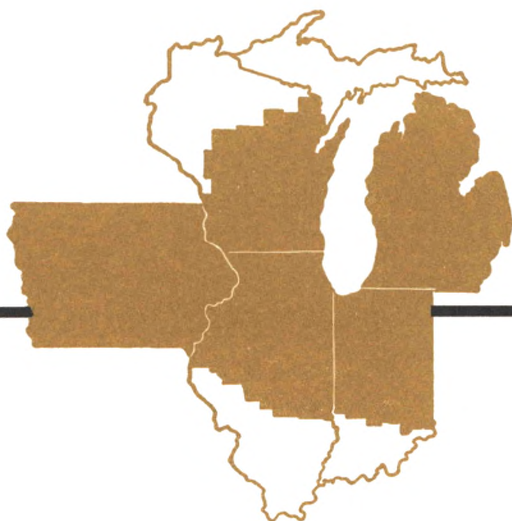
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1967 September

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THE Trend OF BUSINESS

The momentum of the business uptrend was reasserted during the summer months, after leveling or declining trends in output, employment and retail sales through much of the first half of the year. By August, all major measures of activity, including industrial production, pointed up again. The economy had weathered the most drastic inventory adjustment in history faster and with adverse side effects less pervasive than many observers believed possible at the start of the year.

Most manufacturers are now operating with appreciable margins of unused capacity as a result of both reduced production and the startup of new facilities. The transition from full-scale operations requiring extensive overtime has been particularly evident in Midwest industries producing durable goods. Labor markets in most centers, nevertheless, remain fairly tight, and prices appear to be rising faster than in the first half of the year.

Nationally, unemployment was only 3.9 percent of the labor force in July, and except for automotive centers, even lower rates prevailed in most of the Midwest. Barring major strikes, employment in the auto industry can be expected to rise in the fall as high production schedules for 1968 models are achieved.

Executives of most banks and other financial institutions favored the Administration's original request last January for a 6-percent surcharge on individual and corporate income taxes. On the other hand, many businessmen, disturbed by lowered profit margins and eroding backlogs of orders, remained skeptical that higher taxes are necessary or desirable. Mounting evidence of the revival of orders, employment, income and retail sales in the weeks after the August 3 recommendation for a 10-percent tax surcharge convinced many doubters that additional fiscal restraint is needed.

Monetary and fiscal stimulus

Sharp increases in Government spending and rapid growth in bank deposits and other liquid assets had been widely expected to reverse the persistent decline in industrial production evident in the first half of 1967. The main questions concerned the timing and magnitude of the recovery.

Experience indicated that the drop in con-

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struction activity and the leveling of retail sales in the second half of 1966, as well as the peaking of plant and equipment expenditures and inventory investment in the fourth quarter of the year, could be expected to lead to a general downturn. But this was without figuring on the powerful stimulus in the second quarter of a Federal deficit at the annual rate of 13 billion dollars (national income basis) and growth of bank credit at the annual rate of 12 percent. The virtues and efficiency of attempts to "fine tune" the economy can be argued, but there is little doubt of the eventual effect when the volume is turned up enough.

Industrial production declined 2.3 percent between December and June, and output of durable goods was off 3.5 percent. Total output of goods and services (after adjustment for higher prices) was virtually unchanged in the first quarter. Nonfarm wage and salary employment declined 170,000 from March to May—less than three-tenths of 1 percent. The slide was more significant for manufacturing employment, extending from January to May and amounting to almost 2 percent. Until June, total retail sales failed to rise appreciably from the 1966 peak.

Despite gains in final sales, the economy was sluggish throughout most of the first half of 1967.

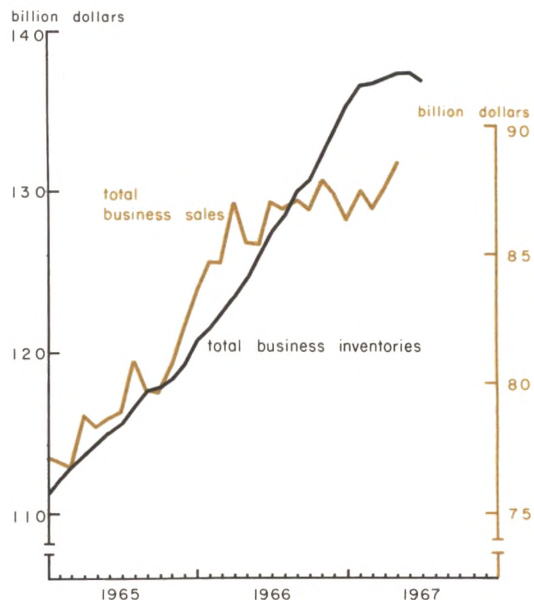
There was danger for a time of a cumulative decline in activity that could have been labeled, in retrospect, a recession. But statistics clearly differentiate this period from clear-cut recessions of the past. During the mild decline of 1960-61, industrial production dropped 7 percent, nonfarm employment declined 2.1 percent and unemployment rose to more than 7 percent of the labor force.

Total business inventories declined by more than 400 million dollars in June—the first month-to-month drop since 1961. At book value, inventories totaled 137 billion dollars and equaled 1.55 times sales for the month. This stock-sales ratio was down from a peak of 1.59 in February but remained well above the 1.47 level of a year earlier, which was near the average for recent years.

