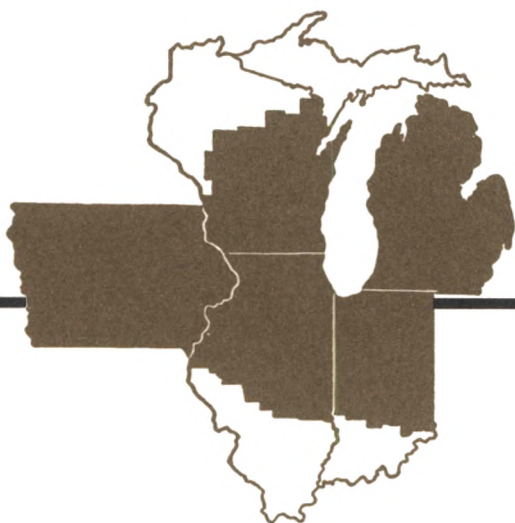


A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1963 November



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Trends in banking and finance

Preliminary estimates indicate that the flow of private short- and long-term United States capital abroad abated sharply in the third quarter of 1963 from the record levels of the first and second quarters of the year. The decline may be attributed in part to a series of monetary and fiscal policy actions adopted and proposed in recent months to help reduce the continuing large deficit in the United States balance of international payments.

In mid-July, the Federal Reserve Banks raised their discount rates from 3 to 3.5 per cent. In addition, the ceiling on interest rates commercial banks are permitted to pay on time money—other than passbook savings—deposited for three to 12 months was raised to 4 per cent, the same ceiling as was in force on time deposits of one year and over. At the same time, the President requested Congress to impose a temporary “interest equalization” tax on United States purchases of foreign securities from nonresidents.¹

¹For a review of the proposed interest equalization tax see “Foreign Long-Term Borrowing in the United States,” *Business Conditions*, September 1963.

The increases in the discount rate and interest rate ceiling together with greater Federal Reserve emphasis on providing reserves through the discount window exerted upward pressure on domestic short-term interest rates. However, the continuing high level of domestic unemployment made it undesirable to transmit the upward pressure fully to long-term interest rates. Higher long-term rates would tend to restrict investment in new domestic facilities. Raising the interest rate ceiling on time deposits contributed to higher across-the-board short-term interest rates by giving banks greater leeway in bidding for three to 12 month deposits. On the other hand, the increased inflow of time deposits encouraged the banks to seek additional longer-term investments, bidding up the prices of long-term securities and tending to at least partially offset upward pressures on long-term rates.

Short-term rates rise

Since the end of June, when anticipations of an increase in the discount rate began to exert a noticeable impact on short-term inter-

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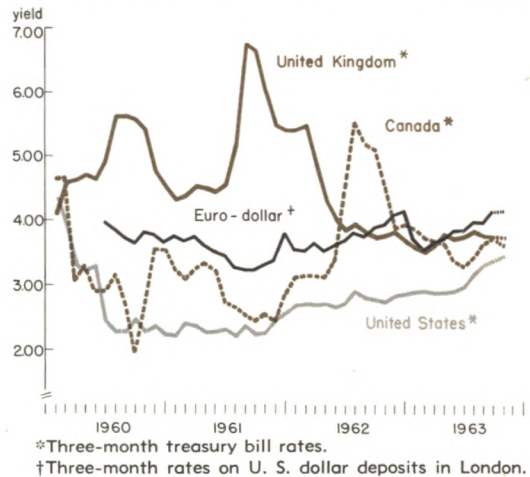
est rates, yields on three-month Treasury bills have increased about .5 per cent to just under 3.5 per cent. At the same time the average yield on long-term Government bonds rose only slightly—from 4 per cent to 4.07 per cent—despite the additional upward pressure exerted by the recent acceleration in business activity and a large-scale Treasury refunding. The latter increased the volume of long-term securities outstanding substantially, lengthening the average maturity of the marketable public debt from 4 years 11 months to 5 years 3 months, the longest in seven years.

Banks have bid vigorously for time deposits. At mid-October, many large banks were offering 3.75 per cent interest on three to six month negotiable time certificates of deposit, compared with the ceiling rate of 2.5 per cent three months earlier. Some banks also offered 3 $\frac{7}{8}$ per cent on six to nine month CDs, $\frac{5}{8}$ per cent more than in mid-July. These higher rates attracted a considerable volume of funds. Large New York City banks increased their volume of outstanding CDs more than 400 million dollars, or almost 20 per cent, in the three months from mid-July to mid-October against an increase of only 11 per cent in the comparable 1962 period.

The total increase in time deposits of individuals, partnerships and corporations—other than passbook savings—at large banks throughout the country was more than 750 million dollars in this period, over twice as much as a year earlier. At the same time, passbook savings, on which the interest rate ceiling remained at 3.5 per cent for deposits held less than one year and 4 per cent for over one year deposits, rose less rapidly than in the 1962 period.

