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Liquidity Developments in Three Business Cycles

THE QUANTITY OF MONEY and holdings of other liquid assets have an important influence on the level of economic activity. Although money provides the highest degree of liquidity, it is only one of numerous assets which may satisfy the public's desires for liquidity. Economic analysis has given some attention to the relationship between the *actual* holdings of liquid assets and the *desired* holdings of liquid assets.[1] Around this concept of liquidity has developed an explanation of forces contributing to expansion and contraction in spending, i.e., total demand for goods and services. In its simplest form the explanation is as follows: If the public's actual holdings of liquid assets are greater than its desired holdings, spending tends to expand. If, on the other hand, the public desires more liquidity than it actually possesses, spending tends to fall.

Some policy implications of this liquidity analysis, briefly stated, are that when total demand for goods and services is insufficient to maintain reasonably full employment, the quantity of liquid assets should be increased. During times when total spending is excessive and tending to cause price inflation, an opposite policy is indicated.

This article does not attempt to inquire into the soundness of either the theory or the policy implications. Also, no attempt will be made to estimate changes in the desired liquidity of the public. Rather, some facts are presented relating to fluctuations in the actual holdings of selected liquidity instruments during the three most recent business cycles.[2] The public's holdings of liquid assets are analyzed in two major classes: those assets whose volume is largely under the control of public policy and those over which the Government has very little direct control. The former include currency, deposits of commercial banks and short-term Government securities while the latter refer to savings and loan shares, deposits in mutual savings banks and United States savings bonds.

One further disclaimer is appropriate before proceeding further. While the public's so-called liquidity position can readily be discussed in theory, it is a concept that does not lend itself to exact measurement. The public's view of the liquidity of a particular asset may change from time to time and the concept "liquidity" is a relative term. For instance, when does a Government security become a liquid debt instrument? A 30-year bond at date of issue is not generally considered a liquid asset. However, this same bond 90 days from maturity could be considered a liquid asset. At what point in time did this bond take on all the characteristics of a liquid debt instrument? Any attempt to measure changes in the public's liquidity involves rather arbitrary decisions as to which items are to be considered liquid assets. Furthermore, the availability of credit (a concept which does not lend itself to exact measurement) influences the public's liquidity.

Money Supply

The money supply, defined as demand deposits and currency, is the most liquid of all assets. All other assets are classified in terms of their nearness to money. The volume of money in existence is influenced by the volume of reserves which the Reserve Banks make available to member banks. From the peak in business activity in May 1960 through February 1961 (the latest month for which data are available) the money supply, adjusted for seasonal variations, expanded at an annual rate of about 1.3 per cent. This was roughly the same rate of expansion that occurred in the first nine months following the previous two peaks in business activity (see Chart I).

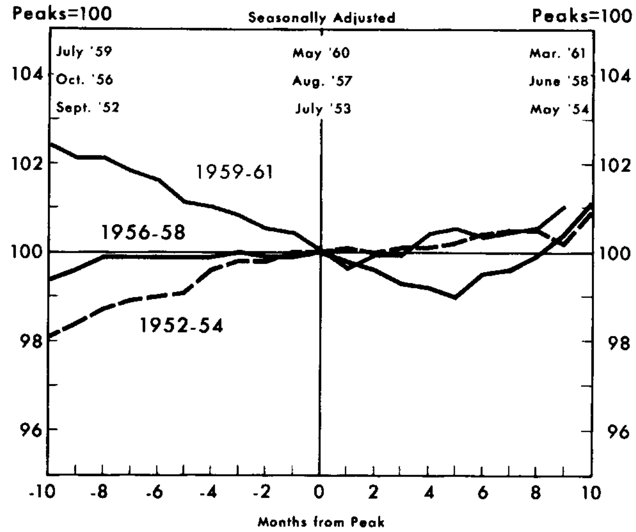
The most striking difference between the behavior of the money supply during the present busines cycle and previous cycles occurred in the expansionary phase leading up to the peak in activity. The money

[1] The term "liquid assets," broadly defined, includes money and other assets which can readily be converted into cash without significant loss. These other assets, often referred to as "near-money," have many characteristics of money.

[2] Fluctuations are measured over a period covering ten months before and ten months after the three most recent peaks in business activity. The article uses National Bureau of Economic Research reference dates, July 1953 and August 1957, which were based on a consideration of ten indicators of economic activity. Although there is no agreed-upon date for the beginning of the most recent economic contraction, May 1960 was selected for this article.

I

Money Supply



supply contracted at an annual rate of 2.9 per cent during the ten months prior to the May 1960 peak. This was in sharp contrast to the 2.3 per cent annual rate of expansion in the like period before the 1953-54 recession and the leveling off in the months preceding the August 1957 downturn.

Time Deposits

Time deposits of commercial banks possess many of the characteristics of money. Like demand deposits, the major component of the money supply, time deposits are liabilities of commercial banks. The total volume of bank reserves influences the volume of total deposits, both demand and time.

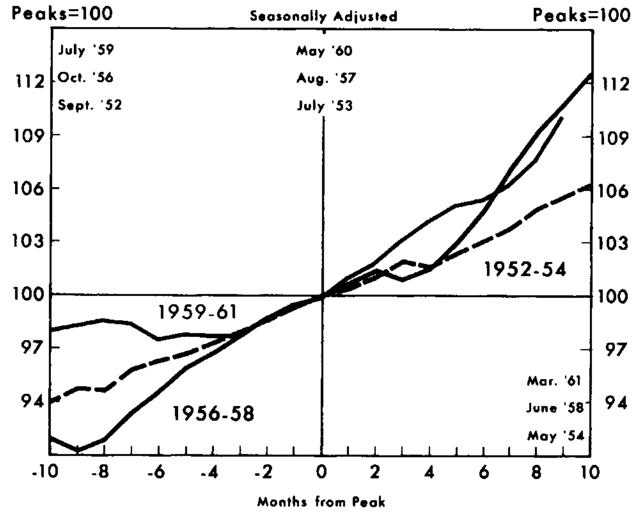
Time deposits have expanded at an annual rate of 13 per cent in the nine months since the May 1960 peak (see Chart II). This was slightly less than the the nine months following the August 1957 peak but higher than the 7 per cent annual rate of increase during the first nine months of the 1953-54 recession. However, time deposits grew at a substantially slower pace during the ten months preceding the May 1960 peak than in the two previous expansionary phases.