Although the actual reduction in inventories in June made headlines, the major impact of the inventory adjustment had been absorbed months before. When inventories are rising, the amount of the increase is added to final sales to boost total demand for goods and services. Any slowdown in the rate of inventory buildup reduces total demand by a like amount, unless the reduction in the rate of increase is offset by higher final sales.

Inventories rose at an annual rate of 18.5 billion dollars in the fourth quarter of 1966—far faster than in any previous period except

Business sales reached a new high in July as inventories declined



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certain quarters early in the Korean War. This sharp rise in inventory accumulation resulted in part from the failure of sales to match expectations. Production cutbacks were required, especially in iron and steel, nonferrous metals, textiles, motor vehicles, household appliances, television and some types of production equipment.

The annual rate of inventory accumulation slowed to 7.1 billion dollars in the first quarter. As a result, inventory accumulation contributed 11.4 billion dollars less to total demand—and therefore total output—in the first quarter than in the fourth. The largest previous quarter-to-quarter reduction in the rate of increase of inventories was 8.7 billion in the third quarter of 1959, a development attributed to a long steel strike.

Current indications are that inventories did not change appreciably during the second quarter as a whole. If so, the rate and output was 7 billion dollars less than it would have been if inventory accumulation had continued at the same rate as in the first quarter. The negative impact of the inventory adjustment on total output was nevertheless reduced substantially from the first quarter to the second.

Largely offsetting the drag of reduced inventory accumulation in the first half of 1967 were final sales to Government, consumers and business, which rose at an annual rate of 15 billion dollars. This increase approached the peak rates of 1965 and 1966.

Total business inventories declined in June —the first such movement since 1961—and are expected to shrink on balance in the third quarter, but the drag on total activity will almost certainly be smaller than in earlier months when inventories were still rising but at a decelerated rate. Inventory accumulation is expected to resume by the fourth quarter. If so, it will contribute to total demand for goods and services instead of subtracting from it. The expected reversal of the inventory cycle provides a major reason for increasingly ebullient forecasts of total activity for the rest of the year.

Surveys of purchasing agents indicate that many companies intend to curtail inventories further. Such intentions may be modified, however, if sales increase more than expected or if currently short lead times on new orders begin to lengthen. The Chicago Purchasing Agents Association reports that 74 percent of its members were ordering principal materials on the basis of lead times of 60 days or less in July, compared with only 40 percent a year earlier.

Some industries—particularly autos, household appliances and television—may have lost sales recently because of excessive inventory reductions in the first half of the year. Dealers had only a 47-day supply of new cars at the end of July, compared with a 61-day supply a year earlier, and some models were almost sold out while production lines were being changed over for 1968 models.

Other plus factors

New orders for machinery and equipment declined from an annual rate of more than 59 billion dollars in the third quarter of 1966 to 52.4 billion in the first quarter of 1967. The decline was due partly to the suspension of the investment tax credit in October. Shipments have been fairly well maintained, with the result that order backlogs declined.

Orders for machinery and equipment rose in May and June—partly because of the restoration of the tax credit—to levels in excess of current shipments. Spending on producer durable equipment will probably be contributing to growth in total activity again soon. In contrast to 1966, equipment producers, except producers of commercial aircraft, electrical generating equipment and

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some industrial machinery, have the resources to increase output. But any rise in equipment spending is likely to be moderate.

With mortgage funds flowing freely again, the decline in construction has been reversed. Construction was at an annual rate of 75 billion dollars in June, exceeding the year-earlier level but still remaining below the highs of early 1966. Construction contracts reported by F. W. Dodge were at a record high in June, indicating a further rise in activity.

In the Midwest, contracts in June were 30 percent higher than 1966, compared with a 12 percent gain for the country as a whole. Apartment buildings led the surge, which included all major construction categories.

Probably the most significant recent development has been the accelerated rise in personal income. After a relatively slow pickup in the spring, personal income increased at an annual rate of 9 percent in both June and July. The rise was caused mainly by increases in total wage and salary disbursements, reflecting renewed growth in employment. In July, personal income was up 7.3 percent from a year before. Despite some growth in retail sales in June and July and some increase in the use of credit, consumers are saving a larger share of their incomes than in 1966, putting themselves in a position to increase spending from recent levels.

In summary, total private expenditures are again in a strong uptrend. Public spending on both defense and civilian programs continues to rise and currently exceeds estimates made at the start of the year. Heavy demand, with upward cost pressures and limited labor resources, suggests that the rise in the general price level may accelerate.

In this environment, fiscal policies designed to bolster a faltering private economy in late 1966 and the early part of 1967 can appropriately be shifted toward restraint of inflationary excesses.

1966 farm loan survey*

Fewer but larger borrowers use more credit

Indebtedness per farm borrower at banks in the Seventh Federal Reserve District nearly tripled during the past decade. And while the number of farm customers of banks declined sharply, the total amount of bank credit outstanding to farmers more than doubled.

These are some of the findings of a recent survey of agricultural loans held by commercial banks in mid-1966 and a similar study conducted ten years earlier. These changes in agricultural credit are further reflections of the trends toward larger but fewer farms, greater investment in capital equipment and mounting outlays for operating expenses.

Two out of every three farmers in the Seventh District had bank credit outstanding in mid-1966. It is probable that the number of farmers using bank credit sometime during the year was actually somewhat higher. This could be particularly true for livestock feeders, who typically borrow large amounts in the fall to purchase feeder cattle. Some livestock feeders were probably not using credit when the survey was made at midyear.

