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Contents

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The Business Situation

As the economy moves into the seasonally active spring months, the prospects remain good that further business gains will extend the duration of what is already the longest expansion since the Korean War. Industrial production and nonagricultural employment both advanced further in March in an economic atmosphere that remained essentially free from inflation. Indeed, broad price measures have remained virtually steady in spite of a recent upturn of some sensitive materials prices. For the first quarter as a whole, total output of goods and services reached a seasonally adjusted annual rate of $608.5 billion, higher than had generally been expected. Retail sales apparently edged off again in April, but both steel ingot production and automobile assemblies recorded considerable gains. Business sentiment, as reflected in plans for capital spending, continues to be optimistic: the regular spring McGraw-Hill survey reports a 12 per cent rise in planned capital outlays this year, slightly more than the increases reported by surveys taken earlier this year.

The recent settlement of the long railroad industry dispute has removed one of the major uncertainties in the economic outlook. Other important labor negotiations, however, still lie ahead—most notably in the automobile industry in August—and their results will have an important influence on the outlook for price stability and on the pace of economic advance. With a generally expansionary economic environment, there will be a continued need for businessmen and labor unions to exercise restraint in wage and pricing decisions.

RECENT DEVELOPMENTS IN KEY DEMAND SECTORS

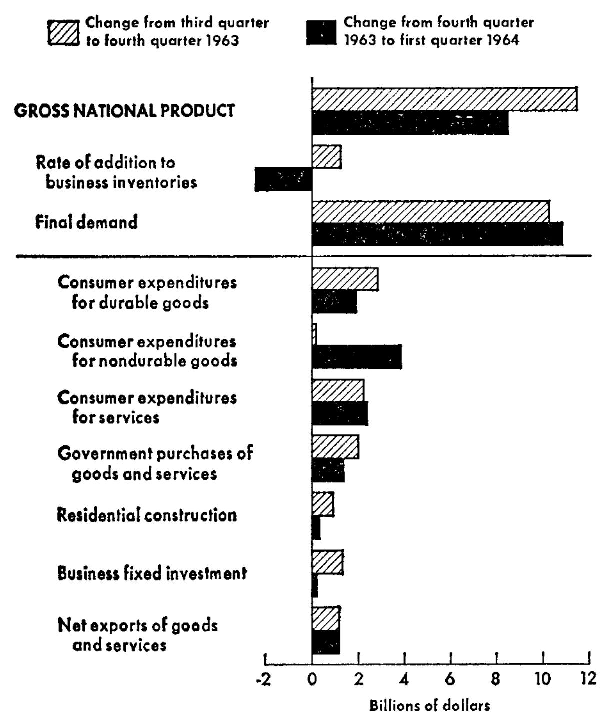
Gross national product rose by $8.4 billion in the first quarter of 1964, according to preliminary estimates of the Department of Commerce (see Chart I). This gain was only a little less than the sizable increases in the last two quarters of 1963. In fact, final demand—the rate at which business, government, and consumers purchased newly produced goods and services for purposes other than inventory accumulation—registered its sharpest advance since late 1961 when the economy was still in the initial phase of the cyclical upswing. The slight slowdown that did occur in GNP growth thus reflected a decline in the rate of inventory accumulation, implying a continued tight alignment between stocks and sales.

Consumer spending accounted for most of the strength in final demand and registered its largest quarterly upsurge since the first quarter of 1951 (during the Korean

Chart I

DOLLAR CHANGES IN GNP AND ITS COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

War). Automobile sales, after allowing for seasonal variation, climbed only slightly from the very high rate that had prevailed in the fourth quarter of 1963, but consumers spent quite heavily on appliances and furniture and also increased substantially their outlays on nondurable commodities such as apparel. Most of this rise in spending reflected the continued advance in consumers' disposable incomes, but the proportion of income spent on consumption also rose. The push in consumption came largely before the tax cut started to go into effect in the first week in March: retail sales during that month actually fell off a bit from their record February pace. Retail sales volume may also have edged downward in April—though the problems of adjusting the figures for the earlier than usual date of Easter make it difficult to assess the underlying trend of sales during the last two months. In any case, too much significance should not be attached to minor variations in the retail sales series, which tends to fluctuate erratically from month to month.

The government spending component of GNP also moved up somewhat in the first quarter, although the increase was a little smaller than in the preceding two quarters. The Federal Government's purchases of goods and services for national defense purposes rose at an annual rate of only $200 million. Defense outlays are scheduled to show a somewhat larger increase in the current quarter, but there are indications that such outlays for the fiscal year as a whole may fall short of the total projected last January.

Outlays for residential construction, after a sharp rise in the last three quarters of 1963, showed only a very slight gain in the first quarter. Even this small increase, however, was contrary to the expectations of those observers who have been predicting an end to what is the longest building boom since World War II. Moreover, the high level of housing starts throughout the first quarter suggests that residential construction outlays may be well sustained in the months immediately ahead.

As had appeared likely on the basis of earlier surveys of capital spending plans, business outlays for fixed investment showed little push in the first quarter. Orders and contract awards in the first quarter as a whole were well above the average levels of the previous quarter, however, suggesting that the advance in capital spending anticipated for the last three quarters of the year may now be in progress. The latest survey of spending plans, conducted by McGraw-Hill in March and April, suggests that manufacturers, particularly auto firms, have raised the total of their planned outlays for 1964 even above the intentions expressed at the beginning of the year. The McGraw-Hill survey points to a 12 per cent rise in over-all plant and equipment expenditures this year, compared with the 10 per cent gain indicated by the Commerce Department-Securities and Exchange Commission survey conducted in February and the 9 per cent rise reported in a special January McGraw-Hill survey. It should be noted that in years of over-all economic expansion the McGraw-Hill spring survey has tended to be on the high side, and the Commerce-SEC spring survey on the low side, of the actual final capital spending figures.

