FEDERAL RESERVE BANK OF NEW YORK

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The Business Situation

There are growing indications that the low point of the recession may now have been passed. In March, industrial production registered a slight gain, the first in eight months, and manufacturers of durable goods reported rising orders for the second month in a row. Moderate gains were also reported for personal income, retail sales, residential construction, and employment. In addition, new survey results suggest an improved outlook for fixed business capital formation, and current data seem to point to a better outlook for housing construction. All in all, the recent behavior of economic time series, including those regarded as "leading" indicators, strengthens the impression that economic activity has begun to move in an upward direction. Preliminary data for April suggest that the March gains have generally been maintained or broadened. If the recession should, in fact, prove to have run its course, it would pass into history as the mildest of the four cyclical contractions in the postwar period.

While the evidence pointing to an end of the contraction is substantial, it will take some time before a more conclusive appraisal of the prospects of recovery becomes possible. There are as yet no signs that the recovery will be vigorous, but the expansion could nonetheless start out with an initially strong upward thrust since a shift away from rapid inventory liquidation might give the economy a marked boost. This in itself, however, is not likely to provide more than a temporary push to aggregate activity and might indeed convey a misleading impression of the rate of advance that the economy will achieve over a somewhat longer period. Even an expansion in total output matching the improvement registered in the strongest postwar recovery period would in all likelihood leave unemployment higher than in the previous recoveries because of the large number of persons expected to enter the labor force. Should there be a noticeable step-up in productivity as a result of technological advances, better utilization of existing capacity with rising output, and other factors, the more immediate task of generating a satisfactory volume of new job opportunities would loom still larger, even though the longer term prospects for the economy's advance would be strengthened.

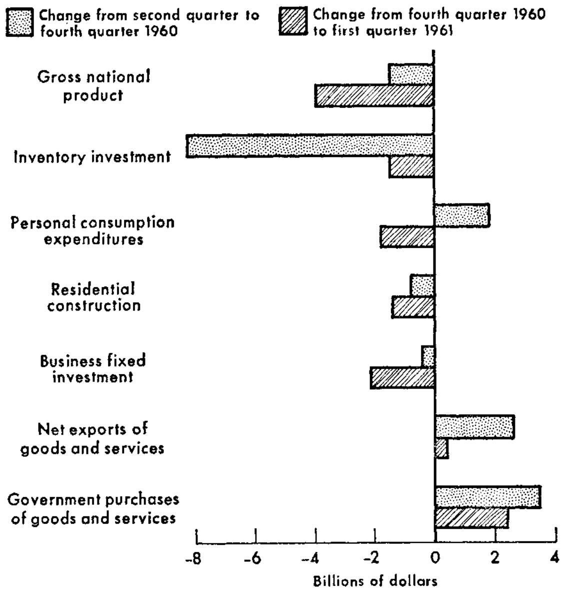
RECENT DEVELOPMENTS

During the first quarter of 1961, the nation's aggregate output of goods and services slipped by $4.0 billion (seasonally adjusted annual rate) from the level of the preceding quarter to $499.5 billion, according to preliminary estimates by the Council of Economic Advisers. The total decline in gross national product since the spring 1960 peak of $505 billion has amounted to an estimated $5.5 billion, or only 1 per cent. In contrast, the full GNP decline in the 1957-58 recession amounted to 3½ per cent, in 1953-54 to 2½ per cent, and in 1948-49 to 3½ per cent. Thus, if the first quarter proves to have been the low point of the current recession—and if the Council's estimates are confirmed by later data—the GNP decline this time will have been smaller than that recorded in any of the three previous postwar recessions.

Final demand in the current recession apparently has held up considerably better than in other recent periods of cyclical decline; by contrast, the reduction in inventory investment has been more pronounced. During the first two quarters of the recession, expanding final demand nearly offset the contractionary impact on GNP of the switch from rapid accumulation to heavy liquidation of business inventories (see Chart I). In the January-March quarter of 1961, however, final demand declined, thus adding to the downward pull on economic activity stemming from an accelerated rate of inventory liquidation. Not only did residential construction and business fixed investment continue to drop—and at a faster pace than in the earlier period—but personal consumption, which had risen in late 1960, also slipped. Net exports advanced less than in prior months. Government spending for goods and on wages and salaries, on the other hand, expanded even more than in each of the two preceding quarters as the Administration sought to bolster business activity by speeding up already authorized programs, especially those for defense and for highway construction.

Although net inventory liquidation in the first quarter of 1961 was larger than in the preceding quarter, the pattern of inventory change shifted in an encouraging direction. Cutbacks in stocks, previously entirely at the manufacturing level, were largely at the retail level. Moreover, the reductions in manufacturers' stocks were very small and were spread rather evenly over all levels of fabrication. This suggested that manufacturers in general did not feel that their stocks were excessive, and that in some cases rising demand could be satisfied only from inventories. A major part of the retail liquidation prob-

Chart I
CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS DURING THE RECESSION
Seasonally adjusted annual rates



Sources: United States Department of Commerce; Council of Economic Advisers.

ably centered in automobile dealers' inventories, which were unusually burdensome at the turn of the year; by the end of March, lower output and higher sales had reduced auto inventories to a more acceptable level. Stocks were cut and sales expanded in late winter in other fields, too, with inventory-sales ratios falling accordingly. The way was thus paved for some increase in orders in various industries where new orders had been moving downward. This was already evident in the orders received by manufacturers in February (when the gains were, however, heavily boosted by a rise in the flow of defense contracts), and there was an even greater improvement in March.

Reflecting the rising flow of orders, the Federal Reserve Board's index of industrial production, which had been falling almost without a break since last May, rose in March by ½ point, seasonally adjusted. (On a rounded basis, the index remained level at 102 for the third consecutive month.) Most of the gain was in nondurable goods, but output also rose in some durable goods industries (mainly steel, furniture, and household appliances). During April steel output again rose, contraseasonally, and the rate of auto assemblies also increased, even though there usually is a decline in that month.

Construction activity, too, has shown a gain, rising in March for the first time in three months on a seasonally adjusted basis and falling back only slightly in April. Spending for private business buildings and for public construction was down over the two months as a whole, and most of the improvement in total expenditures derived from an increase in each month in private residential outlays. In March, private nonfarm housing starts also moved up, by a sizable 10 per cent (seasonally adjusted), suggesting some further advance in residential outlays in the months ahead. Part of the advance reflected the much improved weather, but it is nonetheless encouraging that starts have now risen three months in a row. The number of requests for Government-backed financing, however, remained relatively low, and rental vacancies during the first quarter rose to a new post-World War II high. Thus, it is still uncertain whether the recent easing of mortgage terms and increased availability of credit for the housing sector are in fact beginning to elicit a significant response in home-building activity. Allowance must, of course, be made for the usual lag in response.

Primarily because of the lift from some sectors of construction, total employment as measured by the household survey rose more than seasonally in March, the third increase in as many months. In April, employment slipped to slightly below the January figure, but this resulted entirely from a contraseasonal decline in agricultural employment. The March payroll survey of nonfarm workers also turned up slightly, following a drop in February to the lowest figure in two years. Along with the increased hiring of construction workers, there were small gains in the number of workers on State and local government payrolls and on those of financial enterprises. Employment slipped in all other sectors covered by the survey. The decrease in the manufacturing sector was, however, the smallest of any during the past six months. In addition, factory employees worked more hours per week for the third consecutive month, a development that usually foreshadows an increase in hirings.

Personal income (seasonally adjusted), which had been falling for four months, jumped sharply in March to slightly above last October's peak. About half of the February-to-March gain was traceable to earlier-than-usual payments of 1961 dividends on veterans' life insurance. Normally, payments are spread fairly evenly over the year; the advance payments this year were a contracyclical measure to get purchasing power more rapidly into the hands of the public. The remainder of the March income rise came principally from wages and salaries, which increased for the first time since last July, with construction payrolls the chief source of the improvement.

March also witnessed an increase in retail sales of 1 per cent, seasonally adjusted, following a smaller rise during the previous month. Sales advanced in many fields, but the largest increases were recorded in apparel and in new and used autos. Sales of new autos, which have much significance for near-term employment and income, and which were maintained throughout March at the sharply higher levels (allowing for seasonal increases) achieved during the second half of February, held the gain in early April. Sales of consumer goods at department stores during the early part of April made an even better showing, rising more than seasonally from March.

Despite such economic gains, unemployment continues to be high. The proportion of the labor force out of work remained, after allowance for seasonal factors, virtually unchanged during December-April at about 6.8 per cent. This reflects in part the fact that the labor force has been growing at a relatively rapid rate. The labor market has been receiving the first waves of young people born during the wartime baby boom; in addition, many women whose husbands became unemployed during the past year apparently entered the market. The problem of providing work for the currently unemployed and the new jobseekers is likely to be compounded by an increase in productivity. In 1960, the gain in output per worker in the private sector amounted to only 1¼ per cent, comparing poorly even with the recession years 1953 and 1957. If the cyclical patterns of the fifties are repeated, however, productivity can be expected to rise sharply within the first twelve months after recovery has started.

