

# FEDERAL RESERVE BANK OF NEW YORK



## MONTHLY REVIEW

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**Volume 55**

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## The Business Situation

Most sectors of the economy continue extremely strong. Industrial production and personal income rose rapidly in April. While new orders for durable manufactured goods declined in that month, the backlog of unfilled orders has climbed sharply thus far this year, suggesting further sizable increases in output accompanied by shortages and delays. Exceptionally low inventory-sales ratios, moreover, suggest the likelihood of strong inventory accumulation in coming months. Only residential construction is showing clear signs of weakening, as private housing starts in April fell to their lowest level in eighteen months. The unemployment rate remained unchanged at 5 percent in May, as both the civilian labor force and employment rose slightly.

Amidst the robust economic expansion, pressures on capacity and resultant demand pressures on prices are becoming increasingly severe. The revised fixed-weight price index for gross national product (GNP) increased at an 8.2 percent annual rate in the first quarter, up from the preliminary figure of 7.5 percent.<sup>1</sup> Consumer prices, seasonally adjusted, rose at a 7.8 percent annual rate in April as the advance of both food and nonfood commodity prices remained distressingly rapid. Over the past three months, consumer prices have risen at an annual rate in excess of 9 percent. In light of pervasive reports of shortages and delivery delays, demand pressures on prices seem likely to persist for some time to come.

<sup>1</sup> The Department of Commerce has revised the increase in current-dollar GNP in the first quarter from a seasonally adjusted annual rate of 14.3 percent to 15.2 percent. Most of this change reflected an increase in prices, as the growth in real GNP was raised only slightly. Inventory investment was revised downward, while the estimate of final sales was raised. Corporate profits before taxes climbed \$3.4 billion to a \$99 billion seasonally adjusted annual rate.

### INDUSTRIAL PRODUCTION, ORDERS, CAPITAL APPROPRIATIONS, AND INVENTORIES

The Federal Reserve Board's index of industrial production climbed in April for the eighteenth consecutive month. The preliminary data indicate that the index rose at a robust 11.8 percent seasonally adjusted annual rate in April. During the first four months of this year the index has climbed at a 10 percent annual rate, the same increase as that experienced over 1972 as a whole.

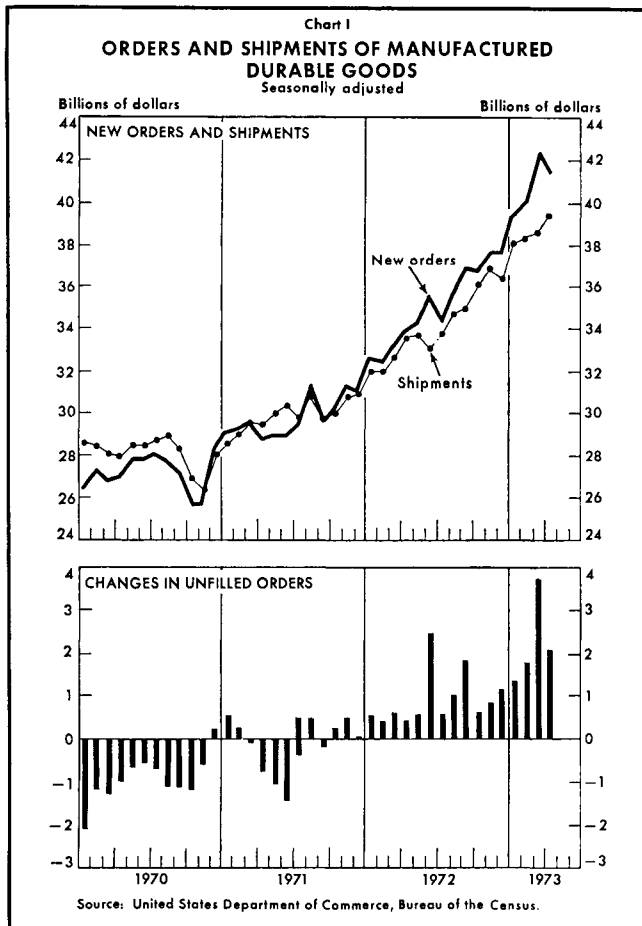
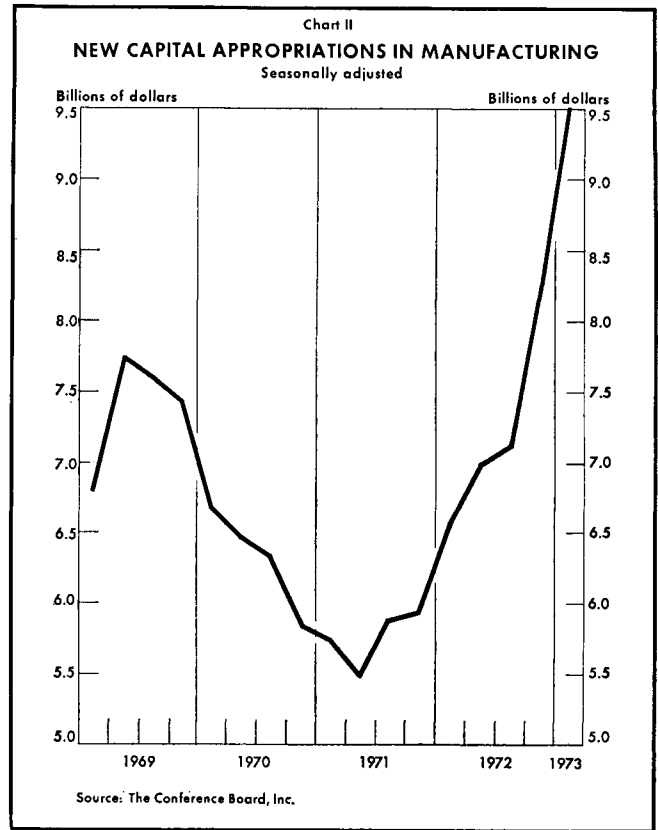
Vigorous growth in most of the major market groupings combined to make the April rise in industrial production much larger than in March. Output of materials and business equipment grew twice as rapidly in April as in the previous month, and production of intermediate products and defense equipment rebounded sharply from declines in March. Similarly, production of consumer nondurables recovered strongly after having been sluggish in February and March. However, the expansion of consumer durable goods output slowed somewhat from the brisk pace of the preceding two months. Assemblies of domestically produced passenger cars eased slightly from the seasonally adjusted annual rate of 10 million units in March to 9.9 million units in April. These assemblies edged up to 10 million units in May, bringing new car production in the first five months of the year to a prodigious annual rate of 9.9 million units.

After increasing markedly over the first quarter, new orders for durable manufactured goods dropped in April by almost \$0.9 billion (see Chart I), or about 2 percent, according to preliminary estimates. The decline was widely distributed among bookings for primary metals, machinery, household durables, and capital goods. At the same time, the backlog of unfilled orders continued to rise, as the level of new orders once again exceeded shipments. Since the beginning of the year, the seasonally adjusted stock of unfilled orders has increased at an exceptionally rapid

33 percent annual rate. While this suggests further sizable expansion in durable goods production in coming months, it may also be indicative of emerging shortages and lengthening delivery times in some industries.

According to the Conference Board, the nation's 1,000 largest manufacturers increased new appropriations for plant and equipment to a record \$9.5 billion in the first quarter (see Chart II), a 15.5 percent gain over the level of the fourth quarter. The first-quarter advance was paced by large increases in the capital appropriations of durable good manufacturers, with particularly sizable gains in the automobile industry. This overall strength in appropriations corroborates earlier indications that capital spending by manufacturing firms will be robust throughout the year.

In March, seasonally adjusted manufacturing and trade inventories climbed \$1.4 billion. The gain was smaller than the unusually large \$2 billion increase averaged over



the previous two months, but was about the same as the monthly rise from August to December of last year when the current inventory buildup began. The \$5.4 billion run-up in the book value of inventories in the first quarter was the largest in twenty-two years. However, to a considerable extent the recent rise in book value inventories reflected sharply higher prices rather than an acceleration in the accumulation of physical stocks. In any event, nearly all of the March rise in inventory spending occurred in the manufacturing sector. Manufacturers added \$1.2 billion to inventories and, in particular, the stocks of durable goods producers rose \$800 million. Aggregate retail trade stocks moved up slightly but, reflecting declines in autos, furniture, and household appliances, inventories of durable goods declined. Wholesalers' inventories inched up only \$50 million. Meanwhile, sales of manufacturing and trade firms continued their strong upward trend and, as a result, the inventory-sales ratio fell further in March to the lowest level since January 1951.

According to preliminary data, the book value of manu-

facturing inventories was unchanged in April, following the very large March increase. Small gains in the durable goods sector offset correspondingly small declines in non-durables. Since manufacturing shipments moved ahead strongly, the inventory-sales ratio declined further from its already very low March level.

sales rose substantially in March (the latest data available), sales of new single-family homes declined markedly. Furthermore, the ratio of unsold new homes to sales of new one-family homes climbed rather sharply over the first quarter.

**PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION**

The growth of personal income quickened in April from the pace of the first quarter. The \$7.6 billion advance raised personal income to \$1,009 billion at a seasonally adjusted annual rate. Most of this increase was accounted for by a \$6 billion gain in wage and salary receipts. Manufacturing payrolls alone rose \$3 billion, with the bulk of the increase coming in durable goods industries.

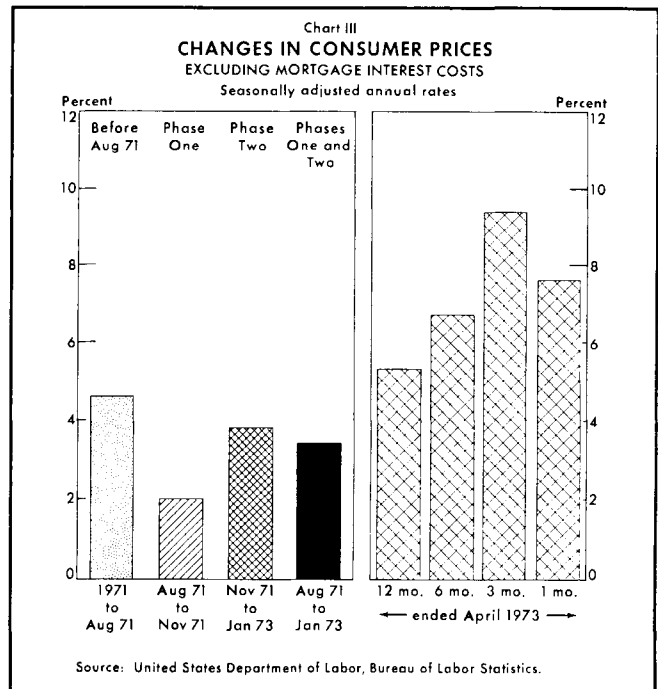
According to the advance report, retail sales slipped 1.5 percent in April on a seasonally adjusted basis following a strong and unusually steady climb. Inasmuch as this series typically moves somewhat erratically, one-month movements—especially in the advance data—are not likely to be very significant. Estimates of retail sales for both February and March were revised down slightly, but the data still show an extraordinary advance in the first quarter. The April drop in total sales reflected a widespread easing in spending. Outlays for furniture and appliances as well as for apparel and other soft goods declined. Sales of new domestically produced autos dipped to a still strong 9.8 million units at a seasonally adjusted annual rate, compared with the record 10.6 million units in March, and imported car sales were down slightly to 1.9 million units annually. In May, however, domestic auto sales moved up to 10.1 million units. While it is still too early to tell if some of the exuberance in consumer spending is beginning to fade, the April Census Bureau survey of consumer buying intentions revealed a pronounced decrease in consumer optimism. Plans to purchase most durable goods, including new cars and furniture and appliances, were noticeably lower than they were in the January survey.

