FEDERAL RESERVE BANK OF NEW YORK

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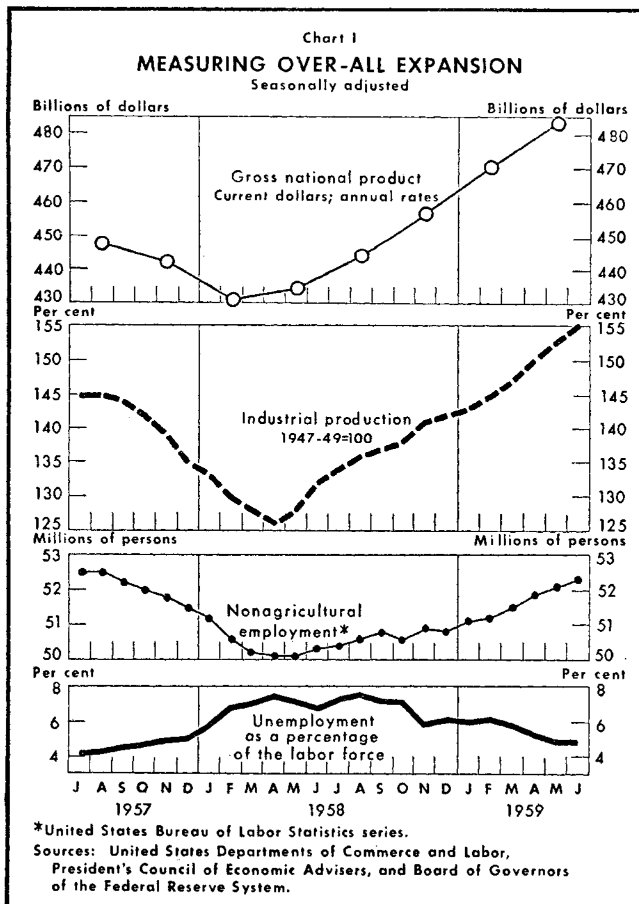
The Business Situation

While the current economic picture is clouded by the steel strike, still unsettled at this writing, the new statistics released during the past month have made it increasingly clear that the economy entered the second half of 1959 on a strongly rising trend. The total output of goods and services as measured by gross national product (GNP) climbed to a seasonally adjusted annual rate of $483.5 billion in the April-June quarter, topping the first quarter of 1959 by $13.3 billion and the recession low point a year earlier by $52.5 billion. (See Chart I.) This new record level is one that many observers, as recently as half a year ago, did not expect the economy to achieve before the end of 1959. The impetus for recent gains, discussed in greater detail below, has been most pronounced in the area of consumer spending, but business investment in plant and equipment has also shown increasing strength.



*United States Bureau of Labor Statistics series.
Sources: United States Departments of Commerce and Labor, President's Council of Economic Advisers, and Board of Governors of the Federal Reserve System.

A noteworthy feature of the rapid increase in the national product is that it has been almost wholly a reflection of real gains, since the price level has been generally steady. In further demonstration of these real gains, the Federal Reserve's seasonally adjusted index of industrial production (also shown in Chart I) set new records in each month of the second quarter, capped by a 2-point rise in June to 155 per cent of the 1947-49 average. (On the revised basis to be published shortly, this index reached an even higher level relative to the base period.) Nonfarm employment, as reported by the Bureau of Labor Statistics, also continued to gain during the quarter, rising by about 670,000 in April and May and by another 218,000 persons in June (after seasonal adjustment). Unemployment also increased in June, but the rise was in line with seasonal expectations as students entered the labor market upon completion of the school year. After adjustment for this and other seasonal influences, the rate of unemployment was unchanged from a month earlier at 4.9 per cent of the civilian labor force. This was considerably below the 6.8 per cent rate a year earlier, although still not quite down to the 4 to 4½ per cent range prevailing from 1955 to 1957.

The limited information available for July points to a continued high level of performance for the economy, except of course for declines in output and employment stemming directly from the steel strike that began in the middle of the month. Retail buying in the early weeks of the month apparently remained close to the record May-June level, with a strengthening in department store sales offsetting a largely seasonal letdown in new car sales from the high pace set in June. Motor vehicle production rebounded quickly after the holiday-shortened week of July 4, although output dipped slightly in the latter part of the month as some producers neared the end of 1959 model runs. Business and consumer demands for bank loans remained strong.

By the end of July the impact of the steel strike appeared to be confined mainly to the steel industry itself, and to mining and transportation activities that directly support the steel-making process. Steel pourings in the few plants that remained in operation in the latter half of July came to about 12 or 13 per cent of the industry's

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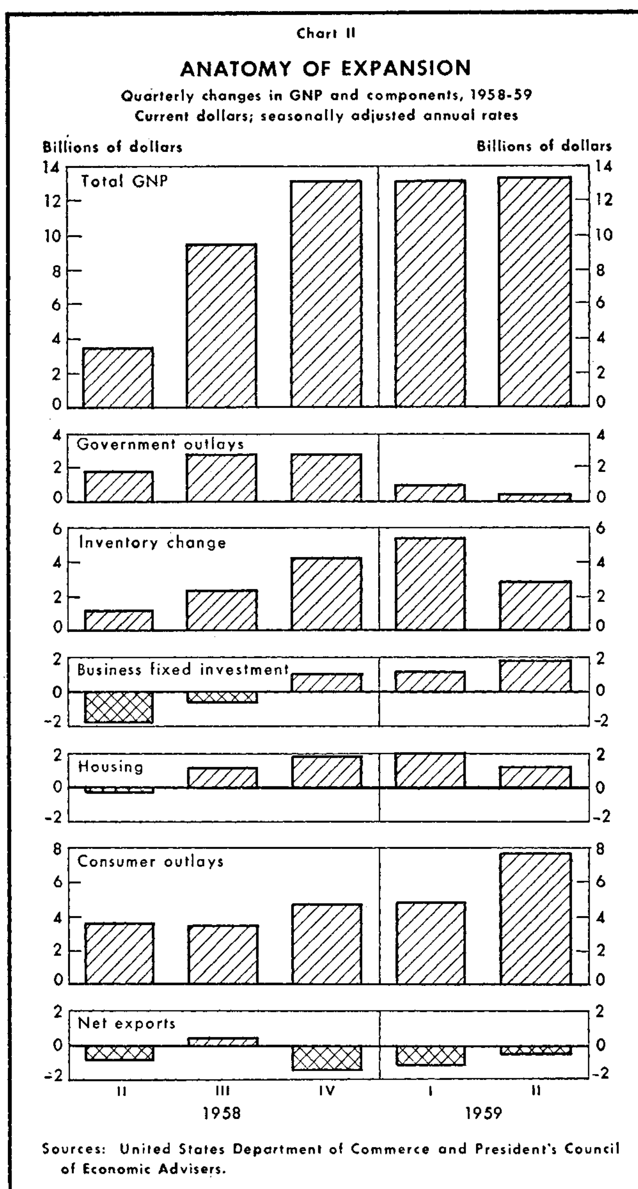
capacity, compared with rates of 90 per cent or more from March through most of June. Steel-consuming industries, on the other hand, had not yet been significantly affected, having built up inventories beforehand that were reportedly ample for a number of weeks. Estimates vary widely as to how long a shutdown could be weathered without severely reducing total economic activity, but a number of observers feel that some appreciable effects on steel-using industries might show up before the end of August, if the strike lasts that long.



