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Glass-Steagll: Resurrection for Interment?

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Glass-Steagall: Resurrection for Interment?

by William E. Whitesell

Born out of the chaos of the Great Depression, the Glass-Steagall Act is one of the many laws enacted to protect bank depositors from loss. It was designed, in part, to sever ties between banking and the securities industries.[1]

Since the passage of the Act in 1933, whether commercial banks could underwrite or deal in securities for their own account has been pretty much a dead issue. Recently, however, it has again become a topic for lively debate. Mutual funds and others are attracting billions of dollars of savings and are investing them in common stocks. As incomes rise, except perhaps for brief periods, public interest in holding shares in American business is likely to continue to mushroom. And since many people don't have the time or expertise to manage their own portfolios, they have been channeling their funds through "intermediaries" like mutual funds.

Many banks want a piece of this action and are exploring what they can do within the law. The Glass-Steagall Act is a major obstacle in their path. Examination of factors prompting passage of the Act and a look at how they fit into the current setting indicate that certain parts of the Glass-Steagall Act may be a lot older and more out of step with the times than its age of 37 years would suggest.

"SOON AS THE GREAT TREE FALLS, THE RABBLE RUN TO STRIP HIM OF HIS BRANCHES ONE BY ONE."

Tales of stock market practices prior to the Great Depression describe a variety of devices

[1] The provisions of the Act discussed here are 12 U.S.C. 24, 78, 92, 377, and 378. For a more detailed discussion of the relevant provisions of the Glass-Steagall Act (Banking Act of 1933) as they affect commercial banks and one-bank holding companies, see William E. Whitesell and Janet F. Kelly, "Is the Glass-Steagall Act Obsolete?" *Banking Law Journal,* May, 1970.

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to beat the market and reap quick profits. Even some bankers succumbed to the fantasy of rich returns as they employed depositors' funds to enhance personal and corporate profits, throwing prudence to the wind. The device used by the miscreants was investment affiliates which were under the control of the parent bank. These affiliates began by financing and issuing preferred stock, but they later turned to accumulating stocks which either appeared to be low in price or susceptible to price manipulation. In pursuing their speculative schemes, investment affiliates siphoned off depositors' funds from the parent bank—all unknown to trusting depositors.[2]

The result of such excesses in the stock market was predictable. The historic market crash wiped out countless fortunes, and the ensuing depression set the stage for strong public reaction to forces believed by some to be responsible for so much economic misery. One outcome of the public desire to seek out and expose the alleged villains of the economic disaster was the Pecora Investigation.[3] The Pecora Report assigned to investment affiliates of banks much of the onus for the financial chaos of the depression, but, interestingly, the investigation itself dealt with very few of the 750 bank-controlled affiliates believed to exist in 1933.

The primary cases of abuse by investment affiliates involved three large New York City banks and several Detroit- and Cleveland-based chain and group banks. These few sensational cases were used to condemn the whole system of bank-controlled affiliates. Moreover, other investigations to determine the extent of unsound practices found that activities prevalent among banks with affiliates were also practiced by banks without affiliates. Since the investigation of investment affiliates is somewhat more sketchy than is popularly believed, we should not merely assume that most bank-controlled investment affiliates (or that only bank-controlled affiliates) were engaged in unethical, if not illegal, practices.

In recognition of the paucity of evidence that a substantial majority of bank-controlled affiliates were engaged in unsound practices, the Senate Committee on Banking and Currency had planned initially to prescribe a rigid system of controls for banks and their affiliates. But public outcry—letters to the Committee and complaints against the alleged injustices of the affiliate system—prompted dismemberment instead of minor surgery. The public wanted a lynching, and Congress responded with the Banking Act of 1933, which severed parent banks from their affiliated investment enterprises.

"THE EVIL LIVES AFTER. . . ."

Bankers, for many years, reflected in their operations the traumatic impact of the lessons of the 1930's. Witness, for example, their tardy entry into the field of consumer credit and often unimaginative selling of banking services. But the declining importance of commercial banks in relation to all other financial institutions ultimately jarred bankers out of this introspective stance. Many have now embarked on aggressive innovation and vigorous expansion of services. But when a New York bank—the First National City Bank—tried to move into still another area by applying to operate a com-

[2] See, for example, John Chapman and W. Parker Willis, *The Banking Situation* (New York: Columbia University Press, 1934), pp. 67 and *passim;* And Department of the Treasury, *Annual Report of the Comptroller of the Currency: 1920* (Washington: U.S. Government Printing Office), pp. 55 and *passim.*

[3] U.S. Congress, Senate Committee on Banking and Currency, *Report on Stock Exchange Practices, Report No. 1455,* 73rd Congress, 2nd Session, 1934.

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mingled investment account (see box), visions of the old investment affiliates and the proscriptions of the Glass-Steagall Act were resurrected. Bankers again slammed up against the kind of constraint which they interpret as a threat to the viability of the banking industry itself.

No sooner had the Comptroller of the Currency given a green light to the First National City plan and the SEC granted the necessary exemption regarding mutual fund control, than two suits were filed to stop the banking invasion. One case, brought by the Investment Company Institute, raised the question of whether the Comptroller could authorize a commingled account which seemed to violate the Glass-Steagall Act. A second issue was raised by the National Association of Securities Dealers, which claimed that the SEC could not grant banks the exemptions required for bank control of mutual funds.[4]

In mid-1968, the Senate passed a bill which would allow banks to operate commingled investment accounts, but a House sub-committee later shelved it. The Senate tried again in May, 1969, to assure banks the right to operate commingled investment accounts, but the Senate and House still seem to be at odds on the subject. The one-bank holding company bill passed

[4] *Investment Company Institute* vs. *Camp,* 274 F. Supp. 624 (1967) and *National Association of Securities Dealers, Inc.* vs. *Securities Exchange Commission,* 420 F.2d 83 (1969).

WHAT IS A COMMINGLED INVESTMENT ACCOUNT?

A commingled investment account is essentially a bank-operated mutual fund. The bank sells units of participation; its trust and investment advisors make investments for participants' accounts; and the bank receives a percentage of the current asset value of the fund as its fee. Agents of the bank are given a majority position on a directing committee elected by the participating membership.

The legal and legislative pyrotechnics involving bank operation of "mutual funds" were set off by the Comptroller's approval in 1965 of a commingled investment fund to be operated by First National City Bank. In September, 1962, the Comptroller of the Currency received the authority to grant fiduciary powers to national banks; formerly, this authority lay with the Federal Reserve Board. The Comptroller revised the relevant regulations in February, 1964, to allow national banks to operate commingled accounts.

When First National City Bank filed its application to operate such a fund, the Comptroller approved, and the Securities and Exchange Commission granted the exemptions regarding control of mutual funds. The Securities and Exchange Commission registration became effective June 14, 1966, a little more than a year after the Comptroller had approved the application. The account became operational after June 14, 1966, as an open-end management investment company and was immediately challenged in the courts.

The right of banks to operate commingled investment accounts is presently snarled in a judicial-legislative quagmire of uncertain outcome.

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by the House would deny bank holding companies the right to operate mutual funds, but this limitation is now under debate in the Senate.

Supporters of bank-operated investment accounts see some reason for optimism in the latest court decision. In July, 1969, an appeals court reversed the lower court decision and ruled that banking laws do not bar collective investment funds sponsored by banks. The court said that commingled investment accounts, like trust and individual managing agency accounts, were essentially trust in nature and fall within the traditional framework of the authority of banks to operate in such a fiduciary capacity.[5] The Appeals Court opinion is not the final word on the matter, however, since the Supreme Court has agreed to hear the case. A review of previous court decisions will help to put the issues into perspective.

"A ROSE BY ANY OTHER NAME . . ."

Does the operation of a commingled investment account constitute involvement in the "securities business" as forbidden by the Glass-Steagall Act? The two court decisions so far have taken divergent views. Why? The answer is bogged down in a question of semantics. A strict semantic interpretation of the wording of the Act gives rise to one position; a broader interpretation produces a second position which relates to the intent and purpose of the Act.

One argument, advanced by the lower Court, employed a strict semantic approach and emphasized that the same Congress wrote the Banking Act of 1933 and the Securities Act of 1933. The word "security" then should be identical in the two acts. If a unit of participation in a commingled account is a security, commingled investment accounts are illegal. Glass-Steagall is quite specific in separating banks from selling publicly, issuing as underwriters, or distributing securities.

