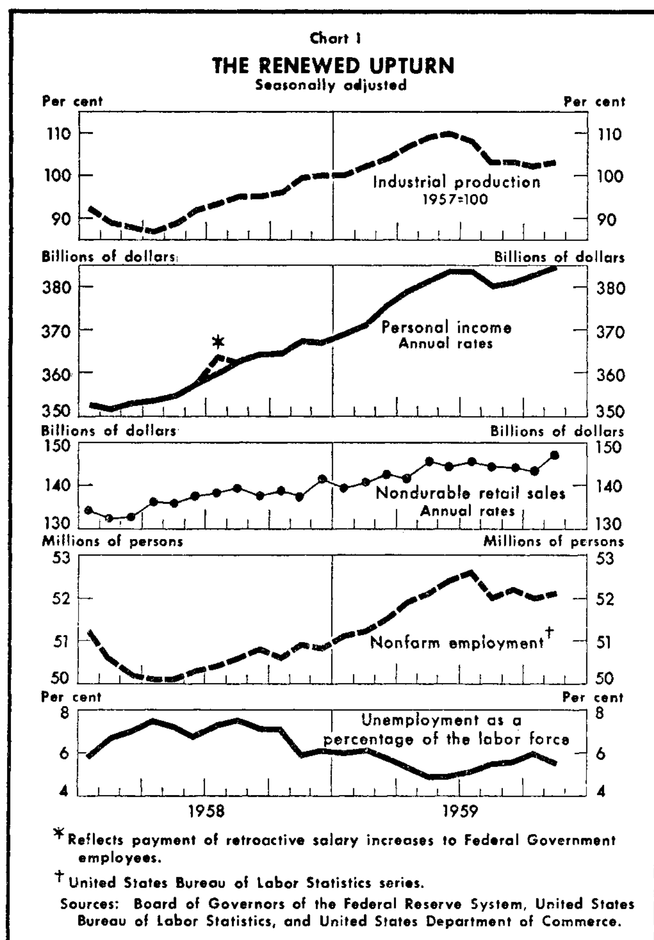
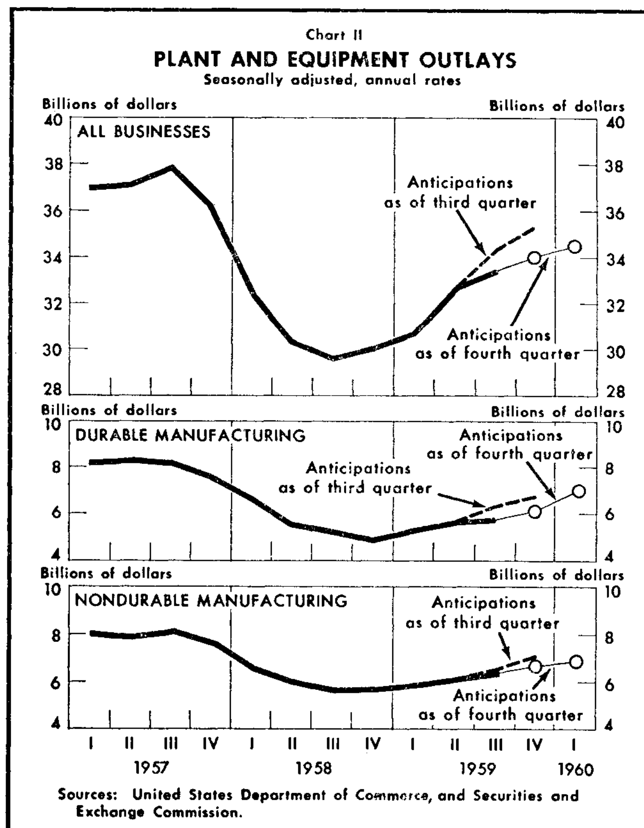


*Reflects payment of retroactive salary increases to Federal Government employees.
† United States Bureau of Labor Statistics series.
Sources: Board of Governors of the Federal Reserve System, United States Bureau of Labor Statistics, and United States Department of Commerce.

INVESTMENT ACTIVITY

Business plans for expenditures on plant and equipment indicate continuing strength in that area, although the anticipated growth is slower than the rates of increase achieved during the first three quarters of 1959. A survey conducted by the Securities and Exchange Commission and the Department of Commerce in late October and early November showed that business firms expected to make capital outlays during the fourth quarter of 1959 at a seasonally adjusted annual rate of $34.0 billion, up $600 million from the third quarter's actual outlays; in the first quarter of 1960, they intend to spend at an annual rate $450 million higher than in the last quarter of 1959 (see Chart II).

Shortages and uncertainties resulting from the steel strike did, of course, depress actual expenditures in the third quarter and presumably contributed to the downward revision in estimates for the fourth quarter. These factors may have held down the spending rate anticipated for the quarter just begun. The principal increases from the third to the fourth quarter of 1959 were expected to occur in manufacturing industries, with an almost equal



Sources: United States Department of Commerce, and Securities and Exchange Commission.

due to steel shortages. Preliminary data on department store sales suggest that consumer demand remained strong in December, although the increase in sales may have been less marked than in the previous month. Automobile sales were still depressed in the early part of December, but may have risen in the latter part as 1960 models began to reach dealers in greater numbers.

In contrast to the foregoing gains, construction outlays in November decreased—the sixth consecutive monthly decline. The biggest drop, $700 million out of the total of $1 billion, was in spending for private residential construction, which was 11 per cent below the May peak. The limited supply of mortgage funds, especially for FHA- and VA-underwritten instruments, was apparently the principal reason for this decline. The rest of the November decrease was attributable to the government sector, and particularly to State and local government outlays for road construction. On the other hand, outlays for private nonresidential construction, which had fallen in September and October partly because of steel shortages, rose slightly.

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division between durables (mainly the iron and steel industry) and nondurables. The further advance foreseen for the first quarter of 1960 was limited entirely to manufacturing, and largely to expenditures planned by iron and steel companies and by manufacturers of motor vehicles and other transportation equipment.

Further confirmation of increasing investment activity is found in the 6 per cent increase in capital appropriations (seasonally adjusted) of large manufacturing firms between the second and third quarters of 1959, as reported by the National Industrial Conference Board. Appropriations—that is, formal approvals of capital spending plans—usually precede expenditures by several months. Excluding the strike-hit steel industry, the recent increase was the largest registered in any third quarter since this survey began in 1956.

Money Market in the Fourth Quarter

During the final quarter of 1959, while other areas of the economy slackened under the influence of the steel strike, demand and expectations remained buoyant in the money and capital markets. Interest rates, both long- and short-term, reached record highs for the past quarter century or more. Bank reserve positions, although no tighter than during the two preceding quarters, reflected the cumulative stress of seasonal credit demands and shrinking liquidity. While the expansion in commercial bank loans appeared to be less rapid than in previous months, this seems to have been due principally to the effects of the steel strike. With the resumption of steel output, and as the effects of the strike work themselves out, market observers generally were anticipating that the demand for credit would be relatively strong after the turn of the year.