There are more definite signs of slackening in residential construction activity. Although housing starts remain high by historical standards, they have declined for three months in a row. In April, a drop-off in both single-family and multifamily units led to a fall in total starts to 2.1 million units annually, their lowest level since October 1971. Moreover, building permits have fallen steeply over the first four months of this year to 1.8 million units. Newly issued permits were about a third less in April than the level of their December 1972 peak. While mobile home

**CONSUMER PRICES**

The economy continues to exhibit serious price strains. Consumer prices rose at a seasonally adjusted annual rate of 7.8 percent in April, following even more rapid increases in the two preceding months. Over the entire three-month interval, consumer prices rose at a 9.2 percent annual rate. To be sure, a concentration of price increases early in Phase Three has contributed to some extent to the recent pace of inflation, but there are signs that significant demand pressures are at work as well. Food prices at the consumer level climbed at an annual rate of 18.3 percent in April, bringing the rate of rise in such prices thus far this year to an extraordinary 26 percent per annum. Prices of nonfood commodities advanced at a rapid 5 percent rate in April, somewhat below the pace of the previous month, and prices of services were up 3.6 percent on an annual rate basis.

Taking a somewhat longer perspective, total consumer prices increased 5.1 percent over the twelve months ended



April 1973. If mortgage interest costs are excluded, the growth was 5.3 percent. While changes in mortgage rates had little impact on the rate of increase in the overall consumer price index during the past year, they have had a sizable impact in some earlier periods. In early 1971, for example, mortgage rates fell sharply, thereby moderating somewhat the rise in the overall consumer price index. Consequently, in comparing recent price experience with that of the period before the Economic Stabilization Program, a better picture is obtained if mortgage interest costs are excluded. Chart III depicts annual growth rates in consumer prices excluding mortgage costs over several periods. As the chart illustrates, the 5.3 percent increase in consumer prices, excluding mortgage costs, during the past twelve months was faster than the rate of increase in these prices during the first eight months of 1971 prior to the price and wage freeze.

Food prices were up 11.5 percent during the twelve months ended April 1973, compared with an increase of only 4 percent in the preceding year. Prices of meats, poultry, and fish led the advance, climbing by more than 20 percent, and prices of fruits and vegetables moved up sharply as well. Nonfood commodity prices rose a moderate 3.2 percent over this same period, compared with 2.3 percent in the preceding year. Prices of nondurables—particularly home and auto fuel—increased relatively rapidly, but these gains were offset to a degree by gener-

ally modest rises in prices of durable goods. Prices of consumer services rose 3.5 percent over the twelve months ended April 1973, compared with 4.4 percent during the preceding twelve-month period.

#### LABOR MARKET DEVELOPMENTS

The survey of households conducted by the Department of Labor indicated that the civilian labor force rose by only 55,000 workers in May, the second small monthly advance after the huge increase in the first quarter. At the same time, civilian employment was also little changed in May, so that the unemployment rate remained at 5 percent for the third consecutive month. In addition, the unemployment rates of the major age-sex groups were virtually unchanged from the previous month.

According to the separate survey of the nation's establishments, payroll employment advanced by 148,000 workers in May following an increase of similar magnitude in the previous month. These recent increases are significantly smaller than the average monthly gains in employment experienced over the fourth quarter of 1972 and the first quarter of this year. Over these two quarters, the average monthly increase in payroll employment was approximately 275,000 workers. Both the average workweek and overtime in manufacturing fell slightly in May from their very high April levels.

#### OPEN MARKET OPERATIONS

*Open Market Operations*, by Paul Meek, has been revised to reflect monetary actions during the late 1960's and early 1970's and the System's use of monetary and credit aggregates. Mr. Meek is Monetary Adviser in the New York Reserve Bank's Open Market Operations and Treasury Issues area. The booklet discusses how the Federal Reserve System purchases and sells Government securities to influence the cost and availability of money and credit. It is intended for college students and money market watchers.

*Open Market Operations* is available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045.

## The Money and Bond Markets in May

Interest rates climbed in May amid indications of buoyant economic activity and continued concern about inflation. Most short-term rates of interest rose  $\frac{3}{8}$  to  $\frac{5}{8}$  percentage point during the month, in part reflecting Federal Reserve efforts to increase monetary restraint. Major banks raised their prime lending rate for large business borrowers in two  $\frac{1}{4}$  percentage point steps to  $7\frac{1}{4}$  percent. Yields on long-term securities were generally steady during the first half of May, reflecting the relatively light supplies of new issues and the strong technical position of the bond markets. However, long-term yields joined in the general rise in interest rates in the final half of the month.

The Federal Reserve took a number of actions in May aimed at curbing the rapid expansion of bank credit. The actions included the raising of the Federal Reserve discount rate to 6 percent and the imposition of a supplemental marginal reserve requirement on large certificates of deposit (CDs) and bank-related commercial paper. The Federal Reserve also terminated Regulation Q ceilings on rates payable on large CDs with an initial maturity of ninety days or more.

Both  $M_1$ —defined as demand deposits adjusted plus currency outside banks—and  $M_2$ , which also includes commercial bank savings and time deposits other than large CDs, advanced rapidly in May. The growth of the adjusted bank credit proxy continued to be strong but was somewhat below the growth rates experienced during the three preceding months.

### BANK RESERVES AND THE MONEY MARKET

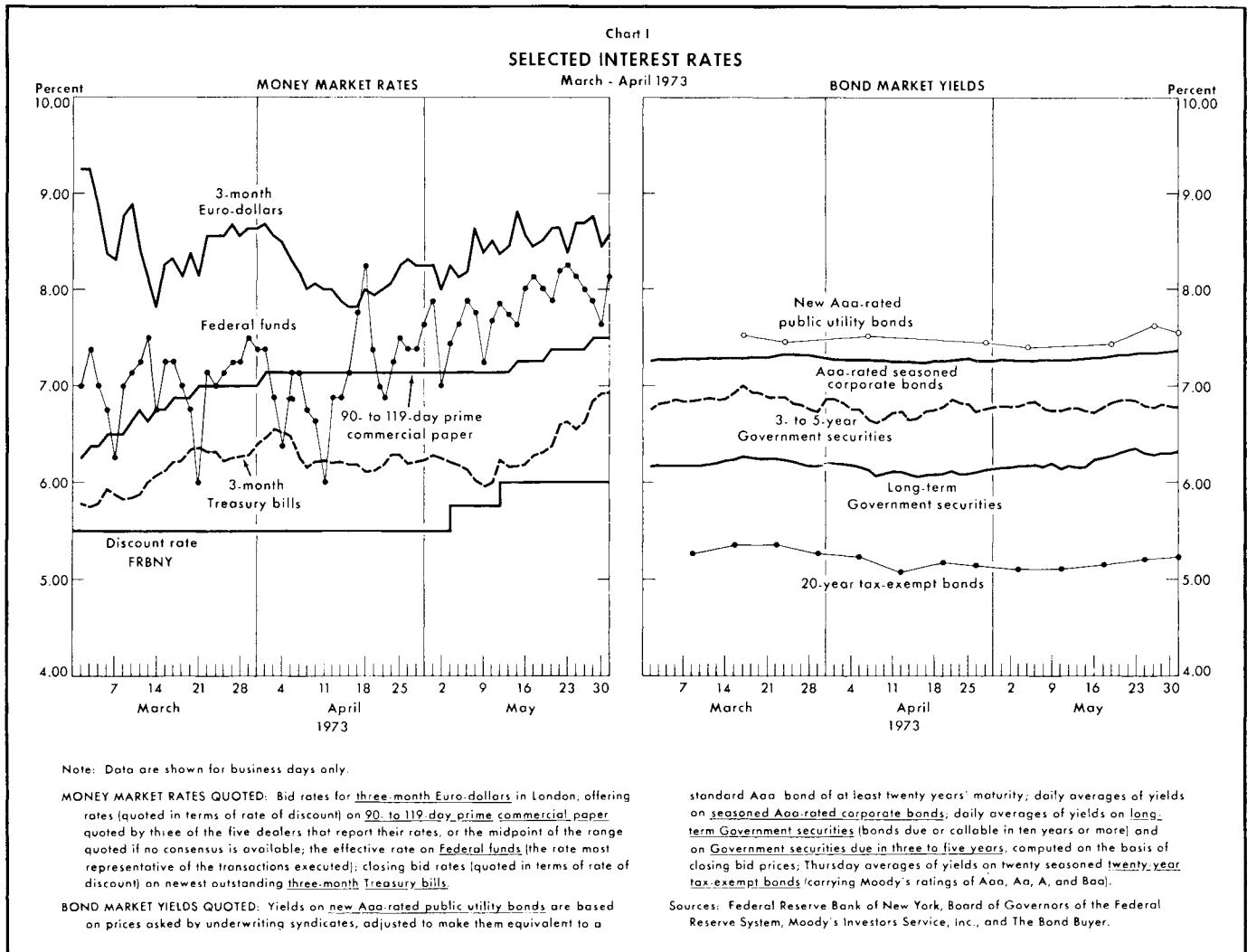
Money market rates moved up sharply in May, as the Federal Reserve resisted the strength evident in the money and credit aggregates. The effective rate on Federal funds averaged 7.84 percent, compared with 7.12 percent in April. Some of the fluctuation in the Federal funds rate early in the month can be attributed to computer malfunctions at the Federal Reserve System's wire transfer center at Culpeper, Virginia, in late April and again during the first week in May. These caused delays in the crediting of reserves to a number of banks, making their reserve posi-

tions appear tighter than they actually were. Subsequently, adjustments were made which added back reserves, contributing to a sharp decline in the Federal funds rate on May 2. Further adjustments also complicated reserve management in the following week. In the latter half of the month the Federal Reserve's cautious management of reserves brought additional pressure on bank reserve positions. The Federal funds rate continued to climb, and during the final weeks of the month it frequently exceeded 8 percent.

Several other short-term interest rates held steady early in May but began to move up by the middle of the month. Rates on bankers' acceptances advanced  $\frac{1}{4}$  percentage point in the third week in May and another  $\frac{1}{8}$  percentage point in the fourth week, as did rates on most maturities of commercial paper. The rate on 90- to 119-day dealer-placed commercial paper was raised from  $7\frac{1}{8}$  percent to  $7\frac{1}{2}$  percent in three steps on May 15, May 21, and May 29 (see Chart I). The prime commercial loan rate charged by most major banks for large borrowers was increased to 7 percent early in the month and to  $7\frac{1}{4}$  percent toward the end of the month. The Committee on Interest and Dividends had specified in April that the large business prime rate should be increased only gradually to avoid disruptive market effects.

On May 10, the Board of Governors of the Federal Reserve System announced approval of an increase in the discount rate at eleven of the twelve regional Federal Reserve Banks to 6 percent from  $5\frac{3}{4}$  percent, effective May 11. The Federal Reserve Bank of Kansas City increased its discount rate on May 18. The Board explained that the increase, which was the fourth thus far in 1973, was intended to bring the discount rate into better alignment with short-term rates generally. The current discount rate is equal to the rate prevailing between April 1969 and November 1970, when the discount rate lagged far behind other short-term interest rates even though it stood at its highest level since 1921. While the present interest rate differential is somewhat less than during the 1969-70 interval, member banks have continued to borrow heavily from the Federal Reserve Banks. During the five weeks





ended May 30, total member bank borrowings averaged \$1.85 billion (see Table I), surpassing the \$1.83 billion of average borrowings in March.

On May 16, the Federal Reserve Board announced a series of policy moves designed to curb bank credit expansion and help moderate inflationary pressures. Strong demand for commercial credit combined with an artificially low prime lending rate had encouraged an explosive advance in bank loans to businesses in recent months. To accommodate this loan demand, banks had issued a net of about \$15.5 billion of additional CDs (seasonally adjusted) during the first four months of 1973. Most of the new CDs issued since February had initial maturities of under 90 days because Regulation Q ceilings on CDs of

90 days to one year initial maturity were substantially below market rates. Consequently, the maturity structure has been shortened. To enable banks to reestablish a more balanced deposit structure, the Federal Reserve suspended Regulation Q ceilings on all maturities of CDs of \$100,000 or more. To slow the rate of CD growth, a marginal reserve requirement of 8 percent is being required, effective June 7, 1973, against further increases in the combined total of large CDs and that portion of bank-related commercial paper currently subject to reserve requirements. A 5 percent reserve requirement continues to be applied to CDs and commercial paper up to the quantity outstanding in the statement week ended May 16. The 8 percent marginal reserve requirement does not apply to banks

with a combined total of less than \$10 million of CDs and bank-related commercial paper outstanding.

