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State and Local Government Borrowing

When state and local governments build schools and roads and other capital facilities, they often borrow to do so. Since World War II, they have borrowed enormous sums, running into the tens of billions. From year to year, however, the volume of financing has fluctuated widely, and the swings have generally been countercyclical, with borrowing reaching a peak when the economy was in a recession. This article examines the forces underlying these swings in borrowing and relates them to fluctuations in the capital spending of these governments.[1]

CHARACTERISTICS AND GROWTH

State and local governments do not finance all their capital projects out of borrowed funds. But, when they do borrow, the funds are likely to be used predominantly for capital expenditures. Indeed, some governments are barred by law or constitutional restriction from borrowing for anything but capital projects. This is rather markedly in contrast to the financial practice of both the Federal Government and the business community, which often borrow heavily to meet current expenditures. There are exceptions to this general tendency, chiefly bond issues to finance veterans aid programs and to retire outstanding issues. These two exceptions together, however, accounted for only 6 per cent of the total bond issues of state and local governments over the past decade.

As one might expect from this close tie with capital spending, most borrowing by state and local governments is long term. In 1961, for example, state and local bond sales amounted to $8.3 billion, while gross short-term borrowing totaled $4.4 billion. Some new borrowing, however, is offset during the year by the retirement of outstanding issues. This is especially true of short-term debt, much of which bridges the gap between tax collections. As a result, long-term debt accounts for a much larger share in *net* borrowing than it does in *gross* borrowing. Of the net increase of $5.3 billion in indebtedness of state and local governments in 1961, probably over nine tenths represented the net increase in long-term obligations.

The need for market financing typically arises when a capital outlay is exceptionally large relative to a government's usual budget. A town may go for many years without a capital expense big enough to require a bond flotation. The time comes, however, when a sewer system must be replaced or a new road built. Since the services yielded by such capital projects are normally enjoyed over a number of years, there is reason to spread the added tax burden over the years also. Moreover, in rapidly growing communities, public facilities may have to be built at a faster rate than the growth in current revenues will allow. A decision to finance these improvements by securities sales means that people who move into such communities after the facilities have been built will share the burden of paying for the improvements. New schools have had an especially prominent place in these community decisions. Over the past decade, for example, they have accounted for perhaps a quarter of the total bond financing by state and local governments. For similar reasons, large amounts have also been borrowed for roads and bridges, public utilities, and public housing projects.

For a variety of reasons, outlays by state and local governments that tend to lead to borrowing have risen quite sharply in the postwar years (Chart I).[2] Many unfilled needs were accumulated during World War II, the population has grown rapidly, and additional new public services have come into being. As a result, the proportion of gross national product accounted for by state and local government construction (including purchases of land) rose fairly steadily to a level of 3.0 per cent in 1958, though it has since subsided to 2.8 per cent in 1960 and 1961.

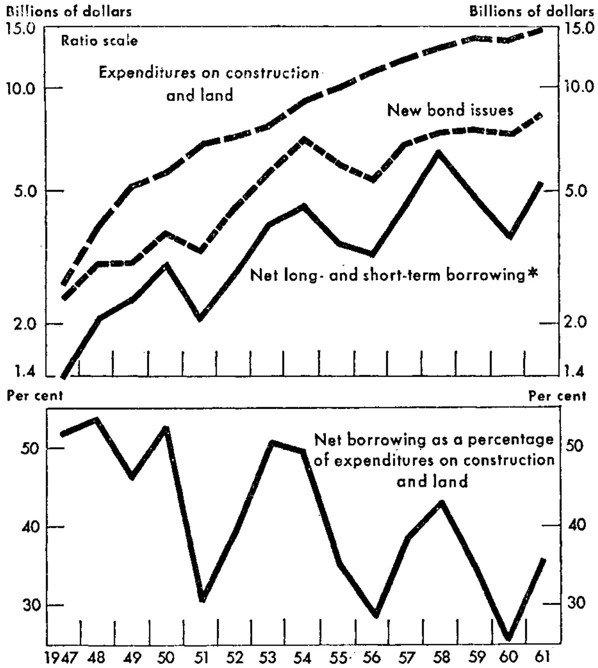
Somewhat surprisingly, however, the postwar growth in borrowing by state and local governments has been much less rapid than the growth in their capital spending. The dollar volume of borrowing has moved up sharply in the postwar period, but at the same time state and local governments have shifted increasingly toward other sources of funds. The proportion of capital outlays financed by borrowing dropped from about 50 per cent in 1947-50 to 40

[1] To compare postwar financing experience with earlier periods (1917-54), see Morris A. Copeland, *Trends in Government Financing*, National Bureau of Economic Research, Princeton, 1961.

[2] For a discussion of the postwar expansion of state and local government outlays, see "The Expanding Role of State and Local Government in the National Economy", this *Monthly Review*, June 1957, pp. 74-9.

Chart I

POSTWAR GROWTH IN STATE AND LOCAL GOVERNMENT BORROWING AND CONSTRUCTION



Note: 1961 partly estimated.

* Bond issues plus short-term issues minus retirements.

Sources: Board of Governors of the Federal Reserve System; Investment Bankers Association.

per cent in 1951-55 and to 35 per cent in 1956-60. This has not been due to a rapid rise in the operating surplus (tax revenues less expenses other than construction) of state and local governments; on the contrary, the surplus has also grown less rapidly than capital outlays. Rather, there has been a marked expansion in Federal grants, particularly since the passage of the Federal Highway Act of 1956. In addition, investment in financial assets (mainly by state and local trust funds) has grown less rapidly, so that a larger share of the operating surplus and other sources of funds was available to finance construction.

The postwar growth in state and local borrowing, however, has about kept pace with the over-all expansion in total market demands from all sources for capital and credit. During the five years 1956-60, state and local governments obtained about 10 per cent of the total of all funds raised (net) in the credit and equity markets, roughly the same share as in 1947-50 and in 1951-55.

SHORT-RUN FLUCTUATIONS IN BORROWING

State and local government borrowing during recent years has tended to follow a roughly countercyclical pattern (Chart II).[3] Securities sales have tended to be relatively heavy during recession periods and have fallen off during economic expansions. In good part, this pattern appears to reflect cyclical swings in the volume of funds available for investment in state and local securities, particularly from commercial banks, as well as the sensitivity of some types of state and local borrowing to variations in interest rate charges.

Commercial banks have played an important role in the market for state and local government securities (frequently referred to as "tax exempts" or "municipals"). From mid-1953 through the third quarter of 1961, these banks purchased over $9 billion of these securities. This was about one fourth of the total increase in state and local securities outstanding and more than the amount provided by any other single lending group except individuals (see table). Morover, the countercyclical fluctuations in total tax-exempt offerings have been closely related to fluctuations in bank purchases (Chart II). About two thirds of bank acquisitions of tax exempts over the entire 1953-61 period were concentrated in the three recessions, while most of the balance occurred in the recovery phases of the cycle (the first two quarters after the trough). Bank purchases during the expansion phases—which covered half of the period from mid-1953 to mid-1961—totaled less than $1 billion of the $9 billion total of bank purchases over the entire period.

This pattern of bank purchases of tax exempts over the business cycle reflects the interaction of several influences: cyclical swings in credit demands of other sectors, countercyclical monetary policies followed by the Federal Reserve System, and commercial bank investment preferences. During recessions, credit demands by business and consumers typically fall off while the Federal Reserve System provides banks generously with additional reserves. As a result, the banks "reach out" for what many of them normally consider less preferred outlets for their investable funds. These include tax-exempt securities as well as Federal Government obligations and real estate loans. Banks are attracted to issues of state and local governments partly because the interest earnings on these securities are exempt from Federal income taxes. Bank purchases help reduce interest rates (or prevent them from rising as much as otherwise) and thereby stimulate a larger flow of new offerings.

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[3] The timing pattern of four-quarter moving averages, such as those shown in Chart II, is not always reliable. Turning points in seasonally adjusted data on net borrowing by state and local governments occurred in II-1954, III-1956, I-1958, and II-1960. The corresponding turning points for the moving average were in IV-1953, III-1956, I-1958, and I-1960.

These purchases are generally high during the early phases of business recovery. As expansion proceeds, however, credit demands of business and consumers at some point begin to rise sharply while the growth of additional bank reserves is restrained. As a consequence, bank investments in tax exempts (as well as in other securities and real estate loans) are cut back sharply, as banks concentrate on meeting loan demands of business and consumers. This tends both to push up interest rates on state and local securities and to reduce the volume of new offerings.