CHANGING PATTERNS IN THE EXPANSION

Typically, as business recoveries mature into expansion, the pattern of growth tends to change; some of the forces that set recovery in motion recede in relative importance and other forces become comparatively stronger. The estimates of GNP for the second quarter of this year, recently published by the President's Council of Economic Advisers, suggest several changes of this nature—perhaps the outstanding ones being the surge in consumer buying, and the simultaneous tendencies for government spending and home-building activity to level off and for the rate of inventory accumulation to grow somewhat more slowly.

As may be seen in Chart II, expanded government purchases of goods and services (including Federal, State, and local government outlays) were fairly important in boosting aggregate demand in the earlier quarters of recovery, but this type of spending tended to level off in the first two quarters of 1959. In the April-June quarter the slowdown in growth was most pronounced in the case of State and local outlays, reflecting especially a less-than-seasonal increase in highway construction. Federal spending for goods and services was about the same in the second quarter as in the first quarter of this year, and slightly less than in the final three months of 1958 when nondefense outlays (notably for agricultural-aid programs) had been unusually high.

The swing from inventory liquidation to accumulation was also a powerful stimulus through the first several quarters of recovery and, unlike government spending, this remained a source of considerable strength during the second quarter, although it has tended to lose some of its forward push. This recent decline in influence is somewhat paradoxical in that the increase in stocks in the second quarter of 1959 was $9 billion (seasonally adjusted annual basis), the fastest rate of build-up since the Korean war period. The pace of accumulation was already high in the first quarter, however, and as shown in Chart II the recent increase in spending on inventories was somewhat less than in the opening quarter of the year. It is unlikely that inventories are being augmented at an annual rate of $9 billion in the current quarter, as some of the heavy build-up in the April-June period reflected the stockpiling of steel in anticipation of a strike. In fact, the pace of accumulation was beginning to recede even before the end of the second quarter. Thus, while total business inventories grew by about $1 billion in book value during April (seasonally adjusted), the increase in May was $600 million and in June possibly about the same. Nevertheless, rapidly rising sales provide a continuing incentive to add further to inventories as the ratio of stocks to sales for business as a whole (includ-

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ing distributors as well as manufacturers) has edged down in recent months to the lowest level since early 1951.

While the contribution of inventory accumulation to growth of GNP was slackening somewhat in the second quarter, business fixed investment outlays were rising a little more quickly. Virtually all of the increase in this type of investment has been in producers' outlays for new equipment, partly reflecting the current emphasis on modernization as distinct from expansion of capacity—which in some industries is still ample as a result of the plant and equipment boom in 1956-57. Commercial and industrial building outlays were rising in May and June, however, and it may be that further increases in capital spending, anticipated during the balance of this year on the basis of recent surveys, will include gains in construction as well as equipment spending.

Expenditures for home building increased relatively little in the April-June period following several quarters of vigorous advance that contributed significantly to the economy's rapid recovery. Residential construction outlays in June slipped for the first time in more than a year, as spending receded slightly to an annual rate (seasonally adjusted) of $22.7 billion from a record $23.3 billion in May. No sharp downturn seems imminent for this area, however. New private housing starts in June were at a seasonally adjusted annual rate of 1,370,000, up from 1,340,000 in May and little changed from the 1,400,000 average of the preceding six months.

It may also be noted from Chart II that movements in the United States net export balance of goods and services continued to exert a contractionary influence on the economy during the second quarter of 1959. While the payments deficit widened somewhat further and enabled foreign countries to continue building gold and short-term dollar assets at a substantial pace, the gap did not increase so rapidly as in the two previous quarters, since a rise in United States exports partially offset the effects of further increases in imports.

ACCELERATION OF CONSUMER SPENDING

Consumer spending has been a major source of strength to the economy since the start of the recovery, and has tended to become more important as the expansion has proceeded (see Chart II). In the April-June quarter of 1959 these outlays surged upward by about $7½ billion at a seasonally adjusted annual rate, topping the increases in the two previous quarters by nearly $3 billion. Indeed, the recent rise is among the largest quarterly increases on record, outdistanced only at those times when consumer buying was stimulated by fears of shortages (as just after the Korean outbreak in 1950) or by the lifting of consumer credit controls (as in 1952).

In large measure, the recent acceleration in consumer buying can be traced to the earlier increases in a variety of income-generating activities. The sharp expansion in home-building activity may have had particularly strong effects, not only boosting employment and income in the construction industry, but also leading to demand for a wide range of products to furnish and equip the new houses. Increased use of consumer credit has facilitated, and probably to some extent stimulated, the sharp advance in consumer outlays; the volume of consumer credit outstanding rose, after seasonal adjustment, by about $1.5 billion in the second quarter of 1959 in contrast to a decline of some $300 million in the same months of 1958.

According to a recent survey of consumers' attitudes and spending intentions, confidence in the economy has strengthened appreciably since late last year, and plans to buy major items—especially houses and used cars—have been reported more frequently. Indeed, the survey's over-all measure of consumer confidence, which is based on attitudes toward the economy as a whole as well as on the individual's appraisal of his own financial position, is nearly as high as in 1955. It is probably fortuitous, however, that consumer buying has gathered new steam just at the time when some other forces, including inventory accumulation, government spending, and residential building, have been losing some of their expansionary push. In any event, it cannot be taken for granted that the growth of such spending will (or can) continue at the robust rate of recent months.

Viewing the recovery period as a whole, the most prominent gains in consumer buying have been in the durable goods area, especially automobiles. As indicated in Chart III, from the first quarter of 1958 (the recession low point in sales) to April and May of this year, retail sales of automobiles, parts, and accessories increased by nearly 20 per cent after seasonal adjustment. This compares with a rise of roughly 11 per cent in total retail store sales and an increase of about 7 per cent in consumer spending for services over approximately the same interval. In June, while total retail store trade is estimated to have remained about unchanged from the record May level, sales of automotive goods increased appreciably further, according to preliminary indications. Dealers' sales of new domestically made cars numbered 580,000 during the month, the best rate since September 1955 and a more-than-seasonal improvement over recent months. New car sales declined in early July from the high June rate, but the letdown appeared to be largely seasonal and sales remained much higher than a year earlier.