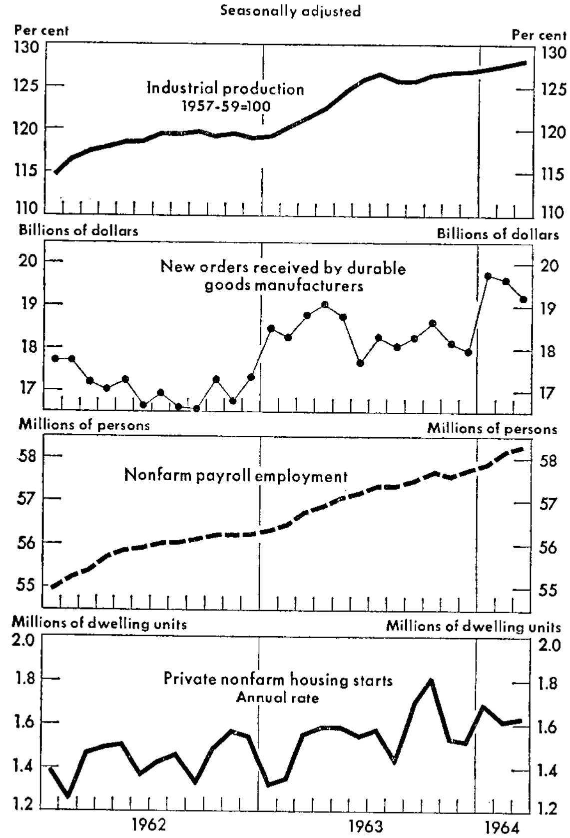
PRODUCTION, EMPLOYMENT, AND PRICES

The Federal Reserve Board's seasonally adjusted index of industrial production edged ahead in March for the sixth month in a row, reaching 128.2 per cent of the 1957-59 average (see Chart II). So far in 1964, total industrial

Chart II

RECENT BUSINESS INDICATORS

Seasonally adjusted



Sources: Board of Governors of the Federal Reserve System; United States Departments of Commerce and Labor.

production has shown only modest gains, in contrast to the substantial increases in the first halves of 1962 and 1963. In both of the past two years, however, anticipations of a midyear steel strike had helped spur the rise in overall output. For most industry groupings, changes in output during March were small. Equipment production, however, moved ahead after two months of decline, a fact that may reflect the start of the anticipated rise in capital spending. Preliminary data for April point to a sharp increase in steel ingot production (on a seasonally adjusted basis), the gain being the largest since April 1963. Automobile assemblies, which slipped somewhat in March after allowing for seasonal influences, also appear to have advanced considerably in April, with producers apparently continuing to be encouraged by reports on dealer sales.

New orders for durable goods edged off for the second month in a row in March. Nevertheless, such orders remained close to the record January high and were still somewhat above durables shipments. The slight backing-away from the January peak in total new bookings probably reflects reduced defense ordering rather than a decline in private orders, which continue to be substantial.

Total nonfarm payroll employment moved further ahead in March and was 1.5 million persons higher than a year earlier, despite a reduction in the number of workers in the construction and trade sectors. In manufacturing, employment moved up to a total only 200,000 persons shy of the post-Korean War high recorded in 1957, and average weekly hours also increased. The recent improvement in the employment situation has apparently been geographically widespread: only 40 of the nation's 150 major labor market areas were classified as having "substantial labor surplus" (an unemployment rate of 6 per cent or more) in March, compared with 48 such areas a year earlier.

Broad indicators of price developments continue to show no inflationary uptrend. The consumer price index, although edging ahead in March after a February decline, has registered little net increase so far this year. Wholesale food prices have remained about unchanged in March and April after a February decline. Average industrial wholesale prices, moreover, have drifted down very slightly this year, in spite of quite a few price increases in sensitive raw industrial materials. Special supply factors in world markets appear to be a major, although not the sole, factor in explaining the movements in sensitive commodity prices. Nevertheless, any such concentration of price increases underscores the need for paying particularly careful attention to price developments in a period when most observers foresee rapid gains in economic activity.

The Money Market in April

The money market continued generally firm in April, although Federal funds traded in volume a shade below 3½ per cent on a number of occasions. Nation-wide net reserve availability expanded slightly in April, while average member bank borrowings from the Federal Reserve Banks declined somewhat. Banks in the money centers were under considerable reserve pressure in the first half of the month, partly reflecting a drawing-down of Treasury deposits in such banks. Subsequently, the reserve positions of these banks improved, as a portion of Federal individual income tax receipts from all parts of the country was redeposited in Treasury Tax and Loan Accounts at Class C banks.[1] Rates posted by the major New York City banks on new and renewal call loans to Government securities dealers generally moved in a 3⅝ to 4 per cent range.

