FEDERAL RESERVE BANK OF NEW YORK

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The Business Situation

The economy has apparently eased somewhat further. Thus, industrial production, employment, working hours, and private wage and salary payments all declined in May. Although the unemployment rate dropped back to 4.7 percent in June, employment fell again, resulting in the first three-month decrease in seven years. Despite the evidences of weakness, the prospects remain reasonably good for renewal of growth in the economy in the not-too-distant future. Contrary to widespread reports of consumer pessimism, the available sales data suggest that consumers have in fact responded to recent Government measures bolstering incomes. An additional boost to spendable income occurred on July 1, when the remaining 5 percent tax surcharge expired. Similarly, housing permits have been rising of late and, with an improved flow of funds into savings institutions, some strengthening in residential construction outlays seems likely in the last half of the year. Moreover, state and local spending will almost certainly continue upward in the coming months. According to the latest Government survey, business plans for an increase in plant and equipment spending this year have been cut back somewhat. This was to be expected, however, and the cuts reported have not been drastic, with spending plans outside manufacturing holding up quite well. Inventory spending has been reduced sharply in 1970 and, while there are still some areas of excess inventory, the greater part of the adjustment in this sector may have been completed. Finally, the policy actions taken by the Federal Reserve earlier in the year have resulted in moderate growth in the money supply and bank credit so far this year, in contrast to little or no growth in the last half of 1969. The recent decision to suspend Regulation Q ceilings on short-dated large certificates of deposit[1] will also help to maintain an adequate overall flow of credit. Inflation remains a most serious problem. There have been a few encouraging signs here and there, but the major price indicators have not as yet shown convincing evidence of a more moderate trend.

PRODUCTION AND ORDERS

Industrial output in May recorded one of the larger declines in the downtrend that began last July. The Federal Reserve Board's index of industrial production dropped by 0.8 percent to 169.0 percent of the 1957-1959 average (seasonally adjusted). This was the lowest level since December 1968 and was 3.2 percent below last July's high. The downtrend had been interrupted last February and March by a small recovery, which had led some observers to believe that the production slump had bottomed out. Recent production data have been difficult to interpret, since the figures have been heavily influenced by labor disputes. The February settlement of the General Electric strike helped boost production in March, and in both April and May work stoppages by truckers caused shortages of some component parts used in production lines. Strikes in the rubber industry also dampened production in May. However, the May decline in the overall production index was widespread.

The big drop in the index occurred among equipment producers. Output among defense industries fell again, reaching a level almost 20 percent below last year's average. Production of business equipment also dropped in May, falling to a level about 6 percent below last October's peak. Iron and steel output eased in the month, although steel ingot production, which accounts for about half the iron and steel index, moved up in June. Recent levels of iron and steel output have run almost 10 percent below last year's peak, and there have been newspaper reports that some price concessions are being made.

In contrast to the general easing, auto output jumped 15 percent in May to a seasonally adjusted annual rate of 8 million units. This uptrend continued in June, when out-

[1] See "Money and Bond Markets in June", this *Review*, page 154.

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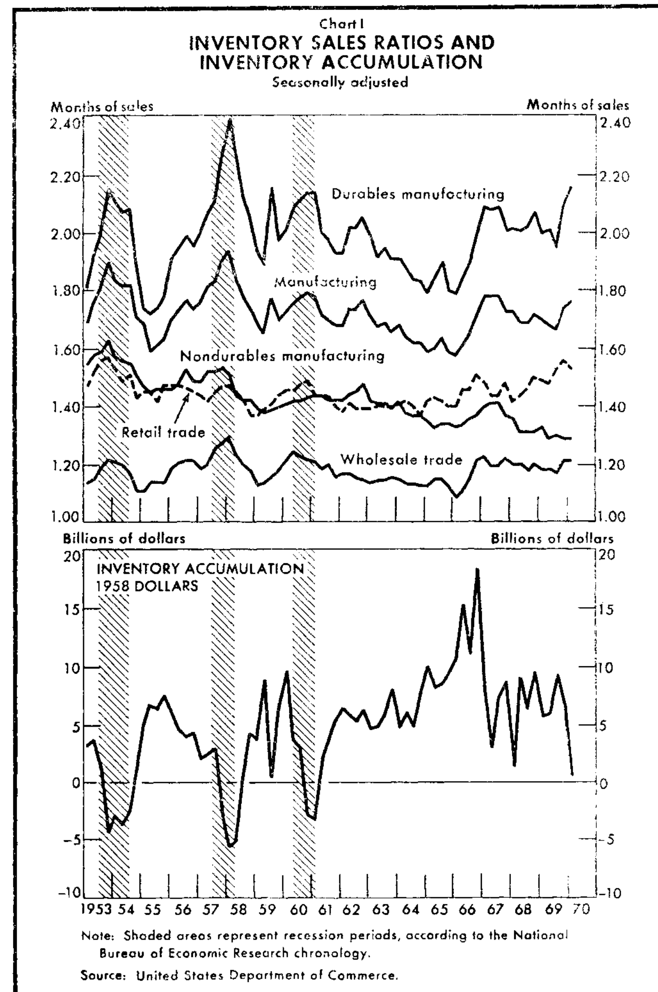
put rose further to 8½ million units. The recent strength in auto production followed several months of slackening. In the second quarter, assemblies averaged 7¾ million units, compared with 6¾ million units in the first three months of the year and 7¾ million units in the final quarter of last year. The recent uptrend largely parallels the recovery in auto sales. After bottoming at a seasonally adjusted annual rate of 6¾ million units in January, the sales pace for domestically produced cars has risen rather steadily, reaching 7¾ million in May. In June, sales advanced sharply to an annual rate of 8½ million units. Better auto sales have led to a reduction in dealers' inventories. By May, the inventory-sales ratio for dealers had fallen back to the 1969 average.

The volume of new orders for durable goods, a leading indicator of industrial activity, rose $0.9 billion to a seasonally adjusted rate of $29.6 billion in May, as orders for transportation equipment—which are often erratic—surged. Durables orders have generally been weak since last fall, however, and even the strong May advance left orders at a level $2.5 billion under the September 1969 peak.



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.
Source: United States Department of Commerce.

INVENTORIES, SHIPMENTS, AND RESIDENTIAL CONSTRUCTION

Business inventory accumulation apparently continued at a slow pace during the first two months of the second quarter. In April, total business inventories rose by $700 million. While this was above the average gain of the first quarter, it was well below the $1 billion average monthly increase of last year. Moreover, a part of the April rise apparently resulted from the truckers' strike which interrupted shipments that month. May data, which are available for manufacturing only, indicate that manufacturing inventories did not rise at all that month. Despite the small advance in inventory spending this year, there are some areas where stocks still appear to be high in relation to sales. As has generally been the case in past slowdowns, this problem is centered in durables manufacturing, where the inventory-sales ratio in May was only slightly improved from the first-quarter level shown in Chart I.

Residential construction activity continued sluggish in May, but there were some indications that the situation might improve. The volume of private housing starts remained at April's seasonally adjusted annual rate of 1.2 million units, compared with 1.5 million units started last year. While the starts rate continued low, the volume of building permits issued by local authorities rose for the second month in a row, reaching the highest level in a year. The recent strength in this series suggests some pickup in building activity in the coming months. Underlying demand for new housing—as shown by near-record lows in vacancy rates and by the rapid growth of household formations in recent years—remains very strong. Moreover, the outlook for home building has been improved by higher deposit inflows to thrift institutions and also by the likelihood of increased Federal assistance to the home mortgage market.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

The economic slowdown has been very evident in the labor market (see Chart II). Over the first six months of the year the unemployment rate increased from 3.5 percent to 4.7 percent, according to the household survey of employment. A part of this increase reflected declines

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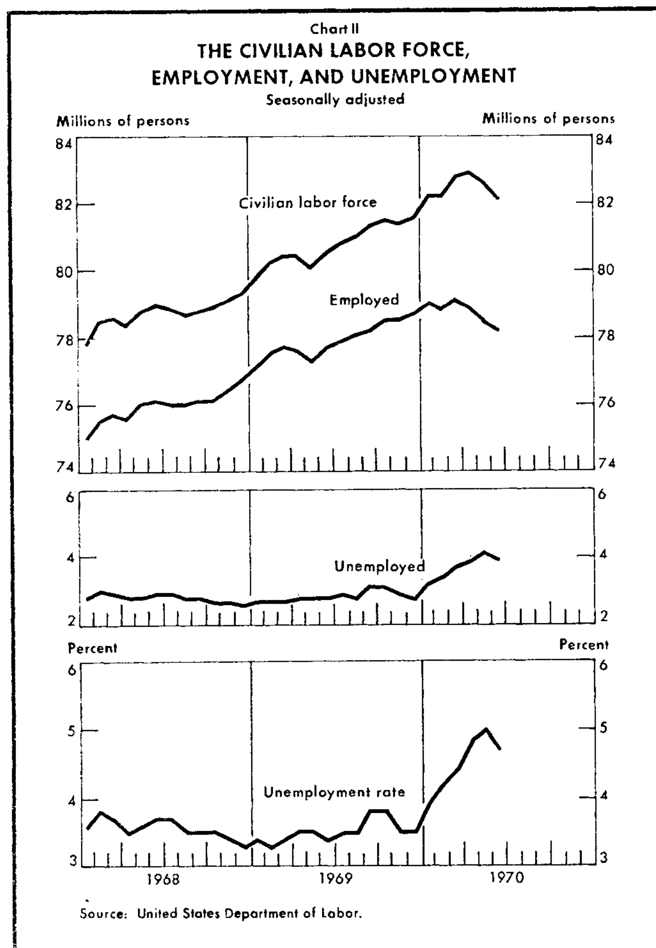
in employment, but an unusually rapid expansion in the civilian labor force also added to the pool of those unsuccessfully seeking work. This acceleration in the labor force was rather unexpected, since a softening in job markets generally leads to a slowdown or an outright reduction in labor force growth as many persons, particularly women and teen-agers, simply leave the labor force after losing a job. (To be included in the civilian labor force, as officially defined, a person must be employed or have actively sought employment within thirty days prior to the survey date.) While the explanation for the labor force acceleration earlier this year is not completely clear, the labor force did revert to more normal behavior in May and June, dropping on a seasonally adjusted basis by a sharp 750,000 in the two months and wiping out better than half the 1.3 million gain registered in the January-April period. The two-month decline was almost entirely accounted for by adult women and teen-agers. In June, teen-agers evidently entered the job market in substantially less than usual numbers, perhaps discouraged by widespread reports that summer employment would be scarce this year. (Spokesmen at the Bureau of Labor Statistics, however, have warned that seasonal factors are particularly difficult to assess in June.) Also in June, seasonally adjusted employment of adult women rose; as a result, total employment did not drop as fast as did the labor force. Thus the unemployment rate fell back 0.3 percentage point from its five-year high of 5.0 percent registered in May.



The payroll series on employment, which is a survey of employers rather than of households, also pointed to large employment declines in May and June. The total decrease in those two months amounted to 0.5 million, with over 0.3 million of that taking place in manufacturing. Since manufacturing employment peaked last September, the number of persons on manufacturers' payrolls has dropped by 0.8 million, with most of the decline accounted for by durables industries. The workweek of production workers in manufacturing also eased 0.2 hour in May to 39.8 hours, almost a full hour below last year's high, and remained unchanged at this level in June.

