As the winter of 1966-67 comes to a close, it is apparent that the six-year business expansion has given way to a period of adjustment. The monetary and fiscal policy actions of 1966 have succeeded in dampening the excesses of demand that threatened an inflationary wage-price spiral, but not until substantial distortions had developed in several sectors.

As the needed adjustments proceed, the Administration and the monetary authorities have turned their efforts toward preventing cutbacks in some sectors, such as consumer durables, some types of business equipment and construction from spreading through the entire economy. The most noteworthy of these steps in March were the reduction in reserve requirements on savings accounts and the decision to lift immediately the suspension of the investment tax credit on purchases of producers’ durable equipment. The suspension had been scheduled to remain in effect until January 1, 1967.

Economic conditions in January and February often provide a poor basis for evaluating future developments. Many activities are at seasonally low levels in these months and abnormally mild or severe weather can strongly influence year-to-year comparisons. This effect is doubly important when opposite conditions prevail in consecutive years.

In early 1966 relatively pleasant weather aided many types of activities, especially residential construction and auto sales. This year, however, storms and record snowfalls tended to keep potential shoppers at home, hampered excavations and concrete work and movements of goods in and out of plants. The Chicago area—with a population of more than 7 million was particularly hard hit. Weather influences, although not subject to precise measurement, should be kept in mind when recent economic data is analyzed. As a sage once wisely said, “avoid highly pessimis-
The table on page 15 should read as follows:

**Foreign credits** of banks in the Seventh Federal Reserve District

<table>
<thead>
<tr>
<th></th>
<th>December 1965</th>
<th>April 1966</th>
<th>September 1966</th>
<th>December 1966</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of reporting</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>banks</td>
<td>17</td>
<td>20</td>
<td>20</td>
<td>21</td>
</tr>
<tr>
<td>Total foreign credits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>subject to ceiling</td>
<td>900</td>
<td>878</td>
<td>820</td>
<td>894</td>
</tr>
<tr>
<td>Target ceiling</td>
<td>979</td>
<td>1,000</td>
<td>1,010</td>
<td>1,029*</td>
</tr>
<tr>
<td>Net expansion of</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>credit since December</td>
<td>- 33</td>
<td>- 55</td>
<td>- 113</td>
<td>- 42</td>
</tr>
<tr>
<td>Net leeway for</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>expansion within</td>
<td>79</td>
<td>122</td>
<td>190</td>
<td>135*</td>
</tr>
<tr>
<td>target ceiling</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Based on 1966 guidelines.
Declines in the Midwest

The industrial Midwest led the nation to full employment prosperity in 1965. During the past six months, however, declines in orders and output have been most significant in steel, motor vehicles, construction equipment, household appliances and black and white television sets—all important products of this region. On the other hand, industries, such as farm equipment and electrical generating and distribution apparatus—also prominent in the area—are expected to continue to produce at capacity levels.

The vital nonelectrical machinery and equipment industries of the Midwest—including machine tools, presses, freight cars and locomotives, and materials handling equipment—continue to operate at or near capacity. The future has been clouded for these activities, however, because of sharp declines in new orders of some firms and cancellations of existing orders since late 1966. In part, the reduction in net new orders for producers' equipment reflected both the withdrawal of the investment tax credit and the growing expectation that it would be reinstated soon.

Income and sales

Unemployment in Peoria (construction equipment) and Kenosha (autos) rose appreciably early in 1967, according to the Department of Labor. Other Midwest centers, especially those concentrating on motor vehicles, also are experiencing easier labor markets. Nevertheless, unemployment overall remains at very low level compared with most earlier postwar years.

Reduced needs of some manufacturers have eased recruitment difficulties, but the number of unfilled jobs remains large. Employers, large and small, throughout the region continue to report dissatisfaction with the quantity and quality of prospective workers interviewed by their personnel departments. Many workers who have been laid off by automotive firms but have hopes of returning to their jobs are reluctant to sever seniority positions by obtaining the "quit slips" often required for employment elsewhere.