In the Treasury bill market, where good investor demand persisted and the redemption of $2.5 billion of April 15 bills reduced outstanding supplies, rates declined 7 to 20 basis points in April. Both offering rates for new time certificates of deposit issued by the leading New York City banks and the rates at which such certificates traded in the secondary market declined somewhat in April. Rates on prime four- to six-month commercial paper were lowered

[1] In the Treasury's classification of the commercial banks that are depositaries of Tax and Loan Account funds, Class C banks are the largest ones—those with *total* deposits of $500 million or more. These banks are subject to Treasury Tax and Loan Account calls or redeposits on only a few hours' notice.

by 1/8 of a per cent to 3 7/8 per cent (offered), while net downward adjustments of approximately 1/8 to 1/4 of a per cent in rates on several maturities of directly placed finance company paper occurred during the month. Dealers in bankers' acceptances raised their rates on all maturities by 1/8 of a per cent early in the month, but this increase was rescinded toward midmonth.

Prices of Government coupon securities rose in April, as commercial bank selling subsided and market participants gradually came to feel that interest rates were not likely to rise significantly in the near future. Prices of corporate and tax-exempt bonds generally stabilized in April somewhat above the lower levels reached the month before, and a sizable volume of new issues moved into investors' portfolios.

After the close of business on Wednesday, April 29, the Treasury announced the terms of its May refunding operation. Holders of $10.6 billion of notes and certificates maturing on May 15 were given the opportunity to exchange them for either a new 4 per cent note maturing on November 15, 1965, priced to yield about 4.09 per cent, or for a new 4 1/4 per cent bond maturing on May 15, 1974, offered at par. Subscription books were open from May 4 through May 6, and the exchange of securities was scheduled for May 15. The market's initial reaction to the refinancing terms was favorable. In early trading, prices of "rights"—the issues eligible for conversion—rose by about 3/32. The 4 1/4 per cent bonds of May 1974, trading on a "when-issued" basis, closed the month at a bid quotation of 100 15/64, while the 4 per cent notes of November 1965 were bid at 100 3/32, or 7/32 above the Treasury's offering price.

CHANGES IN FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, APRIL 1964

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

Factor	Daily averages—week ended Apr. 1	Apr. 8	Apr. 15	Apr. 22	Apr. 29	Net changes
Operating transactions						
Treasury operations*	+ 198	— 56	— 80	+ 80	— 20	+ 122
Federal Reserve float	— 461	+ 81	+ 163	+ 410	— 394	— 201
Currency in circulation	— 75	— 107	— 159	+ 86	+ 99	— 156
Gold and foreign account	— 5	+ 17	+ 12	+ 2	— 7	+ 19
Other deposits, etc.	— 8	— 88	+ 40	+ 69	— 19	— 6
Total	— 351	— 155	— 23	+ 648	— 340	— 221
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 233	+ 382	— 73	— 793	— 65	— 316
Held under repurchase agreements	— 42	+ 22	— 63	—	+ 101	+ 18
Loans, discounts, and advances:						
Member bank borrowings	— 124	+ 53	— 18	+ 129	— 184	— 144
Other	—	+ 1	—	+ 1	—	+ 2
Bankers' acceptances:						
Bought outright	— 2	—	— 2	— 4	— 2	— 10
Under repurchase agreements	— 1	+ 5	— 14	— 41	+ 34	— 17
Total	+ 64	+ 464	— 170	— 708	— 116	— 466
Member bank reserves						
With Federal Reserve Banks	— 287	+ 309	— 193	— 60	— 456	— 687
Cash allowed as reserves†	+ 86	— 268	+ 211	+ 14	+ 86	+ 129
Total reserves†	— 201	+ 41	+ 18	— 46	— 370	— 558
Effect of change in required reserves†	— 35	+ 109	— 141	+ 188	+ 134	+ 255
Excess reserves†	— 236	+ 150	— 123	+ 142	— 236	— 303
Daily average level of member bank:						
Borrowings from Reserve Banks	155	208	190	319	135	201‡
Excess reserves†	272	422	299	441	205	328‡
Free reserves†	117	214	109	122	70	127‡

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† These figures are estimated.
‡ Average for five weeks ended April 29, 1964.

BANK RESERVES

Market factors provided excess reserves on balance from the last statement period in March through the final statement week in April. Member banks gained excess reserves primarily through contractions in Treasury deposits with the Federal Reserve Banks and in required reserves. These gains were only partly offset by a decline in float.

System open market operations absorbed reserves over the period as a whole, more than offsetting reserves provided by market factors. System outright holdings of Government securities declined on average by $316 million from the last statement period in March through the final statement week in April, while System holdings of Government securities under repurchase agreements rose by $18 million. System holdings of bankers' acceptances contracted by $27 million. From Wednesday, March 25, through Wednesday, April 29, System holdings of Government securities maturing in less than one year fell by $279 million, and holdings maturing in more than one year rose by $36 million.

THE GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds edged irregularly higher through most of April, as offerings contracted and demand expanded somewhat. Market confidence in the near-term stability of interest rates was bolstered by reports of a substantial improvement in the balance of payments during the first quarter, and by the strength of investor demand for short-term securities which kept the three-month Treasury bill rate below the discount rate for most of the month. Commercial bank offerings of Treasury coupon issues tapered off after having exerted considerable downward pressure on prices in March. In addition, moderate investment demand was evident throughout the period, augmented from time to time by professional short covering. Trading activity tended to decline during the month, however, as investors moved to the sidelines to await the terms of the Treasury's approaching May refinancing operation. At the close of the month, prices of Government notes and bonds were generally $\frac{2}{32}$ to $\frac{18}{32}$ above end-of-March levels, with the largest gains recorded by the 2½ per cent wartime issues.