Declines in employment and the workweek led to decreases in private wage and salary payments in April and May (June data are not yet available). However, this weakening has been offset by Federal Government actions which have maintained the overall growth of personal income. Total personal income rose by a record $18 billion in April, and declined by $8 billion in May to a seasonally adjusted annual rate of $794 billion. April income had been given a tremendous boost by the 6 percent Federal Government pay raise and the 15 percent social security hike, both of which were retroactive to January. The social security increase alone had added $12½ billion to April incomes, and $8 billion of that represented nonrecurring makeup payments. These makeup payments were absent in May and accounted for the April-to-May decline in total personal income. (The retroactive portion of the 6 percent Government pay raise granted in April was divided equally between April and May and amounted to $3 billion in each month.) The pay raise and the hike in social security payments were large enough so that they not only masked the decline in private wage and salary disbursements, but they even brought the recent growth of personal income to nearly the same rate as last year. Over the first five months of the year total personal income rose at a 7.1 percent annual rate, only a shade below last year's 7.6 percent advance.

Federal actions underpinning personal income were generally expected to stimulate consumer buying, and the

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limited figures so far available are at least consistent with this view. Retail sales in April climbed by $0.6 billion and in May backed off only slightly from that high level. The fragmentary evidence so far available for June, including the strong performance of auto sales noted earlier, suggests that overall sales may have been rather well maintained in the month.

RECENT PRICE DEVELOPMENTS

There has been little solid evidence to date of a general slowdown in the rate of price advance. The consumer price index climbed at a 6.3 percent seasonally adjusted annual rate in May, virtually the same as the rate of increase for all of 1969 and for the first four months of this year. To be sure, without seasonal adjustment the index in May increased from the April level at a more moderate 5.4 percent annual rate, but this statistic is less meaningful than the adjusted figure since some prices, such as those for food, are normally a bit lower in May than in April.

Industrial wholesale prices have also continued to gain rapidly despite wide expectations of easing. In May industrial prices rose at a 4.1 percent annual rate, compared with a 4.2 percent rate in the first four months of the year and a 4.0 percent hike in 1969. A good part of the May rise occurred in prices of fuels, lumber, and iron and steel products. There was a slowing in the rate of advance in industrial prices in June, but this apparently reflected little more than a normal seasonal development. In contrast to the uptrend in industrial prices, the total wholesale price index has risen slowly so far this year, as declines in agricultural prices—which make up a quarter of the total index—have offset most of the advance in industrial costs. The agricultural declines suggest some letup in the rise of consumer food prices, but the current inflation is rooted in developments clearly outside the farm sector.

Recent trends in labor compensation and productivity suggest labor costs will continue to exert pressure on the price level. When increases in compensation per man-hour are not matched by equal gains in productivity (output per man-hour), the labor cost per unit of output rises. Since 1965, gains in compensation per man-hour have outstripped productivity increases and have pushed up unit labor costs. These advances have been major factors in the current inflation. So far this year the situation has shown little improvement, except in the manufacturing sector where layoffs and reductions of expensive overtime work have helped to hold down costs.

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The Money and Bond Markets in June

The nation's financial markets coped successfully with a heavy volume of new private securities flotations in June despite widespread concern about developments in the Middle East and Cambodia and new apprehensions related to the commercial paper market. Although most securities markets had rallied strongly near the end of May, the bond markets during most of June remained under the strong pressure of heavy borrowing demands which pushed yields on new corporate and municipal issues to new highs during the month. Earlier fears of a general shortage of liquidity faded, as the Federal Reserve continued to insure that the money markets would function smoothly with minimal stress during the period of seasonal tax-date pressures. Further indications of a slowing of the economy contributed to strong investor and dealer demand for bonds. As the period drew toward the close, investors were apparently becoming more hopeful that the slowdown would smother the inflationary fires and interest rates would decline.

Against this background the financial markets hardly faltered when the Penn Central Transportation Company, the nation's largest railroad, filed a petition in the third week of the month for reorganization under the Federal Bankruptcy Act. Market participants recognized that this event could lead many investors to reexamine the quality and volume of commercial paper in their investment portfolios, but prompt action by the Federal Reserve Board gave reassurance that the banking system would be in a position to deal with any credit strains that might emerge as this reassessment proceeded. Effective June 24 the Board suspended Regulation Q interest rate ceilings on large certificates of deposit (CD's)—those in denominations of $100,000 or more—for 30- to 89-day maturities. The Board stated that it was taking the action in recognition that unusual demands upon commercial banks for short-term credit could arise as a consequence of current uncertainties in the financial markets. The atmosphere in the bond markets continued to improve in the wake of this action, with yields on most debt securities tending to decline further.

BANK RESERVES AND THE MONEY MARKET

Relatively comfortable conditions prevailed in the money market during June. Cognizant of market concerns, the Federal Reserve System was careful to provide amply for the liquidity of the money market, but System actions did not lead to rapid growth in the monetary aggregates. Lenders in the money market were able to accommodate smoothly the buildup of short-term borrowing pressures around the June corporate tax date. The Federal funds rate declined slightly to about 7¾ percent from 8 percent in late May, and bank reserve positions changed little (see Table I). Average member bank borrowings declined to $907 million from $924 million in May, while the average basic reserve deficit of the forty-six large money center banks rose slightly to a level of $5.3 billion in the four weeks ended on June 24 (see Table II).

The daily average money supply declined in June following a rapid expansion in April and moderate growth in May. The level of the daily average money supply for the four weeks ended on June 24 contracted at a seasonally adjusted annual rate of 5¼ percent from the level recorded in May. On a week-to-week basis, the money supply changed little in June until the week ended on June 24, when there was a marked decline (see Charts I and II). The June performance contrasted with the revised 3½ percent growth rate posted in May, and was largely accounted for by a moderate decline in demand deposits. The currency component, which had experienced an especially large increase in May, continued to expand in June but at a less rapid pace.

The volatile character of the monetary aggregates often makes interpretation of weekly or monthly movements difficult. Because longer term movements are calculated from daily average figures for the first and last months of the period under consideration, these values can also be exaggerated by the choice of particularly high or low months for comparison. If, for instance, the month of February, when the money supply was at a relatively low

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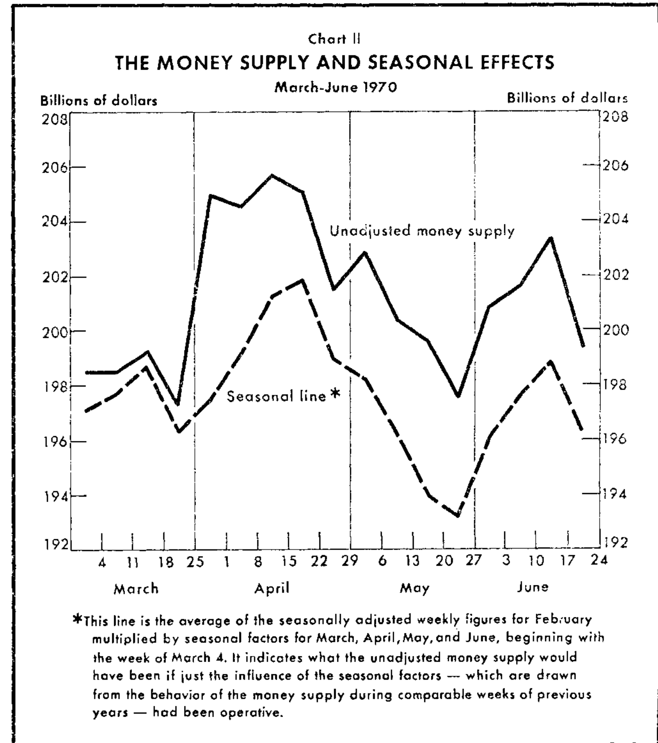
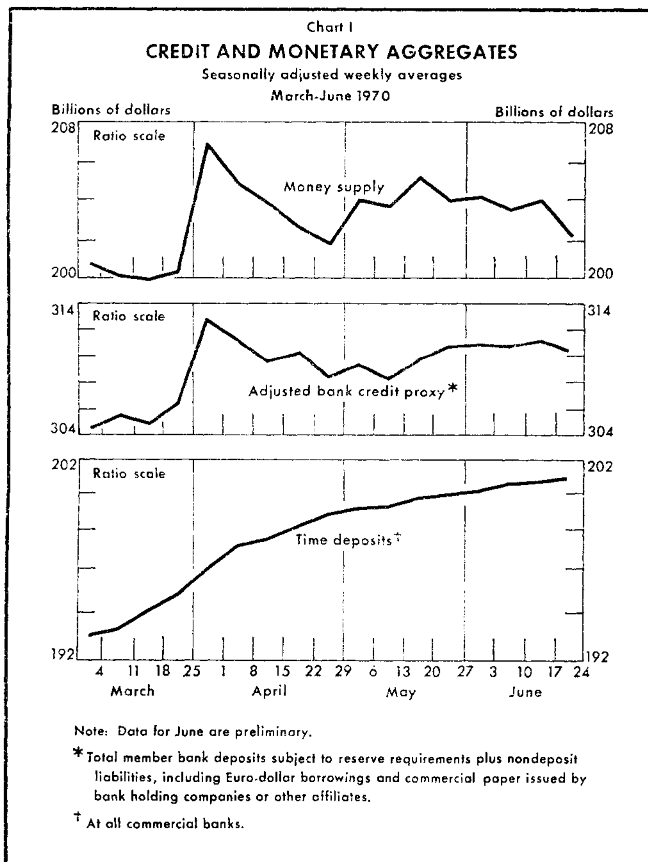
level, is used as the first month of the comparison, the average rate of growth through June is about 6¼ percent. On the other hand, the growth rate would be about 3¾ percent if the first month were December, when the average money supply level was little affected by a sharp increase at the end of the month.

During June, time deposits held at commercial banks expanded at a 7½ percent annual rate, which approximates the average rate of growth achieved on balance thus far in 1970. The change in Regulation Q should lead to further increases in this aggregate, as reintermediation occurs and banks issue a larger volume of the shorter term CD's.

The adjusted bank credit proxy moved upward in June at a 7 percent seasonally adjusted annual rate as contrasted with a 1½ percent rate of decline experienced in May. Most of the strength in this aggregate resulted from continuing rapid time deposit growth and an upsurge of United States Government deposits held at commercial banks. Over the past six months, the adjusted bank credit proxy has grown at an annual rate of 3½ percent, or slightly less than the rate of growth of the money supply during the same period.





THE GOVERNMENT SECURITIES MARKET

The market for United States Government securities stabilized in June, although participants remained somewhat uneasy. Market sentiment improved at midmonth, when President Nixon gave a reassuring address on the state of the economy. This improvement continued with the growing belief that the Federal Reserve would not allow a liquidity crisis to develop and impair the functioning of the markets. Yields on Government notes and bonds fluctuated in a narrow range during the early part of the month, but declined after midmonth (see Chart III). The ability of the money and capital markets to withstand heavy corporate demands for funds appears to have had a salutary effect on this market, especially in the longer term area. During the month, most bill rates experienced sizable declines, as heavy demand pressed against a rather thin market supply. Part of the demand for bills was apparently from investors switching from commercial paper.

