

# FEDERAL RESERVE BANK OF NEW YORK



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## The Emerging Common Markets in Latin America

The drive toward regional economic integration, already a major force in Western Europe, has in recent years also made itself felt in Latin America. Ineffective attempts at partial economic union dot Latin American history, but the current integration movement is based on discussions of a union embracing all Latin America which began shortly after World War II. While it was not until 1958 that some of the countries of the area moved from discussion to treaty making, events have progressed swiftly since then. In the past two years treaties have been signed establishing two regional groupings, together encompassing twelve of the twenty Latin American republics (see map). Regionalism has advanced farthest in Central America, where five countries—Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua—have agreed to eliminate barriers to trade among themselves, establish a common tariff vis-à-vis third countries, and take measures to coordinate their industrial development. But, in terms of the size of the nations involved, a more far-reaching step was the signing last February of the Montevideo Treaty, in which seven countries—Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay—agreed to free their trade with each other.

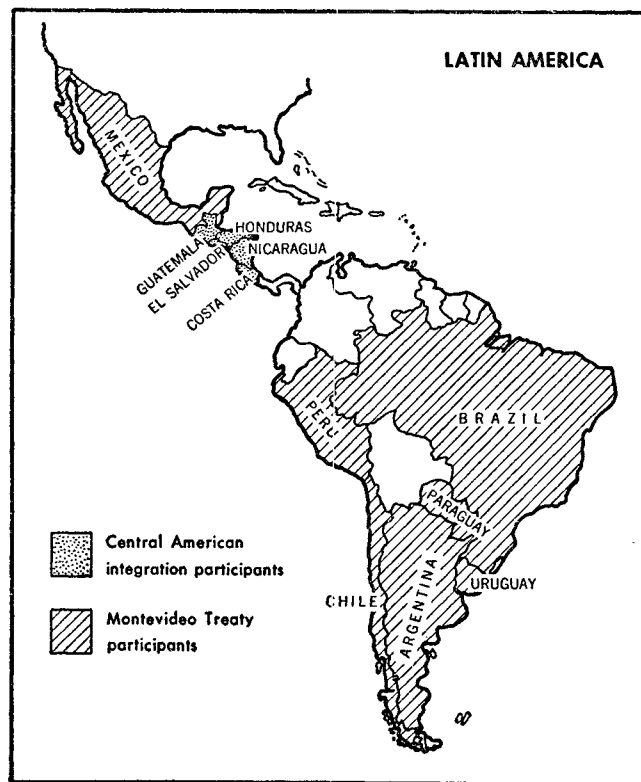
### MOTIVES FOR INTEGRATION

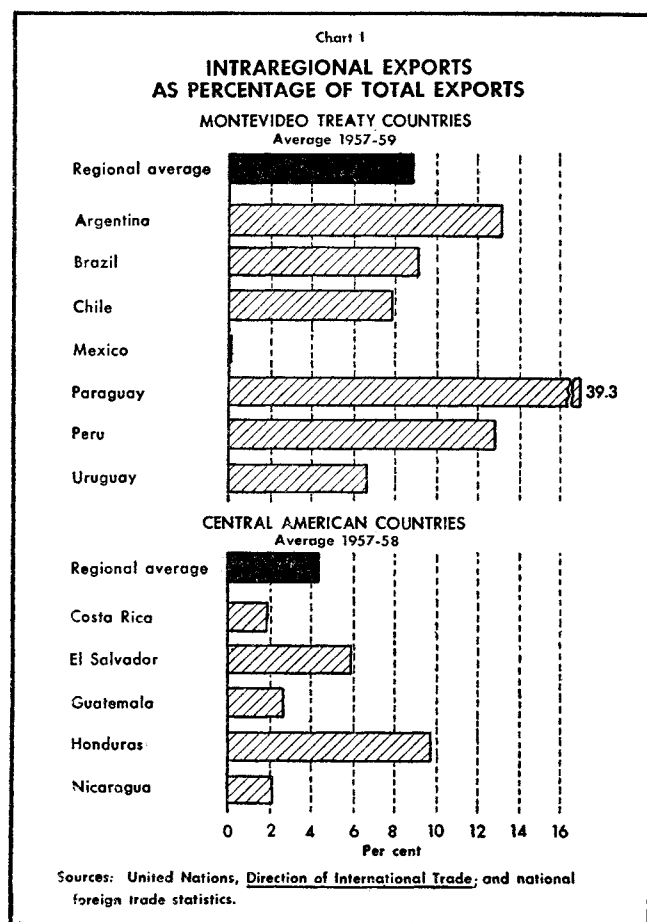
The formation of the six-country European Common Market undoubtedly set an example for the Latin American countries. However, integration by underdeveloped countries, whether in Latin America or elsewhere, obviously entails problems that are in many ways both very different from and more difficult than those faced by the European nations. In Europe, integration involves essentially the sweeping-away of artificial barriers to an increase in trade for which there is already a natural basis in the existing economic structure. The European Common Market is geographically compact and possesses a superb transportation and communication network; the six nations are highly industrialized, and trade between them has long comprised a significant part of their total trade. Moreover, a strong interest in closer political ties in Western Europe has greatly facilitated the formation of a common market.

The conditions that favor economic integration in Western Europe do not, by and large, exist today in Latin America. There is little basis for intraregional trade in

the present economic structure of the Latin American countries. They are largely self-sufficient in foodstuffs and export chiefly agricultural products and minerals. The trade of these countries has therefore been directed to the industrial nations that need Latin America's primary products and can supply Latin America with the manufactured goods it requires. While manufacturing has expanded rapidly in some Latin American countries in the postwar period, it is generally on a scale at most sufficient only to meet domestic requirements and characterized by high production costs. Moreover, the limited opportunities for trade between the Latin American countries has provided little incentive for bridging the region's great expanses and rugged terrain with adequate transport facilities, with the result that freight costs within the region are often prohibitively high.

Trade between the twenty Latin American republics grew faster than their total trade during World War II, but since 1948 intra-Latin American trade has not increased





in relative importance and has accounted on the average for only about 9 per cent (about \$700 million in 1959) of total Latin American exports. (By contrast, even in 1948, before the liberalization of intra-European trade had begun, the European Common Market countries did more than 25 per cent of their total trade with each other.) Within the two groups seeking integration there are substantial differences in the relative importance of intraregional trade to individual countries, but such trade is not large for any of them except Paraguay (see Chart I). Moreover, intra-Latin American trade has been concentrated on a few commodities; Venezuelan petroleum has in recent years accounted for as much as one third of trade within Latin America, and the rest has been made up mostly of a relatively small number of foodstuffs and raw materials. Trade in manufactured goods has been very small.

In these circumstances, integration is looked upon by its advocates primarily as a framework for the future development of the region's production and trade, and is based on the belief that a sweeping reorientation of the Latin American economy is necessary for an adequate

rate of growth. Indeed, a slowing-down in Latin America's economic growth in the past several years accounts in large measure for the accelerated pace of the integration movement. The United Nations Economic Commission for Latin America—which has played a major role in the integration movement—estimates that in the first postwar decade real income per capita in the area as a whole expanded at an estimated average annual rate of some 3.3 per cent. But in recent years, as many international commodity prices have declined and Latin America's foreign exchange earnings have fallen sharply, economic expansion has little more than kept pace with the very rapid population increase. Since commodity prices cannot be expected to recover to the abnormally high levels of the earlier postwar years, many Latin American countries fear that in the future they will find themselves chronically short of the foreign exchange necessary for maintaining an adequate rate of development.