Higher short-term rates appear to have contributed to the slowdown in the outflow of short-term capital in the third quarter. The

Spread between short-term interest rates in United States and abroad narrows in recent months



outflow is estimated to have declined to only about half that of the second quarter when recorded short-term outflows totaled over 500 million dollars.

Capital attracted to highest return

Short-term United States capital movements abroad generally take the form of bank loans, trade credit and investments in foreign liquid assets. Bank loans and trade credit are usually denominated in dollars—and must be repaid in dollars—while investments may be in either dollars or foreign currency. American capital is transferred abroad when net returns there are greater. Capital denominated in dollars is generally transferred in response to interest rate differentials. Capital denominated in foreign currency is influenced not only by interest rate differentials but also by the risk of unfavorable movements in exchange rates that may occur between the time the funds are moved abroad and the time they are reconverted into dollars. Investors may hedge against this risk, if

they wish, by the simultaneous purchase of a like amount of United States dollars for future delivery. Such purchases are called forward cover. Hedged movements respond primarily to the net spread—commonly referred to as the net incentive—between interest rate differentials and the cost of hedging or purchase of forward cover.

The cost of forward cover is the difference between the cost of United States dollars for immediate delivery—the spot exchange rate—and the cost for future delivery—the forward exchange rate. When the forward exchange rate is below the spot rate, the forward rate is said to be at a discount. When the forward exchange rate is above the spot rate, the forward rate is said to be at a premium.²

When the gross interest rate spread is equal to the cost of forward cover, there is no motivation to transfer hedged capital in response to international interest rate differentials and interest rate parity is said to exist.

Although Canada raised its discount rate to 4 per cent from 3.5 per cent in August, only one month after the United States discount rate was raised to 3.5 per cent, Canadian short-term interest rates rose somewhat less in the three months since mid-July than rates in this country. By mid-October, the gross spread between rates on three-month

Treasury bills in Canada and the United States, which had favored Canada by about .25 per cent, was reduced to only a few percentage points. Interest rates on three-month British treasury bills remained relatively stable during this period and the gross spread between American and British rates narrowed from over .50 per cent in favor of British bills to less than .25 per cent.

The changes are similar with respect to the incentives for hedged transactions. In mid-July the net incentive favored Canada by about .20 per cent as a result of somewhat higher Canadian short-term interest rates and a slight discount in the price of the forward Canadian dollar. Three months later, the net incentive favored Canada by less than half as much. The decline in the spread between American and Canadian interest rates was in part offset by a reduction in the discount on the forward Canadian dollar. The discount on forward British pound sterling changed only slightly in this period, but as the spread between American and British short-term interest rates declined sharply, the net incentive to transfer capital abroad on a covered basis turned in favor of the United States.

Possibly more important than the effects of interest rates on capital flows have been the effects of the policy actions in increasing confidence in the ability and willingness of this country to defend the dollar. This has served to diminish the incentive to transfer funds abroad in anticipation of a depreciation of the dollar relative to gold and other currencies. Sharply higher short-term interest rates have been proposed as a solution to the balance of payments problem, particularly by foreigners.

Tax slows capital outflow

Although Congress has yet to take final action on the proposed “interest equaliza-

²The 3-month forward discount or premium is often shown as a percentage to permit ready comparisons with interest rate differentials. The percentage discount or premium is computed, at first approximation, by dividing the difference between the spot and the 3-month forward exchange rates by the spot rate and multiplying by 4 to convert to an annual interest rate basis. For example, if the spot U. S. dollar-British pound sterling exchange rate were \$2.80 for £1 and the 3-month forward rate \$2.78 for £1, the forward dollar would be selling at a premium equal to $(.02 \div 2.80) \times 4$ or 2.86 per cent. Likewise, the forward pound would be selling at a discount of 2.86 per cent.

tion" tax, uncertainty surrounding its adoption has affected long-term capital movements. Foreign borrowers and domestic lenders alike are hesitant about entering into agreements without full knowledge of the tax cost. As a consequence, scheduling of new foreign securities has slowed almost to a standstill. Nevertheless, because the proposed tax exempts new securities registered but not sold before July 18, third quarter figures on long-term capital outflows from the United States will still show a sizable outflow.

The almost complete cessation of new foreign security sales in this country may be attributed more to the uncertainty surrounding congressional approval of the tax than to the penalties of the tax itself. It has been estimated that once Congress acts on the tax proposal, regardless of the outcome, the sales of new foreign issues here will rise again although probably not to the unusually high levels of the first half of the year.

The proposed tax has also created a dual market for outstanding foreign securities. Securities sold by nonresidents frequently sell at a somewhat lower price than the same securities sold by residents. The difference in price roughly reflects the buyer's estimate of the probability of the tax being adopted. Recently, for example, a share of Royal Dutch Petroleum (a Dutch concern) traded on the New York Stock Exchange at \$47 $\frac{3}{8}$ if the seller was a resident and at \$46 $\frac{7}{8}$ if the seller was a nonresident. This difference in price is less than the amount of the proposed tax, reflecting the market's doubts about its passage in the present form.