The Appeals Court, however, did not agree with the lower Court on the meaning of "security." The Appeals Court asserted that the term is really one of "high gloss." The Glass-Steagall Act involves a different context of risk to the public than the Securities Act, according to the Court. The Act was meant primarily to protect depositors, and, therefore, only underwriting and sales of securities which could jeopardize deposits should be within the meaning of that law. When the Court had decided upon this fundamental difference, it found that the Glass-Steagall Act was not designed to, nor does it prohibit commingled investment accounts.[6]

"OUT OF THIS NETTLE, DANGER, WE PLUCK THIS FLOWER, SAFETY."

Could the operation of a mutual fund endanger banks and the public? Commingled investment funds today differ from investment affiliates of the 1920's in such a way that the danger to banks is substantially reduced even if not entirely eliminated. First, in the 1920's, investment affiliates used depositors' funds for speculative activities in the stock market. Purchases and sales were made for the account of the bank—not the accounts of subscribers to a fund, as in the case of commingled accounts.

Investment affiliates in the 1920's could, and in some cases did make liberal use of the de-

[5] The Appeals Court handled both the *National Association of Securities Dealers, Inc.* vs. *Securities Exchange Commission* and *Investment Company Institute* vs. *Camp* together. See *National Association of Securities Dealers, Inc.* vs. *Securities Exchange Commission,* 420 F.2d 83 (1969).

[6] *NASD* vs. *SEC* 420 F.2d 83 (1969).

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posits held by the parent bank. Speculative losses wiped out funds which depositors had entrusted to banks for safekeeping, and the use of this money in the stock market took place without the knowledge or consent of depositors. This is quite different from operating a commingled account where investors know that their money will be used in purchasing stocks and bonds and where depositors know that their funds will *not* be so employed. Besides, the regulatory milieu in which both investors and depositors operate is vastly different today from the '20's when banking was more "self-policed." [7]

Existing legislation suggests that all commingled investment accounts have to operate under the guidelines established by the Comptroller of the Currency. These guidelines provide for periodic valuation of assets, audits, protection against self-dealing, and protection against excessive management fees. Furthermore, accounts would be regulated by the SEC. One of the most important SEC stipulations is that quarterly, semi-annual, and annual reports be made to stockholders in addition to the requirement for audits. All these requirements insure closer scrutiny of the operation of commingled investment funds and their activities than was possible during the 1920's. Bank-controlled investment affiliates of the 1920's sailed along almost completely without public disclosure of transactions and were not held accountable to any public agency.[8]

State banking regulations and controls on the operations of fiduciaries provide additional safeguards for the public. Most of the body of

[7] See William McChesney Martin's statement before the Senate Committee on Banking and Currency in which he states his belief that current laws provide safeguards against bank misuse of deposits and the problems of the 1920's. U.S. Congress, Senate Committee on Banking and Currency, *Hearings on Mutual Fund Legislation of 1967,* Part 3, 90th Congress, 1st Session, 1967, p. 1224.

[8] See Irving Fisher's description of the baneful effects of inadequate regulation in his *The Stock Market Crash—and After* (New York: The Macmillan Company, 1930), pp. 34 and *passim.*

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federal and state regulations which would govern the operation of commingled investment accounts was either nonexistent or untried in 1933 when the Glass-Steagall Act was passed. The draconian actions of Congress in passing the Act were probably justified in 1933, but a greatly changed regulatory environment in 1970 calls for reassessment of its usefulness.

"O, HOW FULL OF BRIERS IS THIS WORKING-DAY WORLD!"

But what happens if the fund falters and undergoes a relatively large decrease in market value? It is quite unlikely that poor fund performance could jeopardize the operations of the parent bank. Just as trust assets must be handled separately, operations of the fund and operations of the bank must be independently managed. Performance of commingled investment accounts is likely to parallel performance of mutual funds as a group. General declines in stock prices, rather than management of the parent bank, are likely to get the blame for poor performance of commingled investment accounts.

And depositors are unlikely to be greatly concerned with the performance of a bank-operated commingled investment account. Many will not even be aware of it. Practically all banks are insured by the FDIC, which protects depositors up to a limit of $20,000, and depositors of larger amounts are presumably sophisticated enough to recognize the separation of most banking operations from the operation of the commingled investment account. Banks have successfully handled trusts and individual managing agency accounts for years without detriment to their depositors.

If bank safety is not jeopardized by fund operations, are there no dangers? The Investment Company Institute argued that banks would be under pressure to expand sales of participation because management fees are tied to the size of the fund. But the Appeals Court countered by noting that banks are under a similar pressure to expand sales of all services offered by the trust department. Also, fee earnings based on size of the fund are fundamentally different from the speculative profits some banks sought in the underwriting which Glass-Steagall forbids.[9]

But would a bank use its position as a source of funds to pressure a borrower to purchase additional services of the bank in exchange for a desired loan? There is always this possibility, of course, but the same problem potentially exists within the current banking system or with any multi-product firm.[10] It is difficult to imagine that the situation would change significantly if bank-operated commingled accounts were allowed.

"LET US HEAR THE CONCLUSION OF THE WHOLE MATTER. . . ."

This examination of the Glass-Steagall Act suggests that the Act appears to be archaic in its application to commingled investment accounts, if the Act does, in fact, apply. Fundamental changes in banking, public regulation, and method of operation of the accounts make it unlikely that practices of the 1920's will be repeated unless both bankers' integrity and supervisors' vigilance break down.

Repeal of parts of the Glass-Steagall Act or a Supreme Court ruling that commingled funds do not violate the Act could provide public benefits.

[9] *NASD* vs. *SEC*, 420 F.2d 83 (1969).

[10] In *Fortner Enterprises, Inc.*, vs. *United States Steel Corp.*, 89 S.Ct. 1252 (1969), tying arrangements which connected product sales to credit extension were found to be illegal. Thus, consumers are not defenseless against tying agreements—a problem which some have envisioned in connection with commingled investment accounts.

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Bank operation of commingled accounts would furnish investors a wider range of alternatives. Besides, investment and management costs to the public might well be slashed because of the competition introduced by commercial bank entry into the business of fund management. Now the whole matter is tied up in a legislative-judicial log jam. Hopefully, the scope of banks' participation in the investment business will be determined on the basis of a careful assessment of regulatory and financial changes of almost four decades.

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What Ever Happened to Truth in Lending?

by Hugh Chairnoff

On July 1, 1969, Truth in Lending became the law of the land. Requiring uniform and meaningful disclosure of the cost of consumer credit,[1] the law has been hailed by some as a major breakthrough in consumer protection and condemned by others as an ineffective addition to the mountain of paperwork already burdening consumer credit transactions. Despite the publicity just prior to Truth in Lending's debut, few consumers had any real idea of what Truth in Lending was or how it was supposed to improve credit decisions, according to a survey made at that time. Consequently, the goal of more informed use of credit by all consumers still seems distant. However, awareness of Truth in Lending and the cost of credit by a significant minority of consumers is encouraging for the goal of a more competitive market for consumer credit.

WHY TRUTH IN LENDING?

The average American now devotes more than 17 per cent of his disposable income to periodic payments of principal and interest. Because credit affects him directly, his knowledge of credit costs and terms is crucial to how he allocates his present and future income.

Truth in Lending was intended as a major step towards helping the consumer adapt to his credit-oriented world. It was designed to help him compare terms offered by competing lenders and make judgments concerning borrowing versus using alternative sources to finance spending. Thus, the goal of Truth in Lending is more informed use of credit through uniform

[1] Other important components of Title 1 of the Consumer Credit Protection Act of 1969 are meaningful disclosure of other terms and conditions; rules for advertising credit terms; and the right to rescind credit transactions under certain circumstances.

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and meaningful disclosure of credit terms, particularly the cost of credit.[2]

But the benefits of Truth in Lending cannot be passively enjoyed. Unlike many consumer protection laws, this one does not require producers to change the quality, safety, or packaging of their product. Instead, the impact of Truth in Lending depends on the willingness of consumers to upgrade their understanding of the dimensions of credit. Moreover, enforcement of the law primarily depends on consumer awareness; less emphasis is placed on public enforcement.[3] So it is important that consumers know about the major elements of Truth in Lending.

A LACK OF AWARENESS

Last June, when publicity surrounding the launching of Truth in Lending probably was at its apex, only one out of every ten consumers knew that Truth in Lending was a federal law which would provide consumers with certain credit information when borrowing or buying on credit. Another one-third of those interviewed recognized Truth in Lending at the specific suggestion of the interviewer. In all, 43 per cent of those contacted registered some awareness of Truth in Lending.

Lack of awareness that Truth in Lending even existed permeated all segments of our society, but certain groups were less aware than others (Table 1).[4] Respondents who earned less than $8,000 annually, lacked education beyond high school, were the youngest or oldest adults, or nonwhite were significantly less aware of Truth in Lending than were other respondents.