Total employment, seasonally adjusted, increased further in January and February despite reductions in some manufacturing industries and in construction. Average hours in manufacturing were reduced sharply, however, as some firms eliminated overtime operations and others scheduled short workweeks. New claims for unemployment compensation...
were substantially above the very low year-earlier level in March for the nation and for each of the Seventh District States—Illinois, Indiana, Iowa, Michigan and Wisconsin.

Retail sales in January and February showed little change, seasonally adjusted, from the level of the last half of 1966 and were only slightly higher than a year earlier. Meanwhile, personal income continued to rise and exceeded the year-ago level by about 7 percent. Seldom before has such a wide divergence between consumer income and retail sales developed in such a short period of time.

**Adjustment periods of the past**

A further rise in total outlays for goods and services occurred in the first quarter and is expected also for the second quarter. This results largely from price increases, not from larger physical volume of goods and services. Unless the major measures of production begin to rise again in the second quarter, the developments in recent months probably will be described as the beginning of a general business recession. Business cycles trace movements in real activity, not changes in dollar aggregates.

The postwar years have seen four general recessions starting in 1948, 1953, 1957 and 1960. In each case substantial declines occurred in industrial production and employment after a period of relative stability. In addition to these periods, described as recessions, activity remained stable or even declined somewhat in a number of additional periods, but not enough or for a long enough period to be described as full-fledged cyclical downturns.

In 1947 industrial production was on a plateau from January through August before a renewed expansion was evident that continued into the third quarter of 1948. Employment followed a similar pattern.

In 1951 and 1952, during the Korean War, industrial production showed no definite upward movement for about 18 months. Moreover, there were short declines in total output resulting from material allocations and the 1952 steel strike. Employment tended to rise throughout this period, but there were intervals of three or four months when only small changes occurred. Following these hesitations, industrial production rose to a cyclical peak in July 1953 before declining after the successful conclusion of truce talks.

From October 1955 through August 1956, industrial production was either stable or declining. As in 1952, the final portion of the period included a widespread steel strike. In this case employment continued to rise while industrial production remained level until the steel strike. After the strike the general expansion resumed and continued for about a year.

The next slowdown and decline without a recession was in 1959, but this development was entirely attributable to another steel
Retail sales have leveled while consumer incomes continue to rise

Strike—the longest in history.

Most recently industrial production and employment remained on an extended plateau in the July-December period of 1962. At that time, as in the earlier slowdowns, there was widespread apprehension that a general business recession was in the making. Instead, the expansion was resumed in 1963 and continued in succeeding years at an extremely vigorous pace.

The recent slowdown in activity differs from the previous hesitations and recessions in a number of ways. One is the continued rise in employment and income. Another is the heavy backlog of orders and plans for construction and equipment purchases temporarily repressed in 1966. Of equal, or perhaps greater importance, is the vigor with which monetary and fiscal policies have been undertaken to help achieve orderly adjustment.

Capital expenditures

Business firms expect to spend 63 billion dollars on new plant and equipment in 1967, 4 percent more than last year, according to a survey released by the Department of Commerce in March. These outlays have been rising since 1961. For the past three years the average annual increase has been 15 percent, much greater than in any previous three-year period.

Clearly, plant and equipment spending could not continue to rise indefinitely at a rate of increase twice that of total activity. In time, margins of unused capacity would be certain to develop, even if total sales continued to rise. But sales have leveled—declined for many firms—in recent months. The result has been a buildup of inventories and widespread reassessments of needs for new plant and equipment. In addition, some programs have been held back because of the suspension of the investment tax credit beginning October 10, 1966. Much has been written concerning the tendency of firms to plan capital outlay programs for several years.
Price indexes show easing of inflationary pressures

Percent, 1957-59 = 100

In the future. This trend may not necessarily contribute to stability on a year-to-year basis, however, because individual projects can be accelerated or postponed in response to current needs, as well as availability of equipment, labor and other services.

The Commerce survey indicates that capital expenditures of all major industries will increase less in 1967 than in 1966. For several industries, including textiles, building materials, motor vehicles, other transportation equipment and the railroads, outlays are expected to be lower than last year.