Yields on coupon securities which had declined in

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Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JUNE 1970

In millions of dollars; (+) denotes increase (—) decrease in excess reserves

Factors	Changes in daily averages—week ended on				Net changes
	June 3	June 10	June 17	June 24	
"Market" factors					
Member bank required reserves	— 151	+ 97	— 99	+ 250	+ 97
Operating transactions (subtotal)	— 258	+ 25	— 111	— 66	— 410
Federal Reserve float	— 69	— 192	+ 371	+ 200	+ 310
Treasury operations*	+ 54	+ 431	— 169	— 162	+ 154
Gold and foreign account	— 15	— 11	— 12	— 50	— 88
Currency outside banks	— 137	— 135	— 447	— 79	— 798
Other Federal Reserve liabilities and capital	— 90	— 69	+ 147	+ 26	+ 14
Total "market" factors	— 409	+ 122	— 210	+ 184	— 313
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 348	+ 154	+ 423	— 678	+ 247
Outright holdings:					
Government securities	+ 255	+ 143	+ 539	— 678	+ 259
Bankers' acceptances	— 7	— 2	— 3	—	— 12
Repurchase agreements:					
Government securities	+ 71	+ 15	— 86	—	—
Bankers' acceptances	+ 7	+ 4	— 11	—	—
Federal agency obligations	+ 22	— 6	— 16	—	—
Member bank borrowings	+ 294	— 369	— 198	+ 229	— 44
Other Federal Reserve assets†	— 102	+ 36	+ 143	+ 53	+ 130
Total	+ 540	— 179	+ 368	— 396	+ 333
Excess reserves	+ 131	— 57	+ 158	— 212	+ 20

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	27,613	27,459	27,680	27,254	27,502‡
Required reserves	27,438	27,341	27,440	27,190	27,352‡
Excess reserves	175	118	276	64	158‡
Borrowings	1,225	856	658	887	907‡
Free, or net borrowed (—), reserves	—1,050	— 738	— 382	— 823	— 748‡
Nonborrowed reserves	26,388	26,603	27,022	26,367	26,595‡
Net carry-over, excess or deficit (—)§	82	122	87	175	117‡

	Changes in Wednesday levels				Net changes
System Account holdings of Government securities maturing in:					
Less than one year	+ 501	— 333	+ 271	— 818	— 379
More than one year	+ 82	+ 187	—	—	+ 269
Total	+ 583	— 146	+271	— 818	— 110

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Average for four weeks ended on June 24.

§ Not reflected in data above.

TABLE II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS JUNE 1970

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on June 24
	June 3	June 10	June 17	June 24	
Eight banks in New York City					
Reserve excess or deficiency (—)*	54	— 22	47	58	34
Less borrowings from Reserve Banks	269	195	—	97	140
Less net interbank Federal funds purchases or sales (—)	947	1,770	1,564	1,508	1,447
Gross purchases	2,174	2,818	2,643	2,540	2,544
Gross sales	1,227	1,048	1,078	1,032	1,096
Equals net basic reserve surplus or deficit (—)	—1,163	—1,988	—1,517	—1,547	—1,554
Net loans to Government securities dealers	428	381	321	445	394
Net carry-over, excess or deficit (—)†	— 3	35	5	37	19
Thirty-eight banks outside New York City					
Reserve excess or deficiency (—)*	70	— 3	97	— 13	38
Less borrowings from Reserve Banks	349	237	251	306	286
Less net interbank Federal funds purchases or sales (—)	3,262	3,637	3,849	3,401	3,537
Gross purchases	5,247	5,732	5,845	5,278	5,526
Gross sales	1,985	2,096	1,996	1,877	1,989
Equals net basic reserve surplus or deficit (—)	—3,541	—3,877	—4,004	—3,720	—3,786
Net loans to Government securities dealers	191	109	10	101	103
Net carry-over, excess or deficit (—)†	25	15	13	46	25

Note: Because of rounding, figures do not necessarily add to totals.

* Reserves held after all adjustments applicable to the reporting period less required reserves.

† Not reflected in data above.

TABLE III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—June 1970				
	June 1	June 8	June 15	June 22	June 29
Three-month	6.824	6.785	6.733	6.626	6.421
Six-month	6.858	6.895	6.947	6.929	6.603

Maturities	Monthly auction dates—April-June 1970		
	April 23	May 26	June 23
Nine-month	6.844	7.352	7.069
One-year	6.814	7.277	7.079

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

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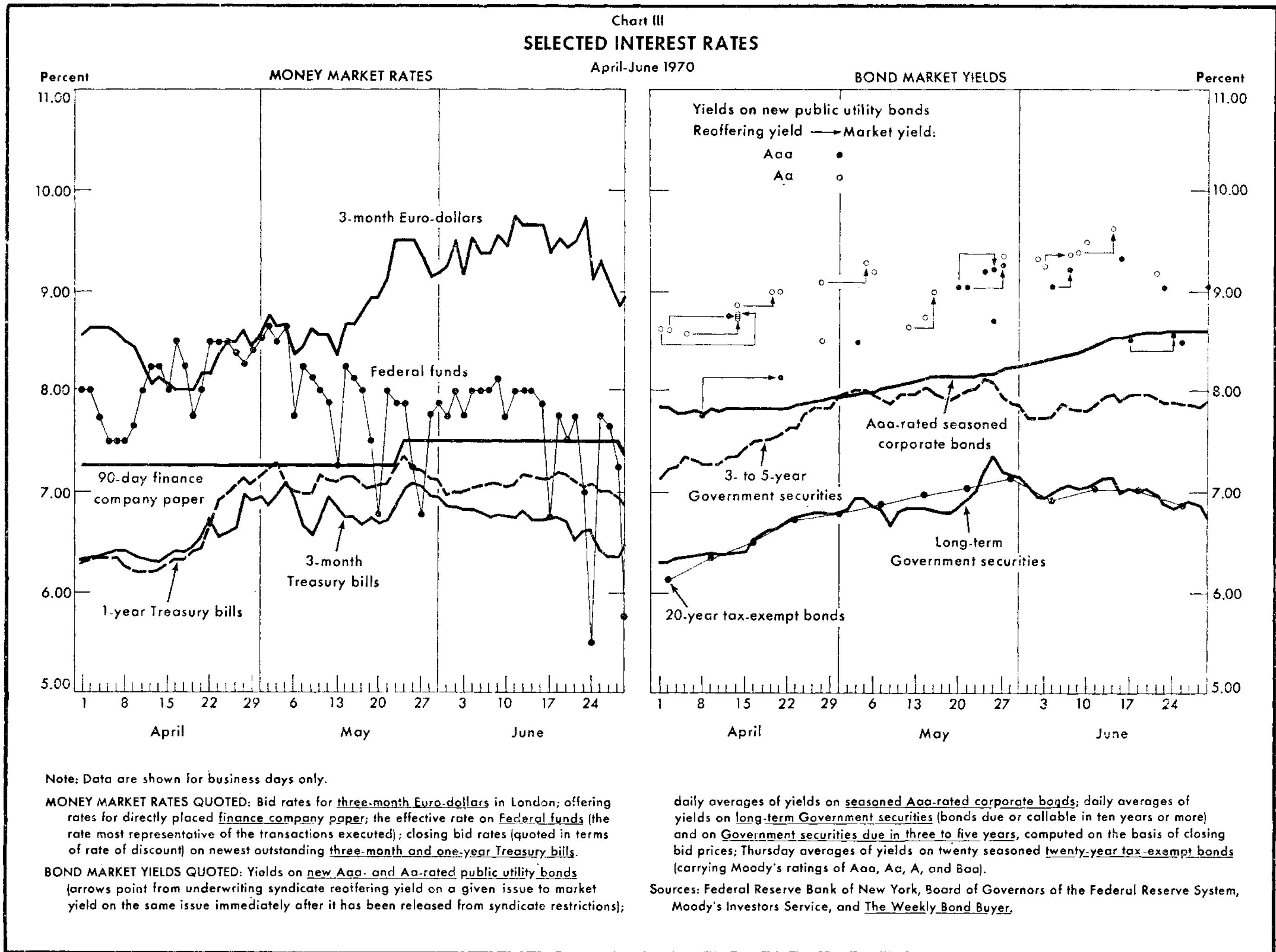

the late-May rally continued to move to generally lower levels during the first days of June, although yields on a number of intermediate-term securities tended to rise. Subsequently, yields on all coupon securities moved higher, partly reflecting the near-term outlook for interest rates, which was affected by the heavy calendar of long-term corporate offerings and the anticipated shorter term financing needs around the June 15 corporate tax date. By midmonth, yields on most securities were higher than levels set at the end of May, although below the peak values posted in that month. Yields on longer term Government securities began to decline, however, with the midmonth improvement in the capital markets, but yields on intermediate-term issues were less affected. The announcement of Penn Central's plans for reorganization benefited both notes and bonds, as investors sought and acquired higher quality issues. Yields continued to fall for the remainder of the month.

Rates on most Treasury bills moved sharply lower in June. Rates initially declined in a continuation of the late-May rally and then fluctuated at lower levels until after midmonth, with shorter term bills generally registering further improvements and longer term bills experiencing some increases in rates. Later in the month, following the Penn Central petition for reorganization, the shift in investor preference toward higher quality issues and the demand from holders of the $4.5 billion of tax anticipation bills (TAB's) maturing on June 22 moved rates lower on

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all maturities. Rates continued to fall until the end of the month, and closed the month about 60 to 20 basis points lower than those at the end of May. The average issuing rates set at the weekly and monthly Treasury bill auctions also declined, as indicated in Table III.

On June 26, the Treasury announced plans to auction $2.5 billion of TAB's maturing on March 22, 1971. The bills were to be auctioned on July 2 for payment on July 8 and qualified depositories were permitted to make full payments for subscriptions through credit in their Treasury Tax and Loan Accounts. At the same time, the Treasury also announced plans for an additional cash offering in the neighborhood of $2 billion to be scheduled prior to the refunding of the August 15 maturities.

OTHER SECURITIES MARKETS

The strong pressures that affected the market for corporate and municipal securities in May moderated somewhat in June. Early in the month yields fell on most new issues, but apprehension over the very heavy calendar of corporate offerings scheduled for the latter half of June led to a subsequent deterioration in rates until midmonth. As it became evident that the large volume of new issues would be placed successfully, market conditions improved. The announcement of the Penn Central's financial difficulties did not impair the performance of the markets for high-grade debt issues.

Attention in the corporate market before midmonth continued to be focused on the heavy schedule of new corporate offerings. After a modest improvement early in the month, apprehension of participants over the upcoming flotations was associated with a significant deterioration in market conditions. The turnaround came on the eve of President Nixon's June 17 economic address. On June 16, a $100 million 40-year Aaa-rated telephone company bond issue was offered at a record yield of 9.35 percent, 25 basis points higher than any previous top-rated telephone company offering. At this high yield, the bonds met an excellent reception, as did most of the other issues marketed on the same day. Yields moved lower thereafter in a revival of demand, particularly among institutional investors. At the end of June, another Aaa-rated telephone company flotation consisting of $150 million of 33-year debentures was successfully offered at a yield of 9.05 percent, 30 basis points below the slightly longer term issue marketed on June 16.

In the market for tax-exempt securities, yields fell moderately early in June when new issue activity was light. *The Weekly Bond Buyer's* index of tax-exempt securities, which had hit a record 7.12 percent in the week ended on Thursday, May 28, fell 20 basis points in the week ended on June 4. Subsequently, however, yields again moved upward and remained at higher levels until midmonth. On June 16, the state of California reentered the market after voters there approved a new 7 percent interest rate ceiling. California had been unable to float new securities for more than a year under the previous 5 percent ceiling. After midmonth, the successful completion of the especially heavy flotations in the corporate market was accompanied by a decline in tax-exempt securities yields as well. At the end of the month, yields on new issues were being set below levels common in May and earlier in June.

