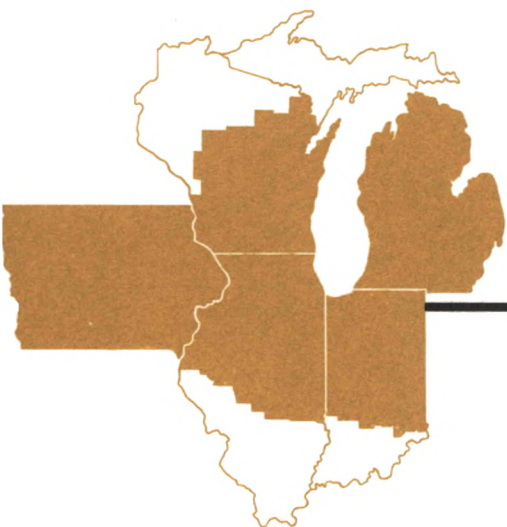


*A review by the* **Federal Reserve Bank of Chicago**

# Business Conditions

**1965 September**



## **Contents**

Trends in banking and finance	2
Commercial fertilizer and agricultural production	7
Capital outflows slow	12

# Trends in banking and finance

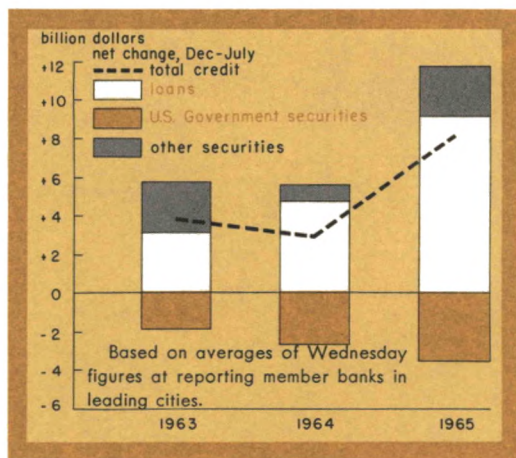
Continued vigorous economic expansion in the current year has been accompanied by a record growth in bank credit. Loans rose rapidly in the first seven months of the year—especially those to industrial and commercial borrowers. Mainly because of loan expansion, and despite bank sales of U. S. Government obligations, total credit of all commercial banks rose at an 11 per cent annual rate in the first half of 1965. This compares with an 8 per cent growth rate for the years 1963 and 1964.

While the demand for funds by the private sector of the economy was strong, the supply of funds seeking investment was also large. Sufficient reserves were supplied to the banking system to support a rapid growth in deposits. Flows of savings into other financial intermediaries, however, were somewhat lower than in the same period of last year. As a result, there were only mild upward pressures on interest rates and yields on most

categories of securities have varied within a narrow range.

The accompanying charts compare the be-

## Bank credit climbs as loan growth doubles



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## ERRATA

*Business Conditions, September 1965*

### Page 5, column 1

The bottom line of type should be read as the first line in the column.

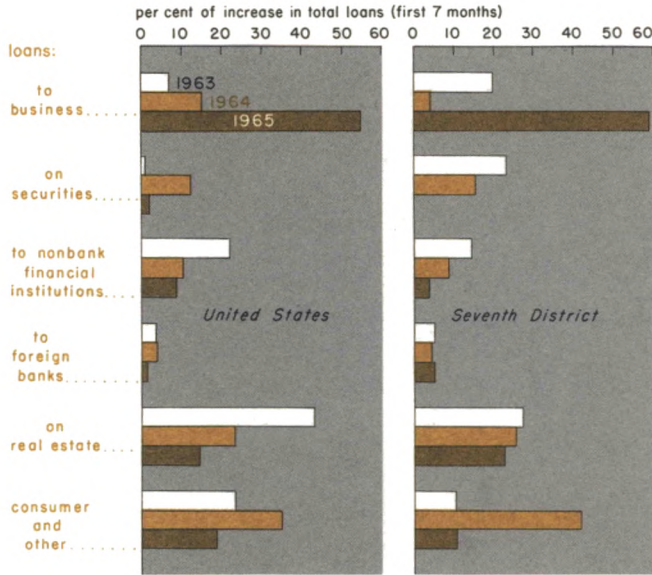
### Page 15, column 1

Two words were omitted at the beginning of line 4. The sentence should read "These purchases had contributed to an outflow of capital in every quarter during the Sixties except *one until* the third quarter of 1963 when the tax went into effect."

### Page 15, column 2

A line was omitted from the sentence designated by the number 1. The sentence should read "Legislation was proposed to continue the interest equalization tax for two additional years to December 31, 1967, and to broaden its coverage to apply to all nonbank credit maturing in one year or more extended to *residents of industrial countries outside* the Western Hemisphere."

## More than half of 1965 loan rise reflects business borrowing



behavior of a number of major financial variables during the first seven months of this year with the same periods of 1963 and 1964. Most comparisons are shown as cumulative changes from the beginning of each year. The data are not adjusted for seasonal variation, but the seasonal patterns are indicated by similar movements for comparable months of different years.