Most Latin American countries have been seeking to end their overdependence on exports of primary products and to stimulate the growth of national industries to produce substitutes for imports. These infant industries have generally been established behind high tariff walls, and their vulnerability to competition from the more advanced industrial nations means that the Latin American countries do not regard the freeing of trade on an over-all basis as a realistic alternative to national protectionism. However, the proponents of integration argue that even in the larger countries national markets are too small to support production on an economic scale in many industrial lines, and that market limitations are likely to make industrialization behind national tariff walls far too costly a way of establishing the more complex capital goods industries. They therefore believe that the only alternative is the creation of broader regional markets which, it is hoped, will enable Latin America to allocate its scarce resources more rationally through intraregional specialization and by establishing large-scale, low-cost industries.

Regional economic integration, its proponents argue, is also needed to enhance the bargaining power of the Latin American countries vis-à-vis third areas. The Latin American countries fear that they may lose important European markets because of the preferential position of some African countries in the European Common Market, and believe that they must band together in order to deal on a basis of equality with other regional groups.

#### CENTRAL AMERICAN INTEGRATION

The twin problems of overdependence on one or two agricultural exports, and of national markets too small

to support industrialization, are especially pressing in Central America. The countries of this region are small and poor; they have a combined population of less than 11 million, a total area not very much larger than that of California, and an average per capita national income estimated at less than \$200 per year. Agriculture is of course the predominant industry, with bananas, coffee, and cotton accounting for more than 80 per cent of the region's total exports. Trade has therefore been directed preponderantly toward the United States and Western Europe. Intraregional trade, while tending to increase in relative importance during the postwar period, still accounted for only about 4 per cent of the countries' exports on the average in 1957-58 (see Chart I). Adequate transportation has been particularly lacking, but with the construction of the Pan American Highway an important breakthrough has been made toward linking up the five countries.

The Central American countries took their first specific steps toward regional integration in June 1958 when they signed an "Agreement on the Regime for Central American Integrated Industries" and a "Multilateral Treaty on Central American Free Trade and Economic Integration".

Under the first agreement, which provides for an industry-by-industry approach to economic integration, manufacturing plants that require access to the full Central American market may be jointly planned and established as "integrated industries". The products of these plants are to be granted immediate free entry to the markets of all five countries; if any plants in the same industries are established independently of the integration program, their products will initially be fully dutiable and will receive free entry only gradually. In order that the benefits of the "integrated industries" may be distributed more equitably among the five countries, it is provided that a second "integrated industry" may not be established in any of the countries until at least one "integrated industry" has been established in every country. This program is to go into effect when the treaty is ratified by all five countries; so far, it has been ratified by El Salvador, Guatemala, Honduras, and Nicaragua, but not by Costa Rica.

The trade treaty provides for the immediate elimination of intraregional tariffs and other charges on 200 commodity groups, and calls for the removal of all other barriers to mutual trade within ten years and for the eventual establishment of a common external tariff. This treaty is already in effect for all the signatories except Costa Rica, which has not yet ratified. The five-nation common market was spelled out in greater detail in September 1959, when a treaty was signed setting a five-year deadline

for the establishment of the common external tariff; so far, El Salvador and Guatemala have ratified this treaty. At the same time, a protocol providing for an immediate 20 per cent reduction in tariffs on all goods produced within the region was also signed, but it has not yet been ratified by any of the five countries.

Finally, this year three of the Central American countries—El Salvador, Guatemala, and Honduras—acted to move more rapidly toward a common market by signing and ratifying a "Tripartite Treaty of Economic Association". This treaty, which commits the signatories to work toward the free circulation of goods, persons, and capital within Central America, provides specifically for the immediate freeing of intra-area trade in all commodities (except about fifty specified items on most of which tariffs are to be eliminated gradually over a five-year period) and the establishment of a common external tariff within five years. The treaty also provides for the creation of a Development and Assistance Fund to assist in financing development projects and in facilitating any readjustments that the opening of the common market might necessitate. In June, the Tripartite Treaty countries reportedly decided to contribute an initial capital of \$5.5 million to this fund and also agreed to the creation of a permanent secretariat to administer the treaty. The Economic Commission for Latin America has been requested by the Economics Ministers of the five countries to prepare a draft treaty that would bring Costa Rica and Nicaragua together with the other three countries in a joint program to create a common market along the lines laid down in the Tripartite Treaty.

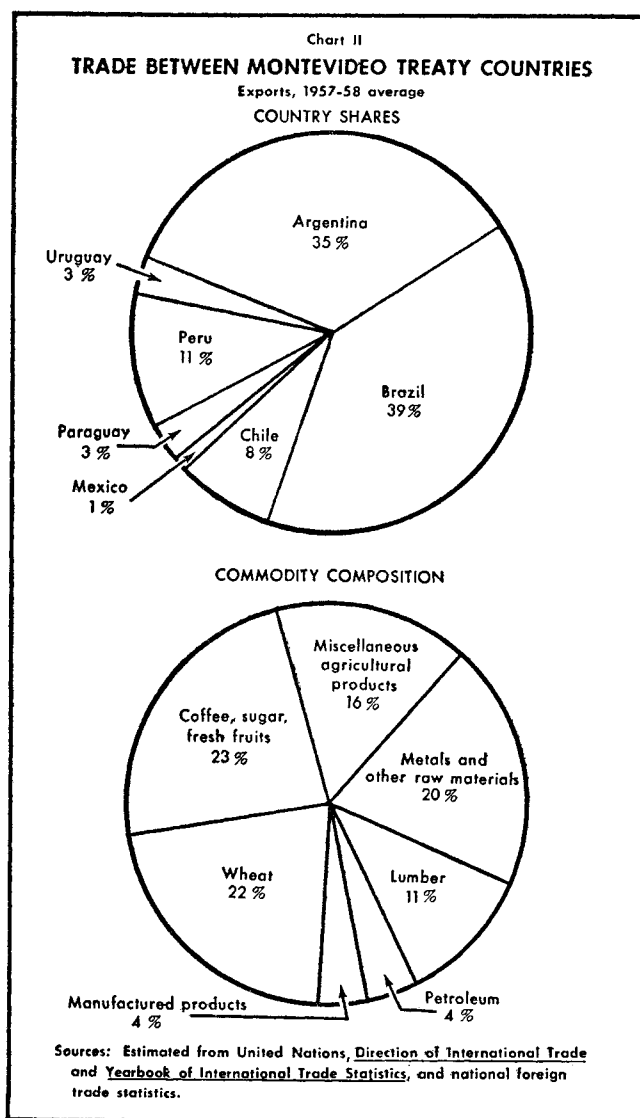
#### THE MONTEVIDEO TREATY

The signing of the Montevideo Treaty early this year was an outgrowth of studies, initiated by the Economic Commission for Latin America in 1956, that looked toward the creation of a common market embracing all Latin America. In April 1959 Argentina, Brazil, Chile, and Uruguay began to discuss the immediate creation of a free-trade area among themselves, and negotiations progressed rapidly thereafter. Bolivia, Paraguay, and Peru joined in negotiating the project, Mexico was invited to become a charter member, and last February a treaty was signed by Mexico and six of the South American countries (Bolivia decided not to adhere immediately). When the treaty is ratified by three signatories, it is to come into effect for them, and for the other countries after their ratification. There is apparently no major organized opposition, and it is expected that all the participating countries will have ratified by the end of this year.