*See *Business Conditions*, May and August 1967 for other articles on the 1966 farm loan survey.

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Bank debts of farm borrowers averaged around $5,924, compared with $2,125 in mid-1956. Most of the increase was the result of larger average loans, which rose from $1,581 to $3,486. But the average number of notes outstanding also rose from about one and a half to two per borrower.

Probably even more indicative of the greater use of credit is the increased proportion of borrowers with large bank debts. In mid-1966, about a third of the farm borrowers had outstanding loans totaling $5,000 or more, compared with about a tenth in 1956. Similarly, borrowers indebted to banks for more than $10,000 but less than $25,000 were three times as numerous in mid-1966 as in 1956, and 13 times as many farmers owed $25,000 or more than was the case ten years before. The number of borrowers with bank indebtedness of no more than $2,000 dropped about half since 1956.

As a result of the sharp increase in the amount of indebtedness per borrower, those owing at least $10,000, while representing less than a fifth of the borrowers, accounted for around two-thirds of the debt outstanding at mid-1966. Farmers owing $25,000 or more represented only about 4 percent of the borrowers, but they owed more than a fourth of total bank debt outstanding.

Farms more specialized

Along with the increase in size of farms during the past decade has come the trend to greater specialization—a trend reflected in the credit extended by commercial banks. The number of general farms—those with no single source of income accounting for as much as half the gross—declined relative to other types, while farms producing cash grains and meat animals increased, both in number and relative to the total.

Because banks often lack detailed information on their farm borrowers, it is likely that they reported a higher proportion of their farm customers as general farmers than was actually the case. Most other types of farms, such as fruit, vegetable and dairy farms, also declined since 1956. This reduction probably reflects the strong rise in wage rates and the difficulty in obtaining the large amounts of labor required to operate them. Returns on these farms, especially dairy farms, have been poor in recent years.

Because of these developments, the character of the farm loan portfolio has changed at many banks. Specialization itself often leads to greater use of machinery and equipment and the need for larger amounts of financing. Moreover, because of the more erratic seasonal flows of income and expenditures, cash grain and meat animal farms typically use larger amounts of credit than general farms and dairies. The average debt outstanding for meat animal farms was $9,030, and the average for cash grain farms was $5,593, compared with about $5,100 for general and dairy farms.

Partially reflecting these changes, loans to meat animal farmers more than doubled since 1956, and those to cash grain operators nearly tripled. By contrast, credit extended to dairy farmers was up only a third, and loans to general farms rose about two-thirds.

More owner-operators

Tenant farmers borrowing from District banks declined sharply both in number and relative to the total, while the proportion of farm borrowers owning all or part of the land they operate increased. Although comparable data are not available from the 1956 survey, farm borrowers owning only part of the land they worked probably increased most rapidly.

The decline in the number of farms has been confined to smaller units, many of

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which were not producing satisfactory incomes for their operators. Many tenant operations fall into this category. Where the tenure was known, tenant borrowers represented nearly two-thirds of the borrowers with net worth under $5,000, reflecting the high concentration of tenants in groups with lower net worth.

Tenants had an average bank debt of around $4,537, compared with $6,534 for operators that owned at least part of their land and $7,249 for landlords. This difference in average indebtedness can be attributed partly to the generally smaller farm operations of tenant farmers. Tenants also typically need less credit than other operators and landlords, who often need credit for land purchases and farm improvements that tenants do not usually make. In mid-1966, loans to buy or improve real estate accounted for about 30 percent of landlords' debt outstanding and about 23 percent of owner-operators' outstanding indebtedness. Such debts represented only 2 percent of the total tenant debt. (A tenant farmer will occasionally own land he does not operate and use it as collateral for a loan.) Also, some tenant farmers probably obtain some credit from their landlords, although this practice is probably less prevalent than it once was.

More part-time operators

Additional evidence that many farms are too small to provide adequate incomes is the sizable proportion of farm borrowers that work part time at other jobs. In contrast to the trend toward a smaller total number of farmers, part-time farm operators—those that receive a third or more of their gross income from off-farm activities—increased more than a third.

This trend has been possible in part because of the development of larger capacity equipment and other labor saving innovations that allow farmers to do a given amount of work in less time. Moreover, booming activity in other sectors of the economy since World War II has created a large number of relatively high paying jobs, encouraging more farmers to seek off-farm work.

While the number of part-time operators rose sharply during the past decade, these operators did not obtain bank credit in proportion to their increased number. The average amount per borrower outstanding to part-time operators amounted to only about three-fifths of the average debt of other operators. As a result, part-time operators, while accounting for about 20 percent of all farmers (where the status of the borrower was known), represented about 14 percent of the bank debt of farmers. This is not surprising, since agricultural activity on many of the farms operated by part-time farmers is limited and, because of this, less credit is required. Also, the flow of income from nonfarm activities provides a source of funds not available to full-time farmers.

Borrowers older

The average age of farm operators increased during the decade, reflecting the high rate of migration of young adults to urban areas. Farm operators of middle age or older now outnumber young operators.

Borrowers under 35 years of age declined about a fourth since 1956 while those over 45 declined only about 8 percent. As with most occupations, the older the worker the less likely he is to change his type of work. Movements from farm to city are closely tied to job openings in the urban areas, with the demand for workers in such areas playing an important part in the shrinking number of farm operators.