Money Supply Plus Time Deposits

The money supply plus time deposits—a concept some analysts term *money*—grew at a greater rate during the 1960-61 recession than during the two previous business downturns. Total commercial bank deposits and currency increased at an annual rate of 5.2 per cent from May 1960 to February 1961 (see Chart III), compared with a 4.4 per cent and 2.1 per

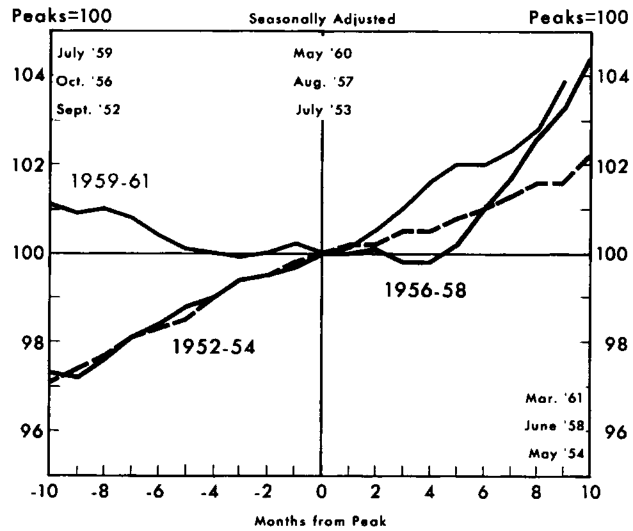
II

Time Deposits



III

Money Supply and Time Deposits



cent rate of expansion during the comparable periods of the 1957-58 and 1953-54 recessions.

In the ten months prior to May 1960 the money supply, broadly defined, declined at an annual rate of 1.3 per cent. In the ten months preceding the peaks of the two previous cycles the annual rate of expansion in money supply plus time deposits was about 3.5 per cent.

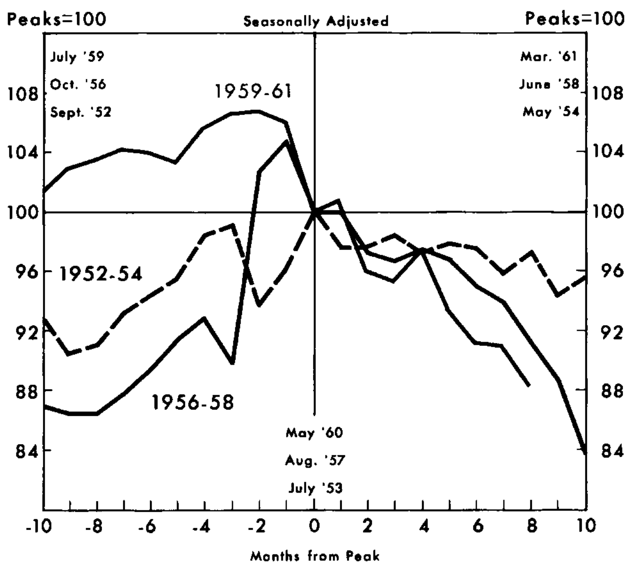
Short-term Government Securities

Short-term Government securities, that is, Treasury bills and other publicly held marketable Treasury issues with less than one year to maturity, are also important liquidity instruments and, like time deposits, are close substitutes for money. Commercial banks, other financial institutions, large corporations, foreign, state, and local governments, and trust funds frequently place their temporarily idle cash balances in these securities. An important feature of short-term Governments is that the quantity outstanding is largely at the discretion of the Government in the sense that the Treasury can place the Federal debt in liquid short-term instruments, long-term investment-type issues, or in intermediate-term issues. The securities issued depend on many considerations, the liquidity of the public being only one.

From May 1960 through January 1961, the latest month for which data are available, the quantity of U. S. Government securities maturing in one year or less in the hands of the nonbank public declined at an annual rate of 16 per cent (see Chart IV). The quantity of short-term Government securities contracted substantially more during the early months of the present recession than during similar months of the past recessions.

IV

U.S. Government Securities Maturing Within One Year



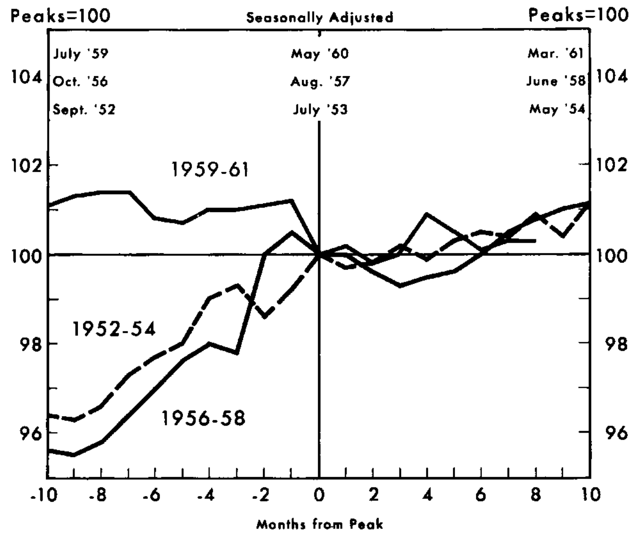
In the ten months prior to the May 1960 peak in business activity, the volume of short-term Governments declined on balance, most of the decline concentrating in the months just preceding the turning point. By contrast, the quantity of Government securities maturing within one year increased at an annual rate of 18 per cent and 9 per cent in the ten months prior to the August 1957 and July 1953 peaks, respectively.

Publicly Controlled Liquidity

Chart V combines money supply, time deposits, and short-term Government securities held by the nonbank public into a single measure of liquidity. The movement of this series about the peaks of the recent business cycles represents changes in the public's liquid assets which are, to some degree, controlled by the Federal Reserve System, which regulates bank deposits, and the Treasury, which controls the quantity of short-term securities outstanding.[3]

V

Money Supply, Time Deposits and Short-Term Government Securities



The liquid assets of the public as measured by money supply, time deposits, and short-term Governments expanded at an annual rate of 0.4 per cent during the eight months following the May 1960 peak. This compares with an annual rate of increase of about 1.1 per cent during the eight months following the previous two peaks in economic activity. Indications, based on the recent expansion in the money supply and time deposits as well as the Treasury debt management operations, are that this measure of the public's liquidity has expanded in the last few months. The expansion over the ten months from last May to March was probably comparable to the expansion which occurred in the like months of the previous recessions.