At the same time, several steps were taken to put other bank liabilities, which often serve as substitutes for CDs, on an even footing with CDs. The marginal reserve requirement on certain foreign borrowings by United States banks, primarily Euro-dollars, was reduced from 20 percent to 8 percent. The Federal Reserve also indicated that it plans to phase out the reserve-free base on these foreign liabilities. The reserve-free base will be reduced by 10 percent in each four-week computation period beginning with the one starting July 5. The Board of Governors also proposed an amendment imposing reserve requirements against funds obtained by banks for use in their banking business through the sale of acceptances that are not eligible for discount at the Federal Reserve Banks. For reserve purposes, the new regulation would treat these so-called finance bills as being equivalent to deposits. At present, about \$1.1 billion of such bills are outstanding.

At the same time that the Board announced the above series of regulation changes, Chairman Burns sent a letter to about 190 of the largest nonmember banks seeking cooperation in the Federal Reserve's efforts to restrain credit. Accordingly, the letter requested that the nonmember banks voluntarily maintain a marginal reserve of 3 percent on CDs and bank-related commercial paper. A subsequent letter from Chairman Burns to about 100 foreign-owned banking institutions in the United States requested that these institutions also maintain marginal reserves, similar to those required of domestic member banks, against funds obtained from foreign banks and other liabilities. On May 22, Chairman Burns had sent a letter to the member banks, requesting cooperation in helping to curb the growth in bank credit and urging prudence in issuing large-denomination CDs and in borrowing from nondeposit sources.

The monetary aggregates advanced even more strongly in May than they had in April. On the basis of preliminary data for May, it is estimated that  $M_1$  increased at a seasonally adjusted annual rate of about 6½ percent during the three months ended in May and by 7 percent over the twelve months ended then (see Chart II).  $M_2$  is estimated to have grown at annual rates of about 8 percent and 9 percent, respectively, over the three and twelve months ended in May. The growth of the adjusted bank credit proxy slowed somewhat in May from the exceptionally rapid pace of earlier months in the year. Even with this slowing, however, the credit proxy increased at an annual rate of about 15 percent during the three months ended in May and by 12½ percent over the twelve months ended then. The slowing in the growth of the adjusted bank credit proxy occurred as the Treasury reduced the level of its Tax and Loan Ac-

**Table I**  
**FACTORS TENDING TO INCREASE OR DECREASE**  
**MEMBER BANK RESERVES, MAY 1973**

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

Factors	Changes in daily averages— week ended					Net changes
	May 2	May 9	May 16	May 23	May 30	
<b>"Market" factors</b>						
Member bank required reserves .....	-209	- 56	- 280	+ 433	+ 117	+ 5
Operating transactions						
(subtotal) .....	- 570	- 382	+ 14	- 671	+ 534	-1,075
Federal Reserve float .....	- 654	+ 138	+ 95	- 208	- 334	- 963
Treasury operations* .....	- 433	- 412	+ 112	+ 323	+ 547	+ 137
Gold and foreign account .....	- 55	- 19	+ 18	- 29	+ 22	- 63
Currency outside banks .....	+ 639	- 84	- 316	- 645	+ 380	- 26
Other Federal Reserve liabilities and capital .....	- 67	- 5	+ 105	- 112	- 82	- 161
Total "market" factors .....	- 779	- 438	- 266	- 238	+ 651	-1,070
<b>Direct Federal Reserve credit transactions</b>						
Open market operations						
(subtotal) .....	+ 467	+ 400	+ 535	+ 482	-1,356	+ 528
Outright holdings:						
Treasury securities .....	+ 929	+ 207	+ 269	+ 181	- 232	+1,354
Bankers' acceptances .....	+ 1	+ 6	+ 3	- 2	- 2	+ 6
Federal agency obligations .....	- 6	- 10	-	-	- 14	- 30
Repurchase agreements:						
Treasury securities .....	- 356	+ 126	+ 196	+ 355	- 971	- 650
Bankers' acceptances .....	- 29	+ 42	+ 13	- 30	- 51	- 55
Federal agency obligations .....	- 72	+ 29	+ 54	- 122	- 86	- 97
Member bank borrowings .....	+ 229	- 391	+ 332	- 228	+ 712	+ 754
Seasonal borrowings† .....	+ 7	+ 2	+ 5	+ 9	+ 14	+ 37
Other Federal Reserve assets‡ .....	- 20	+ 60	- 140	- 302	+ 33	- 369
Total§ .....	+ 676	+ 69	+ 728	+ 52	- 611	+ 914
Excess reserves‡ .....	- 103	- 369	+ 462	- 186	+ 40	- 156
<b>Daily average levels</b>						
<b>Member bank:</b>						<b>Monthly averages</b>
Total reserves, including vault cash‡ .....	32,504	32,191	32,933	32,314	32,237	32,436
Required reserves .....	32,271	32,327	32,607	32,174	32,057	32,287
Excess reserves§ .....	233	- 136	326	140	180	149
Total borrowings .....	1,875	1,484	1,816	1,688	2,400	1,853
Seasonal borrowings§ .....	16	18	23	32	46	27
Nonborrowed reserves .....	30,629	30,707	31,117	30,626	29,837	30,583
Net carry-over, excess or deficit (-)¶ .....	202	175	9	133	115	127

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

\* Includes changes in Treasury currency and cash.

† Included in total member bank borrowings.

‡ Includes assets denominated in foreign currencies.

§ Adjusted to include \$172 million of certain reserve deficiencies on which penalties can be waived for a transition period in connection with bank adaptation to Regulation J as amended effective November 9, 1972. The adjustment amounted to \$450 million from November 9 through December 27, 1972 and \$279 million from December 28, 1972 through March 28, 1973.

|| Average for five weeks ended May 30.

¶ Not reflected in data above.



count balances after the buildup earlier in the year. This reduction resulted because the Treasury has paid down part of the debt and has diverted funds to its accounts with the Federal Reserve Banks. CDs continued to expand rapidly in May, growing at an estimated 60 percent seasonally adjusted annual rate. Still, this is below the explosive 108 percent annual rate of growth posted in the first four months of the year. Reserves available to support private non-bank deposits (RPD) advanced at an estimated 10 percent pace in May, similar to the 10½ percent rate of growth in this series over the first four months of 1973.

### THE GOVERNMENT SECURITIES MARKET

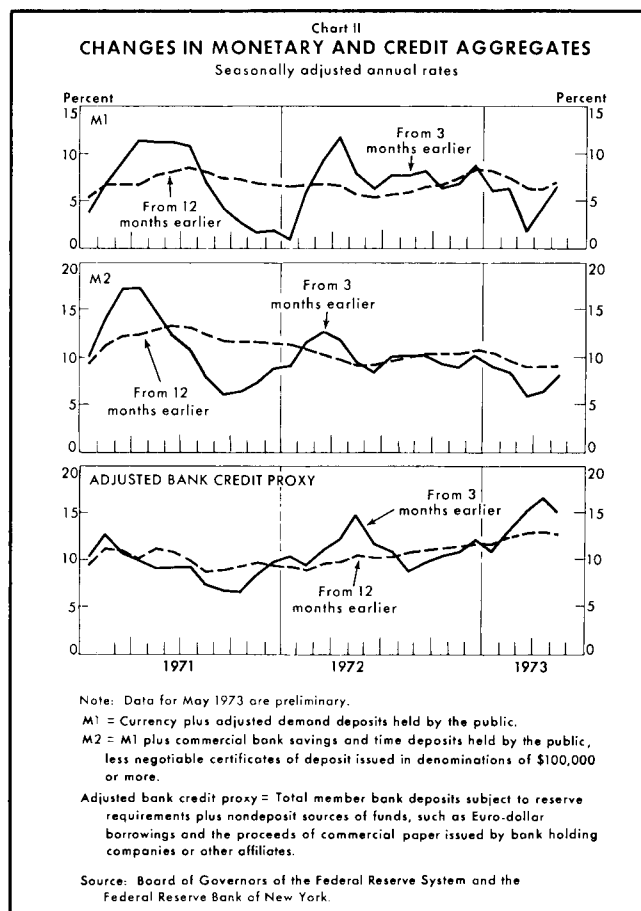
Treasury bill rates rose sharply during the final two thirds of May, after declining during the first third of the month. The skimpy supply conditions that have prevailed in this market in recent months had sheltered bill rates from some of the upward pressure affecting other market instruments. However, rates began to increase following the announcement of the discount rate increase and other policy changes.

Several specific factors contributed to the early declines in bill rates. The Treasury reduced the number of six-month bills being offered by \$100 million a week to about \$1.7 billion, beginning with the May 14 auction. Since there was no decrease in the dollar volume of bills maturing, this move meant that the quantity of bills outstanding is being reduced by \$100 million a week.

The absence of a short-term "anchor" issue from the Treasury's May refunding package, combined with the substantial paydown on maturing issues, was expected to increase further the demand for bills.<sup>1</sup> In addition, foreign central banks purchased marketable Treasury debt during the statement week ended May 16 as a result of speculative pressure on the dollar following the increases in the price of gold on European markets to levels above \$100 per ounce.

Bill rates advanced sharply in the wake of the System's announcements on May 10 of the increase in the discount rate and on May 16 of the changes in regulations dealing with CDs and other bank liabilities. Market participants interpreted these actions as likely to lead to higher short-term interest rates. The higher rates on Federal funds also encouraged market participants to adopt a defensive stance. The Federal Reserve also reduced its holdings of Treasury

<sup>1</sup> For details of the May refunding announcement, see this *Review* (May 1973), pages 126-27.



bills late in May in part to counteract the decline in its holdings of Treasury balances.

The yields established in the weekly auctions reflected the pattern of rates on the outstanding issues. Rates declined about 14 basis points in the May 7 auction on both the three- and six-month bills to 6.136 percent and 6.431 percent, respectively (see Table II). Rates on three-month bills advanced 27 basis points from the week before at the May 21 auction, and rose to 6.694 percent in the final May auction which was advanced to Friday, May 25, because of the Memorial Day holiday weekend. Bill rates continued to climb in the final days of May, with three-month bills trading at 6.92 percent on May 31. In the monthly auction of 52-week bills, held on May 24, an average issuing rate of 6.818 percent was established, 22 basis points higher than the rate set in the auction of similar bills one month earlier.

Prices on most coupon issues rose slightly in early

May but fell off thereafter. Prices on intermediate-term securities have been fairly steady since their advances in January and February. Longer term issues had leveled off early in February. While the auction of the new seven-year note on May 1 initially elicited a fairly cautious response, subsequent demand was brisk and gave support to this segment of the market. Prices of outstanding long-term bonds adjusted downward slightly following the 25-year bond auction of May 2. Note and bond prices fell off a bit after the announcement of reserve requirement changes. Over the month, yields on three- to five-year issues changed little while yields on longer term issues increased by an average of 18 basis points.

Several Federal agencies raised new cash during May. The Federal Home Loan Bank System offered on May 9 three bonds of 18-month, 30-month, and 39-month maturities, respectively, each priced to yield 7.05 percent. The \$2 billion financing raised \$1.6 billion of new cash. These relatively short maturities proved to be very popular, and by the next day all three bonds were trading at a premium. On May 30, the Federal National Mortgage Association raised about \$250 million and also refunded maturing issues through an offering of \$1.3 billion of three debentures with maturities of thirty-three months, five years, and ten years. They were priced to yield  $7\frac{1}{8}$  percent, 7.15

percent, and 7.30 percent, respectively. The offerings attracted heavy presale demand and sold out quickly.