The interest of the six South American countries in economic integration reflects in part the desire to preserve their existing trade with each other. Intraregional trade has generally been more important between these countries than elsewhere in Latin America, although it has been limited to a few primary commodities, principally wheat from Argentina, coffee and fresh fruits from Brazil, metals and petroleum from Chile, cotton from Peru, and lumber from Brazil and Paraguay (see Chart II). Until recently this trade, because of inconvertibility and rigid import restrictions, was conducted largely through bilateral clearing arrangements in which the countries granted preferential treatment to each other's products. However, in recent years all of these countries except Brazil and Uruguay have, with the assistance of the International Monetary Fund, undertaken stabilization programs, aimed at establishing more realistic exchange rates, removing exchange and quantitative trade controls, and placing their trade on a multilateral basis. When Argentina, which accounts for a large part of the trade between the six countries, made its currency convertible in January 1959, these countries were impelled to search for a new framework that would preserve the trade that they had built up among themselves on a bilateral basis.

But the adherence of Mexico to the Montevideo Treaty, despite the negligible size of its trade with the South American countries, shows that these seven Latin American countries were brought together by the desire not only to maintain existing trade, but also to develop new trade. Mexico, as well as Argentina, Brazil, and Chile, has been a leader in industrial progress among the Latin American countries. While manufactured products have not so far entered significantly into their mutual trade, these countries are now able, or expect shortly to be able, to export to each other an increasing number of manufactured products if they eliminate tariffs and other restrictions on each other's goods while maintaining protection against the products of the older industrial nations.

The ultimate goal of the seven countries, as the preamble to the Montevideo Treaty makes clear, is to achieve "complementarity and the integration of their national economies" in the fullest sense. However, the treaty itself actually seeks only the more limited goal of a free-trade area. The heart of the treaty is the agreement by the signatories that over the next twelve years "they will eliminate gradually, for substantially all their reciprocal trade, charges and restrictions of all types that bear upon the importation of goods originating in the territory of any contracting party". There is no provision in the treaty for the formation of a full customs union through unification of the external tariffs of the seven countries. The



re-export within the region of goods imported from outside countries is prohibited, except by special agreement or where the goods have undergone some processing by the importing country.

The actual reduction of tariffs, quotas, and other restrictions is to be achieved through annual negotiations in which the seven countries will draw up national lists of tariff reductions for each country, together with a common list of products upon which all the countries must eliminate their tariffs. On the national lists each country must show successive annual reductions of 8 per cent in the weighted over-all average of its tariffs on the goods that it actually imported from other treaty countries in the preceding three years. In addition, under the common-list



procedure each country will be required by the end of the twelve-year period to eliminate tariffs on goods that have been traded anywhere in the region, even if they have not entered into its own intraregional trade. At the end of three years the common list must include goods that account for 25 per cent of all intra-area trade; 50 per cent must be included after six years, 75 per cent after nine years, and substantially all trade by the end of the twelfth year.

It should be noted that the Montevideo Treaty countries' obligation to reduce tariffs and other trade barriers under this procedure is limited in two important respects. In the first place, the seven countries are apparently specifically committed to include on the national and common lists only goods actually traded within the region. Secondly, the rate at which tariffs on individual commodities are to be reduced is, in effect, left up to each country. The 8 per cent annual reductions that must be shown on the national lists apply only to the average tariff level, and presumably a country may meet this requirement in any given year during the transition period by substantially reducing some duties while leaving other products fully protected. In addition, the placing of a commodity on the common list will apparently mean only that duties on it must be eliminated by the end of the twelve-year period.

Escape clauses in the treaty authorize the temporary withdrawal of concessions on a nondiscriminatory basis where imports "threaten to cause serious damage to specified productive activities of significant importance" or when restrictive measures are necessary for over-all balance-of-payments reasons.

The Montevideo Treaty establishes a Latin American Free Trade Association with two principal organs—an annual Conference of the Contracting Parties and a Permanent Executive Committee. The conference will be the association's supreme authority, empowered to take all actions requiring joint decisions. A two-thirds vote is required for action by the conference and, during the first two years at least, all countries will have the power of veto. The Permanent Executive Committee, composed of one representative from each country, will exercise continuous supervision over the implementation of the treaty with the aid of a permanent secretariat.

#### PROSPECTS AND PROBLEMS

The Central American and Montevideo Treaty countries are thus about to embark on the enormously difficult task of putting economic integration into practice. The agreements that have been signed provide frameworks for dealing with the practical problems of integration, but much will depend on the actual implementation of the treaties.

However, certain basic considerations about economic integration provide bench marks for estimating both the potentialities and the problems that the Latin American countries face.

Economic integration may be presumed to offer the greatest possibilities where it results in the establishment of a market large enough and sufficiently well endowed with a variety of natural resources to permit significant economies through specialization and large-scale production. Integration in Central America will not bring together important natural resources, and even a common market of all the five countries would be smaller, for example, than that of Colombia. Nevertheless, the Central American common market appears large enough to make possible the establishment of many lighter industries that could not function within the sheltered national markets of the participating countries. Moreover, many of the proponents of Central American integration view it primarily as a means of strengthening the economies of the five countries so that they may eventually join in a wider Latin American common market, just as the Benelux union preceded the entry into the European Common Market of the latter's smallest members.

On the other hand, there can be little doubt about the potential advantages over national protectionism of the formation of so large a single market as that contemplated in the Montevideo Treaty. The seven countries' huge and diverse natural resources offer ample scope for the division of labor; and the opportunity of serving a combined market of some 140 million persons should make it possible for even the more complex and capital-intensive modern industries to operate in the region on an efficient scale.

The extent to which the possible economic gains will be realized in practice is likely to depend on the completeness of the integration of the Latin American markets. Production can be fully rationalized only where all sectors of the economies of the participating countries are opened to competition so that the allocation of resources can be determined in a genuinely free market. Partial economic integration is likely to exclude just those hard-core protected products from whose liberalization the most important benefits can be obtained. Substantially complete free intraregional trade is, as noted above, the avowed goal of both groups of countries, but its achievement will depend upon the actual effectiveness of the procedures adopted for freeing trade.

The Montevideo Treaty, in particular, leaves much to future negotiations. In this treaty the seven member governments sought to establish a procedure for tariff reduction that would allow them a maximum of flexibility when exposing their highly protected industries to competition.

This is clearly reflected in the treaty's important special provisions for the agricultural products that account for the bulk of the existing trade between the seven countries. During the twelve-year transition period, the treaty countries will be permitted to restrict agricultural imports to the amount needed to cover deficits in national production and to take measures to equalize the prices of imported and domestic agricultural products. The treaty urges that intraregional trade in agricultural products be expanded by the negotiation of agreements in which the seven countries will give priority to each other's products in meeting their import requirements.

The completeness of the free-trade area may also be prejudiced by the two limitations to the Montevideo Treaty's tariff-reduction mechanism previously noted. The fact that the treaty countries are free to determine the rate at which they will reduce their tariffs on individual products contrasts with the European Common Market countries' agreement to make a fixed minimum reduction on all tariffs at each stage in their program for creating a common market. The danger in the flexibility permitted under the treaty is that it may in practice make the governments of the seven countries more susceptible to domestic protectionist pressure, and thus compound the problem of reducing hard-core tariffs. There may be a tendency to put off the most difficult tariff reductions to the latter part of the twelve-year period, when there will no longer be time under the treaty to make them gradually enough to cushion the impact on national industries.