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Interpreting the Monetary Indicators *

By Richard G. Davis
Adviser, Research and Statistics Function
Federal Reserve Bank of New York

Your Chairman has asked me to present a brief description of some of the key monetary statistics and their use in interpreting credit market conditions and the direction of monetary policy. This is a very large order given the time constraints, and so my presentation will have to be both quite selective and highly condensed. I will in fact briefly describe some of the major monetary and money market statistics and their significance. I will also have something to say about their use in interpreting policy. I will mention some recent modifications in the *modus operandi* of Federal Reserve open market policy, but I will have nothing at all to say about current policy itself, nor will I attempt any interpretation of recent movements in the monetary data.

The monetary statistics I want to discuss can conveniently be divided into three groups: the reserve aggregates, the monetary aggregates, and the money market indicators. Turning first to the reserve aggregates, there are four concepts that are widely discussed. The first is total reserves of Federal Reserve System member banks. This figure consists of member bank deposits at the Federal Reserve Banks plus their vault cash. The size of this reserve aggregate is determined in part by the volume of Federal Reserve open market operations, in part by certain technical market factors (such as Federal Reserve float), and in part by the member banks themselves as they make decisions on whether and how much to borrow at the Federal Reserve discount window—subject of course to the Fed's rules regulating such borrowings. A closely related reserve concept is the so-called "monetary base" or, as it is known in some of the older money and banking textbooks, "high-powered money". The monetary base is simply total reserves of member banks plus cash held by nonmember banks and by the nonbank public. Both these measures, total reserves and the monetary base, are also often presented in the form of variants that subtract borrowings of member banks at the discount window. In this guise they are called, obviously enough, nonborrowed (or sometimes unborrowed) reserves and the nonborrowed monetary base.

All these reserve aggregate measures are of intense interest to the monetary specialist. They are obviously key factors in determining the volume of the money supply and bank credit. In my view, however, the nonspecialist can profitably economize on the use of his time by working directly with the money and bank credit aggregates themselves. Consequently I shall have little further to say about the reserve aggregates.

As you may know, arguments rage interminably as to just what statistical concept best captures the abstract, textbook notion of the "money supply". Henry Wallich, the Yale professor, Government adviser, and *Newsweek* columnist, claims to have discovered at least ten definitions in actual use. There are really only two definitions with widespread acceptance, however. The first treats as "money" the nonbank public's holdings of coin and currency plus demand deposits other than interbank deposits and United States Treasury deposits. This definition is often called the "narrowly defined" money supply or, simply, "M_1". The second definition of money in common use ("broadly defined" money, or "M_2") adds time and savings deposits at commercial banks to the narrowly defined money supply.

As in the case of the reserve aggregates already mentioned and of bank credit, which I am about to mention, both the money supply series have strong seasonal patterns and as a rule should be looked at in seasonally adjusted form—this is true despite the fact that seasonal adjustment procedures often raise some real problems. It should also be noted that meaningful analysis of the

*A talk delivered before the New York Society of Security Analysts, New York City, June 4, 1970.

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money supply series involves the *rates of growth* in these items rather than their absolute levels. These rates of growth are almost always measured in terms of annual percentage rates of change.

Turning to the concept of bank credit, this is simply total loans and investments of commercial banks with some minor adjustments. Unfortunately, data on total bank credit at all commercial banks are available only on a last-Wednesday-of-the-month (or call date) basis. The Federal Reserve System in fact makes use of a so-called "bank credit proxy" for member banks, which is available on a daily average basis week by week. Very briefly, this uses total deposit liabilities of member banks to approximate total loan and investment assets (or bank credit) on the other side of the balance sheet. Total deposits are by no means a perfect proxy for total loans and investments since there are many other, often volatile, items on both sides of the banking system's balance sheet. Thus for many purposes it is desirable to try to make adjustments for some of these items. In recent years, movements in member bank borrowings from their own foreign branches have been a particularly important consideration. Also, an adjustment is usually made to add back the bank credit that disappears from the statistics when banks sell off loans to the parent one-bank holding companies, which, in turn, finance their loan purchases by issuing commercial paper.

A very lively debate has existed for a long time within the Federal Reserve System and among economists in general as to which of the three main monetary aggregates—M_1, M_2, or bank credit—is the best indicator of the banking and monetary system's impact on the subsequent course of the economy as a whole. In fact, the actual behavior of these three aggregates tends to be broadly similar, so that the debate is perhaps not as consequential as it sometimes seems. Again broadly speaking, these three aggregates tend to have roughly similar cyclical turning points and have roughly equal correlation with movements in gross national product and other economic measures. Under present circumstances, I—and perhaps at least a plurality if not a majority of economists—tend to prefer M_1, the narrowly defined money supply, to the other two measures. Bank credit has the disadvantage of being a total of some very heterogeneous items, ranging all the way from bank investments in Treasury bills to twenty-year home mortgages. To me, it seems hard to say anything very meaningful about the market demand for such a hodgepodge. Secondly, the significance of movements in both bank credit and M_2 tends at times to be distorted, in my view, by the effect of Regulation Q on time and savings deposit interest rates and thus on the ability of banks to market such deposits. The argument back and forth on this matter is very complicated and I simply don't have time to go into it. In any case, I would opt for following M_1 on balance as against the other two aggregates, but I doubt that the matter is of really first-class importance.

As I noted a moment ago, interpretations of movements in the monetary aggregates almost always concentrate on seasonally adjusted percentage changes computed at annual rates. In using these data, it is absolutely vital to understand that they contain a tremendous amount of statistical "noise" —that is, random short-run movements tend to be large relative to trend and cyclical movements. (Actually, of course, the time paths of first differences of most economic series contain substantial amounts of noise even when *levels* in the same series show a fairly regular behavior.)

A second and related point to keep in mind about growth rates in money and bank credit is that, contrary to the impression often given in undergraduate economics, the Federal Reserve System does *not* have the tools to control movements in money and bank credit growth rates with any very high degree of precision in the short run. The System can of course exert a powerful influence through its open market operations. Nevertheless, the monetary aggregates are very importantly influenced by other factors not under direct Federal Reserve control. Since the behavior of these other factors may be highly unpredictable in the short run, it may be impossible to know how to adjust day-to-day or week-to-week open market operations to offset their effect. Moreover, incoming preliminary data may at times prove highly inaccurate, making it difficult to know what actions need to be taken. Finally, there are many short-run influences on the money supply that the System may be simply powerless to offset—again in the short run—even if it knows about them. For example, an increase in the demand for bank credit in a given statement week will tend to raise bank deposits and credit and, *within that week,* there will be virtually nothing the Federal Reserve can do about it. I hope these comments on the difficulties of precise short-run control of the monetary aggregates will not appear as a "cop out". Actually, they simply reflect a fact of life that interpreters and users of monetary statistics would do well to keep in mind.

The practical moral to be drawn from the fact that the monetary aggregates may be dominated by erratic and often uncontrollable movements in the short run is that users of these data must avoid the pitfall of overinterpreting short-run developments. Under the circumstances, it will be a wise strategy to adopt some sort of longer run span or moving average technique to force the raw data into a reasonably interpretable form.

There are, to be sure, some problems involved in using devices such as moving averages or moving spans. If the

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length of the moving span or moving average is too short, it will not filter out enough of the noise in the data. On the other hand, if it is too long, it will filter out fundamental movements along with the noise and will tend to distort the timing of significant turning points. I will not try to pinpoint precisely an optimal time span for examining growth rates in the money supply and bank credit. Nevertheless, some suggestions are in order. Thus I would think data for a single week are absolutely useless for the analyst. Indeed I would think even data for a month are of very dubious significance. Measurements taken over a quarterly span or in terms of three-month moving averages may be about the minimum length of time for which meaningful readings of these data can be obtained.

Actually, even three-month spans present problems. Data constructed on this basis still display a fair degree of noise. Moreover, even on a three-month basis, the relationship between the amount of reserves the Federal Reserve supplies or permits to be supplied bears a by-no-means airtight relationship to the volume of deposits and credit created. Thus it may also be useful to look at developments over longer periods of, say, four to six months.

The third set of measures I want to mention briefly are the measures of money market conditions. These measures include the so-called "marginal reserve measures": they are the levels of member bank excess reserves, member bank borrowings at the discount window, and net free reserves, i.e., excess reserves less borrowed reserves. (To complicate matters further, free reserves are usually called "net borrowed reserves" when borrowings exceed excess reserves.) These various marginal reserve measures can be thought of (somewhat loosely) as reflecting the balance between supply and demand in the market for bank reserves. As a result, movements in them have tended historically to show a rough parallelism with movements in short-term interest rates, such as the Federal funds rate, the rates on call loans to Government securities dealers posted by banks, and Treasury bill rates. The often-discussed concept of money market "tone" may be thought of as representing some sort of weighted average of all these various marginal reserve and short-term interest rate measures.

Over much of the 1950's and 1960's, the Federal Open Market Committee (FOMC) tended to rely on money market tone as a focus of short-run operating decisions by the Open Market Account management. The precise money market tone aimed at was of course varied by the FOMC from time to time in line with its broader objectives regarding rates of growth in the monetary aggregates and/or broader measures of credit market conditions, and its ultimate objectives with respect to real growth, employment, prices, etc. To detect changes in the money market tone sought by the Federal Reserve, analysts tended to concentrate their attention on the behavior of free reserves and some of the other money market measures just mentioned. In recent years, there has been an evolution toward a more direct role for the monetary aggregates as targets influencing the short-run conduct of open market operations. The increased stress on monetary aggregates is evident in the published report of the January 15, 1970 meeting of the FOMC.

> The Committee concluded that in the conduct of open market operations increased stress should be placed on the objective of achieving modest growth in the monetary aggregates, with about equal weight being given to bank credit and the money stock. It was agreed that operations should be directed at maintaining firm conditions in the money market, but that they should be modified if it appeared that the objective with respect to the aggregates was not being achieved.

Note that the Committee report does not pick out a single aggregate but mentions *both* bank credit and the money supply. The report speaks of giving "about equal weight" to these two aggregates, but presumably the weights could be altered from time to time if conditions seemed to favor use of one or the other aggregate. Note also that the Committee makes reference to the money market conditions (or tone) it expects to be compatible with its objectives as regards the aggregates. However, it instructs the Account Manager to modify these conditions, if such modification is needed to approach the objectives concerning the monetary aggregates.

The procedure adopted by the FOMC at its January meeting suggests that the growth rates of the money supply and bank credit should prove more directly sensitive to the intent of policy makers than was sometimes the case in the past. Having said this, however, I want immediately to remind you again of the extent to which the short-run behavior of the aggregates reflects factors other than the influence of Federal Reserve actions. It remains true that reasonably meaningful statements about the trend of monetary and bank credit growth rates can only be made over reasonably long periods.

A second implication of the FOMC's new approach is that somewhat greater variability might be expected in some of the traditional measures of money market conditions, such as free or net borrowed reserves and the Federal funds rate, than was true in much of the 1950's and 1960's. Again, however, I think a qualification is in order. It is important to note that increased room for short-run

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flexibility in money market conditions does *not* mean that the Federal Reserve has ceased to be concerned about the condition of the money market. There is no disposition to allow large short-term fluctuations in money market conditions.