#### OTHER SECURITIES MARKETS

Prices fell in the corporate and municipal bond markets in the latter part of May. On the first two days of the month, two Aa-rated utility bond offerings were aggressively priced to yield 7.48 percent and 7.45 percent, respectively, somewhat below yields on similar issues marketed during the preceding three months. Both sold slowly, and yields rose 4 to 5 basis points in the following week when the bonds were released from syndicate price restrictions. Some softness in prices of outstanding corporate bonds was evident, as investors swapped corporate securities for the new Treasury bonds. Two A-rated utility offerings were marketed on May 16 and on May 22. The first, consisting of \$50 million of 25-year debentures, was priced to yield 7.57 percent and sold slowly. The second, a \$100 million thirty-year bond issue, yielded 7.72 percent. The higher yield on the thirty-year bond helped sales initially, but further market deterioration limited follow-up orders. On May 30, a \$60 million offering of Aa-rated thirty-year bonds yielding 7.64 percent sold out quickly. On May 31, a Bell Telephone subsidiary which has an Aaa rating from Moody's but was recently downgraded to AA by Standard and Poor's offered \$200 million of 36-year debentures priced to yield 7.625 percent and \$100 million of seven-year notes priced to yield 7.25 percent. The yield on the bond was only about 9 basis points above that offered on another Bell System debenture a month earlier, while the note yielded 18 basis points more than the previous month's offering. Both issues sold slowly, and the price of the debentures fell sharply after syndicate price restrictions were ended on June 4.

New-issue activity in the tax-exempt market picked up moderately, but remained below the volume of the past couple of years. Receptions were mostly mixed, but price adjustments following removal of syndicate price restrictions were generally modest. Rates on outstanding issues advanced gradually during May. The Bond Buyer index of twenty tax-exempt bonds rose from 5.10 percent on May 3 to 5.22 percent on May 31. Dealer inventories rose slightly but remained on the low side. The Blue List of dealers' advertised inventories increased from \$633 million to \$663 million during May.

**Table II**  
**AVERAGE ISSUING RATES\***  
**AT REGULAR TREASURY BILL AUCTIONS**

In percent

Maturities	Weekly auction dates—May 1973			
	May 7	May 14	May 21	May 25
Three-month .....	6.136	6.179	6.452	6.694
Six-month .....	6.431	6.456	6.748	6.864
Fifty-two weeks .....	Monthly auction dates—March-May 1973			
	March 27	April 24	May 24	
	6.615	6.598	6.818	

\* 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.

## **Foreign Banks in the United States: Scope and Growth of Operations**

By FRED H. KLOPSTOCK\*

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During the past decade, one of the more interesting structural developments in the world's banking industry has been the rapid rise to prominence of multinational banks, i.e., banks with affiliates and/or branches in several countries. United States banks have been the forerunners in this development: the three largest have developed worldwide branch networks and have established or acquired affiliates in many parts of the world. Almost all other major United States banks, as well as some medium-sized banks, have set up overseas branches, and many have acquired control or at least a minority interest in one or several foreign financial institutions.

This remarkable expansion of United States banking overseas is now being paralleled by the rapid penetration of foreign money and loan markets by major European, Canadian, and Japanese banks. Some of these have long had institutional representation outside their own countries. Notably, several British and Canadian banks many years ago developed branch systems abroad, but most of them were regionally oriented and only recently have some of them become truly international banks. During the past decade many other major foreign banks have been greatly strengthening their international branch and affiliate networks. Also, a sizable number of foreign financial institutions that had never had an operational presence abroad have begun to move across national borders. Several banks in Europe have become allied with United States and/or other foreign banks in the establishment of medium-term lending institutions—the so-called consortia banks. Others have entered into a broad variety of cooperative arrangements with

banks in their own and other countries. In some cases these formal and informal groupings have led to the establishment of jointly owned commercial and investment banking institutions in various parts of the world.

The motivations for this expansion abroad have been various. For American banks, and for banks elsewhere in somewhat less degree, the paramount consideration has been to provide financial services to major corporate clients. Thus, to a considerable extent, the rise of multinational banking can be viewed as a response by banks in major countries to the emergence of the multinational corporation as a major force in the world economy. Another important motive has been to finance through foreign offices the international movement of merchandise and thereby to attract the banking and foreign exchange business of companies abroad investing in, or trading with, the home country of the branch or countries where there is another office of the same parent bank. Very often, the propellant has been to escape restrictions at home arising from exchange controls or prohibitions of, or ceilings on, interest payments on foreign balances. Many major banks have sought entry into countries where they can offer their international clientele advantages not available elsewhere, such as rigid banking secrecy, favorable tax climate, and political stability. Banks have also established offices abroad for the purpose of taking advantage of large availabilities of short-term funds in major national and international money markets and of employing these funds for interest rate arbitrage in other money and loan markets. Another objective has been to establish closer contact with individual and institutional investors to whom they can offer a variety of asset-management and investment-advisory and related services and with whom they can place longer term capital issues. Many banks have set up offices and subsidiaries in countries that offer attractive opportunities for the profitable placement of sub-

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\* In preparing this paper the author has made use of an earlier study on this subject matter by Mrs. Rachel Strauber, formerly an economist in the Bank's Balance of Payments Division.

stantial amounts of longer term funds. Banks have also gone abroad to serve the financial needs of emigrants from their own countries. In a few cases affiliates and branches have been set up, primarily with a view toward gaining access to the general public's hard core deposits and engaging in retail business of the same sort as offered by local banking institutions.

It is against this broad background of the growing internationalization of world banking that the recent expansion of foreign banks' representation in the United States must be viewed. In establishing themselves in this country, almost all the forces that have propelled their move to foreign destinations have played some role. But several motivations primarily related to the unique role of the United States and its currency in the world's financial system have been of special significance. The United States, by reason of its huge domestic market and the related challenges for foreign investment and trade, has offered rewarding opportunities to foreign banks desirous of providing financial services to companies, large and small, engaged in international transactions. The nation's large and diversified money market, with its wide range of negotiable short-term obligations and its highly efficient mechanism for the investment of short-dated balances, has attracted foreign banks with large and continuous holdings of dollar balances and those interested in interest rate arbitrage. The time deposit and bankers' acceptance sector of this nation's money market has also excited the interest of foreign banks in need of a dollar base through which to finance or refinance their own and their affiliates' foreign loans. Moreover, the dollar's dominant role as the world's investment, intervention, and settlement currency and the related growth of payments to and from foreign accounts in the United States have induced foreign banks to use their New York offices as a depository, settlement, and service center for their own and their customers' dollar operations. Finally, New York remains by far the most desirable market in the world for the placement of investable funds in securities. This is why foreign banks in their role as major intermediaries in their clientele's equities transactions have developed a lively interest in fashioning direct links with the United States securities markets. For all these reasons, a firm foothold in this country has become a virtual necessity for leading banks in many parts of the world.

#### SCOPE OF EXPANSION

By any standard, the recent expansion in the operations of financial institutions in the United States owned by foreign banks has been very impressive. It has involved not

only a spectacular increase in the number of foreign banks with an operational presence here, but also a very strong surge in the aggregate assets of those foreign-owned banks that were established here many years ago. At the same time, the range of operations of foreign banks' affiliates and offices here has broadened considerably. Many foreign-owned banks no longer confine their operations to foreign trade financing and money and foreign exchange market transactions. They now compete with United States banks for loan business in the domestic market. A few foreign-owned banks, notably in California, are heavily engaged in retail banking and have established branches of their own. The foreign banks' role in the overnight and term Federal funds market has expanded significantly. More importantly, foreign banks have established subsidiaries for the purpose of conducting large-scale operations as brokers and dealers in the United States stock market, and several of these subsidiaries have become investment bankers engaged in underwriting and selling new and secondary domestic securities offerings.

In their endeavor to broaden the scope of their operations, both geographically and functionally, foreign banks have made good use of the various legal alternatives open to them under the banking statutes of several states. In New York, foreign banks have the choice of operating either agencies<sup>1</sup> or branches<sup>2</sup> and of establishing or acquiring subsidiaries, including so-called investment companies.<sup>3</sup> Each of these has certain advantages and disadvantages; by careful choice of organizational arrangements and various combinations thereof, a foreign bank can achieve an operational presence in the United States that best suits its purpose. In choosing between an agency and a branch, several major banks have opted for agencies because of the absence of limitations on individual loans. Others have preferred

<sup>1</sup> The agencies of foreign banking corporations in New York may engage in commercial banking operations, but they cannot accept deposits. However, they may maintain for the account of others credit balances incidental to, or arising out of, the exercise of their lawful powers.

<sup>2</sup> In New York (and in a few other states) the branches of foreign banking corporations may offer full banking services of the same sort as domestic banks. However, the Federal Deposit Insurance Corporation cannot insure deposits in branches.

<sup>3</sup> Investment companies chartered under Article XII of the New York State Banking Law may engage in banking activities, including short- and medium-term lending, the issuance of acceptances, remittances of funds, foreign exchange transactions, and related activities. They may not engage in the business of receiving deposits, except outside New York, but they may maintain for the account of others credit balances incidental to, or arising out of, the exercise of their lawful powers.

branches which, unlike agencies and investment companies, may accept deposits. Compared with subsidiaries, branches have the important advantage that their loan limit is a function of the capital position of the parent bank while that of a subsidiary is a function of its own capital. Several foreign banks with subsidiaries in California have also established branches in that state, primarily to take advantage of the broader loan limits of the latter.<sup>4</sup> Moreover, some foreign banks provide full banking services in several states through a variety of instrumentalities—a privilege denied to domestic banks. Altogether, the organizational structure of foreign banking in the United States is characterized by a remarkably variegated and, as shown below, somewhat bewildering pattern of institutional arrangements.

There are now close to eighty foreign banks that operate various types of subsidiaries and affiliates as well as agency banks and branches in the United States; among them are most of the major banking institutions in Europe, Canada, and Japan. Twenty-one foreign banks or foreign banking groups have become foreign bank holding companies in compliance with the Federal Bank Holding Company Act of 1956, as amended in 1970, which requires registration with the Board of Governors of the Federal Reserve System by any company, domestic or foreign, owning or controlling one or more domestically chartered banks in the United States. Altogether, they own as many as twenty-five United States banks located in New York, California, Illinois, and Florida and also operate a large number of agencies and branches, almost all in New York and California. In addition, close to a dozen foreign banks own shares of United States banks, but do not control them, or own partly or wholly financial institutions engaged in banking activities but not considered banks within the meaning of the Bank Holding Company Act. More than twenty foreign banks own or share in the ownership of securities affiliates in the United States. Several of these, among them some of Europe's major financial institutions, also have a minority interest in commercial banking affiliates or operate branches in the United States engaged in commercial banking. A few foreign banks own financial institutions in the United States engaged in activities other than commercial and investment banking. Furthermore,

foreign banks have approximately 140 representative offices in the United States, but such offices are not permitted to conduct banking operations. However, representative offices are often the first step toward establishing direct financial operations in the United States. Several foreign banks are about to open offices in New York.

Measured by asset size as well as numerically, the United States agencies and branches of foreign banks far outrank their subsidiaries and affiliates. There are now thirty agencies of foreign banking corporations in New York against twenty-two at the end of 1965. Total assets of these agencies amounted to over \$11 billion at the end of 1972, including however a significant amount of funds in the process of collection. A sizable proportion of these assets was acquired with funds provided by their head offices and their foreign sister branches. At the end of 1965, the assets of the New York agencies amounted to only \$3.8 billion. Aside from increases due to an expanded volume of funds in the process of collection, asset holdings of the agencies more than doubled during the brief period of seven years.

The surge in the assets of foreign banks' branches in New York is even more impressive. No more than thirteen foreign banks operated branches in New York at the end of 1965, with assets of almost \$1 billion. At the end of 1972 there were nineteen such institutions with an aggregate balance sheet of more than \$5 billion, again including significant amounts of funds in the process of collection.