The impact of the suspension of the investment tax credit, and its subsequent restoration, on total investment spending in 1967 will never be known with certainty. Once expectations became widespread that the suspension would be lifted before the end of the year, however, it appeared that orders for many types of equipment were being postponed and that output of these would be reduced sharply if the uncertainty were permitted to continue.

The tax credit can be effective in stimulating equipment spending only for marginal projects that would not otherwise have appeared profitable. More important to business firms are prospects for sales and orders. Unless the recent slowing in consumer purchases is reversed, the effect of the restoration of the tax credit will be moderate.

Toward stable growth

Prescriptions to combat the underutilization of resources in the early Sixties were generally similar—calling, in varying degrees, for the encouragement of credit expansion, increases in certain categories of Government spending and tax reductions. But as resources were nearing full utilization and inflationary pressures were strengthening in 1965 and 1966, policy recommendations were far from unanimous. Opinions varied at crucial stages, not only as to whether restraining actions were indicated, but also as to the nature and extent of such actions. The problem of moderating excessive demands proved to be more complicated than the simpler task of promoting utilization of idle resources.

The economic situation in the spring of 1967 also has its difficult aspects. That the overheated boom has cooled is clear enough. But this fact does not necessarily call for the broad expansionary programs of three years ago. The continued rise of many prices and generally low levels of unemployment suggest that excessively stimulative policies could preclude the making of necessary adjustments and perpetuate an inflationary upsurge in wages and prices. Being demonstrated currently is the narrow margin that separates under- and over-utilization of resources. Policymakers in coming months will continue the struggle to develop and implement policies that will help to maintain prosperity through a period of transition from inflation toward stable growth.
Banking goes international

Commercial banks in the United States had almost 12 billion dollars of credits outstanding to foreigners at the end of 1966—a fivefold increase within the last ten years. At the same time the number of foreign branches of American banks increased from 115 to 264, and the assets of these branches amounted to 9.1 billion dollars at the end of 1965.

These figures reflect the tremendous expansion of foreign activities of American commercial banks and the “coming of age” of the United States as a center of international banking and finance.

**Background of the development**

For centuries, international banking was dominated by European banking houses. This tradition dates back to the twelfth century when the money lenders of Lombardy (an area in northern Italy) became engaged in financing foreign trade. Then followed the development of private banking houses in Florence, Genoa and Venice and thus, up to the mid-sixteenth century, Italian banking reigned supreme over international finance. In the latter part of the sixteenth century, the center gradually shifted to the Low Countries—Belgium and Holland. First, Antwerp and, then, in the early seventeenth century Amsterdam became the international financial centers. With the establishment of the Bank of England in 1694, Britain gradually became the focal point of international finance and retained its supremacy until World War II.

United States banks did not engage in international activities in any significant way until 1914. Prior to that time, national banks were prohibited from establishing foreign branches and from accepting bills of exchange; thus they were largely precluded from financing international commercial transactions. Only a modest amount of international banking business had been carried out by private, unincorporated banks and by state chartered banks.

The passage of the Federal Reserve Act in 1913 opened the door to the expansion of the American banks into the international field. Banks were permitted to accept bills arising from international transactions, and any bank with capital and surplus of 1 million dollars or more was authorized to establish branches abroad. However, although the legal door was open, expansion was slow in coming. It was only through vigorous efforts on the part of the Federal Reserve to promote an acceptance market that the volume of trade financing by American banks gradually increased. Total volume of acceptances grew to an estimated 250 million dollars in 1916 and rose further to 1 billion at the end of 1919.

The establishment of foreign branches by American banks also developed slowly. During the three years following the passage of the Federal Reserve Act, only one national bank established branches abroad. To facilitate the expansion, the Federal Reserve Act was amended in 1916 to permit investment by national banks in corporations engaged
principally in international or foreign banking. However, no provision was made for Federal chartering and only three "agreement corporations" were state chartered in the two years following the amendment. ¹

To provide additional inducement for American commercial banks to expand into export and capital financing, Congress passed a law in 1919 (commonly known as the Edge Act after its sponsor, Senator Edge of New Jersey) authorizing the Federal Reserve Board to charter and regulate corporations established "... for purposes of engaging in international or foreign financial operations." Initially, two types of corporations were permitted to be established by Regulation K of the Board of Governors: banking corporations and financing corporations. ² They were authorized to:

—buy and sell spot and future foreign exchange
—receive checks, bills, drafts, acceptances, notes, bonds, coupons and other securities for collection abroad
—buy and sell securities for the account of customers abroad.

