AMERICAN INSTITUTE for ECONOMIC RESEARCH

GREAT BARRINGTON MASSACHUSETTS

WEEKLY BULLETIN

August 4 1958

RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

The Federal Reserve Yields to the Treasury With Inflationary Implications

The requirements and operations of the Treasury in the second half of the year have revived the perennial question of the independence of the Federal Reserve System, a question that antedates the formation of the System itself and has become critical periodically as exigencies of Treasury finance have caused the Board to bow to the Treasury with serious inflationary results. Financing of the prospective cash deficit (the probable magnitude of the deficit was discussed in this bulletin for June 23, 1958) and refinancing of more than $28,000,000,000 of maturing Government obligations (exclusive of weekly bill issues) in the second half of 1958 involve money-credit demands that are the basis of the immediate threat to the System's independence.

In response to this situation the Federal Reserve System has committed itself to a policy of subordinating sound money requirements to the needs of Treasury finance. And again, as in the past, Treasury deficits are currently being made easy to meet at the price of sound money. Following a period of unusually large purchases of Treasury bills, on July 18 the System's Open Market Committee announced that it would cease limiting its purchases of Government securities to bills. (These are the Government's shortest term obligations usually issued with 90- or 91-day maturities.) The announcement marked the end of the System's "bills only" policy, initiated a few years ago when the Federal Reserve discontinued its policy of pegging the Government bond market. Thus, it seems that the "die has been cast" and that the consequences of a disorderly Government bond market will be averted at the price of more inflation, which Senator Bennett of the Senate Finance Committee recently characterized as a "great and increasing threat to our economy," which "seems to be becoming acceptable."

The amount of the maturing obligations and probable cash deficit are alone indicative of a major undertaking involved in the Federal Reserve's decision. However, the responsibility is increased in view of the market background against which the responsibility was assumed. In spite of the easy-money actions taken by the Federal Reserve since last November, which have been reflected in markedly lower short-term interest rates, long-term interest rates recently have advanced with embarrassing consequences to the Treasury. A focal point of the embarrassment was the Treasury's 2⅝-percent 6-year 8-month bond issued in June, which broke in price shortly after issuance. As a defensive measure, the Treasury bought heavily of this issue, and on July 18 announced that during the preceding 3 weeks it had bought nearly $600,000,000 of the bonds.

Immediate basis of the Treasury's concern over the market outlook was the $16,300,000,000 of obligations maturing on August 1 or called for payment on September 15, and for which the Treasury announced on July 17 that it would offer in exchange a 1-year 1⅝-percent certificate. This exchange offering brought into operation the Federal Reserve's newly adopted policy of not restricting its open-market purchases to bills, when holders of nearly $2,800,000,000 of the maturing or called obligations failed to accept the certificates offered. This "attrition rate" was about 40 percent of the publicly held bonds called for payment September 15. Apparently this high rate was partly accounted for by the fact that a substantial part of this issue was held by corporations for tax payments due September 15. Whatever the factors were that accounted for the apathetic reception of the 1⅝-percent certificates, the Federal Reserve banks bought $1,090,000,000 of the certificates, the banks' largest open-market operation in several years.

In addition to this commitment, which was on a when-issued basis for delivery August 1, the Reserve banks bought a substantial amount of bonds in the week ended July 23. However, these purchases were more than offset by the banks' sales of Treasury bills, resulting in a net reduction of about $92,000,000 in the System's holdings of Government securities.

The overall effect of the System's transactions during the first week of the new policy and in support of the Treasury's first major refinancing in the second half of 1958 was to add, as of August 1, $1,000,000,000 of Federal Reserve bank credit to the reserves of the commercial banks. This amount, or such part of it as the Reserve banks retain, will be subject to multiplication 5 to 6 times in the form of commercial bank deposits if the commercial banks use the reserves for loans and investments.

With this recent refunding arranged for, on July 25 the Treasury announced that it would offer $3,500,000,000 of 1½ percent tax anticipation certificates dated August 6 and due next March 24. This offering is the Treasury's first new-money borrowing that will be necessary to meet the large cash deficits anticipated during the next 6 months.