Banks and other financial institutions are

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sometimes criticized for not extending credit to young farm operators. But the survey data indicate that young farmers are receiving credit accommodation about in line with their relative importance as a proportion of all farmers, although their needs for credit may, of course, be relatively greater than the needs of older farmers.

Data from the Census of Agriculture indicate that farm operators under the age of 35 account for about 14 percent of all farmers. Bankers reporting in the farm loan survey at midyear indicated, however, that (where the age was known) about 18 percent of their borrowers were under age 35. Moreover, the proportion of bank borrowers between 35 and 44 years was also greater than indicated by the Census of Agriculture—about 28 percent compared with about 23 percent.

While the average amount of indebtedness of operators under age 35 was smaller

Farm borrowers at commercial banks in the Seventh District, June 30, 1956 and 1966*

Classification	Number of borrowers		Outstanding debt to banks: Total (thousand dollars)		Outstanding debt to banks: Average per borrower (dollars)	
	1956	1966	1956	1966	1956	1966
All borrowers	445,304	368,779	946,267	2,184,674	2,125	5,924
Debt to reporting banks						
Under $500	138,069	40,936	34,340	11,183	249	273
$500-999	81,670	48,234	55,537	33,716	680	699
$1,000-1,999	86,223	63,620	119,226	86,678	1,383	1,362
$2,000-4,999	88,861	90,464	276,396	282,511	3,110	3,123
$5,000-9,999	36,956	61,023	248,124	420,999	6,714	6,899
$10,000-24,000	12,521	50,727	174,495	777,956	13,937	15,336
$25,000-49,000	875	11,459	30,093	380,589	34,374	33,212
$50,000-99,999	130	2,060	8,057	130,430	62,123	63,328
$100,000 and over	—	257	—	60,612	—	236,026
Type of farm						
Meat animal	49,149	61,575	166,352	556,026	3,385	9,030
Dairy	97,206	51,413	196,782	263,557	2,024	5,126
Poultry	2,694	2,222	10,953	26,478	4,065	11,916
Cash grain	69,156	77,633	151,790	434,201	2,195	5,593
Fruit	7,561 (Fruit and Other major product combined)	1,870	19,704 (Fruit and Other major product combined)	14,317	2,606 (Fruit and Other major product combined)	7,658
Other major product		4,108		17,620		4,289
General	200,125	126,359	382,609	648,103	1,912	5,129
Not reported	19,412	43,599	18,077	224,371	931	5,146
Tenure						
Full owner	273,147 (Full owner and Part owner combined)	183,477	644,258 (Full owner and Part owner combined)	1,157,917	2,359 (Full owner and Part owner combined)	6,311
Part owner		45,954		341,284		7,427
Tenant	131,156	81,207	212,573	368,438	1,621	4,537
Landlord	21,648	16,782	72,655	121,748	3,356	7,249
Not reported	19,200	41,316	15,562	195,287	810	4,723
Part-time farm status (individuals only)						
Part-time farmer	47,908	65,793	81,373	258,169	1,699	3,924
Not part-time farmer	380,642	240,979	851,140	1,569,768	2,236	6,514
Not reported	16,601	59,263	12,536	272,617	755	4,600
Age (individuals)						
Under 35	81,931	60,509	152,680	311,883	1,864	5,154
35-44	154,305	89,501	320,888	585,821	2,080	6,545
45-54	189,544 (45-54, 55-64 and 65 and over combined)	97,625	452,896 (45-54, 55-64 and 65 and over combined)	615,724	2,389 (45-54, 55-64 and 65 and over combined)	6,307
55-64		56,641		280,750		4,957
65 and over		20,340		109,324		5,375
Not reported	19,371	41,420	18,585	197,052	959	4,757

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Classification	Number of borrowers		Outstanding debt to banks: Total		Outstanding debt to banks: Average per borrower	
	1956	1966	1956	1966	1956	1966
			(thousand dollars)		(dollars)	
Net worth						
Under $5,000	155,977	10,787	174,643	23,348	1,121	2,164
$5,000-9,999		27,293		76,403		2,799
$10,000-24,999	170,100	99,037	336,376	407,299	1,978	4,113
$25,000-49,999	91,987	91,123	342,059	508,593	3,719	5,581
$50,000-99,999		54,371		451,627		8,306
$100,000-199,999	7,361	24,539	75,184	347,042	10,213	14,143
$200,000 and over		6,769		174,123		25,722
Not reported	19,877	54,860	18,006	196,240	906	3,577
Assets						
Under $5,000	n.a.	4,104	n.a.	5,641	n.a.	1,374
$5,000-9,999	n.a.	9,173	n.a.	14,553	n.a.	1,586
$10,000-24,999	n.a.	72,617	n.a.	185,714	n.a.	2,557
$25,000-49,999	n.a.	93,333	n.a.	426,227	n.a.	4,567
$50,000-99,999	n.a.	82,892	n.a.	545,242	n.a.	6,578
$100,000-199,999	n.a.	36,962	n.a.	480,953	n.a.	13,012
$200,000-499,999	n.a.	12,758	n.a.	239,705	n.a.	18,789
$500,000 and over	n.a.	1,821	n.a.	92,033	n.a.	50,551
Not reported	n.a.	55,119	n.a.	194,606	n.a.	3,531
Annual farm sales						
Under $5,000	n.a.	40,091	n.a.	93,787	n.a.	2,339
$5,000-9,999	n.a.	84,922	n.a.	266,270	n.a.	3,135
$10,000-19,999	n.a.	119,917	n.a.	653,084	n.a.	5,446
$20,000-39,999	n.a.	57,396	n.a.	601,554	n.a.	10,481
$40,000 and over	n.a.	15,190	n.a.	341,399	n.a.	22,475
Not reported	n.a.	51,263	n.a.	228,581	n.a.	4,459
Status						
Individual	428,550	306,772	932,512	1,827,937	1,899	5,959
Partnership		2,644		57,220		21,643
Corporation	153	100	1,219	26,901	7,968	269,221
Line of credit established with borrower						
Yes	n.a.	39,560	n.a.	381,554	—	9,640
No	n.a.	329,219	n.a.	1,803,120	—	5,477