Moreover, the banking corporations were authorized to hold demand and time deposits of foreigners and were permitted to acquire equity investment in foreign corporations engaged in banking. ³ The financing corporations, while not permitted to accept deposits, were empowered to invest in foreign corporations other than banks.

The 1916 and 1919 legislation—together with rapidly growing foreign trade and investment—finally provided the impetus for the expansion of American banks into international banking in the following decade. By 1920, American banks had established 181 offices abroad, and by 1929, 18 agreement and Edge Act corporations were formed. However, the worldwide depression that hit

¹The name "agreement corporations" arose from the provisions of the amendment requiring each corporation to "enter into an agreement" with the Federal Reserve Board regarding the type and manner of activities.

²In September 1963 Regulation K was revised and the distinction between the two types of corporations eliminated. Existing Edge Act financial and banking corporations were permitted to merge all functions into one corporation.

³In 1966, legislation was passed allowing national banks with capital and surplus of 1 million dollars or more to invest, upon the approval by the Board of Governors of the Federal Reserve System, an amount not exceeding 10 percent of its paid-in capital and surplus in the stock of foreign banking corporations, thus opening a more direct route to such investment.
in 1930 brought the expansion to a standstill. Throughout the depression-ridden Thirties and the war-torn Forties, the number of foreign branches and Edge Act corporations declined. By 1945, there were only 78 offices of American banks operating abroad, and only two Edge Act corporations had survived.

After the war and up to the late Fifties, the expansion proceeded at a very slow rate. Although the dollar had emerged in the postwar period as a key currency, and dollar exchange was in short supply throughout most of the world, various restrictions placed by individual countries on the convertibility of their currencies made it difficult for American banks and corporations to extend credit to foreigners. The shortage of dollars to finance the imports and capital needs of the world was met largely through U. S. Government aid programs.

The massive flow of goods and services that the United States assistance made possible produced spectacular results. By 1958, a number of industrial countries of Western Europe reached levels of prosperity and economic stability high enough to enable them to establish free convertibility of their currencies into the dollar.

With the removal of this major impediment, American banks embarked upon rapid expansion that reached its climax by 1964. As the volume of world trade (as measured by world imports) increased from about 100 billion dollars in 1958 to about 160 billion in 1964, the financing extended by American banks—directly or indirectly—increased more than proportionately. The volume of acceptances made by these banks increased from 1.2 billion dollars outstanding at the end of 1958 to almost 3.4 billion at the end of 1964. Short-term claims on foreigners reported by United States banks increased from 2.5 billion dollars to 7.9 billion in the same period.

As American corporations undertook to establish manufacturing facilities closer to their markets abroad, United States banks expanded their network of foreign branches in order to provide their customers with the variety and quality of services they were accustomed to at home. By the end of 1964, American banks were operating 181 branches in 45 foreign countries with total assets of 6.9 billion dollars.

The growth was not limited merely to the expansion of traditional banking activities. Between 1958 and 1964 the number of Edge Act and agreement corporations rose from 8 to 38, and through these, an increasing number of United States banks entered new
areas of foreign activities—equity financing. The banks, either in association with local firms abroad or, in some instances, in association with U. S. Government lending agencies, have made equity investment in foreign manufacturing, mining and public utility industries.

**Enter: the deficit**

Expansion of foreign activities by American banks in the late Fifties and early Sixties coincided with unfavorable developments in the United States balance of payments. Since 1950, the United States balance of payments was in deficit in all years except 1957. Throughout most of the Fifties, this deficit was viewed by all countries of the world as a favorable development not only because it represented net additions of goods, services and capital to the war-depleted world supplies, but also because it enabled war-torn countries to acquire dollar exchange.

