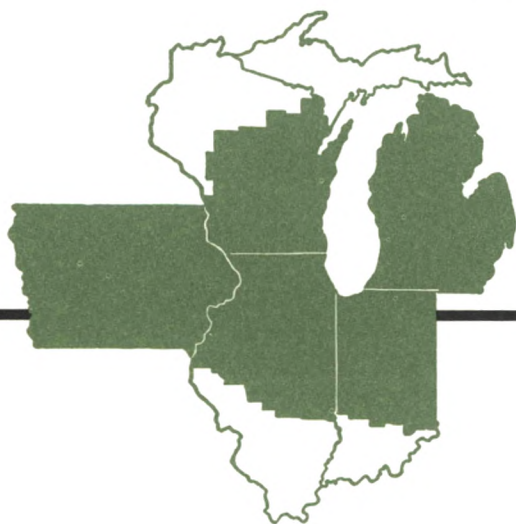


A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1964 September



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Regulation Q: ceiling or umbrella?

Interest rates on commercial bank time deposits, which consist largely of savings accounts, have followed a generally rising trend since the end of World War II. While time deposit rates still are at levels generally lower than those of competitive forms of savings, the gap has narrowed somewhat. The question arises whether limits on time deposit rates prescribed by regulatory agencies are responsible for differences between the rates offered by banks and by other savings institutions.

Early years of regulation

In 1933 the Federal Reserve Board issued its Regulation Q establishing maximum rates to be paid on time and savings accounts as required by the banking act of that year. The objective of the legislation was to limit competition for deposits among commercial banks. It was widely held at the time that bidding among banks for deposits had led to "excessively high" interest rates and that the related search for increased earnings to cover inflated interest costs had contributed substantially to the banking crisis.

The Federal Deposit Insurance Corporation, in its 1934 Report, asserted the belief that "the intent of Congress, through the

granting of these regulatory powers [was] to prevent unsound competition among banks and to check the tendency of competition to raise the rates of interest to levels which may imperil the sound operation of banks." Factual evidence on the relationship between excessively high time deposit rates and the tendency to seek out unsound assets, however, has been too sketchy either to confirm or disprove such a relationship.

Regulation Q initially set the maximum rate member banks could pay on time deposits at 3 per cent. In 1935 the ceiling was reduced to 2.5 per cent in line with declines in market rates of interest, including the rates actually paid on time deposits. Except for minor revisions in 1936 of rates for certain maturities of time certificates of deposit, the legal maximum remained unchanged until 1957.

During the late Thirties and Forties, rates paid by banks were generally well below the regulatory maximums, reflecting the large supply of credit relative to demand. Rates continued at about 1 per cent in the early Fifties, in the United States as well as in the District. Not until the third quarter of 1956 were there any marked advances in rates paid by banks. About that time, banks began to

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compete more aggressively for deposits in order to increase their supply of loanable funds as credit demand continued to expand. Moreover, higher rates paid by competing savings media such as savings and loan associations and credit unions had begun to retard growth of bank time and savings deposits.

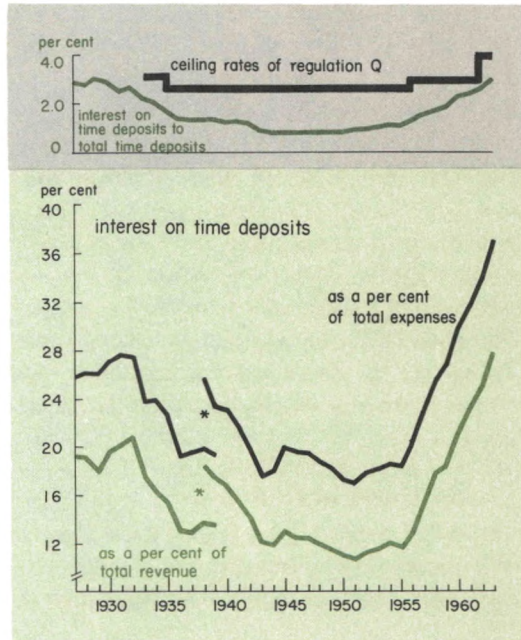
A survey of banks in 43 Seventh Federal Reserve District urban areas revealed that on July 1, 1956, the most frequently reported rate on savings deposits was 2 per cent—a half percentage point below the regulatory ceiling. The survey data for the five major areas are given below:

Maximum interest rates paid (per cent)	Savings deposits (number of banks)	Time CDs
<i>Chicago</i>		
1.5 or less	44	8
2	115	25
2.5	1	20
<i>Detroit</i>		
1.5 or less	22	0
2	5	3
2.5	0	22
<i>Indianapolis</i>		
1.5 or less	0	5
2	9	1
2.5	0	1
<i>Milwaukee</i>		
1.5 or less	9	0
2	17	25
2.5	0	0
<i>Des Moines</i>		
1.5 or less	0	0
2	10	4
2.5	1	7

Renewed interest in time deposits

Rate ceilings on savings and longer-term time deposits were raised in January 1957 from 2.5 to 3 per cent. Commenting on this action, the Federal Reserve Board of Governors stated that

Interest expense relatively greater than before Regulation Q



*Ratios for 1927-38 are computed for aggregate dollar amounts while figures for 1938-63 are averages of individual bank ratios.