[3] The Government also influences the liquidity of the public in other ways, such as issuing marketable securities with maturities just over a year, creating the Federal Savings and Loan Insurance Corporation and guaranteeing mortgages. However, total commercial bank deposits and short-term Government securities are the instruments through which the Government acts directly on the public's actual liquidity position.

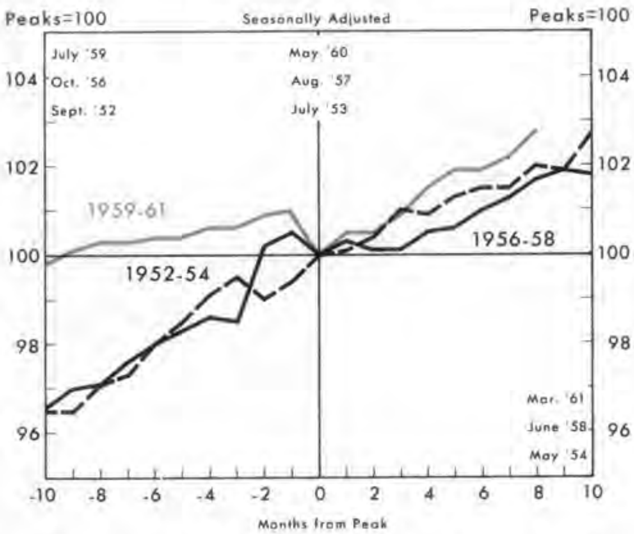
There is a striking dissimilarity between the movement of this measure of liquidity in the ten months preceding the recent peak and the movements leading up to the other two most recent peaks. From October 1956 to August 1957, the increase on an annual basis was 5.5 per cent and from September 1952 to July 1953 the annual rate of increase was 4.6 per cent. In the ten months leading up to the May 1960 peak there was a 1.3 per cent rate of decline in this measure of liquidity.

Total Liquid Assets

A more comprehensive measure of the public's actual liquidity is attained if savings and loan shares, deposits in mutual savings banks, and United States savings bonds are added to money supply, time deposits, and short-term Government securities (see Chart VI). This measure will be referred to as total

VI

Total Liquid Assets



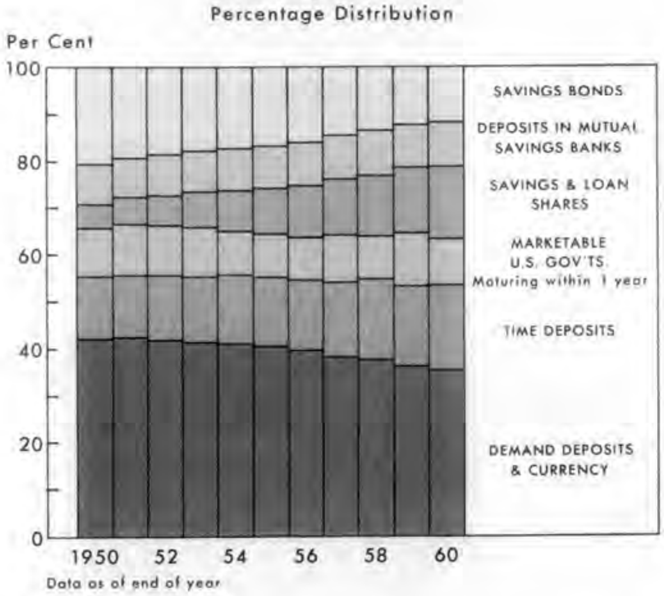
liquid assets, although it should be understood the use of the word "total" does not imply that this is an all-inclusive list. Total liquid asset holdings of the public expanded at an annual rate of 3.7 per cent during the period May 1960-January 1961. Indications are that this rate of increase continued about unchanged in the first quarter of 1961. In the eight months following each of the previous business cycle peaks, total liquid assets expanded at an annual rate of about 2.5 per cent. The rapid growth in the public's total liquidity since May of 1960 was due in part to a rapid growth in savings and loan shares which expanded at an annual rate of 13 per cent.

In the ten months preceding the May 1960 downturn, the public's liquidity position was about unchanged on balance, the growth in savings and loan shares and time deposits being offset by a declining money supply and a reduction of short-term Government debt instruments. In the ten months preceding the August 1957 and July 1953 peaks the public's total liquidity position expanded at an annual rate of about 4.4 per cent.

VII

Total Liquid Assets

Percentage Distribution



Summary

Public holdings of liquid assets expanded at a more rapid rate during the 1960-61 recession than in the like periods of the two preceding recessions. A notable exception to this generalization was the unusually sharp decline in short-term Government securities in the hands of the public. In the ten months prior to May 1960 liquid assets held by the public changed little on balance largely as a result of the contraction in the quantity of bank deposits and short-term Government securities. By contrast, in the months preceding the peak of the previous cycles, total liquid assets of the public expanded at a rapid rate.

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Signs of a Business Turn?

OUTPUT of the nation's mines and factories held steady in February of this year and may have strengthened during March. In March the proportion of unemployed in the civilian labor force remained near its February level, the highest since October 1958. The average factory workweek and the average weekly earnings of employed workers were about unchanged from January to February. Consumers stepped up their outlays at retail establishments in February and March.

Inventory Developments

Inventory developments in recent months are in sharp contrast to those during the initial stages of the current downturn. Inventory liquidation[1] by manufacturers in the early months of the recession was centered in inventories of purchased materials and of goods in the process of production. More recently the picture has been dominated by liquidation in inventories of manufacturers' finished goods and of goods in the hands of retailers.

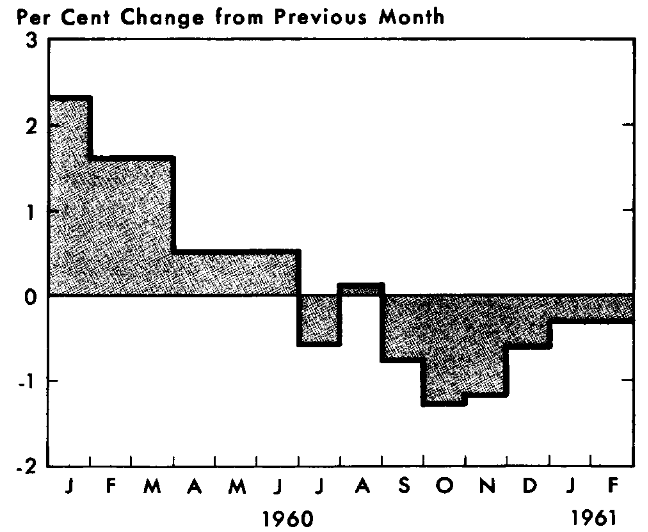
From January through June 1960 total inventories were accumulated, but at a sharply declining rate. These declines were especially clear in the durable manufacturing sector as manufacturers sought to reduce inventories and to pare down production to a level more in line with their declining volume of sales (see Chart 1). Liquidation of durable manufacturers' inventories began in July of 1960 and was especially heavy through October and November.