The money market continued tight throughout the quarter despite some statistical indications of slightly reduced pressure on member bank reserve positions, as average net borrowed reserves of all member banks declined somewhat from their third-quarter level. The reduction in net borrowed reserves, however, in part reflected the release of reserves through changes in regulations permitting the use of certain amounts of vault cash to meet reserve requirements, and through other technical changes. These measures, which became effective in early December, primarily benefited country banks and, therefore, had little immediate or pronounced effect on the tone of the central money market.

Yields on Government securities declined in October but moved irregularly upward thereafter to close the quarter at a substantially higher level than at its start. Rate movements were particularly pronounced in the Treasury bill market, but also spread to notes and bonds. Market psychology during this period was strongly conditioned by expectations of bank and corporate liquidation of bills to meet the increased demand for funds, related not only to the resumption of steel production but also to the mid-December tax and dividend payments. The Government securities market was also affected by Treasury financing operations during the quarter, and by anticipations of additional financing which the Treasury will undertake early in the new year.

After the close of business on December 30, the Treasury announced that it would seek to raise $2 billion in cash through an additional issue of June 22 tax anticipation bills, to be sold at auction on January 5. In addition, it will replace $1.5 billion of the $2 billion bill issue maturing January 15 with a new issue of one-year bills, to be sold at auction on January 12, and will redeem the balance of the maturing bills for cash. Net Treasury cash borrowing in January would thus amount to $1.5 billion, or less than had been generally anticipated.

COMMERCIAL BANK CREDIT

Commercial bank credit developments in the fourth quarter of 1959 followed much the same over-all pattern that was in evidence all year long: there was little change in total loans and investments as a further, if somewhat less rapid, increase in loans was roughly offset by a continued liquidation of the banks' securities holdings.

In the first eleven months of 1959, responding to strong demands for bank credit from an expanding economy, loans of all commercial banks increased by $9.2 billion (data are not yet available for December). This rise was only slightly smaller than the $9.8 billion increase during the comparable period of 1955, when the economy was also in a strong expansion, and it was considerably greater than in any of the intervening years. Data for weekly reporting banks through December 23 point to a further

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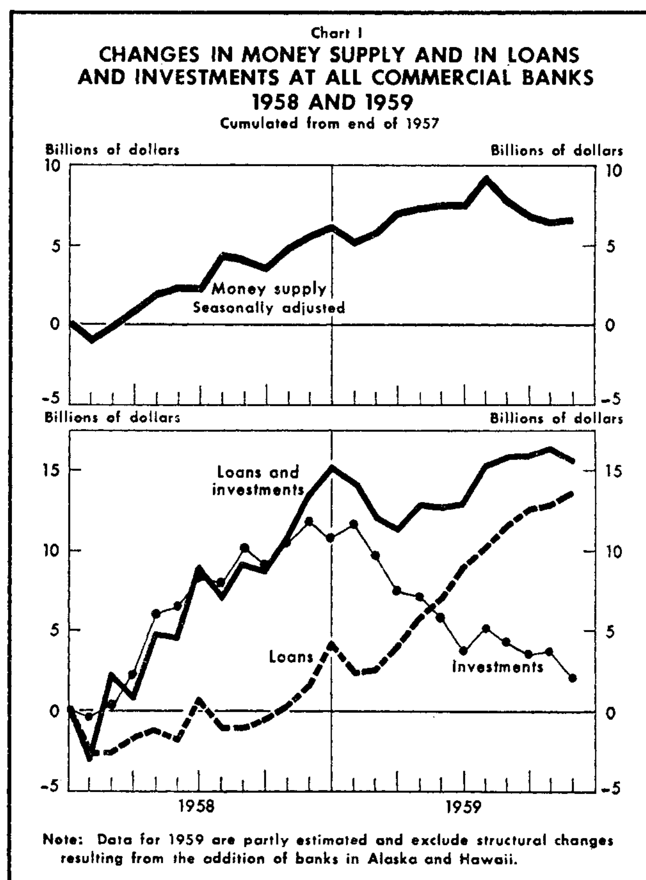
loan advance in that month. As in 1955, consumer and real estate credit and loans to business all contributed to the credit expansion in 1959. Consumer credit, in fact, rose somewhat more rapidly than in 1955, while the increase in real estate credit in the first eleven months of 1959 was roughly the same as in 1955. The $4 billion advance in loans to business, however, did not match the $5.4 billion expansion in 1955.

As noted earlier, preliminary data suggest that the overall expansion of bank loans abated somewhat during the fourth quarter. Loans of all commercial banks rose only $1.0 billion during October-November, compared with increases of $2.1 billion in the comparable period of 1958 and $2.7 billion in 1955, with the decline in the rate of advance having been particularly pronounced for business loans. The slowdown is traceable largely to a lull in growth in October when, under the impact of the steel strike and the attendant liquidation of inventories, the increase was the smallest in a decade. The rate of advance appears to have increased again in November and December, although data for weekly reporting banks through December 23 suggest a smaller increase for the quarter than in either 1955 or 1958.

The commercial banks in the fourth quarter of 1959, as earlier in the year, financed the expansion of their loans through a further liquidation of their holdings of Government securities. Indeed, the investment decline for all commercial banks for the first eleven months of 1959 was somewhat greater than the large net liquidation in 1955—$8.4 billion as against $7.6 billion.



Note: Data for 1959 are partly estimated and exclude structural changes resulting from the addition of banks in Alaska and Hawaii.

Table I

Quarterly Changes in Principal Assets and Liabilities of the Weekly Reporting Member Banks

(In millions of dollars)

Assets	1959			Fourth quarter*		
	I	II	III	1955	1958	1959
Loans and investments:						
Loans:						
Commercial and industrial loans	− 226	+2,303	+1,255	+1,967 }	+ 887	+1,423
Agricultural loans	− 8	+ 50	+ 61		+ 45	− 28
Securities loans	− 145	− 142	− 181	+ 580	+ 517	+ 299
Real estate loans	+ 207	+ 504	+ 258	− 99	+ 489	+ 196
All other loans (largely consumer)	+ 126	+ 262	+ 550	+ 433	+ 355	+ 242
Total loans adjusted†	− 67	+2,955	+1,922	+2,875	+2,290	+2,130
Investments:						
U. S. Government securities:						
Treasury bills	+ 276	− 929	+ 243	+ 540	+ 889	+ 147
Other	−1,780	−2,214	−2,102	− 627	− 374	− 778
Total	−1,504	−3,143	−1,859	− 87	+ 515	− 631
Other securities	+ 157	− 206	− 37	− 435	− 230	− 286
Total investments	−1,347	−3,349	−1,896	− 522	+ 285	− 917
Total loans, adjusted,† and investments	−1,411	− 394	+ 26	+2,353	+2,575	+1,213

Note: Data for 1958 and 1959 are reported on an expanded coverage basis and are not strictly comparable with 1955. For comparability, commercial and industrial loans in the third and fourth quarters of 1959 include the category "loans to nonbank financial institutions".

* The latest 1959 data available are for December 23; fourth-quarter changes for each year cover approximately the same period.

† 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.

