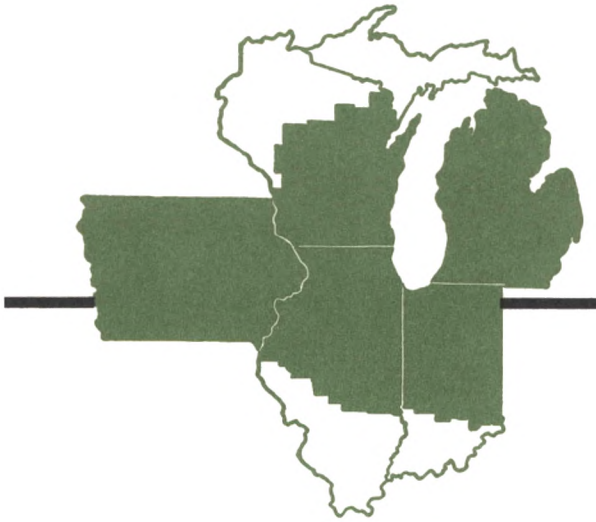
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1966 October

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THE Trend OF BUSINESS

Total nonagricultural employment in the Midwest has been about 5 percent above the record level of a year earlier in recent months, continuing the full employment situation of the past year. New claims for unemployment compensation have been at low levels and are well below last year. Employer recruiting efforts have been intensified, wages boosted, hiring standards lowered and training programs expanded. Nevertheless, shortages of workers—both skilled and unskilled—persist. Sharply increased draft calls, coupled with the larger proportion of young people seeking college degrees, have limited the supply of young workers at a time of intense demand.

Tight labor markets in the Midwest reflect heavy demand for the principal products of this region. With 16 percent of the nation's population, the five-state area of Illinois, Indiana, Iowa, Michigan and Wisconsin accounts for 27 percent of the nation's output of all durable goods and much larger proportions of all household appliances, radio and TV sets, motor vehicles and industrial, construction and farm machinery. With the notable exception of passenger cars, most of these industries have been hard pressed to boost output apace with the rise of new orders.

Increased defense requirements starting in mid-1965 were superimposed on an already booming economy. Prior to that time defense spending had been virtually stable for a period of three years. Defense spending in the second quarter of 1965 was at an annual rate of 49 billion dollars. By the second quarter of the current year, these outlays had reached a 57 billion dollar rate, a rise of more than 16 percent. Indications are that the total will rise further.

Capital spending still rising

Recent estimates place business outlays on new plant and equipment at 61 billion dollars for 1966, an increase of 17 percent over the previous year. These expenditures had risen 14 percent in 1964 and 15 percent in 1965. In each of the past three years, the rise in capital outlays has been about twice the rate of increase in total spending on goods and services. The expansion in capital spending is expected to continue unabated through

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1966. Various developments, however, suggest a slower rise in these outlays in 1967.

Suspension of the 7 percent investment tax credit and accelerated depreciation on commercial buildings unquestionably will have some dampening effect on capital spending. The bulk of this influence, however, will not be evident until next year, because of the momentum behind expansion and modernization programs already under way and the large backlog of orders placed.

A number of major firms have reported that their capital expenditures programs have passed a peak or will soon as major projects undertaken a year or more in the past reach completion. Certain private surveys indicate that the volume of new projects in the planning stage in recent months has been running below last year's level.

Consumer and wholesale price averages continue upward course

It is too early, however, to call a "turn" in the capital goods upswing. Many construction projects were postponed during the past year because of inability to obtain firm bids at what was thought to be reasonable costs. Skilled building trade workers have been in short supply, and this has limited the physical volume of new construction. Any easing of the labor supply could lead to reactivation of some of these plans.

New orders for machinery continued to exceed shipments through August with the result that unfilled orders continued to increase. Order backlogs totaled 23.8 billion dollars in August, up 29 percent from a year earlier. In each of the postwar cycles of economic activity, new orders for machinery and equipment declined for a period of several months before shipments turned down.

Consumers spend more

After-tax income of consumers has been running about 8 percent above last year's rate. Spending on goods and services has been rising at least as fast as income, and there is some evidence that the rate of personal saving has declined.

Consumers are paying appreciably higher prices this year for many goods and services, including medical services, food, shoes, color TV sets, furniture and insurance. In contrast to industrial firms, however, consumers have been able to make purchases of virtually all items without any abnormal delays.

The problem remains

The nation's main economic problem con-

tinues to be "demand pull" inflation. Output has continued to increase at a rapid pace, but total spending has increased even faster. Such a development inevitably is accompanied by higher prices.

Both consumer and wholesale prices are about 3 percent above year-ago levels. Spot prices of some nonferrous metals have declined in recent months and consumers, apparently, will benefit from lower pork prices in the months ahead. However, price increases were announced for a variety of durable and nondurable goods in September, suggesting that the inflation process has not yet been halted.