This new-money offering is expected to enable the Treasury to stay out of the market until October, at

which time it will undoubtedly have to borrow again. The size of that offering will depend largely on what part of the Treasury's cash deficit it plans to provide for at that time. However, the amounts of new-money borrowing in that and the following 2 months are expected to be large. Support for our estimate of a cash deficit in the neighborhood of $13,000,000,000 is found in the Administration's request that Congress increase the legal debt limit by that amount. The total would include $5,000,000,000 already granted and needed to provide for the $3,500,000,000 of tax certificates being offered August 1.

Outside the realm of Treasury finance the money-credit outlook is affected largely by the demand for business loans. Typically this demand increases seasonally in the second half of the year, and with increasing business activity. In the second half of 1955, for example, when the latest boom was well under way, business loans of commercial banks increased $4,400,000,000, or 15 percent. Thus, if the indicated impending business recovery develops to the point of a boom there is no doubt that such a boom will be accompanied by large demands for bank credit, thereby increasing the amount of Federal debt monetized as a result of support of the Government securities market by the Federal Reserve.

However, to the extent that inventory liquidation has increased the liquidity of business, such increased liquidity would tend to diminish both seasonal and cyclical increases in the demand for bank credit for a few months. For example, during the second half of 1954, when the trend of business activity turned upward in August, consumer loans of the commercial banks increased only $750,000,000, or less than 3 percent. Thus, present indications are that the Treasury's financing needs during the second half of the year will be accompanied by an increase in the demand for business loans, but that the increase will be moderate.

The Federal Reserve Board's policy of underwriting the large prospective Treasury deficits in the second half of 1958 seems to assure the addition of several billions of dollars of inflationary purchasing media to the total of purchasing media before the year end. Because Treasury deficits rather than surpluses are indicated for some time, it seems probable that this additional inflationary purchasing media will be more or less permanently added to the money-credit supply with further depreciation of the dollar as one result.

What the Indicators Say

Note: The indicators reported on below are seasonally adjusted.

Among the leading indicators, floor area represented by contracts awarded for residential construction increased from May to June, but that for commercial and industrial construction decreased.

The decrease in commercial and industrial building casts more doubt on the already doubful upward trend of this series. However, even its removal from among those classified up *would not materially affect the tentative signal of an upturn in business activity noted in our latest Monthly Bulletin.*

* * * * *

The *Iron Age* composite price of No. 1 heavy melting steel scrap, not one of the indicators, was $40.83 per ton on July 29, compared with $38.17 on July 22.

SUPPLY

Industrial Production

Production of steel, automobiles, lumber, and electric power (1) in the 1- and 4-week periods ended on the indicated dates in the current year and (2) in the corresponding periods of earlier years was as follows:

	1929	*1932*	*1953*	*1954*	*1957*	*1958p*
Steel						
Ingots—million tons						
Week: Aug. 1	1.32	0.26	1.67	1.18	2.03	1.59
Four weeks: Aug. 1	5.24	0.94	5.48	4.67	8.09	6.07
Automobiles						
Vehicles—thousands*						
Week: July 25	123	46	173	131	151	109
Four weeks: July 25	450	184	657	501	639	384
Lumber						
New York Times Index						
Week: July 18	135	40	108	64	100	94
Four weeks: July 18	132	40	105	63	97	98
Electric Power						
Kilowatt-hours—billions						
Week: July 25	1.72	1.43	8.46	9.10	12.24	12.32
Four weeks: July 25	6.75	5.65	32.74	35.05	47.57	47.64

p Preliminary. * Cars and trucks in U. S. and Canada.