Purchases of state and local securities by individuals—the largest investor group in this market—have also undergone wide cyclical swings. These have often been in the opposite direction to fluctuations in bank purchases, though not large enough to offset the essentially countercyclical pattern of bank purchases. In contrast to banks, individuals generally have a smaller volume of funds available for investment during recessions, as their savings fall off. Moreover, the prospect of capital gains in the stock market may induce wealthy investors, who account for most of individuals' holdings of tax exempts, to shift to the stock market. In addition, yields on state and local securities typically decline during such periods, relative to rates on time and savings deposits and savings and loan shares, encouraging individuals to accumulate deposits or shares rather than to purchase securities. During business expansions, on the other hand, purchases of tax exempts by individuals hold up well or even rise, as higher incomes and more attractive rates on securities relative to deposits and shares lure them back into the tax-exempt market.

Other investors have also played an important role in the market for state and local securities. As the table shows, however, cyclical swings in their purchases have been smaller than for either commercial banks or individuals. The most important of these other investors are fire and casualty insurance companies and trust funds of state and local governments themselves. Life insurance companies also have bought some state and local securities, mainly higher yielding revenue bonds. Other institutions have shown little interest in municipal securities, primarily because they are subject to relatively low taxes and thus find the tax-exempt return on municipal securities of little value.[4]

Changes in the demands of state and local governments for borrowed funds no doubt also contributed to cyclical fluctuations in borrowing. For example, the bulge in borrowing in 1954 and the subsequent decline reflected in good part the rise and fall of toll-road financing. This episode was caused by a variety of factors, in addition to changes in interest rates. The expansion in toll roads reflected the difficulty of obtaining other financing for modern highways. The decline was caused in part by disappointing earnings on some roads and later by the exclusion of toll roads from grants under the Federal Highway Act of 1956.

Cyclical swings in the operating surplus of the various governmental units also influence the demand for borrowed funds. The rise in borrowing during recessions, for example, is probably affected by the slower growth in tax receipts and the faster rise in current expenses as well as by lower interest rates. For example, the downturns in the operating surplus in 1957 and 1960, as business activity slowed prior to declining, may partly account for the relatively early upturns in state and local borrowing in those years (Chart II).

Despite the importance of such factors in influencing the need for borrowed funds, swings in the supply of funds available for investment in tax exempts have left a clear imprint on the cyclical pattern of state and local borrow-

NET PURCHASES OF STATE AND LOCAL OBLIGATIONS
In billions of dollars

Phases of business cycle	Total purchases				Average quarterly purchases			
	All groups	Banks	Individuals	Other*	All groups	Banks	Individuals	Other*
Recession III-1953 to III-1954	5.7	1.8	1.3	2.6	1.1	0.4	0.3	0.5
Recovery† IV-1954 to I-1955	2.0	0.7	0.4	1.0	1.0	0.3	0.2	0.5
Expansion II-1955 to III-1957	9.2	0.5	5.1	3.7	1.0	0	0.5	0.4
Recession IV-1957 to II-1958	4.6	2.3	0.7	1.5	1.5	0.8	0.2	0.5
Recovery† III-1958 to IV-1958	2.2	0.7	0.9	0.6	1.1	0.3	0.4	0.3
Expansion I-1959 to II-1960	6.6	0.2	3.1	3.4	1.1	0	0.5	0.6
Recession III-1960 to I-1961	3.4	1.7	0	1.6	1.1	0.6	0	0.5
Recovery† II-1961 to III-1961	2.8	1.2	0.6	1.0	1.4	0.6	0.3	0.5
Total: III-1953 to III-1961	36.5	9.1	12.0	15.4	1.1	0.3	0.4	0.5

Note: Because of rounding, figures do not necessarily add to totals.

* "Other" includes insurance companies, state and local government funds, mutual savings banks, brokers and dealers, corporations, and banks in possessions.

† Recovery is defined for present purposes as the first two quarters after the trough quarter.

Source: Board of Governors of the Federal Reserve System.

[4] See Roland I. Robinson, *Postwar Market for State and Local Government Securities,* National Bureau of Economic Research, Princeton, 1960, pp. 67-100, for a more detailed discussion of the various classes of buyers of municipal securities.

ing. Underlying this pattern is the sensitivity of some state and local governments to changes in market interest rates.

INFLUENCE OF INTEREST RATES

Interest rate changes can influence the volume of state and local securities offerings in several ways. An increase in rates raises debt service charges in the future. On general obligation bonds (bonds for which the full faith and general credit of the governmental unit is pledged), this means a larger burden on taxpayers which in some cases could influence the willingness of state legislatures, city councils, state or local executives, or taxpayers to authorize additional bond issues. It is, of course, very difficult to assess the importance of the tax burden in decisions on general obligation bond financing, since these decisions are influenced by many factors bearing on the desirability of specific projects in addition to the tax implication.

When bonds are supported by revenues from a specific source (revenue bonds), the importance of debt service charges is more clear-cut because these charges must be covered by anticipated revenues. Interest rates may, therefore, play a more direct role. A project financed by revenue bonds that is just on the margin of being economically feasible might be canceled or postponed if interest rates rise.

State and local offerings can also be influenced by interest rate ceilings of various types. Perhaps of smallest significance are the legal maximum rates on bonds (mostly general obligation bonds) set in many states by constitution or by state law. In most states that have such limits, the maximum allowable rate is 5 per cent or 6 per cent. In fact, these limits have impeded few borrowers, since in the postwar period average yields on Aaa-rated and Baa-rated general obligation bonds have not exceeded 3¾ per cent and 4½ per cent, respectively. Nor does it appear that borrowing has been restricted in practice even in those states with 4 per cent ceilings.

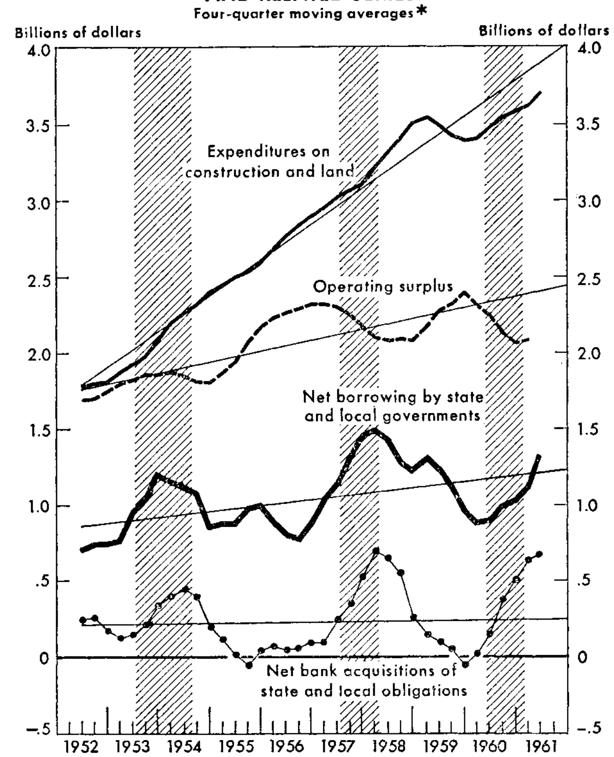
More important are interest rate limits contained in the authorization for specific bond issues given by legislative bodies, state and local executives, or the electorate in referenda. These limits are generally at or above the market rate at the time of the authorization, but since there is frequently a long delay between authorization and the sale of a bond, cases have arisen where market rates have moved above the ceiling before the bond could be sold.

A third type of rate limit is an informal one sometimes imposed by the financial officers responsible for arranging the offering of bonds. Some officials have little or no discretion over the timing of bond issues, and others who do have some discretion prefer not to "play the market" because of the danger of costly mistakes. But there are officials who do exercise discretion in the light of current and expected interest rates, postponing an offering or rejecting a bid by an underwriter if they believe rates are likely to come down.

Chart II

STATE AND LOCAL GOVERNMENT BORROWING AND RELATED SERIES

Four-quarter moving averages*



Note: Shaded areas represent recession periods, according to chronology of the National Bureau of Economic Research. Straight lines represent 1952-60 trends.

* Centered at the end of the second quarter.

Source: Board of Governors of the Federal Reserve System.

In these ways, high interest rates may reduce the volume of bond financing in periods of business expansion and provide a backlog to swell financing in subsequent periods of recession and recovery. Issues that are planned but not offered because of high interest rates are frequently offered at a later date when rates are lower. In addition, when rates are considered low, some issues may be sold earlier than originally intended.