As one might expect, even fewer people knew about the substance of Truth in Lending than were able to identify it. The most important provisions of the law require that borrowers must be told the Finance Charge and Annual Percentage Rate.[5] These two concepts differ substantially from the manner in which financial information is provided under most state laws. In addition, these concepts overcome the confusion caused by a plethora of consumer credit laws within each state by requiring all creditors to disclose this information in an identical fashion.

The Finance Charge concept is borrower-oriented. It includes *all* costs that must be paid by the borrower to acquire credit. Truth in Lending does not permit any distinction among such items as interest, discount, or the time-price differential, and other fees or charges made or required by the creditor.

The Annual Percentage Rate relates the Finance Charge to the amount of credit available to the borrower and the amount of time for which credit is available. It is a percentage rate determined by the same principles (compound interest) which govern the calculation of interest on a mortgage or savings account. With

[2] One of the motivations for Truth in Lending is the belief that acquiring this information through individual effort is costly, perhaps exceeding the value of making better credit decisions. That is why some consumers may cling to the monthly payment so much—it serves as an inexpensive, though crude, indicator of the cost of credit. Thus, by providing the information at a lower cost, Truth in Lending offers consumers an opportunity to realize savings by more shopping for credit and more careful consideration of the decision to use credit.

[3] Truth in Lending provides for liability up to $1,000 for any creditor who, in a civil action *initiated by a consumer,* has been shown to have failed to disclose any information the law requires.

[4] The tables referred to in the article can be found in the Appendix.

[5] For more detailed discussions of the information Truth in Lending requires see Hugh Chairnoff, "What Truth in Lending is All About," *Business Review,* Federal Reserve Bank of Philadelphia, June, 1969, and *What You Ought To Know About Truth in Lending,* Board of Governors of the Federal Reserve System.

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this information, borrowers can compare, with confidence, financial terms offered by competing creditors regardless of differences in state laws, terms of loan, or amounts of credit offered. Finance Charge and Annual Percentage Rate provide consumers with better information on the extent of their sacrifice when borrowing to acquire goods or services.

Many people who were aware of Truth in Lending, independently or when prompted, were unable to describe its provisions. Replies ran the gamut, from the vague—"protect consumers"—to the incorrect—"protection against excessive rates, interest, and charges."

But three-fifths of those who could identify Truth in Lending unaided were able to cite either the Finance Charge or Annual Percentage Rate or both as the main provisions of the law. Of those who recognized Truth in Lending only with the aid of the interviewer, only about one-third cited the Finance Charge or Annual Percentage Rate or both. In fact, many who needed prompting by the interviewer were unable or unwilling to cite any of the key features of Truth in Lending.

Two other very important features of the law were barely recognized. Only twelve of more than 2,000 cited the consumer's right to rescind certain credit transactions within three business days. And only one consumer was aware that creditors can be sued for not obeying the law.

Awareness of the key features increases with educational experience (Table 2). Still, even among the most highly educated, only about one-half were able to cite at least one of the law's key features. For the less-educated, the small proportion acquainted with Truth in Lending and its features spells negligible familiarity with the tools Congress wants them to have.

A LACK OF UNDERSTANDING

Since appreciation of modern credit markets is critical to successful management of a family's income and standard of living, one might assume that full knowledge of credit cost and what it means are second nature to borrowers. Most people familiar with the consumer credit market would regard such an assumption as utopian. Ignorance of the "true" cost of credit means that the goals of Truth in Lending will be frustrated. And, if consumers do not apply the information properly when they borrow or buy on credit, the goal of more informed use of credit may be particularly frustrated.[6]

To test the consumer's knowledge of credit cost, each person was told that two terms are used in talking about interest, the time charge for credit—the stated or contract rate and the "true" annual percentage rate. Each consumer then was asked to estimate the "true" annual rate of interest when the contract rate or stated rate was six per cent. For most consumer installment credit transactions (credit card transactions are a major exception), the stated or contract rate is an add-on or discount rate.[7] This means that the dollar interest charge is based on the original amount of credit extended, though the borrower only will have use on the average of roughly one-half the original amount because he is repaying in regular installments (more credit during the earlier stages of the repayment period, less credit in the later

[6] For example, when buying on credit, the annual percentage rate can be lower and the selling price of the merchandise higher for one credit seller than for another. Yet, the total payments of the borrower can be as much or more in one case than in the other. Thus, the annual percentage rate will not inform the borrower which of the alternatives is cheaper.

[7] Installment credit outstanding accounted for 80 per cent of total consumer credit outstanding in 1969.

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stages). For an add-on rate of 6 per cent, the "true" rate would be 11 per cent. For a discount rate of 6 per cent per year, the "true" rate would be at least 11.5 per cent. We regarded any estimate between 10 and 12 per cent to be correct.

Over half the people interviewed admitted they did not know what the answer might be or refused even to hazard a guess, while more than one-fourth either were too high or, more often, too low in their estimate. So, only 15 per cent of the more than 5,000 consumers interviewed estimated correctly.

Again, consumer knowledge of the "true" cost of credit was related to educational attainment: those with less than a high school degree knew substantially less than those who at least had some college experience (Table 3). Those with a high school degree or beyond tended to underestimate the annual percentage rate more often than their less-educated counterparts, who preferred to admit ignorance rather than hazard a guess. In both cases, consumers had little knowledge of the "true" cost of credit as Truth in Lending entered their lives.

This conclusion is supported by the response of consumers who had entered into credit transactions around the time of the survey in June, 1969. We shall discuss two examples—auto loans and household furniture and appliance loans.

Perhaps no segment of the consumer credit market has been as competitive as that for auto loans. Unlike most other types of consumer credit, competition for auto loans had been characterized by widespread advertisement of the *contract* rate until Truth in Lending came along. The contract rate can be a useful indicator of comparative costs of financing an auto purchase as long as all competitors state the contract rate in the same way (for example, as an add-on rate), and the creditor assesses no other charges or fees. But this latter condition generally does not exist in the market for auto loans. Consequently, reliance on the contract rate may be misleading in many instances. Almost half of those who financed an auto purchase in the twelve months prior to July, 1969, thought the annual percentage rate they were paying was less than 8 per cent. Less than one-fifth cited a rate exceeding this level. Yet, it is highly unlikely that most were paying a "true" rate that low (Table 4). For example, half the cars financed were used ones and contract rates on used auto loans commonly exceed 8 per cent, an implied annual percentage rate of at least 14.5 per cent.

The story is similar for furniture and appliance loans. Barely one-fourth of the borrowers cited an annual percentage rate in excess of 8 per cent. Because of more widespread advertisement of auto loan contract rates and less uniformity in expressing furniture and appliance loan rates, fewer borrowers cited the contract rate, and more were aware that the annual percentage rate exceeded 8 per cent than was the case for auto loans (Table 5).

Economic status did not seem to have much relation to the correct identification of the annual percentage rate for auto and furniture and appliance loans. However, the higher the income, the greater the tendency for borrowers to cite the contract rate rather than admit ignorance or hazard a guess.

TRUTH IN LENDING: A BEGINNING

Consumer awareness of Truth in Lending and the cost of credit immediately prior to the law's effective date reveal widespread deficiences in consumer ability to make better credit decisions. Only about one-fifth of more than 5,000 people

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interviewed could identify the law and its key features. What is more, less-educated or lower income consumers were significantly less aware than their better-educated, higher income neighbors at a time when publicity surrounding the law probably was at its peak. Plus, most consumers were ignorant of the "true" cost of the credit they had contracted shortly before the survey was made. Instead, many identified with the contract rate rather than the annual percentage rate of cost.

Do these results imply that the goals of Truth in Lending are far from being attained? The answer depends on the particular goal in mind. The goal of more informed use of credit requires that all consumers be aware of the "true" cost of credit and how to use it in their credit decisions. The survey results showed that the proportion of knowledgeable consumers was very far short of 100 per cent. Hopefully, this gap is closing as more consumers are exposed to the information the law requires. This may take some time, however, because of the low frequency of borrowing by individual consumers.

The survey results may be more encouraging for the goal of increased competition in the market for consumer credit. It is not necessary that each and every potential borrower have complete command of credit information in order to assure a competitive market for consumer credit. Rather, it is the behavior of a relatively small group of borrowers (as well as lenders) that makes the market work. To the extent that this group is now better-armed and possibly increasing in size because of the information provided under Truth in Lending, an even more competitive marketplace could develop.[8]

[8] The difficulty in actually measuring the impact of Truth in Lending cannot be overlooked. The real test would be what happens to the volume and price of consumer credit. However, there are a number of obstacles. The relatively low frequency of borrowing by an individual consumer implies that it may take some time for the knowledgeable minority to exert an influence. In addition, cost is not the sole criterion in choosing among sources of credit or even in deciding whether borrowing to finance an expenditure is desirable. Finally, not all consumers have the same flexibility in shopping for credit. How much flexibility a consumer has depends on his existing debt relative to a number of factors.