DEMAND

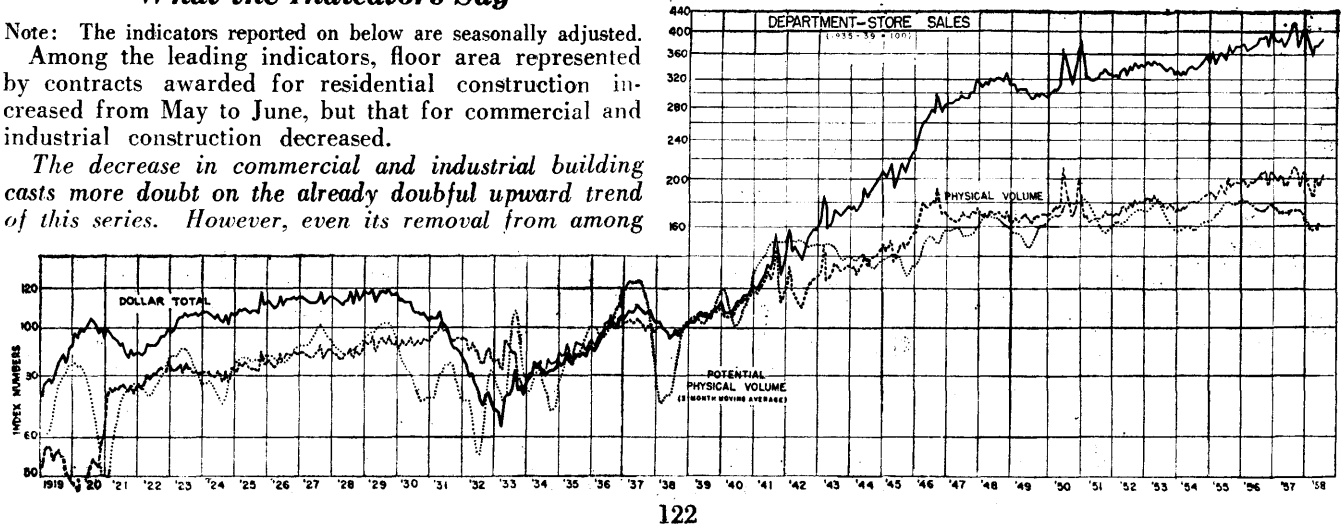
Department-Store Sales

We estimate that the seasonally adjusted sales of the department stores reporting to the Federal Reserve Board were 3 percent more in July than those in June, and 1 percent more than those in July 1957. This would be the third successive monthly increase.

Our index of department-store prices increased slightly from May to June and was unchanged from the index for June 1957 as prices of housefurnishings rose.

Our index of the physical volume of goods sold in department stores increased almost 3 percent from June to July, and was slightly more than that for July 1957.* The potential physical volume of department-store sales, as measured by the production of goods sold in department stores, increased 2 percent from May to June, but

*The index is derived by dividing the seasonally adjusted sales by our index of department-store prices.



was almost 1 percent less than that in June 1957.†

Sales of department stores during the first 5 months of 1958 were about 3 percent less than those during the corresponding period of 1957. Sales of piece goods and household textiles decreased 4 percent; housefurnishings and women's apparel decreased 3 percent; and men's and boys' wear decreased 2 percent. Sales of small wares and miscellaneous departments increased by 2 and 5 percent respectively.

Although sales decreased in June, apparently as a result of unfavorable weather, the trend appears to have been upward since April. Sales in July, assisted by unusually early summer clearance sales, reflected improvements in sales of both durable and nondurable goods.

Opinion among store managers concerning their sales outlook appears to have improved with sales although none seems to be expecting record sales this fall. More faith is expressed in sales of soft-goods lines than of hard goods. A report on developments in the trade indicates that keen competition for sales is expected this fall with increased emphasis on prices. According with this view on price emphasis is the publicity given by the leading mail-order houses on lower prices in their fall and winter catalogues.

Further improvement in department-store sales during the third quarter seems probable.

Latest Weekly Data

Sales of the 325 department stores reporting to the Federal Reserve Board compare with those of corresponding periods a year earlier as follows:

Period	*Percent Change*
Week ended July 26	+3
Four weeks ended July 26	+3
Year to date	−2

PRICES

Consumer Prices

The Bureau of Labor Statistics index of prices of goods and services bought by moderate-income families, known as the Cost of Living Index, increased only one-tenth of 1 percent during the month ended June 15 to another record. The index for June was nearly 3 percent higher than that for June last year.

Food costs remained unchanged for the third consecutive month (after revisions) as sharp declines in prices of fresh vegetables offset increases in prices of meats and fruits. Other components not increasing during the month were housing, apparel, and other goods and services. Each of the other components, transportation, medical care, personal care, and reading and recreation, increased one-tenth of 1 percent.