[1] Unless otherwise specified, changes in inventories and sales have been corrected for seasonal influences.

1

Total Inventories of Manufacturers of Durable Goods

Seasonally Adjusted



Source: U. S. Department of Commerce.

One of the means by which manufacturers can adjust their inventories is to cut back on purchases from their suppliers. Accordingly, as Chart 2 indicates, inventories of purchased materials were the first to show the effects of manufacturers' cutbacks. By June 1960 liquidation was under way in these stocks.

Inventories of goods in process of production reflect, with some lag, current levels of output and employment. Though there was modest liquidation of these inventories in April (see chart), sharp and persisting liquidation began in July, one month after the onset of liquidation in purchased materials inventories.

Finished goods inventories continued to expand through the first four months of the recession as production persistently outran sales. At times, such a situation may reflect a desire on the part of manufacturers to build up their inventories; this was apparently not the case from May to September 1960.[2] In October of 1960 manufacturers succeeded in bringing production in line with the lower levels of sales. From October 1960 through February of this year inventories of finished durable goods declined (see Chart 2). All liquidation by manufacturers in January occurred in finished goods inventories. Inventory liquidation in February centered in finished goods and in goods in the process of production with largest cuts among producers of automobiles. There was also extensive inventory liquidation by retailers, especially by automobile dealers. Liquidation in manufacturers' stocks of finished goods and in retailers' inventories indicates that sales exceeded the prevailing rates of production and supply.

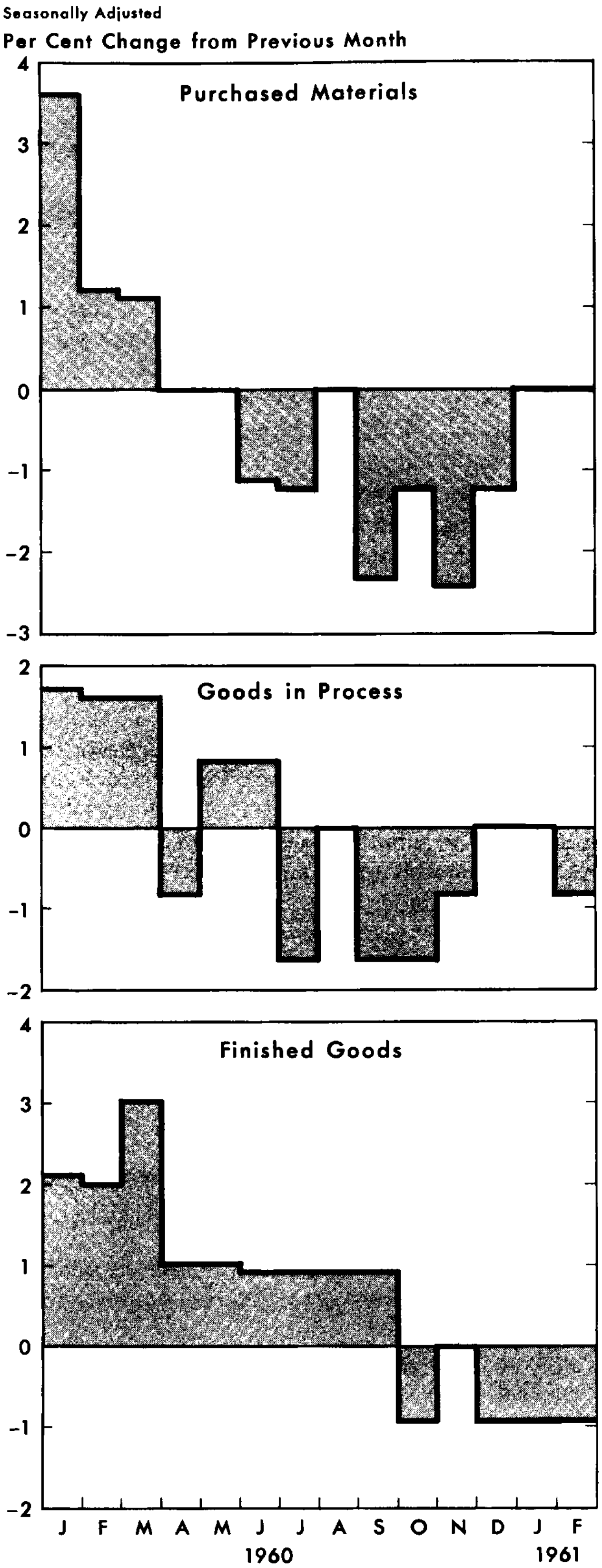
New Orders and Sales

In February manufacturers of durable goods experienced their first expansion in new orders since September 1960. Much of the expansion was attributed to Government defense contracts with the aircraft and instruments industries. Sales of manufacturers' durable goods edged 1 per cent above the January level, the first expansion in this series since May 1960.

[2] Although there is no universally agreed-upon date for the beginning of the most recent economic contraction, May 1960 was selected for this article.

2

Inventories of Manufacturers of Durable Goods by Stages of Fabrication



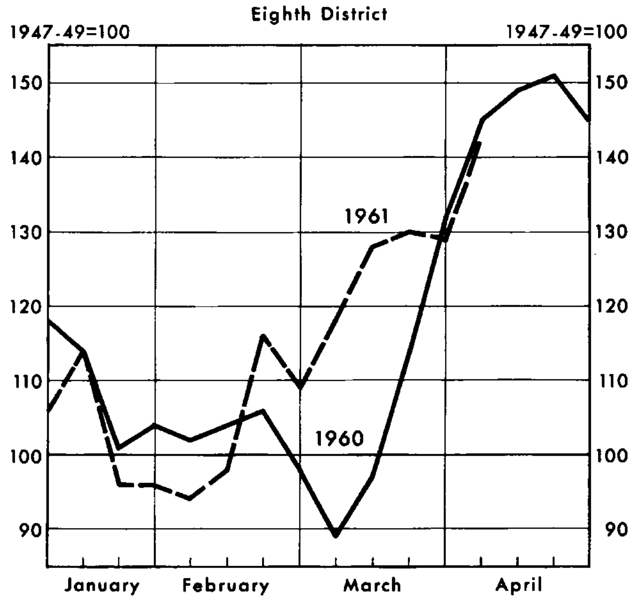
Source: U. S. Department of Commerce.