The fact that goods that are not actually traded between the seven countries need not enter into the annual negotiations may permit the exclusion from the free-trade area of the most highly protected products—those on which existing tariffs are so high as to shut out imports completely—and of goods that have not entered into trade by the end of the twelve-year period because they are still not being manufactured in sufficient quantity in the region. The participating countries' intention of including products not already traded within the area in the liberalization program is stated in the treaty, but since the implementation of this goal is left entirely to future negotiations, the Montevideo Treaty could fall short of its major goal of clearing the way for new trade.

While a complete freeing of intraregional trade is most likely to realize the potential benefits of economic integration for the region as a whole, there is no guarantee that each of the seven countries will receive benefits sufficient to make its participation appear worthwhile. Indeed, the more underdeveloped countries may be the least able to compete for the benefits of free trade, and the reduction of tariffs might grind to a halt if it should appear to be

exacerbating the unevenness of economic development in a region. Much of the discussion leading up to the Montevideo Treaty was concerned with the need to secure balanced economic development, and the treaty calls for the conducting of the annual negotiations on the basis of a "reciprocity of concessions" that will offer each of the seven countries the opportunity to expand its trade. In particular, special concessions are granted to Paraguay, by far the least developed of the seven countries.

Progress toward Latin American economic integration may depend increasingly on the ability of the participating countries to pursue the internal financial policies necessary for maintaining balance-of-payments equilibrium. Controversy over the necessity of measures to insure balance in intraregional trade (as well as over the need for a payments union) was for a time a major stumbling block to agreement among the Montevideo Treaty countries. The treaty actually does not mention this subject, the participating countries having agreed only to continue discussing the payments question. Imbalances in the Montevideo Treaty countries' trade with each other cannot cause difficulties so long as they maintain over-all balance-of-payments equilibrium and are able to cover their intraregional deficits with surpluses earned elsewhere. And initially, while intraregional trade remains small, deficits in intraregional payments may not be large enough to deter even countries whose over-all payments are not in balance from reducing their barriers to intraregional trade. However, if trade between the Montevideo Treaty countries should increase in the future relative to their total trade, countries with over-all balance-of-payments deficits might well become reluctant to move toward complete free trade within the area.

#### CONCLUDING COMMENTS

The short-run impact of a reduction of trade barriers among the Latin American countries is likely to be no more than marginal in view of the existing low level of intraregional trade. Over the longer run, however, the broadening of Latin American markets can serve to stimulate industrialization and give it a more rational basis than the limited national markets. But the pace of economic development cannot be stepped up without a sharp rise in investment, not only in manufacturing itself, but also in such essential supporting activities as power production and transportation. Common markets could contribute to increasing investment by opening up profitable new business opportunities in manufacturing that might attract Latin American capital away from investment in real estate and construction and that might induce Latin Ameri-

can investors to repatriate some of the very substantial amounts of capital they now hold abroad. In addition, its proponents hope that the possibilities of investment in industries serving Latin American common markets will stimulate the inflow of foreign capital into the region, just as the formation of the European Common Market has led to stepped-up United States and other outside investment in the six Common Market countries.

However, the low incomes of the Latin American countries limit domestic savings, while in many instances fundamental fiscal and other changes are needed in order both to improve savings and investment habits and to attract a larger inflow of foreign capital. The extent to

which Latin American countries will be able to take advantage of the opportunities offered by economic integration is, moreover, linked to the solution of other basic economic problems, such as the maintenance of internal and external economic balance, as well as to the development of an adequate regional transportation network. The gains from economic integration will also depend on the ability of the participating countries, when implementing their respective treaties, to make the difficult transition from national protectionism to an economic environment in which the nature and direction of industrial growth and trade expansion are determined by the forces of competition.

## International Developments

### BUSINESS TRENDS ABROAD

After a year of rapid economic growth in the major industrial countries abroad, the advance tended to moderate in the first half of 1960. The expansion appears to have leveled off in Canada and Japan, and in Western Europe it has slowed down slightly. In much of Western Europe, the earlier rapid rise in export demand and inventory accumulation seems to be abating. Although in a number of countries anti-inflationary policies have tempered domestic demand pressures, consumer demand on the whole still remains quite buoyant and fixed investment shows a rising tendency. In several countries, notably West Germany, Britain, and Sweden, the slightly reduced tempo of this year's expansion also reflects growing labor shortages and strains on productive capacity. To date, however, although persisting domestic inflationary pressures have contributed to a deterioration in the foreign trade position of many of these countries, the expansion has proceeded against a background of price stability and ample foreign exchange reserves.

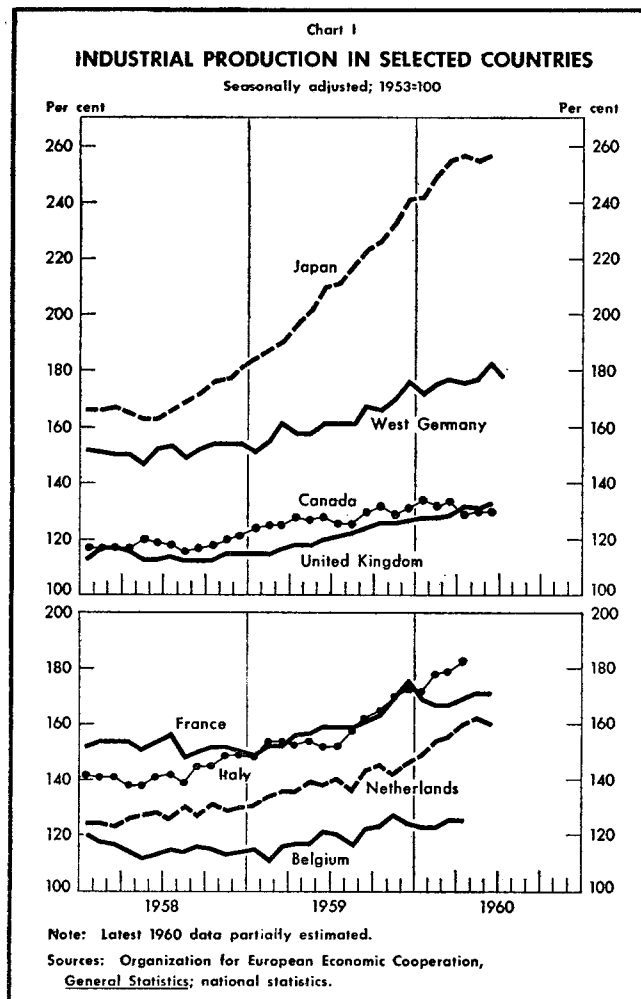
Industrial production in Western Europe as a whole rose by 2 to 3 per cent over the preceding quarter in both the first and second quarters of 1960, somewhat less than the 4 per cent rise recorded in the last quarter of 1959. While vigorous advances continued to be scored in Italy, Austria, and the Netherlands, the expansion in Germany and particularly in Britain lagged somewhat behind last year's (see Chart I). In France, although the first-quarter decline in industrial production was reversed in April and May, the upswing brought industrial output

for the second quarter only slightly above the record fourth-quarter 1959 level. In Japan, on the other hand, there are indications that the industrial expansion may have leveled off: following a 56 per cent advance from the May 1958 low through March 1960, Japanese industrial output rose only 1 per cent during the second quarter. In Canada, industrial production has continued to fluctuate below its January peak.