In California, there are now about thirty foreign banks with branches holding aggregate assets of more than \$3 billion. In mid-1965 only nine foreign banks had branches in California, with assets adding up to a small fraction of those held currently.

Almost all the subsidiaries and other offices of foreign banks have been established in New York and California, but there are incipient signs that foreign banks are becoming interested in other locations. Two foreign-owned banks have been established in Chicago. Still another foreign bank that already owns affiliates in both New York and California has been given permission to open a branch in Massachusetts. Foreign banks also operate a few branches in Hawaii, Oregon, and Washington. Other states either prohibit branching by foreign banks explicitly or do not authorize specifically the establishment of branches by foreign banks.

Despite the marked expansion of foreign banking in this country in recent years, the overall role of foreign-owned institutions in the United States financial system should not be exaggerated. It is true that a few affiliates of foreign banks in New York and California have built up an impressive commercial loan business and now occupy an important place among the medium-sized banks in these two states. But none of these institutions seriously chal-

<sup>4</sup> In California, branches cannot receive domestic deposits because of their inability to obtain Federal deposit insurance. For this reason, they are often designated as "operating agencies". Under a California state law adopted in 1969, branches may accept deposits from overseas sources if authorized to do so by the State Banking Department. Several branches have received such authorization.

lenge the commanding position of the major multinational banks in this country. The Japanese banks' agencies in New York and their subsidiaries and branches in California—by far the most important national group of foreign-owned banking institutions—finance much of United States-Japanese trade, and some members of this group have become very sizable banking institutions. However, a major part of their loans is refinanced directly or indirectly by domestic banks. The agencies of Canadian banks in New York and several of the New York branches of foreign banks now provide a respectable amount of loans to commercial borrowers. Still most of their activities, and virtually all transactions of many other agencies and other branches, remain oriented toward money market and foreign exchange operations and attending to the dollar payments traffic of their parent organizations.

Altogether, commercial and industrial loans extended to parties in the United States by the foreign agencies and branches, by foreign-owned investment companies, and by commercial banks the majority of whose shares is owned by foreign banks amounted to approximately \$7 billion at the end of 1972, or about 8 percent of such loans extended by weekly reporting large commercial banks in the United States. Similar loans to parties in foreign countries added up to \$1.8 billion, and loans to brokers and dealers for purchasing and carrying securities and Federal fund sales were \$1.2 billion each. Aside from claims on directly related institutions amounting to about \$3 billion which includes funds in the process of collection, these are the principal asset items of the United States offices of foreign banks. All the assets of these various institutions, including assets in the process of collection, totaled around \$25 billion at the year-end. (Total assets of weekly reporting large commercial banks were in excess of \$400 billion on that date.) Of the foreign banks' assets, a major part had been acquired with funds made available by directly related institutions in foreign countries; in addition, foreign offices obtained about \$3 billion from other foreign sources and another \$3 billion through borrowings from United States commercial banks, including Federal funds purchases. Although the overall impact of foreign-controlled banking in the United States financial system is relatively minor, it is growing rapidly in significance and plays an important role in several selected sectors.

#### THE DYNAMICS OF THE EXPANSION

The various factors responsible for the remarkable expansion of foreign banks' activities in the United States during the last decade can be discussed best by dividing them into those that have caused many additional for-

eign banks to move to the United States and those that have been conducive to the growth in the activities of long-established institutions. A word of warning is in order at this point: the rationale for foreign banks' decisions to set up offices here and the subsequent evolution of their operational bases vary widely according to the banks' needs and strategy in developing an international banking organization. Very often, in the course of time, the scope of business of particular foreign-owned banks has widened and changed after they opened and as new banking opportunities emerged. For these reasons, it is hazardous to venture generalizations on the attitudes and policies behind the expansion of foreign banking in the United States and on recent operational trends. Much of what needs to be said about motivations and the scope of operations may not apply at all or applies only in some degree to individual institutions.

**FINANCIAL SERVICES TO SUBSIDIARIES OF FOREIGN CORPORATIONS.** One of the key explanatory variables behind the explosive expansion of foreign banking in the United States is undoubtedly the strong desire of financial institutions abroad to provide on the spot a full range of financial services to the United States subsidiaries of corporate clients in their own countries. In the sixties, foreign investment became increasingly a two-way street in the sense that not only major foreign corporations but many medium-sized firms abroad began to emulate the expansion of United States industry abroad by establishing firm footholds of their own in this country. This is clearly revealed in direct investment statistics. At the end of 1971, the book value of foreign direct investments in the United States (excluding those in financial institutions) added up to an impressive \$11.3 billion, against \$5.6 billion at the 1965 year-end. Almost three quarters of these assets were owned by European companies, among them many of the industrial giants in the United Kingdom, Germany, and the Netherlands. A large number of firms in these and other European countries have made sizable capital transfers to this country and have reinvested their affiliates' earnings in order to establish or expand their manufacturing facilities and to service equipment and a large variety of other products that they had exported to, or produced in, this country.

Obviously, foreign banks could not afford to ignore the accelerated pace of investment in this country by so many of their most valued corporate customers. They were well aware that corporations operating or contemplating operations in the United States were an easy target for the competitive onslaught of the business development departments of the branches and affiliates of United States banks in their

own countries which were eager to offer their services and those of their United States head offices to internationally minded corporations. Thus, purely for competitive reasons, major foreign banks—again especially those in the United Kingdom, Germany, and the Netherlands—were under overwhelming pressure to follow their customers by setting up offices in this country that would be able to provide on-the-spot loans, foreign exchange, and related facilities. Similarly, banks that had hesitated to establish offices in this country soon discovered that they were at a competitive disadvantage *vis-à-vis* banks in their own country that had taken the plunge. For these reasons, as soon as one or two banks of any particular country had begun operating here, others quickly followed. Once the new offices were in operation, it soon became evident that they served as a magnet, attracting new corporate accounts to the books of the head office and a variety of additional domestic collateral account relationships.

The desire of foreign banks to come here was often reinforced by the pressure from corporate customers in need of financial services in the United States. From the viewpoint of a foreign corporation desirous of beginning manufacturing or trading operations in the United States, the office of its bank of account in this country can become an invaluable ally. Such an office can be expected to be highly responsive to the needs of the corporation's United States subsidiary. In view of the close account relationship between parent bank and parent company in the home country, it is likely to go to extraordinary lengths to assist in the solution of the complex problems that a foreign corporation encounters when it spreads its wings in this country. Moreover, the United States office of the foreign bank is familiar with local business conditions, is in close touch with United States banking institutions, and is knowledgeable about ways in which to do business in this country. The officers in charge of these banking offices usually have a full understanding of the particular banking needs of the subsidiary and have an intimate knowledge of how the parent company's management team wishes to conduct operations abroad and to finance the subsidiary's overseas needs. For all these reasons, the executives of the subsidiaries typically have a strong predilection to do business with the local offices of banks that serve their parent companies.

It cannot be denied, however, that there are certain limits to the capacity of many foreign-owned banking offices in this country to provide for the needs of their major customers. Agencies and branches with their limited staffs are unable to provide payroll and related services to major customers. Many of the foreign banks' offices, notably the agencies and branches, are not in a position to extend other than short-term credits. Unlike many large United States

banks, the agencies and branches do not have a far-flung network of offices in the United States which can obtain sizable and, in the aggregate, stable deposits from the public. This also applies to many foreign banks' affiliates in this country, except in California where foreign-owned banks have in turn established a sizable number of branches of their own. A very large proportion of the deposits of foreign banks' offices in New York consists of short-dated time deposits and relatively volatile funds that reflect the continuously changing dollar position of the parent banks and their branches abroad. However, some foreign banks make medium-term loan commitments partly on the assumption that their parent organizations will assist them during periods of tight liquidity. At times, foreign banks that arrange medium-term facilities participate substantial portions to regional correspondents in the United States.

**FINANCIAL SERVICES TO DOMESTIC CORPORATIONS.** For some of the new foreign banks arriving on the United States scene, providing financial services to local subsidiaries of their head offices' customers did not appear as a very promising avenue for developing a secure and rewarding operational base. The number of such subsidiaries was simply not large enough for the new office here to live on their patronage. Very often, the few existing subsidiaries were already well served by both United States and other foreign banks.

Some foreign banks' offices expected that they would obtain some, albeit a small part, of the banking business of United States corporations whose overseas affiliates' financial needs were being attended to by the offices' parent banks in their home country or by other offices of the parent banks in various parts of the world. In some cases, such expectations have been fulfilled as the treasurers of major United States corporations have placed balances with the newcomers and entered into other banking relationships in recognition of valuable services rendered to their overseas subsidiaries by the parent bank or its affiliates and branches abroad. Frequently, American corporations seeking close account relationships with foreign banks capable of providing sizable credit facilities to their overseas affiliates have opened accounts with United States offices of these banks. Moreover, some of the offices have gone out of their way to offer very advantageous rates on loans and for other services to multinational corporations in this country in recognition of the highly profitable relations between the parent bank or its offices abroad and the United States corporations' overseas affiliates. As a result, quite a number of the new as well as old-established foreign banks here have been able to extend working-capital and inventory finance loans to United States cor-



porations with operations abroad. But the development of banking relations between United States offices of foreign banks and United States parent companies of affiliates banked by the offices' organization abroad has by no means been automatic, and some offices have obtained no more than a negligible amount of commercial loan business from these and other sources.

Still even in the absence of this type of obvious account relationship, many foreign banks, upon entering this country, could be reasonably sure of garnering attractive business from a variety of other types of customers, notably corporations engaged in export and import business. In soliciting the business of such firms, a foreign bank's United States office can point to its intimate knowledge of political and economic conditions and trends in its home country. It can easily provide information on money and loan market conditions and on exchange controls. It can justifiably boast of its familiarity with the credit standing of individual firms in its domestic area of operation and in those countries where the parent bank has additional affiliates or branches or where it has had traditionally close banking relationships. To corporations exporting to such countries, it can also offer rapid and relatively inexpensive collection facilities.

The offices here of foreign banks also find it quite easy to develop banking relationships with firms that import from their home country and other areas where their parent banks are active. In fact, some of the foreign offices in the United States are largely occupied with providing financial services to firms that import from the areas where their parent bank is operating. In dealing with firms involved in foreign trade, the foreign offices, being relatively small, can offer their clientele flexibility in the provision of financial services and close attention to their individual problems. Several of the banks that have come here have gone out of their way to provide foreign exchange trading facilities to their customers and have in fact earned much of their keep from this particular source. Moreover, the offices' top management is usually at the disposal of even small-sized firms. For all these reasons, a newcomer among foreign banks in the United States can be reasonably sure of attracting customers and, equally important, customers' balances.

**RETAIL BANKING SERVICES.** In New York, most foreign banks have confined their operations to wholesale banking, focusing on offering a wide range of domestic and international corporate financial services. Some of the subsidiaries, notably those with a strong ethnic appeal, and also a few of the branches offer a complete range of retail banking services, including regular savings accounts. How-

ever, in California, foreign-owned banks are much more retail banking oriented. Several foreign-owned banks have taken advantage of the fact that California law permits unlimited branching and have expanded statewide. Some of them have acquired banks with existing branch networks. Presently, five of the fifteen largest state banks in California are controlled by foreign banks. These banks are aggressively seeking retail as well as wholesale business and reach out into suburban communities. Their operations resemble those of medium-sized domestic banks that deal with large numbers of relatively small industrial and commercial customers. Japanese banks in particular have found a ready-made retail market in the Japanese community in California, but they also do a great deal and, in some cases, the major part of their business with non-ethnic accounts.