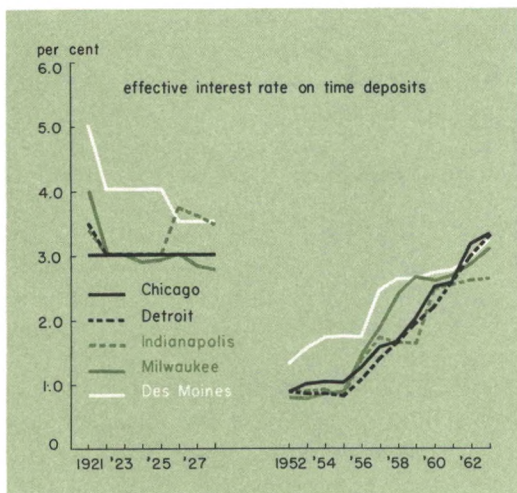
In a period of heavy demands for funds and a relatively high structure of interest rates generally, it would be desirable to permit individual member banks greater flexibility to encourage the accumulation of savings than was available under the existing maximum permissible rates. It also appeared to the Board that there was insufficient reason to prevent banks, in the exercise of management discretion, from competing actively for time and savings balances by offering rates more nearly in line with other market rates.

Although many banks increased rates on time deposits immediately after the change in regulation, it does not necessarily follow that the maximums previously in force had pre-

vented all or even most from doing so earlier. Thus, in late 1956 only about 5 per cent of the urban banks in the Seventh District were paying the maximum permissible rate on savings deposits. Furthermore, while more than 20 per cent of the District's urban banks raised their rates in early 1957—after the change in Regulation Q—the rate hikes in almost three-fourths of these cases represented increases to 2 or 2.5 per cent. Such changes, of course, could have been made before the revision in Regulation Q.

Rates paid by banks generally averaged higher in the Twenties than in recent years (see chart). During these years rates at Des Moines banks were higher than those at banks in other major cities of the District—Chicago, Detroit, Indianapolis and Milwaukee—and apparently this relationship also held in the early Fifties. While Des Moines banks boosted their rates on savings deposits from 2 to 3 per cent in early 1957, it was

In Chicago, Detroit and Milwaukee rates of interest on time deposits higher now than in late Twenties



Announced or advertised rates are used in some of the charts in this article while in others so-called "effective" rates are reported; the latter are computed by dividing actual interest payments during a particular period by an average of balances held during that period. An analysis of data for recent years shows that fluctuations in announced rates on savings deposits at most banks move fairly closely with effective rates on all time deposits combined, undoubtedly reflecting the fact that savings deposits generally constitute the bulk of total time deposits. Indiana has been omitted from some of the tabulations since the state regulation has not been changed concurrently with Federal regulations. Other states that regulate time deposit rates have, in contrast, generally revised their ceilings immediately after changes in the Federal maximums.

not until mid-1959 that most Chicago banks made similar changes.

Prior to the 1957 revision in regulatory ceilings, Detroit banks could have moved rates upward to meet savings and loan competition had they considered it desirable and still have been below the regulatory ceilings. The prevailing rate on savings deposits at Detroit banks in 1956 was 1 per cent. On time certificates of deposit, however, Detroit banks paid the same maximum rate as was available on savings and loan share accounts (2.5 per cent).

The fact that banks in certain of the larger cities maintained interest rates on time and savings deposits at levels below the regulatory ceiling indicates that Regulation Q had not handicapped these banks in competing for savings. Undoubtedly there were factors more important than Regulation Q that contributed to the slower growth of commercial bank savings relative to some other financial institutions. One such factor is the growth in individuals' savings made possible by the generally sustained rise in personal income

since the end of World War II and the effect that rising income may have had on increasing the number of savers and prompting the use of a greater variety of savings forms. In addition, banks may not have sought time funds via rate increases as vigorously as, say, savings and loan associations, partly because, unlike their competitors, they did not have to rely solely on savings funds for loan expansion. Moreover, supplies of credit were ample relative to demand as reflected, for example, in comparatively low loan-deposit ratios.

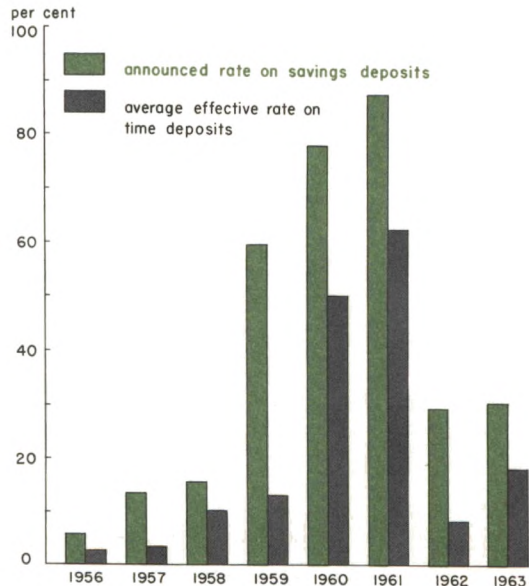
Competition intensifies

The pace of time deposit growth usually quickens, at least temporarily, following rate increases. In the 33 urban areas of the District where prevailing interest rates rose in 1957, the commercial banks reported large increases during the year in savings deposit balances. In contrast, in the 10 areas where the prevailing interest rate remained unchanged, savings deposits declined.