After three successive months of decline, sales by retailers advanced about 1 per cent from January's level, with much of the expansion concentrated in department and other general merchandise stores. February sales of automobiles and durable goods generally were unchanged from January. Although automobile sales increased during March, the level of sales for the month was below the average for this time of year.

Department store sales in the Eighth Federal Reserve District, as in the nation, during the four weeks ending March 26 were up substantially over the corresponding period of 1960.[3] However, part of this

3

Department Store Sales Index



year's increase in sales was attributable to the earlier Easter season. Sales were abnormally low in the same period of 1960 as a result of heavy snowstorms. After adjusting for these factors the margin of improvement over a year earlier is somewhat diminished. Sales in the major metropolitan areas of the district have gained over last year, while sales in the smaller cities have improved even more.

Industrial Production

The nation's industrial output, after declining for six consecutive months, was unchanged during February from January's level. Decreases in materials production, seasonally adjusted, were offset by small increases in consumer goods output, notably in such consumer durables as T.V., radio, and other household appliances.

[3] The Weekly Department Store Sales Index is not adjusted for seasonal influences.

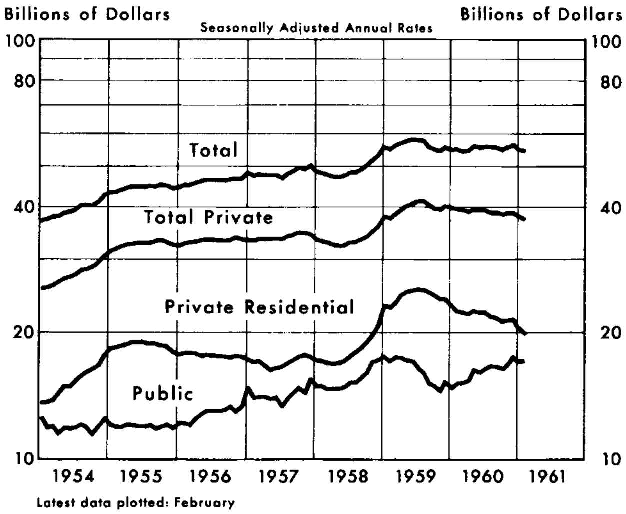
There was modest expansion in iron and steel output during February and March despite continuing weaknesses in the construction and automobile industries, important consumers of steel and steel products. Such developments lend support to the hopes that liquidation of steel inventories may be ending. There was also some strengthening in production of business equipment.

Construction

Expenditures on construction in February, seasonally adjusted, totaled $54.4 billion, down 1 per cent from January. Most of the decline was in private residential construction. Viewed more broadly, however, outlays on construction have been quite stable through the past year; the current level is only 1 per cent below that which prevailed in February 1960.

4

Outlays for New Construction



Source: U. S. Department of Commerce.

Housing starts during February, seasonally adjusted, were up 7 per cent over January. This is the second straight month of advance in this series. Seasonally adjusted applications for FHA commitments were unchanged in February from January. February VA appraisals of proposed new homes were up 27 per cent from January and 15 per cent from February of 1960.

Unemployment and Income

The number of workers on the nation's nonfarm payrolls expanded more than seasonally in March, following a sharp drop in February. Although unemployment declined by 210,000 workers, the decline was less than seasonal. Unemployment in March at 6.9 per cent of the civilian labor force after seasonal adjustment was up only slightly from the level prevailing from December through February but was substantially higher than the pre-recession low of 4.8 per cent in February 1960.

Layoffs during February were prominent among workers in construction and in manufacturing, especially in the automobile industry. In the early weeks of March, layoffs in these sectors slowed somewhat. Although unemployment remained high among steel workers (and in primary metals generally) there was apparently no further worsening in this sector of the economy.

The week ending March 18 marked the fourth successive week of decline in the number of workers in the nation receiving unemployment benefits. Part of the decrease is attributable to seasonal forces; in addition, a substantial number of workers have exhausted their benefit rights. Despite these declines the level of insured unemployment is near the record high for this time of year. As a result of improved weather conditions for outside employment and because of some slackening in layoffs in the automobile industry, initial claims for unemployment compensation declined on balance over the three-week period ending March 25. Though this series is highly erratic, it appears that the pace of initial claims is currently running somewhat behind that set during the corresponding period in the recession year of 1958.

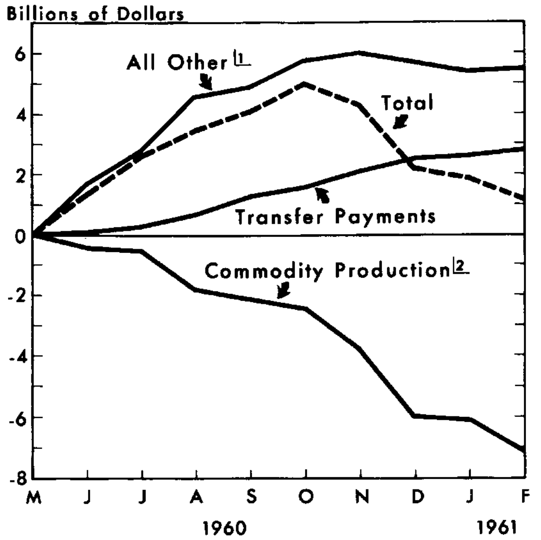
During March, the labor markets of the major metropolitan areas in the Eighth Federal Reserve District reflected a mixed pattern. There was some seasonal pick-up in trade and construction activities in all areas. The number receiving jobless benefits decreased moderately at Memphis and Little Rock, and was 9 per cent under the previous month at Evansville. However, uneven production schedules in the automobile industry contributed to a continuing high level of unemployment at St. Louis and Louisville. At all the major labor markets insured unemployment remained substantially higher than at this time of year in 1959 or 1960.