To summarize briefly, the task of interpreting monetary data unfortunately has major inherent difficulties. There are a large number of these measures; as a group they are quite capable of widely *divergent* movements in the short run; taken singly, many of them are equally capable of very *erratic* movements in the short run. I have noted that the System has moved toward increased attention to the money supply and bank credit aggregates, but that it has retained its interest in the state of the money market. Since these objectives may at times conflict in the short run, attempts to read changes in policy into weekly movements in the data are perhaps even more dangerous now than they may have been in the past. Thus the moral would seem to be: for heaven's sake, don't try to overinterpret short-run movements in any of these figures. To measure the Federal Reserve's intentions, look, instead, to the longer run trend of money and bank credit growth rates.

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Foreign Demand for United States Equities— The Role of Offshore Mutual Funds

By FRED H. KLOPSTOCK
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During recent years, one of the major developments in the evolving international financial scene has been the massive shift of foreign portfolio capital to Wall Street. In the brief span of two and three-quarter years, beginning in the spring of 1967, approximately $4.5 billion of foreign money has been placed in United States equities—surely the largest and one of the most protracted transfers of outstanding securities across national borders in the history of international capital movements.[1] This heavy capital inflow was attributable in large part to the evolution of new financial institutions, notably internationally oriented mutual funds—mostly of the so-called "offshore" type—and the investment management and sales organizations associated with their operations. An incidental benefit of the surge of foreign purchases of American equities was a much needed fillip to the United States balance of payments.

The severe price erosion in the United States stock market during much of the first half of 1970 and the reemergence of net sales of American stocks by foreigners during this period have cast considerable doubt on whether investors abroad will soon again begin to acquire substantial amounts of American equities. In fact, in some prognostications the dire specter of a massive liquidation of foreign-held American equities has been raised. These doubts and questions about the near-term future of foreign investments in the United States stock market have been compounded by the much publicized reversal in the fortunes of Europe's largest mutual fund management and sales organization, the Geneva-based Investors Overseas Services (IOS) group of companies that has sponsored several mutual funds which have been heavy investors in American securities.

Against this somber background, which holds important implications for the United States balance of payments, this paper tries to identify the sources and determinants of the foreign demand for American stocks. Another purpose of the article is to describe the institutional pattern of the demand for United States equities, notably the important role of offshore mutual funds whose future may well have been unfavorably affected by the recent IOS events. The article also examines the significance of the increasing role of professional management of foreigners' investable funds in the international movement of outstanding American and other foreign common stocks. It then explores the economic implications of the large-scale transfer of foreign savings to Wall Street. In the final section, the longer run prospects for foreign purchases of American equities will be considered.

A REVIEW OF FOREIGN PURCHASES OF AMERICAN EQUITIES

Heavy flows of foreign funds into American equities have occurred before, but the nature and institutional pattern of the recent surge differs in several important respects from those of earlier times. In two periods prior to World War II, foreigners poured money into American securities. During the 1928-29 speculative boom, foreign funds worth approximately $1 billion flowed to New York for investment in common stocks, and about the

[1] Foreign investors desirous of adding to their American securities portfolios also purchased in this period $2.5 billion worth of convertible debentures issued in the Euro-bond market by United States corporations' affiliates set up to finance direct investment operations abroad. The inflow to Wall Street would have been even larger had many such investors not sold sizable amounts of American common stocks to finance these purchases. On the other hand, the sales of such convertible debentures and the publicity associated with their issuance may have widened foreign investors' interest in American equities and therefore contributed to the surge of foreign purchases in the New York stock market.

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same amount was invested in the two years ended in March 1937. The desire of foreign investors to cash in on rapid advances in New York stock exchange prices explains, of course, much of this 1928-29 inflow. In the midthirties, the speculative element appears to have been less prominent, though by no means absent. Currency uncertainties in Europe and war fears contributed to the desire of many wealthy foreigners to add to their American equities portfolios at that time. In the thirties, net purchases were large enough to become an important element in the United States balance of payments; in this respect the recent experience resembles that of the thirties. Another element of similarity is that in the midthirties and again in the recent period foreign purchasers bought heavily on price rises but, on balance, did not sell to any significant degree during price declines.

The most recent surge in foreign purchases of American equities began in April 1967 rather suddenly and unexpectedly. The beginning was somewhat less abrupt than conveyed by the published United States Treasury statistics tabulated in the table. These data are misleading on this score because they reflect the net liquidation of equities holdings by the British government that occurred in the midsixties. After adjustment for these official sales, it becomes apparent that private investors abroad engaged in modest net purchases rather than net sales in 1966 and early 1967. Foreign net purchases rose slowly in the second quarter of 1967 and gathered momentum in the fall of that year. September 1967 witnessed for the first time in several decades monthly net purchases substantially in excess of $100 million.

FOREIGN PURCHASES AND SALES OF UNITED STATES STOCKS

1964-April 1970

In millions of dollars

Period	Purchases	Sales	Net purchases (+) or sales (—)
1964	3,076	4,425	— 349
1965	3,720	4,133	— 413
1966	4,740	5,074	— 333
1967: January-March	1,557	1,604	— 47
April-December	6,476	5,672	+ 804
1968	13,118	10,848	+2,270
1969	12,429	10,942	+1,487
1970: January-April*	3,109	3,199	— 90

* Preliminary.
Source: United States Department of the Treasury.

By March 1968 the previous steady net flow of foreign capital into American equities had turned into an avalanche. The student disorders in France and the Russian occupation of Czechoslovakia represented additional factors which induced foreigners to shift funds into the United States stock market in that year. The surge of foreign net purchases carried into 1969, reaching an all-time record in January of that year ($361 million) and remaining at a very high level the following month. Subsequently, net purchases diminished, and in June and July actual net sales were recorded for the first time in two and one-quarter years. In the August-October period, substantial net purchases resumed, but they subsided again toward the end of the year. Altogether, foreigners acquired almost $1.5 billion of American equities in 1969.

In the early months of 1970, foreigners sold United States securities again but net sales were relatively modest. During the first four months, they were approximately $100 million. In May as a result of the precipitous decline of stock market quotations net sales rose sharply, according to preliminary and incomplete data. Shifts between net purchases and sales are reflected in the chart.

The persistence of relatively heavy capital inflows during most of 1969 and the relatively small amounts of net sales during the first few months of 1970 were contrary to widespread expectations. As stock prices began to weaken toward the end of 1968, and New York money market rates rose to ever-higher levels, a common prediction was that foreigners would lose interest in American equities and that they would unload substantial portions of earlier accumulations. In fact, it was widely believed that the high rates for short-term money would exert a perverse effect on our balance of payments. The "standard forecast" was that, as stock prices fell in response to tighter money, foreigners would become net sellers of American equities, thus offsetting much of the beneficial effect of interest-rate-induced short-term inflows on the dollar's international position. Notwithstanding the poor performance of the New York stock market through much of 1969, this did not occur. In contrast to flows of almost $4 billion into Wall Street during the April 1967-May 1969 period, aggregate net liquidations of American equities in June and July 1969 added up to no more than $157 million, a minuscule fraction of the aggregate foreign stake in American equities estimated at close to $20 billion as of mid-1969. During the 1969 period of sharp price declines in Wall Street, foreigners in the aggregate not only retained their holdings but as a group actually added to their commitments, except for rather brief periods. During the first four months of 1970 the amount of liquidation was surprisingly modest, considering the extent

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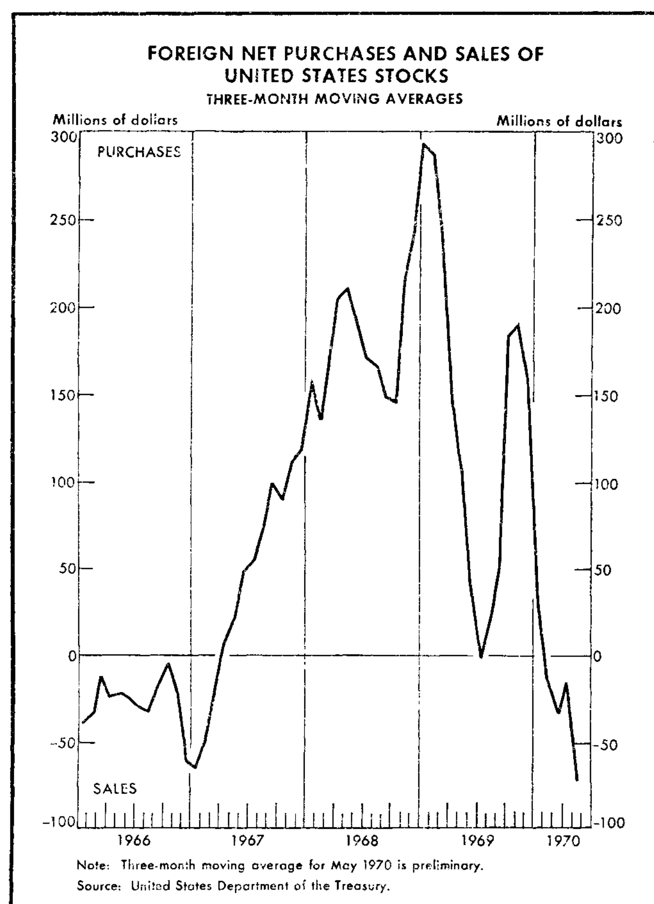

of price erosion.

It would appear that the desire of foreigners to reap short-term profits from rapidly rising prices on the New York Stock Exchange was not the sole and perhaps not even the major factor in the massive investment by foreigners in American equities during the 1967-69 period. This is not to say that the hope for quick capital gains did not play an important role in the inflows in 1967 and 1968. During this period, large amounts of foreign money seeking quick capital appreciation moved into aggressively managed mutual funds. Some of these funds, both domestic and foreign, showed outstanding performance records; as a consequence, many investors abroad became highly performance conscious. Nevertheless, the continuation of relatively large inflows during the 1969 period of declining quotations for American equities and the absence of heavy liquidation in early 1970 would seem to indicate that the desire to participate in the long-term growth of the American economy has been a major motivation of the buying of United States common stocks by foreigners. Reluctance of investors to realize the severe losses on their holdings was, of course, another factor.

Little is known regarding the ultimate geographical origin of foreign purchases of American equities. The available statistics indicate that a major portion of net purchases originate in Switzerland. But such purchases are in large part for account of clients of Swiss banks residing in Europe, the Middle East, and Latin America. And perhaps an equally large part of Swiss-reported purchases originated in orders from mutual funds resident in Switzerland but whose shares are sold virtually worldwide. Large net purchases are shown in the statistics for such countries as the Netherlands, the Bahamas, and Bermuda, and in 1969 Belgium-Luxembourg. Again, operations of institutional investors, notably Netherlands-based investment companies and similar organizations set up by British and United States interests in various tax havens, most likely account for increases shown by these countries.