When aggregate demand outpaces production, additional spending resulting from excessive credit expansion brings only higher prices—not more goods and services. Under these circumstances the need for restraint through a combination of monetary and fiscal policy is clear.

Bank profits—costs and returns for major functions, 1965

Instalment loans proved to be the most profitable bank asset in 1965—yielding a net return of 3 percent on all funds used—followed by mortgages, business and agricultural loans and security investments. This is one piece of information developed from the *functional cost analysis service* undertaken by the Federal Reserve Bank of Chicago and Seventh District member banks last year.[1]

The primary purpose of the functional cost analysis service is to provide individual banks with standardized and detailed information about costs and income for each of several banking functions. Since the information is standardized, it is possible to compare the results of similar size banks, thereby enabling managements to single out those parts of their banking activities which merit closer attention and further analysis.

One hundred eighty-six member banks participated in the functional cost service in the Seventh District in 1965. The majority of the participating banks—128—had total deposits of less than 50 million dollars with 56 falling below 15 million. The remaining 58 banks were larger, including 10 with deposits in excess of 200 million dollars. Participants were scattered geographically throughout the District.

Income and expense information has been developed for eight banking functions. Two of these functions are *funds-supplying*—demand deposits and time deposits (see page 5). Capital, a third source of funds, is not treated as a separate function in this analysis. Funds supplied by the two deposit functions and net capital funds—total capital funds less fixed

[1]Nearly 10 years ago, the Federal Reserve Bank of Boston and the Federal Reserve Bank of New York, acting independently, developed cost accounting services for the member banks in their districts. The programs were planned for banks having less than 50 million dollars in deposits. Later, realizing the potentialities offered by modern computers, the two banks merged their programs into the one described in this article. In 1965, eight Federal Reserve Banks offered the program to member banks in their districts.

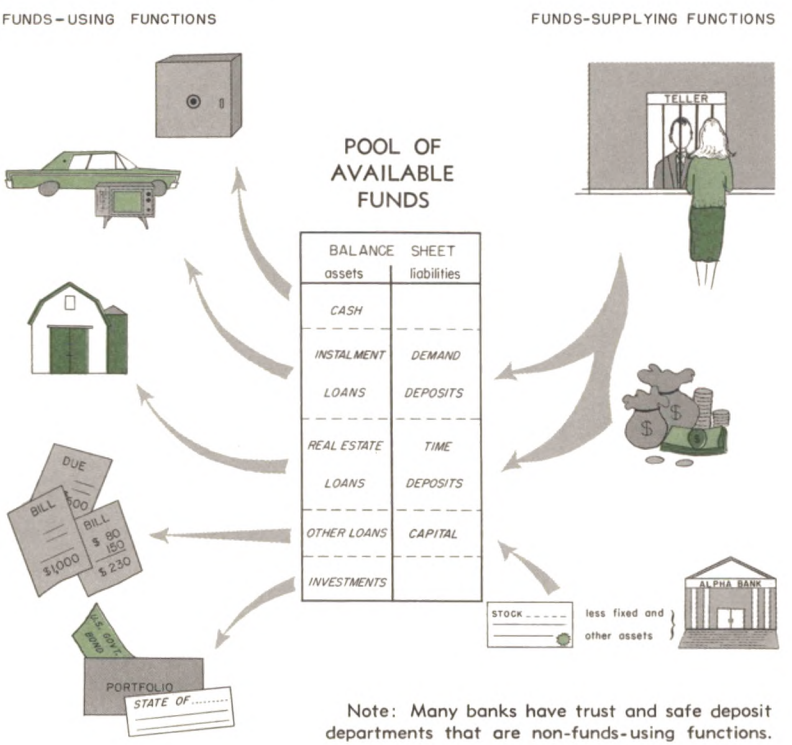
and other assets, such as bank buildings and other real estate—make up a *pool of available funds* for lending and investment. The four *funds-using* functions—instalment loans, real estate loans, other loans and investments—draw from this pool and generate the bulk of a bank's earnings.

In order to determine the net earnings of each function, portfolio income is assigned on an imputed basis to demand and time deposits and capital. The expenses of securing deposit funds—the *cost of money*—is assigned to the four funds-using functions. Thus, the study imputes earnings to the funds sources and charges the cost of money to its various uses.

The gross portfolio yield for the 186 participating banks was 4.2 percent. As a result, for each $100 of deposits, the demand and time deposit functions were assigned $4.20 in portfolio income. A similar income allocation was made to capital funds even though the capital account was not assigned any expenses. The cost of money was 2.4 percent; the three lending functions and the investment function, therefore, were "charged" this rate for all funds used. The average cost of demand deposits, according to this functional analysis, was 1.5 percent compared to 3.9 percent for time deposits.