Monetary and fiscal actions have a fairly prompt impact on capital movements. Effects on other components of the balance of payments would take place more gradually. For example, if higher short-term interest rates discourage business firms from borrowing

enough to create upward price pressures on commodities, this would have a longer-term favorable effect on the trade balance. Slower increases in the prices of domestic products in comparison with foreign prices, would help to increase exports. (For a more detailed analysis of recent price trends see "Foreign Trade—the United States Competitive Position" on page 11 of this issue.) It has long been noted that a country can better achieve a lasting equilibrium in its balance of international payments by increasing exports than by restricting capital outflows.

District business loans strengthen

Business loans outstanding at major banks in Seventh District leading cities rose 165 million dollars in the third quarter of 1963, well over twice as much as in the same quarter of 1962. At the same time business loans at large banks throughout the country rose less than in 1962. At the end of September, District business loans were almost 12 per cent above year-earlier levels. This rate of expansion was almost twice as fast as for the larger banks in all United States leading cities and compares with an increase of less than 8 per cent in the previous 12 month period when District loans expanded at about the national average.

The recent strengthening in District business loan demand is evident for almost all industry groups except retail outlets and miscellaneous durable goods. Loans to petroleum firms, commodity dealers and chemical and rubber concerns showed particular strength, increasing 38, 30 and 19 million dollars, respectively, more than in the third quarter of 1962. Bank loans to finance companies, which are not included in business loans, also expanded sharply, ending the quarter 50 million dollars above the year-ago level.

Stock prices and business prospects

After a dull performance in the early summer, common stock prices surged upward and in September the most widely used indexes broke through the previous record highs reached in December 1961. This development was taken as a favorable omen not only for a further rise in the market but also for general business prospects.

Stock market trends long have been accorded an almost mystical significance. Some believe changes in stock prices directly measure the level of business activity. Others solemnly repeat the adage, "the stock market discounts everything six months in advance." Observers strain at personification: "What is the market trying to tell us? I think the market is saying. . . ." In late summer the message that the business outlook was excellent seemed to be coming through loud and clear. But a leveling of the stock indexes in October gave rise to doubts. Do market trends foretell business prospects in a useful manner? Let's look at the record.

Why should the market tend to lead?

Stock price changes were more generally accepted as a forecasting aid in the Twenties than in recent years. This was partly because the entire statistical framework for analyzing business conditions was relatively undeveloped at that time.

A 1927 book, *Forecasting Business Conditions*, by Hardy and Cox, observed that,

Perhaps the most widely accepted principle in relation to the subject of our study is the doctrine that changes in the stock market

forecast similar changes in the volume and direction of business activity.

The authors went on to voice considerable skepticism toward the market's dependability as a short-run indicator. Their doubts were validated by subsequent developments. Business activity began to decline a month or two before the market crash in 1929 and abortive stock price revivals in 1930 and 1931 raised false hopes of an early end to the business depression.

In recent years most writers on business forecasting have concluded that changes in stock price indexes *tend* to lead changes in business activity but that the relationship is not stable. Nevertheless, when attempts have been made to draw up lists of statistical indicators which customarily move in advance of general business activity an index of stock market price almost invariably is included.

The rationale behind the use of stock price indexes as an indicator of future business prospects is clear enough. The major stock exchanges are among the most perfectly competitive markets in the entire economy with many well-informed buyers and sellers. Prices of shares are determined by the decisions that millions of individuals and institutions throughout the world communicate to traders in the organized stock exchanges. Although some investors buy or sell on the basis of formulas, "systems" or hunches, most decisions are based upon evaluations of a vast array of detailed information on the economy and on individual business firms. Rising prices indicate that optimistic senti-

ment is predominant and that buyers are taking the initiative. In a falling market the opposite conditions prevail—selling pressure is relatively strong because of the growth of pessimistic attitudes.

Changes in the level of stock prices tend to have a direct impact on business conditions. First, since stock prices are widely accepted as a leading indicator, increases or decreases in the indexes may cause businesses and consumers to become more aggressive or show greater caution in spending and in making investment commitments. Second, individuals who hold stocks find that their wealth and borrowing power—using stocks as collateral—fluctuate with stock prices and their spending may be influenced by market movements even though they have not realized gains or losses through sales of their holdings. Third, businesses that contemplate selling stock to finance expansion and perhaps provide a base for additional debt may activate or postpone such plans depending upon whether stock prices rise or fall.

The level of the stock market as measured by common stock price indexes has strong appeal as an economic barometer for a number of reasons. First, changes in prices reflect changes in investors' evaluations of future corporate profit trends, with the aggregate value of all common stocks thus presumably measuring the going concern value of all corporate business. Second, in contrast with most other economic measures, which become available a month or more after the period covered, stock price indexes are calculated every hour of the trading day. Third, the latest stock price indexes are readily available to all interested parties because they are reported regularly over the "ticker," on the radio and in virtually all major newspapers. Fourth, millions of individuals follow the market because they have a personal interest

in stock price indexes as owners or potential owners of stock.