*The above data were obtained by expanding information reported by a stratified sample of banks to previously reported loan totals for all commercial banks in the District. The reliability of the estimates is lower for the subcategories of loans than for the totals.

n.a. Not available.

[1]Corporations were included in 1966, but excluded in 1956.

[2]Partnerships were included in 1956 but excluded in 1966.

than for operators 35 to 54, it was about in line with the indebtedness of farmers over 55 years. This might indicate that the problems of many young operators in the Midwest that are often ascribed to lack of available credit may actually be due to other limitations, such as size of operation.

The equity position of farm borrowers is one of the more important factors influencing the extension of credit. Since 1956, there has been a substantial upward shift in the net worth of farmers borrowing from banks.

The shift is probably due primarily to the large number of operators leaving small farms, but it also probably reflects the financial progress many borrowers have made. Where their financial positions were known, around 2 percent of the borrowers in 1956 had a net worth of $100,000 or more. In 1966, these borrowers made up about 10 percent of the total. Similarly, the proportion of borrowers in the

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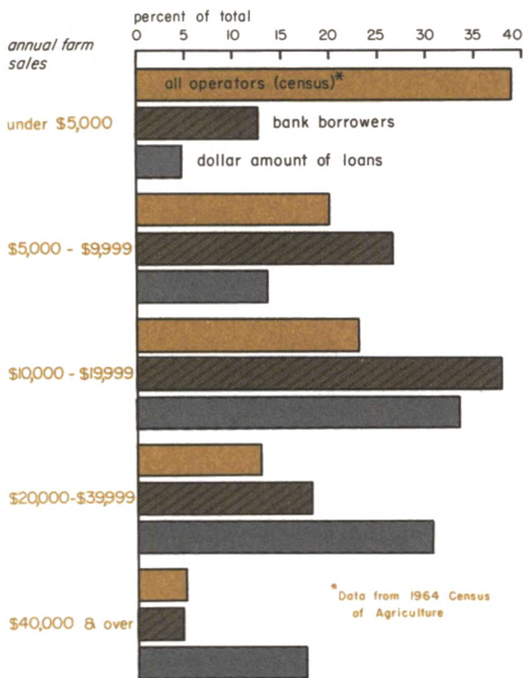
$25,000 to $100,000 category increased from about a fourth of the total in 1956 to more than half in 1966. On the other hand, farmers with net worth of less than $25,000 accounted for around three-fourths of all farm borrowers in 1956, roughly twice the proportion of borrowers in 1966.

Borrowers with relatively large net worth also accounted for a large share of farmers' total bank indebtedness. Farmers with net worth of more than $25,000, while representing around half of the bank borrowers, had about three-fourths of the bank credit outstanding to farmers in mid-1966. Moreover, farmers with net worth of more than $100,000 accounted for about a fourth of the credit but only 10 percent of the borrowers.

Larger farm operators more likely to be bank borrowers and account for greater portion of loan volume



Farmers' equity is usually, though not necessarily, associated with the capacity of the farm unit to generate income. Although information on the volume of sales of farm products was not obtained in the 1956 survey, census data indicate that the proportion of farms in the Seventh District selling less than $10,000 in farm commodities dropped sharply over the past decade, while the proportion selling more than $10,000 increased sharply.

Banks have probably experienced a similar pattern with their farm customers. In mid-1966, farmers selling more than $10,000 of farm products represented about three-fifths of the borrowers. And these borrowers, in turn, accounted for more than four-fifths of the outstanding debt.

Net worth and volume of farm sales are, of course, important considerations to bankers extending credit. Farmers that have accumulated substantial amounts of equity and have the income capacity to repay loans usually have no difficulty in obtaining credit, and on fairly favorable terms.

Borrowers with small equities and a small volume of sales have less capacity to carry debt. The 1964 Census of Agriculture found that around 40 percent of the farmers in the states of the Seventh District had farm sales of less than $5,000, while this category accounted for only about 13 percent of the borrowers at District banks.

Moreover, loans to these borrowers are usually smaller, reflecting the smaller size of their operations and the greater risk in loaning to farmers with small equities. The average indebtedness of borrowers with farm sales less than $5,000 was around $2,339, compared with the average of $5,924 for all farm borrowers. Similarly, the average debt

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outstanding to farmers with net worth less than $5,000 was about a third the average debt of all borrowers. Nevertheless, the debt levels for these borrowers were relatively high. Indebtedness of the group was about 83 percent of its equity, compared with 14 percent for all farm borrowers at District banks.

Partly as a result of the greater risk and the higher costs per dollar of handling small loans, interest rates for these borrowers were higher. Interest rates for borrowers with net worth less than $5,000 averaged 7 percent, compared with 6.3 percent for all borrowers.