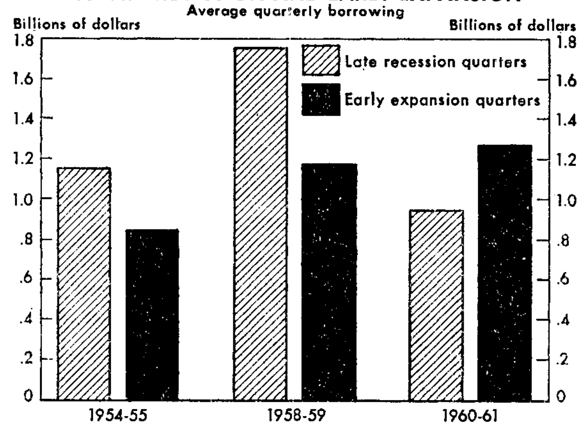
Decisions to alter the timing of issues in the light of expected changes in market conditions are partly reflected in data on postponements of scheduled offerings. One study, for example, which covered the nine months ended

March 31, 1957, indicated that 12 per cent of the tax-exempt bonds for which offering dates were set during the period were not actually offered on these dates.[5] Many of these issues were later reoffered within the period under study, so that by the end of the period only 7 per cent were still unsold. Postponements were higher for revenue bonds than for general obligation issues, with 13 per cent of revenue bonds and 5 per cent of general obligation bonds unsold at the end of the period. Many of these issues were reoffered later. Such a count, of course, misses those issues for which an offering date was never set but which were dropped at an earlier stage of the planning process—perhaps after consultation with underwriters or even when the budget was being drawn up. On the other hand, the reported postponements were not all related to credit conditions; issues postponed because of litigation or for other reasons are also included in the statistics. Postponement of a bond issue need not, of course, affect construction if a state or local unit has alternative sources of financing, including interim short-term loans.

Chart III

NET BORROWING BY STATE AND LOCAL GOVERNMENTS IN LATE RECESSION AND EARLY EXPANSION

Average quarterly borrowing



Note: "Late recession" includes the trough quarter and the quarter preceding it. "Early expansion" covers the three quarters following the trough quarter.

Source: Board of Governors of the Federal Reserve System.

CYCLES IN BORROWING AND CONSTRUCTION

It is evident from Chart II that the pattern of state and local government construction outlays has been dominated by a strong upward trend since 1952. Cyclical fluctuations have been much less pronounced in outlays than in net borrowing. During the 1952-61 period, outlays were never more than 6 per cent above or below the trend whereas borrowing during that period ranged from about 35 per cent above to 25 per cent below the trend.[6] The only decline in construction during that period, in fact, was due in part to special circumstances noted below. Nevertheless, the growth rate in construction was somewhat more rapid during recessions and recoveries in general business than during the periods of expansion.[7]

There are several reasons why cycles in construction are much less pronounced than those in bond sales. To some extent, the explanation may simply lie in the fact that a bond sale provides a lump of funds on one day while construction of the project for which the bond is sold may take months or even years. (Of course, some of the timing discrepancies between construction and bond sales in individual cases are ironed out when bond sales and construction outlays are totaled for all state and local units.)

A large part of construction, furthermore, is financed "internally" through a net excess of current tax revenues over other current expenses. Although the operating surplus also fluctuates over the cycle (Chart II), these swings are more moderate than those in bond sales and are often in the opposite direction. Thus, during periods of economic expansion, tax receipts frequently increase more than current expenses, providing more funds for capital outlays and offsetting to some extent the drop in borrowing.

In addition, some units have enough flexibility in their financial arrangements to permit them to concentrate bond sales during periods when market conditions appear favorable, without upsetting construction schedules. One method is to sell bonds well in advance of need, placing the proceeds in bank deposits or short-term securities as a "construction fund". The fund is gradually drawn upon as construction progresses and replenished when market conditions appear favorable. If the fund runs low when the market is unfavorable, it might borrow for a time from the unit's general fund. In both 1954 and in the last half of 1957 and the first half of 1958, when state and local

[5] Investment Bankers Association, *Statistical Bulletin,* April 1957, pp. 1-4.

[6] This comparison is based on the moving averages and trends shown in Chart II.

[7] A recent study which analyzes a number of statistical series on state and local construction, including some major components of construction, also found a countercyclical pattern in construction that was much less pronounced than in bond sales. Frank E. Morris, "Impact of Monetary Policy on State and Local Governments, An Empirical Study", *The Journal of Finance,* May 1960, pp. 232-49.

In another study covering a small number of governmental units with capital budgets, it was found that, if construction programs were still in the planning stage, then a rise in borrowing costs would lead the governments to plan on tax financing instead of bond financing. For projects already authorized, however, these governments did reduce actual capital expenditures relative to authorized expenditures. Charlotte Phelps, "The Impact of Tightening Credit on Municipal Capital Expenditures in the United States", *Yale Economics Essays,* Fall 1961.

borrowing was exceptionally heavy, additions to liquid assets holdings[8] also were unusually large and this probably reflected temporary investment of the proceeds of bond sales. In the following years, when borrowing was lower, additions to liquid assets holdings were also much smaller, perhaps indicating that assets accumulated from prior bond sales were being drawn down to finance construction.

Some units obtain financing flexibility by selling short-term, or "bond anticipation", notes—a practice common in certain parts of the country, including the Second Federal Reserve District. Bond anticipation notes may be sold at frequent intervals (usually to banks) in amounts no larger than needed to meet current construction expenses, and then refunded in one block by a bond issue. Such flexibility is, of course, limited by the legal maximum maturity generally set by states on bond anticipation notes and by limitations on renewals.[9]

RECENT CHANGES IN CYCLICAL PATTERNS

As in past recessions and recoveries, state and local governments stepped up their borrowing in the 1960-61 recession and increased their outlays on construction. Yet, both borrowing and construction have departed in several significant respects from past cyclical patterns.

Thus, the increase in construction outlays in this recession represented a reversal of a downward movement, rather than just an acceleration of the previous absolute rate of growth as in 1954 and 1958. Apparently, this more pronounced cyclical pattern in construction was related to fluctuations in Federal highway grants, as well as to interest rate changes and other factors. Under the Federal Highway Act of 1956, the Federal Government finances 90 per cent of the cost of an interstate highway network and 50 per cent of the cost of certain other roads through grants from a Highway Trust Fund. Such grants were to be limited to the current receipts and balance of the fund, but in 1958, as an anti-recession move, Congress temporarily waived this pay-as-you-build restriction and provided for additional grants. As a result, expenditures by the trust fund were exceptionally heavy in the latter part of 1958 and the first half of 1959, providing a strong stimulus to construction. Although Federal grants also rose in the last half of 1959, highway construction was cut back—in part, apparently, because of the uncertainty about the amount of grants in fiscal 1961 when the pay-as-you-build clause was once again to go into effect. Midway in 1960, highway construction and total construction rose again, as the volume of Federal financing to be available became more certain and interest rates declined.

Other contrasts with earlier patterns occurred in the behavior of net borrowing. On the one hand, although net borrowing by state and local governments rose during the 1960-61 recession, it did not reach the 1958 peak during the recession period. This probably reflects the later start of the build-up in borrowing and some reduction in the backlog of construction projects, as well as the fact that interest costs did not decline to the levels reached in the two earlier business recessions.

On the other hand, net borrowing has shown unusual strength during the 1961 expansion. During the first three quarters following the 1954 and 1958 troughs in general business activity, borrowing was substantially below the rate reached in the later months of the recession (Chart III). In contrast, borrowing during the last three quarters of 1961 was, on the average, higher than toward the end of the 1960-61 recession. This continued strength in borrowing partly reflected the relatively moderate rise in long-term interest rates in 1961 and the general availability of funds. In particular, banks were heavy buyers of municipal securities, as their reserve positions remained easy through the year and loan demands were relatively slow to rise. Toward the end of 1961, the prospective rise in maximum interest rates on time deposits under Regulation Q also stimulated bank purchases of tax exempts, as banks sought to obtain higher earnings.

[8] The state and local government sector, which includes trust funds, generally adds to its liquid assets holdings.

[9] Bond anticipation financing is also used to avoid having to sell many small bond issues; to take advantage of the lower rates generally prevailing on short-term, rather than on long-term, funds; and to delay the sale of bonds for a specific project until a time when it is clear how large the bond issue need be.

The Business Situation

A number of key economic measures receded slightly in January, and the fragmentary information thus far available for February indicates little if any improvement. While concurrent declines in several broadly based measures do of course raise doubts, temporary hesitations during a cyclical advance are not unusual. As Chairman Heller of the President's Council of Economic Advisers remarked recently, "every recovery has its sharps and flats, its spurts and pauses". Moreover, the early part of each year has more than its share of such lulls. This year, for example, severe snowstorms blanketed large parts of the country during January. Even though such an influence is essentially seasonal, it is not fully taken account of by the usual seasonal adjustment techniques (which only correct for the average effect of seasonal forces) and may have an appreciable impact on business sentiment.

The most notable declines in January were in industrial production, nonagricultural employment, personal income, and retail sales. For February, the reports so far indicate that automobile and steel ingot production declined, after allowing for the normal seasonal influences. At the retail level, the February information was mixed, with sales of new cars in the first twenty days of the month below seasonal expectations while department store sales moved up after seasonal adjustment.