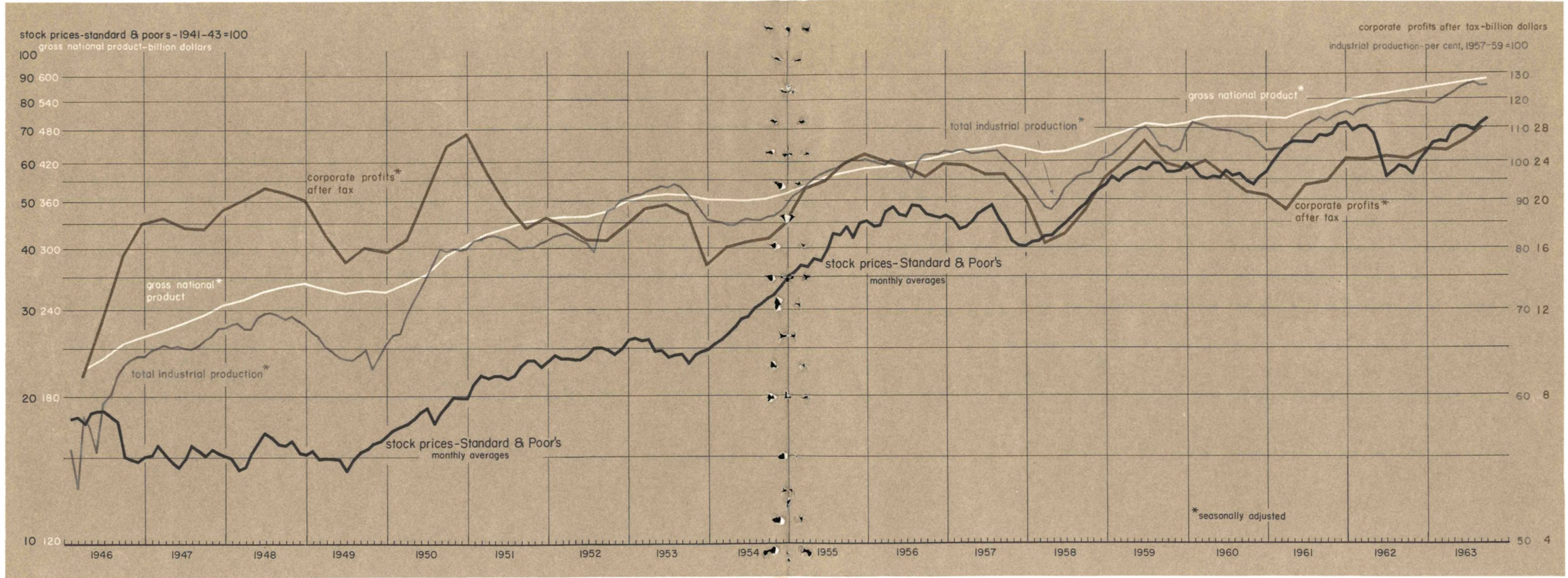
Substantial changes in stock prices often have a highly speculative basis—for example, the sharp drop in September 1955 following President Eisenhower's heart attack. But most stockholders presumably buy and sell on the basis of changes in the prospects for corporate profits (after taxes) available for dividends or reinvestment.

Emphasis on profits does not invalidate the market as a barometer of business activity. For obvious reasons corporate profits tend to rise and decline with the level of business. In the early stages of a business upturn or downturn, changes in business sales bring even greater relative changes in profits because a substantial proportion of business costs are fixed or relatively fixed during short periods of time. After an upswing has been under way for a year or more, rising costs usually begin to catch up with or surpass the rise in sales. As a result, total corporate profits and especially profits as a per cent of sales have tended to decline or rise before general business activity. For this reason corporate profits after taxes, along with common stock prices, appear to be a measure that often changes direction before business activity.

Does the market forecast changes in corporate profits accurately? If so, the market averages would move fairly smoothly some distance ahead of profits. But this has not been the case as the chart on pages 8-9 shows. There is also the matter of relative changes in magnitude over time. In 1962 corporate profits after taxes were nearly the same as in 1959 while industrial production was 12 per cent higher and stock prices averaged 9 per cent higher. In a longer-term comparison 1962 corporate profits were 20 per cent greater than in 1948 while industrial production was up 73 per cent and the index of

Have changes in stock prices "called business turns"?

The postwar record shows many erratic movements.



common stock prices had increased fourfold.

The postwar record

Anyone who has observed the continuing fluctuations in stock prices realizes that it is not easy to determine when a genuine "turn" occurred in the market prior to a peak or trough in the business cycle even if the event is long past. The financial press carries highs and lows in the averages for each trading day.