†The index is a 3-month moving average of production, plotted at the third month to allow for the lag between the production of goods and their receipt at the stores.

During the past year costs of food and medical care have increased the most; cost of apparel has increased the least.

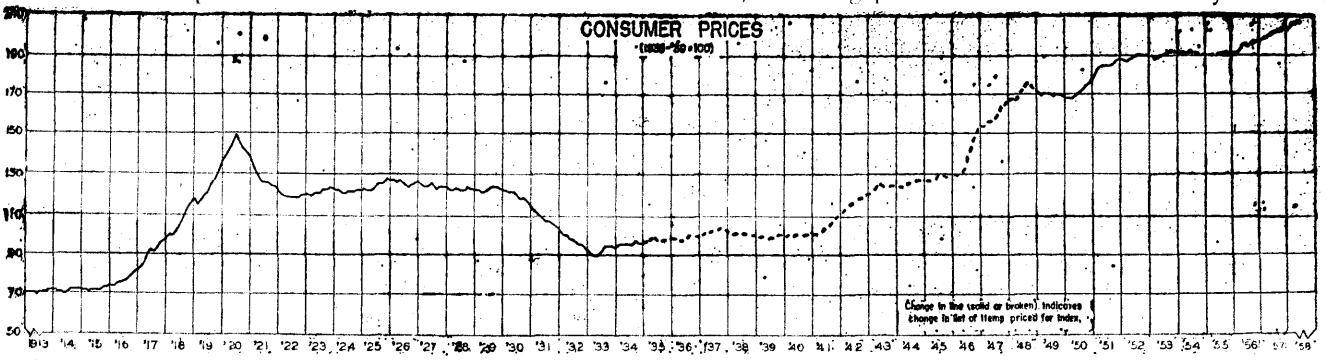
Ewan Clague, Commissioner of Labor Statistics, expressed the hope that even these marginal increases might cease after 1 or 2 months. Prospects that retail food prices, at least, will decline further from their high spring levels are found in a recent report by the Department of Agriculture on the outlook for food prices. The report stated that increased supplies of meat and fresh fruits and vegetables will bring lower prices for these items during the next few months. Increased population and a strong consumer demand were cited as factors tending to prevent sharp declines in grocery prices generally. The Department pointed out that in most postwar years food prices had reached their peaks in July or August, but that this year they had reached their peak earlier. Beef and pork withheld from the market as farmers built up their herds and the Florida freeze have accounted in large part for the higher food prices this spring.

The rising trend of the Consumer Price Index in the early months of 1958 was a subject of discussion by Ewan Clague in the latest issue of the *Monthly Labor Review*. In his analysis of the behavior of the index, Mr. Clague demonstrated that historically the index had been a "slow mover" in relation to turns in the business cycle and that declines in the index during earlier recessions had been relatively small. He attributed this behavioral pattern to the large number of items represented in the index, which fall into 4 main categories, 2 of which are largely independent of current cyclical developments.

The items represented in the index are foods and nonfoods; the nonfoods subdivide into durable goods, nondurable goods, and services, making, with foods, 4 distinct categories. Of these 4, the 2 whose price movements are largely independent of the business cycle are foods and services, and their price movements have dominated in the upward trend of the index during the last 6 to 8 months.

Food-price trends, as recent experience has shown, have been dominated by weather conditions and production cycles peculiar to agriculture and largely independant of current developments in other sectors of the economy. Prices of services, which are greatly affected by custom or public authority, change slowly and were found to have been climbing "slowly but steadily" for the past 20 years. In this, as in earlier recessions, prices of both durable and nondurable goods have, after some lag, tended to decline.

Mr. Clague did not discuss the effects of inflation on the index. However, the eroding effects of inflation on the purchasing power of the dollar over the years have



given the price index a secular upward trend that has tended to prevent cyclical corrections in the index.

A lengthening of the average workweek increased "take-home" pay of workers in June for the second successive month.

Although we do not expect any marked decreases in the Consumer Price Index during the next several months, some downward adjustments in the index seem probable.