Credit lines

The survey in mid-1966 showed that a number of bankers have established lines of credit for their farm borrowers; that is, they had agreed to provide credit as needed, up to some specified amount. Although data on lines of credit were not obtained in the 1956 survey, the practice has probably become more common in recent years, reflecting the rapid rise in farm credit needs.

About 10 percent of the borrowers in mid-1966 had established lines of credit, and these accounted for nearly a fifth of the total debt outstanding. These borrowers tended to be large operators. Around two-thirds of the total amount of lines of credit were to farm borrowers with $50,000 or more net worth and to borrowers with farm sales of $20,000 or more. Moreover, the bulk of the credit lines were extended to meat animal or cash grain farmers—farmers with large credit requirements during certain seasons.

Credit needs to increase further

The trend toward greater use of borrowed capital by farmers will undoubtedly continue. To gain the economies made possible by continuing progress in mechanization, farmers can be expected to expand their businesses further, both through more intensive and specialized use of current land and equipment and through absorption of small farms into larger units. They are expected also to increase further their use of the purchased materials and services essential to efficient farm production.

Many farmers will not be able to adapt to these trends and will leave farming. But those that are successful in combining their managerial capabilities with technological innovations are likely to require substantially larger amounts of borrowed funds.

Serving the future credit needs of agriculture would seem to present no insurmountable problems. The use of large amounts of credit by alert managers of efficient farms should continue to be profitable for borrowers and lenders alike. There may be some question, however, about which of the variety of lenders now serving agriculture are most likely to provide the growth in credit services.

Rural banks are unusually well suited to provide much of this credit because of their proximity to farms and the need by lenders for detailed knowledge of the character and needs of the farm business. Banks can also provide farmers many related financial services. Commercial banks appear capable of providing the various types of credit required by farmers—with the possible exception of some long-term real estate mortgage credit and some marginal high-risk credit.

This assumes, of course, the individual banks are operated efficiently and competitively and that the banking system as a whole provides an effective and adaptive mechanism through which funds flow in and out of areas in response to changing needs, availability and interest rates.

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U. S. wealth abroad

Foreign claims of the United States amounted to more than 106 billion dollars at the end of 1965, while foreigners held claims of 59 billion dollars here. The difference—our net foreign investment—was therefore about 47 billion dollars.[1]

Although this sum represented only a fraction of our total national wealth—less than 3 percent—it is nevertheless significant when viewed against the background of the U. S. position in world trade and finance. As such, it reflects the net contribution the United States has made to world economic growth over the past several decades as a net supplier of international investment funds.

From the viewpoint of the United States, the significance of the sum is twofold: 1) because of the net foreign exchange earnings and income generated by U. S. assets abroad, it represents an important positive factor in the U. S. balance of payments; 2) but because of the strain net capital outflow has placed on the balance of payments, its growth has been a matter of deep concern.

The United States was a net debtor to the rest of the world until World War I. In the early stages of its industrial development, this country depended heavily on foreign capital and in building up industries "mortgaged" part of its wealth to foreigners. In 1900, for example, when the total wealth of the United States, including land and reproducible assets, was an estimated 88 billion dollars, net liabilities to foreigners were 2.5 billion.

On the eve of World War I, total foreign investment in the United States amounted to 7.2 billion dollars—nearly twice the 3.7 billion Americans had invested abroad. But demands of war financing led to a sharp reduction of foreign-owned assets in this country and an increase in foreign indebtedness to the United States. By the end of 1919, U. S. net claims on foreigners amounted to 3.7 billion dollars.

These claims continued to increase throughout the Twenties. By the end of 1930, U. S. investment abroad was 17.2 billion

[1]These figures must be interpreted with some caution because of technical and conceptual difficulties in arriving at an accurate total.

International balance sheet
of the United States, 1950 and 1965

	1950	1965
	(million dollars)	
U. S. assets abroad		
Private assets		
Direct investment	11,788	49,217
Foreign corporate stocks	1,175	5,048
Foreign bonds	3,158	10,176
Banking claims	1,276	12,045
Other assets	1,607	4,456
Government credits and claims*	12,535	25,123
Total	31,539	106,065
Foreign assets in U. S.		
Long-term		
Direct investment	3,391	8,812
Corporate stocks	2,925	14,598
Corporate, state and municipal bonds	181	916
Other long term	1,500	2,082
Short-term		
Private obligations	6,477	18,162
Government obligations	3,161	14,362
Total	17,635	58,932

*Includes holdings of foreign convertible currencies and IMF's gold tranche position but excludes U. S. gold stock and over 20 billion dollars of World War I debt.

SOURCE: U. S. Department of Commerce.

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dollars, while foreign investment in this country was about half that —8.4 billion.

American investment abroad declined throughout the depressed Thirties and stood at only 12.2 billion dollars by the end of 1940. At the same time—particularly in the late Thirties—foreign claims on the United States increased sharply as foreign capital sought haven here. By the end of 1940, these claims had increased to 13.5 billion dollars.[2]

Foreign investment in the United States still exceeded U. S. investment abroad by about 800 million dollars at the end of World War II. But the situation changed drastically in the next five years, largely as a result of capital outflow through U. S. aid to the war devastated countries. By the end of 1965 the United States had provided more than 32 billion dollars in loans and credits to other countries and international organizations.[3] This was in addition to 48.2 billion of foreign grants for nonmilitary purposes between mid-1945 and the end of 1965 that did not appear on the international balance sheet.