The relative stability in total commercial bank loans and investments found its counterpart in the continued stability of the money supply, shown in Chart I. While the seasonally adjusted money supply (demand deposits adjusted plus currency outside banks) rose by $0.2 billion during November, this was the first increase since July. Because of the continuous decline from August through October, the $139.9 billion level reached in November (seasonally adjusted) was still lower than in most months since February and was $2.5 billion below the July peak. For the twelve months ended in November the money supply rose only 0.8 per cent, compared with 3.6 per cent in the year ended November 1958 and an average of 1.8 per cent per year over the past five years. There were indications, however, that the money supply increased somewhat more rapidly in December, and that the total increase for 1959 may be somewhat greater than suggested by the data through November. The relative sta-

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bility of the money supply was accompanied by its more intense use. Thus, the rate of turnover of demand deposits in centers outside New York City and other large financial centers rose 6 per cent during the year through November.

The continued rise in bank loans and the further decline in their Government securities holdings meant, of course, that bank liquidity decreased further and began to exert a more active influence on bank portfolio policies. By December, loan-deposit ratios—which are often used as an inverse measure of bank liquidity even though they include some highly liquid assets (loans to Government securities dealers, for example)—reached 69 per cent for the New York City weekly reporting banks and 58 per cent for reporting banks outside New York, compared with 59 per cent and 51 per cent a year earlier. Similarly, ratios of short-term liquid assets (including Treasury bills and certificates and loans to Government securities dealers) to deposits stood at 14 per cent for the New York banks and 9 per cent for banks outside New York, compared with 17 per cent and 13 per cent in December 1958.

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

Factor	Daily averages—week ended					Net changes
	Dec. 2	Dec. 9	Dec. 16	Dec. 23	Dec. 30	
Operating transactions						
Treasury operations*	− 27	+ 71	− 31	+ 15	− 19	+ 9
Federal Reserve float	− 225	− 83	+ 166	+ 649	− 30	+ 477
Currency in circulation	− 175	− 157	− 197	− 126	+ 31	− 624
Gold and foreign account	− 46	− 78	− 6	− 35	− 33	− 198
Other deposits, etc.	+ 70	+ 14	+ 59	− 3	− 2	+ 138
Total	− 402	− 236	− 8	+ 501	− 53	− 198
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 191	+ 287	+ 12	− 172	− 183	+ 135
Held under repurchase agreements	− 2	+ 36	− 30	+ 3	+ 5	+ 12
Loans, discounts, and advances:						
Member bank borrowings	+ 48	+ 41	+ 45	+ 24	− 52	+ 106
Other	− 2	—	—	—	—	− 2
Bankers' acceptances:						
Bought outright	—	+ 5	+ 4	+ 2	+ 1	+ 12
Under repurchase agreements	—	—	+ 14	+ 13	+ 4	+ 31
Total	+ 235	+ 369	+ 46	− 131	− 224	+ 295
Member bank reserves						
With Federal Reserve Banks	− 167	+ 133	+ 38	+ 370	277	+ 97
Cash allowed as reserves	+ 44	+ 188	+ 10	+ 92	—	+ 334
Total reserves	− 123	+ 321	+ 48	+ 462	− 277	+ 431
Effect of change in required reserves†	+ 74	− 157	− 118	− 247	+ 98	− 350
Excess reserves†	− 49	+ 164	− 70	+ 215	− 179	+ 81
Daily average level of member bank:						
Borrowings from Reserve Banks	870	911	956	980	928	929‡
Excess reserves†	376	540	470	685	506	515‡
Net borrowed reserves†	494	371	486	295	422	414‡

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† These figures are estimated.
‡ Average for five weeks ended December 30, 1959.

MEMBER BANK RESERVES

Country-wide reserve positions of member banks remained under firm, if statistically somewhat reduced, pressure throughout most of the fourth quarter; net borrowed reserves averaged $436 million during the quarter, compared with a $528 million average during the third quarter. In December alone, net borrowed reserves averaged $414 million, little changed from the $433 million level for November. Borrowings from the Federal Reserve averaged $904 million during the quarter as against $956 million in the third quarter.

Bank reserve positions were subjected to strong seasonal influences during the quarter. Operating transactions, on balance, absorbed some $370 million of reserves, as the effects of a seasonal expansion of $1,082 million in currency in circulation, which accelerated after mid-November, more than offset an increase in average float and net gains from the movement in other operating factors. In addition, required reserves rose $314 million over the period, as a $350 million increase in December offset earlier declines.

The money market banks, as usual, bore the brunt of the seasonal pressures, and borrowings from the Federal Reserve increased periodically until the necessary adjustments could be made in bank portfolios. While borrowings continued to be collateraled largely by Government securities, rising loan-deposit ratios and an increasing shortage of Government securities in bank portfolios indicated that the time may be approaching when some banks will revert to the practice of using commercial paper as collateral for their borrowings.

Partly meeting seasonal needs, reserves were released during the period through changes in Federal Reserve regulations, effective in early December, which permitted banks to count part of their vault cash as reserves, and which also permitted member banks to exclude remittance drafts drawn on their reserve accounts when calculating gross demand deposits (so that required reserves were reduced). First estimates indicated that some $400 million of bank reserves were released by these measures, but since they primarily affected country banks, and since the additional reserves thus acquired by individual banks were quite small, the measures had little or no immediate direct effect on the central money market.

For the most part, seasonal reserve needs during the fourth quarter were met through System open market operations. Large amounts of reserves were provided in the first two statement weeks of both November and December, but reserves were reabsorbed in the latter part of each of these months as the expansion in float reached

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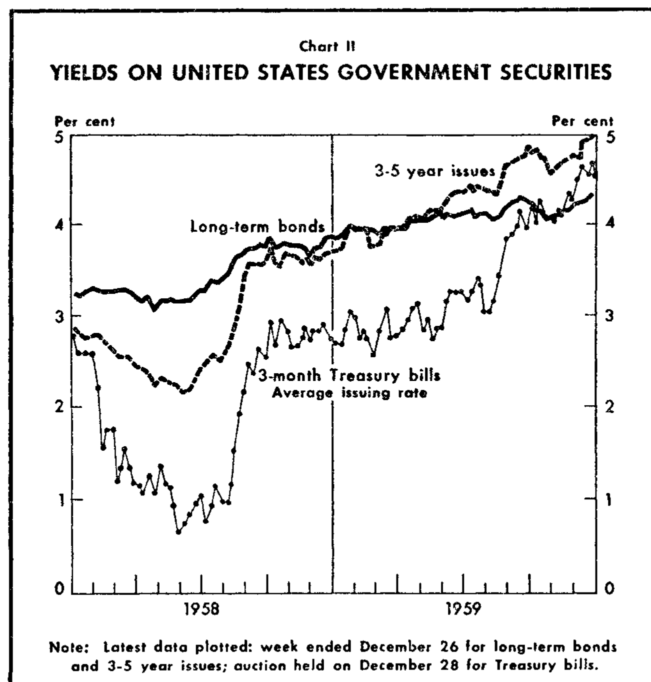
unusually large proportions. From September 30 through December 30, System outright holdings rose $185 million and holdings under repurchase agreements rose $30 million.