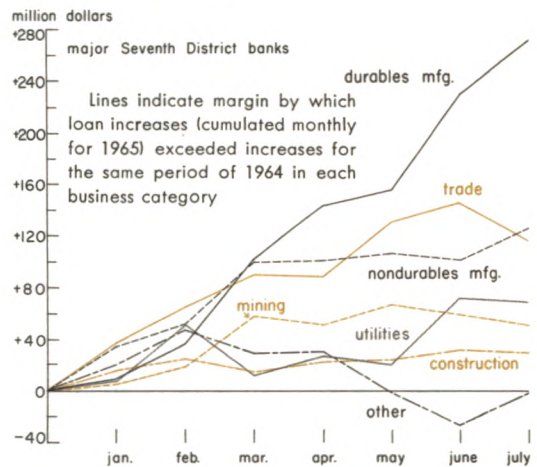
### Loan demand strong

Through July, the increase in loans at the major banks in leading cities was roughly twice that in the same period of the previous year. Available information indicates that commercial and industrial loans, which comprised about 40 per cent of their portfolios at the end of last year, have accounted for more than half of the 1965 expansion despite the fact that business loans usually decline in

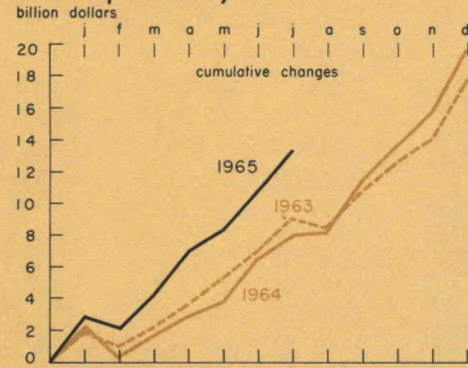
the early part of the year. Real estate and consumer loans rose at about the same pace as in 1964.

At major Seventh District banks, where the relative expansion of business loans was even greater than nationally, demand appears to have been broadly based among industry groups. Through July, loans to nearly all types of business rose more, or declined less, than in the previous year (see chart). Producers of durable goods—especially machinery—accounted for the largest share of the gain over last year. These firms are important steel users, and while some of their credit needs undoubtedly stemmed from the attempt to hedge against possible strike-induced shortages of the metal, the high rate of production to meet current sales was also a factor.

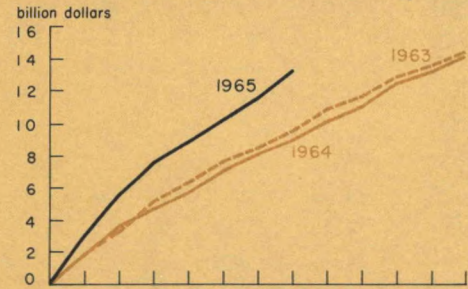
### Biggest rise over last year in manufacturing and trade



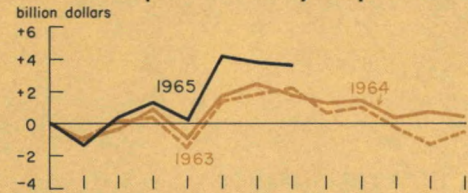
**Total deposits have risen more than in previous years**



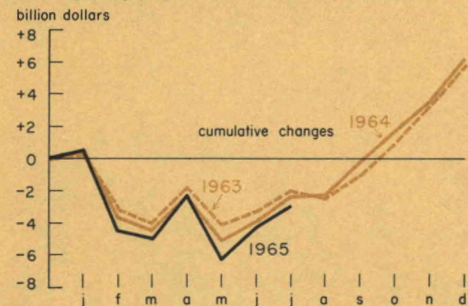
**but with faster gains in time deposits**



**and buildup of Treasury deposits,**



**money supply lags recent pace\***



\*Money supply is demand deposits and currency held by the public.

**Money and other deposits**

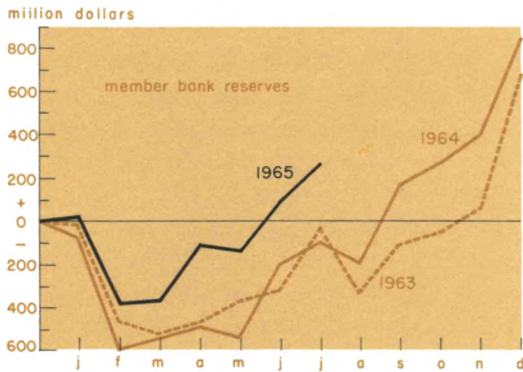
The counterpart of bank credit is, of course, bank deposits. In recent years time deposits—which include passbook savings and certificates of deposit—have accounted for the major share of deposit growth. Time deposits grew very rapidly in response to higher rates offered at some banks after the November 1964 ruling which raised the maximum rates payable on savings of less than 1 year from 3½ to 4 per cent, on time deposits less than 90 days from 1 to 4 per cent, and on those 90 days or longer from 4 to 4½ per cent. Through July 1965, total time deposits rose at an annual rate of about 15 per cent. Of the 13 billion dollar growth, about 2.5 billion reflected the net increase in time certificates of deposit, most of which were issued by the large banks in New York City.

In the second quarter, rising tax receipts resulted in a shift of funds from private demand balances—the major component of the money supply—to U.S. Government deposits, which are not counted in the money supply. The Treasury's balance reached a peak in May and remained at an unusually high level through July.

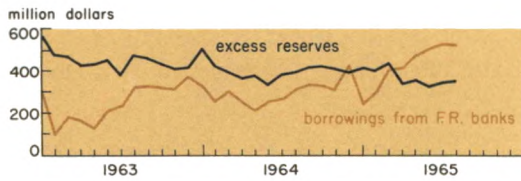
The slower growth of money supply compared with 1963 and 1964 is largely attributable to greater than normal diversion into time and Treasury deposits. As Government expenditures reduce Treasury deposits to more normal levels, these funds will be shifted back to the public, adding to private demand deposits. The effects on time deposit growth are less certain. On a seasonally adjusted basis, money supply rose at a 3 per cent annual rate for the January-July period. This compares with a growth rate of 4.3 per cent for 1964 as a whole.