BUSINESS DATA AT THE TURN

In the past, there have been very rapid revivals following a recession as well as slow revivals. In 1958, for example, a sharp contraction in economic activity ended in an unusually quick turnaround, producing the so-called V-shaped recession and recovery. But more common is the U-shaped pattern that characterized 1954 and 1949 when the economy followed a sideway course for a while before an upward climb began.

How can a lower turning point be clearly recognized when it does arrive? Analysts have long been intrigued with the possibility that a turning point can be identified —and perhaps even anticipated—by a close study of certain key indicators of economic activity. The National Bureau of Economic Research, after many years of careful exploration, has recently focused attention on twelve economic series that commonly have led a turn in general business activity. Another nine series have been found to coincide with the turn, at least roughly. But, as the National Bureau is quick to point out, there is of course no single series or set of series that can signal in advance precisely when a recession will end and a recovery will begin. Sometimes a series may turn up as much as a year, or more, ahead of the general cyclical turn. At other times, the same "leading" series may actually lag behind the cyclical turning point. For example, of the National Bureau's twelve "leading" series, four have failed to lead in about a third of the turns examined by the Bureau, and eight have actually lagged at one time or another. Similarly, less than half of the series labeled as "roughly coinciding" have in fact coincided, even roughly, with the cyclical trough as much as 75 per cent of the time. The pitfalls of a purely mechanical use of statistical series for predicting a cyclical upturn are illustrated by the behavior of the twelve leading indicators during the last three recessions. The number of leading indicators moving upward just prior to the end of each recession was different in each case, and in the trough month of each of the recessions there was actually a temporary, misleading dip in the number of series expanding.

The recent development of other new sets of business indicators by the National Bureau and other organizations will provide better tools for a systematic appraisal of the state of the economy. These new tools include so-called "diffusion indexes" which present a cross-sectional view of more aggregative series to reveal how many of the components are moving up or down at a given time, as well as summary series showing how many of the significant indicators have reached new highs or lows during the month. But, while these new guides can help in business analysis, they cannot yield precise pinpointing of cyclical turning points. It is unlikely that quantitative measures will ever fully replace qualitative analysis.

Efforts to foresee a cyclical turnaround are made all the more difficult by delays in the reporting of current information. Most of the monthly series are available only three or more weeks after the end of the month. Very few data are available weekly, and these are limited in coverage and often quite erratic. Even some of the monthly series are so volatile that figures for two or more months have to be averaged to be of any use, thus in effect further delaying their availability. Other data that are frequently leaders at cyclical turns are available only quarterly and usually with a considerable delay. Hence many of the series that historically are good indicators of an upturn are never available until after the turn. As of the end of April, for instance, the published statistics covering the month of March included only seven of the twelve indicators comprising the National Bureau's leading group.

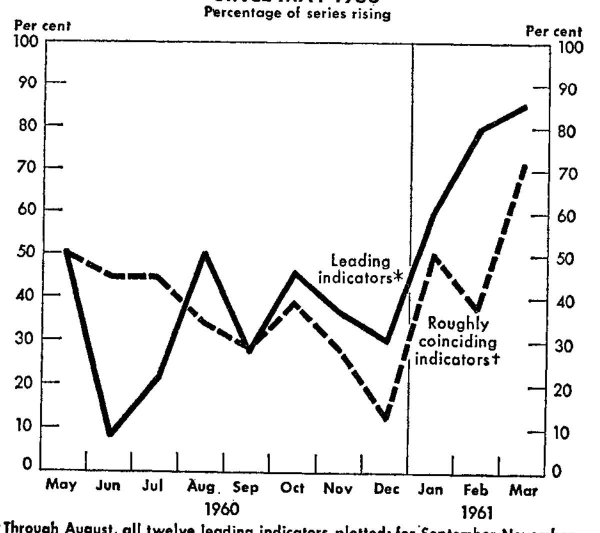
The most recent business data, including the National Bureau's "leading" and "roughly coinciding" indicators, do point to an end of the recession. Chart II summarizes the behavior of these latter two sets of data since May 1960, the month tentatively chosen by the Bureau as marking the last cyclical peak. Using the Bureau's method, each of the twelve leading series that has moved upward during a particular month is counted as one twelfth of the total of 100 per cent, or 8⅓ per cent, while each sidewise-moving series is accorded one half of this weight. Similarly, each of the nine roughly coinciding series is counted as one ninth of the total, or 11⅑ per cent, and each sidewise-moving series as one half of this amount. When fewer data are available for a particular month, the total is apportioned accordingly. Whenever a line passes above 50 per cent, it indicates that a majority of the series are moving up. This has been the situation with the leading series since January and was true for the coinciding series in March.

Many observers expect substantial support for the economy from an early renewal of inventory accumulation, stimulated by higher sales and increased production. This support may well be of limited duration, however. In many fields inventory-sales ratios remain comparatively high, and the National Association of Purchasing Agents reports that its March survey showed continuing widespread resistance to inventory increases. Nor does there seem to be any general expectation of rising materials prices that could cause a prolonged surge of inventory investment; this partly reflects an anticipation of continued foreign competition as well as of increasing domestic competition arising out of recent technological developments.

Chart II

LEADING AND ROUGHLY COINCIDING INDICATORS SINCE MAY 1960

Percentage of series rising



*Through August, all twelve leading indicators plotted; for September-November, only eleven; for December 1960-February 1961, only ten; and for March, only seven.
†Through November, all nine roughly coinciding indicators plotted; for December 1960-February 1961, only eight; and for March, only seven.
Sources: National Bureau of Economic Research; Federal Reserve Bank of New York.

Business outlays for plant and equipment are probably continuing downward in the current quarter. However, the trend may well prove to be more favorable for the year than originally anticipated. A National Industrial Conference Board survey has indicated that capital appropriations by business rose between the third and fourth quarters of 1960. It is thus possible that there will be a turnaround in expenditures before the middle of 1961. According to a recent McGraw-Hill survey of spending plans, moreover, businessmen have raised their spending plans since the winter and now intend to lay out only 1 per cent less during the current year than they did in 1960. This would appear to imply a significant increase in fixed capital outlays during the latter half of the year.

Foreign trade has been a strong force throughout the recession, but it is not clear whether it will continue to be such in the coming months. In a recovery period, imports are likely to increase. Exports will then have to expand more than commensurately to provide a further push to the economy; the prospects, of course, depend in large part on business developments in Europe and elsewhere.

It would appear that, if the economy does gain strong momentum during the year from forces other than an initial inventory spurt, the principal contributory factors are likely to be government and consumer spending. Federal Government outlays may well advance at a higher rate than in the first quarter. This is indicated by the recent increases in appropriations and contract awards, as well as by the enactment of various new programs proposed by the Administration. State and local expenditures can also be expected to continue to rise, as they have almost without interruption for several years. It is as yet by no means clear, however, that total government spending will exert more than a moderate push on the economy.

Consumer outlays could well be the most significant force in the upturn. The decline in such outlays in the past quarter was limited to purchases of durables, and the small increase in the demand for durables in March may be furthered by the recent rise in employment and personal income and by a consequent greater optimism about future prospects. Since personal savings during these last three quarters have been relatively high, it would seem that total personal expenditures could be easily increased if there were a will to spend more. The recent decline in instalment debt suggests, moreover, that some individuals are now in a somewhat better position to bolster their buying by additional recourse to consumer credit. The relative stability in consumer prices during the last year may also prove to be a factor encouraging demand. Indeed, avoidance of price increases may be crucial for the achievement of sustained expansion in consumer buying.

Financing Economic Development in Puerto Rico

A greatly enhanced role for Puerto Rico in United States-Latin American relations was envisaged at President Kennedy's meeting with Governor Muñoz Marin last January, when the two leaders agreed on increased use of the Commonwealth as a "meeting place and workshop" for this country and its neighbors south of the border. Puerto Rico's qualifications for such a role derive in large part from its extraordinary economic progress over the past decade. Last year, at a time when economic growth remained slow in many Latin American countries, Puerto Rico's gross product expanded by a record 9.4 per cent and per capita personal income rose to $571, nearly double the 1950 level and higher than in any Latin American country except Venezuela.[1] Of course, Puerto Rico is a very special case among underdeveloped countries because of its unique position within the United States political and economic system, a position that has been especially significant for the extent to which it has enabled the Commonwealth to tap the mainland capital market.[2] The share of mainland capital in financing Puerto Rico's economic development has increased significantly, rising from about 35 per cent in 1950 to 50-60 per cent in recent years, far more than the share of United States capital in the development of any of the twenty Latin American republics.