GOVERNMENT SECURITIES MARKET

Yields on most Treasury securities moved to a substantially higher level by the end of December than they had been three months earlier (see Chart II), but with rather sharp day-to-day fluctuations in prices and yields during the quarter. Fundamentally, the continued rise in Treasury securities yields—as well as in other market rates—reflected the heavy demand for credit and capital which has accompanied the strong economic upsurge of the past year and which has pressed on a necessarily limited supply of funds. The short-term fluctuations superimposed on this general rise in yields were largely the outcome of pronounced changes in expectations during the quarter, which in turn were conditioned by developments in the steel situation as well as by the Treasury's actual and prospective cash financing and refunding operations.

Prices of Treasury notes and bonds, after having declined sharply in August and September, rose during most of October in a rally which carried yields back to their mid-July levels. The stronger tone of the market during this period to a large extent seemed to reflect some tempering of expectations regarding the prospective demand for credit—and therefore regarding the yield level over the coming months—as the adverse effects of the prolonged steel strike became increasingly felt throughout the economy. The market also was strengthened during this period by the Treasury's highly successful $2 billion issue of 5 per cent notes in early October—the "Magic Fives"—which had an excellent reception in the market generally and from small individual investors in particular.



Note: Latest data plotted: week ended December 26 for long-term bonds and 3-5 year issues; auction held on December 28 for Treasury bills.

The news in early November that steel production would be resumed under a Taft-Hartley injunction, however, was quickly followed by renewed market expectations of heightened credit demands and higher rate levels over the coming months. While these expectations had a particularly marked effect in the Treasury bill market, they were also reflected in lower prices for notes and bonds. The market was also affected by the Treasury's November refunding operations which involved, in addition to $8.9 billion of maturing securities, a special offer to holders of $2 billion of 4 per cent notes due August 15, 1962 (but redeemable at the holders' option—on three months' prior notice—on February 15, 1960) to exchange for new 4⅞ per cent four-year notes; holders of the 4 per cent notes were not eligible to exchange into the other issue offered in the refunding—a 4¾ per cent certificate maturing in November 1960. Although the exchange operation was regarded as successful, it resulted in a greater increase in the supply of three- to five-year maturities than had been generally anticipated, tending to depress that area of the market.

A similar, although considerably smaller, influence in the same direction was exerted by a subsequent Treasury offer to owners of $1.6 billion of nonmarketable Savings bonds to exchange 4¾ per cent Treasury notes maturing May 15, 1964, with holders of $740 million of these bonds indicating they would participate in the exchange. Sales of long-term bonds by investors to finance purchases of new corporate issues at attractive yields and, in December, some tax selling and switching were also depressing influences in the Government bond market. Under these influences, note and bond prices declined throughout most of November and December, more than erasing the October gains. By the end of the year, prices of notes and intermediate-term bonds were generally $^{8}/_{32}$ to $1^{12}/_{32}$ points lower for the quarter while longer term bonds had declined $1^{28}/_{32}$ to $3^{28}/_{32}$ points. The average yield on long-term bonds, which had declined to 4.10 by the end of October from 4.22 at the end of September, climbed toward the end of the year to 4.39 per cent.

Changes in short-term expectations had a particularly pronounced effect on the Treasury bill market. Along with note and bond yields, Treasury bill rates declined

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through most of October, by as much as 20 to 55 basis points for most issues. By the closing days of October, however, demand for bills had been much reduced, while market psychology was adversely affected by expectations of increased demand for credit, not only as a result of the resumption of steel production, but also in connection with the mid-December tax and dividend payments. The Treasury's cash financing operations, moreover, added $4 billion to the supply of outstanding bills during the quarter, while estimates of the cash financing the Treasury might have to undertake early in the new year introduced additional uncertainties. The bill market was also adversely affected by the year-end pressure for funds and the high cost of borrowing, with New York bank loan rates to Government securities dealers remaining at 5 per cent throughout most of November and December. Market rates moved upward in short but pronounced spurts throughout most of November and December, with particularly sharp increases on most of the auction days. The average discount in the regular weekly auctions reached a record high of 4.670 for 91-day bills in the December 21 auction, whereas a high of 4.969 per cent had been established for the 182-day bills in the December 7 auction; while the rates declined to 4.516 and 4.942 in the December 28 auction, these compared with rates of 4.194 and 4.895, respectively, in the September 28 auction. Market rates declined in the closing days of the period, however, as a moderate nonbank demand reappeared and as market psychology was favorably affected by the fact that the Treasury's $1.5 billion (net) cash borrowing scheduled for January, which (as noted above) was announced on December 30, was smaller than most market observers had anticipated.

OTHER SECURITIES MARKETS

The market for seasoned corporate and, especially, municipal obligations was firmer in October, reflecting the same background factors that led to the improvement in Government bond prices. Moreover, despite the reappearance of weakness in the Treasury list, corporate and municipal yields generally held steady throughout November. Perhaps the most important factor contributing strength to the market during this period was the enthusiastic investor response to the $250 million issue of American Telephone and Telegraph Company debentures due in 1986, which was reoffered to investors on November 17 to yield 5.22 per cent. The quick distribution of so large an issue stimulated activity and prices throughout the corporate and municipal market and played a role in this market similar to that of the "Magic Fives" in the Government securities market. In December, however, prices of corporate and, to a lesser extent, of municipal bonds moved irregularly lower. By the end of December, the average yield on Moody's index of Aaa seasoned corporate bonds stood at 4.61 per cent as against 4.56 at the end of September, but the yield on similarly rated municipals had declined to 3.49 per cent from 3.64.

New corporate bond offerings during the period totaled $943 million, compared with $809 million during the July-September period and $773 million during October-December 1958, while new municipal issues totaled $1,292 million, compared with $1,259 million in the third quarter and $1,117 million in the fourth quarter of 1958. Market receptions were mixed, proving favorable when the new issues were attractively priced and unfavorable on certain occasions when underwriters sought to lead the market toward lower yield levels by pricing rather closely. Several syndicate terminations were reported in the latter part of the period, with prices on the undistributed balances subsequently being marked down, while a $100 million State issue that had been scheduled for early December was postponed.

Attention in the market for Federal agency obligations was largely centered on the new issues sector during the fourth quarter. New offerings totaled $1,577 million, of which $1,139 million represented refundings and $438 million new cash. While the total was somewhat smaller than the $1,908 million offered during the third quarter, it was substantially larger than the $925 million total in the fourth quarter of 1958. The new offerings generally met with good investor response, although at yields (usually well over 5 per cent) that were somewhat higher than in the previous quarter.

Several rate changes were announced for short-term marketable debt instruments during the quarter. Bid rates on unendorsed bankers' acceptances were increased from 4⅜ per cent to 4½ per cent on December 2 and to 4⅝ per cent on December 7. Commercial paper dealers' rates for prime four- to six-month maturities were reduced from 4¾ per cent to 4⅝ per cent on October 28, but were increased to 4¾ per cent again on November 20, and reached 4⅞ per cent on November 30. The rate on directly placed 60- to 89-day paper of large sales finance companies also was cut during October, by ½ per cent to 4 per cent, but was raised again in two steps to 4⅝ per cent by early December.