Personal Income

Personal income in the nation, after taking account of seasonal forces, declined slightly in February, the fourth consecutive month of decline. During the current economic contraction the decline in total personal income lagged behind other movements in the economy, while the downturn in income from factories was more prompt. As shown in Chart 5 total personal income expanded for five months following the May 1960 peak. The decline in wages of production workers coincided with the decline in industrial output. Transfer payments, which include unemployment compensation and Social Security benefits, expanded steadily during the period. Other forms of income—including dividends, rents, interest, 5

Personal Income

Cumulative Changes Since May 1960



1 Includes farm and nonfarm proprietors' income, dividends, rents, interest, wage and salary disbursements in trade, service, and Government.
2 Wage and salary disbursements in manufacturing, construction, and in other commodity producing industries.

and income of owners of farms and businesses—expanded (in total) through the first six months from the peak, but have declined slightly since November.

Financial Developments

Total member bank reserves, adjusted for seasonal variation, expanded by about $200 million during January and February but declined slightly in March. The expansion in reserves resulted largely from smaller than usual net sales of securities in the open market by the Federal Reserve. Member bank borrowing from Reserve Banks averaged about $65 million in

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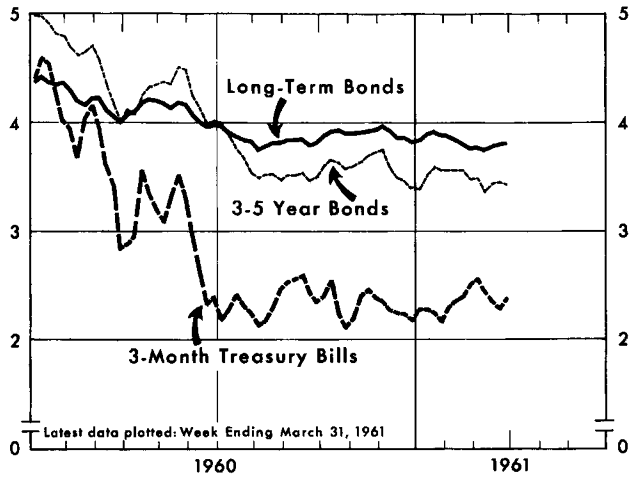
Yields on U.S. Government Securities

Weekly Averages of Daily Figures



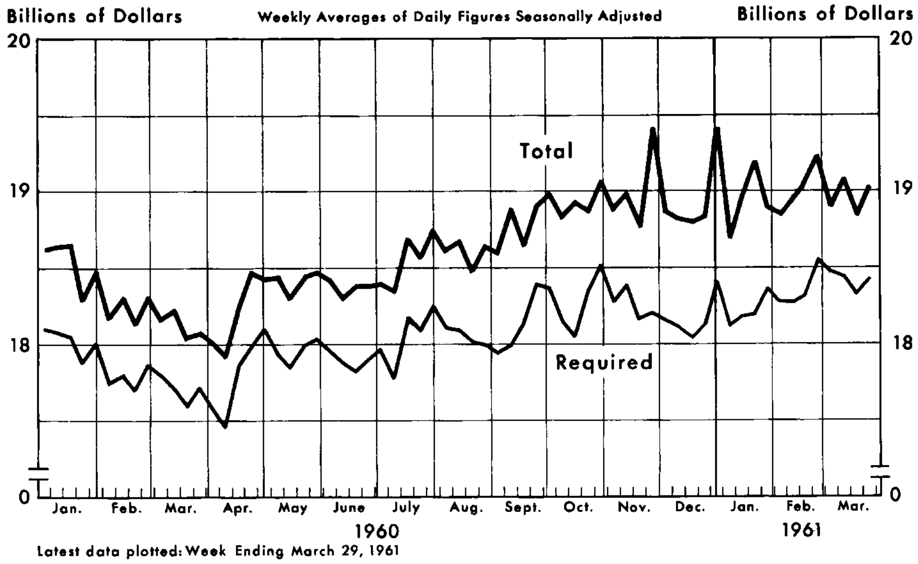
March, down slightly from the level during December of 1960. Excess reserves, which averaged roughly $650 million in March, were also moderately below the levels of late 1960.

Reflecting the strength in reserves, loans and investments of commercial banks, seasonally adjusted, expanded by about $3 billion during the first two months of 1961. Indications based on weekly reporting banks are that total bank credit rose less than usual during March. Business loans at weekly reporting banks expanded sharply during the first quarter of the year. The money supply of the nation (demand deposits and currency) expanded by about $0.7 billion during the first two and one-half months of the year. In this same period time deposits expanded by $3 billion.

6

Reserves of Member Banks*

Weekly Averages of Daily Figures Seasonally Adjusted



* Reserves of member banks adjusted for changes in the percentage of reserves required, sometimes referred to as "effective" reserves.

Yields on Treasury bills averaged about 2.40 per cent during March, down slightly from February, but above the 2.25 per cent level around the turn of the year. Interest rates on long-term Government bonds continued to edge downward in March. In an advance refunding during late March the Treasury exchanged more than $6 billion of four outstanding issues for two new bonds due in 1966 and 1967. Two purposes of the Treasury's operation were to reduce the debt management problems in 1962-63 and to lengthen the average maturity of the debt. The Treasury also sold $1.5 billion of 4½-month tax anticipation bills during the last week in March.

District Banking in Early 1961

TOTAL commercial bank loans and investments as well as deposits exhibited strength in the first two months of 1961. Total credit outstanding, seasonally adjusted, at Eighth District member banks rose about 2 per cent during January and February, while loans and investments at commercial banks throughout the nation increased at a slightly lower rate.

Loan volume, which usually declines during the early months of the year, remained virtually unchanged in the two months at member banks in the Eighth District. Loans at commercial banks throughout the nation declined, but much less than usual. District banks reduced their investment holdings while commercial banks in the nation increased their portfolios on balance.

Total deposits seasonally adjusted, reflecting the changes in loans and investments, rose during the first two months of the year. The money supply of the nation (which consists of demand deposits plus currency) grew at an annual rate of 3.6 per cent from December through February. Demand deposits at district member banks, seasonally adjusted, increased at about twice the rate at which the nation's money supply grew. Time deposits at district banks, as in the nation, increased sharply.

The ratio of loans to deposits for district member banks changed only slightly in the first two months of 1961, remaining at a level just under 50 per cent. At the end of May last year, the loan to deposit ratio reached a peak of 51.4 per cent. By comparison, loans averaged about 45 per cent of deposits in the year 1957 and less than 40 per cent in 1953.