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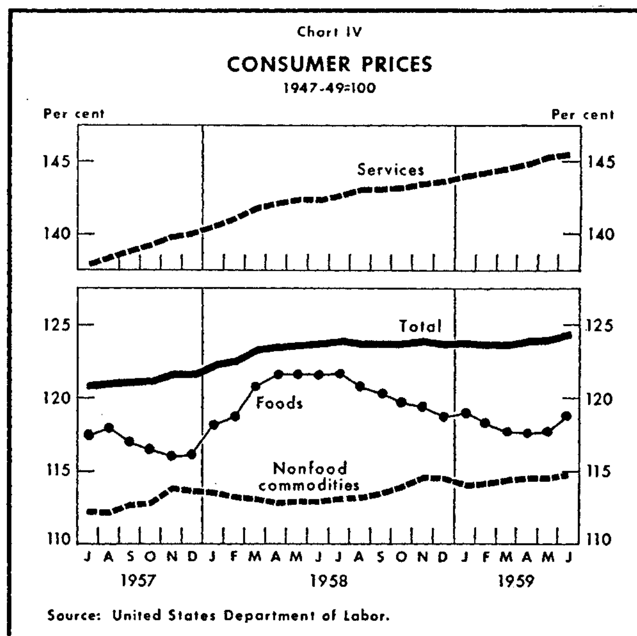
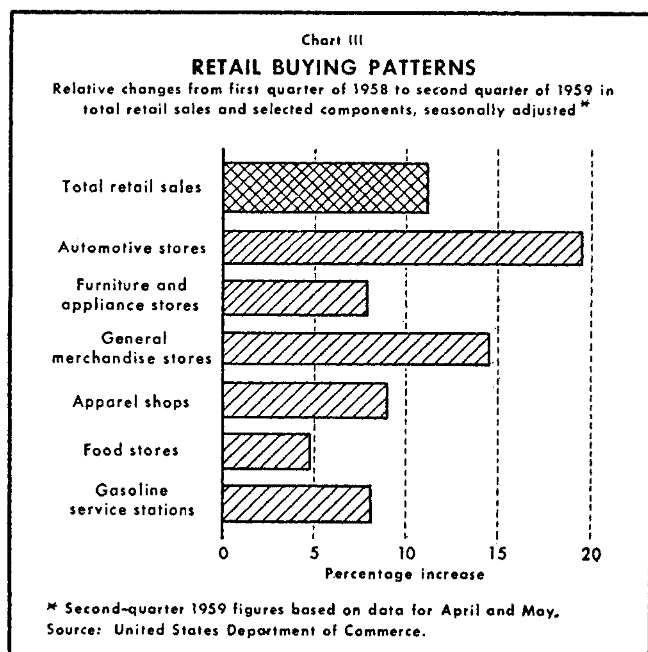
Sizable sales advances have been recorded in other retail lines, too, with the rise in some major categories tending to speed up in the past several months. Furniture and appliance store sales, for example, registered little net change (in seasonally adjusted terms) from early 1958 through the end of that year, but have increased appreciably since then—perhaps partly as an aftermath of the spurt in home-building activity. In the soft goods area, sales at apparel stores have increased vigorously since early 1958, helping to account for the continuing sharp rise in production of textiles and apparel. General merchandise stores have also recorded large gains, reflecting increased sales of apparel as well as a variety of other goods. The rise in sales of food stores has been comparatively modest during the interval covered in the chart, partly because of a net decline in prices during the period; in recent months, when food prices leveled out and then increased somewhat, sales at food stores expanded more quickly.

Since the increases in consumer and other spending over the past year have occurred against a background of virtual stability in broad price averages, the enlarged volume of expenditure has represented a substantial increase in real goods purchased, outpacing population growth by a wide margin. In the second quarter of 1959, real per capita disposable income climbed to a new high of $1,888 in 1958 prices, exceeding the recession low point by 5 per cent and surpassing the pre-recession peak for the first time.





It must be added, however, that the relative stability of prices since the start of the business upturn has come about partly because declines in prices for farm and food products have offset increases in some other lines. In the area of consumer goods and services, as shown in Chart IV, there was an almost uninterrupted decline in food prices from the middle of 1958 through the first quarter of this year, while costs of services rose steadily and nonfood commodities moved slightly (though irregularly) higher. The decline in food prices was partly seasonal, however, and in any event could not have been expected to continue indefinitely. From March through May of this year, as food prices leveled out, the total consumer price index inched slightly higher, chiefly in reflection of increased costs for services. And in June, when food costs increased seasonally by about 1 per cent, and services and nonfood commodities continued edging up in price, the total index advanced from 124.0 to 124.5 per cent of the 1947-49 average. The over-all price stability achieved in the past year thus is no cause for complacency, although it is encouraging in view of the broad and vigorous advance that has taken place in business activity.

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Money Market in July

Bank reserve availability in July was substantially unchanged from the preceding month, but the central money market was tighter than it had been in June. Reserve pressures converged on the New York central reserve city banks, partly reflecting the relatively large participation of these institutions in the $5 billion of new securities sold by the Treasury for cash in early July. The effective rate for Federal funds was at the 3½ per cent discount rate on nearly every day of the month, and the rates posted by the large New York City banks on call loans to Government securities dealers moved higher over much of the period. With financing needs of the dealers at times quite large, the Federal Reserve System used repurchase agreements to supply part of the reserves needed from time to time to avoid congestion in the money market.

Treasury debt operations were a dominant force in the Government securities market. The Treasury raised $5 billion of cash in the first half of July through two special bill auctions, and in the second half of the month it refinanced nearly $14 billion of securities scheduled to mature on August 1. The exchange offering, which carried a 4¾ per cent rate of interest on both a 12½-month note and a 4-year 9-month note, was highly successful, and attrition on the publicly held portion of the securities amounted to only 4 per cent. The cash financing exerted upward pressure on rates on Treasury bills and other short-term Government securities in early July. Short-term rates then turned around sharply at midmonth as nonbank investment demand expanded, and the resulting improvement in market sentiment contributed to the success of the Treasury refunding operation. Yields on intermediate- and long-term Governments, which had risen slightly to new postwar peaks in early July, fell over the latter part of the month in sympathy with the decline in yields on the four new Treasury securities.

MEMBER BANK RESERVES

During four of the five statement weeks in July, member bank reserves were absorbed on balance by autonomous factors or by higher required reserves. The principal losses in the July 1 statement week resulted from a decline in float and an outflow of gold, in the following week from the usual increase in currency in circulation associated with the July 4 holiday, and in the third week from a rise in required reserves associated with the Treasury cash financing. These reserve drains were temporarily interrupted during the week ended July 22 by the usual midmonth float expansion and a post-holiday return flow of currency, which more than offset a further increase in required reserves; but in the final week a decline in float again absorbed reserves.

System open market operations were directed to moderating these swings in reserve availability. Average System securities holdings increased in each week except the week of July 22, when holdings declined moderately. Between June 24 and July 29, open market operations provided member banks with $540 million of reserves. Net borrowed reserves for the period as a whole averaged $482 million, virtually unchanged from the average for the preceding four weeks. The average level of borrowing from the Reserve Banks rose by $30 million to $950 million, while average excess reserves increased by $56 million to $468 million.

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

Factor	Daily averages—week ended					Net changes
	July 1	July 8	July 15	July 22	July 29	
Operating transactions						
Treasury operations*	+ 184	+ 32	+ 115	− 59	− 89	+ 183
Federal Reserve float	− 224	− 84	− 26	+ 377	− 301	− 258
Currency in circulation	− 44	− 254	− 89	+ 158	+ 153	− 76
Gold and foreign account	− 318	+ 10	—	− 12	− 49	− 369
Other deposits, etc.	+ 44	—	+ 20	+ 6	+ 40	+ 110
Total	− 360	− 295	+ 19	+ 470	− 244	− 410
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 82	+ 237	+ 128	+ 7	+ 18	+ 472
Held under repurchase agreements	− 7	+ 18	+ 66	− 52	− 8	+ 17
Loans, discounts, and advances:						
Member bank borrowings	+ 45	+ 106	− 25	− 90	− 22	+ 14
Other	− 1	—	+ 1	− 1	− 17	− 18
Bankers' acceptances:						
Bought outright	—	− 1	—	+ 1	—	—
Under repurchase agreements	—	—	—	+ 1	− 1	—
Total	+ 119	+ 361	+ 169	− 134	− 30	+ 485
Total reserves	− 241	+ 66	+ 188	+ 336	− 274	+ 75
Effect of change in required reserves†	+ 111	+ 97	− 258	− 234	+ 124	− 160
Excess reserves†	− 130	+ 163	− 70	+ 102	− 150	− 85
Daily average level of member bank:						
Borrowings from Reserve Banks	921	1,027	1,002	912	890	950‡
Excess reserves†	369	532	462	564	414	468‡
Net borrowed reserves†	552	495	540	348	476	482‡

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 July 29, 1959.