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International Developments

PROGRESS IN DOLLAR-IMPORT LIBERALIZATION

The easing of discrimination against dollar imports, which began to gather momentum in 1958, continued at an accelerated pace in 1959. With the restoration of external convertibility of the major currencies at the close of 1958, and with rising international reserves, the principal trading nations, as well as other countries around the globe, speeded the process of dismantling quota restrictions on dollar imports. At the same time, the administration of import-licensing systems was relaxed and some of the remaining controls over currency transfers were eased further. Following upon a long series of measures adopted in recent years to restore greater freedom to international trade and payments, these moves marked a decisive phase of the transition to multilateralism from the postwar era of restrictions and discrimination.

The emergence of huge balance-of-payments disequilibria in most countries at the end of World War II resulted in the imposition or intensification of strict quantitative limits on imports. Import quotas were applied in varying degrees to different commodities, depending on how essential they were and in what currency payment would have to be made. Since most foreign countries had large payments deficits with the United States and there was a world-wide shortage of dollars, imports from the dollar area as well as other dollar payments were widely singled out for especially stringent quotas.

With postwar recovery well under way by 1950, an increasing number of countries, particularly in Western Europe, recognized the adverse effects for continued economic growth of the maintenance of import and exchange restrictions. Accordingly, the Organization for European Economic Cooperation (OEEC) in 1950 adopted a "Code for Liberalization" which set forth a program for the systematic removal of quantitative restrictions on both intra-European and dollar trade.[1] The code called for freeing 75 per cent of intra-OEEC trade by 1951 and for gradual elimination of discriminatory quotas on imports from the dollar area. By the end of 1955, quantitative restrictions on some 86 per cent of trade among Western European countries had been removed, and a major start had been made toward the freeing of dollar imports, 54 per cent of which by then had been liberalized.[2] However, with the resurgence of inflationary pressures in Western Europe and the financial repercussions of the Suez crisis in 1956 and 1957, liberalization slowed down. One notable achievement of the period was the increasing reliance on the International Monetary Fund and on the revived use of international short-term currency stabilization loans which, along with domestic measures, enabled most countries to pass through the period without reverting to less liberal trade policies.

The build-up of international reserves in Western Europe in 1958 and 1959 encouraged the rapid extension of dollar liberalization. The United Kingdom virtually eliminated dollar discrimination between May 1957 and December 1959, leaving only a few dollar imports (principally fruits and tobacco, coal, airplanes, and some chemicals) still subject to quotas. Substantial increases in dollar liberalization also were achieved in Denmark, Sweden, and Italy; a large number of previously restricted consumer goods were freed, though quotas on imports of textiles and agricultural products, especially tobacco, were retained. The Benelux countries, long leaders in the removal of discrimination, eliminated virtually all remaining restrictions. Germany, which had advanced particularly far in dollar import liberalization by 1957, imposed quotas on coal in 1958 but resumed liberalization on a wide range of other commodities during 1959. Germany is now planning further moves in this direction in early 1960.

Perhaps the most dramatic extension of dollar liberalization occurred in France, where internal economic problems had kept discrimination high through 1957. In conjunction with its stabilization program, and in view of the rapid strengthening of its external reserve position, France extended dollar liberalization in several successive steps during 1958 and 1959 to a level of over 80 per cent of imports in November by removing a wide range of industrial and consumer goods from the restricted list. A further move to lift import quotas went into effect on January 1,

[1] The members of the OEEC are: Austria, Belgium, the Netherlands, Denmark, France, West Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, and the United Kingdom.

[2] Intra-European import liberalization is computed on the basis of 1948 nongovernment trade; dollar import liberalization is computed on the basis of nongovernment imports in 1953 from the United States and Canada. These figures, compiled by the OEEC, indicate liberalization only roughly, mainly because they do not allow for changes in the pattern of trade since the reference years.

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1960. Dollar imports are now treated on virtually the same basis as nondollar imports.[3]

In addition to trade liberalization as such, various further steps to ease controls on dollar payments were adopted during the year. For example, in several countries including France and the United Kingdom, currency restrictions on foreign travel were considerably relaxed or eliminated altogether.

Outside Europe, Australia and New Zealand substantially increased their foreign exchange budgets (which set limits on the total value of imports), and in the former country dollar discrimination has now been virtually eliminated. Among the African countries, Nigeria and the Federation of Rhodesia and Nyasaland freed a significant volume of their dollar imports, while in the Far East, Malaya, Singapore, and Ceylon substantially modified their quantitative restrictions on dollar purchases. In 1959 Japan expanded its exchange budget for a wide list of products, from both the dollar area and elsewhere, including foodstuffs, raw materials, machinery, and chemical products. Moreover, Japan has announced its intention of ending dollar discrimination altogether over the next fifteen months. Latin America, a large part of whose trade is with the United States, last year saw the further relaxation of dollar discrimination in those few countries where discrimination remained a factor. The establishment of external convertibility in Europe resulted in the termination of special trading arrangements between various Latin American and European countries, thus automatically reducing discrimination against imports from the dollar area.

Apart from the improved international payments positions of the major countries abroad, a widespread shift in attitudes and policies toward economic controls has contributed to the easing of restrictions on dollar imports. Beginning in the fifties a number of countries, particularly in Western Europe, embarked upon measures to widen the scope of free markets. This development, which is now spreading to other regions as well, reflects partly the general economic improvement in many countries in recent years and partly an increasing awareness of the extent to which quantitative import restrictions and discrimination tend to stifle growth and initiative. At the same time, increasingly strenuous efforts have been made in most countries to curb inflation, efforts that in turn have implied policies to secure imports in the cheapest market and to expose domestic industries gradually to the discipline of foreign competition.

[3] See "The French Stabilization Program", beginning on page 11 of this *Monthly Review.*

While the degree of dollar-import liberalization achieved by the end of 1959 has been substantial, discriminatory quotas on imports from the dollar area have not yet been entirely removed in all countries. With greatly strengthened international reserves in the major industrial countries abroad, however, and external convertibility restored, the major reasons for maintaining any discriminatory import restrictions no longer exist. As Per Jacobsson, managing director of the International Monetary Fund, recently pointed out: "Now that all major trading currencies have become convertible, it seems to be generally agreed that there is no longer any balance-of-payments justification for the practice of discrimination."

With the easing of quantitative restrictions both globally and on dollar goods, attention has begun to focus on tariff barriers. Little, of course, would be gained if discriminatory quotas were replaced by preferential tariff arrangements. In this connection, the steps now under way, particularly within the framework of the General Agreement on Tariffs and Trade (GATT), to reinforce the moves toward multilateralism may be regarded as an auspicious development.

EXCHANGE RATES

Early in December spot sterling, under heavy pressure from large sales of sterling in New York and Continental demand for United States dollars in London, declined in the New York market from $2.8011 to $2.7957, the lowest level since November 1957. By midmonth, good commercial demand had firmed the quotation again to the higher level but, as the holiday season approached, activity slackened and the quotation moved lower to about $2.7975. On December 31 the quotation was $2.7998.

In the forward market the premiums on three and six months' deliveries fluctuated between 38 and 58 points and 64 and 87 points, apparently reflecting market sentiment concerning a possible increase in the British bank rate. At the month end, the premiums were 45 and 75 points.

The Canadian dollar declined $^{11}/_{32}$ cents to $1.04⅞ during the first two days of December on commercial demand for United States dollars in Canada and reported switching by some Continental interests from Canadian to United States Treasury bills. Subsequently, European demand and the conversion of the proceeds of a Canadian provincial issue marketed in New York firmed the rate to 1.05^{25}/_{64}$ on December 21. The Canadian dollar thereafter turned lower in a quiet market, and on December 31 stood at $1.05.