In the market for Treasury bills, rates receded in April to the lowest levels since autumn of last year as a consequence of both special and seasonal factors. Early in the month, reinvestment in short-term securities of the proceeds of the recent $1.2 billion American Telephone and Telegraph Company common stock offering exerted a pervasive downward influence on short-term yields. At the same time, state and local governmental units were active buyers of bills, reflecting a seasonal expansion in tax receipts. Investment demand thus was strong, and dealer stocks became increasingly depleted—first of short-term maturities, but later of longer maturities as well. Reinvestment resulting from the redemption on April 15 of $2.5 billion of Treasury bills added further to demand. Market sentiment was also strengthened by the Treasury's decision to confine the last three regular weekly auctions of the month to the roll-over of maturing bills. These offerings were $100 million smaller in each case than in several prior weekly auctions when the amounts offered had included roll-overs resulting from an earlier bill strip financing. Toward the end of the month, demand subsided somewhat but rates stabilized near their lows for the month as market participants anticipated additional demand for bills in connection with the impending May refunding of coupon issues.

During April, rates on outstanding bills declined by a net of approximately 7 to 20 basis points. At the last regular weekly auction of the month held on April 27, average issuing rates were 3.446 per cent for the new three-month issue and 3.616 per cent for the new six-month bill—8 and 9 basis points lower, respectively, than the rates produced in the final auction in March. The April 30 auction of $1 billion of new one-year bills resulted in an average issuing rate of 3.705 per cent, compared with an average issuing rate of 3.765 per cent on the comparable issue sold in February. (At the one-year bill auctions held in February and April, banks were not accorded the privilege of paying by credit to Treasury Tax and Loan Accounts. In March when they were permitted to pay for 50 per cent of purchases in this way, an average issuing rate of 3.719 per cent emerged.) The newest outstanding three-month bill closed the month at 3.45 per cent (bid) as against 3.54 per cent (bid) at the end of March, while the newest outstanding six-month bill was quoted at 3.59 per cent (bid) on April 30, compared with 3.72 per cent (bid) on March 31.

OTHER SECURITIES MARKETS

A firmer tone also emerged in the markets for corporate and tax-exempt bonds in early April, following the sharp price declines of March. Lower dealer inventories and the light volume of new offerings reaching the market contributed to an improvement in the corporate sector during this period. At the same time, the tax-exempt sector was encouraged by the excellent reception accorded a large new issue marketed at the beginning of the month. Against this background, investor interest in both sectors of the market expanded at the prevailing higher yield levels and prices held generally steady in the first half of April. The good investor reaction to several large new flotations marketed in the latter part of the month further reinforced market confidence, and prices of both corporate and tax-exempt bonds rose slightly toward the end of the period. Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 1 basis point to 4.41 per cent, while the average yield on similarly rated tax-exempt bonds declined by 4 basis points to 3.12 per cent.

The volume of new corporate bonds floated in April amounted to approximately $375 million, compared with $355 million in the preceding month and $345 million in April 1963. The largest new corporate bond issue marketed during the month was a $100 million Aaa-rated telephone and telegraph company debenture issue maturing in 1999 and nonredeemable for five years. Reoffered to yield 4.48 per cent, the debentures were accorded a good initial reception, although some of the bonds were still unsold at the end of the month. New tax-exempt flotations in April totaled approximately $1,125 million, as against $770 million in March 1964 and $810 million in April 1963. The Blue List of tax-exempt securities advertised for sale rose by $77 million during the month to $597 million on April 30. The largest new tax-exempt bond issue marketed in April consisted of a series of $141 million of Aaa-rated housing authority bonds. Reoffered to yield from 2 per cent in 1964 to 3.50 per cent in 2004, the bonds were very well received. Other new corporate and tax-exempt bonds floated in April encountered generally favorable investor receptions, although investors responded slowly to aggressively priced issues on several occasions.

Edge Act and Agreement Corporations in International Banking and Finance*

With the steady rise in international trade and investment, United States banks have been expanding their foreign activities. As a consequence, there has been considerable growth in the international departments of United States banks, and the banks have also made increased use of additional possibilities for doing business abroad. Among these possibilities are the so-called Edge Act and Agreement corporations. By now, twenty-three banks and bank holding companies operate a total of thirty-six such subsidiaries.

Edge Act and Agreement corporations are United States corporations carrying out international banking and financing operations, some of which—notably equity investment abroad—the parent banks themselves are not permitted to undertake under existing laws and regulations. The corporations' actual functions range from acting as holding companies to rendering a wide variety of international banking services; and they include also the financing—through term loans and equity participations—of industrial and financial projects in both developed and underdeveloped countries. Furthermore, under strictly prescribed conditions and incidental to their main purpose, the corporations do a limited business in the United States.

BACKGROUND [1]

The origins of Edge Act and Agreement corporations go back almost half a century—to a time when a broader scope for private American financial activity abroad appeared desirable. In 1916, section 25 of the Federal Reserve Act was amended so that any national bank with a capital and surplus of $1 million or more was authorized to invest, singly or jointly, up to 10 per cent of its capital and surplus in a corporation chartered under Federal or state law to conduct "international or foreign banking" activities. Each corporation was required to "enter into an agreement" with the Board of Governors of the Federal Reserve System as to the type of activities it would undertake and the manner in which it would conduct its operations. The wording of this provision gave rise to the name Agreement corporation.[2]

As an additional inducement to the expansion of the foreign business of the United States, Congress passed a law in December 1919 (sponsored by Senator Walter E. Edge of New Jersey). This act added section 25(a) to the Federal Reserve Act, a section that authorized the Board of Governors to charter corporations "for the purpose of engaging in international or foreign banking or other international or foreign financial operations . . . either directly or through the agency, ownership, or control of local institutions in foreign countries". The stock of these corporations, which have come to be called Edge Act corporations, is also eligible for bank ownership. The corporations must be capitalized at a minimum of $2 million.