The record expansion in total bank deposits

**Total reserves were up more than usual through July**



... but part of the rise reflected higher borrowings; excess reserves fell further



amounts of supporting bank reserves—although less than if more of the expansion had been in the form of demand deposits. Required reserves rose more than 300 million dollars from December to July compared with a 50 million increase in the same period last year.

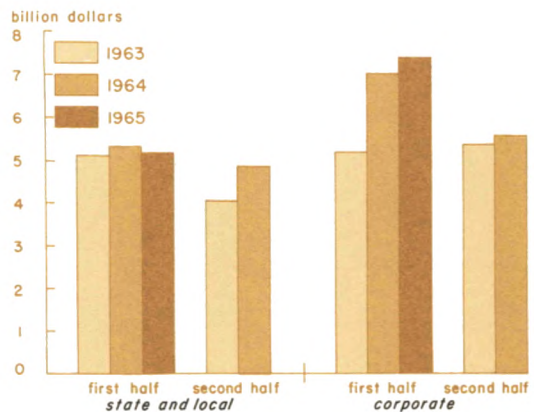
Although total reserves were permitted to grow rather rapidly to support the strong and apparently healthy business advance, part of these reserves were provided through discounts and advances to member banks. Average daily borrowings rose above 500 million dollars in June and July for the first time since mid-1960. The Federal Reserve System also acquired more than 2 billion dollars in Government securities in the first seven months required the creation of relatively large

of the year. Most of this was needed as an offset to the gold outflow and other factors reducing reserves, including a greater than usual increase in the currency component of the money supply.

Meanwhile, the amount of excess reserves in the banking system has declined to an average level of about 350 million dollars. Excess reserves are widely distributed among country banks. Nevertheless, bankers' efforts to remain fully invested have squeezed much of the slack out of bank reserve positions and this has been facilitated by the increasing participation of smaller banks in the Federal funds market.

As excess reserves declined and borrowings rose, the difference between them—so called "free reserves"—declined and became negative. Free reserves decline when deposit growth absorbs a larger amount of reserves in any given period than the Federal Reserve makes available by means other than the discount window. This often occurs in a period of rising business when credit demands are very strong.

**Issues and placements of new securities continued at high levels through first half**



### Capital markets and interest rates

Heavy reliance on bank credit had no apparent dampening effect on offerings and placements of corporate and municipal securities. These markets handled gross new issues of nearly 13 billion dollars in the first half of the year. Although the supply of investment funds was also large, an upward adjustment in yield averages was experienced about mid-year when new issue volume reached a peak. The increased pressure on rates, however, did not reach into the mortgage area where slightly reduced offerings were absorbed by continued large supplies of investment funds.

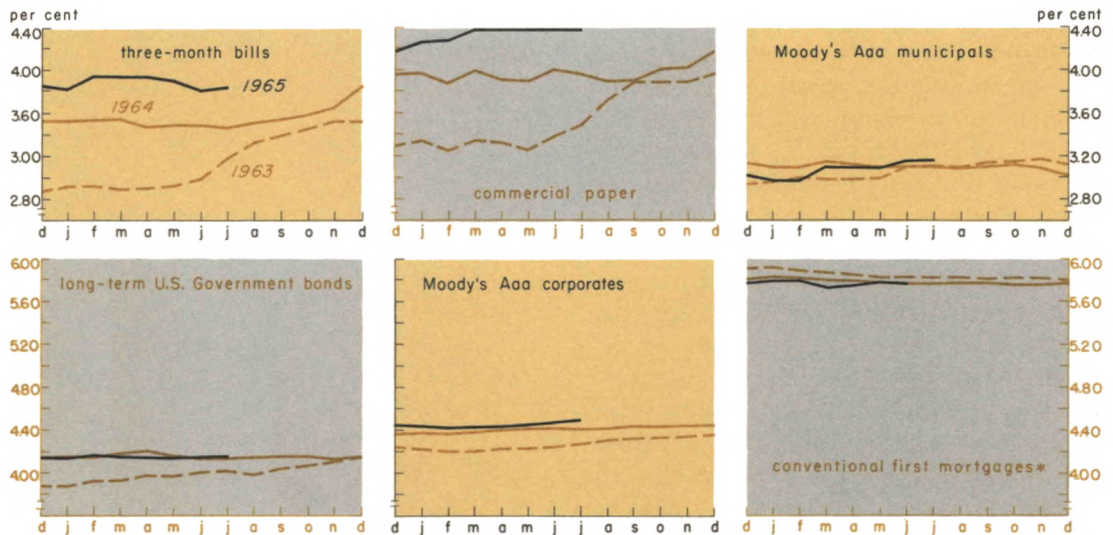
Rates on Government issues held quite stable through July despite sales by commercial banks. Strength in the Government securities market reflected both the seasonal decline in outstandings in the first half and widespread demand from a number of

sources. These include the temporary investment of funds acquired in the capital markets and repatriated from abroad, acquisitions by Treasury investment accounts and purchases by the Federal Reserve to provide for continued growth of bank reserves.