Not everyone agrees with the concept that all funds for lending and investment come from a common pool and should bear an identical charge. In the asset management approach to cost accounting, for example, it is assumed that there is a fixed relationship between specific sources of funds and their uses, taking account of the liquidity of the various types of loans and investments. Time deposits, for example, are assumed to be channeled into mortgages or term loans. In this approach, the cost of funds used for real estate loans would be related to that of securing time deposits. The investment function, on the other hand, might be

Functional approach to cost accounting for banks



Note: Many banks have trust and safe deposit departments that are non-funds-using functions.

charged at a rate comparable to the bank's cost for obtaining demand deposits which is usually considerably lower than the cost of "time money."

The pool of funds concept seems to provide a more realistic reflection of day-by-day banking operations. Rarely would a loan application be rejected solely because a certain type of deposit had not increased by a corresponding amount. This is not to deny the importance of considering deposit-mix for purposes of profit planning and longer-run portfolio composition. Nevertheless, the pool of funds concept permits more effective comparisons between banks and hence is superior for comparative cost analysis.

The remaining two functions—safe deposit box rental and the trust department—do not directly utilize bank funds although they provide income and incur expenses. Safe deposit box rental service was operated at a net loss by the 186 participating banks during 1965—expenses exceeded income by 41 percent. Trust departments were profitable operations during 1965 in a number of the larger banks but typically were operated at a loss in the smaller ones.

Reports available

Each bank participating in the functional cost service receives a report in which its performance in each of the eight functions is compared in considerable detail with other banks of similar size and characteristics. In addition, for analytical purposes and for general information, two District "average bank" reports were developed, one contains averages for 128 small banks (total deposits of less than 50 million dollars); the other contains the same information for 58 large banks (total deposits of 50 million dollars or more). (These reports as well as two similar reports for the 581 small banks and 176 large banks that participated in the service in the eight Federal Reserve Districts during 1965 are available on request to the Federal Reserve Bank of Chicago.)

Selected highlights of the information contained in the two Seventh District "average" bank reports are presented in the following sections of this article. The data provide a generalized picture of more or less typical asset and liability structures and operating results for the major functions for large and small banks.

The loans function

Composition of the assets and liabilities of the large and small banks differs, largely reflecting the abilities of different size banks to serve various segments of the overall credit market and their differing needs and preferences for liquidity. One important difference is the size and composition of the loan portfolio. Loans constitute a greater proportion of total assets for the large than for the smaller banks; there are differences also in the relative proportions of the three major loan categories—instalment, real estate and other—to total loans.

	Large banks	Small banks
	(percent)	
Ratio of loans to total assets	50	40
Distribution of loans		
Instalment	14	25
Real estate	21	38
Other	65	37
Total	100	100

The smaller banks have relatively high proportions of their loans to individuals in the form of consumer instalment loans and residential mortgages. The "other" loan category includes commercial and industrial loans as well as several categories of lesser importance. The commercial and industrial loans are especially important at the large banks,

many of which are the major sources of credit for large manufacturing, finance, wholesale and retail trade establishments, among others. A sizable proportion of other loans for many of the small banks are agricultural loans and loans extended to individuals on a noninstalment basis.

Earnings per $100 of loans provides a much used basis for comparison both among the loan categories and among banks. Instalment loans, of course, had both the largest gross income and the highest expenses as well as the greatest net earnings per $100 of funds used. Income, expense and net earnings for each loan class is shown in the table above.

The dollar volume and number of loans per employe in each lending function provide useful comparative measures of operational efficiency among similar banks. For the two broad groups of banks reviewed in this article, the loan volume per employe in the larger banks is higher in all three lending functions. On the other hand, each employe in the smaller banks serviced a greater number of loans in each function. This partially reflects the larger volume and number of loans in the over 50 million dollar bank group and indicates that more time and effort are required to make and service large than small loans.

One measure of the sizable expense incurred in the instalment loan department is the proportion of bank personnel required. In the average small bank approximately one of every eight officers and employes are assigned to instalment loans—second only to the demand deposit function which accounts for nearly half of the total personnel. The ratio is somewhat smaller in large banks with about one of 10 officers and employes working with instalment credit. More official and nonofficial personnel are used in this func-

Loans function

	Large bank loans[1]			Small bank loans[2]		
	Instalment	Real estate	Other	Instalment	Real estate	Other
Loans						
Volume (millions)	$19.4	$27.9	$88.7	$2.4	$3.6	$3.6
Number	16,285	2,481	3,214	2,325	413	1,074
Average size	$1,192	$11,233	$27,594	$1,031	$8,784	$3,341
Net earnings before "cost of money"	$62	$553	$1,258	$56	$430	$142
Loans per employe						
Volume (thousands)	$532	$2,164	$3,474	$487	$1,842	$1,305
Number	446	193	126	473	210	391
Ratio to dollar volume (percent)						
Income	7.9	5.6	5.1	8.5	5.7	5.6
Expenses	—2.7	—0.7	—0.5	—3.1	—0.9	—1.3
Cost of money	—2.3	—2.3	—2.3	—2.5	—2.5	—2.5
Net earnings	2.9	2.6	2.3	2.9	2.4	1.8

[1]Averages for 58 banks with deposits of 50 million dollars or more.
[2]Averages for 128 banks with deposits of less than 50 million dollars.