**SERVING AS A DOLLAR SOURCE FOR PARENT BANK ORGANIZATION.** A major consideration in foreign banks' decisions to come here has been the desire to acquire a firm dollar base which in case of need can become a source for the dollar requirements of the banks' organization throughout the world and which can provide major head-office clients with a depository and service center for their dollar operations. As the foreign bank's dollar banker, such a base can perform a variety of vital functions. For instance, in the course of receiving and making payments on behalf of their organization's members abroad, a foreign bank's affiliate or office in New York may be called upon recurrently and automatically to extend to them temporary overdrafts within the limits prescribed by the head office. This would occur whenever the local office makes payments in response to cable or telex instructions of the parent bank or its affiliates and branches even though the corresponding funds have not yet been received here from other domestic banks and, as a result, the respective account may have been overdrawn. Moreover, the New York office may be instructed to extend credit facilities to affiliates or branches abroad that need to refinance in dollars their own loan extensions. Or, it may be requested to extend loans directly to the customers of affiliates and branches elsewhere in the world who for a variety of reasons, such as exchange controls, are unable to provide the requisite financing.

Another advantage of a dollar base is the capacity to engage in exchange trading after the bank's head office has closed for the day. Many foreign banks share with major United States banks the ambition to be able to adjust their exchange position at any time, day or night, and to provide their customers with an around-the-clock foreign exchange trading service.

Foreign banks are also interested in improving their capacity to invest on the spot any net dollar balances accumulated here during the course of business for their own account or for the account of other members of their organization. A New York office can place such balances before the end of the business day in the Federal funds market or in other short-dated sectors of the New York money market. Conversely, a New York office in case of need can easily buy Federal funds on short notice whenever it experiences an unusual outflow of funds. This capacity adds to the flexibility of the foreign bank's asset management, diminishes the cost of covering day-to-day dollar requirements, and reduces the need for holding idle working balances with other banks in this country.

Finally, any bank abroad heavily involved in the Euro-dollar market is interested in adequate standby facilities to be protected in the remote case that the market should suddenly dry up, with short-dated Euro-dollar quotations skyrocketing as a result, as has happened on occasion. A New York office can be a ready source for liquidity during such a squeeze and thus permit the parent bank organization to expand with confidence its participation in the Euro-dollar market without matching closely the maturities of its claims and liabilities.

**NEW YORK MONEY MARKET OPERATIONS.** Foreign banks' offices in New York, notably the Canadian agencies, have for many decades been major operators in the New York money market, particularly the market for call loans to securities dealers and brokers. Moreover, virtually all foreign banks' offices have long been active in the Federal funds market as sellers<sup>5</sup> whenever they accumulate excess funds and as buyers whenever shortfalls in their daily money positions occur. Following the introduction in 1961 of the negotiable certificate of deposit (CD), the subsidiaries of foreign banks and to some extent also the branches of foreign banks have made broad use of this instrument to finance their operations in this country. The names of many of these banks are highly regarded by corporate treasurers in the United States, and the banks have therefore been quite successful in their efforts to place negotiable CDs with major corporations. Some of the branches have preferred to accept straight time deposits rather than to sell CDs.

<sup>5</sup> The agencies, branches, and nonmember banks owned or controlled by foreign banks do not hold balances in Federal Reserve Banks, but they may sell balances in member bank correspondent accounts as Federal funds.

In more recent years, some foreign banks have looked at operations in the New York money market in a broader context. In their forward planning they have become increasingly interested in acquiring a global capacity quickly to shift their sources of funds and to maximize the return on these funds in response to changing money market conditions throughout the world. An office in New York is a must for banks with such aspirations. It provides direct access to the United States money and capital markets and thus affords foreign banks welcome opportunities to engage in various arbitrage operations. These may involve, during periods of monetary ease abroad, the shift of excess funds to the United States money and bond markets. Conversely, if rates in the United States money market are low relative to rates in other national and international money markets, the offices may repay balances obtained abroad and tap our markets, notably the Federal funds and CD markets, and shift United States resident funds—within the limits of the Federal Reserve's Voluntary Foreign Credit Restraint program (VFCR)—to other money, loan, and capital markets.

These broader considerations have been reinforced by the existence of arbitrage opportunities between the Euro-dollar and the New York money market. Presently, it is true, shifts of United States resident funds from the United States to foreign money markets are restricted by the VFCR. However, inward arbitrage—i.e., shifts of funds from foreign and international money markets to New York—has recurrently offered, during the last year or two, substantial rewards, and such arbitrage operations have become a profit center for a limited group of foreign banks' offices with sophisticated money desks. Much of this activity has involved acquisition of overnight Euro-dollar deposits by their head offices or sister branches for deposit in their New York offices which then place these funds in the Federal funds market. In these operations, foreign banks' agencies and branches have found themselves in a privileged position relative to United States banks. Under regulations issued by the Federal Reserve Board, member banks have since 1969 been subject first to a 10 percent and then, until recently, to a 20 percent marginal reserve requirement on Euro-dollar takings<sup>6</sup> over

<sup>6</sup> On May 16, 1973, the Federal Reserve Board reduced the reserve requirement on Euro-dollars to 8 percent and acted to eliminate gradually the reserve-free bases. On June 1, the Board requested the agencies, branches, and nonmember bank subsidiaries of foreign banks to maintain voluntarily reserves of 8 percent against Euro-dollar borrowings in excess of a base level.

and above a reserve-free base. Thus they have been severely handicapped since that time in engaging in inward arbitrage operations, even though, on purely interest rate considerations, these would have been profitable. It is true that domestic banks have frequently been able to continue taking balances from Euro-markets for profitable investment or use in lieu of Federal funds, but even these banks could not long remain sizable takers because, to avoid reserve requirements, they had to make sure that their daily average borrowings during the four-week reserve computation period would not exceed their bases, however small. As a result, domestic banks have frequently been forced to diminish their takings from the Euro-market or to withdraw entirely from intermediation between the Euro-dollar and the New York money markets. Only foreign banks' offices—not being subject to similar reserve requirements—were then in a position to move funds from the Euro-market to New York.

For the New York branches of foreign banks, this privileged position has been enhanced further by technical factors. Unlike agencies, which may not accept deposits, branches—under regulations of the New York State Banking Board—must put up reserves against their deposit liabilities in the same ratio as apply to member banks of the Federal Reserve System. However, the branches, not being member banks, are permitted to satisfy their reserve requirements through commercial bank balances shown on their own books as of the opening of business each day (except on Sundays and holidays when the balances at the close of the preceding business day serve as reserves against the deposit liabilities of the branch the following day). The branches may then, during the same business day, sell these reserve balances in the Federal funds market. Thus, by drawing on reserve-exempt Euro-dollar balances and using them for covering their required reserves and then selling them in the Federal funds market, branches have been able to reduce or entirely eliminate the cost resulting from having to hold a portion of their deposit liabilities in idle balances. Consequently, these branches have an incentive to borrow overnight Euro-dollar deposits for investment in Federal funds even if the overnight rate is somewhat higher than the funds rate.

Much of the swap activity between Euro-dollars and Federal funds by the agencies and branches of foreign banks has been taking place in the so-called Thursday-Friday market. In this market, the foreign offices obtain overnight Euro-dollar deposits in the form of New York Clearing House funds value Thursday which become collected funds on Friday. Then they can sell these balances as Federal funds for three days—from Friday through

Sunday—since the New York Clearing House balances used in repayment of the Euro-dollar deposit are not collected until Monday. Overnight rates for Thursday deposits are therefore usually close to three times the prevailing Federal funds rate, but very frequently are low enough to make these transactions profitable. Until 1969, this market was the preserve of major domestic banks. In that year, the Federal Reserve Board introduced a regulation requiring that checks and drafts used in placing and repaying Euro-dollar deposits on behalf of branches be included in reservable deposits, thereby greatly adding to the cost to United States banks of using short-dated Euro-dollar deposits for reserve and liquidity management purposes. Subsequently, Euro-dollar deposit liabilities became subject to marginal reserve requirements, as noted earlier, which virtually eliminated the profitability of these transactions for banks without reserve-free bases. However, branches of foreign banks, not being subject to Euro-dollar reserve requirements, have been able to continue taking advantage of Euro-dollars for reserve purposes. In fact, some tend to purchase substantial amounts of Euro-dollars so as to build up in their depository accounts on Friday morning, often for retention over the weekend, very sizable balances—large enough to take care of their reserve requirements for virtually the entire reserve-computation period.

The ability to hold required reserves in commercial bank accounts conveys other advantages to branches. For instance, uncollected checks can serve as reserves; however, the amount of such checks deposited by branches in their banks is now reported to be relatively small. Also, the branches often acquire reserves through low interest rate loans from their depository banks, a condition of the loan being that the loan proceeds remain in the branch account which thus enables the lender to continue using these funds. The interest rate charged on these riskless loans is based on the imputed cost of the reserves (plus Federal Deposit Insurance Corporation (FDIC) insurance fees) that the lending banks are required to hold against the branch deposit and, therefore, is only a fraction of the Federal funds or prime rates. There exist other arrangements between branches and their depository banks under which the branches are able to obtain low cost reserves.

Agencies and branches of foreign banks are active in many other sectors of the United States money market. They are important operators in the call loan market, and also arbitrage on occasion between the Euro-dollar market and short-dated loans to major United States corporations. They also have become important participants in the relatively new market for term interbank loans, which is also referred to as the market for term Federal funds. This interbank market deals in unsecured loans in a rather broad

maturity range. Offices of foreign banks have been operating on a large scale on both sides of the market. As suppliers, they have found in this market an attractive outlet for Euro-dollar and other balances with nearby maturities. As takers of such loans, they have used them in lieu of more expensive sources of funds such as acceptance and other types of bank credit and CDs. Apart from agencies, member banks and foreign branches have shown a lively interest in these funds since they are not reservable and not subject to the thirty-day minimum maturity requirement. Actually, member banks have gained reserve-exempt access to the Euro-dollar market by buying term and overnight Federal funds from agencies and branches of foreign banks that obtain balances in that market.

As shown by these various and by no means exhaustive examples, many foreign offices have demonstrated much ingenuity in their money market operations and have used them successfully to strengthen and broaden their competitive position in United States financial markets.

**ATTENDING TO PAYMENTS SETTLEMENTS.** For a number of foreign banks, one of the more persuasive considerations in the decision to set up shop here has been the desire to attend, on the spot, to the daily settlement in New York of the often huge volume of their own and their customers' dollar transfers. In recent years, payments and receipts over foreign accounts in United States banks—notably in New York which is the clearing center for such payments—have grown at a spectacular rate, with the daily volume of transfers involving foreign accounts in the United States banks now exceeding \$30 billion. Much of the daily turnover of foreign accounts is closely related to the myriad transactions that take place each day in the Euro-dollar market, which now substantially exceeds \$100 billion (including interbank dollar deposits within countries) and in which overnight and other short-dated transactions have recently accounted for a rising share of total business. Another substantial part of the turnover arises from foreign banks' operations in foreign exchange markets. Even banks whose participation in the Euro-market has been minor have experienced a heavy surge of dollar transfers over their accounts in the United States as a result not only of foreign exchange transactions, but also of their customers' payments orders and receipts for customers' accounts. Of course, these developments are a reflection of the fact that the dollar remains the major instrument for the investment of temporarily unemployed short-term balances held by major banks and corporations in many parts of the world and that it continues to play a pivotal role in the settlement of international trade, service, and investment transactions.

As pointed out in an earlier article in this *Review*,<sup>7</sup> the growing volume of international payments, together with the scarcity of trained staff during periods of labor shortage, has led to a sharp increase in “back-office” problems at the major New York banks, giving rise to large numbers of errors committed in transferring funds. Moreover, costly delays in the execution of foreign payments orders by United States banks have not been uncommon. As a result, many foreign banks have not been happy with the service received from their major bank correspondents. One consequence of their dissatisfaction has been their rapidly growing use, for payments settlements purposes, of smaller banking institutions in New York, notably some of the Edge Act subsidiaries of United States banks, but also in many cases the offices of foreign banks in New York willing and capable of taking on this chore. These smaller banks have claimed that, with their more limited operations, they would be able to do a more accurate and efficient job in attending to fund transfers and to give the needs and inquiries of their correspondent banks a greater degree of personal attention. The foreign banks using the services of these banks have compensated them with commensurate balances and collateral business.