In the short-term area, where rates have risen significantly over the past two years, recent trends have been mixed. Treasury bill rates reached their highs in late February but showed a downward trend thereafter. Other money market rates have generally held at higher levels with the Federal funds rate—the rate at which member banks lend reserves to other banks—in excess of the discount rate a large part of the time.

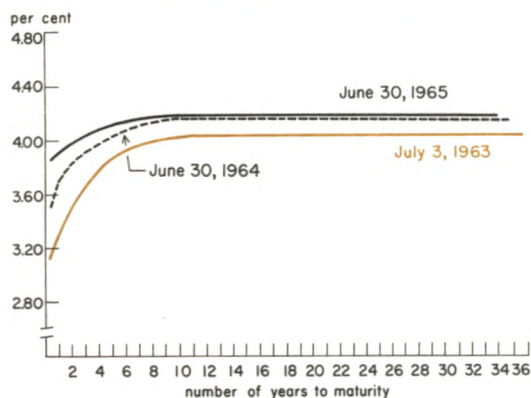
The overall abundance of investment funds, coupled with continued efforts to maintain short-term rates at levels high enough to deter outflow of short-term funds, has been largely responsible for the substantial disappearance

### Yield trends mixed within narrow range



\*SOURCE: Federal Home Loan Bank Board

## Yield differential between long- and short-term Government securities has narrowed



of a rate spread between securities with different maturities. This is illustrated by the flattening of the “yield curve” for U. S. Government securities. As of mid-August the difference in the investment yield on three-month Treasury bills and the longest coupon Treasury bond was slightly more than  $\frac{1}{4}$  of a percentage point. But with such a small incentive for holding long-term issues, any increase in uncertainty as to the outlook for the domestic economy or in the international area would cause short-term obligations to have a stronger investor appeal. This would intensify downward pressure on short-term rates and thus tend to reestablish more normal yield spreads.

# Commercial fertilizer and agricultural production

The increased availability and use of manufactured plant foods have had a key role in boosting the capacity of American agriculture. Even in the face of widespread and costly programs to restrict production, output has risen nearly one-third since the end of World War II and the margin of unused capacity has increased substantially.

The growth of output—actual and latent—is the result of many forces all complexly interrelated and mutually reinforced. While it is not possible to determine precisely the effects of the greater use of fertilizer alone, or of any other one development, some studies have indicated that over three-fifths of the rise in per acre production of agricultural

commodities between 1940 and 1955 was directly attributable to the increased utilization of commercial fertilizers; since 1955 about half of the increase in corn yields in the Midwest appears to have been associated with the further increase in usage. The dependence upon fertilizers in the further expansion of agricultural production in the United States in the years ahead and especially in the older agricultural regions of the world appears destined to become increasingly important.

Although the use of fertilizer in the United States has been increasing for many years, the rise has been especially rapid since the end of World War II. From 1910 to 1945,



annual usage in terms of plant nutrients—N, P<sub>2</sub>O<sub>5</sub>, K<sub>2</sub>O—increased from slightly less than 1 million tons to about 2.8 million; by 1964 annual usage exceeded 10 million tons.

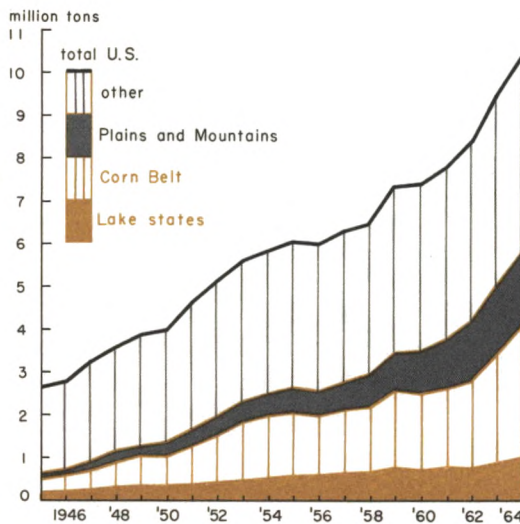
**All nutrients increase sharply**

The most striking gain in recent years has been in nitrogen. Following the widespread introduction of the new production technologies developed during World War II, the use of this nutrient doubled between 1945 and 1951. It doubled again by 1959 and nearly doubled again by 1964 when about 4.4 million tons were used.

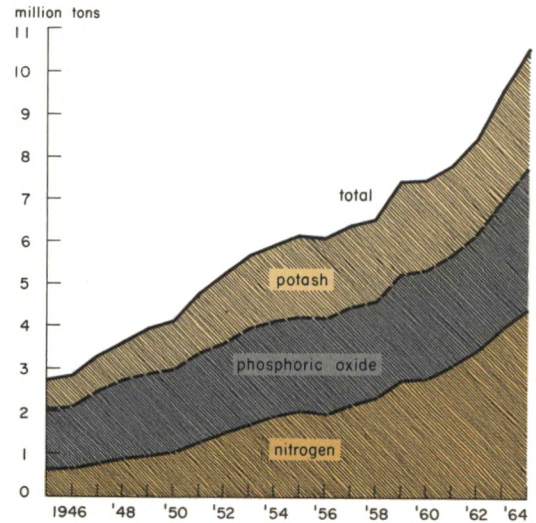
Utilization of potash as fertilizer in 1945 was about equal to that for nitrogen. Although consumption has more than quadrupled during the past 19 years, the expansion in tonnage has been less rapid than for nitrogen. In 1964 about 2.7 million tons were used.