Encouraged by the 1957 response to higher rates and the continued growth of time deposits during the recession year of 1958 and seeking additional funds to accommodate rising loan demands in the face of slow growth in demand deposits, many banks, where regulatory maximums permitted, further increased their rates on time deposits in 1959. During the third quarter of 1959, 34 per cent of the banks in the District's urban areas raised rates paid on savings deposits.

With the rise in market rates of interest from 1960-61 recession lows, pressure for higher ceilings began to mount. Negotiable time certificates of deposit—designed to make time deposits more attractive to corporate investors—were introduced at large Chicago banks in February 1961 and at smaller banks shortly thereafter. (Certificates of deposit had long been available to individuals

Proportion of banks paying Regulation Q's maximum rate generally quite small



Note: Proportion of member and nonmember banks with announced rate the same as Regulation Q ceilings in 43 urban areas of Illinois, Iowa, Michigan and Wisconsin; proportion of banks with average effective rate within 0.50 percentage points of Regulation Q ceilings for all member banks in the four states.

and others in some areas of the District but unlike the new CDs issued by the larger banks, these were not generally considered marketable.) By the end of 1961, declines in negotiable time CDs outstanding appeared likely since the existing ceiling rates would not allow banks to continue to offer rates competitive with yields on other short-term money market instruments.

At that time more than 86 per cent of the District's urban banks were offering the ceiling rate of 3 per cent for savings deposits and nearly all were offering 3 per cent on other types of time deposits. One develop-

ment widely viewed as an indication that banks were limited by the rate ceilings was the increase in the number of banks resorting to "fringe benefits" and non-rate inducements to strengthen their appeal to savers.

Several large Chicago banks announced a switch in late 1961 from semiannual or monthly computation of interest to calculation on a daily basis (that is, interest paid from day of deposit to day of withdrawal). This practice, however, was not generally adopted. A 1962 survey by the American Bankers Association indicated that more than 75 per cent of all banks in the Midwest continued to compute interest semiannually during 1961.

Effective January 1, 1962, Regulation Q was revised to permit member banks to pay 3.5 per cent on savings deposits on hand less

than one year and 4 per cent on deposits held for longer periods. The Board of Governors explained its action as follows:

For some time prior to this action, a number of commercial banks had contended that a 3 per cent maximum rate restricted them in their efforts to compete for savings and time deposits. The action taken by the Board had the effect of increasing freedom of competition and enabling each member bank to determine the rates of interest it would pay in light of the economic conditions prevailing in its area, the type of competition it must meet and its ability to pay. The action also had the effect of enabling member banks to compete more vigorously for foreign deposits Further, it was contemplated that the action would give member banks the latitude that might be needed, for a considerable period ahead, to provide an added incentive

Rates paid on savings at Seventh District banks and savings and loan associations in late 1963

Maximum announced interest rate at commercial banks (per cent)	Total	Illinois					Wisconsin	
		Cook County	Other	Indiana	Iowa	Michigan	Milwaukee County	Other
Under 2.5	5	4	—	7	6	3	3	19
2.5	2	—	—	2	13	—	—	—
3.0	47	18	36	91	66	50	76	81
3.5	21	37	30	—	—	26	7	—
4.0	25	41	34	—	15	21	14	—
Number of banks	433	158	53	43	53	61	29	36
Dividend rate on shares at savings and loan associations (per cent)								
3.5	2	1	1	11	4	3	—	3
3.75-4.0	52	12	57	83	92	93	—	87
4.125-4.25	23	36	22	1	4	1	70	6
4.5	23	51	20	5	—	3	30	4
Number of associations	800	166	196	175	83	68	40	72

Note: Commercial bank figures are for all banks in urban areas of the Seventh District; savings and loan figures are reporting associations in the entire state. The ratio of reporting associations to all operating associations is as follows: Illinois, 61 per cent; Indiana, 82 per cent; Iowa, 91 per cent; Michigan, 93 per cent and Wisconsin, 74 per cent.

for accumulation of the savings necessary to finance the future economic growth that would be essential to the expansion of job opportunities for a growing population

In early 1962 more than 39 per cent of all District urban banks posted increases in rates on savings deposits and over two-thirds raised rates on other time deposits. These percentages were roughly similar to those for the nation as a whole: 49 per cent of all member banks in the United States raised rates on savings deposits in early 1962, with more than four-fifths of these moving their rates above the previous ceiling of 3 per cent. Almost all member banks that raised rates on time deposits other than savings moved them up to 3.5 or 4 per cent. The move to higher rates, however, cannot be taken as a direct measure of the effect the previous rate ceilings had had in holding rates down.