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GOVERNMENT SECURITIES MARKET

Activity in the Government securities market during July was stimulated by Treasury debt operations that involved about $19 billion of securities. As had been announced on June 25, the Treasury offered two special bills totaling $5 billion early in the month. In the first auction, held on July 1, $3 billion of tax anticipation bills dated July 8 and maturing March 22, 1960 were sold at an average issuing rate of 4.075 per cent. Commercial banks were awarded the bulk of the offering, but they later sold a large volume of their holdings to corporations. In the second auction—held one week later, on July 8, for $2 billion of one-year bills dated July 15—the banks bid more cautiously, expecting that nonbank demand for these bills would be much smaller than for the tax anticipation issue. As a result, this issue was sold at an average issuing rate of 4.728 per cent, equivalent to an effective yield of over 5 per cent, and tenders were accepted at rates as high as 4.83 per cent. The rate of return proved to be so attractive that, contrary to market expectations, the banks were reluctant to part with their holdings. The high yield also attracted a stronger nonbank demand than had been anticipated, and the market rate on the new bills declined rapidly from 4.86 per cent bid at the start of "when-issued" trading to 4.23 per cent at the close of the month. Meanwhile, the nonbank demand for other bills also expanded, reflecting the reinvestment programs of a few recent borrowers in the capital market and, later, the substantial volume of switching out of August 1 "rights".

Following the sale of one-year bills, the Treasury on July 16 announced the terms of an exchange offering for $13.5 billion of 1⅝ per cent certificates of indebtedness due on August 1, of which $5.4 billion was held by the public, and for the $473 million of Series A-1961 4 per cent Treasury notes on which holders had exercised their option to redeem on August 1. In exchange for these issues, holders were offered a choice of two Treasury notes, one a 12½-month maturity and the other a 4¾-year maturity, each bearing a 4¾ per cent coupon rate. The shorter note was dated August 1 and will mature August 15, 1960; the longer note was dated July 20 and will come due on May 15, 1964. Because the longer note bears interest from July 20, the effective yield to holders of the certificate rights was 4.77 per cent, 2 basis points higher than the coupon rate. Subscription books were open three days, July 20 through July 22.

In view of the impressive market performance of the new one-year bills, the returns on the new securities offered in the exchange were considered increasingly attractive by the market. By July 22, just prior to the close of the subscription books, the bid quotation on the certificate rights had risen to 100$\frac{3}{32}$. Subsequently, the Treasury announced that $13.7 billion of the matured securities had been exchanged into $9.6 billion of the 12½-month notes and $4.2 billion of the 4¾-year notes, leaving $233 million (or 4 per cent of the publicly held portion) to be redeemed for cash on August 1. The System exchanged its $8.1 billion holdings into $5.5 and $2.6 billion, respectively, of the shorter and longer notes. A sustained investment demand for both new Treasury notes carried the bid prices on these securities to premiums of about ⅜ of a point by the close of the month.

Rate movements in the regular three- and six-month issues of Treasury bills during July reflected the pressures early in the period resulting from the Treasury cash financing and the later improvement in the market tone as demand for bills expanded sharply. In the regular weekly auctions, the three-month Treasury bills were successively awarded at average issuing rates of 3.266, 3.401, 3.337, and 3.047 per cent, compared with 3.164 per cent on June 29. The six-month bills were awarded at rates of 3.964, 4.029, 3.869, and 3.860 per cent in the respective July auctions, compared with 3.703 in the last auction held in June.

Prices of intermediate- and long-term Government securities rose as much as one point in July, after fluctuating irregularly within the period. Yields rose early in the month to new postwar highs, declined around midmonth in response to an increased demand, and then rose briefly after the refunding announcement both in adjustment to the return on the new note and in reflection of some liquidation by investors switching into rights. The buoyant market tone in the latter part of the month, largely reflecting the appeal of the new Treasury issues, caused yields to turn downward again. At the end of July the average yield on long-term Treasury bonds was 4.10, compared with 4.11 per cent at the end of June.

OTHER SECURITIES MARKETS

The corporate and municipal bond markets were firm during July, as new financing activity declined sharply. The steadying of yields on municipals followed four months of upward adjustments associated with a persistently heavy calendar of new offerings. During July, new tax-exempt issues coming to market totaled an estimated $370 million, representing a fall-off from both the $555 million total for July 1958 and the $895 million total for June of this year. Estimated corporate bond flotations for new capital purposes, which have been running below year-earlier levels for several months,

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declined in July to $170 million from $260 million in June and $680 million in July 1958. With some increased investor interest, particularly for municipals, most of the month's flotations were accorded favorable market receptions. The average yield on Moody's Aa-rated new corporate bonds offered during July was 4.93 per cent, representing a decline from the 4.98 per cent average for similarly rated June offerings.

Commercial paper dealers lifted their rates by ⅛ per cent on July 7, but on July 31 most major dealers reduced their rates by the same amount; the offering rate on prime four- to six-month paper is now split at 3⅞-4 per cent. Bankers' acceptance dealers increased their rates by ⅛ of 1 per cent on July 14, bringing the bid and asked rates on 90-day unindorsed acceptances to 3⅝ per cent and 3½ per cent.

International Financial Developments

EUROPEAN INVESTMENT BANK

The European Investment Bank, the first international lending institution created as a regional bank, made its initial loans early this year. The bank, which came into being with the launching of the Common Market in Western Europe on January 1, 1958, is to serve as a source of capital for the type of project in the area that "contributes to the increase of economic productivity in general and promotes the development of the Common Market".[1]

Several unsuccessful attempts had been made earlier in the postwar years to establish a supranational lending institution in Western Europe. These proposals had failed, partly because they were not offered within the broader framework of a program aiming at European economic integration. The desirability of such an institution was discussed again during the negotiations that led to the Common Market treaty. At that time it became evident that the smooth economic integration of the six member countries would involve a number of difficulties, arising among other reasons from the presence of less-developed regions within the area, low productivity in certain sectors, and inadequate power facilities in some regions. It was felt that substantial capital outlays would be required to overcome these and similar problems and to facilitate the establishment of new, area-wide activities and installations, and that these outlays could best be financed in part by a special financial institution, at the Common Market level. The European Investment Bank was accordingly created. However, the bank functions independently of the Commission of the European Economic Community, which administers the Common Market.

The European Investment Bank has three administrative organs. The highest of these is the board of governors, which is composed of the finance ministers of the six member countries. It lays down the general directives for the bank's lending policy, carries the final responsibility for the bank's operations, and appoints the other two administrative bodies: the twelve-man board of directors and the three-man management committee. The directors (and their alternates) are appointed for five-year terms —three each upon nomination by the governments of France, West Germany, and Italy, two jointly by the governments of Benelux, and one by the Commission of the European Economic Community. The board of directors has the exclusive power of decision in the granting of loans, the setting of interest rates and commission charges, and the raising of additional capital. The directors are assisted in their deliberations by the management committee, consisting of the bank's president and two vice presidents whose terms run for six years; the committee is charged with conducting the bank's day-to-day operations and hence is responsible for implementing the decisions of the board of directors.

The bank's capital amounts to $1 billion equivalent, and is being subscribed by the six member countries in proportions corresponding roughly to the share of each country's gross national product in the total national product of the Common Market in recent years. Thus, the quotas of France and Germany amount to 30 per cent each of the total, that of Italy to 24 per cent, and those of the Benelux countries combined to 16 per cent. Of the total capital, 25 per cent, or $250 million, is to be paid in five equal instalments at seven-month intervals. The unpaid part of the bank's capital may be called only

[1] Two additional financial agencies were created under the treaty establishing the Common Market. The Overseas Development Fund is to finance investments, on a grant basis, in the members' affiliated overseas territories, and the European Social Fund is to reimburse members for half the cost of retraining and relocating workers temporarily unemployed, while firms are being converted to different lines of production under the Common Market program. For a fuller discussion of the Common Market, see "The Common Market and European Economic Integration", *Monthly Review*, April 1959.