Consumer demand, which provided a major stimulus to the 1959 boom, showed some signs of tapering off in the early months of 1960 but generally has remained at high levels. Moreover, in several countries, particularly France, Germany, and the United Kingdom, consumer spending is expected to climb in coming months as a result of continuing wage and salary increases. In Britain there are indications that this process has already largely offset the impact of the instalment credit controls introduced last April; although sales of consumer durables continued to weaken, by July total retail sales (seasonally adjusted) had regained their April peak. In Germany, too, consumer spending has recently shown more strength. In Canada, on the other hand, although the first-quarter decline in retail sales (seasonally adjusted) was reversed in April-June, total sales for the three months were only 1 per cent above their corresponding 1959 level.

While the winter spurt in inventory accumulation may have begun to subside in a number of countries, a major expansionary push has been coming from the investment outlays induced in most countries by dwindling reserves of physical capacity and labor and by increased international competition. The investment booms continued





throughout the first half of the year in Italy and Germany. In Britain, real fixed investment in the first quarter of the year rose 3 per cent (seasonally adjusted) over the fourth quarter of 1959; while public sector investment is leveling off, business plant and equipment expenditures and private housing outlays are continuing to rise rapidly. In Japan, plant and equipment outlays are estimated to have risen about 16 per cent over the previous three months in the first quarter of 1960 and at an even higher rate in the second quarter.

Although export demand has remained generally firm, in some major trading nations exports no longer seem to be rising at their spectacular 1959 rate. Seasonally adjusted exports from several countries—notably Austria, Italy, and Switzerland—it is true, continued to rise rapidly in recent months. On the other hand, on the same basis, the expansion of French, German, and Japanese exports slowed down somewhat, and British exports in May-July

actually fell 5 per cent below their February-April levels. Seasonally adjusted Canadian exports also continued to decline through June, reflecting primarily a reduction in sales to the United States.

Perhaps the most important check on further rapid expansion of output in Western Europe in the near future will prove to be spreading shortages of skilled—and in some cases even unskilled—labor. In West Germany unemployment continued to fall rapidly to a new postwar low in July of 0.6 per cent of the labor force, while vacancies rose to over four times the number of people seeking work. In Britain, also, labor scarcities have spread in recent months, although the labor market eased slightly more than seasonally in August. A similar pattern applied in the Netherlands, Sweden, Switzerland, Austria, and Denmark where labor shortages, already severe in the construction sector, intensified in other sectors of industry as well. In Canada, in contrast, unemployment has remained high; in July it rose contraseasonally to 4.7 per cent of the labor force, the highest July level in many years.

In Western Europe the tightening of labor markets against a background of buoyant corporate profits has touched off a steady rise in salaries and wages this year. Significant wage increases have been granted in Germany, Austria, and Denmark. In the United Kingdom wage rates rose 1 per cent in both the first and second quarters, and substantial new pay demands are expected during the autumn round of wage negotiations. In France wage rates are estimated to have risen about 1.5 per cent in each quarter, and the high incidence of strikes and labor disturbances before the summer holidays suggests that here, too, labor may press vigorously for further wage increases in the fall. Civil servants, in particular, have asked for changes in the salary structure involving sizable pay increases. Moreover, due to the recent rise in the cost of living induced by government price measures, the minimum wage is to be raised 2-3 per cent on October 1.

Despite this upward pressure of wages, however, with few exceptions, the price stability achieved in the major industrial countries abroad has been maintained in 1960. This price stability reflects in part the steadiness of world commodity prices. In several countries, also, productivity has continued to rise very rapidly, and earlier measures of trade liberalization have permitted rising domestic demand to be met to an increased extent by imports.

#### MONETARY TRENDS AND POLICIES

The monetary restraint policies that have been adopted in most Western European countries since last autumn were strengthened further in the past three months. On

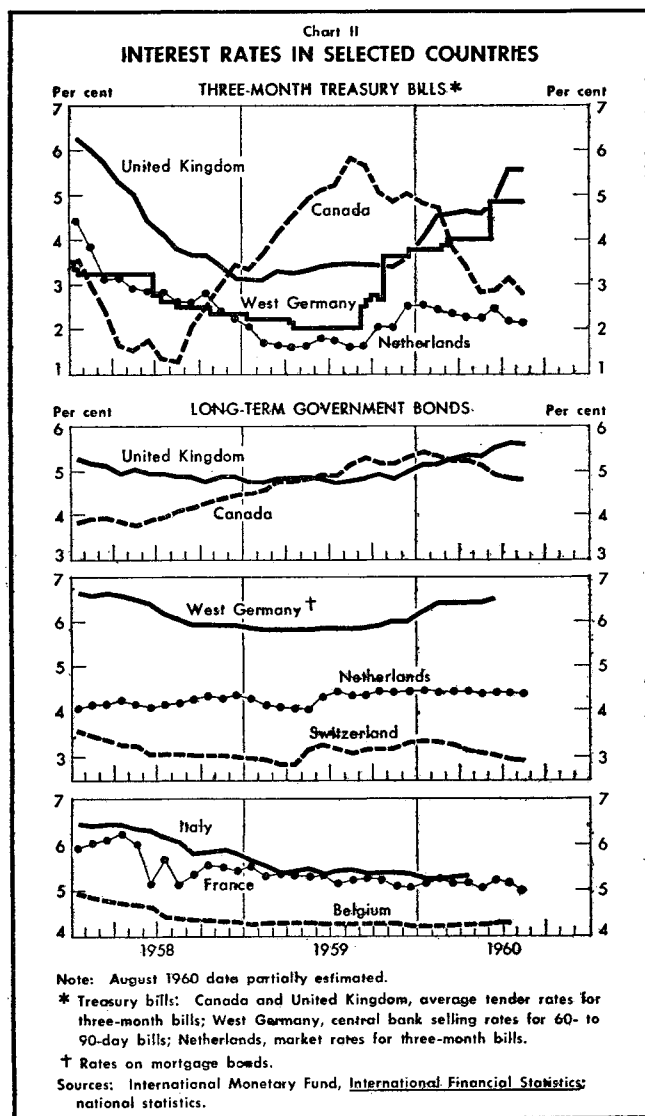
the other hand, in Japan, the authorities took their first easing measure in August, and in Canada credit conditions continued relatively easy.

In many Continental European countries, where the current economic expansion is being accompanied by balance-of-payments surpluses, general liquidity remained high and interest rates were stable or tilted slightly downward (see Chart II)—although generally at higher levels than in this country. The monetary authorities of these countries are facing the problem of having to deal with additions to bank liquidity resulting from inflows of funds from abroad, as restraint measures have led both to the repatriation of funds held abroad by domestic commercial banks and to an influx of foreign capital at-

tracted by higher interest rates. In addition, German and Swiss official international reserves were swelled during the summer months by other capital flows—in the case of Germany the result of Deutsche-mark appreciation rumors, and in the case of Switzerland the result of international political disturbances.

In Germany, where the problem of liquidity-increasing capital inflows has been particularly serious, the Federal Bank continued to move energetically to restrain the domestic boom and slow the inflow of funds. On June 3, the bank raised its discount rate for the third time since the beginning of the current business expansion—to 5 per cent from 4. Effective July 1, it raised to the legal maxima the reserve requirements for increases in deposits of residents above their March-May average, sharply cut back the commercial banks' rediscount ceilings, and took other steps to tighten reserve requirements. At the same time, German credit institutions were prohibited from paying interest on foreign-owned deposits and from selling money market paper to nonresidents. The inflow of foreign exchange continued, however, and bank liquidity remained high. In August, therefore, the Federal Bank reached an agreement with the commercial banks under which the latter agreed to purchase DM 1 billion of nonnegotiable two-year 5½ per cent government notes, thus in effect raising required reserves while keeping that instrument available for future use. Later in the month, in a further effort to stem the inflow of funds, the bank announced its willingness to enter into dollar swap transactions with German banks—under which it will buy forward dollars at a 1 per cent premium—for periods up to six months.