Most of the banks serving individual local communities offer identical rates for savings deposits although in most communities these rates are below the maximum rate permitted. This has been true in both small and larger areas. In the largest metropolitan areas where rates have varied somewhat they have been virtually the same for the larger banks.

There is some evidence that markets for bank savings are relatively localized. For example, in Decatur and Springfield, Illinois, and Sioux City, Iowa, banks are paying the maximum authorized rate on savings deposits even though lower rate levels prevail in surrounding communities.

The similarity in rates among banks within market areas implies, among other things, that most banks set interest rates on savings and time deposits primarily in response to competitive market factors. Furthermore, while some of the commercial banks' closest competitors for savings, such as savings and loan associations and credit unions, do not

confront rate restrictions similar to those of commercial banks, the competitive nature of the savings market is such that there is a spillover of the effects of bank regulation.

The current situation

Many Indiana banks raised rates on savings deposits in early 1964 following the change in state regulation but at most banks outside Indiana rate schedules have remained unchanged since 1962. As of June 1964 only one-fourth of all banks in urban areas of the District were offering the ceiling rate of 4 per cent on savings deposits held one year or longer. The proportion of "4 per cent banks" was higher in Illinois and in Michigan than in either Iowa or Wisconsin, but even in the first two states it was no more than 35 per cent. No bank in Indiana was paying 4 per cent on savings deposits since the maximum rate remains at 3.5 per cent by state regulation. In contrast with rates on personal savings deposits, almost all banks in the District's urban centers were at the legal ceiling of 4 per cent on at least some maturities of time CDs issued to individuals.

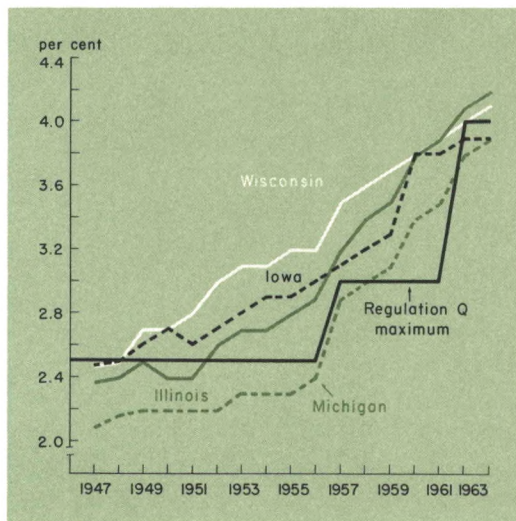
Competitive interest rate relationships have at times made it possible for banks to offer lower rates on time certificates of deposit issued to corporations, other businesses and governments than on CDs offered to individuals. In mid-1964, however, rates on new time CDs of negotiable form issued to corporations by large Chicago banks were quoted in the 3.75 to 3.80 per cent range for shorter maturities and $3\frac{7}{8}$ to 4 per cent for maturities of six months or longer. Rates on CDs issued to corporations appeared to be close to Regulation Q ceilings at most banks.

Commercial banks compete for corporate funds primarily with short-term money market instruments, particularly Treasury bills. Rates of interest on corporate time deposits,

which are more flexible than rates on savings deposits, tend to reflect demand and supply conditions in short-term money markets. During the period from late 1961 to mid-1963, when banks were prohibited from paying more than 2.5 per cent on certificates of deposit maturing in less than six months and rates on Treasury bills of comparable maturities were yielding more than 2.5 per cent, the volume of CDs issued in the shorter-term maturity range was small. The bulk of issues carried longer maturities.

Prior to mid-1963, investors wanting shorter CD maturities usually could buy them in the secondary market at higher yields than were obtainable directly from banks. Maximum rates of interest payable on certificates with maturities of 90 days to one year were raised to the same level as the ceiling on one-year certificates in mid-1963. The Board of

Rates paid by savings and loan associations generally above ceiling on savings deposits at banks



Maximum interest rates permitted on savings and other time deposits*

Maturity	Effective date			
	1936	1957	1962	1963
	(per cent)			
Savings deposits				
1 year or more	2.5	3.0	4.0	4.0
Less than 1 year	2.5	3.0	3.5	3.5
Other time deposits¹				
1 year or more	2.5	3.0	4.0	4.0
6 months to 1 year	2.5	3.0	3.5	4.0
3 to 6 months	2.0	2.5	2.5	4.0
Less than 90 days	1.0	1.0	1.0	1.0

*Amendment to Regulation Q effective October 15, 1962 made time deposits of foreign central banks and governments and international institutions exempt from regulatory ceilings for a period of three years.

¹Time certificates of deposit and open-account time deposits.

Governors, in stating the reasons for the revision, again noted that the action was taken because it appeared that the regulation had begun to have a restrictive effect on commercial banks in their competition for time funds.

Summary

The current ceiling rates on savings deposits are not limiting the ability of most Midwest banks to pay the rates they wish. In a number of areas banks have maximum rates on personal CDs equivalent to the rates savings and loan associations are paying on share accounts (see table). The fact that rates being paid have been set at the legal maximums does not necessarily indicate that many banks would pay higher rates if they were allowed to do so.