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if this should become necessary in order to meet the bank's obligations to its own creditors. The bank may also raise additional funds on the various capital markets, with emphasis on those of its member countries. The monetary authorities of these countries may not refuse their consent to such borrowing unless the particular country's capital market would be seriously disturbed by the flotation. In addition, the bank may sell in the market the bonds or other securities that it can require borrowers to issue to it. If, however, the bank is unable to raise funds on the market, it may request special loans from the member governments. Such loans are not to aggregate more than $400 million, or $100 million in any one year, and the member countries will participate in proportion to their subscriptions to the bank's capital.

The bank ordinarily may lend only to the member countries or to public or private enterprises in these countries for investment projects to be carried out within the countries' metropolitan areas; in addition, the bank may assume credit guarantees for such projects.[2] The bank's statutes do not exclude loans to enterprises owned or controlled from outside the Common Market, such as subsidiaries of foreign firms. The specific purposes for which the bank may extend loans or assume guarantees are spelled out in the statutes. These "general lines" of loan policy were restated and redefined by the board of directors last December and, of course, may be amended as economic integration proceeds. First, the bank is to devote a large part of its resources to the financing of projects that are likely to promote the economic development of the less-developed regions of the Common Market area. Secondly, the bank is to finance projects that are of joint interest to two or more member countries and, in particular, is to assist joint undertakings that are likely to lead to a closer linking of the markets and to the further integration of the economies of the member countries. Thirdly, the bank is to participate in financing the modernization or conversion of existing enterprises, or the establishment of new ones, made necessary by the progressive implementation of the Common Market. In general, the bank is to lend only when funds from other sources are not available on reasonable terms. Its loans thus are to supplement rather than to supplant other means of financing that may be available to the borrower. Special attention, moreover, is to be given to projects that draw on capital from several member countries. Finally, in conducting its operations the bank is to keep in mind the general objective of eventual economic integration, including unification of the capital markets of its members.

The bank's statutes contain several provisions to minimize the risks connected with lending operations. First, when extending credit to a private concern, rather than a member government, the bank is required to obtain either a guarantee of repayment from the member country in whose territory the project is located or "other adequate guarantees". Secondly, the rates charged by the bank (as well as the commissions charged for guarantees) must be set according to prevailing market conditions and in such a manner as to enable the bank to meet its obligations, to cover the cost of its operations, and to build up a reserve fund equal to 10 per cent of the subscribed capital. Thirdly, the total commitments entered into by the bank (loans plus guarantees) may not exceed two and one half times the subscribed capital, or $2.5 billion.

The bank's first loans involved participation, to the extent of $24 million, in the financing of four projects. Of these credits, $20 million formed part of a $70 million loan package—including also $20 million from the International Bank for Reconstruction and Development and a $30 million bond issue placed in the New York market—that was made available to the Southern Italy Development Fund for a power plant near Naples and two petrochemical plants in Sicily. The bank's lending activities thus have been on a modest scale so far. However, the bank's president, in submitting his first annual report last April, pointed out that the institution had already entered "a phase of concrete activity" and had taken its place on the international financial scene.

EXCHANGE RATES

In the New York foreign exchange market the pound sterling and the Canadian dollar generally declined during July in terms of the United States dollar. Spot sterling at the month end was quoted at $2.8108, compared with $2.8132 at the close of June. The Canadian dollar, after appreciating to $1.05 1/64, gradually eased to $1.04 23/64 on July 31.

Offerings of French francs from German sources, in anticipation of the financial integration of the Saar region with Germany, contributed to a decline in the French franc early in the month. Subsequently, the quotation recovered, and at the month end stood at $0.002040.

Effective July 20, the Spanish Government established, in agreement with the International Monetary Fund, an initial par value of 60 pesetas to the United States dollar (1 peseta = $0.016666), thereby unifying Spain's multiple exchange rate structure. The new rate represents a devaluation of 30 per cent from the earlier basic buying rate.

[2] However, upon unanimous approval by its board of governors, the bank may also grant loans and assume guarantees for projects located in the members' affiliated overseas territories.

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Inflation and Economic Development

Since World War II, inflation in its various forms—open or suppressed, creeping or galloping—has taken its toll in virtually all countries, regardless of their stage of economic development. The extent of the problem is dramatized by the fact that since 1950 only sixteen of the sixty-three countries for which data are available have succeeded in confining the advance of the domestic price level to an annual average of 1.5 per cent or less. And, while there were only a few countries in which the price level remained virtually unchanged, several suffered the ravages of hyperinflation that pushed its victims to the brink of economic and political collapse.

Contrary to common belief, the incidence of inflation in economically underdeveloped countries appears to be no greater than in the more advanced economies. In fact, viewing the postwar period as a whole, there were proportionately fewer developed than underdeveloped economies that managed to escape sustained inflationary pressure. On the other hand, there is good evidence that, where inflation has occurred in the less-developed countries, it has often been more intense, has affected the economic and social environment more profoundly, and generally has been checked neither early enough nor energetically enough to avoid more painful later adjustments. A particularly disturbing aspect of inflation in these less-developed regions is the frequent inclination to regard it as an inevitable by-product of the growth process, if not indeed a positive element promoting productive advance.

Two recent articles in this *Review* have dealt with certain aspects of the problem of inflation in economically advanced countries.[1] This article examines the problem in the underdeveloped countries of the world, where widespread poverty, disease, and human suffering make economic development an urgent necessity and a prime objective of policy.

INFLATION AND UNDERDEVELOPED ECONOMIC STRUCTURE

It is somewhat hazardous to define an economically underdeveloped country, mainly because there is no absolute standard or criterion against which the degree of development or underdevelopment can be measured. Perhaps the best basis for defining such a country is in terms of its relatively low levels of per capita income and productive efficiency. These conditions, in turn, generally reflect other structural characteristics of the underdeveloped economy: the national income is derived largely from subsistence farming, the industrialized sector is small, exports are relatively undiversified, and capital resources, technical skills, and entrepreneurship are scarce. In most underdeveloped countries, moreover, financial institutions and markets tend to be rudimentary.

One of the basic causes of inflation in underdeveloped countries is that the investment effort regarded as necessary in order to raise productive capacity to a desired level is usually far in excess of what is feasible on the basis of available savings. In the majority of these countries private savings probably represent, on the average, no more than 4 to 6 per cent of national income; by comparison, gross investment averages at least twice that amount. Although foreign capital is usually counted upon to fill at least a part of any shortfall in domestic savings, such expectations are only rarely fulfilled—partly because foreign investors tend to shun countries where severe pressures on prices and exchange rates seem likely to develop. Quite apart from this, the availability of external funds offers no assurance that inflationary pressures can thereby be wholly avoided; to the extent that such funds are spent on local resources, rather than on imported goods, upward pressures on prices emerge.

Another element in the special sensitivity of underdeveloped countries to strong inflationary influences is the large extent to which domestic money income is determined by export receipts. Sustained increases in export prices, such as have occurred on several occasions since World War II, generally lead to an immediate swelling of the domestic money supply and the demand for goods, driving prices upward and putting pressure on imports. Attempts to keep the domestic repercussions of an export boom from getting out of hand generally meet broad public resistance, with the result that the authorities—often against their better judgment—are induced to yield to the inflationary tide.