APPENDIX: A SURVEY OF CONSUMER AWARENESS

Title I of the Consumer Credit Protection Act of 1968, popularly known as Truth in Lending, directed the Federal Reserve System to promulgate implementing regulations and to report annually on the impact of this legislation. To aid in this latter duty, the Board of Governors commissioned a full-scale survey of consumer awareness of Truth in Lending and consumer knowledge of credit costs. This survey, made just prior to the effective date of Truth in Lending, will serve as a benchmark against which the effectiveness of the law can be measured from time to time.

There are many facets to the survey. The three facets on which this article focused were:

(1) consumer awareness of Truth in Lending's existence;
(2) consumer awareness of the information Truth in Lending is to provide;
(3) consumer awareness of the "true" cost of credit.

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Interviews with heads of households took place during June and the first week of July in 1969. Eighteen per cent of those randomly selected refused to cooperate. In all, 5,149 usable interviews were obtained.

TABLE 1

Awareness of Truth in Lending By Income, Education, Age, and Race June, 1969

	Proportion of Group		
	Unaided Awareness	Aided Awareness	Total Awareness
Income*			
Less than $8,000	4.0%	24.2%	28.2%
$8,000 or more	16.5	39.1	55.6
Education*			
Through high school	5.0	27.6	32.6
Some college or more	23.0	41.8	64.8
Age*			
18-24 and 65 and over	4.8	25.0	29.8
25-64	11.9	33.7	45.6
Race*			
Nonwhite	4.1	20.2	24.3
White	10.9	33.1	44.0
Average	10.6	31.7	42.3

*Differences are significant at 1% level.
Based on 5,147 interviews.

TABLE 2

Awareness of Truth in Lending's Key Features by Education June, 1969

Education	As a Proportion of Those Aware of Truth in Lending*	As a Proportion of All Those Interviewed
Grade school or less	17.2%	0.5%
Some high school	31.9	2.6
High school graduate	38.0	6.6
Some college	50.1	14.7
College graduate	46.0	13.9
Post-college graduate	52.0	20.2
Total	40.3	16.7

*Differences are significant at 1% level.
Based on 2,145 responses.

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TABLE 3

Distribution of Estimates of Annual Percentage Rate By Education
June, 1969

Education	Less than 10%	10-12%	More than 12%	Don't know
Grade school or less	11.3%	4.1%	4.1%	80.5%
Some high school	16.2	11.1	6.6	66.2
High school graduate	20.2	14.9	11.2	53.7
Some college	22.4	23.3	13.7	40.5
College graduate	22.0	27.4	11.1	39.6
Post-college graduate	16.2	32.6	15.8	35.4
Total	17.8	15.3	9.6	57.3

Shaded column denotes correct answers.
Based on 5,142.

TABLE 4

Percentage Distribution of Annual Percentage Rate on Auto Loans
By Income of Respondent
June, 1969

Annual Percentage Rate	Respondents' Income						Total
	Under $3,000	$3,000-4,999	$5,000-7,999	$8,000-9,999	$10,000-14,999	Over $15,000	
Less than 8%	24.6%	25.6%	42.2%	50.2%	57.8%	60.6%	48.4%
8% or more	19.7	18.0	16.7	18.5	17.5	23.0	18.5
Don't know	55.7	56.4	41.2	31.3	24.6	16.4	33.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Per Cent of Income Class Purchasing Auto with Credit	4.4	13.0	20.7	25.3	21.4	22.6	18.2

Columns may not add due to rounding.

TABLE 5

Percentage Distribution of Annual Percentage Rate on Furniture and Appliance Loans
By Income of Respondent
June, 1969

Annual Percentage Rate	Respondents' Income						Total
	Under $3,000	$3,000-4,999	$5,000-7,999	$8,000-9,999	$10,000-14,999	Over $15,000	
Less than 8%	13.4%	16.0%	17.4%	31.6%	34.0%	34.9%	27.2%
8% or more	5.0	9.4	27.8	19.0	26.6	27.3	24.0
Don't know	81.7	74.6	54.8	49.4	39.4	37.7	48.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Per cent of Income Class Purchasing Furniture or Appliance With Credit	10.1	13.9	20.8	17.2	16.4	9.8	15.1

Columns may not add due to rounding

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Have you ever wondered why the United States has had a persistent deficit in its balance of payments? What the mechanism is for making payments in international transactions? Or how we go about defending the dollar? Designed for the general reader rather than the expert in international economics, this is the first of 3 articles which attempt to provide answers to these questions.

Balance of Payments

by Clay J. Anderson

A nation's balance of payments is a statement of its receipts from, and payments to other countries during a given period of time.

Spending, borrowing, lending, and investing are not confined within national boundary lines. Consumers and business firms in the United States buy goods and services from all over the world. Firms in the United States sell goods and services in other countries. We lend and invest in foreign countries; foreigners lend and invest here. We pay interest and dividends on foreign investments in this country and, in turn, receive income on funds loaned and invested abroad. We are spending large amounts for foreign travel—much more than foreign visitors spend here. Our Government makes large payments abroad; foreign governments make payments here. These illustrations are only a few of the multitude of transactions that crisscross national boundaries. Some transactions result in receipts from, others in payments to foreign countries.

In this article, we shall discuss three main topics:

1. Composition of the balance of payments;
2. Recent trends in the balance of payments of the United States;
3. Implications of the balance of payments for economic policy.

STRUCTURE AND COMPOSITION

There are millions of separate transactions between citizens, business firms, and government in the United States and their counterparts abroad during a year. A statement of the balance of payments of the United States classifies and summarizes the transactions in a way which shows the major sources of receipts and the principal types of payments. Each classification of receipts and payments represents the total of a large number of individual transactions.

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It would be rare, indeed, if having totaled all receipts and all payments, the two totals should be equal. Typically, one is larger than the other. If receipts are larger than payments, the balance of payments shows a *surplus;* if payments exceed receipts, it shows a *deficit.* Total receipts and total payments balance only if settlement items, such as transfers of gold and net changes in foreign assets and liabilities, are included.

The following simplified statement illustrates a common form and principal components of the United States balance of payments.

UNITED STATES BALANCE OF PAYMENTS*
(Billions of dollars)

Receipts	
Merchandise exports	$33.6
Military sales	1.4
Transportation, travel, and other services	7.9
Income from investments abroad**	7.7
Inflow of foreign capital, net	8.6
Total recepits	$59.2
Payments	
Merchandise imports	33.0
Military expenditures abroad	4.5
Transportation, travel, and other services	7.6
Income payments on foreign investments in the U.S.	2.9
Remittances and pensions	1.2
Outflow of private capital, net	5.2
U.S. Government grants and capital outflow, net	4.0
Errors and unrecorded transactions	0.6
Total payments	$59.0
Surplus (+) or deficit (−)	
Liquidity basis	+0.2
Official settlements basis	+1.6

Note: Detail may not add to totals because of rounding.
*Data are for 1968.
**Mostly from private investments.

Receipts. Our primary source of foreign receipts is sale of United States goods abroad, which contributes roughly three-fifths of the total. Industrial supplies and materials, manufactured goods, and agricultural products account for a substantial part of our exports. Transportation and other services rendered foreigners, including foreign travel in the United States, contribute about one-seventh of total foreign earnings. Another source of receipts of about equal importance is income from foreign investments, mostly private, such as interest, dividends, and profits. New foreign investments in the United States also produce an inflow of funds. This source of foreign receipts is more volatile than the others, but usually contributes less than either services or investment income.

Payments. Payments abroad as well as receipts arise from a multitude of individual transactions. The largest category of payments is for merchandise imported from abroad. Interest and dividend payments on foreign investments in this country, transportation and other services supplied by foreigners, and expenditures of Americans traveling abroad are other sizable

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classes of payments.

United States Government operations are a much more important source of payments than receipts. Military expenditures abroad and Government grants and aid to foreign countries have been substantial through most of the post-war period. A net outflow of private investments, direct and portfolio, has been another significant source of payments, especially in the past decade.

Surplus or deficit. The difference between total receipts and total payments is the surplus or deficit: a *surplus* when receipts *exceed* payments; a *deficit* when receipts *fall short of* payments.

In the statement illustrated, there is a surplus of $200 million on the liquidity basis and $1.6 billion on the "official settlements" basis. The difference in the amount of surplus reflects divergent views on how certain items should be shown.