Phosphate used as fertilizer at the end of

**All areas show gains in fertilizer use**



**Fertilizer use rises sharply**



World War II was about double that of either nitrogen or potash. The amount has more than doubled during the postwar period, rising to about 3.4 million tons in 1964.

With fertilizers, as with other items used in producing agricultural commodities, the amounts are determined largely by relative costs, availability and knowledge of their effectiveness.

The sharp increase in usage of nitrogen relative to other plant nutrients following World War II appears to have resulted from several factors. The need for nitrogen for munitions greatly increased the demand for this material during the war. Erection of many new nitrogen plants and the development of new production technology substantially boosted the productive capacity to supply these needs. With the disappearance of military demand for nitrogen following the conclusion of major hostilities in 1945, a large part of this capacity became available to supply nitrogen for agriculture. In

addition, there was an increasing awareness of the complementary effect nitrogen had with phosphate and potash on crop yields. Soils were often rich in natural phosphate and potash but lacking in nitrogen. Farmers for many years had grown legumes—largely clover and alfalfa—to help increase the nitrogen in the soil. These long-established cropping systems, however, were subject to change as manufactured nitrogen became available in increasing amounts and with declining costs—as horses and oats gave way to trucks and tractors, legumes are giving way to commercial fertilizer.

### More acres and heavier rates

Farmers have boosted the amounts of fertilizer applied per acre and increased the number of acres fertilized. Data recently published by the U. S. Department of Agriculture provide some measure of rates of application on different crops through 1959, the latest census year for which such information is available (see table). Although fertilizer use has increased nearly 3 million tons since 1959, the pattern of use probably has not changed greatly.

The total acreage to which fertilizer was applied increased about three-fifths from 1954 to 1959, with about half of the total

## Acreage fertilized and rates per acre increase

Crops	Acreage fertilized		Nutrients applied per acre fertilized					
			Nitrogen		Phosphate		Potash	
	1954	1959	1954	1959	1954	1959	1954	1959
	(per cent)		(pounds)					
<b>Intertilled crops</b>	50	61	34	46	35	39	30	35
Corn	60	64	27	39	28	34	25	30
Cotton	58	64	49	67	31	33	25	30
Tobacco	97	99	60	75	121	148	117	188
Large seeded legumes	23	21	7	7	33	33	32	34
Fruits	58	73	78	93	33	34	40	54
Vegetables	63	76	59	71	84	89	66	64
Other	12	22	32	53	22	17	9	7
<b>Close-growing crops</b>	29	35	19	25	27	24	19	16
Wheat	28	37	18	23	27	24	19	14
Oats and barley	30	33	17	22	28	24	20	18
Other	30	32	27	58	24	23	17	15
<b>Hay and pasture</b>	12	13	14	20	40	43	28	33
<b>Crops and pasture</b>	30	48	27	37	34	36	27	30

SOURCE: U.S.D.A., estimates compiled from Agricultural Census.

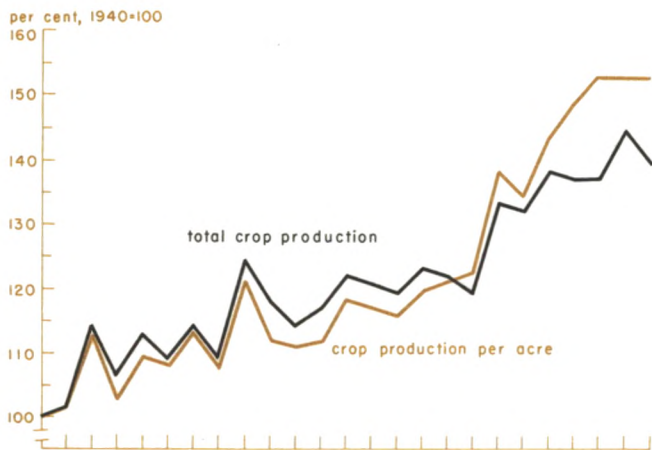
harvested acreage of crop and pastureland receiving at least some fertilizer in the latter year. Acreages of intertilled crops such as corn, cotton and soybeans are fertilized in far greater proportion and generally more heavily than either the close growing crops or pastureland, partly because such crops generally yield a much higher income per acre. In addition, close growing crops such as oats and barley are often grown as nurse crops on which heavy applications of fertilizer could result in excessive foliage and shade out the young seedlings.

The average application per fertilized acre in 1959 was well over 100 pounds of plant nutrients—15 pounds more than in 1954. Tobacco, potatoes and vegetables received the heaviest applications per acre. Corn received the most fertilizer, however, account-

ing for nearly a third of the total. Although the proportion of pastureland receiving fertilizer is relatively low, it ranks second to corn in total fertilizer use because of the large acreage.

Sizable increases in fertilizer use have occurred in all parts of the country, but the areas of most rapid growth have been in the Lake and Corn Belt states (which includes the Seventh Federal Reserve District) and especially in the Plains and Mountain states. The sharp rise in the latter two areas has been from a very low level of consumption due to the later adoption of fertilization in these areas compared with other regions. In the early Forties, about 17 per cent of all fertilizer was used in the Lake, Corn Belt, Plains and Mountain states. In recent years, however, these four areas have accounted for about half of the total consumption and last year accounted for more than three-fourths of the annual increase in total fertilizer use.

### Greater use of fertilizer has boosted crop production



### Factors influencing use

A number of factors probably have influenced the upward trend in fertilizer use, but those making the primary contribution have been the research and educational programs of various government and private agencies, the relatively low cost of fertilizer materials and Government programs that have withdrawn land from production.