With reconstruction abroad well under way in the Fifties, the outflow of capital through U. S. Government aid programs subsided. But the favorable investment climate resulting from vigorous reconstruction abroad began to attract large amounts of private U. S. capital, particularly in the late Fifties and early Sixties.

Value of U. S. direct investment abroad by area and industry, year-end 1965

Industry	Canada	Latin America	Europe	Africa	Asia	Oceania
	(million dollars)					
Manufacturing	6,855	2,741	7,570	292	673	950
Mining and smelting	1,755	1,114	55	361	37	162
Petroleum	3,320	3,034	3,429	1,020	2,384	499
Public utilities	486	596	60	*	61	2
Trade	881	1,034	1,716	114	253	103
Other	1,875	852	1,065	117	203	95
Total	15,172	9,371	13,894	1,904	3,611	1,811

*Less than 0.5 million dollars.
SOURCE: U. S. Department of Commerce.

The surge in foreign investment

Surveys conducted by McGraw-Hill show desires to open new markets and protect existing markets as the main reasons for American businessmen deciding to invest abroad. For example, establishment of the European Common Market as a large unified market area, with the new opportunities it offered for profit through application of large-scale production and marketing techniques, significantly influenced the flow of direct investment to Europe.[4]

The differential in profit rates—revealed by McGraw-Hill as the next most important consideration of businessmen—was also important to the surge of investments abroad. Returns on both portfolio investments and direct investments have generally been higher abroad than in the United States. This differential helps explain why U. S. net foreign investment has grown so much faster than net domestic investment—why the foreign net

[2]These increases were accompanied by large transfers of gold from abroad. Between 1935 and 1940, the gold holding of the United States rose from 10 billion dollars to almost 22 billion.

[3]Military assistance during this period amounted to 36.1 billion dollars. Thus the total net foreign grants amounted to more than 84 billion dollars.

[4]Direct investment means acquisition of assets and equities in businesses abroad in which U. S. investors have an important voice in the management.

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worth of the United States increased almost 3.5 times between 1950 and 1965 while net domestic assets (the domestic net worth) only about doubled.

Traditionally, U. S. direct investment abroad has taken the form of new production facilities or expanded facilities established through local partnerships, rather than acquisition of existing foreign companies. In 1964, for example, net acquisition of foreign enterprises by U. S. companies amounted to only 328 million dollars— less than 9 percent of the total direct investment undertaken abroad that year. In 1965, the figure was 279 million dollars—about 5.7 percent.

American investment abroad has generally benefited the areas where it was undertaken. Among other things, it has almost always:

- Helped raise local incomes by providing new employment opportunities
- Improved local standards of living by introducing new products
- Provided additional tax revenues for local government
- Introduced new technology in industry and new skills into the labor force
- Introduced new competition into local markets, encouraging local business to become more efficient
- Increased foreign exchange earnings of the host countries through increases in their exports

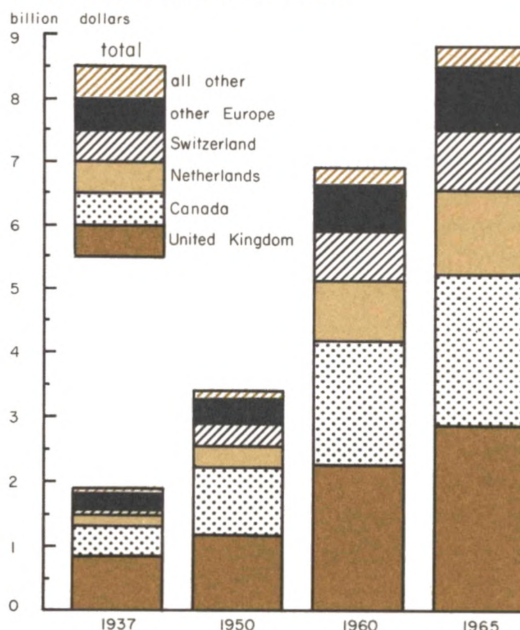
Economic criteria alone are not always appropriate in evaluating overall impact, however. Social, and especially political, factors are also traditionally important considerations in countries determining the desirability of foreign investment. Just as many Americans complained about the inflow of European capital at the turn of the century, some countries complain about the inflow of American capital 60-odd years later.

The arguments are often distorted with exaggerations sometimes serving the purposes of special interests. Many complaints, for example, have been raised against the size of the U. S. investment in Europe and the implied American domination of European industry. Although the U. S. share in some foreign industries is more than half—as in the case of carbon black in England and accounting machines in France—the overall, long-term investment position favored Europeans until very recently.

Until 1964, European long-term investment in the United States exceeded our long-term investment in Europe—and that had been the case for decades.

Only in 1965 did Americans finally catch up. And even then, U. S. investment in Europe exceeded European investment here

Foreign direct investment in the United States reached almost 9 billion dollars in 1965



SOURCE: U. S. Department of Commerce.

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by only about 800 million dollars.

Only a small part of the foreign assets in the United States at the end of 1965 was represented by direct investment. Unlike U. S. investors abroad, foreign investors here have shown a strong preference for corporate stocks and, more important, for such short-term investments as bank deposits and U. S. Government securities.