PROBLEMS OF MEASUREMENT

Several problems arise in presenting the balance of payments. For one thing, complete data are not available. Some transactions must be estimated on the basis of fragmentary information. Many small transactions are not recorded because of lack of data. Consequently, an item such as "errors and unrecorded transactions" is necessary in order that total receipts and total payments will balance. In the statement illustrated above, "errors and unrecorded transactions" amounted to $600 million. The consensus of students of balance-of-payments statistics seems to be that a large part of unrecorded transactions consists of capital flows, especially short-term movements.

Significant conceptual problems arise in formulating a statement of the balance of payments. One which has received considerable attention recently concerns which items should be segregated "below the line" as balancing or settlement items.

A truly neutral concept would dictate listing *all* receipts and *all* payments during a given period, without any segregation of settlement items. In a statement of this type, there would be no surplus or deficit in the usual sense. Total receipts and total payments would be equal (except for errors and omissions), and no items or categories would be segregated as to unusual significance.

The common practice, however, is to segregate some items, "dropping them below the line" as settlement or balancing transactions. The size of the surplus or deficit from ordinary "above the line" receipts and payments depends on what is included as financing or settlement items. The statement illustrated above shows the surplus derived from the two concepts most commonly used in the United States: the "liquidity" and the "official settlements" basis.

The liquidity concept, developed and used by the Department of Commerce, centers on the role of the United States as financial leader in the free world and its unique commitment to buy or sell gold from or to foreign official institutions at a price of $35 an ounce. The impact of international transactions on the liquidity position of the United States and its ability to honor its commitment is considered of unusual significance. More specifically, the effect on liquidity position is determined by net changes in total liquid liabilities (public and private) to foreigners and net changes in official holdings of international monetary reserves.[1] Hence, these changes are regarded as "below the line"

[1] Liquid liabilities are defined as liabilities with a maturity of one year or less.

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or balancing items. The surplus so derived is $200 million.

The "official settlements" basis of measuring the surplus or deficit focuses on the position of the monetary authority—its ability to meet its foreign liabilities and to maintain a stable rate for its currency in foreign-exchange markets. Thus, the significant aspect of a nation's balance of payments is the impact on the monetary authority's liabilities to foreign official institutions and its holdings of reserve assets to meet those liabilities. For the United States, this means changes in liabilities of the Treasury and Federal Reserve to foreign "official" institutions and in Federal Reserve-Treasury holdings of international reserve assets (gold, convertible foreign currencies, United States unused gold tranche in the IMF and SDR's). Using this concept, the statement given above would show a surplus of $1.6 billion.

Where the line is drawn between ordinary and balancing items has an important bearing on the size of the surplus or deficit. Items listed above the line produce the imbalance; those listed below are visualized as settling the surplus or deficit thereby created. The principal differences between the liquidity and official settlements methods are twofold: (1) the liquidity basis excludes long-term liabilities to foreigners as a balancing item and includes all short-term liabilities, both public and private; (2) the official settlements method excludes all private liabilities to foreigners but includes all liabilities—short- and long-term—to foreign official institutions. These differences for the balance of payments given above are tabulated below.

Surplus accounted for on:
(Billions of dollars)

Liquidity basis			$0.2
Change in *liquid* liabilities to foreigners			
Private	+3.8		
Official agencies	−3.1		
Net increase in liquid liabilities		+0.7	
Increase in official reserve assets		+0.9	
Surplus			$0.2*

*Net increase in official reserve assets of $0.9 billion, less net increase in liquid liabilities of $0.7 billion.

Official settlements basis			$1.6
Change in liabilities to foreign official agencies			
Liquid liabilities	−3.1		
Nonliquid liabilities	+2.4		
Net change		−0.7	
Increase in official reserves		+0.9	
Surplus			$1.6*

*Net increase in official reserve assets of $0.9 billion, plus net decrease in official liabilities of $0.7 billion.

This summary table shows why the surplus was $1.4 billion larger in 1968 on the official settlements basis than on the liquidity basis. The primary reason was the large borrowings of United States commercial banks in the Euro-dollar market. Short-term liabilities of commer-

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cial banks to foreigners rose $3.4 billion and other private short-term liabilities, over $400 million for a total of $3.8 billion. Intermediate and long-term liabilities to foreign official institutions increased $2.3 billion. The $3.8 billion increase in private short-term liabilities abroad, omitted from the official settlements basis, more than offset the $2.4 billion rise in nonliquid liabilities omitted in the liquidity method. Private short-term liabilities rose $1.4 billion more than nonliquid liabilities to foreigners, thereby reducing the $1.6 billion official settlements surplus to $0.2 billion on the liquidity basis.

There are sound reasons for both of these concepts of measuring a balance-of-payments surplus or deficit. In the present international monetary system, the United States permits only foreign official institutions to use their dollars to buy gold from the Treasury; private foreign holders cannot do so. From this point of view, it is logical to regard the international liquidity position of the United States as being determined by its holdings of international monetary reserves[2] in relation to its liabilities to foreign official institutions. The potential drain that private foreign owners of dollars may exert indirectly is disregarded.

The liquidity view regards all short-term liabilities to foreigners as potential claims, directly and indirectly, on United States international monetary reserves. The United States dollar is widely used as a means of international payment. In complying with the IMF agreement, most foreign free-world countries maintain their currencies within the agreed limits of par in terms of the United States dollar. If the dollar becomes too plentiful in foreign-exchange markets, foreign currencies will tend to rise to the ceiling as private holders of dollars offer them for sale. To keep their currencies from breaking through the ceiling, foreign central banks sell their currencies for dollars—i.e., purchase dollars.[3] As foreign central banks acquire dollars from private holders, they may use them to buy gold from the U.S. Treasury. Private short-term liabilities to foreigners are, via their central bank, a potential claim on our gold and other reserve assets. Hence, advocates of the liquidity view contend these liabilities should be included in measuring the international liquidity position of the United States.

Advocates of the official settlements concept, however, counter that a large part of these private foreign-owned dollars and short-term dollar assets represent working balances of commercial banks and other private participants in foreign-exchange markets. Widespread use of the dollar in international payments requires such participants to hold dollar balances for their day-to-day operations. It is highly unlikely, therefore, that the bulk of private short-term liabilities to foreigners will ever become a drain on United States international monetary reserves.

RECENT TRENDS

Current and prospective developments in our balance of payments may be better understood if viewed in the perspective of major trends in the postwar period. Some of the highlights are summarized below.

Declining trade surplus. Historically, the United States has sold more goods abroad than it has purchased from foreign countries. Merchandise exports have exceeded imports every year in the present century except for a very small deficit in 1935.

[2] Gold, convertible foreign currencies, unused gold tranche in the IMF, and SDR's.

[3] These operations are explained more fully in the two articles to follow.

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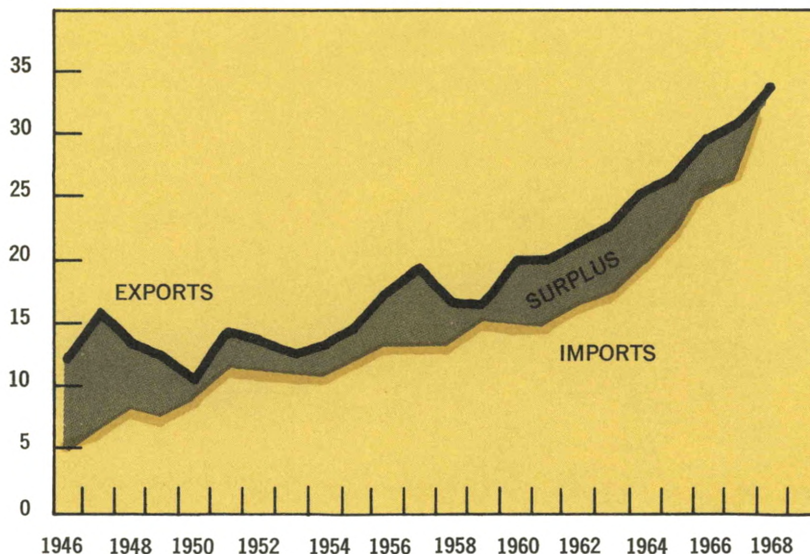
The trade surplus was especially large in the early postwar years, reaching a peak of $10 billion in 1947. Wartime destruction seriously impaired productive capacity in major foreign industrial countries. Foreign demand, inflated by reconstruction needs, was directed mainly at the United States, the principal source of supply. Large United States grants for reconstruction and recovery enlarged the purchasing power of foreign countries and underwrote the demand for United States exports. Meanwhile, United States imports were relatively small: intense domestic demand abroad and scant supplies of goods in foreign industrial countries held down exports by foreign countries. These conditions gave rise to the much-discussed "dollar shortage."

BALANCE OF MERCHANDISE



Source: U.S. Department of Commerce.