Nevertheless, the financing of Puerto Rico's economic development also owes much to the vigorous efforts of the island's government and financial institutions both in exploiting their access to mainland capital and in mobilizing local savings. An article last year in this Bank's *Monthly Review* showed how Puerto Rico has worked through "Operation Bootstrap" to make optimum use of its tax and other attractions for industry.[3] Similarly, although the fact that Puerto Rican public bonds are tax exempt in the United States has been a big help, the sound management of the Commonwealth's public finances and its efforts to develop a market for its public securities on the mainland have also contributed much to making the sale of such bonds an important source of United States capital in recent years. And while Federal Housing Administration insurance has been the key to the sale of Puerto Rican mortgages on the mainland, the Puerto Rican banking system has played an important role in developing this market, and also in bringing in funds from mainland head offices and correspondents. Moreover, the preponderant role of mainland capital should not be allowed to detract from the importance of the steadily increasing volume of savings by government and business in Puerto Rico. The growth of personal savings is attested to by the rapid increases in insurance-company and pension-fund reserves, in savings and loan accounts, and especially in time and savings deposits in the commercial banks. Nevertheless, personal debt has also risen rapidly and, while estimates differ, net personal savings appear at best to have been relatively small.

[1] Puerto Rican economic and financial statistics are reported for the fiscal year ending June 30. Except where otherwise noted, all annual data given in this article are for the fiscal year.

[2] "Mainland" as here used refers to the continental United States.

[3] "Private Investment and the Industrialization of Puerto Rico", *Monthly Review*, April 1960, p. 68.

GROWTH AND STRUCTURE OF THE BANKING SYSTEM

The Puerto Rican banking system has unquestionably made an outstanding record in increasing its resources and putting them to work, and in so doing it has contributed importantly to the island's economic progress. Indeed, a recent study of banking in Puerto Rico, prepared under official auspices by Dr. John S. deBeers, shows that the banking system has grown more rapidly than the rest of the economy and that it is already relatively highly developed.[4] Nevertheless, as the deBeers study also points out, credit is very tight in Puerto Rico, and business needs for bank financing appear generally to be less well filled than on the mainland. Rapid expansion and intensive use

[4] J. S. deBeers, *A Study of Puerto Rico's Banking System*, prepared for the Finance Council of Puerto Rico, February 1960.

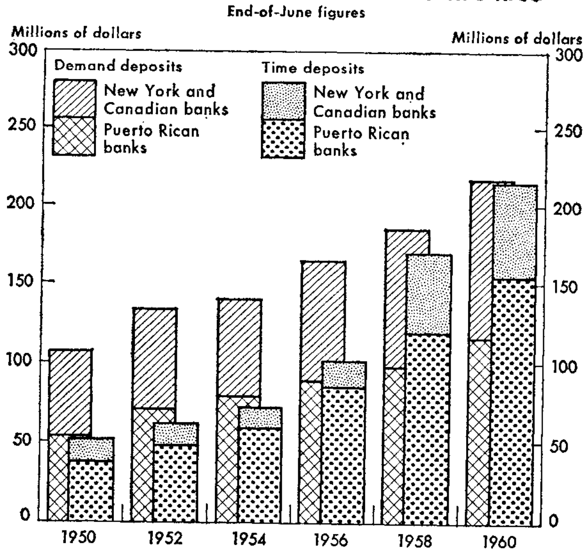
of bank resources on the one hand, and a shortage of credit on the other, are of course typical of a fast-growing economy. Indeed, credit stringency is characteristic of many rapidly progressing underdeveloped nations as well as of regions within the United States where, for one reason or another, there has been a rapid growth of business activity.

From 1950 to 1960 total private deposits of the commercial banks rose more than 180 per cent to $431 million (see Chart I); deposit growth was much greater than the expansion in the island's gross product during the same period, and also far in excess of the growth of bank deposits on the mainland. Nearly three fifths of the increase was in time and savings deposits, which more than quadrupled, thus providing perhaps the strongest testimony to the banks' success in mobilizing savings. As Chart I shows, at the end of 1960 time and savings deposits accounted for one half of total private deposits, compared with only about one third in 1950. Of key importance in attracting to the banks the growing volume of savings becoming available from the rapid increase in incomes have been the banks' efforts to offer greater inducements to savers; to provide additional services to depositors; and, especially, to make banking facilities available throughout the island. The number of commercial banking offices on the island has more than doubled since 1950, reaching 128 at the end of 1960 or about one office for every 18,000 persons—a figure that compares favorably with that for the mainland, given Puerto Rico's much greater population density. Thirty-three of the branch offices are mobile ones, introduced in 1958. These bus-like vehicles travel from town to town daily, providing regular banking service for a limited number of hours to communities not large enough to warrant a permanent full-time branch.

Chart I

GROWTH OF PRIVATE DEPOSITS IN PUERTO RICO

End-of-June figures



Source: Commonwealth of Puerto Rico, Department of the Treasury.

The expansion of bank lending (see Chart II) not only has greatly surpassed the over-all growth of the Puerto Rican economy, but has also outpaced by far the rise in deposits. Loans rose by nearly 248 per cent from 1950 to 1960, and the ratio of loans to gross product increased from about 16 per cent to some 27 per cent. This ratio—which provides at least a rough indication of the relative importance of bank lending in the economy—is now somewhat higher in Puerto Rico than on the mainland, and is well above the ratios in most important Latin American countries. The more rapid increase in loans than deposits was made possible by substantial reductions in the proportion of assets held in cash and investments, and by the fact that the branches of foreign banks operating on the island brought in funds from their head offices. One indication of the important extent to which the growth in bank lending has contributed to development financing is the fact that commercial and industrial loans at the end of 1960 accounted for some 44 per cent of total loans, compared with 36 per cent for all insured United States commercial banks and 25 per cent for Federal Reserve country member banks. Additional evidence of the developmental character of much bank lending was uncovered by a special survey made in connection with the deBeers study, which indicated that a relatively high portion of commercial and industrial loans was made to manufacturers and that new businesses received about 16 per cent of total loans, about twice the percentage on the mainland.

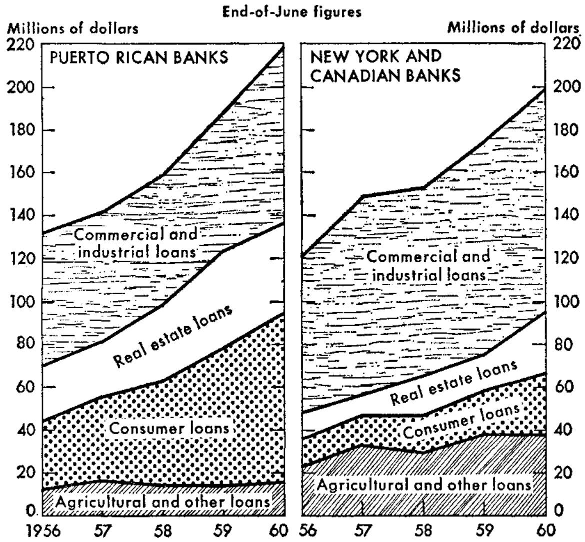
An important contribution to the outstanding record just outlined has undoubtedly come from the institutional improvements—including, most prominently, measures to integrate the Puerto Rican banking system more closely with that of the mainland—which have strengthened the banks and helped to economize their resources.[5] Perhaps the most important step was the extension of Federal Deposit Insurance Corporation insurance to the island's banks in 1950. Banks operating in Puerto Rico are now subject to the same standards and supervision as mainland FDIC member banks, and this fact, together with deposit insurance, has undoubtedly contributed to the building of the high esteem that the banking system now

[5] Cf. "Puerto Rico's Monetary System and Economic Growth", *Monthly Review*, March 1958, p. 38.

Chart II

BANK LOANS IN PUERTO RICO

End-of-June figures



Source: Commonwealth of Puerto Rico, Department of the Treasury.

enjoys and therefore to its ability to attract deposits. FDIC insurance has also helped the banks to use their resources more fully, as has the establishment in 1952 of a United States Treasury cash depot which has made it unnecessary for the banks to carry large reserves of vault cash.

Major improvements have also been registered in making the services of the Federal Reserve System available to the banks in Puerto Rico. (Puerto Rican banks are eligible for System membership, but none has so far chosen to join, principally because as members they would be required to maintain higher reserves than under Puerto Rican law).[6] In 1952, as the result of the joint efforts of Federal Reserve technicians and the Puerto Rican authorities, a modern intra-island check-clearing system was established, which has helped to diminish the volume of float. The settling of clearing balances and the transfer of funds between the banks and their mainland correspondents have been greatly facilitated by the establishment of a nonmember clearing account at the Federal Reserve Bank of New York for Puerto Rico's Government Development Bank, which acts as settling agent. Furthermore, the clearing mechanism was expanded to embrace checks drawn on the mainland after January 1, 1958, when Puerto Rico became part of the Second Federal Reserve District for purposes of check clearing, following the adoption of par clearance by the island's banks.