In Switzerland, where the expansionary strains seem to have been somewhat less pronounced and where the authorities have fewer monetary instruments at their disposal, the central bank acted forcefully to discourage the inflow of capital from abroad. In August, the Swiss National Bank announced an agreement with the commercial banks under which no new nonresident Swiss franc sight deposits are to be accepted, a 1 per cent annual charge is to be made on all foreign franc deposits of six months or less (except for specified working balances and certain other accounts) that have been established since July 1, and no interest is to be paid on new foreign franc holdings except in small savings deposits. In addition, the banks agreed to do their utmost to see that foreign funds are not invested in Swiss securities, real estate, or mortgages. In the Netherlands, the central bank, which earlier had warned the commercial banks against the repatriation of funds held abroad, on July 22 raised reserve requirements from 7 to 8 per cent in an effort to prevent



too rapid an expansion of domestic credit, and in Finland, where credit also has been expanding rapidly, the central bank in August increased its penalty rate to 3 per cent above the discount rate on rediscounts for commercial banks.

In the United Kingdom, the authorities have not had to contend with similar difficulties—partly because the institutional framework is more suitable for dealing with the liquidity effects of foreign exchange flows, and partly because the inflow of short-term funds seems to have assumed sizable proportions only recently. Thus, they have been able to concentrate on curbing the domestic factors in the expansion. On June 23, in the third of a series of restraint measures begun early this year, the Bank of England raised its discount rate to 6 per cent from 5 and also doubled its original April call for “special deposits” from the London clearing banks and Scottish banks (to 2 and 1 per cent of gross deposits, respectively). At the same time, the Chancellor of the Exchequer announced the government’s intention to hold public capital expenditures in fiscal year 1961-62 to the current year’s level. The severity of the new measures had not been anticipated by the market in view of the strength of the pound and of the sharp drop in the expansion of clearing bank advances in May and the first part of June. Bank advances again rose sharply in the following five-week period, but dropped—for the first time since August 1958—in the statement period ended August 17.

The classic problem of falling foreign exchange reserves accompanying inflationary pressures has been faced in Sweden, where the government acted to tighten bank liquidity by raising the statutory liquidity reserve requirements against sight liabilities and by authorizing the central bank to negotiate with the commercial banks for an increase in the voluntary variable liquidity reserves applicable to total deposits. An increase in the latter requirements would be especially important since time de-

posits in Sweden account for the bulk of bank deposits. Another country under pressure was Belgium, where the effect of the Congo situation in weakening the franc was a major factor behind the increase in the central bank’s discount rate to 5 per cent from 4 on August 4.

In contrast to these credit tightening measures, the Bank of Japan on August 24 lowered its discount rate to 6.935 per cent from 7.3 (reversing its December increase), as domestic business conditions showed weakening tendencies following two years of very rapid economic expansion. In Canada, meanwhile, where business conditions continued hesitant, the government relaxed its terms for low-income housing loans and increased its grants for public works. In spite of the general uncertainty, however, the chartered banks’ business loans have continued to expand somewhat more than seasonally. Although there was some tightness in the money market in early July, interest rates have since declined further.

#### EXCHANGE RATES

In the New York foreign exchange market, spot sterling gradually advanced during the first part of August as short-term funds continued to flow to London. Following the August 11 announcement of the reduction to 3 per cent in the discount rate of certain Federal Reserve Banks, the quotation moved abruptly to \$2.8123, the highest in over a year. It then turned lower, reflecting substantial offerings from the Continent and a reduced movement of capital to London as the result of the rising interest yields on United States Treasury bills. At the month end it closed at \$2.8114. In the forward market the discounts on three and six months’ sterling moved somewhat erratically, in a relatively narrow range.

The Canadian dollar, principally as the result of movements of long-term capital to Canada, appreciated approximately one cent, to reach \$1.03 $\frac{1}{2}$  by August 15. By the end of the month, however, it had eased to \$1.02 $\frac{1}{4}$ .

### The Business Situation

The economy apparently has continued to edge sidewise in recent weeks. Comprehensive measures of economic activity such as employment and industrial production remained in July at or near the high June levels, and personal income advanced a bit. Private nonresidential construction outlays showed a small gain in August, after vir-

tual stability in July, but outlays for residential construction declined further. Some weakness appeared in consumer demand during July, principally in sales of new automobiles, and incomplete auto and department store data suggest that consumer demand did not improve in August. The hesitant business atmosphere has been reflected in a

further decrease in manufacturers' new orders and also in price declines for certain industrial commodities. On the other hand, efforts to hold back inventory accumulation, and to effect actual reductions in durable goods lines, are meeting with a measure of success. Such efforts have been a prime factor hindering expansion in output, and their easing could add strength to employment and to economic activity generally. Over all, the summer months, traditionally a sluggish period, have thus far done little to clarify the business situation.

### THE DIVERGENT INDICATORS

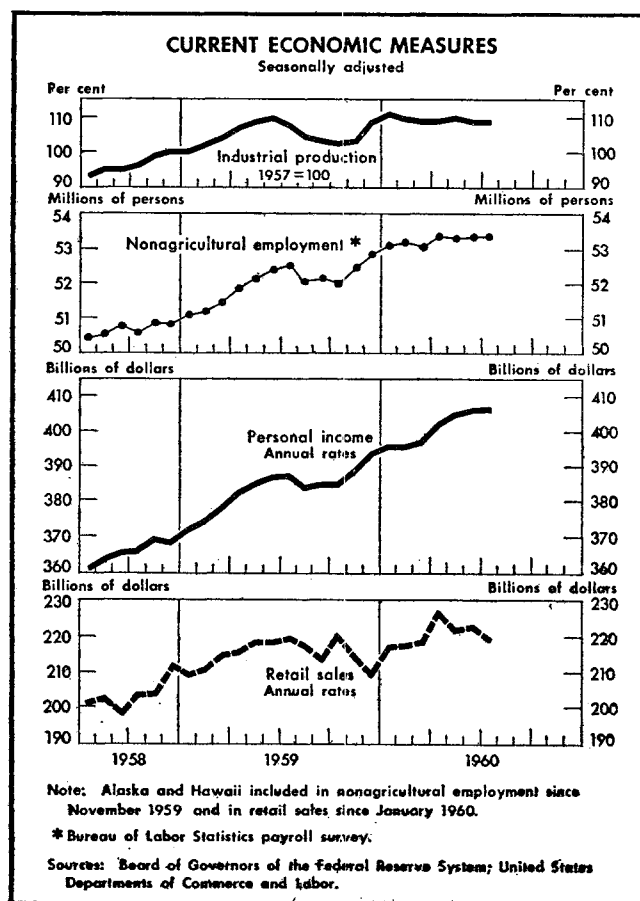
In July, the Federal Reserve index of industrial production remained, after allowing for the usual seasonal dip, at the June level of 109 (1957=100). The manufacturing component of the index was also unchanged in July, as sharp cutbacks in automobile assemblies and a slightly more-than-seasonal decline in iron and steel output were offset by small increases throughout a wide range of products, both durable and nondurable. In terms of "market" classification, some strength was shown in (nondefense) business equipment output, which rose to a record level. Consumer goods output, however, slipped a little—a result of the deep cut in automobile assemblies and of a small reduction, for the second consecutive month, in the "home goods and apparel" group. Production of materials was stable, as a rise in the output of nondurable materials compensated for a continued, although more gradual, decline in durables.