In contrast to the declines in many economic series, new orders received by manufacturers of durable goods, a "leading" indicator, showed a marked and widespread increase in January; according to reports by purchasing agents, moreover, further gains in orders appear to have been registered in February. Government expenditures have also increased substantially so far this year and are expected to continue upward. This trend, as well as the stimulus exerted by the new orders for durables, would seem to suggest that the underlying forces of expansion continue quite strong. With the sudden break-off of steel wage negotiations last week, the possibility arises that the economy will receive a further boost through a sharp spurt in steel orders, unless the Administration succeeds in its announced intention of getting the bargaining going again soon. Such a stimulus would only be temporary, however, while rapid conclusion of a noninflationary settlement would clearly add to the long-run strength and stability of the economy.

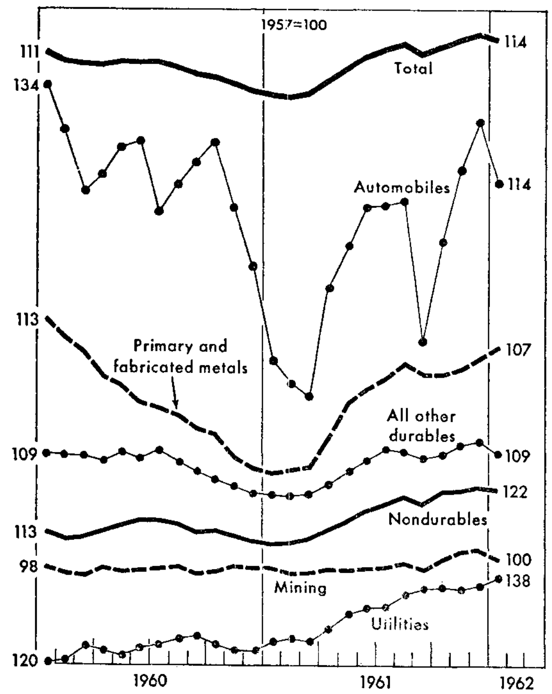
PRODUCTION DECLINES BUT ORDERS RISE

Industrial production receded from its record high in December. It fell back nearly 1 per cent in January to its November level (see Chart I), the first reversal since September 1961 when automobile output had been curtailed by strikes. In January it was again the auto industry that led the decline. Auto assemblies dropped 10 per cent from December's record annual rate of 7.3 million units (seasonally adjusted), as manufacturers sought to bring output more closely in line with sales, and during the first three weeks of February assemblies were cut back further. Autos were not, however, the only industry to show a decline in January. The total output of all other nonmetal durables fell 2 per cent. Nondurables output and mineral production also declined, although the decrease in the former was less than 1 per cent.

Chart I

RECENT DEVELOPMENTS IN INDUSTRIAL PRODUCTION

Seasonally adjusted



Source: Board of Governor of the Federal Reserve System.

The principal advance in January was in the output of primary and fabricated metals, which reflected a gain of almost 4 per cent in iron and steel production. Steel ingot production continued to move upward in early February but then declined slightly, probably reflecting the halt around midmonth in the upsurge of new orders for steel. Orders had been spurred by anticipation of a strike, but this influence was much moderated as intensive efforts by the Administration brought hopes of an early and non-inflationary wage settlement in the steel industry.

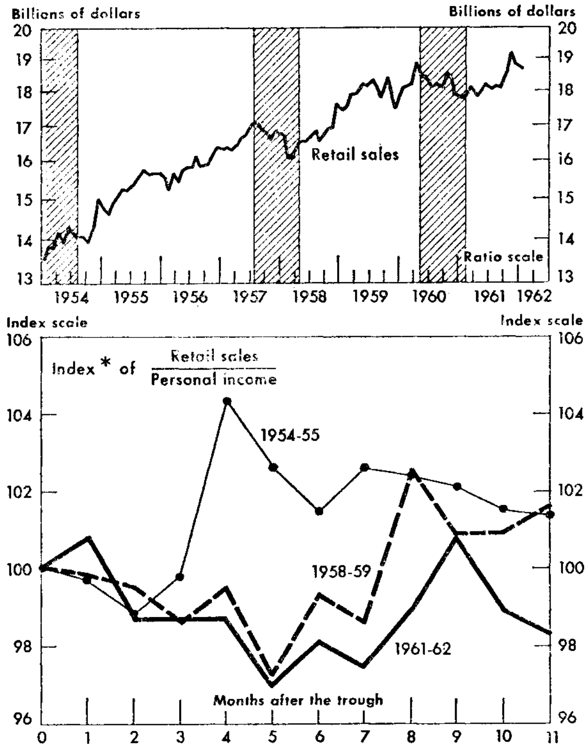
The continuing strength of demand was underscored by a jump in January in the volume of new orders received by durable goods manufacturers, a series that normally leads output. Such orders rose 2 per cent, seasonally adjusted, despite a decline in automobile orders (which actually represent auto manufacturers' deliveries to dealers) and little change in steel orders. This was the twelfth consecutive monthly advance in durables orders, and the first time in five months that the number of industries reporting gains increased. In December, when the value of new orders had risen 1 per cent, only ten of the twenty-one durable goods industries had shared in the gain, according to preliminary information, and the lion's share had gone to steel producers. In January, by contrast, fourteen of the industries reported increases.

Forward-looking indicators of construction activity are less buoyant. Private nonfarm housing starts fell slightly in January, for the third consecutive month of decline in this erratic series, and the volume of new building permits dropped sharply after a strong rise in December. The residential building statistics for January, however, were probably influenced by the storms that swept many parts of the country. Not only may housing starts have been delayed, but the storms made it difficult for enumerators to do their customary counting. In commercial and industrial construction, contract awards dropped sharply in January, following the mild decline a month earlier. This series, however, is also quite erratic.

Chart II

RETAIL SALES IN THREE BUSINESS EXPANSIONS

Seasonally adjusted



* Index in trough month=100 in each case.

Note: Business-cycle turning points are those indicated by the National Bureau of Economic Research chronology. Troughs: August 1954, April 1958, and February 1961. Peaks: July 1953, July 1957, and May 1960.

Source: United States Department of Commerce.

PAUSE IN EMPLOYMENT, INCOME, AND RETAIL SALES

Total nonfarm employment (as measured by the Bureau of Labor Statistics payroll survey) declined slightly between December and January, as reductions in manufacturing, mining, and construction payrolls were largely offset by increases in Government and trade employment. This left nonfarm employment in January only 1.8 per cent above the level at the business cycle trough eleven months earlier, significantly less than the 4.5 per cent and 3.8 per cent increases during the comparable periods of the 1954-55 and 1958-59 expansions.

The January slowdown in industrial production was accompanied by a more-than-seasonal reduction in average hours worked by production workers in manufacturing, and in their average weekly earnings. Part of this decline was attributable to the storms in the South and Midwest, but the major factor was the sharp cutback in overtime work in the automobile and a number of other industries. The decrease in average weekly earnings contributed to the January decline in personal income of $1.5 billion (seasonally adjusted annual rate). More than half of the decline in income reflected, however, the absence in January of the unusually large volume of corporate dividends that had been paid out at the end of the year and the special life insurance dividends that had been distributed in December to veterans of the Korean conflict.

Retail sales also decreased in January, for the second month in a row, to a level only slightly better than that reached last October (see Chart II). Moreover, in February, auto sales in the first twenty days appeared to be running somewhat behind their January rate, and the decrease may offset the slight gain in department store sales during the month. The January decline in retail sales pushed the ratio of retail sales to personal income downward for the second consecutive month, with the result that the ratio remained below its level at the trough of business activity in February 1961. By contrast, at comparable stages of the two previous upswings, consumers had responded to the generally improved business situation by spending an increased percentage of their incomes for retail purchases. With retail sales relatively low in relation to personal income, there is apparently ample scope for a future expansion in such sales, if consumers feel so inclined—and their inclinations may become an increasingly strategic factor in the months ahead.

The Money Market in February

The money market was comfortable during February. The effective rate on Federal funds fluctuated in a fairly narrow range of 2½ to 2¾ per cent during most of the month, dropping occasionally to as low as 1½ per cent. Dealer loan rates posted by the major New York City banks held in the neighborhood of 2½-3 per cent on most days. In the Treasury bill market, rates tended to drop a bit early in the month, then edged up through mid-February to the highest levels in over a year. Subsequently, however, a strong demand developed and rates declined in the last auction to the lowest level for 1962. The market for Treasury notes and bonds was strengthened by the decline in a number of economic indicators for January, which generated expectations that interest rates might stay at current levels or even decline. Prices thus tended to move up during the month. In this atmosphere the Treasury's two large refunding operations, described below, were accorded good receptions.

MEMBER BANK RESERVES

Market factors absorbed member bank reserves during the first and final statement weeks and released reserves during the second and third weeks (see table). A drop in vault cash was the chief loss of reserves in the first week. Reserve pressures subsequently were eased by a decline in required reserves and then by a sizable rise in float. During the final statement week of February, a drop in float withdrew reserves once again.

System open market operations generally offset these fluctuations in reserves stemming from market factors. Thus reserves were provided during the first and last statement weeks of the month, and withdrawn during the second and third. Over the month as a whole, average System holdings of Government securities declined by $25 million. Between Wednesday, January 31, and Wednesday, February 28, System Account holdings of United States Government securities declined by $172 million to $28,360 million.