Doing the job themselves was an obvious proposition for foreign banks seeking additional business for their newly established offices in New York. These banks believed that, by concentrating in their New York office all their own payments and receipts associated with international trade, foreign exchange, Euro-money market, and investment operations, they would regain full control of the settlement of their worldwide dollar transactions and, in particular, eliminate or quickly clear up the various errors that crop up in the course of handling large numbers of payments orders. Equally important, after having concentrated all payments and credits in their New York office, they could look forward to earnings gains as they would then reduce commensurate balances with those correspondent banks that had been attending to their clearing business in New York. They would then also be able to arrange for the temporary investment of any balances that might occasionally accumulate here for a day or two as the result of the arrival of funds prior to the day on which the beneficiary would draw on them. And doing the job “in-house” also prevents other banks from gaining potentially valuable clues on what type of operations a

<sup>7</sup> See Irving Auerbach, “International Banking Institutions and the Understatement of the Money Supply”, this *Monthly Review* (Federal Reserve Bank of New York, May 1971), pages 109-18.

foreign bank is conducting here and abroad.

Closely related to attending to the clearing function is the making of payments through official checks issued by the New York office to United States payees on behalf of head-office clients. By performing this additional function, the New York office can become the beneficiary of substantial amounts of float arising from the time difference between the day the head office sells dollars against local currency to its domestic client and the day the official check is presented in New York by the payee's bank.

To achieve additional efficiency gains and economies, some of the newcomers among foreign banks decided right from the start of operations to automate the transmission of payments orders and other data through linking their head-office computer with that of the New York office. Several of the new offices have thus been able to offer their customers rapid and accurate execution of payments transfers to and from the United States as well as accelerated collection services, a not unimportant selling point in holding and gaining corporate clients. Moreover, computer linkage has enabled foreign banks to shift to their head offices the work load arising from the preparation of trade documentation, payments orders, and checks as well as the keeping of the New York office's books, thereby minimizing the relatively costly requirements for American staff.

**ESTABLISHING LINKS WITH UNITED STATES SECURITIES MARKETS.** Another major consideration in the move of foreign banks to this country has been their desire to enter into the business of underwriting new domestic securities issues and of trading domestic and foreign securities in the United States market. During recent years, foreign banks have established about a dozen broker-dealer securities firms in New York, many of them jointly owned by two or more foreign institutions. Most of these firms have become members of regional United States stock exchanges. Moreover, one major Italian bank and a Belgian bank have bought into United States stock exchange firms. Significantly, several of the banks that have established or bought into broker-dealer firms are also engaged in commercial banking in the United States, typically but not exclusively through branches. In this respect, they occupy a privileged position, since United States banks are not permitted under the Glass-Steagall Act to combine banking with a securities business. It should be noted in this connection that the Federal Reserve Board last year denied the request of a newly registered foreign bank holding company to retain a one-third interest in a New York securities affiliate. The Board stated that "an affiliation with a securities company would give a foreign bank holding company an unfair competitive advantage over a domestic bank holding

company in that a foreign bank holding company would be able to offer its customers an alternative means of obtaining financing to credit facilities, namely, underwriting facilities".<sup>8</sup>

The intense interest of foreign banks in entering the business of dealing in and distributing United States securities can be easily explained. First of all, commercial banks abroad, especially on the European continent, are heavily engaged as principals in the securities brokerage and dealer business and act as investment advisers to their clientele. Many of these clients have relinquished investment decisions to their banks, which thus administer very large securities portfolios. In addition, many European banks hold sizable amounts of securities for their own account, and several European banks have established and are managing mutual funds with geographically diversified portfolios of very sizable dimensions. Many prominent foreign bankers are members of advisory boards associated with major European mutual funds established by other banks.

Secondly, many of these banks as well as the investment companies that they manage or advise have added substantially to their holdings of United States equities, notably since the midsixties. Also, a large number of investment companies have been established in Switzerland, Germany, Britain, and elsewhere for the specific purpose of acquiring United States and Canadian equities.

Apart from the desire of these various investor groups to participate in the long-term growth of the American economy, they have been attracted to the United States securities market by its breadth and depth. More than any other national securities market, the United States market can handle large individual stock transactions with relative ease, as it can absorb very sizable deals without the quotations for the respective stocks being materially affected. Moreover, the United States market offers a wider and more diverse range of stocks traded than virtually any other market.

Considering the growing exposure of these banks and of their major institutional and individual clients in American equities, it is not surprising that many have considered it desirable to gain a direct foothold in the United States securities market. To some extent, the motivation has been to enhance their prestige as active participants in international securities markets, but for the most part the objectives were of a more tangible sort. In the first place, by engaging directly in securities trading in the United States

<sup>8</sup> See *Federal Reserve Bulletin* (October 1972), page 941.

and through membership in regional exchanges, foreign-bank-owned securities firms can become intimately involved in United States stock markets. They thereby find it easier to gain direct personal access to research conducted by United States securities firms and to secure good execution of their orders. They can serve as a listening post for their parent banks and bring current market trends for various securities and special situations to the attention of their banks' customers. Consequently, the parent banks are in a better position to offer their foreign clientele asset-management services of the same type as provided by the foreign branches and affiliates of United States banks. And, at the same time, they can earn additional commissions on orders placed by their customers.

Another consideration has been the interest of the parent banks in opening up direct channels to major American institutional investors with whom the banks may some day place medium-term notes and longer term securities issues of the United States affiliates of their clients. Thus, the establishment of, or participation in, a securities affiliate may eventually serve to supplement the short-term loan facilities provided to European clients' affiliates by the parent banks' United States branch or subsidiary bank.

A major motive for direct entry by foreign banks into the United States securities business has been their hope to obtain a place among United States underwriting groups and thus to earn underwriting and selling commissions derived from placing securities as a member of an underwriting syndicate. Many United States underwriting syndicate managers are eager to include foreign securities affiliates with good placing power abroad in underwriting groups floating new issues or engaged in a secondary distribution. In some cases, corporations that have benefited from close financial relations with major European banks insist that the United States securities affiliate of these banks be included in the syndicate underwriting their issues. Securities affiliates interested in gaining entry into any particular underwriting syndicate can make use of their considerable bargaining power arising from their own or their parent banks' ability to direct large amounts of commission business to United States securities dealers. Another reason why foreign securities affiliates are invited to join underwriting syndicates is that their parent banks are often in a position to reciprocate by including the managing underwriter of a United States issue as a co-manager in Euro-bond underwriting syndicates.

The securities affiliates have made remarkable strides in their role as underwriters of United States securities as measured by the number of issues underwritten and the aggregate amounts handled. The smaller domestic investment houses, and especially some regional firms, have felt the

competitive onslaught of the foreign affiliates. Still, in terms of overall assets and underwriting income, the affiliates account for only a small fraction of the aggregate business of domestic underwriters.

In many instances, the predominant orientation and major source of earnings of foreign-owned broker-dealer firms is not underwriting but brokerage business. They earn commissions on orders placed at regional exchanges in which the securities affiliates have acquired membership. They also can earn either commissions or markups in the over-the-counter market and the "Third Market". Aggregate orders for purchases and sales of United States equities placed by the securities affiliates now account for a rapidly growing, albeit still minor, portion of total orders placed by foreigners even though many foreign banks continue to channel a large part of their United States securities orders through domestic firms rather than their own affiliates so as to maintain valued relationships.

Securities affiliates offer financial advice and services to foreign clients interested in obtaining financing in the United States or in making direct investments here. They also assist in joint ventures, mergers, and acquisitions and provide investment advisory and "research in depth" services to American clients, notably those interested in European financial markets. They trade not only in United States equities but also in various fixed-interest securities. Some of them have joined groups bidding for new issues of municipal securities. They also engage in arbitrage between stocks traded on both United States and foreign exchanges.

Some foreign banks have established affiliates for the specific reason of being better able to take care of the securities business of their clients, some of whom have been dissatisfied with the service obtained through other channels, notably during the late sixties when many United States brokerage firms were beset by back-office problems.

One aspect of this new institutional development is joint ownership of the majority of these firms by several banks. In part, this reflects the fact that major European banks have entered into a variety of cooperative links, some of which have provided specifically for joint ventures abroad. But several securities affiliates are owned by banks that are not participants in such cooperative arrangements. The motives have been to minimize expenses, to take advantage of the greater stature and trading capacity of a larger and well-capitalized firm and its superior management, and to transfer to the United States the intimate relationships that have been fashioned by individual banks in securities underwriting and distribution in Europe.

In broad perspective, the entry of foreign securities affiliates into the United States should be viewed as an-

other manifestation of the increasing linkage and integration of national financial markets. Until recently, long-term financial markets, unlike money markets, have remained largely isolated in the sense that the public's aggregate holdings of foreign securities have accounted for no more than a small fraction of their total portfolio. Gradually this is changing. Investors and distributors of securities have broadened their horizons and an increasing number of major corporations are seeking international distribution of their securities and registration of their equities in foreign stock markets. The foreign securities affiliates in this country are major agents in the forging of new links among national capital markets and in the internationalization of the world's capital markets.

**GROWTH OF LONG-ESTABLISHED INSTITUTIONS.** The surge in recent years of the aggregate assets held by the various foreign subsidiary organizations operating in the United States is due only in part to the activities of new arrivals here. A major factor in their growth is the rapid expansion of operations on the part of a number of subsidiaries, agencies, and branches that have been here for a number of years, some of them for several decades.

**Japanese agencies.** Foremost among the older institutions that can boast an outstanding growth record are the agencies of Japanese banks in New York. Their assets early in 1961 were a mere \$700 million. At the end of 1965 they had grown to \$1.5 billion. By the end of 1972 they were more than \$6 billion.

For the most part, though not exclusively, the business of the Japanese agencies in New York is related to the financing of Japanese trade with the United States. Thus, the remarkable growth of these institutions finds a ready explanation in the spectacular expansion during recent years of United States exports to, and imports from, Japan. However, it should be noted that the agencies also take a hand in the financing of exports of Latin American countries to Japan and, on occasion, refinance the dollar needs of head-office customers in that part of the world.

As the operating arm in the United States of their head offices in Japan, the New York agencies provide a wide range of international banking services. They pay sight bills for account of their customers, purchase export and import bills, and, most important, create and settle bankers' acceptances primarily for account of their head offices. Apart from trade finance, they deal in foreign exchange, collect trade bills, and open and receive letters of credit. A very large part of the imports from Japan into the United States is financed under letters of credit opened by the agencies.

Some Japanese agencies also act as dollar bankers of their head office's worldwide organization, and invest its

excess dollar balances in the New York money market.

Much of the agencies' dominant role in New York in financing trade transactions between the two countries can be traced to their serving as the banks of account of Japanese trading companies and other subsidiaries of Japanese corporations in the United States with which they have had close and long-standing financial relationships. These companies dominate Japanese-American trade and have required very substantial dollar financing facilities, both from the agencies and from United States banks.

To find the requisite funds for their financing operations in the United States, the agencies have tapped with great skill and at minimum cost a wide range of resources. For the most part, the underlying funds have come from their head offices in Japan, which in turn have fallen back on various sources of their own. Among these, the most important have been their acceptance credit lines with United States banks—long the mainstay of Japanese dollar finance. More recently, however, they have made less use of these facilities, since the Bank of Japan has shifted substantial amounts of its monetary reserves to Japanese banks at more attractive rates than the cost of United States bankers' acceptances. As a result of this infusion, head-office funds in the agencies have surged, greatly strengthening their competitive position in the United States market for loans financing trade with Japan. A third, and at times very important head-office dollar source, has been Euro-dollar deposits obtained primarily in London from their own branches.