Investments function

	Large banks[1]	Small banks[2]
Investments		
Volume (millions)	$87.4	$8.3
Ratio to dollar volume (percent)		
Income	3.4	3.6
Expenses	—0.2	—0.1
Cost of money[3]	—2.3	—2.5
Net earnings[4]	0.9	1.0
Adjusted net earnings	4.4	4.1

[1]Averages for 58 banks with deposits of 50 million dollars or more.
[2]Averages for 128 banks with deposits of less than 50 million dollars.
[3]Includes interest on borrowed funds.
[4]Tax-exempt income converted to taxable basis.

tion in both large and small banks than any other funds-using function.

The investments function

There are differences in both the relative size and composition of security holdings of the participating banks. The small banks hold higher proportions of total assets in investments and relatively more of their investments are in the form of Government securities than do the larger banks. The bigger banks, on the other hand, hold higher proportions of tax-exempt securities and liquidity loans.

	Large banks	Small banks
	(percent)	
Ratio of investments to assets	32	40
Distribution of investments		
U. S. securities	43	65
Tax-exempt obligations	39	24
Other investments	6	6
Liquidity loans[1]	12	5
Total	100	100

[1]Federal funds sold, commercial paper, brokers loans, bankers acceptances and purchased certificates of deposit.

The average gross yield on Government securities held by both large and small banks during 1965 was 4 percent. Tax-exempt securities and loans returned 3 percent for the large banks and 2.7 percent for the smaller banks. When earnings on tax-exempt securities are converted to a taxable basis, large banks earned 4.4 percent and the smaller banks averaged 4.1 percent on all funds used in the investment function. Liquidity loans yielded 4.1 percent in large banks compared with 3.9 percent in small banks.

The different proportions of tax-exempt securities in the two average portfolios are reflected in the earnings of the investments function. For the larger banks, tax-exempt income represents approximately 33 percent of total investment income compared with 19 percent for the smaller banks. Net earnings of the investments function on a tax-exempt basis are practically the same for both bank groups: 0.9 percent for large banks and 1 percent for the small banks.

The demand deposits function

Demand deposits include regular checking accounts, special checking accounts and a third group of deposits—Treasury tax and loan funds and officers checks. Demand deposits were a greater proportion of total deposits at the large than at the small banks. Also, the number of accounts and the average account size were considerably larger.

	Large banks	Small banks
	(percent)	
Ratio of deposits to total assets	87	90
Distribution of deposits		
Demand	54	48
Time	46	52
Total	100	100

The small banks generated relatively more income per $100 of demand deposits than the large banks—$3.90 compared with $3.30. However, this was largely offset by relatively higher operating expenses at the small banks.

To provide an accurate estimate of the income, expenses and net earnings of each function, portfolio earnings are assigned (on an imputed basis) to both demand and time deposits. The demand deposit function in the small bank group received an allocation of $3.25 per $100 of deposits. In the large banks, the allocation amounted to nearly $3.00 per $100 of functional volume. Imputed portfolio income was the major source of income for the demand deposit function in both groups. Activity charges and other income derived from checking accounts were about 65 cents per $100 in the under $50

million bank group and 30 cents per $100 in the $50 million or more banks.

Expense differences in the two groups were due largely to higher processing costs for each dollar of demand deposits in the smaller banks, possibly reflecting smaller average size of transactions. Commercial tellers and bookkeeping personnel expenses accounted for nearly 90 cents per $100 of demand deposits in the small banks, compared with just over 50 cents in the large banks. Other expenses, such as furniture and equipment, paper and printed materials, were proportionately lower in the large banks, reflecting economies of large-scale operations. Total expenses per $100 of functional volume were approximately $2.25 in the small banks compared with $1.50 in the larger banks.