THE GOVERNMENT SECURITIES MARKET

In the market for Treasury notes and bonds, interest centered on the two large refunding operations held during the month. The first of these refundings was announced on February 1, and offered holders of four issues of Treasury notes maturing February 15 and April 1, 1962 the right to exchange these issues at par for either of two new securities: 3½ per cent certificates of indebtedness due February 15, 1963 or 4 per cent notes due August 15, 1966. The offering was very well received as the public exchanged $3.4 billion of maturing issues into the new certificates, and $2.9 billion into the new notes, leaving only $420 million, or about 6.2 per cent, to be redeemed for cash.

On February 15, the Treasury announced a large-scale advance refunding through which holders of nearly $19 billion of outstanding bonds could extend the maturity of their current holdings for additional terms ranging between 6½ and 26½ years and receive higher current rates of return. In the operation, the Treasury combined for the first time a "junior" advance refunding (in which holders of relatively short-term maturities were given an opportunity to exchange them for an intermediate maturity) and a "senior" advance refunding (in which holders of intermediate-term securities could exchange them for a longer term issue). In the junior refunding, holders of $3.9 billion of 3 per cent bonds of February 1964 and $6.9 billion of 2⅝ per cent bonds of February 1965 were offered new 4 per cent bonds maturing in August 1971.

In addition, holders of the 1965 issue were offered, as a second option, additional amounts of the outstanding 4 per cent bonds maturing in 1980. The senior advance refunding was available to holders of the $8 billion of 2½ per cent bonds maturing in June, September, and December 1967-72. Holders had the option of selecting either of two outstanding bonds—the 3½ per cent bonds maturing in February 1990 or the 3½ per cent bonds maturing in November 1998. Books were open for subscriptions beginning Monday, February 19, and remained open to institutions through Wednesday, February 21. Individuals, and bank trustees who indicated their intent to exchange by February 21, were allowed to subscribe for a further period through Wednesday, February 28.

The large-scale advance refunding was accorded a good reception, as holders converted $2.8 billion of eligible bonds into new 4 per cent bonds of 1971, $560 million into the reopened 4's of 1980, and $850 million and $860 million, respectively, into the reopened 3½ per cent bonds of 1990 and of 1998, according to preliminary figures.

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, February 1962

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

Factor	Daily averages—week ended				Net changes
	Feb. 7	Feb. 14	Feb. 21	Feb. 28	
Operating transactions					
Treasury operations*	+ 50	— 72	+ 13	— 29	— 38
Federal Reserve float	— 110	— 67	+ 005	— 315	+ 113
Currency in circulation	+ 16	— 112	+ 18	+ 15	— 63
Gold and foreign account	— 38	+ 11	+ 1	— 30	— 56
Other deposits, etc.	+ 19	+ 45	— 163	— 4	— 103
Total	— 62	— 196	+ 473	— 363	— 148
Direct Federal Reserve credit transactions					
Government securities:					
Direct market purchases or sales	+ 278	— 13	— 518	+ 223	— 25
Held under repurchase agreements	—	—	+ 28	— 28	—
Loans, discounts, and advances:					
Member bank borrowings	+ 12	— 2	+ 2	— 16	— 4
Other	+ 16	—	—	+ 2	+ 18
Bankers' acceptances:					
Bought outright	+ 1	— 1	—	— 1	— 1
Under repurchase agreements	—	—	—	—	—
Total	+ 305	— 15	— 483	+ 180	— 13
Member bank reserves					
With Federal Reserve Banks	+ 243	— 211	— 10	— 183	— 161
Cash allowed as reserves†	— 303	+ 33	+ 69	+ 43	— 158
Total reserves†	— 60	— 178	+ 59	— 140	— 319
Effect of change in required reserves†	— 14	+ 218	— 23	+ 87	+ 268
Excess reserves†	— 74	+ 40	+ 36	— 53	— 51
Daily average level of member bank:					
Borrowings from Reserve Banks	72	70	72	56	68‡
Excess reserves†	457	497	533	480	492‡
Free reserves†	385	427	461	424	424‡

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 February 28, 1962.

Investor confidence was strengthened during the month by market discussions of the less buoyant appearance of the economy, and by related views that longer term interest rates may very well hold about steady or even edge lower in the period just ahead. The price of the newly issued 4½-year 4 per cent note due August 1966 had risen $^{11}/_{32}$ by midmonth, and $^{30}/_{32}$ by the month end, while prices of outstanding notes and bonds of comparable maturity rose by $^{22}/_{32}$ to about 1½ points over the month. Prices of the long-term bonds reopened in the advance refunding were mixed, but other long-term bonds generally rose from about ½ to 1½ points on balance over the month.

Following a slight drop early in the month, Treasury bill rates tended upward through mid-February before dropping sharply toward the month end. Bidding in the auctions of February 9 and February 19 was cautious, reflecting in part the $100 million increases placed on each of these bill offerings. In the February 19 auction, rates reached about 2.85 and 3.03 per cent for three-month and six-month issues, 15 and 13 basis points, respectively, above the levels in the February 5 auction. In the last auction of the month, however, bidding was quite strong, as a broad market demand was augmented by the temporary placement of the proceeds of large corporate and municipal bond flotations. Although the three-month bill was again increased by $100 million, rates on both the three-month and six-month issues fell to the lowest levels of 1962 at 2.66 and 2.85 per cent, respectively. For the month as a whole, outstanding bill rates were generally from 4 basis points higher to 14 basis points lower.

OTHER SECURITIES MARKETS

Attention in the corporate and tax-exempt bond markets during the first half of the month was focused on the $300 million American Telephone and Telegraph issue offered on February 14. The 4⅝ per cent bonds, which will mature in 1994 and are nonredeemable for five years, attracted strong bidding by underwriters. When reoffered to the public at a price to yield 4.52 per cent, the bonds were considered closely priced and market reception was only fair; the pace of distribution quickened later in the month, however, and the issue was reported all sold by the close of February. The volume of other corporate flotations was light, amounting to no more than $190 million, compared with aggregate corporate offerings of $270 million in January and $310 million in February 1961. Original market reception of other new corporate issues ranged from fair to good, but subsequently most issues found a good market.

The market for new tax-exempt issues absorbed a record volume of offerings in a remarkably smooth manner. An estimated $1,120 million of state and local securities reached the market, up from $890 million in January and from $620 million in February 1961. The largest new publicly offered flotation, consisting of two issues of 4⅛ per cent state turnpike revenue bonds maturing in 2002 and priced at par, moved to a premium of 102½ on the first day of sale.

Prices of seasoned corporate bonds held firm during most of the month, reflecting the same generally confident atmosphere that prevailed in the market for Treasury notes and bonds. In the market for seasoned tax-exempt securities, prices rose through much of the month, but then declined as dealers built up a very large inventory of recent offerings. The Blue List of advertised dealer offerings rose from the February 1 level of about $270 million to $530 million on February 19 and to a new record of $560 million on February 28. At the end of February, Moody's average yield on seasoned tax exempts stood at 3.08 per cent, down 4 basis points for the month, while the average of Moody's Aaa-rated corporate bonds remained unchanged at 4.42 per cent.

The Balance of Payments and International Financial Cooperation*

By ROBERT V. ROOSA

Under Secretary of the Treasury for Monetary Affairs

We are now thankfully, and at last, living in a highly competitive world. Together with the other free, democratic, capitalistic countries, the United States has begun over the past few years to experience some of the shocks of actually living in economic conditions which resemble, rather closely, many of the ideals which we have for generations been endorsing. Europe has for several years had greater mobility of labor than the nationalism of earlier times could ever have permitted, and at the same time a rate of economic growth that no one would have dreamed possible a decade ago. The constructive force of active competition in manufacturing and trade, both for us and for others, has been greatly strengthened by the striking adaptations to rapid technological advance that have occurred in Western Europe, Japan, and elsewhere. In the United States we seem to have come much closer to our aim for reasonable price stability. And for more than three years now there has been a free interconvertibility among the currencies of nearly all of the major industrial countries.

These are the kinds of conditions we want to live with; they are part of the framework for a vigorous, expanding, prosperous community of free nations. But they did not just happen; and we will not keep them if we ever relax into just taking them for granted. The base on which all our performance rests, of course, is the effort of the individual as laborer, farmer, employer, investor, and indeed, as public servant. What I want to center on today, though, is the part of government policy and action in helping to construct some of the new international financial arrangements, public and private, we will need to sustain the remarkable advances of these past few years in Western capitalism as an economic system. Even for much of the sphere of government, our own and others, I can scarcely begin a catalogue. But I can start at the center, the balance of payments, and work out from there into several areas of real significance for international financial cooperation:

> First, a cursory restatement of the links that remain between the old gold standard and the balance-of-payments disciplines, within a system of fixed exchange rates, which govern the world economy of the 1960's.
>
> Then, a look at the present United States deficit and its counterpart, the surpluses of some of the European countries.
>
> From this, a review of what has been done or can be done to improve the payments arrangements among all countries, the developed and the developing, in the non-Communist world.
>
> And finally, a sweeping glance forward toward the outlines of the kind of international monetary system for which we may be heading.