Today, Puerto Rico's commercial banking system consists of seven "local" or Commonwealth-chartered banks, together with branches of the two largest New York City banks and of two major Canadian banks. Two of the "local" banks and the branch of one of the New York banks each hold substantially more than $100 million in deposits; another "local" bank and the other New York bank branch are of intermediate size, with deposits of about $60 million each; the Canadian bank branches and the remaining four "local" banks are much smaller, with deposits of less than $20 million each. The "local" banks' deposits have increased more rapidly than those of the New York and Canadian bank branches, and they now hold some 62 per cent of total deposits. The "local" banks' share of time deposits is even larger, about 72 per cent (see Chart I), reflecting the fact that they have played the principal role in attracting local savings to the banking system through their extensive network of branch offices (more than four fifths of the banking offices on the island are maintained by the "local" banks). As Chart II shows, the composition of the loan portfolio of the "local" banks differs considerably from that of the New York and Canadian bank branches, since the "local" banks make a smaller portion of their loans for commercial and industrial purposes while making relatively more real estate and consumer loans.

Paralleling the growth of the banking system in recent years has been a very rapid expansion of Puerto Rico's principal nonbank financial institutions. Although the first savings and loan association was established less than ten years ago, there are now seven such institutions in important cities on the island. In 1960, their share accounts grew by nearly 20 per cent to almost $60 million. All of the Puerto Rican savings and loan associations are chartered by the Federal Home Loan Bank Board, and their accounts are thus federally insured. Their great success in attracting savings is attributable not only to the attractive yields they have offered to savers (currently 4½ per cent), but also to their intensive advertising campaigns aimed at stimulating the savings habit. The savings and loan associations have also helped to bring in mainland capital by their success in reselling mortgages to mainland savings institutions. The credit union is another type of savings institution that has grown markedly in Puerto Rico, chiefly in response to the rising demand for low-cost

[6] Puerto Rican law does not set a minimum reserve requirement against time and savings deposits, which now account for nearly 60 per cent of the Puerto Rican banks' total private deposits; members of the Federal Reserve System must maintain a 5 per cent minimum reserve against time and savings deposits. The only legal requirement in Puerto Rico is that a fixed minimum reserve of 20 per cent, in cash and funds due from banks, be held against demand deposits.

personal loans. In the past five years, membership in the island's various credit unions has nearly doubled to about 70,000, and they were recently estimated to have more than $19 million in loans outstanding.

BANK CREDIT PRACTICES

The heavy pressure on the supply of credit in Puerto Rico is evidenced by the very highly "loaned-up" position of the banks, relatively high interest rates, a preponderance of demand loans, and stringent collateral requirements. The ratio of total loans to total deposits in the "local" banks soared from 44 per cent at the end of 1950 to 66 per cent in 1960. The latter figure contrasts with a ratio for Federal Reserve member banks of 56 per cent at the end of June 1960, and clearly indicates that the Puerto Rican banking system has been placing maximum emphasis on satisfying loan demands. With the demand for credit so strong, it is not surprising that interest rates in Puerto Rico are relatively high. Interest rates on larger business loans in San Juan in November-December 1958 were about 1½ per cent higher than in New York and about 1 per cent above the levels prevailing in even the higher interest areas of the mainland in the South and West (taking into account differences in statistical reporting and in banking practices such as compensating balance requirements). For smaller sized loans, the rate differentials tended to be greater. However, compared with most other underdeveloped countries, Puerto Rican interest rates are quite moderate, and the differential over the mainland level has undoubtedly helped to attract funds to the island.

The cost of credit may, moreover, be much less significant than its availability, especially in a rapidly developing area. The great majority of business borrowers interviewed in connection with the deBeers study in fact indicated that they were generally quite well satisfied with the banks. Dr. deBeers believes that it is, on the whole, unlikely that any high-grade risk cannot obtain credit in Puerto Rico, although he also feels that there is a substantial "unsatisfied margin" of borrowers—especially among those seeking medium-term credit—who would be eligible for loans on the mainland. A special loan survey made in November 1958, moreover, underscored the important differences between the forms in which credit is available in Puerto Rico and on the mainland. Banks in Puerto Rico obtained collateral or guarantee for more than 85 per cent of their business loans, while about half of such loans made by Federal Reserve member banks were unsecured at the time of a mainland survey conducted a year earlier. Furthermore, the banks in Puerto Rico concentrated heavily on demand loans, which actually made up some three fourths of their business loan portfolios, while term loans accounted for only about 6 per cent; by contrast, only a very small proportion of the business loans made by Federal Reserve member banks were demand loans and close to 40 per cent were term loans.

The pronounced differences between Puerto Rican and mainland bank-credit practices can be explained in large part by the highly loaned-up position of the Puerto Rican banks, their consequent concern with keeping their loan portfolios as liquid as possible, and the existence of a lenders' market for bank credit. But differences in the business environment in Puerto Rico and on the mainland also help to explain the divergences in bank-credit practices. For example, the banks' attitude toward collateral is conditioned by the fact that most Puerto Rican businesses are small ones in which the owners have little equity, that many are new enterprises, and that they often do not maintain good records. The relative scarcity of term loans may be related to the same factors, as well as to the lesser industrialization of Puerto Rico, the tendency of many of the more soundly based new manufacturing plants to obtain financing on the mainland through parent firms, the higher proportion of bank loans to retail and wholesale trade in Puerto Rico, and the need of most Puerto Rican businesses to carry higher inventories because of the distance from the mainland. Moreover, the banks' preference for demand loans and collateral does not, in Puerto Rican practice, appear to be so onerous as might at first be presumed. A large proportion of demand loans tends in fact to remain outstanding for considerable periods of time, thus in effect providing a form of longer term accommodation (although one lacking some of the advantages of term loans). Moreover, the widespread use of such debt instruments as bearer mortgage notes makes it easier for business to meet the collateral requirements.

The most rapidly growing part of the banks' loan portfolios in recent years has been their consumer loans (see Chart II). Since 1957 consumer loans have been increasing by an average of nearly 25 per cent per year, chiefly owing to their rapid expansion at the "local" banks, which accounted for nearly three fourths of the total personal loans of the banking system at the end of 1960. The ratio of consumer to total loans in the "local" banks rose rapidly to 36 per cent in 1960 from 25 per cent in 1956; the New York and Canadian bank branches' consumer loans did not begin to increase markedly until 1959, and at the end of 1960 they still accounted for only 15 per cent of these banks' total loans. (The consumer loans of Federal Reserve member banks have held steady in recent years at around 20 per cent of total loans.) Retail automobile instalment loans have been the most rapidly rising category of consumer loans, although personal instalment loans still account for more than half of the consumer loan total. The rapid expansion of consumer credit seems to reflect chiefly the Puerto Rican consumer's desire to raise his living standards as rapidly as possible, especially through the acquisition of consumer durable goods, the sale of which has been heavily promoted on the island. While recognizing the role of consumer credit in permitting an accelerated rise in living standards, the Puerto Rican authorities have been increasingly concerned about the diversion of bank credit from the business sector that the rise in consumer loans has undoubtedly entailed.

THE GOVERNMENT DEVELOPMENT BANK

The Government Development Bank has played a vital role in the financing of fixed investment in Puerto Rico and in the development of the island's financial mechanism. The bank was established in 1942 to provide medium- and long-term credit for projects, especially industrial ones, that contribute to economic growth but cannot be financed through commercial bank channels—the same purpose that has led to the establishment of similar government lending agencies in most underdeveloped countries. Today the Development Bank's capital, coming mainly from Commonwealth Government appropriations, exceeds $32 million, and the bank holds nearly $30 million in public time and demand deposits. Since its inception the bank has disbursed about $85 million in loans to the private sector, including $26 million in housing loans made almost entirely in the pre-1950 period. Actually, the bank's business loans expanded relatively slowly up until 1958, when a decision was taken to step up such lending. As a result, the bank has made some 335 new loans in the past two years alone, and the total amount of its loans outstanding has soared more than 70 per cent to $30.9 million.

Fully 69 per cent of the loans outstanding at the end of last year was to manufacturers and 23 per cent to commercial enterprises. Most of the bank's loans are for new undertakings, and normally it will finance up to 60 per cent of the appraised value of land and improvements and 50 per cent of the value of machinery and equipment. At present, annual interest charges are generally 6½ per cent for industrial and 7½ per cent for commercial loans. Great emphasis is placed on the detailed examination of each project in order to determine its over-all economic significance, its prospects for business success on the island, and the financial and managerial ability of the applicants. Although the bank's loan criteria appear to have been relaxed somewhat in recent years, its basic policy is to make only those loans which it believes time will prove to be "bankable"; and for a development institution its loss record has been extremely good. (Projects of economic merit that may nevertheless be too risky to qualify for Development Bank financing may obtain loans, and even minority equity capital, from another agency of the Commonwealth Government, the Puerto Rico Industrial Development Company.)