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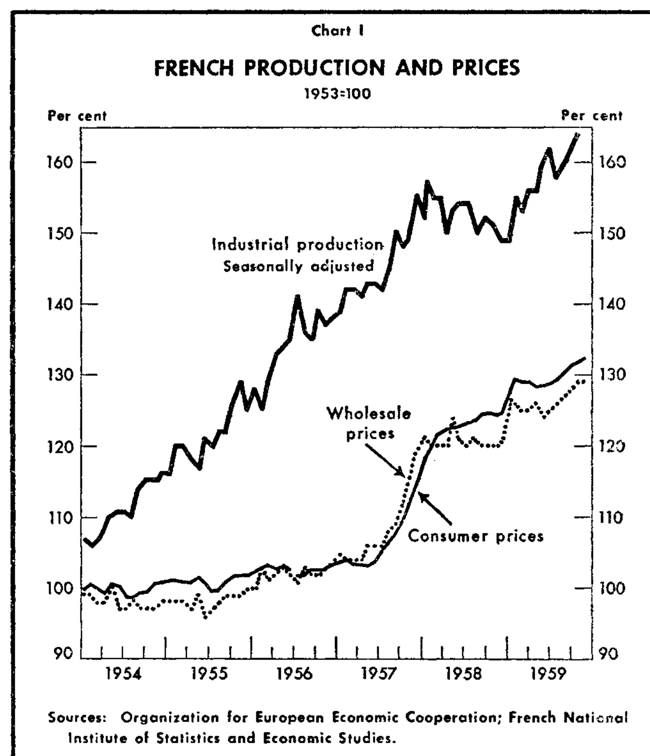
The French Stabilization Program

One year ago France embarked upon a comprehensive economic reform program designed to break the pattern of inflation and of recurrent balance-of-payments crises, which have plagued the French economy throughout most of the postwar period. The program, which went into effect at the same time that the European Common Market was inaugurated and nonresident convertibility was restored, was more far-reaching and fundamental than previous stabilization attempts. Attacking basic causes rather than symptoms, the program combined financial austerity with a gradual dismantling of protectionist barriers and of the obstacles that had interfered with the functioning of free market forces in the domestic economy. The results so far have been impressive. Confidence in the currency has been restored, official international reserves have been rebuilt to near-record levels, and the upward movement of prices has been slowed. While the world-wide easing of inflationary pressures, along with earlier stabilization measures, facilitated the implementation of the reforms, a basic element in the success of the program was the emergence of a government able to muster broad public support for a stabilization effort that necessarily called for sacrifices.



THE INFLATIONARY BACKGROUND

Since World War II, France has been subjected to recurrent inflationary pressures which culminated toward the close of the 1956-57 boom, when an acute inflationary thrust pushed wholesale prices up by 19 per cent. During the same period, official international reserves declined by about $1.3 billion to barely $600 million and confidence in the currency all but collapsed.

The French economy, it is true, recorded a remarkable productive advance during the postwar period, and especially in recent years. Between 1954 and 1957, for example, the gross national product (expressed in constant prices) increased at an average annual rate of some 6 per cent and industrial production advanced at an annual rate of 10 per cent (see Chart I). Contributing heavily to these achievements was a rise in industrial output per man-hour of nearly 8 per cent a year, an increase unsurpassed in any other Western country during the same period. However, this rate of expansion was clearly not sustainable, since it was achieved only at the expense of a massive drain on international reserves and the accumulation of huge external debts.

The causes of the French inflation were deep-rooted, basically reflecting the enormous demands made on the economy since the end of World War II. Despite sizable United States aid, the postwar reconstruction effort and the tremendous task of re-equipping and modernizing French industry resulted in persistent pressures on available productive capacity. The government bore a major share of the reconstruction burden, in both the nationalized and the private sectors of the economy, and also made large outlays for social welfare, including a variety of subsidies aimed at limiting increases in the cost of living. Moreover, after the end of World War II, France became deeply involved in overseas armed conflicts, first in Indochina and then in Algeria. These constituted heavy drains both on the country's resources and on the budget—although, until the end of 1955, substantial military assistance from the United States alleviated the burden of France's total defense spending. Throughout the period chronic budget deficits, which were often financed to a considerable extent by borrowing from the banking system, were a major inflationary force.

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While budget deficits thus fed the inflation, attempts to minimize the effects of currency depreciation led to the establishment of a widespread network of so-called "escalator" clauses which did much to reinforce the price rises. Clauses tying wages to the cost-of-living index were incorporated in labor contracts and led, as the cost of living rose, to automatic wage adjustments which, in turn, pushed up prices. The index-clause system also spread to other contractual relationships, notably bonds. While private industry was often in a position to finance its investments from retained earnings, the Treasury and the nationalized industries found it repeatedly necessary to issue obligations in which principal or interest, or both, were tied to the output or price of specific products, to gold, or even to stock exchange quotations. This system of indexed obligations, along with attempts to hedge against the depreciation of the currency by moving capital abroad, hoarding gold, or channeling savings into speculative investments, severely disrupted the capital market.

Unavoidably, inflation had a direct impact on the balance of payments. During the two years 1956-57 the external payments disequilibrium resulted in the loss of $1.3 billion of official international reserves, already noted, and exhausted existing foreign credits. During 1958, moreover, France used up almost all of an additional $655 million package of credits extended at the beginning of the year by the International Monetary Fund, the European Payments Union, the Export-Import Bank, and the United States Treasury. By the end of 1958, it was evident that France could no longer rely on foreign assistance and the drawing-down of its international reserves. Vigorous measures had to be taken to halt inflation and to balance the external accounts in order to utilize the rich potential of French resources for a well-balanced and sustained expansion.

Several attempts had been made to deal with these problems in the postwar period. In mid-1957 a program was adopted which included a measure of fiscal austerity, tightening of credit controls, reinforcement of import restrictions, and partial devaluation of the franc. Beginning in February 1958 the Bank of France imposed ceilings on most types of commercial bank credit for a year. At the same time the Treasury succeeded in reducing its budget deficit, mainly through the imposition of additional taxes, and with the advent in midyear of a more stable government it was able to float a sizable long-term bond issue on terms that induced the dishoarding of some $170 million of gold—the first dramatic evidence of a decided shift in public confidence. While helpful, however, these various measures were not fully adequate to cope with an advanced stage of inflation which required a determined attack on all fronts at once.

THE REFORM PROGRAM

This comprehensive attack was undertaken by the de Gaulle government, operating under decree powers, in December 1958 and January 1959. The program was designed not only to eliminate the inflationary effects of the budget deficit but also to eradicate distorting influences and uneconomic practices that had largely grown out of the inflation itself. For this reason, the reform measures were aimed not only at keeping down the government's budget deficit but also at a gradual dismantling of escalator clauses, subsidies, rent controls, import restrictions, and the like—in short, at reversing the succession of attempts to rely on ingenious contrivances as an escape from the implications of basic market forces.