THE PATTERN OF FOREIGN DEMAND FOR AMERICAN EQUITIES

Purchases by institutional rather than directly by individual investors have indeed become the dominant element in the foreign demand for American equities. This relatively recent phenomenon has resulted primarily from the very rapid growth during the last half of the past decade of internationally oriented foreign investment companies, notably the so-called offshore mutual funds.[2] The fast-growing and well-sustained purchases of the shares of these foreign-based investment companies by individual investors in many parts of the world has had an important bearing on the demand abroad for American equities. In addition, the foreign demand for American equities has received substantial impetus from the increasingly international investment orientation of a great many

[2] Investment companies are corporations or trusts set up for the purpose of investing the proceeds of sales of their shares to the public in a diversified assets portfolio. They may be open ended, i.e., they may have no fixed number of shares outstanding and the company will continuously sell new shares and redeem shares of those shareholders who wish to liquidate their holdings. In the United States, open-end investment companies are usually referred to as "mutual funds". In the United Kingdom, they are called "unit trusts". Closed-end investment companies or investment trusts, on the other hand, have a fixed capitalization. Unlike mutual funds, they do not offer additional shares to the public on a continuous basis, nor do they redeem their outstanding shares. Investment companies are designated "offshore" if they are chartered under the laws of countries other than those where most of their shares are sold.

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mutual funds and closed-end companies abroad that confine the marketing of their shares primarily or entirely to the residents of their own countries. These various types of foreign investment companies have become the most important channel for cross-frontier portfolio capital movements.

UNITED STATES OFFSHORE FUNDS. In recent years, American financial interests have established abroad substantially more than two hundred mutual funds. The major groups responsible for their organization were first of all American financial executives and lawyers in Europe, some without any ties to United States financial institutions while others have been associated with American mutual funds. The investment advisers of these funds in the United States, New York securities dealers and brokers, and investment and commercial banks have also played a prominent role in the establishment of these funds. It is no exaggeration to say that several of these investment companies, usually referred to as United States offshore funds, have revolutionized the savings and investment habits of the burgeoning middle classes in many parts of the world and created new and important markets for equity capital in countries where stock ownership by small investors was virtually unknown. Much of the heavy movement of foreign capital into Wall Street in the 1967-69 period was ascribable to the purchases by American-managed offshore companies. Their aggregate American equities portfolio, virtually all purchased during the late sixties, may well have been close to $1.3 billion at the end of 1969. In addition, these companies at that time may have held close to $900 million in the Euro-dollar market.

The phenomenal growth of the offshore mutual funds industry and the proliferation of offshore funds through 1969 owed much to the spectacular expansion—prior to its recent crisis—of the IOS group of mutual fund management and sales and other financial service companies headquartered in Geneva, Switzerland. In terms of assets under management, which amounted at the end of 1969 to approximately $2 billion, this group had developed into the largest mutual fund organization outside the United States. Of the other investment company managements operating offshore funds established by American interests, not even the largest has under its control more than a small fraction of the assets controlled by IOS. Much of the rapid growth of this organization was due to an imaginative system of sales incentives, including stock options, which inspired highly aggressive marketing of fund shares. The success of this group until early 1970 as measured by the rapid growth of the assets held by its affiliated mutual funds and other financial service organizations explains to a considerable extent the entry of numerous other American (and European) financial interests into the international mutual funds industry. Whether the recent reversal of this group's fortunes will adversely affect the longer run future of the offshore industry cannot be predicted with any assurance at this point in time.

The question suggests itself why foreigners interested in American investment management would buy into newly established offshore funds rather than existing American mutual funds. Actually, the shares of the better known United States funds, notably those with outstanding growth records, have been and continue to be bought by foreign investors. However, offshore funds were easily able to persuade investors abroad that its particular investment vehicle conveyed certain benefits not obtainable by the purchase of the United States funds. In fact, some investment management firms associated with domestic mutual funds established offshore funds, with a view to enabling their shareholders to obtain the services of the same management group and at the same time reap the benefits that only foreign-based investment companies can supply. One of the principal benefits to the foreign investor is that offshore companies are not subject to the Internal Revenue Code.[3] United States investment companies to meet certain requirements of the code may not derive more than 30 percent of their gross income for any taxable year from sales of securities held for less than three months. Unlike offshore companies, they are subject to capital gains tax though they are allowed a deduction to the extent that capital gains are paid out to their stockholders. Moreover, they are subject to the interest equalization tax when they buy Japanese, Australian, and certain other foreign equities. By buying into an offshore fund, foreign investors can obtain the advantage of American professional management of an international equities portfolio with a heavy dollar content and at the same time benefit from the increased investment flexibility that derives from the absence of tax considerations in investment decisions. Offshore investment companies are, moreover, typically set in jurisdictions where there is no income tax and where other taxes such as those on the issue and trans-

[3] Under the Internal Revenue Code, as amended by the Foreign Investors Tax Act of 1966, offshore investment companies are considered nonresident foreign corporations as long as they do not have their principal office in the United States and their only business in the United States is trading in stocks and securities. Their nonresident status prevails even if such trading is conducted by investment managers resident in the United States.

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fer of shares are either minimal or nonexistent.[4] Another fairly important advantage of offshore companies is that individuals holding shares in them are not subject to the United States estate tax on their holdings, while foreign owners of shares in American mutual funds, if the individuals' aggregate direct holdings in the United States exceed a certain amount, may incur such a liability. Of equal importance and frequently the decisive consideration in the minds of sales prospects is the ability of offshore funds established in tax havens to provide virtually foolproof guarantees that the prospect's holdings will remain completely anonymous. Altogether, much of the success of offshore funds is attributable to the fact that they have been especially tailored to offer a variety of legal and tax advantages in the various areas where they are offered.

Generally, offshore investment companies are not subject to the regulations, designed to protect the investor, that apply to United States companies. Unless precluded by their statutes, or the laws of their countries of incorporation, offshore investment companies can sell stocks short and leverage their assets by incurring debt. They can purchase warrants and put and call options. If not permitted by their statutes to engage in short sales, they may be authorized to acquire so-called hedge funds that are set up abroad for the explicit purpose of selling stocks short in addition to holding a conventional portfolio. Such funds typically operate on margin accounts. (In the United States, in order to avoid classification as investment companies subject to the registration requirements of the Investment Company Act of 1940, hedge funds must have fewer than one hundred owners and may not make a public offering of their securities.) Certain offshore companies also buy and sell commodities and real estate.

Commissions payable to offshore management companies often include not only basic management fees but also so-called performance fees, based on actual or even unrealized portfolio gains. Sometimes, they provide for performance bonuses if the investment company outperforms some specified stock market index. In fact, the attractive emoluments that the advisory and sales organizations administering successful offshore companies were able to reap during the 1967-68 period of rapidly rising stock prices have been a major motivating factor for the establishment of "offshores".

The door-to-door sales concept and advertising approach employed by the IOS-managed mutual funds has been imitated by other investment companies established in recent years. Several such companies have built up or are in the process of developing a highly aggressive sales force that attempts to place various types of investment vehicles over the telephone or through personal visits at the homes of investors. The large majority of investment companies, however, do not have their own sales force but place fund shares with international consortiums of European banks and investment firms or through broker-dealers and other financial intermediaries. Even prior to the recent price erosion in the world's major stock markets, their marketing problem had become more difficult, partly because of alternative investment opportunities but also because of market congestion and capital outflow restrictions in several major European countries. As the number of offshore companies sponsored by American investment advisers with impressive performance records multiplied and the market became increasingly saturated, the sales efforts of the funds' sponsors have met growing resistance. In particular, European banks, some of them operating mutual funds of their own and disposing of considerable international investment know-how, have found themselves in a rather strong bargaining position *vis-à-vis* American interests trying to place their product. These banks are no longer satisfied with the once-and-for-all placement fee or sales commission. As a result, some offshore management companies have had to offer greater participation in income to important financial intermediaries in Europe. European banks and brokers have been offered rights to buy into the management companies in return for buying or placing a minimum number of investment company shares. This gives the banks and brokers an opportunity to share in management fees that are based on the assets of the funds. Some investment companies have established advisory boards abroad, which prominent members of the placing syndicate are invited to join and thereby either receive a share in the fees earned by advisory companies or are paid fees directly by the investment companies. Several banks also felt that, by joining management companies or advisory boards, they would be able to look after the interests of those clients with whom they placed offshore funds shares.

[4] Most offshore investment companies are incorporated in Panama, the Bahamas, Bermuda, the Netherlands Antilles, and Luxembourg. Each of these jurisdictions has its special attractions. These relate to ease of organization and communication, tax advantages, minimal exchange controls, and legal provisions bearing on the right continuously to issue new and redeem existing shares. Tax liabilities can be minimized by choosing different jurisdictions for incorporating the investment companies, the investment advisory and sales organizations associated with them, and the holding companies that in turn own the shares of the investment advisory and sales companies. The operating offices of the companies, irrespective of where incorporated, are located in most cases in European countries, notably the United Kingdom, Switzerland, and Luxembourg.

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Offshore realty companies that sell their shares in several countries have become fairly important competitors of foreign investment companies that place their funds solely in equities. During the last two years, several such companies have been set up abroad by United States citizens, and two or three have established remarkable sales records as a result of providing highly rewarding incentives for their sales force. For the most part, these funds invest in corporations that acquire high-income-producing office and apartment buildings in United States metropolitan centers.[5] These properties are heavily mortgaged so that they provide leverage to their owners who are in a position to take advantage of the favorable depreciation provisions of the United States Internal Revenue Code. The companies managing these funds also act as real estate agents in the purchase and sale of the properties and are thus able to add substantially to their income. Some of these funds are being marketed by offers of participation in the management companies to the sponsoring banks.

Toward the end of 1969, the aggregate assets managed by offshore investment companies organized by United States financial interests may have reached close to $3 billion. This very rough estimate excludes the portfolios of the offshore realty companies and of national funds established by the management companies associated with offshore funds. (National funds are investment companies selling their shares predominantly or solely in the countries where they are established.) The estimate also excludes the assets held by a sizable number of "in-house" offshore funds set up by American investment and other banks whose shares are placed only with wealthy foreign clients of these banks. Including the assets of these various investment companies and also the portfolios of United Kingdom and Canadian offshore funds, the aggregate assets of the international offshore industry may have approached $4.8 billion at the end of 1969.

UNITED KINGDOM OFFSHORE FUNDS. In the last year or two, rather substantial amounts of American equities have been acquired by United Kingdom offshore funds. These are mutual funds that have been established in Bermuda, the Bahamas, and other tax havens by British merchant banks and other financial institutions engaged in supplying investment advisory and other management services to United Kingdom investment companies. Shares of these offshore funds may be sold to United Kingdom residents, while offshore companies established by American interests in an effort to remain exempt from United States securities and tax laws will not sell their shares to United States citizens. Some of these United Kingdom offshore funds invest primarily in the sterling area. They serve principally the needs of sterling-area residents who desire professional management of British equities portfolios but who are averse to investing in United Kingdom resident investment companies because of the companies' exposure to the United Kingdom capital gains tax.

The investment orientation of most United Kingdom offshore funds is, however, the dollar area. Among these funds, a distinction must be made between those that sell their shares against sterling and those whose shares are denominated in dollars. Those whose own shares are denominated in sterling must acquire dollars at varying premiums over the official rate in the so-called investment dollar market except to the extent that they are officially permitted and able to borrow dollars. The investment dollar market is a pool of foreign currencies which is fed mainly by the proceeds from sales, redemptions, or liquidations of nonsterling-area portfolio and direct investments by United Kingdom private and institutional investors. British exchange control requires that 25 percent of such proceeds must be surrendered at the official rate; the balance is normally eligible for reinvestment in nonsterling-area securities or sale in the investment currency market. To the extent that United Kingdom offshore companies draw on this pool rather than borrow dollars, there is generally no net addition to the demand for American equities.