More important than the actual amount of the Development Bank's loans has been their pioneering character. By making potentially "bankable" loans in areas that the commercial banks were not already serving, the Development Bank has not only financed strategic new investments in the island's economic development but also broken new ground for the broadening of the commercial banks' activities. For example, prior to 1950 the Development Bank provided interim financing for several large low-cost housing projects being built with FHA-guaranteed mortgages; these mortgages were eventually taken over completely by private institutions that have since independently developed a mainland market for such mortgages. Other important examples of the Development Bank's initiative include the financing of plants to process agricultural products, of supermarkets and shopping centers, of hotels, and most recently of apartment and office buildings constructed on the condominium principle of ownership.[7] To cultivate commercial bank interest in its lending activities, the Development Bank requires borrowers to obtain interim financing from the commercial banks — on the basis of its loan commitment—until the machinery is installed or the building construction is completed. In addition, participation loans with commercial banks are actively promoted and, while the Development Bank usually takes the longest maturities, the participations have served to encourage term lending by the commercial banks. The Development Bank also aids the commercial banks directly by acting as settling agent for the check-clearing mechanism as previously noted and, in addition, on a few recent occasions has performed another central banking function—that of "lender of last resort"—by making short-term advances to the commercial banks.

In 1945 the Development Bank was granted the additional task of acting as fiscal or borrowing agent for all of Puerto Rico's governmental and other public bodies, and this is the task to which it has actually devoted the bulk of its efforts. The importance of this function is to be measured in part by the fact that public borrowing, locally and on the mainland, has in recent years provided some 20 per cent of the total capital funds invested in Puerto Rico. Perhaps

[7] The condominium principle of ownership, as it applies to housing, permits the acquisition, with a full, clear, and recordable title, of each separate dwelling unit in a multi-unit building.

even more significant, these funds have been largely devoted to providing the basic "social overhead" facilities—from electric power stations to hospitals—that have been the indispensable prerequisites for Puerto Rico's industrial growth. Last year the Development Bank handled financing operations totaling more than $167 million, including the sale of some $85 million of long-term bonds. In March 1961 the bank arranged for the flotation of a $40 million bond issue, the largest in the Commonwealth's history. In borrowing on the mainland, Puerto Rico's public bodies have had the great advantage of being able to issue tax-free bonds, just as State and local governments do in the United States. Nevertheless Puerto Rico's success in raising large amounts of funds on favorable terms owes much to the centralization of public borrowing in the hands of the Development Bank and to the bank's vigorous efforts to exploit and extend the mainland market for Puerto Rican public securities.

Puerto Rican public borrowing has mounted rapidly, more than doubling in the past five years alone and bringing net public bonded indebtedness to $407 million at the end of 1960. About 7 per cent of this debt was owed by the various municipalities, about 28 per cent by the Commonwealth Government, and the remaining 65 per cent by the Puerto Rico Water Resources Authority and four smaller public corporations that issue their own obligations. Due chiefly to the rapid rise in incomes on the island, the Commonwealth Government's revenues have more than kept pace with the increase in its current expenditures (nearly half of which are devoted to health and education); and the government's operating surpluses, together with the drawing-down of its cash balances, financed the bulk of its capital spending prior to 1958. Since then, however, the government, having utilized the bulk of its cash balances, has had to borrow about half of the funds for its expanding investment program, with the result that in the past two years the Commonwealth Government's outstanding debt has nearly doubled. Debt-service requirements, however, are still equivalent to only about 5 per cent of government revenues.

LOOKING AHEAD

Puerto Rico is hoping that per capita income by 1970 will be nearly doubled to about $1,000, a goal that will require an even faster rate of growth in the sixties than was achieved in the past decade. The record of the island's banking and financial mechanism gives grounds for confidence that the financing required to step up the rate of economic development will be found through more intensive efforts to mobilize local savings and to tap further the mainland capital market. Nevertheless, more rapid economic growth in the years ahead implies a continuation, and perhaps an intensification, of the present credit tightness in the private sector. This prospect places a premium on measures to strengthen the financial system, augment its resources, and encourage the allocation of credit directly to development purposes. The Puerto Rican authorities in recent years have therefore been giving careful consideration to a variety of legislative and other measures in the field of banking and finance.

One of the most important measures now under consideration is the elimination of the personal property tax on the banks, which may have discouraged the "local" institutions from increasing their capital. At the end of 1960, these banks' capital was equivalent to only some 5.3 per cent of their deposits, compared with 9.3 per cent for insured mainland commercial banks. The favorable earnings of these banks suggest that an increase in capital might be forthcoming if the tax were repealed. A strengthened capital structure, in addition to raising the banks' lending capacity, might also increase their willingness to make longer term loans. The latter purpose would also be served, it is believed, by passage of pending legislation to lift the present 180-day legal limit on loans made from demand deposits. Furthermore, if the banks were to devote a greater portion of their funds to medium-term loans, the Government Development Bank's role in assisting the banks as a lender of last resort in periods of exceptional credit stringency would fit in better with its primary function as a development bank.

A shift of bank resources away from consumer financing could play an important role in making more funds available for developmental business lending. The pressure on the commercial banks to make consumer loans might be relieved by facilitating the establishment of specialized consumer-financing institutions, for which the necessary legislation is now pending before the Puerto Rican legislature. An additional channel for funneling mainland funds to the island may have been opened up by recent New York State legislation permitting Puerto Rican and foreign banks to establish branches in New York. One Puerto Rican bank has already applied to convert its two New York City agencies into branches, which could prove especially effective in attracting deposits from the city's Spanish-speaking population. Finally, the recent move by one "local" bank to offer participations in FHA-insured mortgages to small investors on the island provides fresh evidence of the Puerto Rican banking system's continued efforts to stimulate local savings by expanding its facilities and offering new services to the public.

The Money Market in April

The money market eased somewhat further in April, although this tendency was interrupted by short periods of relative firmness when the money market banks in New York City came under moderate pressure. The New York banks made fairly heavy net purchases of Federal funds over most of the period but, as these funds were readily available, the effective rate seldom rose above 2 per cent and generally fluctuated between ½ and 2 per cent. Rates posted by the major New York City banks on new and renewal call loans to Government securities dealers varied from 1 to 3¼ per cent but, for the most part, were in the 1½ to 2¾ per cent range.

This predominantly easy money market and a heavy increase in the volume of long-term corporate financing were the major factors influencing securities markets in April. The strong demand for short-term Government securities and the resulting decline in short-term rates were primarily attributable to the ready availability of funds, while increasing pressure from offerings of new corporate securities was largely responsible for rising yields on intermediate and long-term obligations during the first half of the month. Subsequently, reoffering prices of new issues tended to level off. As the proceeds of capital market financings moved into the hands of corporations and other borrowers, some part of the amounts raised sought temporary reinvestment in short-term Treasury securities, adding thereby to the downward pressure on short-term rates. An unusually large stock issue by the American Telephone and Telegraph Company contributed to an expansion of bank securities loans. Since the corporation placed a portion of the proceeds into Treasury bills, the demand for these instruments was further increased.

Over the four statement weeks ended April 26, additions to member bank reserves from operating transactions and an increase in vault cash were only partly offset by a decline in Federal Reserve securities holdings and by a rise in required reserves. Free reserves averaged $568 million, compared with $505 million in the five statement weeks ended March 29. Average excess reserves rose by approximately $58 million during the April period while average borrowings were $5 million lower.

GOVERNMENT SECURITIES MARKET

During a good part of the month, a complex of influences produced disparate tendencies in the long and short areas of the Government securities market. These were partly reflected in divergent price trends but also extended to the volume of activity. Thus, while the Treasury bill market was active throughout the period, trading in intermediate- and long-term issues was moderate.

During the early part of the month, prices of Treasury notes and bonds tended to move lower under the sway of persistent reports of improvement in the economic outlook, an upsurge in the stock market, expectations of budget deficits, and increased Treasury borrowing. Moreover, there was some tendency for investors to shift out of Government securities into corporate obligations on which yields were moving higher under pressure of a greatly expanded volume of new issues. The rise in yields on Treasury notes and bonds was moderate, however, as offerings for the most part met fairly steady demand.

Toward the middle of the month the market for Treasury notes and bonds stabilized, as offerings tapered off and congestion in the corporate bond market eased somewhat. Later in the month, prices of longer Treasury issues moved progressively higher in response to reports of the favorable reception of a $300 million offering of debentures by a large industrial corporation and a sharp temporary break in stock prices. Some upward pressure was also attributed to reports that the Administration intends to press for lower long-term interest rates well beyond the early stages of business recovery. Over the period as a whole, prices of intermediate- and long-term Treasury securities rose from about ⅛ of a point to over 1 point.

After the close of business on Thursday, April 27, the Treasury announced that it would borrow $7,750 million for the purpose of paying off in cash securities maturing May 15, 1961. In the operation, $3.7 billion of 4⅜ per cent certificates and $4.1 billion of 3⅝ per cent notes maturing May 15, 1961 are to be retired with the proceeds of about $5.3 billion of 3 per cent certificates maturing May 15, 1962 and $2.5 billion 3¼ per cent notes maturing May 15, 1963. The Treasury also indicated that some new cash borrowing might be included in the operation.