Not enough is known about the structure of savings markets to explain fully the be-

havior of banks in relation to Regulation Q. While some banks may look upon the regulation as a hindrance to setting the rates that they desire to offer, other banks may settle upon the regulatory limits as providing the

top rates that all banks—both large and small—in the community can safely pay. This situation results in divergent views on the proper posture of public policy in the setting of interest rate maximums.

Capital markets— United States and Europe

In August, Congress enacted the temporary interest equalization tax proposed by the Administration more than a year earlier. The tax—2.75 to 15 per cent on new or outstanding foreign bonds maturing in three years or more—has the effect of adding approximately one percentage point to the cost of borrowing in the United States capital market and is intended to discourage such financing. A 15 per cent levy also is placed upon purchases of foreign stocks. Because of historical dependence on American investment funds, Canadian issues are exempted from the tax, as are those of less developed countries.

New foreign security issues in the first half of 1963 were sold in the U. S. market at a 2 billion dollar annual rate—four times as much as in 1960. Proposal of the tax—retroactive to July 1963, the time of its announcement—brought about a virtual cessation in foreign flotations and a concomitant improvement in the balance of international payments (see chart). It remains to be seen how effective the tax will be in dampening such transactions. Some analysts have suggested that enactment of the tax will stimulate foreign issues, now that uncertainties on its precise nature have been removed. Rapid

economic expansion in Europe accompanied by high profits has enabled European borrowers to pay interest rates that are very high by United States standards.

The Administration decided upon the interest equalization tax reluctantly, because it has been American policy to encourage free capital markets at home and abroad. It is widely expected that further developments already under way in foreign capital markets eventually will reduce existing disadvantages of floating securities in home markets and make the tax unnecessary.

Among the materials assembled by the Treasury Department in support of the tax proposal is a 280-page study, “A Description and Analysis of Certain European Capital Markets.” This report highlights the great differences between the structure and performance of capital markets in the United States and the principal nations of Western Europe.

Many European business firms and governmental or quasi-governmental bodies attempt to satisfy their needs for funds in the United States because their own capital markets are not large enough or well-enough organized to accommodate sizable capital

issues readily. Virtually all capital markets outside the United States either are undeveloped or severely limited in the size of the flotations that they can absorb. Moreover, operation of these markets is closely circumscribed by custom as well as by regulations imposed by public or governmentally sanctioned private bodies.

What are capital markets?

The network of facilities and arrangements by which capital funds are gathered and invested in long-term debt or equity is an important feature of every developed nation.

While the term “capital market” may call to mind only sales of large issues of government securities handled by dealers and investment bankers and marketings of corporate securities by such agencies or by private placement, many needs are financed in other ways. Much capital is acquired in relatively small amounts—some on the basis of rather informal arrangements. The results are the

same, that is, the transfer of funds from those having investible surpluses to those seeking to use them. Small business firms and home buyers who borrow from relatives or friends or from local banks or savings and loan associations have an important role to play in the capital market, to use the term in a broad sense.

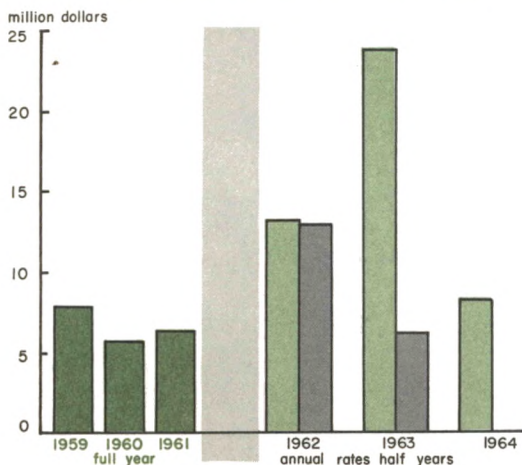
To serve the economy well and promote economic growth, capital markets must channel funds into the most productive uses. This process requires, first, facilities for the preparation and distribution of new issues of shares or obligations, that is, “primary markets” and also “secondary markets”—the stock exchange is a prime example—in which outstanding securities may be traded. The presence of viable secondary markets enables investors to purchase securities with the knowledge that these can be disposed of when desired and thus tends to broaden the market for new issues.

Not all capital market instruments are readily marketable. For example, of the 280 billion dollars of mortgage loans outstanding in the United States at the end of 1963, nearly three-fourths were in the form of “conventional” mortgages, that is, loans not federally insured or guaranteed, which are too localized and varied to possess wide marketability. Moreover, the shares of many small corporations are not traded on organized exchanges.