Research has provided better information on soil requirements and more reliable estimates of probable yield response from applications of plant nutrients. The development of new equipment and new forms of fertilizer have enabled farmers to apply plant foods more easily and effectively. The development of higher analysis fertilizer has reduced the volume of material that had to be handled in order to obtain a given application of plant food.

While the development of new technologies in production, distribution and application of fertilizer has been important, a factor not to be overlooked in the rapid growth of fertilizer usage has been its relative cheapness in terms of increased crop output as compared with other items used in agricultural production.

Fertilizer prices edged higher during a brief span of years following World War II, but since the early Fifties have remained virtually stable. While the index of prices for all crops has trended lower over this period, crop prices have been substantially supplemented by direct Government payments to farmers. As a result, increased applications of fertilizer have continued to yield a relatively high return in terms of the dollar

## Fertilizer use in other developed countries exceeds United States

	Primary nutrients applied (1960-61)			
	Nitrogen	Phosphate	Potash	Total
	(pounds per acre of cropland) <sup>1</sup>			
Netherlands	192	96	119	407
Japan	111	72	88	271
W. Germany	65	68	105	238
Denmark	40	37	58	135
United States	13	12	9	34
Spain	12	12	4	28
India	2	0.3	0.2	2.5
World <sup>2</sup>	7	7	6	20

<sup>1</sup>Including meadow and pastureland.

<sup>2</sup>Excluding mainland China and North Korea.

SOURCE: National Plant Food Institute.

value of this increased output. Moreover, since the mid-Forties an index of prices of all the major items used in agricultural production has nearly doubled. This price relationship has made it increasingly attractive to substitute fertilizer for those other production inputs for which it can be substituted effectively.

Government programs which have restricted the acreage planted to crops have also had a significant effect on farmers' purchases of plant nutrients. Inasmuch as these programs have provided relatively high price supports and payments for production on smaller allotted acreages as well as penalties for overplanting, farmers have cultivated their allotted acreage intensively, and sharply increased the per acre application of fertilizer.

### Use to rise further

Although the use of fertilizer has increased markedly, rates of application are

indicated to be lower in most areas than those which would yield maximum profits at current price levels. Studies made by the U. S. Department of Agriculture indicated a decade ago that about \$3 of additional production of crops and pasture were obtained with an additional \$1 of fertilizer applied. Obviously, the amount of fertilizer used was substantially below that which would have been most profitable. All available evidence indicates that most farmers are still using less than the optimum amounts of fertilizer although by a much smaller margin than in 1954.

While the amount of fertilizer used has increased sharply, such developments as new hybrids, closer plant spacings, minimum tillage, irrigation and greater applications of herbicides and pesticides have increased potential crop production per acre and, therefore, the optimum amounts of fertilizer needed to achieve the full benefit from these items.

For many years farmers attempted to maintain soil fertility by growing rotations of crops which included legumes and using livestock systems of farming. In recent years, however, the practice of continuous cropping of intertilled crops boosted production of the major crops and the requirements for plant nutrients. Even on the more productive soils, heavier applications of fertilizer are necessary to supply the amounts required to maintain soil fertility. Estimates by the National Plant Food Institute indicate that the amount of nutrients removed by crops harvested in 1963 exceeded the amount supplied by fertilizers by about one-fourth, indicating that nearly 3.4 million additional tons of fertilizer would have been required to completely replace the amount of nutrients extracted from the soil by crops.

Although economic conditions differ great-

ly in other regions of the world and therefore affect the level of optimum fertilizer usage, a comparison of fertilizer use in the United States with that in other countries illustrates the level of use that is reached under some economic conditions. In the 1960-61 period, fertilizer consumption in the United States in terms of plant nutrients per arable acre amounted to about 34 pounds, lagging far behind most other developed countries (see table). Comparable estimates for the Netherlands and Japan, for example, indicate that fertilizer was used at rates of about 407 and 271 pounds, respectively. For the world (excluding Mainland China and North

Korea), fertilizer use was only 14 pounds per arable acre, less than half the rate for the United States.

Numerous estimates have been made by various private and Government agencies on the probable consumption of fertilizer by United States farmers over the next several years. All projections indicate a sizable increase. The Tennessee Valley Authority, for example, indicates that total plant nutrients used by 1975 will rise to 13-15 million tons compared with 10.5 million in 1964. It should be noted, however, that in the past, projections of this type have generally fallen short of the actual levels achieved.

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## Capital outflows slow

**T**he outflow of long-term capital abroad has been a large contributor to the persistent deficit in the United States balance of payments. In 1964 there was a net outflow of 4.4 billion dollars of long-term capital—up from 3.7 billion in 1963 and 2.9 billion in 1962. The accelerated outflow continued into the first quarter of 1965 when it was over twice as great as in the first quarter of 1964.

Long-term capital outflows may be divided into four major categories: 1. direct investment, 2. purchases of new foreign securities, 3. purchases of outstanding foreign securities and 4. other long-term capital movements including bank loans with maturity of one year or over. Except for purchases of outstanding securities, the outflow in each category was considerably greater in 1964 than in 1960.