Commodities at Wholesale

Index	1957 July 30	1958 July 23	1958 July 30
Spot-market, 22 commodities	277	267	268
Commodity futures	334	332	328

Note: The indexes are respectively those of the United States Bureau of Labor Statistics and Dow Jones. Both indexes are converted so that their August 1939 daily averages equal 100.

BUSINESS

Business Failures

Liabilities of business failures in June were $61,400,000, about 9 percent more than those in May and 19 percent more than those in June 1957. Our 3-month moving average of failure liabilities for May was $67,200,000, about 5 percent less than that for April but 25 percent more than that for May 1957.‡ The decrease in the average was the second since March when the average reached a peak of $73,600,000.

There were 1,260 failures in June, about 6 percent fewer than those in May but 16 percent more thon those in June 1957. In June as compared with May, failures were less numerous in every division of trade and industry except in wholesale trade, in which the number of failures was unchanged from May to June.

‡This article is based on data reported by Dun & Bradstreet. Reported liabilities exclude long-term debt publicly held. Our 3-month moving average is centered and plotted at the second month.

Business Failures: Number and Liabilities
By Months, 1956-1958

Month	Number 1956	Number 1957	Number 1958	Current Liabilities (000 omitted) 1956	Current Liabilities (000 omitted) 1957	Current Liabilities (000 omitted) 1958
January	1,048	1,148	1,279	$ 42,890	$ 54,060	$ 64,442
February	1,024	1,146	1,238	49,200	65,406	65,295
March	1,170	1,336	1,495	42,600	55,833	71,555
April	985	1,175	1,458	41,870	57,103	83,977
May	1,164	1,200	1,341	59,901	52,552	56,246
June	1,105	1,084	1,260	43,013	51,454	61,445
July	1,018	1,059		48,689	44,299	
August	1,101	1,145		55,040	43,514	
September	932	1,071		39,313	45,420	
October	1,158	1,122		50,004	47,428	
November	999	1,173		39,886	52,899	
December	982	1,080		50,279	45,325	
Total	12,686	13,739		$562,697	$615,293	

Business Failures: Number and Liabilities
By Type of Business
June 1957 and 1958

Business	Number June 1957	Number June 1958	Percent Change	Liabilities* June 1957	Liabilities* June 1958	Percent Change
Mining & mfg.	179	235	31	13.0	18.9	46
Wholesale trade	95	125	32	7.2	5.7	−21
Retail trade	553	640	16	17.7	21.7	22
Construction	164	161	−2	10.1	7.4	−27
Com. services	93	99	6	3.5	7.7	117
Total	1,084	1,260	16	51.5	61.4	19

*In millions of dollars.

Liabilities per business failure averaged $48,800 in June, compared with $41,900 in May and with $47,500 in June 1957. The month's increase was caused by a larger number of businesses failing with liabilities exceeding $100,000.

The number of failures in the 4 weeks ended July 24 was 1,110, about 18 percent more than those in the corresponding period last year.

During the first half of 1958, about 14 percent more enterprises failed than did during the same period last year. This increase was shared by all divisions of trade and industry, ranging from 22 percent in mining and manufacturing to 6 percent in construction. Liabilities of business failures in the first half of 1958 increased about 20 percent over those during the same period last year, chiefly in commercial services and retail trade.

As percentages of all monthly failure liabilities, liabilities among the various divisions of industry and trade changed from May to June as follows: commercial services from 7 to 13; retail trade from 33 to 35; mining and manufacturing from 32 to 31; wholesale trade from 10 to 9; and construction from 19 to 12.

Dun's Failure Index, seasonally adjusted and expressed as an annual rate per 10,000 active enterprises, increased from 55.3 in May to 57.3 in June, compared with 30.0 a year ago.

The unusually large total of failure liabilities for April and the more moderate rate of failures in July strongly suggest that the next moving average of liabilities, that for June, will be less than that for May. If the decrease is realized, it will make the third successive one and thereby provide considerable evidence that the average for March was the peak for the series in this recession.

Because of the general reliability of this series as a leading indicator of business activity, an indicated downturn in the series provides good reason for expecting an early upturn in business activity.