In the Treasury bill market, the month opened with a day of heavy bill offerings from investors preparing to pay for the new September tax anticipation bills on April 3 and from Chicago banks selling bills accumulated in connection with the April 1 Cook County tax date, which brought somewhat higher rates. Thereafter rates

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, April 1961

In millions of dollars; (+) denotes increase, (−) decrease in excess reserves

Factor	Daily averages—week ended April 5	April 12	April 19	April 26	Net changes
Operating transactions					
Treasury operations*	+ 86	+ 36	− 28	+ 50	+ 144
Federal Reserve float	− 62	+ 62	+ 306	− 31	+ 275
Currency in circulation	− 123	− 109	+ 27	+ 173	− 32
Gold and foreign account	− 33	+ 39	+ 41	− 22	+ 25
Other deposits, etc.	− 14	+ 92	+ 49	+ 14	+ 141
Total	− 145	+ 117	+ 398	+ 182	+ 552
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 112	+ 18	− 263	− 202	− 335
Held under repurchase agreements	+ 34	− 20	− 4	− 10	—
Loans, discounts, and advances:					
Member bank borrowings	+ 29	− 55	− 8	− 7	− 41
Other	− 1	− 1	+ 1	− 3	− 4
Bankers' acceptances:					
Bought outright	− 2	—	—	− 2	− 4
Under repurchase agreements	—	—	—	—	—
Total	+ 172	− 57	− 275	− 223	− 383
Member bank reserves					
With Federal Reserve Banks	+ 26	+ 60	+ 123	− 41	+ 168
Cash allowed as reserves†	− 117	+ 20	+ 121	+ 67	+ 91
Total reserves†	− 91	+ 80	+ 244	+ 26	+ 259
Effect of change in required reserves†	+ 26	− 34	− 137	− 5	− 150
Excess reserves†	− 65	+ 46	+ 107	+ 21	+ 109
Daily average level of member bank:					
Borrowings from Reserve Banks	107	52	44	37	60‡
Excess reserves†	535	581	688	709	628‡
Free reserves†	428	529	644	672	568‡

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† These figures are estimated.
‡ Average for four weeks ended April 26, 1961.

worked lower almost continuously through the month.

In the early part of the period, a broad demand from commercial banks in an easy money market, augmented by strong buying interest from dealers and other nonbank sources, was largely responsible for the downward pressure on rates. Despite the Treasury's raising of an additional $100 million of new cash in three consecutive weeks, bidding in the regular weekly auction on April 10 was fairly aggressive (as had been the case a week earlier) so that average issuing rates on new 91- and 183-day bills were 2.360 and 2.556 per cent, respectively, or 11 and 10 basis points below those of the previous week. The firm tone was undisturbed by the roll-over auction on April 12 of $2 billion of one-year bills maturing on April 15, on which the average issuing rate of discount was 2.827 per cent, 15 basis points above the average rate established at the previous one-year bill auction on January 11 of this year.

Later in the month, the market for Treasury bills was strengthened further by reinvestment demand originating from those holders of the one-year bill maturing on April 15 electing not to roll them over, and by attempts of dealers to maintain inventories in anticipation of still greater demand. At the regular auction on April 24 bidding was unusually aggressive and average issuing rates sank to 2.186 and 2.300 per cent on 91- and 182-day bills, respectively, a record low for the six-month maturity.

OTHER SECURITIES MARKETS

During April, the volume of new publicly offered corporate bonds rose to $630 million excluding refundings—one of the highest monthly totals in recent years—from $76 million in March of this year and $340 million in April 1960. Nearly half of the total was accounted for by the issue of $300 million of 25-year debentures of a large industrial corporation—an event which had a pervasive influence on long-term markets. Under pressure of this heavy supply some congestion developed, as prices moved lower over the first half of the month but leveled off later on light trading when it became apparent that the $300 million issue would be marketed successfully. Relative stability in the corporate market was not achieved, however, until many industrial and utility issues had lost considerable ground from their two-year highs achieved in March. The average yield on Moody's Aaa-rated corporate bonds rose to 4.28 per cent, 6 basis points above the end-of-March level.

The volume of new tax-exempt flotations declined to $660 million in April, slightly below the March level of $687 million but somewhat above the $633 million in April 1960. The market for tax-exempt securities remained relatively stable during the month despite the continued large volume of new issues. However, prices did not resist altogether the influence of heavy offerings and of rising yields in the corporate sector. There was, in consequence, some tendency (as measured by the broadest index) for prices to inch lower.

In the market for short-term paper, several rates were adjusted downward during the month. Effective Friday, April 14, commercial paper dealers lowered their rates on prime 4- to 6-month paper by ⅛ of a percentage point, making the new offered rate on such paper 2⅞ per cent. On the following Tuesday (April 18), the major sales finance companies reduced their rates on directly placed paper by ⅛ per cent, bringing the new rate on 60- to 89-day paper to 2⅜ per cent (offered). On Wednesday, April 19, four of the five major dealers in bankers' acceptances lowered their rates by ⅛ per cent, making the new rate on 90-day unendorsed acceptances 2⅞ per cent (bid). The fifth major dealer followed with a similar rate reduction on April 26. On April 25, commercial paper dealers again reduced their rates by ⅛ per cent, bringing the new rate on 4- to 6-month paper to 2¾ per cent (offered).

Prosperity for Free Men*

By WILLIAM McCHESNEY MARTIN, JR.
Chairman, Board of Governors of the Federal Reserve System

At the outset, I want to make clear that I am not here for the purpose of making any business predictions nor even forecasting what the level of interest rates may be a year from now. My concern is with basic principles and the application of those principles in such a way as to get the most and best out of the American economy, whose capacity and future no one can seriously doubt.

The strength of this economy, we all recognize, is based on the market system. It is founded upon concepts of private property, competitive enterprise, and the profit motive.

Experience has, in my judgment, pretty well demonstrated the reliability of the market system as a means of directing human effort—voluntarily, rather than by compulsion—to the task of achieving a higher standard of living for all. The more we can do to increase the breadth, depth, and resiliency of our markets, to use a phrase with which some of you have become familiar as a result of our frequent discussions of open market operations in Government securities, the better off all of us will be.

Certainly if the Western world is to have the economic growth and strength which is required to meet any threat that may be posed by the Communist bloc, we who inhabit the Free World must do everything in our power to organize the resources of our communities in such a way as to maximize their combined economic potential. If we are to resolve permanently the balance-of-payments difficulties on which we have achieved a measure of progress over the past few months, and to play fully our role in the development of wider world markets, we must accept external competition as a challenge to be met on the time-honored basis of working more efficiently to produce goods and services at prices which people are willing and able to pay.

This, I recognize, is harsh doctrine to some and obviously a hard road to travel under some conditions. But the goals to be achieved are unlikely to be gained in any other way.

Let all of us, in the banking community, in Government, and in labor and management in every field of endeavor, accept this challenge. Throughout our country, we must not only increase our productivity but also pass some of the gains on to the consumer in the form of lower prices rather than having all of it go exclusively to labor in higher wages, or to the owners in higher profits. By this means, demand can be stimulated to provide more jobs for those who are now unemployed, and to keep the economy moving to higher levels and still greater job opportunities in the future.

Now one of the most visible and striking changes in the world of our time—and this is what makes the problem urgent—is the steady shrinkage of space.

Already, a globe-girdling network of fast air transport is binding our planet's three billion people together so closely that the word "stranger" has diminishing significance. The earth has been compressed into a neighborhood of some 120 nations.

Yet even by the biggest and fastest jet airliners, it still takes more than six hours to transport 125 people across the Atlantic. But by cable, it is possible to transfer $125 million across the Atlantic almost instantly.

More important than the speed of a cable transfer, however, is the readiness with which the currency of one country can now be exchanged for that of another. For now that dollars, pounds, francs, marks, lire, and yen can be exchanged almost as readily as a ten dollar bill for two fives, the financial linkage of the free countries of the world has, in a broad sense, been completed.

The implications of that fact, to which we as a nation only recently have been awakening, are enormous in practical significance. It means that in commerce and in finance Americans are in competition not only with each other but also with the world; in competition not only for goods and services but also for capital funds; in competition not only in design, quality, promotion, and credit terms but also in prices; in competition not only as sellers and lenders but also as buyers and borrowers. These things haven't come about overnight, and they didn't "just happen" by accident.

Soon after World War II we began to give generous aid to the war-devastated countries to help clean up the ruins, rebuild homes, factories, transport facilities in order to restore those countries to the family of self-supporting nations. They did the work of reconstruction; we supplied some of the materials and tools.

* An address before the annual meeting of the Association of Reserve City Bankers, Boca Raton, Florida, April 11, 1961.

In the course of time our aid programs bore fruit. The war-torn countries took on a new appearance. They changed from paupers to producers, from debtors to creditors, from borrowers to lenders, from aid to trade.

As they prospered they produced more and consumed more, got their finances in order, expanded their foreign trade, and created the means and opportunities for a freer flow of funds across their borders.