Steel production, which had dropped to 50 per cent of capacity in July, was close to 55 per cent of capacity throughout August, despite two railroad strikes in the Pittsburgh area that caused the closing of several mills for some time. Industry sources continued to express disappointment with the level of incoming orders, and it was reported that the industry did not anticipate a significant improvement before October. Most steel orders during August were for "quick" delivery, suggesting that steel users had worked down their inventories and were now operating hand to mouth. But there were also reports that other steel users had not yet reduced inventories as much as intended. The principal source of disappointment for steel producers has been the automobile industry. Although auto assembly plants were closed for model change-over earlier than usual this year, the expected large-scale orders for steel for the new models have not yet materialized.

Total employment (as measured by the Census Bureau household survey) inched up in July to 68.7 million per-

sons. The increase was entirely a result of the employment of young people newly out of school; the number of adults employed actually declined. The total was sustained, moreover, by farm employment, which usually falls in July but this year remained at about the June level because of a late planting season. Still, after seasonal adjustment, total employment was down 300,000 from the June peak. The Bureau of Labor Statistics payroll survey of nonfarm employment (which differs in some significant respects from the household survey) showed a seasonal decline of almost 400,000, so that after adjustment this series was about equal to the previous month's 53.4 million total (see chart). More-than-seasonal contractions in employment in automobile and steel manufacturing and—because of the reduced pace of steel output—in the coal mining and transportation industries were offset by gains in construction, trade, finance, and services. Unemployment as a proportion of the civilian labor force was down in July by a scant  $\frac{1}{10}$  of a point to 5.4 per cent, seasonally adjusted.

The maintenance of high levels of employment helped push up personal income in July to a record annual rate



of \$407.1 billion, seasonally adjusted. This was, however, just \$1 billion more than in June, and with a single exception was the smallest monthly advance since last year's steel strike. About half of the gain was in wages and salaries; increased payments in the construction industry plus the effects of the recently enacted pay rise for Federal Government employees more than offset a reduction in the manufacturing sector. Interest income also rose. However, about one quarter of the month's total income gain resulted from an increase in unemployment insurance benefits. Meanwhile, farmers' income dropped for the first time in four months as a result of a decline in meat prices.

At the same time that personal income has been posting new records, retail sales have been sluggish. In July, sales slipped for the second time in three months—falling, according to the advance report,  $1\frac{1}{2}$  per cent below the June total and 3 per cent under the April peak, seasonally adjusted. Most of the July decline reflected slower automobile sales, but purchases of nondurables also decreased somewhat. The data so far available for August on automobile and department store sales do not suggest an upturn in consumer expenditures. These developments may possibly reflect some lessening of consumer optimism regarding the business and employment outlook.

Probably as the combined result of the lack of spark in consumer demand and the absence of increased strength in investment demand, new orders received by manufacturers, which had risen slightly in April and May, seasonally adjusted, declined in June and again in July, falling back close to the November 1959 level. The June decrease was entirely in durables and covered several impor-

tant industries. In July, durables declined somewhat further but nondurables accounted for almost three fourths of the total drop. New domestic orders for machine tools, which had risen in June after two months of decline, fell sharply in July to mid-1958 levels, although industry sources continued hopeful that orders would pick up after the Machine Tool Exposition in Chicago this month.

Order backlogs, which had declined in June to the lowest level since December 1958, increased a bit in July, principally as a result of a small growth in unfilled orders in the durable goods industries. Data for unfilled orders are not seasonally adjusted, however, and an increase in backlogs is normal for July—but this time it was unusually small. Backlogs in nondurable goods industries fell, meanwhile, to early 1959 levels. Manufacturers' inventories, seasonally adjusted, fell slightly in July after rising for eight successive months, although recently at a declining pace. Stocks held by producers of durable goods declined from the record level reached the previous month, while stocks in the hands of nondurable goods producers remained unchanged from the high June total. The inventory-sales ratio of all manufacturers was at its highest point since November 1958—although not so high as it had been during most of the 1956-58 period.

Data on construction activity have been mixed. Outlays for private nonresidential construction, which had fallen for four consecutive months through June, seasonally adjusted, remained almost unchanged in July and advanced in August. Moreover, nonresidential contract awards rose in July. Private residential construction outlays, however, declined in both July and August, and July residential contract awards were also down.

## Money Market in August

The Board of Governors of the Federal Reserve System on August 8 announced several actions liberalizing member bank reserve requirements. From August 25 country banks may include in their reserves vault cash in excess of  $2\frac{1}{2}$  per cent (instead of 4 per cent) of their net demand deposits, and effective September 1 reserve city and central reserve city banks may count as reserves vault cash in excess of 1 per cent (rather than 2 per cent) of their net demand deposits. Also effective September 1, the reserve requirement against net demand deposits of central reserve city banks was reduced from 18 to  $17\frac{1}{2}$  per cent. After the close of business on August 11, this

Bank and three other Reserve Banks announced a reduction in the discount rate from  $3\frac{1}{2}$  to 3 per cent effective the following day. During the remainder of the month six other Reserve Banks followed suit.

Bank reserve positions eased somewhat further in August. While New York City and Chicago banks continued to be net purchasers of Federal funds on most days, the effective rate prior to the August 12 discount rate reduction was often below the  $3\frac{1}{2}$  per cent "ceiling". After August 12 the effective rate for Federal funds traded by New York City banks on most days stood at or close to the new 3 per cent "ceiling", although some trading



occurred at higher rates in centers where the discount rate had not yet been reduced. Rates posted by major New York City banks on loans to Government securities dealers varied generally within a range of  $3\frac{3}{4}$  to  $4\frac{1}{4}$  per cent. On August 22-23 leading commercial banks announced cuts in their prime lending rates from 5 to  $4\frac{1}{2}$  per cent.

#### MEMBER BANK RESERVES

Reserve positions of member banks, which had come under gradually lessening pressure during the first seven months of this year, eased further in August. While operating factors, on balance, absorbed a substantial amount of reserves during the month, decreases in required reserves released funds to the member banks. At the same time, reserves were augmented by System open market operations and, toward the close of the month, by a large increase in allowable vault cash. In the five statement weeks ended in August, the average level of excess reserves was \$22 million higher than in July and average free reserves rose by \$115 million to \$225 million.