From the end of February to March 22, bank credit at district member banks was virtually unchanged on a seasonally adjusted basis, according to data received from weekly reporting banks in leading cities. However, it appears that total deposits declined slightly, a rise in time deposits being more than offset by a decline in demand balances.

Banking conditions varied in the different parts of the district in the early months of 1961. A brief review of developments in the major cities in the district points up some of these differences.

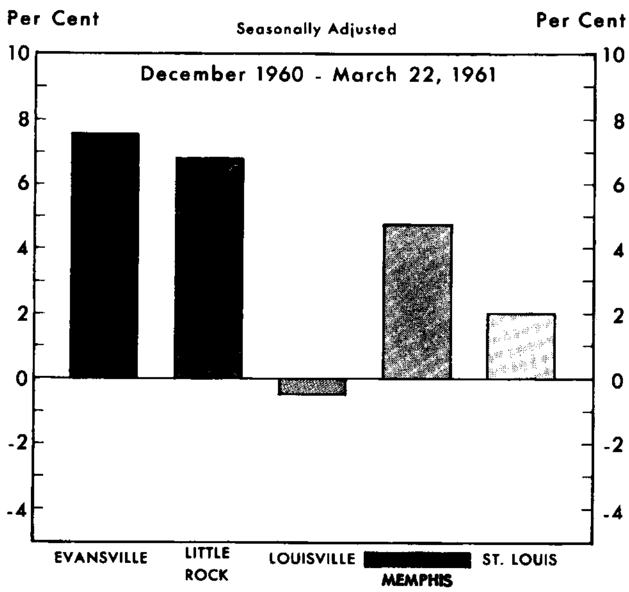
St. Louis—Total deposits at weekly reporting banks in the city of St. Louis showed modest strength during the first twelve weeks of 1961 (through March 22). Time deposits rose $39 million, and demand deposits contracted $93 million. Adjusted for seasonal influences, total deposits rose about 2 per cent during early 1961.

Reflecting in part the deposit experience, total credit at the St. Louis weekly reporting banks, after seasonal adjustment, increased about 1.5 per cent during the first twelve weeks of 1961. Loans, which normally decline at this time, rose slightly ($2.0 million). A substantial drop in loans in financial institutions failed to offset rises in advances to consumers and to businesses, primarily textile, apparel and leather manufacturers, contractors, and wholesale firms. On the other hand, these banks sold on balance $6 million of their security holdings in the period.

Louisville—From the end of December through the third week in March, total deposits at Louisville weekly reporting banks, seasonally adjusted, showed little net change, a sharp rise in February being offset by decreases in January and early March. Demand deposits declined $79 million. Time deposits rose only slightly, contrary to the pattern of large increases in these accounts at banks in most other cities of the nation.

Changes in Total Deposits

Weekly Reporting Banks in District Cities



Total loans and investments at Louisville banks contracted about seasonally in early 1961. Total loans declined slightly less than they usually do at this time of year, with the most notable contraction in outstanding advances to consumers. Investment portfolios were reduced about $9 million.

Memphis—Total deposits at Memphis banks, seasonally adjusted, rose about 5 per cent from the end of last year through March 22, 1961. Demand balances of state and local governments and certified and officers' checks rose, and other demand balances declined less than usual in the first twelve weeks of the year. Time deposits increased 8 per cent.

Total credit outstanding at Memphis banks contracted much less than usual during early 1961. Loans contracted $14 million, which was less than usual at this time because of increases in consumer loans reflecting a sizable purchase of consumer receivables. Memphis banks reduced their holdings of investments $6 million in the twelve weeks under review.

Little Rock—Banks in Little Rock gained deposits in the first twelve weeks of 1961. Total deposits rose $6 million, compared with declines of $9 million and $16 million during the corresponding periods of 1960 and 1959, respectively. Demand deposits increased $5 million and time and saving accounts rose $1 million.

Total credit contracted $2.6 million at Little Rock banks in the same period. Both loans and securities declined slightly. Total credit at these banks decreased $3 million during the corresponding weeks of both 1960 and 1959. A contraseasonal rise in agricultural loans this year partially offset seasonal declines in other types of loans.

Evansville—Total deposits at weekly reporting banks in Evansville increased about $2 million from the end of 1960 to March 22, 1961. This compares with declines of about $12 million during the corresponding period of 1960 and of $17 million in the like weeks of 1959. Demand deposits declined moderately, but the decrease was more than offset by a rise in time deposits.

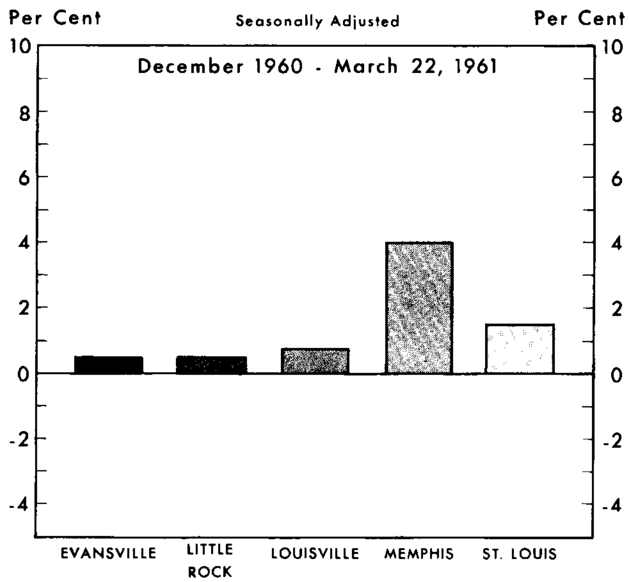
Evansville banks expanded the total amount of credit outstanding by $6 million during the first twelve weeks of the year. By comparison, bank credit was virtually unchanged during the corresponding weeks of 1960 and declined $5 million during 1959. The increase in early 1961 resulted from net purchases of securities, primarily short-term Government issues. Loans were virtually unchanged during the period.

Other District Member Banks—Total deposits, seasonally adjusted, at member banks in the smaller cities and rural areas of the district rose from the end of 1960 through the middle of March 1961. Time deposits increased $31 million, and evidence suggests that demand deposits declined less than seasonally.

Credit outstanding, when adjusted for seasonal variation, increased somewhat. Loans rose, but holdings of securities, primarily Government obligations, were reduced.