Often trends are established for several days, even weeks and months, only to be reversed several times before a peak or trough in the business cycle occurs.

Some who follow the market try to interpret the highly erratic day-to-day movements. Business cycle analysts normally employ monthly averages which smooth out some random movements. Standard and Poor's composite index of 500 industrial, rail and

utility stocks is most commonly employed for analytical purposes. How has this measure performed in relation to general business activity during the postwar period?

The S & P composite index averaged 49 per cent higher in September 1963 than five years earlier. In the 60 months between these dates the index rose 36 times and declined 24 times. The longest "run" in one direction was seven months and the second longest was

four months. Between the start of the current business expansion in February 1961 and September 1963 the index rose 17 per cent. During the period there were 19 increases and 12 declines. The longest consecutive run in one direction was only four months and the index changed direction from one month to another no less than 14 times out of a possible 31!

There have been eight business cycle turns

in the period from 1946 to date. Peaks were reached in 1948, 1953, 1957 and 1960 and troughs occurred in 1949, 1954, 1958 and 1961. In each case the change for better or worse was preceded by at least one similar movement in stock prices. But in some periods, particularly before the peaks of 1957 and 1960, a market decline was reversed in the months immediately before the turn in business. On several occasions, most noticeably in 1946 and 1962, there were relatively sharp changes in the market that were *not* followed by comparable changes in business activity. Assuming a change of 5 per cent or more to be a “swing” in the monthly average of the Standard and Poor’s composite index, there have been 11 declines in the market and 13 rallies since 1946 as compared with only four business cycle troughs and four peaks.

In retrospect the sharp drop in the market in 1962—21 per cent from March to June with no appreciable recovery until November—presents one of the most noteworthy false signals provided by the stock price indexes. Forecasts of a decline in general business activity became widespread in October 1962 just at the time that a renewed upswing was about to begin.

Only one other postwar decline in stock prices—as measured by changes in monthly averages—was as severe as that of 1962. Between May and November 1946 the composite index dropped 21 per cent. This development, however, was followed by two years of vigorous expansion in business activity during which time the index never approached its 1946 high.

A different sort of false signal was offered by the stock market in 1957 when the Standard and Poor’s index rose 12 per cent between February and July. The latter month afterwards was accepted widely as the peak

of the business expansion. The same story was retold, although less emphatically, in 1960 when the market rose 4 per cent between March and June although May 1960 later was accepted as a business peak.

Reading the market’s message

Historical comparisons of trends in common stock prices and business activity reveal no clear or dependable pattern. Since the early postwar period, stock prices have risen far more than most broad measures of activity and many zigs and zags in the market have not had counterparts in business fluctuations. In short, if the market is “trying to tell us something” about short-term business prospects, we have not yet learned its language.

In the long run, on the other hand, stock market prices measure public confidence in the future of American prosperity. Market appraisals of the worth of business firms, individually and collectively, comprise a vital part of our economic intelligence.

The Two Faces of Debt

A new booklet entitled **The Two Faces of Debt** has recently been published by the Federal Reserve Bank of Chicago. It presents a description of the role of debt in our economy and the distribution of debt among major groups of debtors and creditors. Copies of this booklet, as well as **Modern Money Mechanics**—a workbook on deposits, currency and bank reserves, are available to banks, business organizations and educational institutions from the Research Department, Federal Reserve Bank of Chicago, Box 834, Chicago, Illinois 60690.

Foreign trade—the United States competitive position

Can United States exports be increased enough to eliminate the deficit in its balance of international payments? This possible remedy is given high priority in American international economic policy. Businessmen are urged to seek out additional export opportunities and Congress has authorized expansion and improvement of insurance and financing facilities that aid private exports. But many persons call attention to the fact that this country now exports nearly 5 billion dollars more of goods each year than it imports and many observers express doubts that this surplus can be boosted substantially. Others not only believe that boosting exports is the most desirable attack on the balance of payments problem but also that this approach has good prospects of succeeding.

One view — reiterated recently by the Brookings Institution, a privately endowed research organization — is that European wages and prices will continue to rise fairly rapidly and that this will go a long way toward ending, possibly in five years, the deficit in the United States balance of payments.¹ The Brookings study also assumes a faster rate of economic growth in the United States, both relative to its own record in recent years and relative to the growth rate in Western Europe in the years ahead. While there are plausible reasons for making these

¹Such deficits, which have occurred almost every year since 1950, result from the fact that the United States spends, lends, invests and gives away abroad more than foreigners spend, lend and invest in this country.

assumptions, placing major emphasis on continued inflation abroad to provide a solution to our balance of payments problem leaves us in the awkward position of relying on the failures of others in order to solve our own problems. Whether these assumptions, and the conclusions based upon them, prove to be correct will be determined largely by the answer to a more basic question: is the competitive position of the United States strengthening relative to that of its major world trading competitors?