Demand deposits function

	Large banks[1]			Small banks[2]		
	Demand deposits	Checking accounts		Demand deposits	Checking accounts	
		Regular	Special		Regular	Special
Demand deposits						
Volume (millions)	$127.6	$115.6	$2.8	$9.0	$8.2	$0.4
Number of accounts	25,674	14,719	10,955	2,244	3,874	1,370
Average size	$4,971	$7,850	$259	$1,715	$2,110	$267
Ratio to dollar volume (percent)						
Income	3.3	3.1	8.3	3.9	3.7	7.5
Expenses	—1.5	—1.3	—8.5	—2.3	—2.1	—7.0
Net earnings	1.8	1.8	—0.2	1.6	1.6	0.5
Monthly account activity (dollars)						
Activity income		.95	1.16		.82	.95
Portfolio income		19.44	.64		5.72	.72
Total		20.40	1.80		6.54	1.67
Expenses		—8.81	—1.83		—3.67	—1.56
Net earnings		11.51	— .03		2.87	.11

[1]Averages for 58 banks with deposits of 50 million dollars or more.
[2]Averages for 128 banks with deposits of less than 50 million dollars.

Net earnings of demand deposits at the large banks exceeded those at small banks due to lower operating costs for each $100 in demand deposits.

Demand deposit expenses are also a major item in total bank expenses. Approximately 26 percent of total adjusted expenses are related to this function in the small banks and 22 percent in the large banks. The function also employs the largest number of nonofficial personnel.

Special checking accounts

Special checking accounts are a very minor proportion of demand deposit volume in both bank groups, even though they represent 43 percent of the total number of accounts in large banks and 26 percent in small banks. The average balance in special checking accounts is less than $300 in both bank groups. Regular checking accounts of both individuals and firms—for purposes of comparison—had average balances of $7,850 at the larger banks and $2,110 at the smaller banks.

Special checking accounts are largely convenience accounts for households and, thus, are very likely in the hands of middle- and lower-income groups or those who prefer to pay a service charge for each check rather than maintain a larger balance that is often required with regular checking accounts.

Each month special checking account holders in both large and small banks wrote an average of nine checks and made two deposits, compared with averages of 34 checks and four deposits for holders of regular checking accounts at large banks and 19 checks and three deposits for those at small banks.

Even so, regular accounts were considerably more profitable than special accounts on a per account per month basis in the large banks. Special accounts in these banks "lost" 3 cents per month for each account while in small banks they earned 11 cents per month after all expenses. Portfolio income made up a large portion of regular checking account income in both bank groups. Because of the small net volume of funds supplied by the special checking accounts, the portfolio contribution was small.

The time deposits function

Time deposits comprise 52 percent of total deposits at smaller banks compared with 46 percent in the large banks. The composition of total time deposits is about the same for the two bank groups. Regular savings accounts are nearly two-thirds of the total with other time deposits—mainly certificates of deposit—making-up almost all of the remainder. Club and school accounts are a very minor part of total time deposits in both large and small banks.

	Large banks	Small banks
	(percent)	
Distribution of time deposits		
Regular savings accounts	67	69
Club and school accounts	*	1
Other time deposits	33	30
Total	100	100

*Less than 0.5 percent.

Portfolio income provided virtually all of the income related to time deposits. Interest paid on deposits was the biggest expense and amounted to nearly 0.5 percent more in large banks than in small banks. Interest and operating expenses exceeded total income in the large banks leading to a net loss of nearly 30 cents per $100 of time deposits. The small bank group had net earnings of 20 cents per $100 of time deposit volume.

Time deposits function

	Large banks[1]	Small banks[2]
Time deposits		
Volume (millions)	$109.2	$9.7
Number of accounts	39,785	6,777
Average size	$2,745	$1,431
Ratio to dollar volume (percent)		
Portfolio income	3.9	4.0
Other income	*	*
Total	3.9	4.0
Operating expenses	—0.4	—0.4
Interest on deposits	—3.8	—3.4
Net earnings	—0.3	0.2

[1]Averages for 58 banks with deposits of 50 million dollars or more.

[2]Averages for 128 banks with deposits of less than 50 million dollars.

*Less than 0.1 percent.

Many banks in both groups are carrying on their books a sizable number of small accounts that in total comprise a very low proportion of total time deposits. At the large banks 38 percent of all time accounts had balances under $100 and these in the aggregate accounted for less than one-half of 1 percent of total time deposits; the corresponding figures for small banks were 44 percent of the number of accounts and 1 percent of total time deposits.

Another year

The functional cost analysis service will be provided for member banks in the Seventh Federal Reserve District again in 1966. The information will become increasingly useful to banks as they obtain cost and returns for major functions in their respective banks in successive years. They will be able to detect effects of changes in their operations on the profitability of individual bank functions.

Several improvements will be made in the service. Capital funds will be treated much

like deposits and will be assigned an appropriate share of bank expenses. This change is being made because of the growing use of long-term debt as a part of the capital account. Computer services will be treated as a separate function so that those banks which operate a sizable data processing center on a fee basis will have this activity separated out of the other functions. Other minor changes will be made as a part of the effort to provide an accurate picture of bank income and costs within a standardized framework.

On balance of payments, more progress needed

The world has made phenomenal economic progress since the end of World War II. Total production of goods, for example, has more than doubled in the last 15 years. A contributing factor has been the tremendous expansion in international trade which has made possible the specialization of production and the large flows of capital and technology from areas of the world where these are abundant to areas where they are less available.