Our trade surplus declined as reconstruction and recovery in the major industrial countries enabled them to supply more of their own demands. United States exports declined and remained at a relatively low level until the mid-1950's, and imports showed a general upward trend. The trade surplus remained at a relatively low level in the 1950's except for the sharp rise

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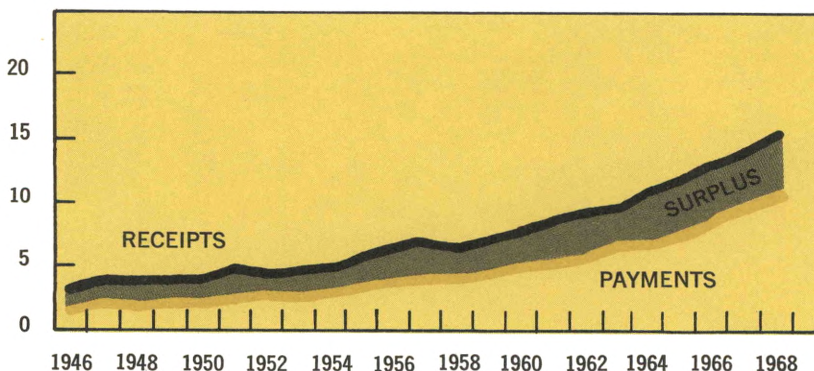
in 1956 and 1957. This increase reflected in part the export stimulus arising from the Middle East crisis and closing of the Suez Canal.

The decade of the 1960's ushered in several years of relatively large export surpluses. Rapid rates of economic growth in major foreign countries and relative price stability in the United States created a strong demand for United States goods. Exports rose more rapidly than imports until 1965. Then the situation began to shift. Soaring demand, approximately full employment, and rising prices in the United States induced a strong rise in imports, and the trade surplus dwindled. It hit a postwar low in 1968, and there was a small deficit in the first half of 1969.

BALANCE ON SERVICES*



*Consists mainly of transportation, travel, and receipts or payments on investments.

Source: U.S. Department of Commerce.

Surplus on services grows. Transportation, travel, investments, and other services produce a flow of foreign receipts and payments. The United States has maintained a surplus in this category every year in the postwar period. The surplus on services remained fairly stable until the 1960's, ranging from a low of $1.4 billion to a high of $2.5 billion. In the 1960's, the surplus more than doubled, rising from $2 billion in 1960 to $5 billion in 1968.

The major contributor to the growing surplus was income from private investments abroad. The excess of receipts from investments abroad over payments on foreign investments in the United States soared to almost $5 billion in 1968. Service payments to foreigners have risen

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Balance on Capital Flows*
(Billions of dollars)

Year	Net outflow U.S. capital Govt.	Net outflow U.S. capital Private	Net inflow foreign capital**	Surplus (+) or deficit (−)
1946	5.3	0.4	−0.6	−6.3
1947	6.1	1.0	−0.4	−7.5
1948	4.9	0.9	−0.4	−6.2
1949	5.6	0.6	0.0	−6.2
1950	3.6	1.3	0.2	−4.7
1951	3.2	1.0	0.5	−3.7
1952	2.4	1.2	0.1	−3.5
1953	2.1	0.4	0.1	−2.4
1954	1.6	1.6	0.2	−3.0
1955	2.2	1.3	0.3	−3.2
1956	2.4	3.1	0.6	−4.9
1957	2.6	3.6	0.5	−5.7
1958	2.6	2.9	0.2	−5.3
1959	2.0	2.4	0.7	−3.7
1960	2.8	3.9	0.4	−6.3
1961	2.8	4.2	0.7	−6.3
1962	3.0	3.4	1.0	−5.4
1963	3.6	4.5	0.7	−7.4
1964	3.6	6.6	0.7	−9.5
1965	3.4	3.8	0.3	−6.9
1966	3.4	4.3	2.5	−5.2
1967	4.2	5.7	3.4	−6.5
1968	4.0	5.2	8.6	−0.6

*Includes short-term capital.
**Includes certain special Government transactions.
Source: Survey of Current Business, June 1969, pp. 26-27.

steadily, but at a slower pace than receipts. Travel is our main deficit item in the service category. In the past three years, United States tourists spent on the average $1.3 billion more annually in foreign countries than foreign travelers spent in the United States.

Military expenditures abroad. As leader of the free world, the United States has incurred large expenditures in maintaining troops and military bases in foreign countries. Military expenditures abroad have been a substantial deficit item for the past 15 years. These outlays reached $2 billion in 1952, passed $3 billion in 1957 and, because of the hostilities in South Vietnam, soared to over $4 billion annually in 1967 and 1968.

Deficit on capital account. Private firms, individuals, and the Government have loaned and invested more in foreign countries every year since World War II than foreigners have loaned and invested in the United States. The deficit on capital account ranged from a high of $9.5 billion in 1964 to a low of less than $1 billion in 1968.

In the early postwar years, Government grants and loans for reconstruction in war-devastated countries dominated our capital flows. The net outflow on Government account averaged over $5 billion annually from 1946 to 1949. There was a substantial decline in the early 1950's.

The outflow of private capital was at a very low level until the mid-1950's. Restoration of

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convertibility of the major currencies in the late 1950's and relaxation of Government restraints on capital movements set the stage for enlarged flows of private capital abroad. The net outflow began to rise in the mid-1950's and averaged nearly $5 billion yearly during the period 1960 to 1967.

The net outflow of Government capital remained at a relatively low level in the latter part of the 1950's, but military and economic aid to developing countries boosted the figure to $4 billion in 1967 and 1968.

There was a net outflow of foreign capital in the latter part of the 1940's, as foreigners liquidated investments to pay for United States goods. A net inflow, which emerged in 1950, remained at a low level until 1966. The sharp rise beginning in that year, which approached $9 billion in 1968, reflected both temporary and more permanent forces. Periodic doubts about some major foreign currencies, such as the French franc and the pound sterling, induced an outflow of funds into safer currencies, including the United States dollar. Inflationary pressures, exceptionally high interest rates, and the tight-money policy in the United States, especially in the latter part of 1968, sucked in a large flow of funds from abroad. Large commercial banks turned to the Euro-dollar market to replace their loss of time certificates of deposit and to augment funds available to meet strong customer loan demand. A buoyant stock market probably also attracted some foreign funds.

More permanent factors in the rise in foreign portfolio investments in the United States are the increase abroad in United States-controlled or -oriented mutual funds, a rising volume of foreign savings being invested in securities instead of being hoarded as money, and a broad securities market in the United States which enhances the liquidity of portfolio securities held abroad.

Basic structural shifts? A substantial surplus on goods and services and a relatively large deficit in capital flows (Government and private) have characterized the United States balance of payments during most of the postwar period. The trade surplus largely financed Government grants and loans and net private investments abroad. The modest deficits in most of the early 1950's helped redistribute the large volume of international monetary reserves accumulated by the United States in the war and early postwar years.

The relatively large deficits which began in the late 1950's reflected mainly a rising net outflow of capital and since the mid-1960's, a dwindling trade surplus. An important question is whether the shifts which have been occurring in the United States balance of payments reflect only temporary forces or the emergence of more basic structural changes.

Gross capital flows have been increasing relative to the total volume of merchandise trade. The large net outflow of private capital in the 1960's was stimulated in part by rapid economic growth and improved market opportunities in major industrial countries of Western Europe. In the United States, a slow rate of economic growth in the first part of the sixties, low interest rates, and an ample supply of credit also stimulated loans and investments abroad. Government controls and voluntary restraint programs have restricted the outflow in recent years.

The recent decline in the deficit in capital flows reflects important temporary forces. Government controls and voluntary credit restraint programs have limited private loans and invest-

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ments abroad. A rapid rate of economic growth, high interest rates, and a strong demand for credit in the second part of the decade produced attractive investment opportunities at home. These conditions tended to reduce the outflow of private capital and, in turn, offered a strong inducement for foreigners to make loans and investments in the United States. The large increase in the inflow of foreign capital was the principal reason for the drastic drop in our deficit on capital account in 1968.

But more enduring forces also appear to be reducing our net capital outflow. The large volume of private investment abroad produced a return flow of interest and profits. Income from foreign investments almost trebled in the past decade and totaled nearly $7 billion in 1968. Income, saving, and the supply of funds seeking investment have been rising at a rapid pace in some major industrial countries abroad. Our highly developed and broad securities markets together with growing solicitation by mutual funds and other financial institutions are contributing to an enlarged flow of foreign funds into our securities. Also, the rapid growth rates in several Western European countries relative to the United States which induced a large volume of direct investments by United States corporations seem to be subsiding somewhat. Apparently, there are underlying forces tending to swell the inflow of foreign capital and diminish the volume of direct investments abroad. If so, our persistently large deficit on capital account until 1968 may show a downward trend.