All these developments were rightly hailed as necessary steps toward world-wide economic rehabilitation. By the same token, our own role in international affairs has shifted. We are now in a new era of vigorous competition and new problems are an inevitable by-product.

In ten of the past eleven years we have been running a deficit in our international balance sheet. That means we have been spending, lending, and investing abroad more than foreign countries have been spending, lending, and investing here.

As long as the yearly deficit was of modest proportions there was no cause for alarm, but in each of the past three years—although for most of that period exports exceeded imports—the deficit ran well above $3 billion.

The international flow of goods and services and capital is a two-way street, and the traffic is mutually advantageous to all participants. It will benefit us as well as the rest of the world to expand the flow. One of the worst things that could happen to compound our balance-of-payments difficulties would be to adopt a restrictive trade and investment policy. It would wipe out the hard-won gains of years of effort to promote freer international exchange. The more we trade, the more we prosper. The less we trade, the less we have.

With European countries almost fully restored and with Asiatic and new African nations striving for better standards of living, we simply must recognize that we are living in a more competitive world. The way out of our troubles is not to draw into our shells, not to fence ourselves in, but to summon our strength, to launch out, to engage in the competitive fray for all we are worth.

Meeting the competition of the world requires of Americans initiative, imagination, inventiveness, enterprise, managerial skill, and self-discipline, both in our private and in our governmental processes.

In domestic and foreign markets, we are going to have to come up with the right goods and services, at the right places, in the right times, with the right prices.

We cannot afford to be priced out of the market by the wage-price spiral: in our private enterprise, employers must remember they are competing with other employers over the world for sales and profits, and employees must remember they are competing with other workers over the world for jobs as well as wages.

Neither can we afford to be priced out of the market by currency inflation: in our governmental processes we must guard against reckless budgetary and monetary practices that can undermine the value of our currency, and with it undermine our competitive position as both sellers and buyers of goods and services throughout the world.

In short, solution of our balance-of-payments problems requires energetic private competition in an environment of appropriate fiscal, monetary, and wage-price policies. This does not mean, of course, that the economy be kept under constant fiscal and monetary restraint. For some time now we have had to face a serious unemployment problem at home, along with a deficit in the balance of payments.

Very early in 1960, well over a year ago, the Federal Reserve launched upon a vigorous program of actions to buttress the economy against weaknesses that were to become increasingly evident after midyear. In March, the Federal Reserve System's open market operations began to bolster the lending capacity of member banks by reducing the borrowed portion of bank reserves. Between March and July, with business on the decline, some $1.4 billion of additional reserves was provided to induce an expansion in bank credit and the money supply. Early in June, and again in August, discount rates were reduced. Between August and December, nearly $2 billion of vault cash was made eligible to be counted as reserves, and still more reserves were provided by open market operations.

Some measure of the effectiveness of the foregoing actions by the Federal Reserve is recorded in the dramatic change that took place in bank reserve positions. At the beginning of 1960 member bank borrowings were $400 million more than their excess reserves. Now they have $500 million of free reserves. Moreover, we have been able to sustain a high rate of increase of bank credit, based in part on growth of time deposits. Total bank loans and investments at the end of February were $12.8 billion above the level of February 1960.

Nevertheless, the task of engineering monetary ease was increasingly complicated during 1960 by an outflow of short-term capital which intensified the balance-of-payments problem of which I spoke earlier. An important cause of the outflow was the disparity between short-term interest rates in this country and short-term rates abroad.

Abundant liquidity prevailed on this side of the Atlantic, where slack business conditions and lack of demand for funds caused short-term interest rates to decline. We were out of phase with high levels of business activity prevailing on the other side of the Atlantic where there was a vigorous demand for funds and consequently high short-term rates of interest, particularly in Germany and the United Kingdom. Under those circumstances, substantial amounts of liquid capital flowed overseas to take advantage of better returns. The continuing accumulation of foreign claims on American dollars and the outflow of gold reached a stage where confidence in the American dollar was being questioned in overseas financial centers and it gave rise, as you may remember, to a short but dramatic speculative upbidding in the price of gold on the London market last fall.

This conjuncture of events, domestic and international, forced the Federal Reserve System to confront a difficult dilemma.

During the latter months of 1960, economic recession at home called for increases in bank reserves to foster expansion of bank credit as a recovery measure. If we supplied these reserves by purchasing Treasury bills, in which our open market operations had been concentrated for several years, the direct impact of our purchases might drive short-term rates so low as to encourage a further outflow of funds to foreign markets, aggravating the balance-of-payments problem.

Thus, the Federal Reserve began, last October, to provide some of the additional reserves needed by buying certificates, notes, and bonds maturing within fifteen months, somewhat longer than the twelve-month limit we had usually held to prior to that time.

Then, on February 20 of this year, the Federal Reserve began to buy securities having maturities beyond the short-term area.

The twofold purpose of this new practice of operating in all maturity sectors of the Government securities market is to see whether we can provide reserves necessary to stimulate business without fostering further outflow of liquid funds.

Some people have said, "You are trying to make water run downhill in one direction and uphill in another. It can't be done." Quite frankly, nobody can be sure as yet how much can be accomplished by these operations. But the problem is there, and we must make every effort to solve it. That we intend to do.

Since the Federal Reserve instituted its all-maturities procedure seven weeks ago, there has been, quite naturally, considerable discussion about the procedure itself and still more about its results to date.

In much of this discussion, it seems to me, there has been a mistaken overemphasis placed upon the *levels* of interest rates, as if some particular levels of rates could be in themselves an objective of monetary policy.

That is not the case. What the Federal Reserve is seeking to do is not to set some particular level of rates for either short- or long-term securities, but rather to influence the flow of funds in international and domestic channels.

The progress of its efforts, therefore, cannot be measured merely by matching the level of rates prevailing at any given time with the rates prevailing just before transactions were extended to all maturities.

To me, it would appear, the best gauges of that progress are these: in respect to short-term rates, whether the outflow of funds to foreign centers is being stemmed; and in respect to long-term rates, whether the flow of capital into productive investment activities is being facilitated.

To anyone surveying developments in recent weeks certain things will be apparent.

On the international front, despite some turbulence in foreign exchange markets following revaluation of the German mark in early March, speculation against the dollar has quieted.

It would be foolish, however, to presume our troubles on this front are over. The fact remains that currency convertibility makes it possible, at any time, to have dangerously large flows of volatile funds in international finance—flows on a scale that could shake confidence in even the strongest currencies, and cause internal difficulties in even the strongest economies. To gain and hold the world's confidence in the dollar, we are going to have to remain on guard against the causes of these flows—differences in interest rates, conditions of monetary ease or tightness, budgetary conditions, and developments of any kind that raise questions and doubts about determination to preserve the value of our currency.

On the domestic front, there is evidence that funds are beginning to flow somewhat more freely into activities that may help to spur expansion of the economy. Record highs have been registered within the last month in the number and dollar volume of proposed corporate securities flotations submitted to the Securities and Exchange Commission. The total of flotations planned by State and local governments for the month of April, after a sharp rise in March, adds up to one of the highest monthly figures for recent years.

Meanwhile, market yields on long-term securities have been steady, at levels appreciably below the highs of a year ago, in the face of developments that often have produced higher interest rates in the past. Among these developments have been some widely publicized predictions of an economic upturn which appear to have given a boost to general expectations; also, there has been an increase in international tensions. Many of you will recall that, in somewhat similar circumstances in mid-1958, the securities market experienced a drastic price decline and a sharp rise in interest rates.

In mentioning these developments, I do not—emphatically not—mean to claim great accomplishments for the Federal Reserve. We have played a part, but that is all.

Furthermore, I would hope that it would be clear to everyone by now that we have never intended to try to establish an arbitrary rate level. Instead, we have recognized from the beginning that the effectiveness of Federal Reserve operations depends heavily upon the reactions of investors. Also, that investors are very likely to react adversely to attempts to set rates arbitrarily, and hence are likely to make any such attempts self-defeating by moving their investments elsewhere. In our country, the Government cannot compel anyone to invest or lend his money at rates he is unwilling to accept, any more than it can compel anyone to borrow at rates he will be unwilling to pay. That is a fact that no public authority can ever afford to ignore.

What we have been trying to do is to operate over a wider range in the execution of our transactions, and thus to register more speedily in the various maturity sectors of the market whatever direct impact our transactions can make. But our operations have been within the framework of a free market. We have respected the freedom of investors to decide what they wish to do, and the necessity that the market remain basically free to reflect the underlying forces of general supply and demand that mainly shape both the trend of interest rates and the flow of funds.

At the moment, we have pressing need to reduce unemployment and to promote economic growth at the maximum sustainable speed.

In March, the number of persons holding jobs totaled 65.5 million, a record high for that month. But another 5.5 million, constituting 6.9 per cent of the labor force, were looking for work in vain. Not since World War II had so many been unemployed at that season.

Getting these people into active, productive work will require comprehensive efforts, on several fronts, for we will need to press forward—simultaneously—against differing causes of unemployment.