With respect to the budgetary reform proper, the keystone of the program was a determined bid to reconcile increases in expenditures—including those incurred for capital investment — with the necessity of keeping the deficit low enough to avoid inflationary financing. The object of the reform was, in fact, to tailor the excess of public outlays over revenues to the financing capacity of the domestic savings stream. In order to break the pattern of rising budget deficits, the authorities attacked both the expenditure and the revenue sides of the budget and succeeded in keeping the projected 1959 budget deficit about 100 billion francs below the 1958 deficit of 690 billion. On the expenditure side, the reforms all but swept away the elaborate system of government subsidies that had been paid on food, fuel, and public utilities in vain attempts to limit cost-of-living increases. In addition, social welfare services were curtailed to some extent, and veterans' pensions were eliminated for all but the lowest income groups. However, projected outlays for defense, public investment, and housing—all regarded as essential—were allowed to rise. Nevertheless, as a result of the reform measures, the estimated increase in total spending between 1958 and 1959 was kept down to 5 per cent, in contrast to increases of 10-15 per cent in each of the three preceding years. On the revenue side, an increase of about 8 per cent was projected, as a number of taxes were raised, including those on wine and tobacco and on individual and corporate income.

On the external front, the franc was devalued by 14.93 per cent. This measure, along with those taken internally, enabled France to join the other Western European countries in the move toward currency convertibility at the end of December 1958 and, shortly thereafter, to abolish restrictions on capital transfers by foreigners. Import liberalization, which had been suspended in 1957, was also resumed; by mid-January 1959 France had

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eliminated quota restrictions on 90 per cent of her imports from the other members of the Organization for European Economic Cooperation (on the basis of 1948 trade) and on 50 per cent of her dollar imports (on the basis of 1953 trade). Furthermore, with the inauguration of the Common Market on January 1, 1959, France and the five other participating countries began to dismantle restrictions on trade among themselves and to extend part of their mutual trade concessions to a number of other nations as well.

No less important than the above measures was the enactment of legislation sharply curtailing the use of escalator arrangements. The indexing of bonds was not affected, but existing cost-of-living clauses in wage contracts were ruled inoperative after December 31, 1958. The virtual ending of escalation represented a major achievement since many individual segments of the economy had come to regard escalator clauses as a primary defense against price rises, while the general effect of these interlacing index ties was an accelerated propagation throughout the economy of any impluse toward rising prices originating in one sector or another. To ease the burden of the stabilization effort on the weakest sectors of the economy, the minimum wage rate remained linked to the cost-of-living index and was raised 4½ per cent to compensate for the initial price increases expected to result from the reforms.

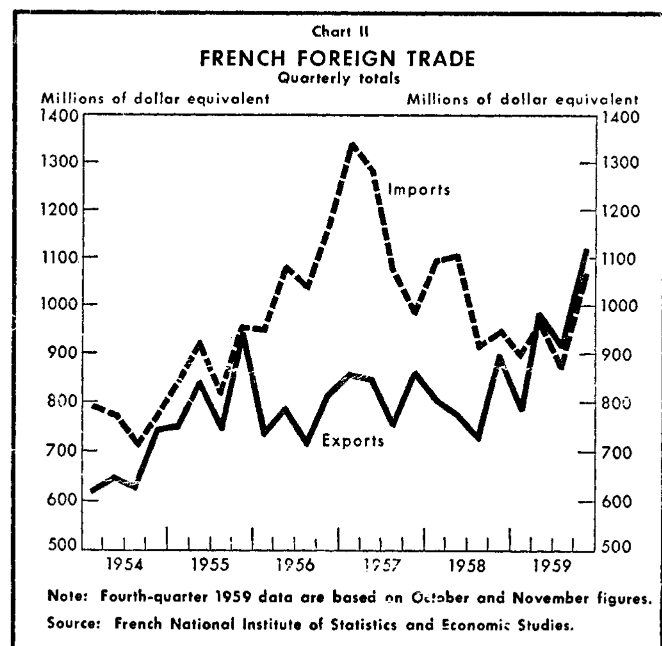
Finally, as a symbol of the definitive nature of the stabilization to be achieved by the program, the government introduced a new monetary unit, the "new franc", worth 100 old francs and scheduled to replace the old franc on January 1, 1960. Undertaken primarily for psychological reasons, this measure emphasized the government's determination to defend the currency against any further depreciation.

THE RESULTS

The results of the stabilization program so far have been striking—although the danger of renewed strains has by no means been completely dispelled. In the first year of stabilization, the price rise was slowed considerably and, in contrast to earlier periods, most of the increases were transitional or transitory in character. Moreover, the Treasury's cash position was so improved as to make recourse to the capital market for long-term funds unnecessary, while the dramatic strengthening of the country's balance of payments allowed France to rebuild her official international reserves. At the same time, France was able to make large repayments on her foreign debt and to liberalize substantially her economic transactions with the rest of the world. Meanwhile, the slackening of economic activity that had occurred in 1958 came to an end, and in the second quarter of 1959 expansion was resumed.

Perhaps the most spectacular of the program's results has been the complete reversal of France's external position, attested by the constant quotation of the franc in foreign exchange markets at or near the upper limit of the official margin and by the fact that the Paris "free market" rate for the dollar has consistently been below the official rate. Partly as a result of the devaluation, the trade gap was first drastically narrowed, and was then transformed into a surplus beginning in the second quarter of 1959 (see Chart II). Official exchange receipts from tourism rose considerably, as foreign tourists bought their francs through official channels rather than through the free market. Moreover, a large inflow of foreign exchange resulted from a repatriation of French funds and an increase in foreign investment in France.

As a consequence of these developments, France was able to rebuild official international reserves from $1.1 billion at the end of 1958 to $1.8 billion at the end of November 1959 (see Chart III). During the same period, foreign exchange liabilities of some $850 million were liquidated by the French authorities, including the repayment of $340 million to French commercial banks, $200 million to the International Monetary Fund, and substantial amounts to the members of the former European Payments Union, to the United States, and to other foreign creditors. Moreover, France was able to cancel the unused stand-by credits totaling $240 million that had been ex-



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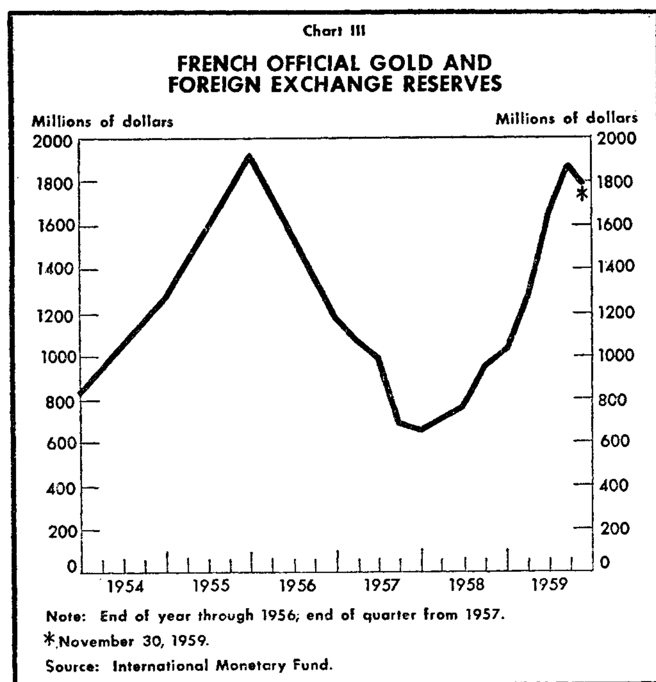

tended by four European central banks and the Bank for International Settlements in support of the convertibility move, as well as a $200 million credit extended by a group of New York City banks for the same purpose. Finally, last month France for the first time in thirty years was able to return to the United States capital market; taking advantage of the new financial strength achieved, the Crédit Foncier, a semipublic financial institution, successfully floated a $50 million bond issue here.