Prices and wages rising

Prices and wages have advanced during the last few years in both the United States and Europe. But in the United States, consumer prices rose less rapidly than in France, Germany, Italy and Britain. This has been true even if allowance is made for changes in offi-

Prices and wages, 1962

| | Consumer prices | Wholesale prices | Hourly earnings in manufacturing |
|---------------------|-----------------|------------------|----------------------------------|
| | (1958 = 100) | | |
| United States . . . | 105 | 100 | 113 |
| France | 119 | 113 | 133 |
| Germany | 109 | 103 | 140 |
| Italy | 109 | 101 | 132 |
| United Kingdom . | 110 | 107 | 127 |

SOURCE: OECD, *General Statistics* and U. N., *Monthly Bulletin of Statistics*, July 1963.

cial values of currencies. France's prices probably rose somewhat more than they would have in the absence of the 17 per cent devaluation of the French franc in December 1958, and Germany's prices may have been held down somewhat by the upward revaluation of the German mark in March 1961. Wholesale prices were stable here but advanced in the Old World—though only nominally in Italy.

The relative price stability in the United States must be attributed in large part to the ample capacity in major industries and a measure of restraint in wage settlements and fringe benefits. These settlements, of course, are related to the over-all job market and have been influenced by the relatively high level of unemployment.

It does not necessarily follow from the above, however, that the United States export position has improved *in proportion*. For export and import prices, which are important factors affecting the quantities of American goods demanded by foreigners and the quantities of foreign goods demanded by Americans, do not necessarily move in step with the broad gauge price indexes. This is especially true for a country like the United States whose exports and imports are a much smaller fraction (8 per cent) of gross national product than is the foreign trade of most other industrial nations (30 to 40 per cent).

Unfortunately, the available evidence that pertains more directly to exports and imports also is less than adequate, largely because of difficulties in representing in one or a few numbers the composite effects of price and

volume changes in many different commodities. Nevertheless, based upon available information, it appears that export prices, in terms of dollars, rose in the United States, Germany and Britain, and fell in France and Italy from 1958 to 1962. Import prices declined in each of the five countries. Both export volume and import volume in 1962 were larger for each country than in 1958.

There is no consistent pattern between price changes and volume changes. For example, although prices (unit values) of exported goods rose somewhat more steeply in Germany than in the United States, Germany was able to boost its exports substantially more. And although German import prices fell less than those in the United States, Germany's imports rose at a faster rate. On the other hand, Italy, whose prices declined most on both sides of the trade ledger, ranked first in gains in both exports and imports.

In all the countries, export prices rose

Export-import prices and volume, 1962

| | Export prices ^a | Export volume | Import prices ^a | Import volume |
|-------------------------------|----------------------------|---------------|----------------------------|---------------|
| | (1958 = 100) | | | |
| United States..... | 103 | 117 | 96 | 127 |
| France..... | 96 | 150 | 95 | 144 |
| Germany..... | 104 | 144 | 97 | 171 |
| Italy..... | 93 | 198 | 90 | 211 |
| United Kingdom..... | 103 | 116 | 97 | 122 |
| Common Market..... | 100 | 147 | 95 | 159 |
| European Free Trade Area..... | 102 | 125 | 97 | 136 |

^aExpressed in United States dollars in order to reflect revaluations of national currencies against the dollar. Index figures not strictly comparable because of varying procedures used by countries in compiling indexes.

SOURCE: IMF, *International Financial Statistics* and U. N., *Monthly Bulletin of Statistics*, July 1963.

relative to import prices and the rise in import volume generally outpaced the advance in export volume. The only exception to this is France, where export and import prices moved nearly in step but import volume was up less than export volume.

A convenient way to measure the relative strengths of exports and imports is to let the ratio of import volume to export volume of each country be equal to one for the base year (1958).

Import-export ratios, 1962
(1958 = 1.00)

| | |
|--------------------------|------|
| France | 0.96 |
| United Kingdom | 1.05 |
| Italy | 1.07 |
| United States | 1.09 |
| Germany | 1.19 |

Of the five countries compared, France was the only one whose export volume rose faster than import volume from 1958 to 1962.

The foregoing data suggest a few conclusions. First, relatively small percentage increases in the fairly comprehensive measures of domestic wages and prices do not assure a country a favorable standing in the prices and the volume of goods exported. This is partly because the commodity composition of total exports differs from that in the wholesale and consumer price indexes. Prices and wages rose considerably more in France than in the United States, but it was able to boost its export volume by about three times as much due partly to its currency devaluation in December 1958. The fact that France's import volume advanced only a little less, despite higher franc prices of its imports after devaluation, may be largely attributable to the new trading opportunities which arose as the members of the Common Market began to reduce their tariff barriers on January 1, 1959. In contrast, Germany's export expansion was slowed and its import growth

boosted by the upward revaluation of the mark in March 1961.