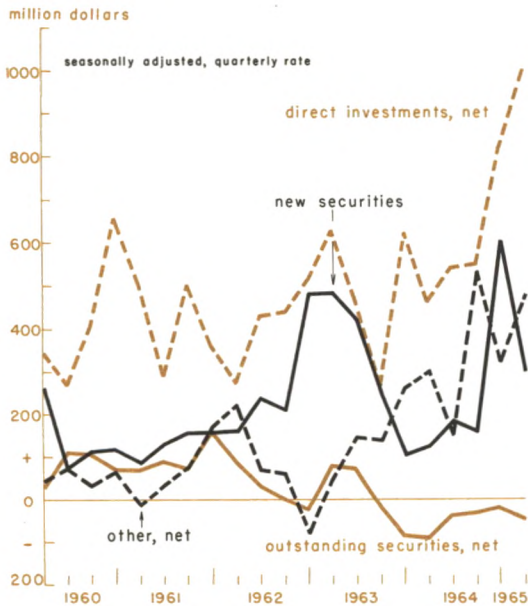
### **Direct investment**

Direct investment abroad includes all over-

seas investment by American residents in which managerial control is an important consideration. Such investments (net of reinvestment of undistributed earnings on these investments) have increased rapidly in the past two years, and in the first quarter of 1965 were over twice as large as in the first quarter of 1964. The exceptional increase in the first quarter probably resulted, in part, from a speedup in planned investments in anticipation of possible restrictions in later periods by either the United States or foreign governments.

Overseas direct investments are motivated primarily by the prospects of earning greater profits abroad than at home. Since the mid-Fifties, economic activity has risen faster in most Western European countries than in the United States. In part, goods produced in American plants abroad replace exports to these countries. On the other hand, foreign

## Outflows of long-term capital rose sharply in 1964 and first quarter of 1965



investments may stimulate exports of raw materials, semi-manufactured goods and machinery to overseas plants. Frequently, decisions to invest in firms abroad are motivated by high foreign tariff walls, exchange restrictions or other regulations which severely restrict market penetration through exports.

About half of the net direct investment abroad in recent years was directed to Western Europe; another 20 per cent was to Canada. Although direct investments have an unfavorable impact on the balance of payments at the time the investment is made, earnings in subsequent years have a favorable impact and in the aggregate have exceeded annual new investments in the long run. In the Sixties, income on foreign direct investments

has exceeded new investment by more than 50 per cent.

### New foreign securities

Sales of new foreign securities in the United States rose rapidly in the early Sixties. Many foreign governments and business firms found that the limited size of capital markets, high interest rates and/or official government intervention—to limit the amount of both internal and foreign borrowing—made it difficult or impossible as well as costly to meet credit needs either at home or in foreign capital markets outside the United States.<sup>1</sup> While some of the foreign securities marketed in this country have been resold to foreigners, most were purchased by American residents and have resulted in a net outflow of dollars.

In 1962, more than 1 billion dollars of newly issued foreign securities were purchased by United States residents—twice the volume of the previous year. When it seemed as if this amount would double again in 1963, an interest equalization tax was imposed on resident purchases of securities maturing in three or more years issued by foreign industrialized countries outside the Western Hemisphere. The tax was designed to reduce the effective yields on such securities to American investors by about 1 per cent—the approximate spread between yields on foreign and domestic securities of similar issue size and maturity.

The tax has caused two markets to develop for new foreign securities in the United States—one for nonresidents, the other for Americans. On the latter market, the security yields are quoted after adjustment for the tax liabil-

<sup>1</sup>For a description of the restrictions of foreign capital markets and a more complete analysis of why foreigners borrow in the United States see "Foreign Long-term Borrowing in the United States," *Business Conditions*, September 1963, pp. 5-9.

ity. A recent new issue by the Australian government, for example, was priced to yield 5.63 per cent to nonresidents and only 4.98 per cent to residents.

Some issues are sold entirely to nonresidents even though marketed in this country because local markets are often neither sufficiently broad nor experienced to handle large issues successfully. In addition, many foreign investors have become accustomed to the procedures and characteristics of the United States market and prefer to do business here. Sales of such securities to foreigners do not result in an outflow of capital. Such operations, however, produce income for the American underwriters and enhance the prestige of the United States as an international money market. Recently, new securities marketed here by the governments of Denmark and New Zealand and the city of Tokyo were sold entirely to foreign investors.

Sales of new foreign securities dropped abruptly following the imposition of the equalization tax in mid-1963 but rose again in 1964. Canada, which is exempted from the

tax, increased its importance as the major foreign borrower in the United States. In 1964, Canadian securities accounted for 65 per cent of the total United States purchases of new foreign securities, compared with only 42 per cent in 1962. Although overall purchases of foreign securities declined 15 per cent from 1963 to 1964, the dollar volume of Canadian securities rose slightly. At the same time, American purchases of new Western European issues dropped sharply from 272 million dollars in 1963 to 35 million in 1964.

### Outstanding foreign securities

A broad and active market also exists in the United States for outstanding debt and equity securities of foreign governments and major business firms. Trading is similar to that in domestic securities. Some foreign issues are listed on national security exchanges, while others are traded "over-the-counter." The interest equalization tax applies to the purchases of any foreign security by United States residents from foreigners. Transactions between residents do not produce an outflow of dollars and therefore are exempt from the tax. The ownership of foreign securities is typically noted on market quote sheets so that the purchaser may know whether his purchase would be subject to the tax or not.