The activities of Edge Act corporations are thus governed by the Federal Reserve Act, and by the related Regulation K of the Board of Governors which was first issued in 1920 and has since been periodically revised. The primary purpose of the latest revision, effective September 1, 1963, was to enable Edge Act corporations to operate more effectively in financing international trade and commerce.[3]

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* George H. Bossy had primary responsibility for the preparation of this article. Edna K. Reynolds and Robert Ritchie provided technical assistance.

[1] For a fuller description, see F. M. Tamagna and P. B. Willis, "United States Banking Organization Abroad", *Federal Reserve Bulletin,* December 1956, pp. 1284-99; Richard A. Wiley, "Edge Act Corporations—Catalysts for International Trade and Investment", *The Business Lawyer,* XVI, July 1961, pp. 1014-29; and T. M. Farley, *The "Edge Act" and United States International Banking and Finance* (mimeographed) New York: Brown Brothers Harriman & Co., May 1962.

[2] Since the Banking Act of 1933, these provisions have been applicable to state member banks of the System as well; and both national and state member banks have, or have had, such corporations. All Agreement corporations have been state chartered.

[3] An authoritative description of the major changes may be found in a Board of Governors press release dated August 23, 1963.

NUMBER OF EDGE ACT AND AGREEMENT CORPORATIONS*
1956-64

End of year	Edge Act corporations	Agreement corporations	Total
1956	3	4	7
1957	4	3	7
1958	5	3	8
1959	6	3	9
1960	10	5	15
1961	11	5	16
1962	22	4	26
1963	30	5	35
1964 (March)	31	5	36

*Numbers exclude corporations organized but not yet open for business on dates given. There were two such corporations at the end of 1963 and one at the end of March 1964.

After a short period of moderate operations during roughly the first decade following World War I, Edge Act and Agreement corporations were relatively inactive until the midfifties, although there were a few significant exceptions. Since the late fifties, on the other hand, their number has grown markedly. As shown in the accompanying table, most of this recent growth has been in Edge Act rather than in Agreement corporations.

PRESENT USES AND FUNCTIONS

The uses and functions of Edge Act and Agreement corporations are influenced by two main factors—the scope granted by laws and regulations and the needs of their parent banks. Between January 1957 and September 1963, an Edge Act corporation was required by Regulation K to operate either as a "banking corporation" or as a "financing corporation". While the activities of the two types of corporations could overlap to a modest extent, banking corporations had a much wider range of banking powers than did financing corporations. In particular, they could accept deposits, which financing corporations could not do. On the other hand, the equity investments of banking corporations were limited to the stock of corporations engaged in banking or closely related activities. Financing corporations—which operated solely on the basis of parent bank funds plus retained earnings—were empowered to invest in foreign concerns not engaged in banking (and only in these).

The latest revision of Regulation K eliminates the formal distinction between the two types of corporations and considerably modifies the substantive distinctions. A United States bank thus has now more freedom to have *one* Edge Act subsidiary engage in both banking and financing operations. Nevertheless, there are still certain restrictions. For example, a distinction is drawn in the present regulation on the basis of whether or not a corporation is "engaged in banking" (i.e., has aggregate demand deposits and acceptance liabilities exceeding its capital and surplus). If it is, the corporation's commitments to any one person are not permitted to exceed 10 per cent of its capital and surplus, whereas the limitation is 50 per cent if the corporation is not "engaged in banking". For reasons such as this, and because of the recent date of the latest change in the regulation, the corporations' activities still tend to reflect the prior distinctions. Thus, of the total of thirty-one Edge Act corporations active as of March 31, 1964 (as shown in the table), fourteen would previously have been considered banking corporations and seventeen financing corporations. This background, together with the availability of the Agreement corporation device, accounts for the fact that a number of banks have several subsidiaries. (Agreement corporations are limited to the powers exercised by Edge Act corporations engaged in banking.)

In terms of a rough distinction between the former banking and the former financing corporations, those active in banking either do a variety of business typical of that of the international department of a commercial bank or function as holding companies for equity investments in foreign banks. In some cases, they fulfill both functions. The former financing corporations have tended to operate in a different area, with investments in the stock of nonbank financial concerns, development corporations, or commercial and industrial firms.

Edge Act corporations have, for example, enabled banks with head offices outside New York City to operate in that key location for foreign banking operations (since an Edge Act corporation does not have to be established in the same city as the owning institution). Such a corporation may, for instance, hold demand and time (but not savings) deposits of foreign parties; issue or confirm letters of credit; finance foreign trade by extending loans and advances, by creating bankers' acceptances, or by making other credit facilities available; receive items for collection and offer other services to customers, such as remitting funds abroad, purchasing and selling securities, or holding securities for safekeeping; issue certain guarantees; act as paying agent for securities issued by foreign governments and certain foreign corporations; and engage in both spot and forward foreign exchange transactions.