* An address before the American Bankers Association Midwinter Trust Conference luncheon, New York City, February 7, 1962.

* * *

The gold standard, as a concept and as a symbol, has always been a convenient abbreviation for the need that every country faces to keep its balance of payments in equilibrium within the context of fixed exchange rates. That is, whether a country formally adheres to the gold standard or not, it must have a reserve of some kind of internationally acceptable purchasing power—either gold, or dollars, or possibly pounds sterling, or an equally usable quick line of credit. Whenever its current receipts from sales or the inflow of capital do not equal its current outpayments, it has to draw on this reserve. Consequently, the size and ready usability of the reserve—together with the quick claims against it—must be watched continually as an indication of changes in each country's external economic strength or weakness.

No country can pursue policies indefinitely which consume its external reserves and draw down its potential credit abroad. Though the United States has for a long time been shielded from this hard fact, all of you know well that any country must, in time, if it is to retain contact with the world outside its borders, balance its international accounts and maintain some foreign exchange reserves. On the other hand, no country—and for that matter no bank, nor even any trust department—can afford to build liquidity indefinitely. Sooner or later the strong countries acquire all the liquidity they want, or at the least they slow down their accumulations, so that they can increasingly acquire other kinds of profitable assets. Once it has acquired substantial liquid reserves, the creditor country rightly encounters pressures to change its ways that are, in the end, just as strong and just as clear as those impelling the deficit countries to change. But for about a quarter of a century, until these past three or four years, it was only the United States among the leading countries which had been faced with the need to behave as a creditor country.

Under the theoretical conditions of the full gold standard, these offsetting adjustments by debtor and creditor countries in order to restore equilibrium could be direct and automatic. When gold left the debtor country, its internal monetary system contracted, interest rates rose, prices fell, and eventually sales abroad rose while imports declined until balance was restored. The creditor country, receiving the gold, had a corresponding rise in its internal money supply; its interest rates declined; its prices rose; its exports fell off; its imports went up; and eventually balance returned. This was, in its simplest terms, the old gold standard version of the balance-of-payments disciplines. Of course, things never did really work out in just that way. But what matters most for us now is that the world has for some time rejected the harshness of a system of correctives which presumed that creditor countries must undergo inflation, and debtor countries must create unemployment, to reach a suitable equilibrium. The solutions now must take a different form, but the balance-of-payments disciplines which must be served are still the same, and are still inescapable.

The difference now is that the world is finding new ways to serve these disciplines—ways that reflect the new conditions in which sustained economic growth, and the minimizing of cyclical fluctuations in business activity, are also important goals. And they must also reflect the other conditions which I mentioned a few minutes ago—those of price stability, of labor mobility, of aggressive and open competition in production and trade, and of currency convertibility. In a complex of such varied and such important conditions as these, there can be no single golden formula. There must be some reliance upon the judgment of men, expressed through governmental action, to help achieve a continuing reconciliation between the imperatives of the balance of payments, the competitive forces of the market place, and the other broad, vital objectives of modern economic society.

My own view is that there are two strong surviving attributes of the gold standards of earlier eras that must be continued, if the balance-of-payments disciplines are to be effectively fulfilled within the array of differing monetary and fiscal policies now pursued by the various countries. One is that a fixed link must be preserved between gold—the universal monetary metal of timeless acceptability—and at least one national currency. Since the mid-thirties, the dollar alone has served that function. It is essential that the United States continue freely buying gold, and selling it to the monetary authorities of the world, at the price of $35 per fine ounce. The second requirement, in my judgment, is that all leading countries maintain fixed (rather than variable) rates of exchange in relation to the dollar, with narrow permissible spreads around the declared par value—such as the 1 per cent, each way, established by the International Monetary Fund. There must be room for market forces to demonstrate, through small changes within such a band, whether a given currency is presently strengthening or weakening. But there must not be an escape hatch through which one country or another can seek temporary refuge from balance-of-payments disciplines by juggling its own exchange rate—beggaring its neighbors and disrupting the orderly processes of cost and price adjustment among the various products and services that are required for eventual balance-of-payments equilibrium.

A fixed price for monetary gold, and fixed exchange rates, are essential. But, in place of the other automatic features of the old gold standard, there are now new arrangements for common appraisal and concerted action, centering in the International Monetary Fund. Other important supplements, arising from consultation among the leading industrial countries themselves, as well as from a variety of reinforcing bilateral arrangements, also offer new potentialities. But before turning to these, I think we can usefully look briefly at our own current balance-of-payments deficit and its counterpart, the European surpluses.

* * *

On present estimates, the combined balance-of-payments deficits of the United States, the United Kingdom, and Canada were only slightly larger in 1961 than the combined surpluses of France, Germany, and Italy. Of course, all six countries, for reasons arising partly from their own domestic institutions, prepare their balance-of-payments records in different ways, so that little arithmetic exercises of this kind can be quite misleading. The United States method of balance-of-payments accounting—for a variety of reasons—takes no credit for any of the short-term claims of its nationals on foreigners in calculating its over-all balance-of-payments deficit. Unlike some other countries, we treat short-term foreign private capital inflows as part of our deficit rather than as an offset to the outflow of United States private capital. The rather paradoxical result is that the whole of our reported deficit is currently much larger than the sum of its parts (as reported in the surpluses of other countries).

Statistics aside, however, we have been undergoing far too long a balance-of-payments deficit that is far too large. It is of little avail either to the British or ourselves to find temporary respite through passing our deficits back and forth between each other. It is useful, though, in appraising our own prospects, to pay some attention to the sources and the durability of the European surpluses. This is particularly relevant since the United States is itself, and has been almost uninterruptedly, a large creditor country too, so far as the trade and services accounts are concerned. We are in trouble partly because we continue to perform, on a substantial scale, the role of a good creditor country, while the newer creditor countries have until quite recently either been too awed by their new strength, or too uncertain of its continuation, to follow our earlier example.

As they do, through extending more foreign aid, through prepaying debts owed to us, through offsetting more of our military outlays by compensating arrangements, through opening up their markets, and through removing the restrictions that many of them still retain on the outward flow of their own capital, they will be giving further evidence of the two theses that have run through my remarks thus far:

(1) that the adjustment process toward balance-of-payments equilibrium, though no longer of the old gold standard form, still does require change and adaptation by both the deficit and the surplus countries; and

(2) that the process requires, increasingly, the exercise of positive judgment and action by governments, and perhaps more particularly by their financial officials, on the basis of extensive cooperation and joint analysis of many interrelated problems.

Yet the underpinning for all successful cooperation must still be aggressive and effective corrective action on the part of the deficit countries themselves. That ranks first among the various implications of international financial cooperation that I am discussing here. That is why, regardless of all the essential action which the surplus countries can undertake (and such action is essential), the United States Government has given the highest priority to reducing the net outflow of dollars for our military effort, for our aid, and for our other governmental operations, while expanding in every practicable way the program for stimulating the export performance of American business. We must sell abroad, on commercial terms, enough to pay for all of our imports, for all of the governmental programs which prudence commands, and at the same time support the unrestricted flows of capital that our national interest requires. That is the only fundamental solution to the balance-of-payments problem which is also consistent with all of our other goals—market freedom, growth, stability, steady prices, currency convertibility, and expanding commerce among all of the free nations.

It is the urgent need to strengthen our balance of payments that underlies, of course, the President's effort to modernize our tariff procedures through the proposed Trade Expansion Act of 1962. That same need also explains the determined effort to promote productive investment in the United States through depreciation reform. It motivates the formulation of a balanced Federal budget for the fiscal year 1963, in order to create an atmosphere of business confidence conducive to even greater competitive effort in the years ahead, and to avoid the drain which Federal budget deficits might otherwise place upon the supply of capital and savings available for new investment. It underscores the need to continue our present efforts to maximize the use of our foreign aid money in the United States, and to minimize the dollar outflow for maintaining our military forces overseas. It explains the intensified promotion of export markets through all available means.

Most notably and recently, the export drive has been sparked by the opening, just two days ago, of the Foreign Credit Insurance Association, which supplements the export credit insurance already available through commercial banks, in conjunction with the Government's Export-Import Bank. By utilizing the facilities of fifty-seven associated private insurance companies, also in cooperation with the Export-Import Bank, the new Association will guarantee (for a fee) the political and commercial risks of extending short-term credits to buyers in other countries.