Longer run forces also may underlie the recent deterioration in our trade surplus. The marked decline in our export surplus since 1965 was undoubtedly the result mainly of temporary conditions in the United States—strong inflationary pressures which lifted United States prices relative to those in major foreign countries and work stoppages in some of our main industries which encouraged imports. From 1965 to 1968, imports rose over 50 per cent, compared with an increase of less than 30 per cent for exports.

There are indications, however, that longer run forces may be altering our trade position vis-a-vis industrial countries abroad. Since 1948, the total volume of free-world trade has about quadrupled. The United States proportion of the total has declined slightly while that of the industrial countries of Europe has risen substantially. Reconstruction following the war modernized the industrial facilities of several West European countries, thereby improving their competitive position. Large direct investments by United States corporations in order to better penetrate the Common Market in Europe have shifted some production abroad, thus tending to reduce exports. It may be that forces such as these will diminish the relative importance of merchandise trade in our balance of payments and reduce our customary trade surplus.

IMPLICATIONS FOR POLICY

International transactions are relatively less important to the United States economy than to the economies of most other major countries. For example, the United States exports only about one-eighteenth of its total output of goods and services as compared to over one-fifth for the United Kingdom, one-fourth for West Germany, and almost one-half for the Netherlands. The impact of the balance of payments on the economy of the United States, however, is often much greater than such data might indicate.

Domestic effects of international transactions

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have many ramifications.[4] Our concern here is with a much more limited aspect—the impact on our reserve position and implications for monetary and economic policies.

In international transactions, as in domestic, we can spend more than we receive only by going into debt, or by giving up something, such as gold, that foreign creditors are willing to accept in payment. The initial effect of our deficit mainly is to increase bank deposits in the United States owned by foreigners. Deposits in excess of minimum working-balance needs are frequently invested in highly liquid earning assets, such as U.S. Treasury bills, other short-term securities, and commercial paper. Thus, when foreigners accept dollars in payment of deficits, our liabilities to foreigners increase, and they accumulate deposits and other short-term dollar assets in the United States.

In 1969, foreign holdings of short-term dollar assets rose above $40 billion. The sharp rise in 1969 reflected in part borrowing by United States banks from their foreign branches, but the principal cause of the increase over the years has been the deficits in the United States balance of payments.

What determines whether our deficits are settled in dollars or in gold? The choice rests with our foreign creditors. A substantial part of our short-term liabilities to foreigners is to official institutions—central banks and governments—and to international institutions such as the International Monetary Fund. Widespread use of the dollar as a medium of international payments, ability of foreign official institutions to convert dollars into gold for legitimate monetary purposes, and confidence that the United States will maintain the value of the dollar are important reasons why foreigners are willing to hold dollars. Many foreign central banks hold a part or all of their monetary reserves in dollars; others hold practically all their reserves in gold. When the latter acquire dollars, a loss of gold is almost automatic.

Private institutions, which hold the major part of foreign-owned, short-term dollar assets, need dollar working balances in conducting international transactions. Willingness to hold an excess above a minimum working balance depends on their confidence in the future value of the dollar and on the interest rate they can earn on short-term investments compared with rates available on similar investments in other countries with stable currencies. With convertibility of the major currencies, interest-rate differentials tend to generate a flow of short-term funds from international money centers with lower to those with higher short-term rates. Ordinarily, official institutions and international organizations do not shift balances from one center to another to take advantage of interest-rate differentials.

One might well ask, why so much fuss over the balance of payments—it is just a collection of statistics. What difference does it make whether receipts and payments balance? The answer: a persistent deficit or surplus has far-reaching economic effects.

The persistent deficit in the United States balance of payments resulted in a substantial

[4] To illustrate, exports increase output, employment, and profits of many domestic producers. Imports provide some goods, such as certain tropical products, that we cannot produce; they supply some materials and finished goods more cheaply than can be produced here. Cheaper raw materials may enhance the profits of some manufacturers; lower-priced finished goods may restrict the profits of others. Both exports and imports tend to stimulate innovation—by domestic exporters in order better to penetrate foreign markets and by domestic producers threatened by an inflow of foreign products. In general, a free flow of goods and capital among countries encourages specialization, more efficient production, and a higher standard of living.

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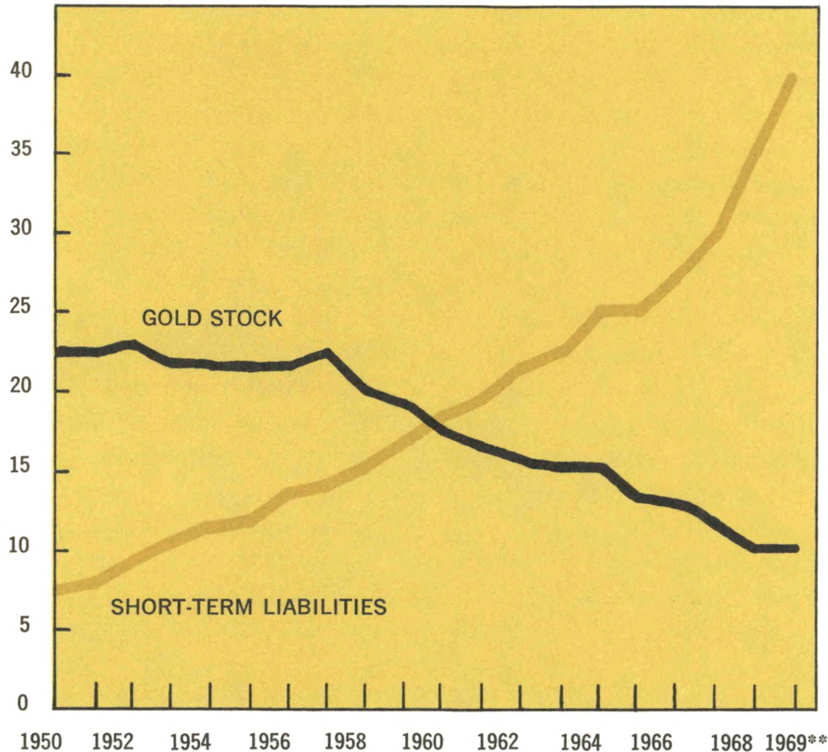
GOLD STOCK AND SHORT-TERM LIABILITIES TO FOREIGNERS*



*Reported by banks in the United States.

**October for liabilities and November for government.

Source: Board of Governors of the Federal Reserve System

drain on our gold stock, absorbed member-bank reserves, and caused much of the growing accumulation of short-term dollar assets owned by foreigners. Excessive holdings of dollars tend to undermine confidence in the dollar and create a further strain on our monetary reserves. Only our large gold stock and the willingness of foreigners to hold large quantities of dollars en-

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abled the deficit to continue for such a long period without disastrous results. Even so, the deficit had a significant influence on monetary policy and led the Government to take actions to reduce the deficit and defend the dollar in foreign-exchange markets.[5]

Large balance-of-payments deficits complicated pursuance of effective monetary policies in the early 1960's. Economic slack and a slow rate of growth called for easy money and other economic policies designed to stimulate recovery and economic growth. But the easy-money policy and low interest rates needed to stimulate recovery and growth also encouraged an outflow of capital, especially short-term funds. This capital outflow tended to enlarge the balance-of-payments deficit. The deficit interfered with the most effective use of monetary policy to achieve domestic economic goals.

Occasional deficits are not serious; however, persistent, large deficits are cause for considerable concern. Large deficits put a substantial flow of dollars at the disposal of foreigners, weaken the dollar in foreign-exchange markets, and result in a drain on our international monetary reserves. The tendency is to undermine the dominant position of the dollar in international finance and the role of the United States as leader of the free world. Adverse effects of our persistent and substantial deficits are an important reason why it is essential that inflation be brought under control. Halting the rise in U.S. prices relative to prices in major foreign countries is a prerequisite to restoring our normal trade surplus and improving our balance-of-payments position.

[5] The latter will be dealt with in a later article.

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THE FED IN PRINT

Continuing our project of current information begun in the March issue, we are publishing a list of subjects covered by articles in the Federal Reserve Bank monthly *Reviews* during the first quarter of 1970. The March bibliography was selective for the year 1969. This one is more comprehensive, including titles of all analytical studies and summaries of banking and business conditions for the period of a year or more.

Your comments on the scope and form of this index are invited and your use of the library facilities is welcomed. Individual *Reviews* may be obtained by writing to the Public Information Department of the *issuing bank.* Addresses of the Federal Reserve Banks appear on page 34.