By the late Fifties, however, the attitude of the major countries of the world toward the United States deficit began to change. The flow of private United States capital (including bank credit), particularly to Western Europe, rose rapidly under the impetus of free convertibility and profit opportunities arising from the establishment of the European Common Market. Although the United States continued to realize an increasing surplus in goods and services accounts, this was not sufficient to offset the rising deficit in the capital accounts. Consequently, the overall balance of payments deficit widened. Confronted with heavy inflows of dollars into their treasuries, a number of countries began to convert accumulated dollars into gold.

Faced with these developments, the U. S. Government undertook various measures to reduce or eliminate the deficit. Overseas procurement for military purposes was restricted to items for which prices were far below those for domestically supplied goods. Foreign aid was increasingly “tied” to procurement in the United States.

These measures notwithstanding, the United States deficit continued at a high level. Therefore, in 1963 the President proposed a tax on purchases of foreign securities by United States residents. Its purpose was to “equalize” the cost of long-term capital financing between the United States and other developed countries, thereby reducing the incentive for capital outflow via purchases of foreign securities.

The Interest Equalization Tax (IET) appeared to have been highly successful in accomplishing its objective: sale of new issues of foreign securities in the United States dropped from a 1.8 billion dollar annual rate in the first half of 1963 to a 660 million
annual rate in the second half. Although securities sales rose somewhat in 1964, this was primarily the result of increased borrowing by countries exempt from the Interest Equalization Tax. Overall, the net outflow of United States capital through the transactions in foreign securities was reduced from 1.1 billion dollars in 1963 to 677 million in 1964.

But while foreign securities sales in the United States declined, foreign lending by United States banks increased. Outstanding loans to foreigners rose by 1.5 billion dollars in 1963 and 2.5 billion in 1964 and continued to rise rapidly in the early weeks of 1965. To deal with this problem, the President, on February 10, 1965, announced extension of the Interest Equalization Tax to bank loans of over one year maturity.

Although the measure was not enacted into law until 1964, the original request by the President—and the ultimate enactment—called for retroactivity to the date of proposal, July 18, 1963. Thus the restraining effect of the tax was felt in late 1963.

Capital outflows play a dominant role in the United States balance of payments deficit

![Graph showing capital outflows](http://fraser.stlouisfed.org/)

Bank lending to foreigners reverses sharply in 1965

![Graph showing bank lending](http://fraser.stlouisfed.org/)

and a Voluntary Foreign Credit Restraint (VFCR) program to reduce bank lending abroad. Under this program, the banks were requested to limit the extension of credit to foreigners during 1965 to 105 percent of the amount outstanding at the end of 1964. The banks were further asked to give priority to credit used in financing United States exports and that extended to developing countries.

These measures, no doubt, have greatly impeded foreign activities of American banks. However, recognizing the importance of achieving balance in international payments, the banks have shown an overwhelmingly favorable response. The heavy outflow of banks’ funds experienced in 1964 was reversed, and by mid-1965 the accounts showed a net reduction in outstanding foreign loans.

During 1965, banks contributed substan-

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*Although the measure was not enacted into law until 1964, the original request by the President—and the ultimate enactment—called for retroactivity to the date of proposal, July 18, 1963. Thus the restraining effect of the tax was felt in late 1963.

*Originially, the 1965 extension of IET to bank loans was thought to be applicable to loans made by foreign branches of United States banks. Therefore, the tax acted as an impediment to long-term lending by United States-based banks—as well as by their branches abroad. However, in 1967 Congress passed legislation explicitly exempting foreign branches from the tax.
tially to the improvement in the nation's balance of payments position. Yet, the deficit, although cut from 2.8 billion dollars in 1964 to 1.3 billion in 1965, still remained at an uncomfortably high level. Thus, the Government found it necessary to extend the VFCR program through 1966. The banks were asked to restrain expansion in foreign credits so that the amount outstanding at year-end would not exceed 109 percent of the amount outstanding on December 31, 1964.

The 1966 program, combined with general monetary restraint imposed to combat domestic inflationary pressures, produced a 260 million dollar net reduction in foreign credits of commercial banks in 1966.