For British and overseas-sterling-area investors interested in obtaining a foothold in American and other dollar-area common stocks, funds whose shares are denominated in sterling but which purchase dollar securities are attractive for two reasons: (1) the investor need not incur the risk of directly entering the dollar premium market, which is subject to substantial price fluctuations, and (2) he avoids becoming subject to the 25 percent surrender requirement. Moreover, by reason of the fund's residence outside the United Kingdom, there is no capital gains tax liability on investment switches within the fund. Such funds themselves are subject to the 25 percent surrender requirement on switches of dollar securities; this requirement they are able to avoid, however, either by buying into, and holding onto, the shares of affiliated or other funds whose own shares are a dollar security or by borrowing dollars under exchange control rules governing institutional borrowing of foreign currencies for portfolio investment.

[5] Our balance of payments records such investments as direct investment by foreigners in the United States.

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The appeal to sterling-area investors of offshore funds whose shares are denominated in dollars is based on several grounds: by reason of their external status, the funds are not subject to the requirement to acquire dollars through the premium market nor are they subject to the 25 percent surrender requirement and capital gains tax on investment switches; moreover, if the sterling-area investors are institutions, they may be able to expand their dollar-denominated fund holdings by borrowing dollars rather than buying them at the premium rate. However, United Kingdom and, in certain circumstances, other sterling-area residents become subject to the 25 percent surrender rule if and when they sell the dollar-denominated shares of offshore funds. The number and scope of operations of United Kingdom-sponsored dollar-area-oriented funds have been increasing at a rapid rate during the past year and, in the longer run, they may well be able to mobilize rather impressive amounts of "free" dollars, i.e., dollars not originating in the dollar investment pool, for expanding their stake in American equities.

EUROPEAN INVESTMENT COMPANIES. European financial institutions, mostly banks, have established a large number of internationally oriented investment companies, many of which have sizable American equities portfolios. Some of them have been set up for the specific purpose of providing investors with a vehicle to acquire a stake in a broadly diversified portfolio of shares issued in a great many countries. Others define their investment objective as seeking capital appreciation or long-term capital growth through the purchase of the common stock of American and Canadian corporations. Still others purchase only the shares of companies incorporated in specific European countries or in such regions as the Pacific area. Some of these funds have been established by large local banks for the explicit purpose of offering the shares to these banks' international clientele who are often interested in funds with a diversified portfolio that contains a sizable dollar content. For instance, the foreign participation in Swiss investment companies has been estimated to be as high as 40 to 50 percent.

At the end of December 1969, twelve large internationally oriented investment companies organized by European banks and other financial interests held assets of approximately $1.9 billion, of which about $470 million was invested in American equities. More than two thirds of this amount was accounted for by a prominent group of Dutch investment companies.

Still another category of European funds has been set up by the management groups associated with offshore companies. The motive was to conform to new laws and regulations (discussed below) which have thrown roadblocks into the path of foreign-based investment companies. These so-called national funds, established primarily in Germany and Italy, cater to the needs of investors in their own countries. While holding substantial amounts of local stocks, often in response to legal or informal requirements of the governments concerned, they also invest heavily in the United States, Japanese, or other foreign securities. This trend toward national funds is likely to continue as an increasing number of countries seek to restrict the operations of foreign-based investment companies doing business in their countries.

A rather large number of investment companies organized in Western Europe to meet the needs of domestic investors and to place their resources primarily in domestic investments nevertheless tend to hold at least a part, and sometimes a sizable portion, of their portfolios in foreign securities. This is particularly true of several Swiss and German funds and, in the United Kingdom, applies with particular force to the Scottish investment trusts, which have traditionally been heavy investors in American equities. Toward the end of 1969, almost two fifths of these trust portfolios was invested in dollar-area stocks. The United States portfolio of all United Kingdom investment trusts was as much as £1,187 million (after making allowance for the dollar premium), or 23 percent of their total assets at the end of 1969.

British institutional investors have often been reluctant to add to their investment risk by paying the rather high and volatile dollar premium in the investment dollar market. To avoid the risk of adverse movements of the premium, as well as to avoid the 25 percent surrender requirement, many trusts and other institutional investors in the United Kingdom have been led to finance an increasing portion of American and other dollar-area equities purchases with borrowed rather than investment dollars. Two major avenues have been used: Euro-dollar loans and so-called "back-to-back" loans.

Medium-term Euro-dollar loans may be employed with Bank of England approval for financing equities purchases and are known to amount to several hundred millions of dollars, though in 1969 their use fell off because of high rates. Back-to-back loans have their origin in the United Kingdom credit restraint program and the ensuing difficulties for United Kingdom affiliates of foreign corporations in their search for adequate bank finance. To help them overcome these difficulties, large institutional investors in the United Kingdom, including investment trusts and insurance companies, have offered the affiliates sterling finance at attractive terms on the condition that

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their parent companies advance an equivalent dollar amount to the investor (a so-called "triangular" financing arrangement). These loans are kept under surveillance by the Bank of England; they are also subject to restrictive requirements administered by the United States Department of Commerce's Office of Foreign Direct Investments, if the supplier of the dollars is a United States direct investor.

Resort to these loan facilities has failed to prevent net sales of American equities by United Kingdom residents in recent years (owing largely to the withdrawal of United Kingdom tax relief from overseas corporate taxation under the 1965 Finance Act), but it has helped to sustain the United Kingdom demand for American equities and has made a not unimportant contribution to the net flow of capital into Wall Street. Moreover, to an indeterminate extent, sales by British residents of American equities have been offset by their purchases of shares of offshore funds that invest heavily in the New York market.

FOREIGN BANKS. Banks in several foreign countries, notably in Europe, operate on a large scale in American equities markets. Some of these banks, notably Swiss and French institutions and a few British merchant banks, have set up investment affiliates in New York and thus have established close contacts in the New York market. For the most part, operations of foreign banks in American markets reflect customers' orders, including those of institutional investors—such as mutual funds and insurance companies—to whom these banks provide substantial investment services and on whose portfolio choices they exercise a great deal of influence. But during the past decade, an increasing portion of total orders of foreign banks, the larger part in the case of some private banks, has been placed for account of customers who have relinquished investment discretion to these banks. Many foreign investors, interested in a geographically diversified portfolio but ill informed about the investment climate abroad and thus at a loss concerning which foreign stocks to choose, prefer to let professional investment managers of knowledgeable banks administer their equities portfolio. The investment discretion of the banks is usually restricted by customers' directives that reflect their particular needs and preferences. Among the relatively wealthy people who use banks of two or three European countries to make investment decisions for them are, of course, many investors who do not wish to use the mails or the telephone for communicating with their foreign banks of account. Aggregate orders for American equities purchases handled by foreign banks with discretionary authority from their customers add up to impressive amounts.

THE RETAIL DEMAND. Direct purchases by individuals, placed either through foreign banks or the local branches of American brokers, continue to play an important part in the net foreign demand for American equities. This group of investors is very heterogeneous. During the 1966-68 period a great many foreign individuals entered the American market in the expectation of much more rapid capital appreciation than in their own markets; these investors tend to pull out of New York when the market shows signs of weakness. A minority consists of quite volatile and very performance-conscious investors, many of them relatively wealthy, who step into and out of various stock markets in response to speculative opportunities and currency developments. Another group of fairly well-to-do investors around the world, not only Europeans but also South Americans and residents of the Middle and Far East, are primarily interested in obtaining protection of their wealth from the effects of local inflation and in some cases from confiscatory taxation. Being essentially safety oriented rather than of a speculative bent, they are typically long-term investors. This is also true of many small investors abroad who are not concerned with day-to-day stock price fluctuations but are convinced that by acquiring American equities they are buying "guaranteed long-run growth". This type of investor appears to be persuaded that patience will eventually be rewarded and does not panic when New York market quotations wilt. For the most part, however, these small savers buy shares of investment companies, both American and foreign, rather than American equities directly. Their general investment philosophy is well reflected by the fact that gross purchases by small investors of offshore funds with large American portfolios held up quite well at least during the early phases of the recent period of depressed price conditions in the New York stock market; with few exceptions, share redemptions by investors in offshore funds remained on the low side, at least in 1969 and early 1970.[6] One reason for their inertia is the few alternatives they have for the employment of funds. Their own markets tend to reflect conditions in the New York stock exchange, and typically they know even less about basic conditions, and the shares of individual companies, in other distant markets than they know about the Ameri-

[6] It should be noted that the relatively low redemptions are partly attributable to the fact that small savers typically purchase ten- or fifteen-year programs for monthly investments. Since a large part of the sales commission is collected on the early instalments, redemption of the shares soon after their purchase is expensive for the investor.

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can market. These considerations help to explain the absence of large-scale foreign liquidation of American equities in 1969 and early 1970. However, many offshore funds investors who have hesitated to redeem their shares at a loss may do so after the value of their shares recovers.

Individuals' direct purchases in the New York market have been greatly stimulated by the proliferation of American brokerage offices abroad. The branch offices have done a great deal to bring investment opportunities in the American market to the attention of individual investors and have provided institutional investors, notably foreign banks, with access to available research and other services. Presently, approximately 250 such offices are operating in about thirty countries, including more than fifty offices in Canada and more than forty offices in Switzerland. In 1969, however, various measures have been taken abroad to restrict purchases of American equities; consequently, branch offices in several areas may well be closed. In some countries, American brokers confine themselves to institutional business and refuse to handle retail orders, sometimes under formal or tacit arrangements with local banking groups which do not look kindly upon foreign securities firms that try to trespass on what they consider their own preserve.

GLOBAL ASSET MANAGEMENT

International portfolio investment patterns have undergone significant changes, as rapidly increasing amounts of individual savings in many countries abroad have come under professional investment management. There is now a much higher degree of mobility of such savings among national stock markets. Surely, the typical small investor abroad who bought into internationally oriented funds would not have had the courage, even if he had the desire, to venture on a large scale and on his own initiative into unfamiliar investment territories. This is in sharp contrast to the attitude of professional investment advisers associated with offshore funds, other major foreign-based investment companies, and large foreign banks. Many of them have gradually become adherents of a relatively new concept of investment administration referred to as "global asset management". This means that they are now quite prepared to shift their resources quickly among stock and even money markets in response to changing conditions in major countries' investment climates. As a result, the portfolios of many foreign-based investment companies are now much more internationally diversified than is generally realized. Even among the American-managed offshore funds, which used to put virtually all their resources into the New York market, there are several important institutions that now hold substantially less than one half of their assets in American common stocks. The trend toward international portfolio diversification and a lower ratio of American stocks in fund portfolios gained additional force during 1969; a few such funds now hold a rather small fraction of their total resources in the United States. On the whole, the declining ratio of American equities holdings in aggregate portfolios during 1969 involved little, if any, net liquidation of securities in the New York market. In part, it was due to a relatively sharp decline in the price of some volatile "glamour" stocks held by a number of the investment companies. Moreover, many funds employed an increasing portion of their continuously growing resources in other markets rather than New York. In 1969, their preferred outlets were the Euro-dollar market and the Japanese stock market.