Size of capital markets

The United States capital market is much larger than those of other nations, and, therefore, can absorb large issues with relative ease. Total capital market instruments outstanding in this country—including corporate stocks and bonds, mortgages, Federal and state and local government securities and foreign securities—amount to more than 1 trillion dollars (see table). This is more than

Foreign securities marketed in the United States slowed in mid-1963



Outstanding capital market instruments, December 31, 1962

	Business		State and local government	Mort- gages	Foreign	Central government	Total	GNP 1962
	Bonds	Stocks						
United States	105	484	81	251	7	111	1,039	556
Seven European countries	37	133	*	*	*	67	324	314
United Kingdom	4	62	7	15	2	46	136	79
France	7	23	1	9	*	3	43	72
Germany	10	9	4	20	*	1	44	84
Italy	8	23	*	*	*	4	39	40
Netherlands	1	8	4	3	*	4	20	13
Belgium	4	4	1	*	1	6	21	13
Sweden	3	*	2	9	*	3	21	13

*Not available; very small in the case of foreign securities.

three times the combined total for the seven wealthiest nations of Western Europe—Germany, the United Kingdom, France, Italy, the Netherlands, Belgium and Sweden. The total output of goods and services—a rough measure of the “size” of an economy—is only 75 per cent greater in the United States than the total for these seven nations combined. Gross security issues (excluding mortgages), moreover, have been four or five times as great here as in the seven European nations in recent years.

Gross saving in the United States—including private and public outlays on construction and equipment, but excluding durable consumer goods—is close to 20 per cent of national product. Most European countries estimate even higher savings rates. But incomes in the United States are more than twice as high on a per capita basis, and total saving, therefore, is much greater.

Western Europe, of course, does not constitute a single capital market. Each nation is a compartment within which access to

capital funds by foreigners may be closely restricted.

West Germany has the largest national income of any nation in the Free World outside the United States, with the United Kingdom close behind; both countries are at levels only one-seventh that of the United States. Switzerland, noted as a financial center, has a total national income less than 2 per cent of this country's.

In the period from the end of 1958 through the first half of 1963, 4.3 billion dollars of foreign securities were sold in the United States, about 55 per cent consisting of Canadian issues (see chart). During this period all European markets combined accommodated only 1.4 billion dollars of foreign issues—half were placed in Switzerland. The United Kingdom absorbed 400 million dollars in new securities, virtually all from Commonwealth countries with which special financial and trading relationships are maintained. The other nations accepted only small quantities of foreign securities. The Nether-

lands, for example, permitted no foreign issues at all in three of the five years of the period. Although, historically, the Netherlands has been a prime financial center, foreign issues in recent years have been allowed only in times of balance of payments surplus.

Restrictions and regulations

The new U. S. equalization tax may be contrasted with regulations in the various European nations governing capital market operations, both foreign and domestic. Checks on the free flow of funds there are numerous and complex and should be taken into consideration when American international financial problems and policies are under discussion.

Capital markets in Europe traditionally operate under the general guidance of public policy, expressed through government agencies or semiofficial cartels. Certain of the restrictions date from the early Thirties when the worldwide financial crisis led to extraordinary measures. Others, however, were imposed in the chaos of the postwar period. After World War II, scarce foreign exchange was carefully mustered and channeled to needs deemed essential by public authorities. Some of these controls remain in effect today, well after conditions that created them either have disappeared or have been substantially ameliorated.

Capital market regulations abroad are not confined to international issues. In Germany, for example, there are no special restrictions on foreign issues. But such flotations are very rare. There are three main reasons. First, security sales are costly. Second, a large share of savings is pre-empted and channeled by the government. Third, the Central Capital Market Committee, a private organization without statutory power, effectively controls the timing and amount of new issues. (This com-

mittee is a good example of the important financial institutions found abroad that lack counterparts in the United States.) In short, while the German capital market is "freely open" to foreigners, barriers confronting most outsiders are virtually insurmountable.

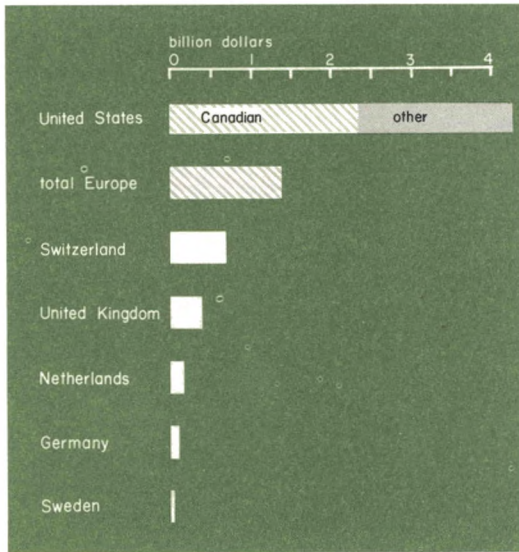
In most of Europe special licenses are required before foreign issues can be floated. Few of these have been granted in the postwar period, except in the case of the securities of certain international financial institutions.

Switzerland and the Netherlands possess well-developed capital markets, and long-term interest rates there recently have been below those in the United States. But both countries restrict capital issues, domestic and foreign, to amounts the market can absorb comfortably without pushing rates up. All other European governments control, in large degree, the conditions and terms of new domestic issues, and most have the power either to veto individual new issues or to postpone them indefinitely. In short, capital and money markets abroad are insulated to a substantial extent, not only from foreign influences, but also from market forces at home.