Even more important for the longer run, both in terms of domestic growth and of balance-of-payments equilibrium, will be the recognition by labor and by management of the guidelines presented two weeks ago in the Annual Report of the Council of Economic Advisers, for relating changes in wages and prices to productivity over the years ahead. These clearly stated principles (pages 185 to 190, in case you have not seen them), and the Council's straightforward handling of their possible statistical ambiguities, represent in my judgment the most promising advance yet made in this country toward assisting (without controlling or regulating) the processes of collective bargaining. They should help all responsible citizens to proceed, not only in wage bargaining but also in price determination, along lines that can and will serve best the general interest of the public as a whole. As acceptance of these principles spreads, and if their significance can actually be amplified through a succession of specific settlements, the United States will not only gain greatly in its internal affairs but will also have passed a most crucial milestone on the road toward lasting equilibrium in its balance of payments.

Meanwhile, the Government's present attack on the balance-of-payments deficit is proceeding aggressively on all other fronts. The net dollar drain for military purposes —which was reduced substantially last year—will be cut by at least a third this year. With only one third of our economic aid now flowing out on an untied basis, we are determinedly at work to reduce that fraction to one fifth (leaving the remainder to go largely to countries and purposes that are likely to result in spending here, in any case). And we are negotiating actively with various creditor countries for the further prepayment of the large debts still owed to us.

These measures and policies are all aimed at restoring balance in our basic accounts—that is, covering all of our imports, everything the Government has to spend abroad, and our net outflow of long-term investment. It was this basic deficit that reached $4.3 billion in 1959, dropped to $1.9 billion in 1960 as exports rose dramatically while imports declined and the economy went into recession, and has apparently dropped further on the strength of trade factors to about $1¼ billion in 1961 (before allowing for debt prepayment, which reduced the figure to about half of that amount, or $600 to $700 million). To continue progress in 1962, as our surging economy draws in more and more imports, will be difficult; it will require all of the vigor that the exporters of America can exert, alongside the determined governmental efforts which I have just reviewed. But the place to look for evidence that the underlying correctives are still at work will be mainly in the record of our commercial exports, that is, after deducting all exports dependent upon our own aid program. For, if these exports can continue to expand, there will be a continued and strengthened basis for that confidence of others in our capabilities which has so much to do with the movements of short-term capital in and out of the United States.

It is these short-term capital movements to which we should now turn, both in rounding out a quick view of our present balance-of-payments position and in preparing the way for some discussion of those aspects of international financial cooperation which I personally find most interesting—the various forms of payments arrangements, and the consultative facilities, which we have introduced or expanded during the past year.

The outflow of short-term capital in 1961 (including that elusive statistical aberration, the "errors and omissions") will probably prove to have been almost as large as in 1960. It looks as though it will have accounted for roughly three quarters of the total deficit in the United States balance of payments. What does this mean? Is it evidence of declining confidence in the dollar? Or, if not, does it imply possible trouble ahead? What can we learn at this stage, before the detailed data have been completed and disclosed, from an analysis of that experience?

Four characteristics of the outflow of short-term funds this past year stand out. First, they did not reflect a flight from the dollar; there was a gain, not a loss, of confidence in our determination and ability to hold the value of the dollar. That is confirmed by the shrinkage of our gold loss to one half that of 1960, as central banks added to their holdings of dollars by amounts nearly equal to their purchases of gold from us. It is further confirmed by the fact that foreign private holdings of dollars rose, perhaps by as much as three quarters of a billion dollars, whereas in 1960 they had actually fallen. What this meant was that in 1960 the entire outward flow of dollars had been unloaded upon the central banks which were engaged in supporting their own exchange parities with the dollar.

A second factor, which partly accounted for the willingness of private recipients to retain the dollars they received, was the removal of much of the interest rate advantage in moving short-term funds abroad. Short rates here were held much higher than in any previous recession-recovery period since the war. Some key rates abroad were lowered. And after giving effect to the costs of forward cover, there was from April onward no obvious advantage in shifting, so far as the customary money market instruments were concerned. But investors will be investors, and some Americans, at any rate, sought out the more unusual, perhaps I should say exotic, forms of short-term paper abroad in order to better their yields—thereby adding to our over-all balance-of-payments deficit.

Although neither confidence factors nor the more simple forms of interest rate arbitrage had much to do with our short-term outflows this year, various aspects of commercial banking operations did—these are third in my list of four characteristics. Loans for the financing of foreign trade—the most normal and healthy component of short-term capital outflows—rose sharply. The increases to Japan alone accounted for more than two fifths of the entire recorded short-term capital outflow during 1961. If the new facilities for export credit insurance serve their purpose, this kind of short-term capital outflow will probably continue, though no doubt the special needs of Japan have been nearly satiated for the present.

But there is another commercial banking component of the outflow, which also loomed large during 1961, and which seems quite different in nature. Foreign commercial banks, some of them functioning in New York through their agencies, have taken advantage of a favorable competitive position costwise to attract American deposits and in turn lend these proceeds in the call market in New York and in other ways. This shift, involving in many cases no net movement of funds out of the United States, gives rise to added short-term claims on the United States. These added claims are part of our recorded balance-of-payments deficit. But there is no offsetting credit for the claims by the original depositor on the foreign banks. Whether or not all of this is good banking, or good for banking, it has the statistical result of increasing our recorded balance-of-payments deficit.

The fourth factor to be mentioned here has worked both ways on our short-term capital movements over this past year—perhaps not accounting for any great part of the final total for the year as a whole, but going far toward explaining some of the variations we have had from quarter to quarter in our over-all short-term flows. This is the reverse influence upon us of disturbing economic or political developments abroad. In March, when the German mark and the Dutch guilder were appreciated, a wave of rumors began to spread concerning other possible currency moves. The position of the United States had just been so resolutely restated by the new Administration that this wave passed us by, and tended to center, so far as drains were concerned, upon the pound sterling. But after the British government initiated a vigorous new program in July, and borrowed $1½ billion (plus a $500 million stand-by) from the International Monetary Fund, the flows turned sharply around. Much of our rather large outflow that will soon be published for the fourth quarter of 1961, including (as already announced) a sizable part of our gold sales, is attributable directly or indirectly to the gratifying improvement shown by the British pound—the only other currency now used extensively as part of the monetary reserves of other countries.

There was, of course, another wave of unsettlement through the foreign exchange markets, that associated with the events in Berlin, triggered particularly on August 13. For a brief time this, too, sent some funds moving. But perhaps because the British position with respect to governmental action affecting the balance of payments was then somewhat comparable to ours of the spring, the greater part of any initial flows benefited the British reserves rather than our own. Fortunately, Berlin soon subsided as a factor in the exchanges, but it did play a large part in holding our net outflow of short-term capital in the third quarter to an unusually small figure.

* * *

Both of these dramatic events—the sterling strain early in the year and the Berlin crisis of the summer—taking place within a structure of convertible currencies, gave rise to immense shifts of short-term capital. The fact that these movements were contained within orderly patterns, and their potentially disruptive influences were avoided, can and should be attributed in considerable part to the implementation during the year of several new approaches to international financial cooperation. All of these steps had been in the making since the return of convertibility at the beginning of 1959. It was no doubt the pressure for action, first stimulated by the events of last March, which brought the new arrangements more quickly and effectively into functioning form. But they had their origin in a new spirit of international cooperation, a spirit fostered by the existence of convertibility and the widening recognition of the responsibilities which its preservation imposes upon all of the leading industrial countries. There were four important kinds of innovations during 1961—innovations which helped greatly to check any cumulative speculative distortions in the structure of the world payments system.

The first of these came to be called the "Basle Agreements". The governors of the various leading European central banks attend each month in Basle the meetings of the Bank for International Settlements (meetings to which senior representatives of our own Federal Reserve System have always been invited and which, for nearly two years now, they have attended regularly). It was at such a meeting last March, when massive money flows around Europe had been set off by the German and Dutch currency revaluations, that the governors of the central banks receiving large inflows undertook to lend them back to the Bank of England, from which most of the drains were flowing. Thus the potentiality of a currency crisis was avoided and time gained for the orderly development of measures to strengthen the British balance of payments and attract a return flow of funds to the United Kingdom.

Although the United States was an active participant in many of the deliberations, it was not in a position to lend substantial amounts back to the United Kingdom because no substantial inflows here had occurred. We did have another direct and important interest, however. Virtually all of the funds withdrawn from London took the form either of gold or of dollars, apparently somewhat more of the latter. If these dollars were to remain long in the hands of central banks which normally maintained high gold ratios, or if any of the central bank holders had entertained any serious concern over the position of the dollar, the next round of consequences following the initial strain upon the British would have been a resumption of our heavy gold outflow.

In fact, the United States received a small gold inflow during the second quarter. To be sure, that mainly represented a redistribution of some of the gold which the British had already paid out. But it was also symbolic evidence that the new spirit of mutual understanding and responsibility, developed not only in the meetings at Basle but in others that I will describe in a moment, had begun to affect the actions of central banks and governments. It had become apparent to them that they, too, had an important share in maintaining the conditions of stability in the international monetary system.