The vulnerability to acute inflationary pressures in underdeveloped countries results not only from the volatile nature of demand but from the supply side as well. In these countries, productive capacity is relatively small and limited in variety. Consequently, output is unresponsive over the short period to an increase in demand, and immediate pressure is placed on prices whenever money income expands. Moreover, poorly developed distributive channels and the inadequacy of transportation, communi-

[1] "Creeping Inflation", June 1959 and "Growth Without Inflation in Britain", July 1959.

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cations, and other basic facilities aggravate the problem of achieving an adjustment between demand and supply at stable prices.

In addition to these factors, there are several others which, if not among the initiating causes of inflation, at least play a major role in allowing it to accelerate. The regressive tax structure characteristic of underdeveloped countries, and its dependence on specific rather than ad valorem taxes, often results in a tendency for budgetary receipts to lag behind the rising cost of government services during periods of advancing prices. Budget deficits consequently tend to widen, rather than to narrow, during such periods. Another deterrent to price stability is the relatively small number of savers, which limits public support for policies intended to keep the purchasing power of the currency intact. At the same time, the narrowness of financial markets not only impedes the effective mobilization of savings, but to some extent also restricts the field of action for credit policy. More important, however, political instability and a history of inflation in many underdeveloped countries create an atmosphere in which the public is ever poised to speculate on a depreciation of the currency and thus to add fuel to inflationary pressures whenever they arise.

THE ILLUSION OF GROWTH THROUGH INFLATION

While the disruptive economic and social impact of hyperinflation is generally acknowledged, there still exists in many underdeveloped countries a tendency to regard some inflation, not only as tolerable, but indeed as necessary to promote economic development. This view rests on the belief that rising prices, by stimulating investment and capital formation, spark the economic development process.

Thus, the argument is advanced that inflation, by raising business profits, increases the returns on investment and induces enterprises to expand their scale of operations or to undertake new productive ventures. The proponents of economic development through inflation go on to assert that, in countries where the savings habit has not yet fully developed, the resources necessary for new investment often can be obtained only by enlarging the share of national income that goes to profit recipients, who save a higher proportion of their income than wage earners.

The point is also frequently made that inflation creates money income where little or none existed previously. This is supposed to stimulate the movement of previously underemployed resources, notably labor, into more productive employment and to help widen the market economy. Another thesis, not often espoused openly, is that inflation dramatizes a country's development effort and, to the extent that it leads to balance-of-payments difficulties, tends to bring forth "distress loans" from abroad which furnish investment funds that otherwise might not be forthcoming. Such inflation-induced balance-of-payments strains also enable countries to justify the imposition or maintenance of exchange restrictions, which can be employed to protect domestic industries against foreign competition and to control the allocation of domestic economic resources.

The various claims in favor of inflation have, in practice, proved largely illusory. One of the main reasons is that this line of argument ignores the economic waste and the social costs of inflation, which are an excessive price to pay for gains that are generally small, irrationally distributed over the economy, and unsustainable.

The social costs inherent in inflation must be a particularly important consideration in underdeveloped countries, where most of the population lives at a bare subsistence level and social inequities are already very pronounced. The rise in profits and the lag in wages that accompany the process of inflation in its early stages aggravate the maldistribution of income and intensify these social inequities. The claim that such a redistribution of income may be necessary to bring forth new savings is particularly difficult to justify, for it means that, for any additional amount of savings that might be obtained by transferring income to the high-saving group, a larger amount of real income has actually to be shifted from the low-savings group; the reason is that only a part—and during inflation a declining part—of increments to profits is saved, the remainder being spent on consumption. One of the important effects of such a redistribution of income from the poor to the wealthy is to retard the growth of a large and vigorous middle class which is so important not only in promoting self-sustaining economic progress, but also in fostering democratic institutions and a politically stable society.

Not only are the social costs of inflation intolerable but there are no grounds for believing that inflation is essential to break the vicious circle of poverty and to help set in motion a cumulative process of capital formation and economic growth. On the contrary, the expectation of continually rising prices engendered by inflation often leads to economic decisions that would be considered wholly irrational under conditions of price stability. Investment in new plant, machinery, tools, research facilities, power projects, and the like, all of which are essential to balanced economic development, are usually discouraged because they are amortizable only over long periods and do not promise quick inflation profits. This is illustrated by the case of Chile where

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prices rose more than ten times from 1950 to 1957 while investment in fixed capital declined sharply over the same period.

Along with the deterrent effects on productive investment, inflation usually enhances the attractiveness of investment in the kind of real assets that can be turned over rapidly and assure high capital gains yet add little to the expansion of productive capacity. In the underdeveloped countries, where the range of industrial investment opportunities is characteristically small and the inclination to trade and speculate strong, inflation generally leads to an immediate build-up of inventories. For example, in Brazil inflation was accompanied during 1950-54 by a more-than-sixfold increase in the flow of goods into stocks. Such inventory accumulations, in addition to diverting resources from more productive undertakings, are often also a principal cause of the balance-of-payments difficulties that accompany inflation. Inflation provides a similar stimulus to investment in real estate. This stimulus is generally magnified in underdeveloped countries by the social prestige that attaches to the ownership of land or dwellings, by the fact that real estate is often the type of collateral preferred by lenders, and by the mistaken view that the management of real estate requires no special aptitude.

Similarly, inflation militates against investment in fixed-interest securities, thus undermining the development of capital markets. In underdeveloped countries this affects mainly government bonds and severely restricts the government's capacity to finance in a noninflationary manner various types of "social overhead" projects, notably schools, health centers, and basic utilities. Such projects are often unsuited to private investment but represent the foundation on which any broad and balanced economic development effort must rest.

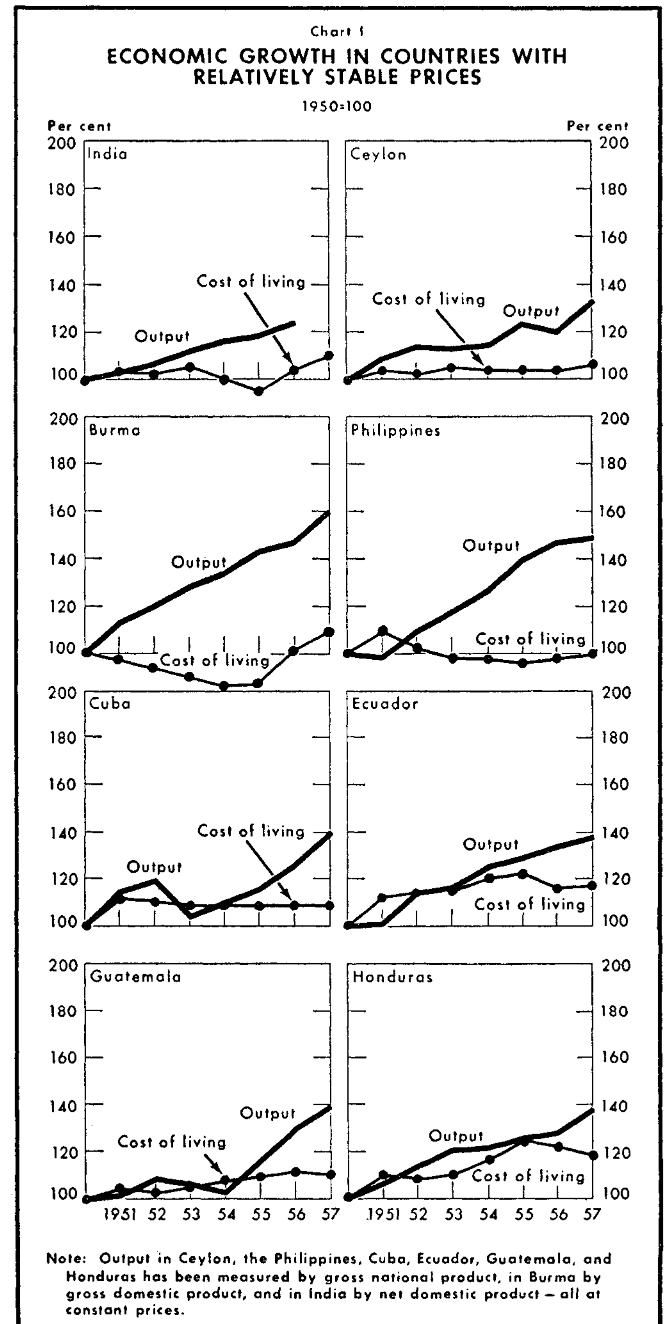
A particularly disturbing aspect of inflation in underdeveloped countries is its deterrent effect on exports, which often constitute the prime source of private domestic investment funds and government revenues. To the extent that inflation raises production costs while export prices remain determined by world market conditions, export income is often drastically reduced and output discouraged. In recent years, this has represented a particularly serious problem in Argentina and Uruguay. The fact that inflation also gives rise to exchange rate instability and to exchange restrictions, thus discouraging the inflow of private foreign investments, requires no elaboration.

