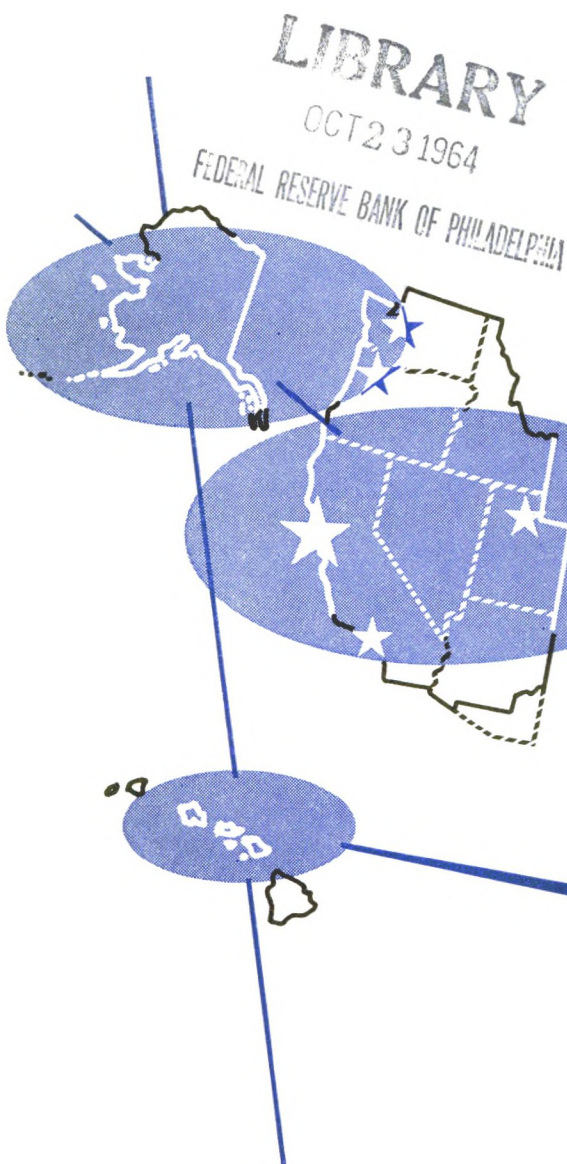


FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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Can We Afford to Invest Abroad?

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Can We Afford to Invest Abroad?

I. The Data

THE passage of the interest equalization tax marks another step in the nation's effort to reduce its balance of payments deficit. Earlier action dealt with practically every other aspect of our balance of payments accounts—merchandise trade, tourist expenditures, transportation costs, military expenditures, foreign aid, and so on. More recently, it has been the turn of the private capital sector.

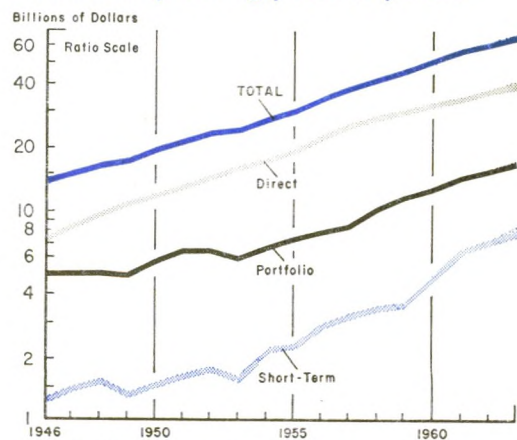
Each sector, of course, has been subjected to a searching examination during recent years to determine the contribution it might make to cutting back our net payments abroad. Since some new measures, such as the campaign to expand export markets, are expected to show results only after an extended period of time, and since the balance of our international transactions in goods and services continues to register a surplus, the spotlight lately has turned to the Government and private capital accounts. Government credits have been tied to purchases in this country, and the balance of payments impact of defense and other Government spending abroad has been minimized wherever possible. In addition, the Treasury and the Federal Reserve System have initiated operations in the foreign exchange markets to counter speculative pressures against the dollar and to dampen international flows of volatile capital.

The stage was set for the interest equalization tax by the steady rise in private capital exports throughout the postwar period, culminating in a peak annual rate of outflow of \$6.5 billion in the second quarter of 1963. The interest equalization tax was designed to operate as a deterrent to U. S. investments in foreign securities—by increasing the cost to the foreigner of financing in this country or, alternatively, reducing the yield of these as-

sets to the U. S. investor. The tax proposal has met with mixed reactions both here and abroad, but, in general, imposition of the tax has been recognized as a step that will strengthen our payments situation pending the working out of longer term adjustments.