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, August 1960  
In millions of dollars; (+) denotes increase, (-) decrease in excess reserves

Factor	Daily averages—week ended					Net changes
	Aug. 3	Aug. 10	Aug. 17	Aug. 24	Aug. 31	
<b>Operating transactions</b>						
Treasury operations*	+ 17	+ 22	- 104	+ 82	+ 6	+ 23
Federal Reserve float	- 197	- 68	+ 154	+ 38	- 226	- 299
Currency in circulation	- 3	- 85	- 55	+ 97	+ 107	+ 61
Gold and foreign account	- 63	- 20	- 57	- 18	- 50	- 208
Other deposits, etc.	+ 2	+ 8	- 43	- 106	- 2	- 141
<b>Total</b>	- 244	- 142	- 105	+ 94	- 166	- 563
<b>Direct Federal Reserve credit transactions</b>						
Government securities:						
Direct market purchases or sales	+ 238	+ 46	+ 6	- 40	- 90	+ 160
Held under repurchase agreements	+ 93	+ 123	- 64	- 9	- 114	+ 29
Loans, discounts, and advances:						
Member bank borrowings	- 36	- 22	+ 123	- 223	+ 80	- 78
Other	-	-	-	-	-	-
Bankers' acceptances:						
Bought outright	+ 1	+ 2	-	+ 3	- 2	+ 4
Under repurchase agreements	-	+ 1	+ 3	+ 9	- 12	+ 1
<b>Total</b>	+ 297	+ 149	+ 69	- 262	- 137	+ 116
<b>Member bank reserves</b>						
With Federal Reserve Banks	+ 53	+ 7	- 36	- 168	- 303	- 447
Cash allowed as reserves†	- 13	- 74	+ 75	+ 8	+ 307	+ 303
<b>Total reserves†</b>	+ 40	- 67	+ 39	- 160	+ 4	- 144
<b>Effect of change in required reserves†</b>	- 27	+ 86	+ 36	+ 43	+ 105	+ 243
<b>Excess reserves†</b>	+ 13	+ 19	+ 75	- 117	+ 109	+ 99
<b>Daily average level of member bank:</b>						
Borrowings from Reserve Banks	315	293	416	193	273	298‡
Excess reserves†	488	507	582	465	574	523‡
Free reserves†	173	214	166	272	301	225‡

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 August 31, 1960.

The effect of these developments upon the reserve situation was, however, moderate on the whole, and the atmosphere in the money market tended to be somewhat tighter than might have been expected. The different discount rates prevailing at the various Federal Reserve Banks during the middle weeks of the month tended to interfere with the flow of reserves through the Federal funds market, and the shifts of funds arising from the settlement of the Treasury's financing on August 15 produced additional reserve pressures on the banks in the New York money market.

From July 27 to August 31, System Account holdings of Government securities increased by \$78 million. The purchases were concentrated in the first part of the month, offsetting the absorption of reserves by operating factors and permitting member banks to reduce somewhat their borrowings at the Reserve Banks.

#### GOVERNMENT SECURITIES MARKET

The market for Government securities began the month on a tone of firm confidence based on several factors: (1) the expectation of a substantial reinvestment demand resulting from a net Treasury debt redemption of \$1.5 billion during the month, (2) the absence of a long maturity issue in the Treasury's new offerings, (3) the reduction in stock margin requirements in late July, and (4) widespread expectations of somewhat easier credit conditions—associated with uncertainty about near-term business prospects. As the month progressed, however, market confidence gave way to caution in spite of some general encouragement provided by the easing in reserve requirements and the reduction in the discount rate. Broad reinvestment demand did not develop as expected, and dealer inventories reportedly had to be carried at relatively high interest costs. Another dampening influence affecting longer issues was the market expectation that advance refunding would put more issues in the long-term area.

The August refinancing operation was generally considered successful. The refunding offer, which did not give pre-emptive rights to the holders of the maturing securities, was heavily oversubscribed. Allotments of the new  $3\frac{1}{8}$  per cent certificates were only 13 per cent of subscriptions, except for certain types of subscribers who were allotted 100 per cent. Allotments of the new  $3\frac{3}{8}$  per cent bonds ranged from 15 to 25 per cent for the various types of subscribers.

For the month as a whole, prices of notes and intermediate bonds were generally  $\frac{7}{32}$  higher to  $\frac{1}{32}$  lower and longer term bonds declined by  $\frac{1}{4}$  point to  $12\frac{5}{32}$ .

points. The average yield on three- to five-year issues closed at 3.50 per cent on August 31, up 4 basis points from July 29, while the average yield on issues due in ten years or more rose by 9 basis points to 3.83 per cent.

The atmosphere in the Treasury bill market also changed from one of strong confidence to somewhat more caution during August. Following the Treasury announcement in late July of its August debt operations, bill rates declined sharply in view of the prospective reduction in the outstanding short-term debt. In the regular Monday auctions on August 1 the average issuing rate of 2.131 per cent for 91-day bills was the lowest since August 1958, while the 2.409 per cent rate for 182-day bills was the lowest in the history of this series. Issuing rates rose steadily in the next four auctions, reaching 2.550 and 2.825 per cent for the 91-day and 182-day bills, respectively, in the final auction of the month (August 29).

#### OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds the month opened on a firm tone, largely reflecting influences similar to those that affected the Treasury bond market. While this early enthusiasm faded to some extent in respect to some corporate issues, price gains of tax-exempts generally were fairly well retained during the month. The announcements of liberalization in reserve requirements and reductions in discount rates gave further strength to these markets, particularly in the tax-exempt sector. Moody's series of average yields for seasoned high-grade tax-exempt and corporate bonds both declined to new lows for the year. The average yield on Aaa-rated tax-exempt bonds fell from 3.28 per cent on July 27 to 2.99 per cent on August 31, and the average yield on similarly rated corporates declined from 4.35 per cent at the end of July to 4.23 per cent at the end of August.

New corporate bond flotations in August amounted to \$587 million, an increase over both the July total of \$422 million and the August 1959 total of \$411 million. Most corporate issues were well received, but the response to some utility offerings was slow. Offerings of new tax-exempt bonds aggregated \$554 million (including one offering of \$200 million), compared with \$462 million in July and \$454 million in August 1959. Tax-exempt issues generally were well received.

The cut in prime loan rates was followed on August 24 by a  $\frac{1}{8}$  per cent reduction of rates on bankers' acceptances, which brought the bid rate on 90-day unendorsed acceptances to  $3\frac{1}{8}$  per cent. Earlier in the month, dealers had lowered their rates on acceptances by  $\frac{1}{4}$  per cent, but the cut had been restored a week later. On August 23, the New York City banks reduced from 5 per cent to  $4\frac{1}{2}$  per cent the rate on loans secured by customers' stock exchange collateral. On August 25, dealers in commercial paper reduced rates on all maturities by  $\frac{1}{8}$  per cent, setting the new offered rate on prime 4- to 6-month paper at  $3\frac{3}{4}$  per cent. Sales finance companies increased various rates by  $\frac{1}{8}$  to  $\frac{1}{4}$  per cent, effective August 31, bringing the rate on 60- to 89-day paper to  $2\frac{3}{4}$  per cent.

#### SELECTED PUBLICATIONS OF THE FEDERAL RESERVE BANK OF NEW YORK

The following selected Federal Reserve Bank of New York publications may be of particular interest to educational institutions. These booklets are available from the Publications Division of the Federal Reserve Bank of New York, New York 45, N. Y. Where a charge is indicated, remittance should include New York City sales tax, if applicable.

**Deposit Velocity and Its Significance** by George Garvy. 60 cents per copy; 30 cents per copy on orders from educational institutions.

**Federal Reserve Operations in the Money and Government Securities Markets** by Robert V. Roosa.

**Foreign Central Banking: The Instruments of Monetary Policy** by Peter G. Fousek.

**Monetary Policy Under the International Gold Standard: 1880-1914** by Arthur I. Bloomfield. 50 cents per copy; 25 cents per copy on orders from educational institutions.

**The Money Side of "The Street"** by Carl H. Madden. 70 cents per copy; 35 cents per copy on orders from educational institutions.

**The New York Foreign Exchange Market** by Alan R. Holmes. 50 cents per copy; 25 cents per copy on orders from educational institutions.