In December 1966, in view of the still unsatisfactory balance of payments situation, the Administration announced extension of the VFCR program for another year. The 1967 foreign credits ceiling for commercial banks was retained at 109 percent of the 1964 base, and each bank was asked to limit the use of its leeway available on October 1, 1966, to not more than 40 percent before March 31, 1967, not more than 60 percent before June 30 and not more than 80 percent before September 30, 1967. In addition, banks were requested to expand nonexport credits to developed countries by not more than 10 percent of the October leeway.

Effects of the restraint program

In terms of the immediate balance of payments considerations, the VFCR program has apparently been highly successful. Although the United States deficit continued to be large in 1966 mainly because of what appears to be a temporary deterioration in trade surplus—see Business Conditions, January 1967—the position of the dollar in the exchange markets has improved considerably. This improvement was reflected in the surplus of 271 million dollars in the United States balance of payments on the official transactions basis during 1966—as opposed to a deficit of 1.3

### Foreign credits of United States banks

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of reporting banks</td>
<td>161</td>
<td>161</td>
<td>161</td>
<td>159</td>
<td>156</td>
<td>148</td>
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<tr>
<td>Total foreign credits subject to ceiling</td>
<td>9,652</td>
<td>9,367</td>
<td>9,429</td>
<td>9,142</td>
<td>9,303</td>
<td>9,496</td>
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<tr>
<td>Target ceiling</td>
<td>9,973</td>
<td>10,076</td>
<td>10,179</td>
<td>10,290</td>
<td>10,375</td>
<td>10,360</td>
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<tr>
<td>Net expansion of credit since December 1964</td>
<td>156</td>
<td>-134</td>
<td>-77</td>
<td>-369</td>
<td>-200</td>
<td>-3</td>
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<tr>
<td>Net leeway for expansion within target ceiling</td>
<td>319</td>
<td>709</td>
<td>751</td>
<td>1,148</td>
<td>1,072</td>
<td>864</td>
</tr>
<tr>
<td>Banks in excess of target ceiling</td>
<td>35</td>
<td>22</td>
<td>24</td>
<td>13</td>
<td>20</td>
<td>18</td>
</tr>
<tr>
<td>Net reduction in credit necessary to achieve target</td>
<td>114</td>
<td>18</td>
<td>26</td>
<td>17</td>
<td>30</td>
<td>31</td>
</tr>
</tbody>
</table>

1 Target ceiling was generally 109 percent of December 1964 base.

2 Target ceiling was generally the amount outstanding on September 30, 1966, plus 40 percent of the difference between that amount and 109 percent of the December 1964 base.
billion in 1965. This surplus meant that the dollars accruing to foreigners during 1966 as a result of our "liquidity deficit" did not flow into "official" hands and thereby become a direct claim on United States gold. Partly because of this, the outflow of gold from the United States in 1966 amounted to only about a third of the large outflow in 1965.

American banks played an important role in this improvement, not only through their performance within the framework of the VFCR program, but also through their activities and those of their foreign branches in the Euro-dollar market.

During 1965—the first year the VFCR program was in operation—the total deposits of overseas branches of member banks of the Federal Reserve System increased 1.8 billion dollars or 36 percent. Almost the entire increase—1.69 billion—was accounted for by a gain in time deposits, believed to be mostly the so-called Euro-dollars. The gain in deposits enabled the branches to increase their loans outstanding by 1.4 billion dollars or 43 percent, in the same period. This development reflected, to a considerable extent, the impact of the Government's balance of payments program under which United States companies were urged to finance the operations of their foreign subsidiaries from foreign sources—and a shift to foreign branches of some bank loans which, in the absence of the voluntary foreign credit restraint effort, might have appeared on the books of the head offices of these branches.

In 1966, this development intensified considerably. The branches, being increasingly hard-pressed for funds, began to bid more actively for Euro-dollar deposits, and some banks issued negotiable dollar-denominated certificates of deposit in London in order to obtain funds. As the demand for funds—and thus the competition for Euro-dollars—intensified, the rate of interest paid on such deposits continued to climb.