Second, a fall in import prices *relative to* export prices tends to favor growth in imports relative to exports. In the case of the industrial countries considered here, the relative growth of imports reflects an improvement in their terms of trade vis-a-vis the countries whose major exports are raw materials. In other words, prices of their exports tended to rise relative to prices of their imports. The shifts in these price ratios, 1958-62, for the main regions of the world were:

| | |
|------------------------------------|-----|
| United States and Canada | 106 |
| Common Market | 105 |
| European Free Trade Area | 105 |
| Latin America | 96 |
| Africa | 90 |
| Middle East | 89 |

SOURCE: U.N., *Monthly Bulletin of Statistics*, July 1963.

Third, the greater relative increase in the foreign trade of Germany, Italy and France, despite greater percentage increases in wages and prices, reflects the high rate of growth of trade within the Common Market. The smaller relative increase in foreign trade of the United States reflects the slower rise of demand in Latin America and Canada, which are important United States markets.

Another possibility for gauging a country's "exporting strength" is to express its export (import) surplus as a per cent of its total merchandise trade during a given period. For the five countries considered, the results are given in the table on page 14.

The two countries with an export surplus in 1958 (United States and Germany) were still net exporters in 1962, though by a somewhat smaller margin. Countries with an import surplus in 1958 (France, Italy, United Kingdom) were still net importers in 1962—

by an even larger margin—except France which had nearly eliminated her import surplus.

Wages, output and prices

The most basic ingredient of international competition, of course, is comparative production costs. While relative movements of production costs are affected by many things, possibly wages loom largest. But while better information is available for wages than for most other industrial costs, the implications of wage trends for shifts in competitive strength are not easily appraised. Hourly earnings in manufacturing do not reveal whether or not the cost gap between United States and European goods that are internationally traded narrowed in relative terms between 1958 and 1962. A rising wage trend might be reinforced, or offset, by movements of fringe costs, changes in output per man-hour and other factors.

On an hourly basis, manufacturing workers in major European countries in 1962 earned on average about one-third more than

in 1958; in the United States the rise was about one-eighth. But because of their low starting point, representative European wages in 1962 were on the whole still only from one-fifth to two-fifths of the comparable American average, and in *absolute* (rather than relative) terms the gap widened from 1958 to 1962.

Fringe costs, which are not included in the wage data, are often a sizable share of total labor costs, and the relative importance varies widely from country to country. In Italy, fringe benefits are almost equal to “regular” earnings. In France they account for about two-thirds and in Germany for about half, but in the United Kingdom fringe benefits are only about one-seventh of regular earnings. The comparable ratio in the United States is about one-fifth.

Combined hourly and fringe payments in major Western European countries range from approximately one-fourth (Italy) to one-third (Germany) of the comparable United States total. Including fringe benefits has the effect, therefore, of narrowing the

range of differences in total hourly wage costs in Europe while at the same time bringing the *average* European hourly wage costs closer to the United States figure. Such a broad, multi-country average, of course, conceals large differences. This is also true of country averages, which gloss over differences among regions, industries and firms. Nevertheless, wage differences

Total trade flows and trade surpluses

| | Value of foreign trade | | Export (import-) surplus | | Ratio of surplus to value of foreign trade | |
|----------------------|------------------------|----------------------|--------------------------|--------------------|--|-------|
| | 1958 | 1962 | 1958 | 1962 | 1958 | 1962 |
| | (millions) | | | | (per cent) | |
| United States | | | | | | |
| (dol.) | 31,307 | 38,115 | 4,533 | 5,173 | 14.5 | 13.6 |
| France (fr.) | 45,070 ^a | 73,450 ^a | —2,050 ^a | — 750 ^a | — 4.5 | — 1.0 |
| Germany (m.) . . . | 68,810 ^a | 102,040 ^a | 5,150 ^a | 3,860 ^a | 7.5 | 3.8 |
| Italy (L.) | 3,621 ^b | 6,701 ^b | — 399 ^b | — 869 ^b | —11.0 | —13.0 |
| United Kingdom | | | | | | |
| (stg.) | 7,066 | 8,441 | — 430 | — 543 | — 6.1 | — 6.4 |

^a Figures given in billions, with two decimal places only. In converting to millions, a zero has been added.

^b Billions.

14 SOURCE: IMF, *International Financial Statistics*, July 1963.

Comparative wage earnings in manufacturing

| | Hourly earnings in manufacturing | | Difference from U. S. | | Other nations as per cent of U. S. | |
|------------------|-------------------------------------|------------------|--------------------------|-------------------|--|-----------------|
| | 1958 | 1962 | 1958 | 1962 | 1958 | 1962 |
| United States... | \$2.11 | \$2.39 | | | | |
| France..... | .38 | .50 | \$1.73 | \$1.89 | 18 | 21 |
| Germany..... | .54 | .81 | 1.57 | 1.58 | 26 | 34 |
| Italy..... | .35 | .40 ^a | 1.76 | 1.99 ^a | 16 | 17 ^a |
| United Kingdom | .78 ^a | .99 ^b | 1.33 | 1.40 | 37 | 41 |

^a 1961 (1962 figures not available).