In their capacity as holding companies, Edge Act corporations can own the stocks of foreign banking subsidiaries and affiliates (which member banks cannot own directly). This fact accounts for the existence of a number of Edge Act corporations (and of several Agreement corporations, which can serve the same purpose). A foreign banking subsidiary may be more advantageous than a branch, or it may actually be a necessity for doing business in a given country. Certain countries—e.g., the Union of South Africa—prohibit nondomestic banks from opening branches in their territory. A United States bank wishing to operate in such a country can do so by establishing a subsidiary, the stock of which would, however, have to be held through an Edge Act or Agreement corporation. In other instances—Brazil, Italy, and Liberia—such corporations have been the channel through which United States banks have acquired an interest in well-known foreign banks.[4]

Edge Act corporations have also been the instrument through which, as previously noted, United States banks have acquired equity interests in foreign nonbanking concerns.[5] Such investments, to be sure, are subject to prior specific consent of the Board of Governors under certain circumstances—as is the acquisition of stock in foreign banks.[6] Furthermore, such equity investments are only a fraction of the total assets of all Edge Act corporations, albeit a significant one of those formerly considered financing corporations. At any rate, equity investments in nonbanking concerns, and the combination of loans and equity acquisitions in "packages", give the activities of a number of Edge Act corporations a distinct characteristic, well worth exploring in some detail. The remainder of this article is therefore devoted primarily to the portfolio management of Edge Act corporations in those cases in which they go beyond short-term commercial banking and holding company functions. (This covers mainly the former financing corporations but also includes a number of the former banking corporations. Agreement corporations are at present mainly used as holding companies for foreign subsidiaries and affiliates.)

FINANCING THROUGH EDGE ACT CORPORATIONS

RECIPIENTS OF FINANCING. Two broad classes of nonbank borrowers from Edge Act corporations may be distinguished—specialized foreign financial institutions, and commercial and industrial firms. As regards foreign financial intermediaries, Edge Act corporations have in numerous instances helped in the financing of foreign official or semiofficial development corporations through purchases of shares. These institutions, as the Edge Act corporations often do themselves, help finance slowly maturing enterprises in their early stages. By channeling funds to development institutions, an Edge Act corporation can avoid the detailed studies and investigations that might render small investments unprofitable. Edge Act corporations have also participated in foreign finance companies. Such companies may, for instance, be engaged in the financing of private purchases of consumer durable goods, including some manufactured in the United States. In a few cases, the portfolios of Edge Act corporations also include investments in the stock of foreign securities underwriters.

In most instances, however, Edge Act corporations finance foreign commercial and industrial borrowers directly through loans and equity participations. While such financings do not normally involve the acquisition of control, the Edge Act corporation is seldom a passive partner. The primary purpose typically is to supply capital to promising foreign enterprises at an early or other important stage. Thus, the Edge Act corporation may be dealing with a newly launched business or with a firm planning, or engaged in, a major expansion, modernization, or reorganization. Negotiating and carrying through such ventures call for ingenuity and enterprise.

INDUSTRIAL AND GEOGRAPHICAL DISTRIBUTION. The loans and equity investments of Edge Act corporations cover a broad spectrum—manufacturing, mining, and service industries; and, while the financing of public utilities is rare, there is one instance of a gas pipeline interest of an Edge Act corporation. Manufacturing industries are perhaps the most frequent borrowers, but a certain specialization within that broad category can be detected. Thus, Edge Act corporation financing, at least in the less developed countries, is often directed toward manufacturing enterprises that process a country's resources of pri-

[4] Edge Act corporations themselves may also establish branches or agencies abroad, although prior approval of the Board of Governors is required for the establishment of the first branch or agency in a particular foreign country.

[5] Since September 1963, of course, *all* Edge Act corporations have been permitted to hold both banking and nonbanking equity investments.

[6] Specific consent is *not* required when the stock acquisition (a) is incidental to an extension of credit to the foreign corporation (in making loans to foreign enterprises, Edge Act corporations frequently acquire an equity participation); (b) consists of shares in a foreign bank, but does not bring the Edge Act corporation's holdings of the voting stock of the foreign bank to or above 25 per cent; or (c) is "likely to further the development of United States foreign commerce", provided the purchase of the stock of any one foreign corporation does not exceed $200,000. It should also be noted that Edge Act corporations, like all United States investors, would of course be subject to the proposed interest equalization tax on purchases of securities issued by foreign borrowers in developed countries. (This tax, proposed by the Administration in July 1963, has been passed in the House of Representatives but is still to be considered by the Senate.)

mary materials—concrete products from cement, chemicals based on oil, paper mills, cotton textile mills, and even steel mills where there is coal and iron ore.

Edge Act corporations appear to have no particular preference with regard to the geographical distribution of their portfolios. They will, of course, be deterred from financing in countries considered politically unstable, or those in which attitudes and policies are inimical to foreign investment. Apart from such obvious considerations, however, the location of loans and investments appears to be chosen only on the basis of business criteria. In terms of the value of equity investments alone, the portfolios of Edge Act and Agreement corporations at present appear to be distributed roughly as follows: Europe, about 40 per cent; Latin America, approximately 20 per cent; Canada, almost 20 per cent; Africa, about 10 per cent. The Far East accounts for almost one half of the remainder.

INITIATING AN OPERATION. Financing decisions of Edge Act corporations call for special skills in appraising not only technical matters but also the "human element" in the foreign business and political environment. Since in many cases it would be difficult—for lack of a market—to pull out should the project not be giving satisfactory results, the initial investigation and evaluation must be thorough.

The project is almost invariably initiated abroad, with the foreign concern in need of capital making contact with the Edge Act corporation or—more frequently—its parent bank. The initial proposal usually contains a fairly detailed description of the project, supported by documentation. Further data may be requested from the foreign party as the Edge Act corporation begins to look more closely into the proposal, and the officers of the Edge Act corporation or the parent bank may go abroad for personal study and negotiation. On the strictly technical side, the degree of reliance on the studies of the foreign applicant may be heavy in the case of well-established foreign firms.