The increasing interest rate made it progressively more attractive for foreigners re-

### Overseas branches of member banks of the Federal Reserve System

<table>
<thead>
<tr>
<th>Country</th>
<th>England</th>
<th>Continental Europe</th>
<th>Latin America</th>
<th>Far East</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of branches*</td>
<td>21</td>
<td>21</td>
<td>88</td>
<td>50</td>
<td>31</td>
<td>211</td>
</tr>
<tr>
<td>Assets (million dollars)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>877</td>
<td>301</td>
<td>175</td>
<td>76</td>
<td>81</td>
<td>1,510</td>
</tr>
<tr>
<td>Loans</td>
<td>2,020</td>
<td>664</td>
<td>465</td>
<td>866</td>
<td>595</td>
<td>4,610</td>
</tr>
<tr>
<td>Due from head offices and branches</td>
<td>1,083</td>
<td>198</td>
<td>131</td>
<td>359</td>
<td>224</td>
<td>1,995</td>
</tr>
<tr>
<td>Other</td>
<td>277</td>
<td>191</td>
<td>107</td>
<td>399</td>
<td>13</td>
<td>987</td>
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<tr>
<td>Total</td>
<td>4,257</td>
<td>1,354</td>
<td>878</td>
<td>1,700</td>
<td>913</td>
<td>9,102</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand deposits</td>
<td>520</td>
<td>488</td>
<td>425</td>
<td>293</td>
<td>338</td>
<td>2,069</td>
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<tr>
<td>Time deposits</td>
<td>3,193</td>
<td>461</td>
<td>226</td>
<td>652</td>
<td>422</td>
<td>4,954</td>
</tr>
<tr>
<td>Due to head offices and branches</td>
<td>315</td>
<td>247</td>
<td>131</td>
<td>396</td>
<td>138</td>
<td>1,227</td>
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<tr>
<td>Other</td>
<td>229</td>
<td>158</td>
<td>96</td>
<td>354</td>
<td>15</td>
<td>852</td>
</tr>
<tr>
<td>Total</td>
<td>4,257</td>
<td>1,354</td>
<td>878</td>
<td>1,700</td>
<td>913</td>
<td>9,102</td>
</tr>
</tbody>
</table>

*Includes branches in the Commonwealth of Puerto Rico and overseas dependencies of the United States. Includes assets and liabilities in United States dollars and all other currencies.
Euro-dollar rate shoots up

With this increasing flow of funds into the Euro-dollar market, deposits in the branches of American banks in England—the center for the Euro-dollar market—increased by more than 1.7 billion dollars in the first nine months of 1966. As in the past, these funds were used partly to accommodate the loan demand by what were formerly foreign customers of the home offices. During 1966, however, these funds were used increasingly by the home offices of United States banks to help meet their strong loan demand at home. As monetary restraint in the United States intensified, the banks turned increasingly to the Euro-dollar market to supplement their reserve position; Euro-dollar deposits obtained by branches abroad were channeled to their home offices. This process accelerated in the latter part of the year when the liabilities of United States banks to their foreign branches increased sharply from 1.8 billion dollars at the beginning of July to more than 4.3 billion in mid-December.8

While somewhat complicating the management of domestic credit policies of the Federal Reserve, these developments had a two-fold beneficial effect. First, the increasing supply of dollars made available to the branches of the American banks abroad had enabled them, to the extent that these were used to make loans abroad, to fill the “financial vacuum” created by the reduction in foreign lending by United States banks in response to the VFCR program. Second, by offering rates high enough to attract Euro-dollars, the banks prevented these funds from ending up in foreign official holdings and thus, from possibly becoming a direct claim on United States gold. This latter aspect of the foreign operations of American banks contributed significantly to the strengthening of the dollar in the exchange markets in 1966.

In its initial phase, the development of international activities of American banks centered on the eastern seaboard, particularly New York. Until the late Fifties, only a few...
Midwest banks maintained a foreign department, and even in cases where such a department existed, its operation was largely limited to small amounts of foreign trade financing for domestic customers. However, certain developments in the late Fifties greatly influenced the rate of expansion of Midwest banks into international banking.