Against cyclical unemployment, which arises from contraction of over-all demand, the Federal Reserve has been and is striving—with an assist now from fiscal policy—to give stimulus to the economy.

But there is another front on which specific actions in supplement of monetary and fiscal operations are needed if we are to deal effectively with the unemployment problem without at some point risking harmful side effects as, for instance, the touching off of a new wage-price spiral.

My reference now is to structural unemployment, which arises from changes in technology, shifts in consumer preferences and in defense production requirements, depletion of resources, relocation of plants, and so on.

A major difficulty in getting workers displaced by such developments into other jobs is that their skill, education, training, and backgrounds are not generally those required in expanding activities. But we can help them to overcome that by providing them with educational and training programs, better information about job opportunities, revision of pension and benefit plans to eliminate penalties against movement to new jobs, and reductions of impediments to entry into jobs, along with tax programs to stimulate investment that will expand work opportunities.

In some of these instances, the primary obligation of the Government will be leadership, rather than action, for obviously a major responsibility and role in efforts to overcome unemployment, both cyclical and structural, rests upon management and labor.

The Federal Reserve intends now, as in the past, to make vigorous use of its monetary powers in order to contribute to the attainment of conditions conducive to a productive, actively employed, steadily growing economy with relatively stable prices.

But clearly those conditions cannot be provided by monetary policy alone. Help is needed, especially in directly attacking some of the problems of unemployment that cannot reasonably be solved by credit measures. Without such help, we might find at some point that the plague of unemployment was still with us, but by then it had been compounded by inflation.

What is needed, in my judgment, is a judicious blend of specific actions, well-balanced monetary and fiscal policies, and wage-price policies fitting to a vigorously competitive market structure.

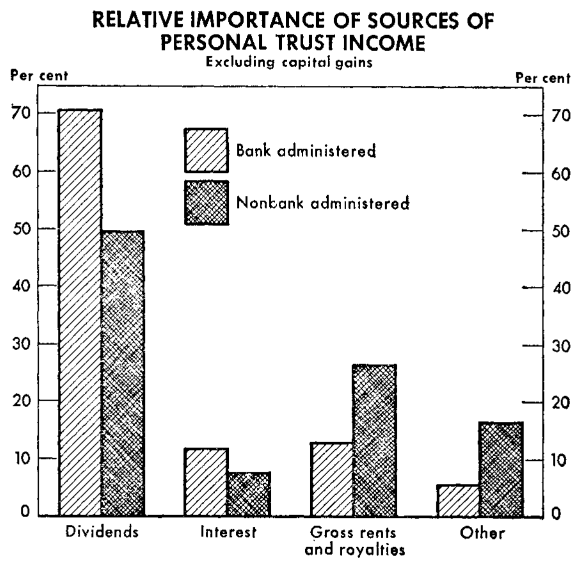
In such a setting, the Federal Reserve System would be able to carry out its operations more effectively and, at the same time, with greater moderation in respect both to easing and to tightening credit conditions. In consequence, swings in interest rates and in bond prices should likewise prove more moderate.

And in such a setting, conditions would be ripe for the type of demand expansion I mentioned at the beginning of these remarks: a demand expansion built upon provision of better value through passing some portion of productivity gains to the consumer in the form of lower prices, and a demand expansion further fostered by active American trade in widening world markets.

In my judgment, there is no surer path than this to an enduring prosperity, in which all free men may share. If we actively pursue this course no threat the Communists may produce will seriously endanger our security.

Bank-Administered Personal Trusts

Personal trusts are funds created by the wills of persons now deceased, or established by living persons on behalf of specified beneficiaries. They are administered by a trustee who frequently has broad discretionary powers with regard to the investment of funds. Banks serve as trustees for a significant proportion of all personal trusts, in some cases with cotrustees. Despite the importance of bank-administered trusts, however, relatively little statistical material on such trusts has existed until recently. Comprehensive data on the income and capital gains of bank-administered personal trusts have now become available as the result of a new tabulation by the Internal Revenue Service (IRS) of the United States Treasury. This information, computed from tax returns filed in 1959, constitutes an important addition to our statistical knowledge of this type of trust.[1]



The IRS data cover all types of personal trusts, including guardianships established for minors and committeeships established for individuals designated as "incompetents". Excluded are decedents' estates (as distinguished from testamentary trusts established by the wills of deceased individuals), trusts for nonprofit institutions and other institutional trusts (such as employee pension and profit-sharing funds), and trusts set up for special purposes such as trusteeships in bankruptcy. Income from common trust funds, which pool resources of several trusts, is not taxed as such and, hence, is not reported directly to the IRS. Income from these trusts is included indirectly, however, since shares of such income paid to participant trusts must be reported by them.

Prior to publication of the present report, data on bank-administered personal trusts were, in the main, limited to their asset holdings. Some rough estimates by Raymond Goldsmith[2] on the assets of all bank-administered personal trusts were prepared for 1952 and selected earlier years, but the first comprehensive sampling of such assets was made by the American Bankers Association (ABA) for 1958. (While surveys were also conducted in 1959 and 1960, no survey is planned for 1961.) Since 1955, annual figures on the assets of bank-administered common trust funds have been published by the Board of Governors of the Federal Reserve System, but such funds account for only a small fraction of the total assets of bank-administered personal trusts.

The ABA survey estimated that bank-administered personal trusts had total assets of nearly $60 billion in 1959. (The results of the 1960 survey are not yet available.) The magnitudes indicated by these estimates clearly demonstrate the quantitative significance of this type of trust and, therefore, underscore the importance of the new IRS income statistics.

The IRS data provide information on trusts administered by individuals and other nonbank administrators as well as on bank-administered trusts.[3] In 1958, the total income of all personal trusts (exclusive of net gains on sales of capital assets) was a little over $3 billion, of which about $1.8 billion or 61 per cent accrued to bank-administered trusts (see table). In addition, all trusts had

[1] The data appear for the first time in the Treasury publication entitled *Fiduciary, Gift, and Estate Tax Returns.* Most returns filed in 1959 report income earned during the calendar year 1958.

[2] Raymond Goldsmith, *Financial Intermediaries in the American Economy Since 1900* (Princeton, 1958).

[3] The data are based on a complete tabulation of all returns showing total incomes (including capital gains) of $50,000 or more, while income data for trusts in lower income categories are based upon a sample.

net capital gains of about $0.8 billion on sales of assets, with bank-administered trusts accounting for about 65 per cent of the total.

The IRS data reveal some significant divergences between bank-administered trusts and other personal trusts with respect to the relative importance of different income sources. These divergences may be indicative of differences in the nature of the trusts administered, differences in investment policies, or some combination of these two factors. Evaluation is made difficult by the absence of asset data for nonbank trusts comparable in scope to the ABA's studies of the bank-administered group.

Dividends from common and preferred stock, which are known to be the most important assets of bank-administered trusts, amounted to about 71 per cent of their total income—excluding capital gains—but to only about 50 per cent (see chart) of the income of other personal trusts. (Goldsmith's figures suggest that holdings of common and preferred stock by bank-administered personal trusts alone may account for more than 10 per cent of the stock holdings of all types of investors, both institutional and individual.) On the other hand, gross rents and royalties constituted about 12 per cent of the income of the bank-administered group, compared with 26 per cent of the income of other trusts. Interest income (including dividends from mutual savings banks) brought in about 11 per cent of bank and 8 per cent of nonbank trust income. For both groups, the remaining sources of current income arose from participation in businesses as well as from several other minor sources. Net capital gains were equal to about 30 per cent of current income for bank- and 25 per cent for nonbank-administered trusts.

Income of Bank- and Nonbank-Administered Trusts in 1958
In millions of dollars

Income source	All trusts	Bank administered	Nonbank administered
Total income:	**3,022**	**1,846**	**1,177**
Dividends	1,886	1,302	584
Interest	301	210	91
Gross rents and royalties	539	230	309
Other income	296	103	193
Net gains on sales of capital assets	**833**	**538**	**294**
Total income and net gains on sales of capital assets	**3,855**	**2,384**	**1,471**

Note: Data are based on tax returns filed during 1959. Most returns cover earnings during the calendar year 1958. A relatively small number report income on a fiscal-year basis, while a few represent delinquent returns reporting income earned in earlier years. Because of rounding, figures do not necessarily add to totals.

The IRS survey indicates that the average income of bank-administered trusts from all sources (including capital gains) was about $9,000 in 1958, compared with about $10,000 for the nonbank-administered trusts. The degree to which this difference may be due to differences in rates of return on investments is not known. Some 81 per cent of all returns filed by bank-administered trusts indicated incomes under $10,000, but this group accounted for only 25 per cent of total income reported by such trusts. Trusts with reported incomes ranging from $10,000 to $100,000 accounted for 18 per cent of the number of returns filed and 47 per cent of total income reported. Larger trusts ($100,000 and up) were responsible for less than 1 per cent of the number of returns filed but received 28 per cent of income reported. The pattern of income distribution among large, medium, and small trusts was about the same for nonbank-administered trusts.