The investor, as already suggested, will wish to find out a good deal about the foreign company's financial structure, management and organization, indebtedness, past history, the market outlook for its products, and its competitive position. This may well lead into studies of the host country's economy, growth, and policies, which in turn may necessitate some study of international trade and finance as they affect that country. All of these efforts are designed, of course, to add up to an informed appraisal of risks and earning prospects, which in turn becomes the basis for a firm decision.

Size of financing. Once the soundness and potential profitability of the project have been established, a decision is required on the size and type of a commitment and on possible partnership arrangements. The decision will vary not only from one project to the next, but also according to the role of the Edge Act corporation within the banking organization to which it belongs. On the whole, the minimum size of an individual financing that might interest an Edge Act corporation is smaller if the parent bank has a large network of foreign branches and representatives. For a bank without local representation, the costs of study and evaluation can be high and therefore worthwhile only for a relatively large potential financing. As regards the maximum size of an individual operation, one limitation—previously noted—is that an Edge Act corporation's commitments to any one party cannot exceed 50 per cent of its capital and surplus (10 per cent if engaged in banking). The size of such capital and surplus in turn reflects parent bank policy.

Most Edge Act corporations probably will not normally consider requests involving less than $100,000, and some even place the preferred lower limit as high as $1 million. But actual commitments have occasionally fallen well below these minimum levels, and they frequently range upward into several millions.

Period of financing. Edge Act corporations tend to extend loans over a broad range of short and intermediate maturities. As to equity investments, the corporations usually seek to disengage themselves within five to ten years. The size of an Edge Act corporation is a factor in the maturity structure of its portfolio. Most such corporations naturally consider their capital as a revolving fund—new investments being made with the proceeds of the liquidation of previous ones. The larger corporations tend to make somewhat longer loans than the smaller ones, because their more numerous and bigger commitments generate larger return flows from which frequent new financings can be undertaken. Smaller corporations prefer to restrict their time horizon to shorter periods in order to avoid situations in which they might be out of the new-project business—unless, of course, the parent bank injects new capital.

In liquidating equity holdings, Edge Act corporations frequently avail themselves of prenegotiated resale agreements (discussed below). In some instances, the foreign partners make efforts to develop a local market for such securities.

Remuneration. The negotiation of the amount and form of its remuneration tends to be an intricate operation for an Edge Act corporation, since the circumstances of individual financings tend to differ widely. Equity participations frequently are a method of compensating for risks exceeding those ordinarily taken on loans. (Sometimes an

Edge Act corporation makes an equity investment while the parent bank grants a loan.) When both a loan and an equity investment are involved, the potential returns from the financing will typically be appraised as a whole rather than separately. For example, relatively low interest on the loan portion can be offset to some extent by a higher equity interest for the Edge Act corporation. Besides the possible dividend income, the equity portion of the investment may, of course, result in a capital gain—often a very important consideration. Should no present or foreseeable market for the shares exist—as is true in many instances—the Edge Act corporation may enter into an agreement with the firm's local shareholders for the sale at predetermined future dates of its holdings to them. The sale price is determined according to any of a number of formulas, which usually contain a provision for ascending values of the shares.

The Edge Act corporation often receives some additional shares or cash as a bonus to compensate it for the efforts expended in bringing together various partners—including technical assistance and third-party capital—in an enterprise it helps to finance. The work done in initiating and negotiating such partnerships frequently entails the devising of an intricate financial structure.

Associates in financing. Most Edge Act corporations consider local partnership of the highest importance and often believe it advisable that the local partners hold majority control. Technical management, on the other hand, is frequently supplied from abroad.

With the exception of investments in subsidiaries, Edge Act corporations are unlikely to be the sole or principal capital-supplying partner in large projects. Other private United States or foreign investors, as well as United States or international government lending agencies, are frequent participants. Such mixed investments are often made in conjunction with the International Finance Corporation (IFC)—a 76-member subsidiary of the International Bank for Reconstruction and Development (World Bank). The IFC is authorized both to grant loans and to make equity investments in private enterprises located in developing areas, and thus undertakes operations frequently quite similar to those of Edge Act corporations. To date, most of the investments made jointly by Edge Act corporations and the IFC have been in the fast-growing field of development corporations. In a recent financing, for instance, the Private Development Corporation of the Philippines sold shares totaling $6 million equivalent to the IFC, to ten Edge Act corporations and one Agreement corporation, to three other United States private investors, and to four banks in other countries; in addition, the Philippine institution received loans from the World Bank and the Agency for International Development (AID) of $15 million and $7 million, respectively.

The participation of a governmental agency, however, does not entail a guarantee of the Edge Act corporation's investment. If such a guarantee is desired, the Edge Act corporation may apply to the AID. The AID has an insurance program for new private United States investments in underdeveloped countries that covers three types of risks: inconvertibility, expropriation, and damages due to war or civil disturbances. Edge Act corporations are steady users of this facility.

OUTLOOK

Edge Act corporations, as has been shown, are a highly adaptable instrument of international finance and enhance the range of activity of United States commercial banks. An intensified use of such corporations therefore may be expected whenever the general conditions for expanded international trade and financial operations are favorable. This was the case in the early 1920's when Edge Act and Agreement corporations first blossomed. It has been the case again since the late fifties following the end of the postwar reconstruction period and the relaxation of exchange controls. In order to participate fully in the recent growth of international commerce and investment, United States banks "rediscovered" the Edge Act instrument.