Because inflation undermines exchange rate stability, it also results in a tendency—particularly strong in underdeveloped countries—to speculate against the currency by moving funds abroad or hoarding gold or foreign exchange. Such "investments" represent an obvious waste of financial resources, put heavy pressure on the balance of payments, and thus help bring about the expected devaluation. In Mexico, for example, the sustained rise in the price level during 1950-57 was at various times accompanied by massive movements of liquid funds abroad, including a substantial expansion in Mexican commercial

Chart 1

ECONOMIC GROWTH IN COUNTRIES WITH RELATIVELY STABLE PRICES

1950=100



Note: Output in Ceylon, the Philippines, Cuba, Ecuador, Guatemala, and Honduras has been measured by gross national product, in Burma by gross domestic product, and in India by net domestic product — all at constant prices.

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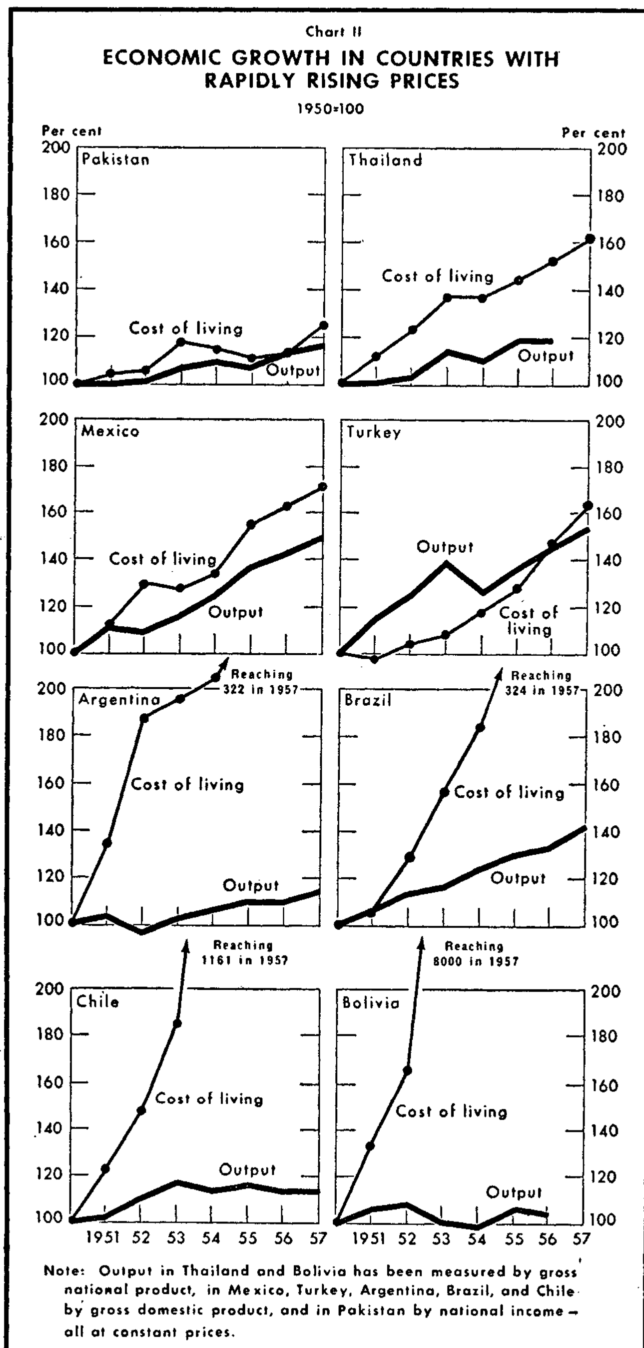

Note: Output in Thailand and Bolivia has been measured by gross national product, in Mexico, Turkey, Argentina, Brazil, and Chile by gross domestic product, and in Pakistan by national income—all at constant prices.

bank deposits denominated in United States dollars.

One of the basic weaknesses of the "economic-development-through-inflation" thesis is that it fails to take account of the adverse effects of rising prices on the capacity and willingness to save. It is evident that, unless an economic system can generate a high and rising volume of internal savings, economic growth cannot be maintained. Although data on saving are fragmentary for underdeveloped countries, there are indications that sustained inflationary pressures have generally been accompanied by a leveling-off or decline in private savings. This has occurred in spite of the income redistribution referred to earlier. In the underdeveloped countries, where the savings habit is not yet widespread and needs to be fostered, inflation is therefore particularly injurious.

Perhaps the decisive argument against inflation as the path to economic development is that eventually it either becomes cumulative or leads to crippling economic controls—or both. The experience of many underdeveloped countries suggests that, where inflation has been permitted to continue unbridled for any length of time, the application of corrective measures has become progressively more difficult. The usual outcome has been the adoption of elaborate economic controls, which have concealed the symptoms of inflation without attacking its basic causes. Such controls, which generally take the form of price ceilings, the linking of wages to the cost-of-living index, import quotas, exchange controls, or multiple exchange rate systems, have in many underdeveloped countries led to the growth of an administrative machinery that has promoted the emergence of vested interests, a swollen bureaucracy, and corruption. The intensification of such controls, moreover, as rising prices become ever more difficult to curb without fundamental adjustments, tends to hasten the economic paralysis to which inflation leads in its final stages.

THE RECORD OF ECONOMIC GROWTH: INFLATION VS. PRICE STABILITY

Any attempt to show statistically the relationship between economic growth and price stability or inflation is necessarily difficult. The reasons are not merely technical —notably the lack of comparability, or even absence, of data—but conceptual as well. The process of economic development is highly complex and involves not merely quantitative but far-reaching qualitative changes. These changes, which sometimes represent a transformation of the economic system and the social structure of a country, are not capable of effective statistical measurement. Moreover, mere quantitative additions to an economy's total output of goods and services may signify little over the longer run if they are accomplished largely at the cost of exhausting international reserves, mortgaging future production to repay sizable external obligations, or fostering an increasingly unequal distribution of income. Economic growth on that basis is not likely to be lasting and, therefore, cannot be regarded as satisfactory.