**Activities of District banks**

The opening of the St. Lawrence Seaway in 1959 was perhaps the most important of these developments. The Seaway permitted exports originating in the “land locked” Midwest to move directly to Canadian ports and to the Atlantic Ocean on oceangoing vessels. The waterborne exports originating in the ports of the Seventh District increased from 1.7 million tons in 1955 to more than 4.3 million tons in 1964; imports increased in the same period from 1.7 million tons to more than 8.8 million. Exports of manufactured goods originating in the five states of the Seventh District increased 18 percent between 1960 and 1963.

In 1963, such exports totaled 3.7 billion dollars and accounted for about 23 percent of United States exports of manufactured goods. Of the total exports of machinery, the five District states’ share was more than 41 percent in 1963. In agriculture, 44 percent of total feed grain exports and 50 percent of total soybean exports in 1964 originated in the Seventh District states. Of the total volume of 6.2 billion dollars of United States agricultural exports in 1964, 21 percent originated in the Seventh District.

The increasing importance of the Midwest in United States foreign trade helped to boost the activities of banks in financing that trade. For example, the volume of bankers acceptances originating in the Seventh District increased from 23 million dollars outstanding at the end of 1958 to more than 191 million dollars at the end of 1966, and the District’s share in the total outstanding increased from less than 2 percent to more than 5 percent. The acceptances based on exports rose from about 5 million dollars to more than 31 million dollars in the same period.

The most significant increase, however, has occurred in acceptances based on goods stored in, or shipped between, foreign countries and those based on creation of dollar exchange. While at the end of 1958 such acceptances amounted to about 2.6 million dollars (less than 1 percent of the national total) at the end of 1966, these amounted to almost 127 million (or more than 7 percent of the total). From this evidence, it appears that the Midwest banks...
are becoming increasingly engaged in international finance.

While the Seaway opened the door for expansion of foreign trade financing by District banks, the development of the multinational, American-based corporation in the late Fifties and early Sixties provided additional opportunity for enlarging their international operations. The Midwest corporate giants have participated heavily in the foreign investment boom of recent years. Many of them established new subsidiaries and manufacturing branches in foreign countries, particularly in Western Europe. A recent survey\(^9\) shows that 21 percent of the total expansion of foreign facilities undertaken by United States firms between July 1960 and June 1965 originated from four states in the District; more than 10 percent originated from the Chicago metropolitan area alone!

With the internationalization of their operations, the corporations' credit needs became increasingly international in nature. The Midwest banks responded by establishing Edge Act banking corporations and branches abroad. In 1960, none of the District's banks operated a branch abroad, and none had established an Edge Act corporation.\(^{10}\) By the end of 1966, the District banks had established six branches and six Edge Act corporations, and numerous representative offices and foreign-correspondent relationships were enlarged. Through their Edge Act corporations, the banks also have acquired financial interests in a number of foreign banks, enabling them to utilize established banking facilities abroad to serve their customers' needs directly.

For many of the District banks, the inception of the VFCR program was a severe blow to their plans for foreign expansion. A number of them had only begun to lay a foundation for what appeared to be a substantial increase in international activities. Thus, their performance in conforming to the guidelines has been all the more remarkable.

**A look to the future**

The expansion of American banks into international finance was slow in coming. Long after the United States, through the development of its tremendous industrial base, became a key force in the world economy in the Twenties, American banks still played only a small role in the international scene. The stormy weather in the international financial relationships of the Thirties and Forties provided little incentive for expansion during that period. But once having taken the step, the American banker with proverbial Yankee ingenuity, has introduced fresh approaches to many aspects of international banking.

Further expansion in the near future most likely will continue to be impeded by the troublesome United States balance of payments. But once this problem has been resolved, the United States banks will have an almost unlimited potential for growth in the international area, both in their role as financial intermediaries for the channeling of savings into productive investment and in their role of providing a broad array of financial and related services—roles they have performed so effectively for the American economy.

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\(^{10}\)The first Midwest bank to participate in foreign branch banking was Corn Exchange National Bank of Chicago—one of the five original founders of the American Foreign Banking Corporation of New York. The Corporation was established as a New York State chartered company in 1917 and eventually operated 21 branches in Central and South America and the Far East. It was liquidated in 1925, shortly after the Corn Exchange National terminated its existence in late 1924.