There is some evidence that private capital transactions have been at least partly responsible for our payments deficit. During most of the postwar period, for example, economic growth rates in the major industrial countries abroad were higher than in the United States, and this tended to stimulate U. S. private investment overseas. Since mid-1960, in addition, the concurrent existence in the United States of rather high unemployment, substantial excess plant capacity, the absence of strong inflationary pressures, and a current account surplus precluded the adoption of an aggressive policy of credit restraint and high interest rates, such as might be called for in the classical case where a payments deficit was caused by inflationary pressures. Relatively easy credit conditions thus

U. S. private investments abroad rise steadily during postwar period



Source: U. S. Department of Commerce

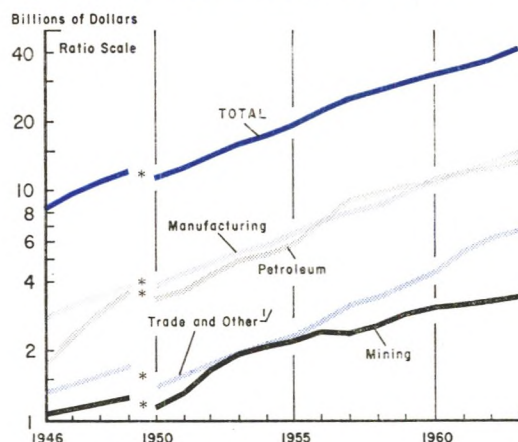
have been maintained in the past several years for primarily domestic reasons. This policy, however, has resulted on occasion in the emergence of significant spreads between interest rates here and in other countries. These spreads, along with structural impediments abroad to the efficient mobilization of capital, may have unduly stimulated private capital exports from the United States.

The role of private capital flows in the U. S. payments picture therefore should be examined to determine 1) whether we can afford to continue investing abroad at the rate of the past several years, and 2) what effects a reduction in this outflow might have on international liquidity. The success with which private capital can satisfy the liquidity needs of the international trading and financial community—and thereby reduce official international liquidity requirements—is another important aspect of the problem.

What kind of investments?

Private capital investments abroad fall into three major categories: Direct investments (including reinvested earnings), long-term portfolio investments, and short-term investments. Direct investments, the first category, include the value of all investments of U. S. residents in foreign incorporated companies and of U. S. firms in overseas subsidiaries and affiliates where 25 percent or more of the total combined voting power is held by Americans.¹ Most investment of this type has taken place in petroleum and manufacturing facilities. Within the manufacturing sector, investment in facilities producing autos and other transportation equipment has been rising most rapidly, especially in Europe and other developed countries where modernization of highway systems and higher living standards

Manufacturing, petroleum facilities account for most direct investments



*Represents break in series.
Note: ¹Excluding public utilities and agriculture
Source: U. S. Department of Commerce

have supported a growing demand for passenger cars. Manufacturing thus is the leading type of direct investment in Canada and Western Europe, but it lags far behind in Latin America and in "all other countries," where primary products still tend to dominate the economy.

Petroleum investments, on the other hand, after increasing rapidly from 1945 through 1957, have tended recently to expand more slowly, especially in view of the completion of basic productive facilities and the discouragement of foreign participation in resource development in a number of countries. The development of other energy substitutes also may have had some bearing on the tapering off in this activity. Exploration for petroleum has grown less rapidly than refinery facilities, especially in Western Europe. In the mining and public utilities sectors, meanwhile, project completions have been responsible for some leveling off in direct investments. At the same time, investments in trade and in other industries have been stimulated by the high rate of expansion in these sectors in Western Europe and in "all other countries."

Long-term portfolio investments, the sec-

¹In some cases where less than 25 percent of the voting stock is United States-owned, an investment is still classified by the U. S. Department of Commerce as a direct investment if control or a significant voice in management is exercised by United States residents. On a balance of payments accounting basis, on the other hand, reinvested earnings are not included in either the direct investment outflow or in the investment income inflow.

ond major category, consist of equity and debt investments in foreign companies other than those classified as direct investments, as well as long-term credits extended by banks and nonfinancial concerns to foreigners. Most of the growth in security transactions occurred in the last two years, and has been concentrated in new foreign dollar-bond offerings by Canada, the World Bank, Japan, and Western European countries. Debt financing has been the preferred form of financing, possibly because of fears that equity issues would dilute company control. Net purchases of outstanding foreign securities have tended to fluctuate from year to year over the postwar period, but an upward trend has become evident in the past five years because of quickening American interest in the securities of Western Europe and Canada. Both bank and nonbank long-term credits to foreigners have increased sharply in the past several years.

Short-term investments, the third major category, include all short-term claims on foreigners of U. S. banks and nonfinancial concerns, other than claims on foreign affiliates which come under the direct-investment category. Short-term claims, in other words, include such items as loans, bankers' acceptances, and trade credits. Banks account for some three-fourths of total short-term claims outstanding, but corporations and traders have also been increasingly active in extending such credits in recent years. Claims on Japan have shown the most spectacular increase, although claims on all other areas also have risen.