The preference of foreigners for portfolio investment has long been evident. Before 1914, foreign long-term investment in the United States was concentrated in bonds, particularly railroad bonds. The acquisition of U. S. corporate stocks by foreigners increased rapidly after World War I and soon exceeded bond holdings, particularly as the market value of stocks soared in the Twenties. During the depressed Thirties and war-affected Forties, the value of foreign portfolio investment in the United States remained fairly stable.

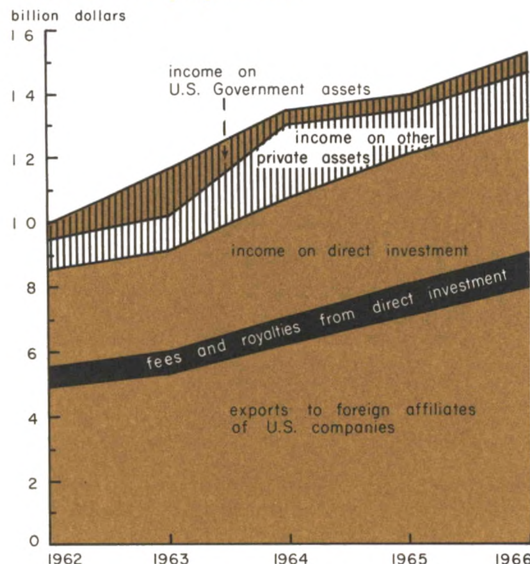
A sharp increase began in the Fifties and has steadily continued. As major European countries relaxed restrictions on purchases of foreign securities, the purchase of U. S. securities was taken up again. This—with the continued rise in market values—quadrupled the value of foreign holdings of U. S. corporate stocks in the Fifties. Even though there was some net liquidation of stocks held by foreigners, between 1964 and 1966, the total value of foreign holdings has continued to rise as the market value of the remaining holdings climbed.

Also in 1965, a new type of American security appeared on the international market and became available to foreign investors. In response to Department of Commerce guidelines aiming for U. S. corporations to reduce the outflow of funds from the United States and encouraging them to finance their direct overseas investment by borrowing abroad, several companies established special domestic financial subsidiaries.

These subsidiaries began borrowing abroad through issues of special debentures and bonds to obtain funds needed to finance foreign investment by parent companies. Competitive yields of these securities, and in many instances their convertible feature, made them highly attractive to foreign investors. That year, 191 million dollars of these securities were purchased abroad, and almost 600 million were purchased in 1966.

Short-term claims of foreigners at the end of 1966 amounted to about 30 billion dollars. The preference of foreign investors for short-term, liquid-dollar assets stems largely from the position of the U. S. dollar in international finance. Since World War II, the dollar has served as one of the two most im-

U. S. assets make a positive contribution to the country's balance of payments



SOURCE: U. S. Department of Commerce.

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portant reserve currencies and is used widely as an international means of payment.

To the extent that short-term claims on the United States are held by foreign official institutions, they represent an important source of international reserves.

And to the extent that these short-term claims are held by private individuals and corporations abroad, they constitute an important source of international liquidity for trade and investment. It has been estimated that more than a third of the world's trade in 1966—192 billion dollars as measured by world imports—was settled in dollars. Foreign banks and individuals participating in such transactions find it convenient to maintain dollar balances to facilitate payments. The availability of large amounts of short-term financial instruments in the U. S. money market and the development of the Euro-dollar market abroad have greatly facilitated profitable investment of these balances.

The balance of payments

The large amounts of foreign short-term investment in the United States attest to the confidence of most foreign investors in the soundness of the dollar. But the rate at which this investment increased since the early Fifties has been a concern to governments and individuals here and abroad.

As a banker to the world, the United States must stand ready to discharge these liabilities on short notice by exchanging them for other internationally acceptable assets. The continuation of the dollar as a reserve currency—indeed the continuation of the international monetary system in its current form—depends largely on the ability of the United States to fulfill this responsibility.

Gold has traditionally been the major internationally acceptable asset for use in discharging obligations of this kind. But while U. S. short-term obligations increased between 1950 and 1965, the U. S. gold stock slipped from 22.8 billion dollars to 13.8 billion. Allowed to continue, this development could impair the ability to maintain the gold-convertibility of the dollar.[5]

For that reason, the U. S. Government has taken steps to reduce the deficit in the balance of payments and thereby the rate at which foreigners have accumulated short-term dollar assets.[6] Several of the steps were designed to reduce the outflow of dollars resulting from the acquisition of foreign assets by Americans. In addition to asking corporations to restrain their foreign investment, the Government asked commercial banks to reduce their lending abroad.

Assets abroad have made a significant positive contribution to the country's balance of payments. Through an increasing inflow of repatriated earnings and other related incomes and through exports in the form of unfinished goods from parent companies in the United States to affiliates abroad, foreign investments have boosted U. S. earnings of foreign exchange and thus improved the balance of payments. In recent years, these positive contributions have more than offset the negative effect of the outflow of investment dollars. Given, however, the need for a prompt and substantial reduction of the U. S. balance of payment deficit, restraint on foreign investment is necessary, even if it results in forfeiture of some long-term benefits.

[5]The U. S. Government is formally committed to convert into gold or convertible currencies only the dollars held by foreign official institutions.

[6]The "liquidity" deficit in the U. S. balance of payments is computed by adding the increases in short-term dollar assets held by foreigners (liabilities), the decline in the U. S. holding of gold, and the decline in the International Monetary Fund position. Thus, the increase in foreign short-term investment in the United States constitutes a part of the balance of payments deficit.

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