Until World War I, the London market dominated the international financial picture. Fifty years ago 85 per cent of the new issues in the United Kingdom came from outside, compared with about 10 per cent recently. In the past year, however—particularly during consideration of the interest equalization tax—the London capital market has experienced a sharp rise in the volume of foreign capital issues marketed.

Since 1932, new security issues in the United Kingdom, domestic and foreign, have been under government control. Currently, only foreign issues and those of local authorities are restricted, but statutory authority to require approval of all domestic issues re-

Foreign bond issues floated in the United States have dwarfed those sold in Europe



mains. In addition, the Bank of England operates a "queue," which determines the timing of all issues of 1 million pounds and more.

Special arrangements in Europe also control purchases of existing foreign security issues by citizens. In the United Kingdom, the Netherlands and Belgium, special arrangements must be made for the acquisition of foreign exchange for such transactions. Exchange rates for transactions in goods are stabilized, but prices of foreign exchange used in security purchases move more freely. Heavy demand for foreign issues by investors in these countries can result in a substantial premium on available exchange and may make such purchases prohibitive.

Most national governments have ready access to the capital funds of their citizens largely because there is little danger of legal

default and because their issues are broadly marketable. This advantage is fortified in various ways in Europe. In France, government issues have first priority and other issues are held off the market when necessary. In several other nations—Germany, for example—substantial taxes are levied on private and foreign issues, which do not apply to issues of the federal, state or municipal governments, or other institutional borrowers whose quests for funds are encouraged by public policy.

Government in industry

Railroads, telecommunications, gas and electric utilities, coal mines and important manufacturing enterprises in most European countries are owned and operated by government. In the United States, of course, government enterprises play a much smaller role. Less than 3 per cent of fixed investments are made by government corporations and enterprises while the proportions for some European countries are as follows: Belgium 9, Netherlands 14, Sweden 22, France 26 and the United Kingdom 29. In Germany and Italy, the proportion of public to total investment is roughly the same as in France and the United Kingdom.

In addition, certain European governments lend funds to favored private enterprises, either directly or through intermediaries. Operating budget surpluses of the federal and state governments in Germany are made available to housing, the utilities and industry.¹ Authorities in France and Italy employ various devices to assure that both short- and long-term funds loaned by the various financial institutions are directed to enter-

¹In most European countries the treasury prepares two budgets, an operating budget and a capital budget. The former usually shows a surplus, while the latter often requires large debt financing.

prises whose activities promote the “national plan” for the economy.

Channeling of bank funds to desired uses is aided in Europe by governmental powers unknown in the United States. For example, the four largest French commercial banks, with branches throughout the country, have been nationalized since World War II. Much of the housing credit in Germany is provided by municipal savings banks. The central bank in Italy controls the composition of commercial bank loan portfolios. Italy also authorizes “special credit institutes,” which provide intermediate term funds under government supervision for particular segments of the economy, such as agriculture, electric utilities and the motion picture industry.

Home building has been strongly encouraged in all major European countries in recent years—even more than in the United States. Aid has been provided by a variety of devices, including public construction and ownership, tax incentives and preferentially low interest rates. Belgium channels 30 per cent of all investment funds, public and private, to housing, and the proportion is similar for most other countries. Nine of every 10 new dwelling units in France benefit by some form of subsidy. German housing takes about 50 per cent of the funds provided by the capital markets, much of the total representing security issues of mortgage banks which are exempt from the tax on new private issues.

A striking characteristic of the continental nations in contrast with the United States or the United Kingdom is the much smaller importance of private life insurance and pension

Borrowing costs in major countries in 1962

	New industrial issues				
	Yield to investor	Issue cost amortized	Additional annual expense	Cost to borrowers	Yield-cost spread
	(per cent per year)				
United States	4.45	0.10	—	4.55	0.10
United Kingdom	6.43	0.21	0.04	6.68	0.25
France	5.77	1.17	0.88	7.82	2.05
Germany	6.12	0.76	0.14	7.02	0.90
Italy	6.15	0.53	2.22	8.90	2.75
Netherlands	4.81	0.45	0.05	5.31	0.50
Belgium	5.57	0.43	0.12	6.12	0.55
Switzerland	4.02	0.36	0.04	4.42	0.40

SOURCE: Adapted, in part, from *Lloyds Bank Review*, July 1963.

funds. These institutions have accounted for 38 per cent of the net acquisition of financial assets by households in the United States in recent years and an even larger proportion in the United Kingdom. In Germany this proportion has been only 16 per cent and in France only 8 per cent.

The relative unimportance of private life insurance and pensions in most of continental Europe reflects, partly, past experience with ruinous price inflation and partly the relatively greater welfare benefits provided by social security. In some nations huge reserves have been built up in social insurance funds. Sweden’s National Pension Insurance Fund invests substantial sums in housing, public utilities and bonds of private businesses.

America’s private insurance companies play a much more important role in financing business—through purchases of bonds, either direct from the issuers, or through the capital markets—than their European counterparts. Clearly, limitations on the ability of insurance investors to participate in business financing in most large European countries impede the

development of strong primary and secondary capital markets.