It was in these circumstances that the United States Treasury began, for the first time in more than a generation, to conduct operations in foreign currencies through the good offices of its fiscal agent, the Federal Reserve Bank of New York. We began with the German mark and then the Swiss franc, the two currencies toward which the great bulk of the short-term movements of dollars had gone from the United Kingdom. As the events slip further into the background and the possibilities for speculative inference recede, we are taking steps to describe fully these and other later operations in our various official publications. For now, it is sufficient to stress that the second powerful innovation of 1961, in helping to calm potential unsettlement in the sensitive markets of a convertible world, was the active entrance of the United States into the markets for several of the other leading currencies of the Western world. It is with great anticipation that we in the Treasury now look forward to the early entry of the Federal Reserve System itself, operating for its own account, into the area of foreign exchange operations. Certainly we have already found our own operations helpful in 1961, even when operating on the very slender resources available to the United States Treasury for these purposes.

The third innovation is still not formally completed, but it was the subject of continuing negotiations from the early spring until the end of December in 1961. I am referring, of course, to the decision taken by the Executive Board of the International Monetary Fund on January 5 of this year to provide for supplemental stand-by resources of $6 billion to be loaned by ten industrial countries. This was another of the needs which became so clearly evident at the frequent discussions among the financial officials of various affected countries that began to take place in the early months of 1961. For in the new world of convertibility, uses abound for other convertible currencies; not all drawings on the International Monetary Fund, by the larger or the smaller countries, need be made in dollars. The practices of the IMF had already begun to recognize this, and its supplies of some of the other strong currencies were rapidly dwindling. Thus, where there might indeed be a general need for an over-all increase in the Fund's resources, to keep pace with the continual expansion of its useful activities, the clearest need was to replenish its supply of the newly convertible currencies of the other leading industrial countries.

As you know, proposals respecting the United States participation in these new arrangements were sent to the Congress by the President on February 1. We are hopeful that action can be completed by the necessary number of participating countries before the middle of this year. The stand-by resources are designed, particularly, for use in the event of massive movements of funds, such as those which affected the pound sterling last spring. It is significant that when the British drawing actually was made in August, in order to restore British reserves and permit them very largely to repay the central bank credits of the Basle Agreements, roughly two thirds of the initial drawings were made in currencies other than the United States dollar. The same proportion is being preserved under the stand-by arrangements.

But I said there were four main avenues of innovation and development—the first was that among the central banks; the second, our own entry into the foreign exchange markets of the world; and the third, expanded use of the International Monetary Fund. The fourth is the growing reliance which all of the leading industrial countries in Western Europe can now place upon the Organization for Economic Cooperation and Development—the OECD. At the suggestion of the United States, at the first meeting of the Economic Policy Committee of OECD held last April, two special working parties were established, one to deal with the problems of growth, the other with the monetary, financial, and balance-of-payments problems of common interest. My own involvement has been heaviest with this second group. And I can indeed affirm, despite the stresses of incessant trans-Atlantic journeys to attend meetings held at intervals of four to six weeks in Paris, that the progress achieved has already amply repaid all of our efforts.

For, at these meetings, active financial officials from the capitals of each of ten participating countries are present, full of the current problems confronting them and eager to analyze together the financial forces at work which affect the balance of payments of any or all of the participating countries. Not much can or should be said, on a current basis, concerning the work of a committee of this kind. It is a pioneering experiment; it is being conducted with the flexibility and the uninhibited freedom of inquiry that is appropriate to such an experiment. The aim is understanding, not negotiation from prepared positions, and least of all the semantic exercise of preparing communiques. But the results of 1961—not only in terms of what has occurred at the meetings, or in the parallel discussions which the meetings make possible, but also in broadening our immediate awareness of what is going on abroad as we work out our own domestic financial programs—assure great potentialities for the future of this regular, frequent, face-to-face contact for international financial consultations. They enlarge, they supplement, but they do not in any way replace or supplant, all of the other existing forms of contact and exchange through the staffs permanently assigned to the various international institutions in the economic and financial fields.

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These remarks have ranged widely over our balance of payments and the growing and related role, not only for last year and for this year but more importantly for the future, of international financial cooperation. Step by step, the fresh approaches which began at Bretton Woods in 1944, and carried us through nearly fifteen years of postwar inconvertibility, are now being reshaped for a world in which the currencies of the principal industrial countries have assured convertibility, at fixed rates of exchange.

The emerging pattern has at its center, of course, the International Monetary Fund with a membership now of seventy-five countries and resources, on hand or on call, soon hopefully to exceed the equivalent of $21 billion—distributed among all manner of currencies, both the weak and the strong. Operating within the framework of Fund practices are the central banks or treasuries of the various member countries—all of them also engaging, for their day-by-day affairs, in a network of contacts with each other, and concentrating in a thick web of interrelations among the financial institutions, both public and private, of the leading industrial countries. Somewhere in the middle stands the United States, with the largest holdings in the IMF, with some two fifths of the world's known monetary gold reserves, with $50 billion of other financial assets or resources in other countries, and with short-term liabilities of some $18 billion to foreigners (about equally divided between official and private foreign accounts), and buying and selling gold at the fixed price of $35 per ounce.

Clearly the strong performance of this country is crucial, for us and for the international monetary system. That is why the first order of priority in the Government's financial program (and in the President's own thinking and concern) has been, and continues to be, the restoration of equilibrium in our balance of payments. That is why, too, we have turned our attention so concertedly to the strengthening of the payments arrangements that can best surround the dollar, and strengthen or complement the underlying supporting role of the IMF itself, through the years ahead. For convertibility brings problems with its opportunities, and it will not be protection enough for the system as a whole to have a strong dollar and a sturdy Fund. There must be a growing set of relationships and understandings among the other leading countries which are strong enough to assume some responsibility for the defense of the system as a whole against the capricious raids of speculators or the pressures set off by threats to political or economic stability in various parts of the world.

It is with a view to these longer run requirements that the United States has moved energetically toward developing, in the living context of today's problems, an experimental approach toward various ways to spread among other currencies some portion of the burden that has for so long been borne by the dollar alone. That is the most obvious, and compelling, requirement. But beyond that, in a variety of ways, we have learned much, and have hopes that the machinery of payments arrangements will profit much, from the close working relations developed during the past year with Germany, Switzerland, Italy, Holland, France, Sweden, and several of the other countries represented at Basle and in the OECD.

The outlines of what may emerge can barely be sketched now. But the promise lies in the high degree of understanding, and the close integration of common action, that has emerged in the face of the various tests presented by the events of 1961. The answer will not be found, I feel sure, in any drastic rewriting of the codes or procedures of international monetary behavior. It will, instead, emerge, step by step, from the kind of experimentation that has marked the evolution of joint operations in various currencies, the imaginative lending of funds among central banks and between governments, the extensive use of the resources of the International Monetary Fund, notably in support of sterling, and the introduction of facilities for new forms of frequent and intimate consultation on emerging problems and appropriate action. This is the pragmatic course from which all of our lasting banking institutions have evolved. We have much to do now in developing international arrangements to match the effectiveness, and the flexible adaptation to local conditions, that has been achieved in the domestic monetary systems of most of the leading industrial countries of the world.

The essence of all these new developments is understanding, but there must all along be an intermixture of hard negotiations and determined actions. For both, the United States is not yet adequately prepared. It is not enough for a few representatives of government to eat, sleep, and dream the balance of payments and its implications for the American economy; there must be a spreading, permeating consciousness of the balance of payments and its significance throughout the business and labor communities.

The buffeting which the United States has undergone over the last few years has led to many good results. Everyone who travels from Washington out through the country returns with a sense that the country as a whole is indeed aware of our balance-of-payments position and senses its significance. That is the essential beginning. But we will not have reached the stage in which we can, in the best, responsible democratic manner, adequately discharge our responsibilities as first among the leading countries until the typical labor leader, or the typical business executive, in this country can analyze the main lines of economic development in balance-of-payments terms in the same taken-for-granted manner that characterizes his counterpart in the other industrial countries with whom our contacts must now be so much closer, in our convertible currency world.

My observation is not meant as a complaint. For so many generations the United States has been able to live without direct concern for its external economic affairs that we have not been forced by the events of daily experience to develop the same consciousness of export markets, or of foreign trade finance, or of the effects of capital flows, that have been, equally for generations, the everyday concern of people in the European countries, whether they are in business, in finance, in trade unions, or in government.

That is why I have had the temerity today to speak so long and to try to touch upon so many aspects of our balance-of-payments position when I was given the opportunity of appearing before this captive audience of bankers. For it is among bankers as in no other single group in the country that a genuine understanding of the elements in our balance of payments has been, for a much longer period, an essential part of the stock in trade. And I think it will fall upon bankers to carry a major part of the effort toward broadening and deepening the general public knowledge of all the questions that we have been reviewing here today.