Apart from head-office funds, the agencies have resorted to various other sources of dollar finance. Several of the agencies have been able to sell impressive amounts of their own acceptances in the market. In addition, they have drawn on their own acceptance lines with United States banks which, because of the Federal Reserve System's VFCR, have at times preferred to extend loans and acceptance credits to the agencies rather than to their head offices abroad. The agencies also have obtained sizable amounts of advances from United States banks and have sold participation in their loans to these banks. They have borrowed directly in the Euro-market, again almost entirely through their London sister branches. More recently, they have obtained sizable balances in the term Federal funds market. Altogether, United States banks have financed directly or indirectly the bulk of agency operations in this country. They have operated essentially as wholesalers of loans which have been "retailed" by the agencies.

**Canadian agencies.** Another long-established group of foreign banks' offices in New York that can boast of an impressive expansion in their operations in recent years consists of the New York agencies of the Canadian chart-



ered banks. Their total assets now account for more than 25 percent of total assets held by the New York agencies and branches of foreign banks.

Canadian agency operations in New York are of long standing, dating back to the nineteenth century when United States dollar balances and, in particular, call loans to New York securities dealers and brokers were the first line of secondary reserves of the Canadian banking system. Much of the growth of Canadian agency operations in more recent periods stems from the huge expansion of the Canadian banks' international money market and wholesale foreign currency banking activities. These activities have involved the acquisition of United States dollars from a variety of sources, among them: (1) United States corporations and banks, (2) Canadian residents (who can place with the chartered banks interest-bearing United States dollar deposits on a swap basis free of exchange risk), (3) banks operating in the Euro-dollar market in London and elsewhere, and (4) customers and correspondent banks in the Caribbean and Latin American countries where some Canadian banks occupy an important role in local banking systems.

The Canadian banks have employed these balances notably in Europe, but also in Canada, the United States, and some other parts of the Western Hemisphere; the New York agencies are thus only one of several outlets for the chartered banks' United States dollar resources. The traditional function of the agencies has been to attend to and administer the very large balances in the United States that arise from the far-flung operations of the Canadian banks. In discharging this task, the agencies have always held sizable amounts of money market assets in New York, primarily as a liquidity reserve for the United States dollar-denominated liabilities of their head offices and sister branches abroad. In addition, they have been active in international money market arbitrage operations and more recently in commercial loan operations.

The agencies obtain almost all of their dollar resources from the head offices and branches of the chartered banks. Funds obtained in the United States have been an insignificant source of agency resources since, as pointed out previously, agencies of foreign banks cannot accept deposits, but only credit balances. United States corporations, wishing to place balances with Canadian banks, carry them almost entirely in accounts with the head offices and the Canadian branches of the chartered banks. The placement of such deposits has been facilitated by the exemption of Canada since 1968 from all the various United States balance-of-payments programs.

The most recent growth of Canadian agency assets in New York reflects a rapid expansion in two major areas:

commercial loans and arbitrage between the Euro-dollar market and the overnight Federal funds and term inter-bank loan markets. However, the role of the agencies as the administrator of United States dollar liquidity of the Canadian banks has somewhat diminished.

Much of the growing commercial loan business of Canadian banks is with major United States corporations. These loans are not restricted to foreign-trade financing. Unlike the Japanese agencies, the Canadian offices in New York do very little foreign lending which is handled almost exclusively by their Canadian head offices. The agencies' portfolios include working-capital loans for the financing of a variety of short- and longer term capital expenditures and revolving credits for general purposes. In more recent years, the Canadian banks have also been extending to United States corporations some loans with medium-term maturities.

In their attempts to develop business with United States firms, the Canadian banks have benefited from the rapid expansion of United States investment in, and trade with, Canada. Many United States corporations through their Canadian subsidiaries now enjoy close contacts with the chartered banks, and have developed relationships that afford many opportunities for the agencies to acquire new loan and collateral banking business. Similarly, United States corporations that trade with Canada offer obvious contacts for the business expansion departments of the agencies. Thus, a very large part of the loan business of the Canadian agencies has some connection with Canada, direct or indirect.

The Canadian banks have long been active operators in the New York market for call loans to securities dealers and brokers. The Canadian agencies are specialists in this so-called "Street" market. They offer rates on stock collateral fractionally below those charged by domestic banks, primarily because, unlike the latter, they do not have trust accounts that normally would generate orders to the borrowers for securities transactions. Call loans have been very attractive to Canadian agencies because they can be terminated at any time and thus constitute an excellent source of dollar liquidity. Not so many years ago, the agencies accounted for a major part of call loans to securities dealers and brokers in New York City but, since the midsixties, their participation in that market has declined both absolutely and as a proportion of total New York call loans.

One reason for the lesser reliance on call loans for liquidity purposes has been the use of alternative sources of United States dollar liquidity, notably the Federal funds and the Euro-dollar markets. With few exceptions, names in the Euro-market are much better known than in the New York call market and, consequently, much larger sums

can be placed with and shifted among individual takers in Europe than in New York, subject of course to the balance-of-payments guidelines of the Canadian authorities.

More recently, the agencies became more hesitant lenders in the Street market as a result of the collapse of several New York brokerage firms, which at least temporarily did some damage to the credit standing of the dealer-broker community. However, in 1972, call loans again increased and the aggregate amount of such loans extended by Canadian agencies remains sizable, though still less than in the early 1960's.

The Canadian agencies have long been active in the Federal funds market. Their dollar positions are subject to large daily fluctuations, and the Federal funds market has provided (1) an attractive outlet for day-to-day surplus funds accumulated in their accounts with United States banks and (2) a source for United States dollar liquidity. More recently, the Canadian banks have become important suppliers in the term sector of the market. Their money desks have been quick to take advantage of lucrative opportunities for shifting short-dated Euro-dollar balances into term Federal funds.

Altogether, the United States dollar operations of the Canadian banks through their agencies in New York have not kept pace with the surge of their foreign dollar assets. Agency transactions in the United States would have grown even more rapidly, had the head offices not been able to look to their placements and borrowings in the short-dated sectors of the Euro-dollar market as a convenient and plentiful supplier of United States dollar liquidity.

#### CONCLUSION

The heavy influx of foreign banks to New York in recent years, together with the impressive growth of operations of the older foreign subsidiary organizations, has immeasurably enhanced New York's role as an international financial center and greatly added to the international character of what not so long ago was primarily a domestic market. Similarly, the move of foreign banks to California has substantially contributed to the international orientation of banking in that state. There is no doubt that the expanded operations of foreign banks have brought many tangible and intangible benefits to the United States. The foreign bank offices have added importantly to the availability of international financial services to multinational corporations and the foreign trade community in the United States. They have developed and refined financial facilities in this country. In particular, they have added much to the breadth and depth of several segments of our money market and, even more so, of our foreign exchange

market. They have also furnished helpful services to foreign corporations and other foreigners making direct and portfolio investments in the United States.

The foreign banks' overall impact on our balance of payments has been favorable, though the evidence is somewhat ambiguous. Some foreign banks have invested sizable amounts of funds in their United States affiliates and supplied substantial balances to their agencies and branches to enable them to finance their operations. Their securities affiliates have facilitated and encouraged investments in our capital market, but the precise extent of this benefit cannot be pinned down. Unfortunately, it is impossible to ascertain the amount of private funds channeled into the United States through the offices of foreign banks that might have come here anyhow even in their absence. At the same time, the offices of foreign banks have drawn heavily—directly or indirectly—on acceptance and other credit lines of United States banks, and have obtained substantial, though limited, amounts of nonbank time deposits and other balances in this country with which to finance their international operations. As outposts of major foreign banks with footholds in many foreign and international money markets, at least some of the offices, guided by their head offices and parent banks, tend to move large amounts of funds from various parts of the world into the United States when interest rates make such movements attractive to them. But, if rate constellations in money and loan markets here and abroad or disturbances in exchange markets favor the outflow of short-term capital from the United States, foreign banks then tend to reduce their stake in the United States money market, and their offices in New York draw to a greater extent on American funds for the financing of their operations. During periods of pressure on the dollar exchange rate, they tend to finance on a large scale—often in response to instructions of their head offices—precautionary payments to parent companies by foreign corporations' affiliates in the United States. Thus, the offices have become a major channel for capital movements not only from the rest of the world to the United States, but also from the United States to foreign destinations.

The significance of these capital movements goes beyond their balance-of-payments implications. In a broader context and perspective, they should be viewed as contributing importantly to the integration of the world's money and capital markets. The offices of foreign banks in the United States now provide important contact points in the growing interlinkage of financial markets.

Foreign banks have obviously obtained substantial benefits from the prevailing regulatory climate in the United States which on the whole has been highly favorable—so

favorable indeed that some domestic interests have voiced complaints about unfair competition. Both commercial and investment bankers sometimes assert that there are too many foreign banks sharing the business which they claim should belong to them, and that these institutions enjoy privileges not available to United States banks. As noted earlier, foreign banks do enjoy several opportunities denied domestic banks, but it is also true that at least the agencies and branches differ in many respects from indigenous institutions; above all, they must depend for most of their resources on funds supplied by their head offices. Moreover, it should not be overlooked that agencies and branches also face a variety of statutory handicaps. For instance, branches of foreign banks are not eligible for coverage by the FDIC and are thus faced with an important handicap in obtaining deposits from the general public. (On the other hand, some branches of foreign banks have evidenced no interest in acquiring insurance protection.) Not being members of the Federal Reserve System, the agencies and branches do not have access to the discount window. Moreover, their long-term time deposits are subject to the interest equalization tax.

Presently, the entry of foreign banks into this country is almost exclusively governed by state laws and regulations. The only exception is the Bank Holding Company Act of 1956 as amended, which has introduced a degree of Federal jurisdiction over foreign bank operations, but only when they are conducted through state-chartered subsidiaries. With every state adopting its own attitude toward foreign banking, and in the absence of a coherent national policy, the paradoxical situation has emerged of the existence side by side of a highly permissive and a highly restrictive climate for foreign banking operations in different states. It is not surprising, therefore, that at various times suggestions have been made for the restructuring of the present system. The most prominent proposals in this direction were made several years ago by Dr. Jack Zwick, then of Columbia University, in a study prepared for the Joint Economic Committee. As an outgrowth of this study, four bills were introduced in 1967 in the Con-

gress providing for varying degrees of Federal control of the United States offices of foreign banks, but they all died even without benefit of hearing. Considering that in the intervening years the operational activities of these offices have assumed increasingly large dimensions, it would not be surprising to see a revival of legislative attempts to bring them under a greater degree of Federal jurisdiction. Pointing in this direction is the announcement by the Board of Governors of the Federal Reserve System on February 1, 1973 that it has been reviewing for some time the regulatory issues posed by United States activities of foreign banks and that eventually it expects to consider the possible need for legislation. The Federal Reserve will be carrying forward its review in these fields with the assistance of a Steering Committee made up of three members of the Board of Governors and three Presidents of the Federal Reserve Banks. They are Governor George W. Mitchell, Chairman, and Governors J. Dewey Daane and Jeffrey M. Bucher and Presidents Alfred Hayes of the Federal Reserve Bank of New York, Bruce K. MacLaury of the Federal Reserve Bank of Minneapolis, and John J. Balles of the Federal Reserve Bank of San Francisco. Meanwhile, to obtain current and comprehensive data on the activities of United States agencies, branches, and domestic banking subsidiaries of foreign banks, the Federal Reserve Board has recently begun to collect a new monthly report of condition from these institutions. The collection of these data is evidence of the growing concern of our monetary authorities over the impact of foreign banks' direct operations in our money and loan markets. Yet, at this point it would be premature to speculate on the evolving official attitude toward the operations, organizational forms, and legal status of foreign-bank-owned institutions in the United States. Whatever legislative developments are ahead in this area, there is every reason to expect that entry of foreign banks into this country and their operations will continue to be regulated in a manner that will permit this country, and New York in particular, to fill with distinction and with enduring success the role of the world's leading financial center.