The Euro-dollar market last year attracted very large amounts of money destined eventually to enter or reenter long-term capital markets. The aggregate amount of long-term portfolio account funds placed in the market was probably close to $2 billion, including placements by individual investors. With three-month rates for Euro-dollars in the 9 to 12½ percent range through much of 1969, portfolio managers, beset by doubts and hesitations about adding to their stake in the depressed New York stock market, were easily lured into placing their investable funds in European banks. Some purchased Euro-dollar certificates of deposit from London banks rather than using ordinary Euro-dollar deposit facilities. Thus they had a fairly liquid instrument on hand, if they desired on short notice to reenter equities markets that showed incipient signs of renewed strength. Others preferred to take advantage of the somewhat higher rates for deposits, spacing their maturities in order to provide them with the necessary liquidity for possible reentry into securities markets. Sizable funds held for eventual long-term investment were also placed in local-currency time deposits with European banks, notably in Germany.

International diversification of portfolios has involved greater interest in Japanese equities. Foreign institutional interest in Japanese equities rose rapidly in 1968 and even more so in 1969. A few major European mutual funds now hold a larger amount of Japanese than United States stocks. Some of the European bank-sponsored funds specializing in Japanese stocks have grown at a rapid rate. The remarkable strength displayed by the Japanese economy in recent years, its impressive growth rate, its rapidly growing exchange reserves, and the low earnings multipliers at which many leading Japanese shares are traded

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constitute the major factors in the growing foreign interest in Japanese stocks. The large turnover at the Japanese stock exchanges, which consequently can absorb substantial purchases and sales with relative ease, and the availability of American and European depository receipts for Japanese stocks are other elements that attract foreign funds into Japanese stocks. Yet, despite the concerted efforts of investment companies to add to their expertise on Japanese industry and the presence in New York and London of several affiliates of Japanese securities dealers and brokers, many members of the international investment community continue to feel rather remote from Japan.

On balance, it appears that the New York stock market has a great deal going for it in the international competition for investable funds handled by professional portfolio managers. The New York market, more than any other, can handle large individual stock transactions with relative ease and absorb very sizable deals without quotations for the respective stocks being materially affected. This is, of course, of great relevance to portfolio managers who wish to buy and sell large blocks of stocks and who must put great emphasis on portfolio liquidity, considering that their funds' shares are subject to redemption by their holders. In many Continential exchanges, an order to buy or sell a large block of shares of any one stock typically has significant price effects. Apart from New York, only the Japanese and London stock exchanges have the depth that large institutional investors require.

The New York stock exchange also offers a greater degree of diversity in stocks listed than virtually any other market. For fund managers interested in growth stocks, the large number of technology-oriented stocks makes New York particularly attractive. Information on industry developments in the United States is ample, and a good deal of financial disclosure is required by Securities and Exchange Commission rules. This is in sharp contrast to the paucity of relevant data issued by corporations in major foreign countries.

New York has also benefited from the fact that quite a number of the offshore funds, notably some of those sponsored by United States banks, are committed under their statutes only or primarily to invest in common stock issued by United States corporations. Also, the American investment advisers of offshore funds have a natural predilection for investing in the New York market since they know the United States market better than any other. But, as noted before, a strong desire to spread their wings and look for new investment horizons can be discerned from the behavior of their portfolios.

IMPLICATIONS FOR THE INTERNATIONAL ECONOMY

The emergence of offshore investment funds and the ensuing accelerated movement of foreign capital into American equities have left distinct marks in several sectors of the international economy. In many countries, changes have occurred in the allocation of the public's savings and new links have been forged among national capital markets. The balance of payments of some of the capital-exporting countries, as well as that of the United States, has been importantly affected.

ALLOCATION OF SAVINGS: NATIONAL AND INTERNATIONAL. The initial success of the aggressive sales campaign of the investment company industry has not been without effect on savings patterns in both less developed and industrial countries even though, in the aggregate, equities purchases still occupy a relatively modest role as an outlet for savings abroad. Often for lack of satisfactory investment outlets, potential investors in developing nations have hoarded gold and other valuables or invested in real estate. Such individuals might find investment in United States mutual or offshore funds attractive, but a flow of funds into such investment tends to interfere with development of domestic capital markets.

In the industrial countries of Western Europe, too, foreign-based and locally sponsored mutual funds have produced changes in the investment patterns of the public. Of course, middle-class savers in these countries have for decades bought a broad range of securities for long-term investment. But not infrequently the flow of funds into equities was inhibited by savings banks and even commercial banks that preferred to put their customers into time deposits or fixed-interest-bearing securities. In several Western European countries these institutions, though the principal dealers and brokers in securities, did little to promote sales of stocks among people with moderate means. These institutions became interested in stock ownership only after the large-scale entry into the European continent of the performance-oriented American mutual funds and their offshore affiliates and the emergence of commercial-bank-sponsored funds in Europe. Thus, even in Western Europe, the intensive sales effort of the investment company industry, both national and international, has made equities a more important repository for savings of people in every walk of life. However, the severe price declines of recent months in the world's major stock markets may shift the investment preferences of many individuals abroad back to fixed-interest-bearing assets.

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Whether these changes in foreign investment patterns and the ensuing movement of portfolio capital into the United States have contributed to an optimal allocation of financial resources is questionable. It could be said that it does not appear to make economic sense for as wealthy and capital-rich a country as the United States to import large amounts of capital by selling outstanding stocks to the rest of the world. Very often the movement into Wall Street involves the shift of funds from capital-poor countries that can ill afford the loss of financial resources. On the surface, there appears little to be said for such capital flows. Obviously, however, the sale of financial assets helps to equilibrate our foreign accounts. In very broad perspective, the United States capital market can be viewed as providing intermediary financial services. It may serve the desire of investors in search of long-term capital appreciation, and it may supply in return direct investment capital, often to the same countries that export portfolio capital to this country.

For obvious reasons, this view finds little support among the governments of many capital-poor countries whose citizens have become heavy buyers of American equities either directly or indirectly through mutual funds. In many countries of the less developed world, notably in Latin America, governments have issued various regulations prohibiting or at least making more difficult the sales of foreign mutual fund shares. Such regulations reflect the efforts of these governments to channel savings into domestic investment and to protect their monetary reserves. In fact, a not insignificant amount of the aggregate foreign demand for United States equities comes from individuals seeking refuge or a safehaven from their revenue and exchange control authorities.

In industrial countries, as the public's stake in shares of foreign-based investment companies grew at a rapid rate, several governments became increasingly concerned over the safety of these investments. This concern was enhanced further by the absence of any supervision and regulation of these investment companies in the countries, mostly tax havens, where they were incorporated. To some extent, this concern was also prompted by widespread criticism of the selling and advertising methods employed by some offshore funds. Consequently, several governments felt compelled to adopt new laws to put share sales of foreign-based mutual funds under a measure of restraint and supervision. In some countries, there was also concern over excessive capital exports, but for the most part the major motive was to protect savers. A case in point is the law on foreign investment companies adopted last year in the Federal Republic of Germany. The law imposes far-reaching restrictions on the timing of sales charges and on other sales practices; it requires foreign funds desirous of selling their shares in Germany to establish a legal presence in Germany, and outlaws the sale of those funds that invest in other mutual funds. Laws and regulations restricting the operations of offshore funds have also been adopted or are in various stages of preparation in several other major European countries. For instance, funds offered in Italy must have at least 50 percent of their assets invested in Italian companies. A variety of restrictions on purchases of foreign funds were also adopted in France and several other European countries. The unfavorable publicity surrounding the operations of some of the mutual funds sponsored by IOS might well give further impetus to legislative action curbing operations of offshore funds. These measures may inhibit the progress of some of the offshore mutual funds. On the other hand, the ingenuity of the industry to adapt itself to whatever regulatory climate it encounters should not be underestimated.

FINANCIAL INTEGRATION. During the past decade, national financial markets have become increasingly linked together as close ties have been fashioned between major money markets and the Euro-dollar market. The banking systems of several major countries now hold sizable portions of their liquid funds in that market. But long-term financial markets, at least until recently, have remained largely isolated in the sense that the public's aggregate holdings of long-term securities issued in countries other than those of their own residence have remained a small fraction of their total holdings of long-term financial claims. The emergence in the midsixties of the Euro-bond market, in which interest-bearing securities were sold simultaneously in a large number of countries by multinational underwriting syndicates, has made a scant beginning in demolishing major barriers between individual financial markets. This process has been given further stimulus, as the international investment funds sold United States shares to foreigners, as newly formed national investment companies in the late sixties placed substantial portions of their resources abroad, and as American securities brokers and dealers increasingly engaged in worldwide operations.

BALANCE-OF-PAYMENTS ASPECTS. The heavy movement of equity capital to Wall Street had both equilibrating and disequilibrating effects on the international accounts of the countries involved. In several areas of the underdeveloped world where inflation and exchange rate depreciation were among the motives for investors seeking investment outlets abroad, the heavy flow of capital into foreign equities served to aggravate pressures on monetary

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reserves. This was also true of a few European countries. On the other hand, some countries with large current-account surpluses in 1967 and 1968 welcomed the greater balance in their overall accounts that stemmed from the heavy movement of domestic capital to New York (whether via investment company shares or directly into American equities or Euro-bonds). Germany, one of the most important markets for American and offshore investment company shares, is a conspicuous example.

In the United States, the flow into stocks has had an important influence on our international accounts. Notably in 1968, the $1.4 billion increase in net foreign purchases of United States stocks over 1967 served to offset almost half of the current account's shrinkage during that year. In 1969, the decline of the inflow was one of several factors that explain the worsening of our liquidity balance. But it should be noted that foreign purchases of United States stocks in 1969 were still the second highest on record and made an important contribution to a much better balance in our capital accounts. Moreover, many offshore investment companies that ordinarily would have invested their own net accruals in United States equities indirectly contributed to the capital inflow by placing funds in the Euro-dollar market, where they were acquired by the overseas branches of United States banks for head-office account. Without these inflows, our official reserve transactions surplus for 1969 might have been substantially reduced.

OUTLOOK

Prognostications about the outlook for foreign purchases of American equities call for great caution, especially in view of recent changes in the investment environment in the New York market. The past period of heavy buying is far too short to permit extrapolation of 1967-69 trends. The recent problems of the IOS group of companies and the poor performance of many offshore funds during the last twelve months will probably militate against effective sales campaigns of existing funds and make it difficult, if not impossible, to float new funds in the months ahead. Considering the huge accumulation of American equities by foreigners, there is always the possibility of substantial disinvestment. Nevertheless, a qualified optimism appears to be in order. The fact that foreigners purchased $1.5 billion of American stocks when the New York market performed as dismally as in 1969 is significant.

Several long-term forces may contribute to continued growth of foreign investment in Wall Street. Institutional investors in Europe, notably insurance companies and pension funds, are becoming increasingly interested in foreign stocks. Despite recent setbacks, prospects are fairly good for growing interest in the direct and indirect ownership of common stocks among savers in many areas of the world. Wall Street may well benefit from this trend. While recent laws and regulations adopted in many countries may curb the growth of offshore investment companies, national funds associated with the American and British management companies that established the offshores are likely to gain in importance. And, as in the past, there is good reason to expect that these companies will continue to supplement their holdings of United States corporate shares with superior growth prospects. In this connection, it is noteworthy that the Japanese government has recently authorized Japanese investment companies, within certain limits, to buy corporate securities in the United States and several other countries.

For the United States balance of payments, these longer term prospects have encouraging implications. Foreign purchases of American equities hold good promise for making an important contribution to the eventual achievement of a greater degree of balance in our international accounts.

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