Meanwhile, France has continued to liberalize her economic transactions with the rest of the world. The inflow of foreign exchange enabled the authorities first to reinstate, and then to triple, the foreign exchange allocation granted to French tourists traveling abroad. At the same time, France in successive steps considerably expanded the scope of the initial import-liberalization measures taken in December 1958 and January 1959. By November 1959 the liberalization percentages had been brought to more than 95 per cent for imports from the members of the Organization for European Economic Cooperation (1948 basis) and to substantially more than 80 per cent for imports from the dollar area (1953 basis). Moreover, additional liberalization measures went into effect on January 1, 1960, and imports from the dollar area are now admitted on virtually the same basis as those from all other areas.[1]

[1] See also page 9 of this *Monthly Review.*

Internally, the December 1958 devaluation—unlike previous ones—was not followed by a surge of speculative pressures on prices. Instead, such price rises as occurred were inevitable results of the measures adopted and were smaller than had been anticipated. Indeed, prices stabilized shortly after the devaluation. So far, restraint on the part of labor has kept wage increases down as well. By midyear, consumer prices were only about 3 per cent above their pre-devaluation level, and wages had increased only 3½ per cent. Since June, prices of manufactured products have remained relatively stable, but food prices have risen, primarily as a result of a severe summer drought. As a consequence of the drought and of the earlier effects on prices that naturally followed in the wake of a devaluation and a major reconversion to free markets, consumer and wholesale prices had by the end of November edged up to levels 6 to 7 per cent above those of December 1958 (see Chart I).

In view of the generally favorable developments, the government was able to step up its efforts to counteract the slackening in economic activity that had developed in 1958. Monetary policy had already gradually become less restrictive, beginning in the second half of 1958. By February 1959 the commercial bank credit ceilings, imposed one year earlier, had been removed; by April the Bank of France's basic discount rate had been reduced gradually to 4 per cent from 5, and by early July its two penalty rates had been lowered to 5 and 6 per cent from 8 and 12. In addition, during 1959 the government accelerated its investment outlays and enacted a program of tax incentives designed to stimulate private investment, which was still lagging. Tax concessions were granted to companies entering economically depressed regions, and a schedule for the gradual relaxation of rent controls was adopted so as to spur the flow of private funds into housing. Consumption was encouraged by an easing of consumer credit restrictions and a 10 per cent increase in family allowances. In the second quarter, economic expansion resumed, and by October (as shown in Chart I) industrial production was 10 per cent above its low of December 1958, and nearly 5 per cent above the peak it had reached early in 1958.

The Treasury has benefited from the general improvement of economic conditions. An upward revision of expenditures in the course of the year was covered by larger-than-anticipated tax receipts. As a result, the budget deficit was maintained within the limits envisaged by the stabilization program, despite the continuation of the Algerian conflict. The budget for 1960, moreover, projects a deficit no larger than that for 1959. Thus, if events fulfill expectations, 1960 will be the third successive year in

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which the government will have succeeded in keeping its budget deficit down to what it considers a manageable level.

To finance its deficit for 1959, the Treasury borrowed short term by tapping the rising liquidity of both the banks and the nonbank public that stemmed from the large-scale inflow of foreign exchange and the temporary slackening in economic activity. The authorities thus abandoned earlier plans for a long-term bond issue, and left at the disposal of private borrowers a greater share of the resources available on the capital market. With the new confidence in the currency and the inflow of funds from abroad, the capital market began to show signs of revival, as illustrated by the fact that, in the first six months of 1959, corporate flotations of bonds were more than double their year-earlier level. Long-term interest rates remain relatively high—5½ to 6 per cent for corporate bonds—but they are sharply below their 1957 peaks.

LOOKING AHEAD

Despite the impressive performance of the French economy under the stabilization program, serious problems remain. New upward pressures on prices have developed which, while not yet alarming, have created some concern. One of the factors on which the government had pinned its hopes of keeping prices down in the fall of 1959 was the prospect of bountiful harvests. Instead, an extremely dry summer brought about shortages in a number of foodstuffs and a persistent inching-up of the price level in recent months. The price rise resulted, on November 1, in a statutory 2½ per cent increase in the minimum wage rate, under the escalator arrangement. This wage hike is expected to lead to adjustments in other wage rates as well, and may put some pressure on prices. In this connection, the recent advances in the general liberalization of imports are expected to assist in safeguarding price stability. However, continuation of the restraint that French labor has shown—at least until recently—in wage demands, and restraint on the part of industry in its pricing policies, both remain basic elements in France's struggle to preserve stability.

On the external front, France's newly acquired international strength needs to be consolidated. Imports are expected to increase as a result of the pickup in economic activity now under way, although it is hoped that the recent discovery and development of oil and gas in France and in the Sahara will drastically reduce the country's dependence on foreign fuel. In the next few years, France's balance of payments will also be burdened with heavy short-term debt repayments—principally to the International Monetary Fund and to members of the former European Payments Union—as well as with the servicing of $2 billion in long-term obligations.

Over the long run, France like other countries is confronted with the problem of sustained and balanced economic growth. Large-scale investments in housing, education, and industry, both at home and in the associated territories, will require a steady expansion in the flow of voluntary savings, which will be forthcoming only in a climate of price stability and of confidence in the currency. Such a climate would not only be likely to elicit a favorable response from a traditionally thrifty people but might well induce Frenchmen to sell to the government a substantial part of their large holdings of gold and foreign assets, which have been variously estimated at between $4 billion and $10 billion. The progress so far in restoring confidence and encouraging savings represents a beginning. However, given the postwar experience of inflation and currency depreciation in France, it may take some time before complete confidence in the currency can be restored and a flourishing capital market re-established.

France also faces a number of structural problems. While many French industries are highly efficient, the country's productive and distributive system still includes antiquated and inefficient sectors which seriously handicap the economy's over-all progress. France hopes to modernize these sectors as rapidly as possible, and to eliminate the remaining institutional and psychological obstacles to expansion which were an outgrowth of inflation and of government controls that stifled free market forces.

While many problems thus remain to be solved, France now seems to be in a position to deal with them effectively. A major achievement of the stabilization program, apart from those already noted, is that it has hastened the restoration of self-confidence and has added vigor to the economic life of one of the most richly endowed countries in the world. France's recent export performance, both within and outside the Common Market, is one of the first signs of this transformation. Provided that a resurgence of inflationary pressures is avoided, and that reliance upon a genuinely free market mechanism continues to broaden, there can be high hope everywhere that France will regain and maintain the economic strength that her role in the Free World requires.

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