In part, an economic environment that until recently had been increasingly free from restrictions on international trade and capital movements has been a necessary condition for this surge. But in no small measure, the progress has been aided by the existing international monetary system of relatively stable exchange rates between major currencies, enabling traders and international investors to conduct their activities with only minimum concern over changes in the money value of their contracts.

The contribution made by the present national payments system, however, has not been available without a "price tag." One price has been the self-discipline that the participating nations must continually exercise to make the system function. In principle, this "discipline" is simple; it requires that no nation embark upon expenditures in excess of its capacity to finance them, that is, that no nation try to obtain from the stream of world production more than it can earn now, or in the near future (or more than it has earned in past years and has incarnated temporarily in monetary reserves), or more than it can obtain by borrowing from other nations.

If the expenditures are financed by short-term borrowing, the "discipline" requires that such borrowing be backed up by adequate reserves of internationally acceptable media of exchange so that the obligations incurred may be discharged at short notice.

Hardly anyone would question the soundness of this principle. Nations, like individuals, must earn their way. There is no magic, effortless means of boosting consumption either for an individual or for a nation. Yet, nations, even more than individuals, find it difficult to adhere to this simple principle.

The difficulty arises from the disparity that exists between individual and national interests. While the myriads of transactions involving international money transfers are undertaken by individuals in pursuit of their

personal objectives, the responsibility for adherence to the principle of balance between the total of in- and out-payments must be borne collectively. But just as there is no a priori reason why at any point in time the domestic taste for foreign wines must be exactly matched by foreigner's need for domestically produced machinery, so there is no a priori reason why the accounts should always balance. Thus balance of payments deficits or surpluses appear almost continuously in the account of every country.

Adjustments mechanism

To be sure, the existing international payments system contains certain "built-in" mechanisms that work automatically toward elimination of imbalance. The functioning of this mechanism can be illustrated by the following example: suppose that in the United States the demand for imported French wines increases and as a result a deficit appears in our balance of payments. Such a deficit manifests itself, in the first instance, as an increase in the supply of dollars in France (as the French exporters receive their payments from the American wine importers)—relative to the demand for dollars by the French importers of American goods.

An increased supply of anything—be it potatoes or foreign currency—relative to the demand for it tends to cause the price to decline. In this particular instance, the United States dollar would tend to depreciate relative to the French franc. However, the French monetary authorities, being committed by the Articles of Agreement underlying the present monetary system to maintenance of a fixed exchange rate of the franc vis-á-vis the dollar, would step in to purchase the "excess" dollars by exchanging them for francs. Thus, as a result of the United States balance of payments deficit, French exporters wind up with more francs in their pockets and the Banque de France with more dollars in its coffers. And here, the automatic forces working toward establishment of a balance begin to operate: the French exporters, their incomes having risen, increase both their purchases and—in order to meet greater American demand for their products—production and employment in their industries, thus raising the overall domestic income and expenditures.

Such an increase will lead to two subsequent developments. First, the prices of the domestically produced goods (including wine) will be bid upward; second, increases in domestic purchases will include imported goods, including the imports from the United States. Both of these developments will work toward elimination of the initial imbalance: increases in the price of wine will discourage the consumption of wine in the United States, thus reducing the United States wine imports. Increased purchases of American goods by the French will lead to a boost in United States exports to France.

At the same time, forces in the opposite direction will be working in the United States. Since the initial increase in consumption of French wine occurred at the expense of some domestically produced goods, incomes of the producers of these goods will drop. Lower incomes will lead to lower overall domestic expenditures (including expenditures on French wine) and thus to a downward pressure on prices in the United States. Lower prices will stimulate exports, and with higher exports—and lower imports—balance will tend to be restored.

However, in order for the mechanism to operate as described in this simplified example,[1] it is necessary that certain conditions

[1]Further refinements of the example could be achieved by taking into consideration capital flows and resulting interest rate adjustments.

are met. The most important is that prices, wages and interest rates adjust promptly in response to changes in domestic and foreign demand-supply conditions. Unfortunately, very few economies in the modern world are capable of achieving such a prompt and smooth response. Certain rigidities—mostly a result of contractual wages and prices and the modern large-scale production process—preclude rapid adjustment, particularly in the downward direction. Consequently, the elimination of a balance of payments deficit, as induced by the "built-in" mechanism, has tended to take the form of unemployment in the deficit countries or of changes that were viewed as being inflationary in the surplus countries.

It is this aspect of the adjustment process that has made the nations reluctant to adhere to the discipline as imposed by the automatic forces of adjustment. National governments, increasingly concerned with the social welfare of their citizens, have striven to negate the impact of adjustment to a balance of payments deficit or surplus upon the domestic economy by insulating the economy from the full impact of the adjustment forces.