Business finance abroad

The spread between the yield to investors and costs to borrowers is very small in the case of large private bond issues sold in the United States, because markets are efficient and highly competitive. A long-term, high-grade American corporate bond yielding 4.5 per cent to investors may cost the debtor 4.6 per cent with all underwriting and administrative costs amortized over the life of the issue. In England this "spread" may be 0.2 to 0.3 per cent. In France or Italy the spread may be as great as two full percentage points, and the cost of a bond issue to the borrower may be 7.5 per cent or more per annum (see table).

There are several reasons for the large spreads on European bond issues. Underwriting fees commonly are 2 to 5 per cent even when issues are sold to institutions. In addition, there are taxes on the total value of new issues in some countries—in Germany, for example, the tax is 2.5 per cent on foreign or nonexempt domestic issues and in Belgium, 0.7 per cent on domestic issues and 1.6 per cent on foreign issues.

High costs and regulations combine to restrict the extent to which European firms use their home capital markets. As a result they rely heavily upon retained earnings and depreciation allowances and short- or intermediate-term loans.

Nonmarketable business debt, mainly bank loans, accounts for about 35 per cent of total business debt in the United States compared with 50 per cent in the United Kingdom, 76 per cent in France and 79 per cent in Germany. In some cases European bank loans have maturities of three to five years and are similar to United States "term loans." Others, however, are for very short terms, such as 90

days, and are continually renewed.

One reason why large numbers of European firms have sought to borrow in the United States is that profit margins have been narrowing in recent years—partly as a result of rising wage costs—and their supply of internally generated funds has been less adequate than several years ago. If this trend continues, greater dependence upon capital issues will be required if Europe's economic growth is to continue unabated. At present, capital markets are not sufficiently developed to supply these needs.

Appeal to the public

The typical family in continental Europe is much less likely to hold corporate stocks or bonds, either directly or indirectly through institutions, than its American counterpart. Low incomes are partly responsible. Also, the European public is not well acquainted with the security markets. Even the well-informed are wary of stocks and bonds because business firms in Europe, particularly in France and Italy, do not release comprehensive information on their operations and recognized techniques of investment analysis are not easily applied to determine the relative worth of shares.

Stock ownership in most countries also is discouraged by tax structures that penalize shareholding as compared with the incentives commonly provided to promote holding of various types of liquid assets. In addition, many well-known firms are entirely or largely family owned. In the latter case, a secondary market is apt to be thin, if it exists at all, so that fair prices may not be obtained if a shareholder desires to sell.

Investors in France, Germany and Italy have experienced price inflation and unsettled domestic conditions on a scale unknown in the United States. Concern regarding future

price inflation tends to encourage stock ownership in the United States where such investments, rightly or wrongly, are considered a suitable "hedge" against rising commodity prices. To some extent this view prevails also in Europe; nonetheless, share ownership has not become widespread.

Toward liberalization

Financial leaders in most European countries strongly advocate steps that would permit an easier flow of capital funds from savers to users within national boundaries, and international, as well. Special study groups, such as the Radcliffe Committee in the United Kingdom and the Lorain Committee in France, have made detailed recommendations intended to promote such a development. These commissions have concluded, though, that substantial government controls over capital markets must be maintained.

Nevertheless, substantial international economic cooperation has been achieved in the postwar period and further liberalization of barriers inhibiting the free flow of goods and funds over international borders is anticipated. This cooperation has been notable in the operation of the World Bank, the International Monetary Fund, the Organization for Economic Cooperation and Development (OSCD) and the European Economic Community (EEC).

The OECD in December 1961 adopted a code to liberalize capital markets. In 1963 EEC (the Common Market) proposed that all capital markets be opened completely to foreign issues by the end of 1967.

Specific recommendations to aid the development of capital markets include removal of discriminatory taxes, broadening of the investment discretion open to managers of insurance companies and other institutions,

encouraging the expansion of mutual funds and investment trusts that pool funds for equity investments, increasing information made available to investors by business firms and a broadening of the types of securities issued by corporations to include such instruments as preferred stocks, convertible debentures and variable income bonds to increase financial flexibility. Most important, of course, is the recommendation that regulations discriminating against foreign issues be relaxed. Such changes are asked particularly of such nations as Germany and France, which import capital despite strong balance of payments positions.

Experimentation with a number of new devices also is advocated. The successful development of the Eurodollar market in which loans denominated in United States dollars are made in Europe has encouraged other innovations. One of these is the "unit of account loan" denominated in various currencies. In addition, proposals have been made for loans that would be marketed simultaneously in several countries and bear interest rates related to the prevailing levels in the nations in which the issues were sold. Finally, the recent strengthening of London's position as an international financial center, or entrepot—particularly in the past year—has added an encouraging note.

The objective of funds freely flowing from one nation to another may not be wholly realized in the two-year life of the interest equalization tax, if ever. Nevertheless, the world appears to be moving gradually, if unsteadily, toward this goal. In the eyes of the Administration, the interest equalization tax is a necessary measure under current conditions and clearly preferable to such alternatives as general exchange controls or a capital issues committee vested with wide discretionary authority.