A substantial further increase in Edge Act (and possibly also in Agreement) corporation activities may thus, in a broad sense, depend upon the future growth of international trade and investment. Currently, of course, economic transactions among the industrialized countries are continuing to rise. Furthermore, quite a few newly emerging nations are seeking to avail themselves of the managerial and financial capabilities of the industrialized countries through private as well as through public channels. There is a distinct possibility, therefore, of a continued rise in the activities of Edge Act corporations and hence in their role in United States foreign economic relations.

Fiftieth Anniversary of the Federal Reserve System-Incorporation of the Federal Reserve Bank of New York*

The seal of the Bank which appears on the front cover of the *Review* indicates that the Federal Reserve Bank of New York was incorporated on May 18, 1914. This major step toward the opening of the Bank for business on November 16, 1914 required a number of preliminary actions. For example, the Organization Committee established by the Federal Reserve Act—composed of the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency—had to complete the work of designating Federal Reserve Districts and of fixing the location of the new Reserve Banks within the Districts. The Committee then had to file with the Comptroller a certificate containing this information.

National banks, which were required to become members of the new system if they were to keep their national charters, had been given sixty days following passage of the act in which to signify their acceptance of its terms and provisions. The action was not required of state banks and trust companies, which were free to decide individually whether or not to apply for membership. By April 2, 1914, when the lines of the new Districts and locations of Reserve Banks were announced, 477 national banks had submitted their assent in this District, which then encompassed only New York State. Based on the provision that subscriptions equal 6 per cent of capital stock and surplus of each member bank, the capital subscription of this Bank was estimated to exceed $20 million.

With the minimum subscription requirement ($4 million for each Federal Reserve Bank) thus satisfied, the Organization Committee designated as incorporators five of the commercial banks which had filed applications for membership. The five incorporators of the New York Bank, in the order of their listing, were the National Commercial Bank, Albany, National Park Bank, New York, Marine National Bank, Buffalo, First National Bank, Syracuse, and Irving National Bank, New York. (As a result of various changes in organization, none of these banks survive under exactly the same name today.) These incorporators executed a certificate of organization specifying the name, the jurisdiction, the capital structure, the membership, and other attributes of the new Bank. The certificate also stated that it "is made to enable those banks executing same, and all banks which have subscribed or may thereafter subscribe to the capital stock of such Federal reserve bank, to avail themselves of the advantages of this [Federal Reserve] act".

The completed certificate was filed with the Comptroller of the Currency on May 18, 1914. Under the terms of the Reserve Act, incorporation was automatic upon this filing.

Although the corporate life of this Reserve Bank began on that day, much remained to be done before the November opening. In the intervening time, positions on the Board of Directors were filled as prescribed by the Federal Reserve Act, bylaws were adopted, and accounting procedures established.

The franchises of the Reserve Banks were originally granted for a specified period of twenty years—perhaps an echo of the historical controversies involving the First and Second Banks of the United States, and quite possibly also a reflection of the uncertainty of how the new System would work out. This limiting feature was removed by an act of Congress in 1927.

*The fifth in a series of historical vignettes appearing during the System's anniversary year.

Publications of the Federal Reserve Bank of New York

The following publications are available free (except where a charge is indicated) from the Public Information Department, Federal Reserve Bank of New York, New York, N. Y. 10045. Copies of charge publications are available at half price to educational institutions.

DOMESTIC MONETARY ECONOMICS

1. MONEY: MASTER OR SERVANT? (1954) by Thomas O. Waage. A 48-page booklet explaining in nontechnical language the role of money and banking in our economy. Includes a description of the structure of our money economy, tells how money is created, and how the Federal Reserve System influences the cost, supply, and availability of credit, as it seeks to encourage balanced economic growth at high levels of employment.

2. THE MONEY SIDE OF "THE STREET" (1959) by Carl H. Madden. A 104-page booklet giving a layman's account of the workings of the New York money market and seeking to convey an understanding of the functions and usefulness of the short-term wholesale money market and of its role in the operations of the Federal Reserve. 70 cents per copy.

3. FEDERAL RESERVE OPERATIONS IN THE MONEY AND GOVERNMENT SECURITIES MARKETS (1956) by Robert V. Roosa. A 105-page booklet describing how Federal Reserve operations are conducted through the Trading Desk in execution of the directions of the Federal Open Market Committee. Discusses the interrelation of short-term technical and long-range policy factors in day-to-day operations. Has sections on the role of the national money market, its instruments and institutions, trading procedures in the Government securities market, what the Trading Desk does, the use of projections and the "feel" of the market, and operating liaison with the Federal Open Market Committee.

4. OPEN MARKET OPERATIONS (1963) by Paul Meek. A 43-page booklet describing for the interested layman or undergraduate student how open market operations in United States Government securities are used to cope with monetary stresses and promote a healthy economy.

5. DEPOSIT VELOCITY AND ITS SIGNIFICANCE (1959) by George Garvy. An 88-page booklet discussing the behavior of deposit velocity, over the business cycle and over long periods, with emphasis on the institutional and structural forces determining its behavior. 60 cents per copy.

INTERNATIONAL ECONOMICS

6. MONETARY POLICY UNDER THE INTERNATIONAL GOLD STANDARD, 1880-1914 (1959) by Arthur I. Bloomfield. A 62-page booklet analyzing, in the light of current monetary and banking theory, the performance and policies of central banks within the framework of the pre-1914 gold standard. 50 cents per copy.

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