The impact of the interest equalization tax on capital outflows resulting from United States purchases of outstanding foreign securities from foreign-

Net direct investment overseas							
	1960	1961	1962	1963	1964	First quarter	
	(million dollars)					1964	1965
<b>Total</b>	<b>1,674</b>	<b>1,599</b>	<b>1,654</b>	<b>1,976</b>	<b>2,376</b>	<b>420</b>	<b>959</b>
W. Europe	962	724	867	924	1,342	288	504
Canada	451	302	314	365	250	66	213
Latin America	95	173	-32	69	156	3	4
Japan	n.a.	29	54	68	73	30	15
Other <sup>1</sup>	166	371	451	550	555	39	231
<b>Earnings on investments</b>	<b>2,355</b>	<b>2,768</b>	<b>3,050</b>	<b>3,134</b>	<b>3,741</b>	<b>946</b>	<b>1,043</b>

n.a. Not available.

<sup>1</sup>Includes international organizations.

**United States purchases of new foreign securities**

	1960	1961	1962	1963	1964	First quarter	
						1964	1965
	(million dollars)						
<b>Total</b>	<b>555</b>	<b>523</b>	<b>1,076</b>	<b>1,250</b>	<b>1,063</b>	<b>127</b>	<b>302</b>
W. Europe	24	57	195	272	35	0	9
Canada	221	237	457	693	700	86	99
Latin America	107	18	102	35	201	13	5
Japan	n.a.	61	101	164	0	0	0
Other <sup>1</sup>	203	150	221	86	127	28	189

n.a. Not available.

<sup>1</sup>Includes international organizations.

funds. Short-term funds may also have been used by foreigners as temporary replacements for longer-term borrowing subject to the equalization tax. The recorded outflow of short-term capital reached 2.1 billion dollars in 1964—almost three times the amount in 1963.

**Stemming flow**

Because of the continued rise in the net outflow of long-term capital and the failure of the balance of payments to respond adequately to previous corrective actions, several additional measures were undertaken early in 1965 to help reduce the deficit by reducing the outflow of capital.

1. Legislation was proposed to continue the interest equalization tax for two additional years to December 31, 1967, and to broaden its coverage to apply to all nonbank credit maturing in one year or more extended to the Western Hemisphere.

2. All commercial bank loans with maturities of one year or more extended to foreigners in industrialized countries outside the Western Hemisphere were made subject to the tax.

3. Bank and nonbank business firms were requested to voluntarily restrict the amount of dollars used overseas.

Banks were requested to restrict their total loans to foreigners to no more than 5 per cent above the volume outstanding at year-end 1964. The guideline encompasses all bank loans, whether short term or long term and whether or not subject to the equalization tax.

Nonbank financial institutions were re-

ers was marked and immediate. These purchases had contributed to an outflow of capital in every quarter during the Sixties except the third quarter of 1963 when the tax went into effect. Since then, American residents have sold more outstanding foreign securities to foreigners in every quarter than they have purchased from them.

**Other long-term capital**

Outflows of long-term United States capital resulting from other than direct investments or the purchase of foreign securities are classified as other long-term capital. This category covers bank loans and credit extended by individuals and nonbank businesses for over one year.

Long-term lending by these institutions rose sharply since 1962, in part as replacements for other forms of credit subject to the interest equalization tax and in part in anticipation of possible additional restrictions. The outflows of this type of long-term funds doubled from 1962 to 1963 and again from 1963 to 1964. Western Europe, which was affected the most by the interest equalization tax, was the primary recipient of United States



requested to keep their foreign credit extension (other than their liquid investments) with maturity of 10 years or less to no more than 5 per cent above the level of December 31, 1964.

These firms were also requested to gradually reduce their holdings of liquid investments abroad to year-end 1963 or 1964 levels, whichever was lower.

The restrictions on overseas credit are not expected to reduce the ability of financial institutions to finance United States exports; ample provision is made for the complete financing of the anticipated rise in United States exports during 1965. In addition, participation in Export-Import Bank loans and Federal Credit Insurance Association insured export loans are exempt from the program.

Quantitative guidelines have not been imposed on direct overseas investments because of the long-run favorable impact of these on the balance of payments. However, United States business firms have been requested to limit or postpone current new investment abroad where investments are not likely to expand exports or to increase overseas earnings substantially in the near future. In addition, these firms have been asked to utilize foreign financing where possible.

### Improvement permanent?

The long-run impact of the current program on capital movements is difficult to evaluate. Early evidence indicates that the

### Other long-term capital outflow, net

	1960	1961	1962	1963	1964	First quarter	
	(million dollars)					1964	1965
<b>Total</b>	<b>200</b>	<b>263</b>	<b>258</b>	<b>591</b>	<b>1,298</b>	<b>275</b>	<b>453</b>
W. Europe	16	115	84	504	671	161	135
Canada	-32	-10	37	-2	276	0	47
Latin America	159	108	39	-21	115	40	120
Japan	n.a.	34	108	120	135	61	33
Other <sup>1</sup>	57	16	-10	-10	101	13	136

n.a. Not available.

<sup>1</sup>Includes international organizations.

measures have had the desired immediate impact. Primarily because of reversals in capital flows, the balance of payment was in surplus in the second quarter of the year for the first time since 1957.

At the time the program was announced in February, overseas loans of many banks and nonbank lenders were already more than 5 per cent above the amounts at the end of 1964. As a result, a slowdown and even a rollback in foreign credit extension was to be expected. In addition, many business firms have reported intentions to postpone new overseas investments or, where this was not feasible, to borrow the necessary funds abroad.

It is recognized, however, that the announced measures will not cure the basic causes of the deficit. This can only be brought about by increased domestic efficiency, more competitively priced exports and, conditions permitting, reduced government spending abroad. The measures can, however, help to buy the time in which the more fundamental adjustments can be made.