Doris Zimmermann, Librarian

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Bank Credit Proxy—Rich March 70 p 12

BANK LIQUIDITY

An Alternative Approach to Liquidity: Part II—Kans Feb 70 p 11

Disintermediating Year—San Fran Feb 70 p 44

BANK LOANS

Banking Responds to Monetary Restraint—Atlanta Jan 70 p 7

BANK LOANS—FARM

Farm Finance in a Period of High Interest Rates—Chic March 70 p 12

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Central Banker (Eastburn)—Phila March 70 p 3

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Real Economic Expansion Pauses St. Louis Feb 70 p 2

Extent of the Slowdown—St. Louis March 70 p 2

BUSINESS FORECASTS & REVIEWS

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Forecasts 1970: A Cooling Economy?—Rich Feb 70 p 2

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Regional Economy Loses Some Zip in '69—Phila Jan 70 p 36

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A Note on Professor Friedman's Views—
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Gold and the International Monetary System—Kansas March 70 p 11

MONEY MARKET
Appears every month in N.Y.

MONEY SUPPLY
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MORTGAGES
Federal Housing Agencies and the Residential Mortgage Market—Rich Jan 70 p 9

NEGROES
How Businessmen Can Assist the Black Capitalism Movement—Boston Jan 70 p 23

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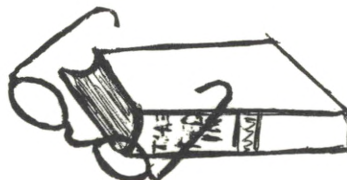

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SPECIAL DRAWING RIGHTS
Activation of SDR Facility in I M F—N.Y.
Feb 70 p 40
TREASURY BILLS
Trends and New Developments—
1959-1969—Cleveland Jan 70 p 3

NOW AVAILABLE

THE MYTH OF FISCAL POLICY: THE MONETARIST VIEW

One of the liveliest debates among economists in recent years is the relative importance of fiscal vs. monetary policy in determining the level of national income. Economist Ira Kaminow outlines both sides of this controversy in the pamphlet, "The Myth of Fiscal Policy: The Monetarist View," which has been reprinted from the December, 1969 *Business Review*.

Copies of the pamphlet are available upon request to the Public Services Department, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101.

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FEDERAL RESERVE BANKS

(Alphabetically by Cities)

Federal Reserve Bank of Atlanta
Federal Reserve Station
Atlanta, Georgia 30303

Federal Reserve Bank of Boston
30 Pearl Street
Boston, Massachusetts 02106

Federal Reserve Bank of Chicago
Box 834
Chicago, Illinois 60690

Federal Reserve Bank of Cleveland
P.O. Box 6387
Cleveland, Ohio 44101

Federal Reserve Bank of Dallas
Station K
Dallas, Texas 75222

Federal Reserve Bank of Kansas City
Federal Reserve P. O. Station
Kansas City, Missouri 64106

Federal Reserve Bank of Minneapolis
Minneapolis, Minnesota 55440

Federal Reserve Bank of New York
Federal Reserve P. O. Station
New York, New York 10045

Federal Reserve Bank of Philadelphia
925 Chestnut Street
Philadelphia, Pennsylvania 19101

Federal Reserve Bank of Richmond
Richmond, Virginia 23213

Federal Reserve Bank of St. Louis
P.O. Box 442
St. Louis, Missouri 63166

Federal Reserve Bank of San Francisco
San Francisco, California 94120

Mail will be expedited by use of these addresses.

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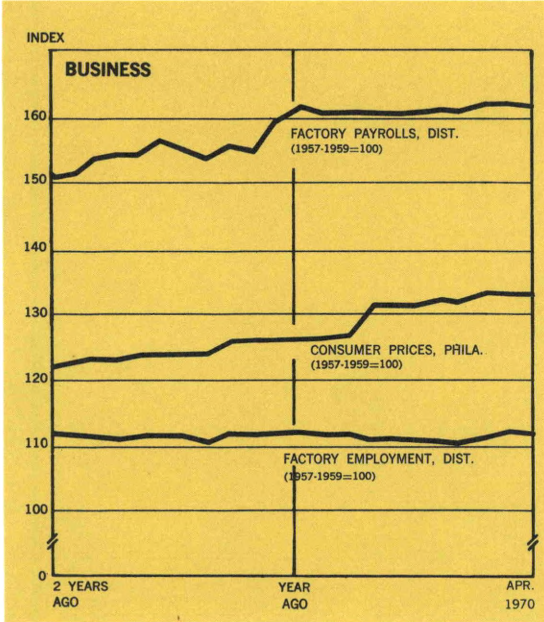

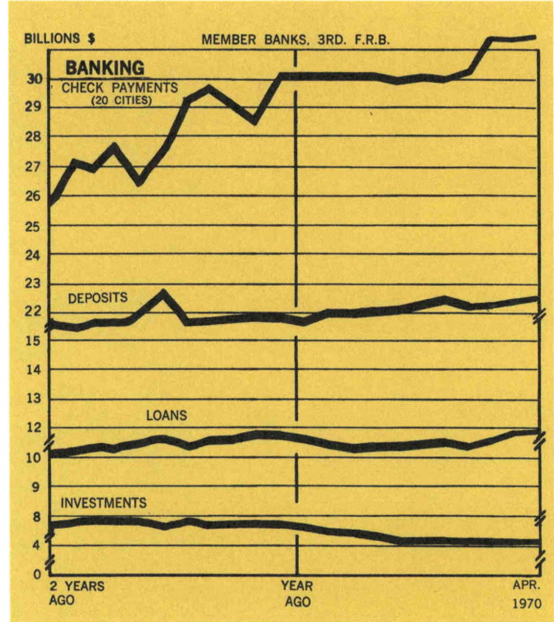

SUMMARY	Third Federal Reserve District — Per cent change — April 1970 from mo. ago	April 1970 from year ago	4 mos. 1970 from year ago	United States — Per cent change — April 1970 from mo. ago	April 1970 from year ago	4 mos. 1970 from year ago
MANUFACTURING						
Production	....	....	....	− 1	− 2	− 1
Electric power consumed	− 1	+ 3	+ 4	....	....	....
Man-hours, total*	− 1	− 2	− 2	....	....	....
Employment, total	− 1	− 2	− 1	....	....	....
Wage income*	− 1	+ 3	+ 4	....	....	....
CONSTRUCTION**	+182	+206	+77	+10	+15	+12
COAL PRODUCTION	− 6	− 8	− 3	+ 1	+ 2	+ 4
BANKING						
(All member banks)						
Deposits	+ 2	− 5	− 3	+ 1	− 3	− 2
Loans	+ 1	+ 4	+ 6	+ 1	+ 6	+ 7
Investments	0	− 9	−10	+ 2	− 4	− 7
U.S. Govt. securities	− 1	− 13	−15	+ 2	−10	−14
Other	0	− 7	− 6	+ 2	+ 1	− 1
Check payments***	+ 4†	+ 16†	+13†	+ 3	+14	+12
PRICES						
Wholesale	....	....	....	0	+ 4	+ 5
Consumer	0‡	+ 6‡	+ 6‡	+ 1	+ 6	+ 6

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES — Standard Metropolitan Statistical Areas*	Manufacturing — Employment — Per cent change April 1970 from mo. ago	Employment — year ago	Payrolls — Per cent change April 1970 from mo. ago	Payrolls — year ago	Banking — Check Payments** — Per cent change April 1970 from mo. ago	Check Payments — year ago	Total Deposits*** — Per cent change April 1970 from mo. ago	Total Deposits — year ago
Wilmington	0	+ 6	− 2	+ 9	− 3	+13	+ 1	− 2
Atlantic City	....	....	....	....	+14	+12	+ 1	+10
Trenton	0	− 4	− 1	+ 1	−16	+21	+ 6	+ 4
Altoona	+ 2	+ 4	+ 1	+ 2	+21	+10	− 1	+ 4
Harrisburg	0	− 1	− 2	+ 7	+ 6	+22	+ 1	+39
Johnstown	+ 1	+ 2	− 3	+ 1	+ 6	+13	+ 2	+ 6
Lancaster	0	− 1	− 1	+ 6	− 1	+18	+ 1	− 5
Lehigh Valley	0	+ 1	− 1	+ 8	0	− 1	+ 2	− 9
Philadelphia	0	− 3	0	+ 1	+ 7	+18	+ 2	− 7
Reading	− 1	− 2	+ 1	+ 5	+ 3	+11	+ 1	+ 4
Scranton	+ 1	− 3	+ 1	− 1	0	− 8	+ 1	+ 2
Wilkes-Barre	− 2	− 2	− 1	+ 6	+ 7	+ 6	− 4	−27
York	− 1	+ 1	− 3	+ 3	+ 2	+12	0	− 8

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.

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