With these cautions, Charts I and II depict the growth of real output and price movements in sixteen under-

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developed countries. The selection of the particular countries is partly determined by the availability of data and partly by the fact that they represent a cross section of economies at various stages of development and with differing structures. While the data do not purport to offer conclusive evidence of any causal links between inflation or price stability and economic growth, they do lend support to the arguments set forth earlier.

The principal generalization they suggest is that the countries where prices advanced moderately or not at all from 1950 to 1957 (Chart I) experienced rates of economic expansion which by and large were steady and which clustered around an average of close to 6 per cent annually. In contrast, the countries where sustained inflationary pressures developed during this period have shown widely varying and somewhat sporadic growth; the average rates of growth have ranged from less than 1 to more than 7 per cent, with an average of about 4 per cent for the whole group. These data lend no support to the contention that price stability in underdeveloped countries is incompatible with rapid economic expansion. On the contrary, they confirm the view that, while stable prices tend to promote an orderly and fairly rapid expansion in output, inflation tends to lead to uneven and, in many cases, lagging rates of over-all growth.

Chile represents, of course, a classic case of chronic inflation exploding into hyperinflation. During the three years from 1953 to 1956 the cost of living advanced nearly fivefold; at the same time, the output of goods and services not only stopped expanding, but actually declined. This contraction coincided with a marked curtailing of productive investment and a sharp drop in productivity. However, after the inflation had been brought under some degree of control in 1957, output once again began to expand. Similarly in Bolivia, which experienced one of the most violent inflations ever recorded, the near collapse of the price mechanism was accompanied by stagnation of production and the complete disruption of the economic system.

But even in countries where inflation was somewhat less extreme, the growth of output appears to have suffered as the price level climbed. For example in Argentina, where the cost of living advanced threefold during 1950-57, aggregate output actually declined during the years when the inflation was most intense. The sluggish recovery in the more recent period is presumably far below the country's capacity for growth; even so, it has been achieved mainly by running down international reserves and incurring heavy external liabilities. Similarly, in such countries as Pakistan and Thailand, mounting inflationary pressures have been accompanied by lagging output.

The cases of Brazil, Turkey, and Mexico reveal vigorous rates of economic expansion side by side with fairly intense inflationary pressures. In the Brazilian case, the expansion in output was sustained largely at the cost of incurring a huge and mounting external debt. This debt is likely to place a heavy burden on the balance of payments in the years ahead, making present growth rates difficult to maintain unless inflation is curbed and new stimuli are thereby provided for domestic savings and foreign investment. Turkey's impressive economic expansion under inflationary conditions also has been underpinned by a massive inflow of external funds, mainly foreign aid. In the case of both Brazil and Turkey, moreover, inflation has tended both to distort the pattern of economic growth and to prevent the expansion from reaching the point where it can continue on its own momentum. Mexico is perhaps the only case where rapid —and on the whole reasonably well-balanced—economic expansion has occurred during a period of substantial inflationary pressures. Many factors, notably Mexico's fairly well-developed basic utilities, its productive agriculture, a large internal market, heavy foreign investments, and an expanding tourist industry, all contributed to this expansion in output. That even rapid growth with inflation has had its drawbacks is suggested by the necessity of several devaluations of the peso in recent years and by the maldistribution of income. In fact, the Mexican authorities have in recent years devoted considerable effort to curbing inflation and thus establishing a sounder foundation for economic advance.

Turning to the group of countries shown in Chart I, the relative price stability that characterizes them reflects, to a considerable extent, the pursuit of financial policies intended to confine the demand generated by development efforts to proportions that could be satisfied by domestic and imported goods and services. This is particularly true in Ecuador, Ceylon, the Philippines, and India, where various kinds of monetary and fiscal measures have been applied to minimize any strong upward pressure on the price level. The confidence in the stability of the currency engendered by such measures, in turn, has helped to promote voluntary savings, notably in India; it has also induced a more rational investment pattern than that in countries where inflation has been permitted to develop, and has encouraged—particularly in India, Ceylon, and Cuba—the growth of a broad capital market. In most of these countries, the absence of strong inflationary pressures was partly attributable to their capacity to finance a rising volume of imports, by aid or investments from abroad or by rising export income. Exchange inflows from such sources were not, however, unique to

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these countries and occurred also—and perhaps to an even greater extent—in the countries that experienced marked price advances.

CONCLUSION

The test of a sound economic development program is that the growth in output and productivity strike a sustainable balance among the different economic sectors, that the process be socially equitable, and above all that it be self-propelling, leading to greater and greater real income and not to an early stagnation. Inflation as a part of the growth process does not help to fulfil any of these requirements. It directs financial and real resources to the least productive segments of the economy and favors particular economic sectors at the expense of others. It is likely to be accompanied by gross social inequities that impair the basis of economic progress and undermine political stability. And it leads to balance-of-payments difficulties and heavy international reserve losses that eventually bring the economic development process to a grinding halt.

Reasonable price stability, by contrast, provides much more favorable conditions for sound economic development. First, it permits investors and entrepreneurs to plan rationally for the future, thus promoting the kind of long-term capital formation on which continuing productive advance is based. Secondly, it sustains confidence in the currency, thus permitting money to perform its proper function in the economy and encouraging the growth of savings. Finally, stable prices minimize the possibilities for sudden shifts in income distribution that lead to social frictions, intrusive governmental controls, and political instability.

Once inflation has been permitted to get out of hand, as it tends to do most quickly in the underdeveloped countries, stabilization involves adjustments that are immeasurably more painful than any initial policy of preventing inflation could be. In practice, as many countries have found, restoration of price stability is difficult to achieve merely by stimulating production through increased investment, in the hope that the rise in output will eventually catch up with money income and offset the price pressures that may have been tolerated at the start. Moreover, once prices have been rapidly on the move, stabilization programs require much more than merely stopping further expansion in the money supply or breaking the wage-price spiral. Inflation will usually have already distorted the whole pattern of production and relative incomes and prices. Correction of these distortions involves difficult adaptations on the internal and external front, including austerity measures that often are not readily accepted by the public. Nor can stabilization necessarily be accomplished rapidly, by the mere act of resolutely adapting a "tough" program. The restoration of confidence in the currency and the reallocation of resources, once inflation has worked its havoc very long, requires in some form all the stern measures just described, and even then takes time.

Economic development through inflation has repeatedly turned out to be a chimera. It is unacceptable as a conscious economic policy. Price stability, as the record shows, is not a luxury that only a few selected countries can afford; nor is it an unattainable goal in a country attempting to achieve a breakthrough that will launch the economy on the road to cumulative economic growth. If it were, there could be no balanced or lasting economic development.

The limitation of general movements in prices is never easy; no single formula to that end has been suggested here. But the effective resolution of any problem, great or small, depends first upon a recognition of the nature of the problem. And the first step in the design of any framework of public policy on economic growth, in the unique conditions of any country, is to recognize that reasonable price stability is not an alternative to economic development but an essential condition for its achievement.

TREASURY-FEDERAL RESERVE STUDY OF THE GOVERNMENT SECURITIES MARKET

The United States Treasury Department and the Federal Reserve System early last spring initiated a joint study of the Government securities market. Part I of the study is devoted principally to a summary of the informal consultations with individuals associated with, or informed about, the functioning of the market. Part II will be a factual review of the Government securities market in 1958, while Part III will contain supplementary studies on specialized and technical subjects.

Part I of the study is available for distribution. It may be obtained by writing to the Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington 25, D. C. The price is $1.00 per copy for each part. There is a special price of $2.50 for the set of three books, when all are ordered at one time. The individual parts will be forwarded as they become available.

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