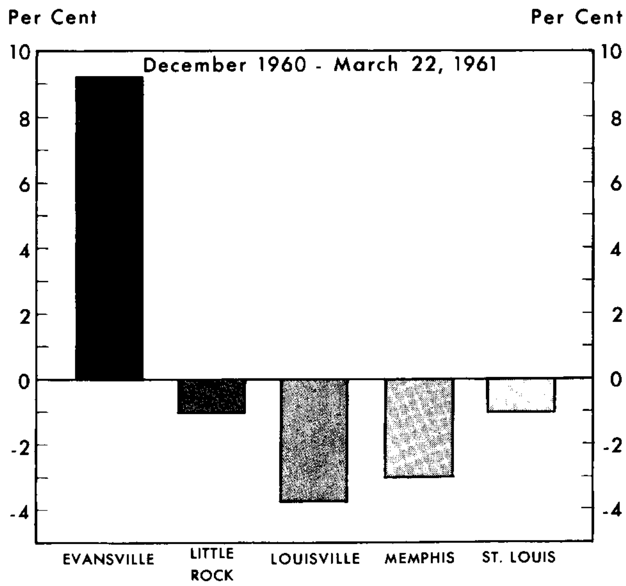
Changes in Total Loans

Weekly Reporting Banks in District Cities



Changes in Total Investments

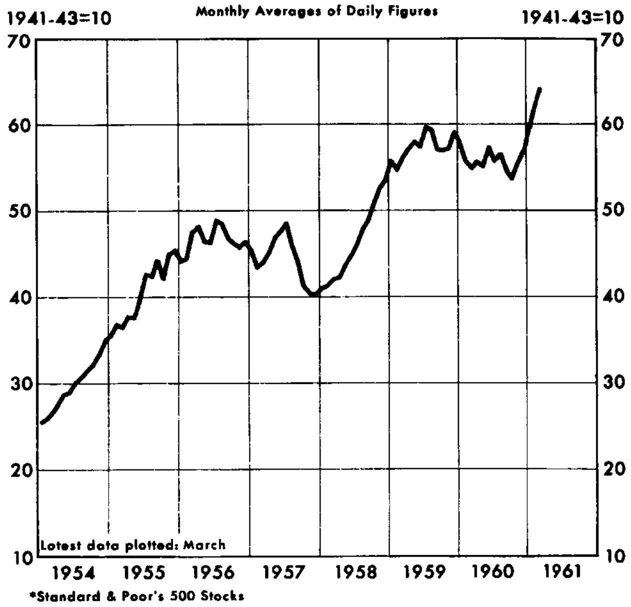
Weekly Reporting Banks in District Cities



The Stock Market in Recent Months

BEGINNING IN OCTOBER 1960 and continuing into March this year, the stock market experienced a marked rise of prices. Daily average prices during the month of March 1961, as measured by the Standard and Poor's 500 stock index, were 19 per cent higher than in October last year. Furthermore, security prices were 7 per cent above prices prevailing in the previous peak month of July 1959 (see Chart I). The daily volume of transactions also increased substantially, from an average of 2.6 million shares in October last year to 5.4 million shares this March.

Stock Prices*

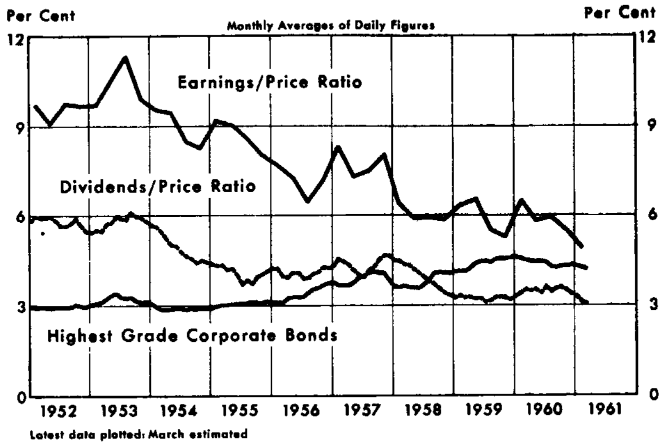


The boost in stock prices in the past few months occurred in spite of a downward trend of corporate profits since the first quarter of 1960. Corporate profits fell 17 per cent, seasonally adjusted, from the first three months of 1960 to the fourth quarter of the year. Moreover, in the first quarter of this year corporate profits were probably somewhat below the fourth quarter last year.

In comparison with past periods, corporate stock prices are now high in relation both to corporate earnings and to dividends paid. In the first quarter of 1961 earnings probably averaged below 5 per cent of stock prices. This is in contrast to an average of about 5.9 per cent in 1959 and 1960 (see Chart II). From 1955 to 1957 corporate earnings averaged nearly 7.7 per cent of security prices. Although stock market data for the decade of the 1920's are not exactly comparable to those of today, the average earnings-price ratio in the first six months of 1929 was about 5.5 per cent. The ratio probably fell slightly below 5 per cent in September of that year, the month when stock prices reached their peak.

Dividends as a per cent of stock prices have also declined in recent months. At cash dividend rates existing last October the average annual yield on shares in the Standard and Poor's 500 stock index was roughly 3.60 per cent (see Chart II). By March of this year, the ratio of dividends to prices had fallen below the 3.11 per cent average of July 1959, the previous postwar trough. On the other hand, the average yield on corporate shares in the three years ending with 1957 was 4.17 per cent. During the first half of 1929 it averaged 3.36 per cent.

Stock Yields and Interest Rates



The recent rise in stock prices took place in the face of a decline in industrial activity. It is not unusual, however, for stock prices to rise during a business contraction, in anticipation of recovery. In the 1957-1958 recession the Standard and Poor's index began to move upwards from December 1957, and had increased 5 per cent through April 1958, the trough of industrial activity. Similarly, during the 1953-1954 downturn industrial production reached a low in March 1954, while stock prices had already climbed more than 11 per cent during the six preceding months.

An appreciation in prices of corporate stocks, similar to those which occurred in the later stages of the two previous business recessions, may give a positive stimulus to economic activity. The advance in value of equity shares probably tends to increase stockholders' feeling of wealth and liquidity. As owners of stocks which have risen in value begin to feel more wealthy, they may tend to augment their purchases of goods and services. To the extent that they increase their spending, stockholders help to moderate a decline in business activity and add strength to any tendency toward economic recovery. Thus, the recent rise in prices in the stock market may contribute to an increase in total demand and economic recovery.