Postponement: pressures cumulate

Under certain circumstances, such "insulation" may be considered a sound policy. For example, if the deficit has been brought about by a temporary disruption of normal flows—such as a domestic crop failure that resulted in a larger than usual importation of agricultural products—it is to the interest of all citizens that the government use the foreign exchange reserves accumulated in the past (or foreign credits granted currently by other nations) to carry the country over the difficulty. Also, mitigation of the impact of a more basic imbalance, by allowing the necessary adjustment to take place gradually while corrective forces continue to operate, may be appropriate.

However, the line between mitigation and negation is thin and difficult to follow. Any postponement of the necessary adjustments may allow the domestic imbalances that have initially led to the emergence of the deficit to become more deeply implanted in the structure of the national economy thus, in the end, necessitating an even more severe "shake-up" than would have been required initially. Also, particularly if the postponement of the adjustment has been financed by borrowing abroad, there is the ever present danger that the creditors may become dissatisfied with the rate of progress toward a balanced position and begin to suspect that a devaluation of the currency might be contemplated as a means of easing the necessary adjustment. In these circumstances holders of claims on the currency in question, in order to protect the value of their assets, initiate conversions of both current and prospective future claims. In addition, noting that these developments could possibly *force* a devaluation, speculators may take positions in anticipation of the event. Such actions may force the government to adopt drastic measures to restore balance rapidly and at a much higher price in terms of the severity of impact on the economy than would have been necessary under more orderly conditions.

The inescapable fact in international commercial relations is that no country, large or small, rich or poor, can indefinitely spend, invest or give away abroad more than it earns or receives from abroad and avoid erosion of its currency. Sooner or later, balance must be achieved. Recent economic history provides many examples of nations being reminded in no uncertain terms of the truth of this principle. Since World War II, several countries have experienced foreign ex-

change crises that induced their governments either to devalue the currencies or to adopt severe restrictive measures to restore balance in their international accounts.

Current example

Attention has recently been focused on Great Britain. Faced in the past 18 months with repeated speculation against the pound sterling, the British government has adopted a series of measures that when fully implemented are expected to have widespread effects on the domestic economy. In the meantime, the people of Great Britain will be experiencing the effects of the discipline imposed upon their economic lives by the deficit in their country's balance of payments.

The accompanying table presents a summary of the measures adopted by the British government since the fall of 1964, together with estimates of their quantitative impact. Officially, it has been estimated that, as a re-

Measures undertaken
by the British government since the fall of 1964

Date adopted	Measure	Estimated impact: Annual amount[a] (million dollars)	Estimated impact: Area
1964			
October 27	Rebate on exports of 1.5 percent	n.a.	Exports
	Import surcharge of 15 percent[b]	840[c]	Imports
November 12	Gasoline and oil excise tax	260	Government revenue
	Income tax raised from 38.75 to 41.25 percent	342	Government revenue
November 23	Discount rate increased from 5 to 7 percent[d]	n.a.	Bank credit
1965			
April 6	Tobacco excise tax	207	Government revenue
	Alcoholic beverages tax	140	Government revenue
	Motor vehicle tax	140	Government revenue
	Higher postal rate	90	Government revenue
	Long-term capital gains tax increased	350[c]	Government revenue
	Special deposits requested from banks	260	Bank credit
July 27	Maturity of instalment purchases reduced from 36 to 30 months	n.a.	Consumer spending
	Stricter rules for licensing of privately sponsored construction projects	n.a.	Private investment spending
	Reduction in mortgage lending by local authorities from £180 to £130 million ordered; all new constructions are to be postponed six months	n.a.	Government investment spending
July 28	Reduction of 1 percent in the cost of export financing by facility discounts	n.a.	Exports
	Prepayment of imports prohibited	n.a.	Imports
	Various minor restrictions on investment currency market	n.a.	Capital outflows
1966			
February 1	Bank lending limited to 105 percent of March 1965 level	n.a.	Credit
February 8	Downpayment on consumer durables raised from 15 to 25 percent and repayment period reduced to 27 months	n.a.	Consumer spending
April 9	Guidelines on wages and prices, calling for a maximum increase of 3.5 percent	n.a.	Government revenue