^b Males.

Note: Figures are dollar equivalents of payments received by (all) wage earners in their national currencies. Conversion into dollars at end-of-year exchange rates.

SOURCE: U. N., *Monthly Bulletin of Statistics*, July 1963.

among leading European industries are far less pronounced than the gap between these industries and their United States counterparts. In 1960, for example, average hourly earnings and fringe benefits in the chemicals and machine tool industries in European countries tended to cluster around the equivalent of \$1; for workers in the United States employed in these industries, the average was more than \$3 an hour.

Any meaningful appraisal of relative unit costs must take into account production per hour as well as wages. Although reliable data are scarce and problems of interpretation are numerous, there can be no doubt that wide differences exist, both in absolute levels of output per man-hour and in the trend of changes in these levels, both among the European countries and between them and the United States. For example, it is estimated that gross production per man-hour in manufacturing increased from 1954 to 1960 by well over 30 per cent in Germany, nearly 30 per cent in France, but slightly less than 20 per cent in Italy, the United Kingdom and the United States.

Since the extent to which an increase in production per man-hour offsets the increase in wages varies, changes in wage cost per unit of output also differ between countries. For example, in the industrial sector (mining, construction and manufacturing) gains in output per hour in France and Germany between 1954 and 1961 offset roughly half the increase in wage cost per hour, hence unit wage cost rose by somewhat more than one-third. In the United States and Italy, on the other hand, output per hour advanced at nearly the same rate as wages,

resulting in only a very small rise in labor cost per unit of output in these countries. In the United Kingdom unit cost rose at a rate almost equal to Germany's, although the two components of unit cost advanced much less rapidly.

It is of great consequence to industry on both sides of the Atlantic how the major determinants of unit labor costs will move in the principal trading nations. If wage costs in Europe increase on average 8 per cent per year while output per man-hour advances only 4 per cent, and if at the same time American wage costs increase 4 per cent per year while output per man-hour increases 3 per cent, Europe's competitive position will worsen on balance.

Any estimate of future changes in comparative output per man-hour among various countries—if anything more than an extension of recent trends—must take into account many things. Commercially useful inventions, for example, may increase production per man-hour faster in one area than another.

The economic integration of the European Economic Community (EEC) and of the

European Free Trade Association (EFTA)—not to mention similar efforts in the less developed countries of Latin America and Africa—might possibly help Western Europe to keep unit wage costs in check. But competitive improvements on this score could be offset by the effects of the new United States tax incentives (accelerated depreciation and tax credit provisions recently enacted) designed to spur a higher rate of capital investment in this country. The currently proposed reduction of corporate income tax rates would tend to have similar effects.

Inflationary pressures in Europe are still another uncertainty. They have lately generated increased interest in public policies on wages and prices and resulted in adoption of programs to restrain these pressures.

Conclusions and outlook

On the basis of presently available information, it is difficult to evaluate the competitive position of the United States in international trade. There is some indication that the United States competitive position vis-à-vis other major trading nations declined somewhat from 1958 to 1962, despite the stability of wholesale prices in this country.

In recent months, however, several countries—especially France and Italy—have experienced a rapidly rising trend in hourly labor costs. If it continues, it may well lead to a strengthening of the competitive position of the United States, but statistics on exports and imports in 1963 hardly suggest that such an improvement has already occurred.

Labor remains in relatively short supply in Europe, while it is relatively abundant in the United States. This should help to maintain stable prices here. In years past, as the economy has moved close to full employment, an accelerated rise of wage rates and prices has followed. It may be necessary, therefore, to

develop wage-making arrangements which permit the country to approach full employment without incurring cost-inflating wage increases. The United States as well as Europe has shortages of particular skills, as education and training have lagged behind changing technological requirements and changing consumer demands.

The growth trends in the labor force in Europe and the United States will diverge during the remainder of this decade. It has been estimated that by 1970 the European Economic Community's labor force will be only 5 per cent larger than it is now, while the working population will be 17 per cent greater in the United States and 7.5 per cent larger in the United Kingdom.

Even if the rate of population increase in Europe should rise above its 1 per cent annual average of recent years and approach the 1.7 per cent annual increase in the United States, it would be many years before the effects of the accelerated trend showed up in the labor force. In the meantime Europe, like the United States, may expect some addition to the industrial labor supply resulting from the shift of manpower "from farms to factories." Whether the momentum of this movement, already significant in the late Fifties, can be maintained in the Sixties will depend in part on how the area's hard fought-out agricultural policy is finally implemented.

In the broadest view, some facets of prospective developments in other industrial countries will tend to favor a net gain in the United States competitive position in world markets in the Sixties. But the evidence is not clear enough to assure that this will be the outcome, and it is unlikely that the sizable deficit in the balance of international payments of the United States can be resolved by attention to exports alone, important as that is.