to strengthen their balance of payments position

Date adopted	Measure	Estimated impact: Annual amount[a] (million dollars)	Estimated impact: Area
1966			
May 3	Selective employment tax introduced	882[e]	Government revenue
	Tax on overseas trading corporations	280	Balance of payments
	Voluntary foreign lending restraint program for investment into sterling area	280	Capital outflow
July 14	Discount rate increased to 7 percent	n.a.	Credit: business expenditures
	Special deposit requirement increased to 2 percent	n.a.	Credit: business expenditures
July 20	Changed: Downpayments Old (percent) 25 / New (percent) 40; Repayments Old (months) 27 / New (months) 24	448	Credit: consumer expenditures
	Changed: Downpayments Old (percent) 15 / New (percent) 20; Repayments Old (months) 27 / New (months) 24	448	Credit: consumer expenditures
	Changed: Downpayments Old (percent) 25 / New (percent) 33⅓; Repayments Old (months) 24 / New (months) 24	448	Credit: consumer expenditures
	Increase of 10 percent in purchase tax on spirits and alcoholic beverages	420	Government revenue
	Surtax on gasoline	56	Government revenue
	Surcharge of 10 percent on general surtax	73	Government revenue
	Price and income freeze	n.a.	Income
	Dividend payment freeze	n.a.	Income
	Construction controls imposed	28	Private investment
	Government spending on public service	154	Government investment
	Government spending nationalized industries	266	Government investment
	Cut in government spending abroad by military and civilian	280	Balance of payments
	Overseas travel allowance reduced to £50 per year	140	Balance of payments

n.a. Not available.
[a]Converted into dollars at par.
[b]Reduced to 10 percent in the spring of 1966 and is slated to expire November 1966.
[c]Original estimate which subsequently has been revised several times.
[d]Reduced to 6 percent in June 1965.
[e]This estimate is for 1966 only; due to partial tax refunds starting January 1967, the net receipts are estimated at $675 million per annum in 1967 and thereafter.
SOURCE: Various official press releases and other unofficial estimates.

sult of these measures, unemployment will rise from the present level of around 1.1 percent of the labor force (that is, from about 264,000 workers) to about 2 percent (about 500,000); some unofficial estimates place the figure as high as 700,000. Such a shakeout—to use Prime Minister Wilson's term—has been deemed necessary to bring the domestic economy in line with the requirements placed upon it by the nation's balance of payments.

British difficulties may be traced back to World War II. Their war efforts resulted in large deficits in their balance of payments. These were financed partly from gold and dollar reserves and sale of assets but to a much larger extent by borrowing — accumulation of short-term sterling liabilities to other countries. While the sterling liabilities at the beginning of the war amounted to £476 million, in mid-1945 they amounted to £3,355 million.

In 1958 these balances were made convertible into other currencies. At the end of 1958, after the return to convertibility, Britain held gold and foreign exchange reserves of 2.8 billion dollars against over 9 billion dollars of total net sterling liabilities. This reserve-liability ratio was recognized and acknowledged by the British government as a potentially dangerous position. In the memoranda of evidence submitted to the Committee on the Working of the Monetary System by the British treasury in 1959, it was pointed out that

> . . . our reserves are, and have been since the war, altogether too small in relation to our needs. . . . Three major factors in our external monetary position (the status of sterling as an international currency, long-term investment overseas and the relationship between our monetary assets and liabilities) of necessity, gives rise to two dominant objectives in external policy: (a) the maintenance of confidence in sterling and (b) the earning of an adequate external surplus.

Thus, since 1959 the British economy has been charged with a formidable task that, as far as the external objectives were concerned, implied the achievement of a surplus necessary to improve its reserve ratio. This task has been made more difficult by basic changes in British trade patterns.

Prior to World War II, Britain experienced a traditional deficit in the "visable trade" accounts; but this was more than offset by income from investment and services. For example, in 1938 net receipts from services could pay for 33.6 percent of imports, and income from overseas investments could pay for 26.9 percent of imports. By 1960 this situation had changed drastically: the income from services could pay for only 1.5 percent of imports, and income from investments only 5.8 percent. Thus, the main burden in achieving a surplus rested upon a sharp increase in exports relative to imports. However, with strong domestic demand, imports continued to increase faster than exports. In 1961, and again in 1964, the British experienced a severe crisis of confidence in their ability to achieve the two dominant objectives set in 1959. These developments led finally to the measures listed on pages 14 and 15 which deal with the underlying economic imbalances that brought on the recent crisis.

Lesson learned?

The British case stands perhaps as an example of the discipline to which a nation must subject itself in order to eliminate an excessively large or persistent deficit in its balance of payments; the apparent severity of the present measures illustrates the price of delaying needed adjustments.

There is also an important lesson to be learned from the British experience. For the past 15 years (with the exception of 1957), the United States has been running a deficit in its balance of payments. Although the nature of the United States deficit has been vastly different from the British and although our reserves of gold relative to our direct obligations to foreign central banks have been far more satisfactory than Great Britain's ever were, there is a limit to how large and for how long a deficit can be accommodated.

Many positive steps already have been taken to reduce the deficit in the international payments of the United States. They have produced marked results. Yet, the deficit is still with us and further steps appear to be necessary before the problem will be resolved. If we are to avoid a predicament similar to Britain's, for example, we must press further and achieve an orderly elimination of our deficit.