Although the outflow of private capital from the United States—both in the aggregate and by type—has tended to vary sharply from year to year, the trend has been upwards. The value of privately held foreign assets, as a consequence, has increased consistently throughout the postwar period. But the different categories have shifted in relative im-

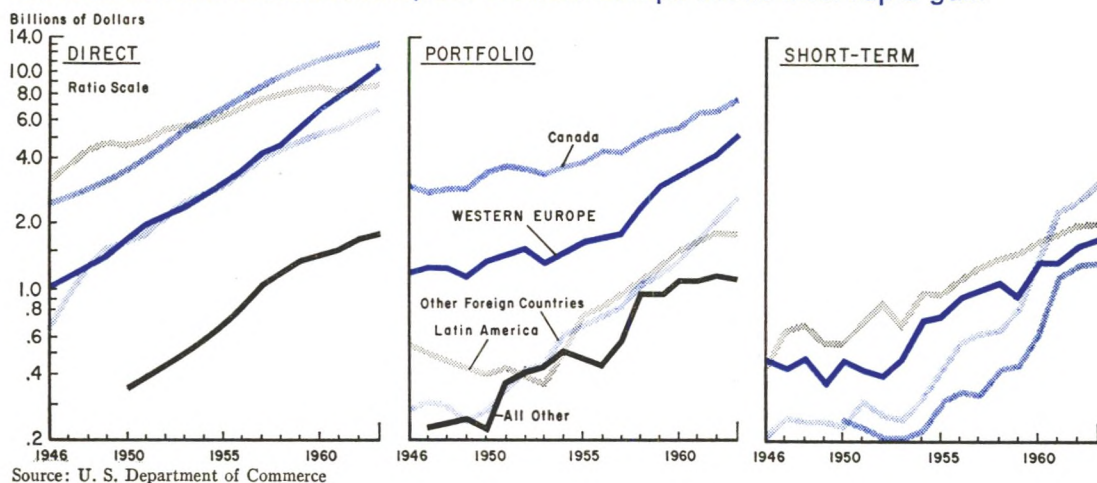
portance: Direct investments have accounted for a declining share of the total since 1957, portfolio investments have constituted a decreasing share despite the recent upswing in new issues, while short-term investments have been growing in importance over the past decade.

Where are our investments?

Canada has been the major outlet for the funds of private U. S. investors throughout the postwar period, followed by Western Europe (since 1961), "other foreign countries," and Latin America. Private investments in "other foreign countries" exceeded investments in Latin America in 1963 for the first time. Relative rankings, however, fail to indicate the changes that have occurred in the relative importance of these areas as magnets for privately held American dollars. Investments in Latin America, and in Canada to a lesser extent, have shown a tendency to level off. On the other hand, American investor interest in Western Europe and in countries such as Japan and some of the British Commonwealth countries has grown apace, both relatively and in dollar terms.

A somewhat different picture of geographical dispersion arises, however, when the major investment categories are considered separately. Canada accounts for the largest share of direct and portfolio investments overseas because of that nation's relative freedom from exchange restrictions, its close economic ties with the United States, and its abundance of natural resources. But investment in Western Europe in these two categories has been rising at a rate that bids fair to equal the Canadian performance. All types of private investments in "other foreign countries" also have increased rapidly, partly as a result of increased acceptance financing by Japan and the widespread easing of restrictions on capital transactions. Meanwhile, direct and short-term in-

**Importance of each type of investment varies by geographical area . . .
Canada remains overall leader, but Western Europe shows most rapid gain**



vestments in Latin America have tended to lag behind the growth of investments in other areas.

The geographic distribution of private investments abroad, their nature, and their relative rates of growth are of particular significance in assessing the present impact and probable future trend of private capital exports from the United States. Investments in a vigorously expanding area, compared with those made elsewhere, may produce a larger return flow of funds, although the possibility of more attractive yields or more favorable opportunities for capital appreciation of financial asset holdings in such an area may operate in the opposite direction to attract more capital from the United States. Investments in a developing country may have a smaller adverse balance of payments effect than investments in a highly industrialized country because a larger proportion of the American capital outflow may be matched by American merchandise exports. Countries carrying heavy external debt burdens and experiencing payments difficulties, on the other hand, may be unable to meet their foreign financial obligations as they fall due; the result may be involuntary extension or renewal of credits by

U. S. investors, with accompanying adverse effects on our balance of payments.

Why invest abroad?

The phenomenal growth of U. S. private foreign investments has been linked with the postwar development of the American dollar as the dominant international currency, the abundance of savings in the United States, and the expansion of international trade. The gradual freeing of international payments as foreign economies recovered from the war also helped to stimulate private capital exports by providing a favorable investment climate. The relaxation of exchange restrictions—particularly the restoration of convertibility for the major European currencies at the end of 1958—encouraged Americans to invest abroad and gave foreigners progressively greater leeway to arrange external financing. But since various economic and political disturbances had deterred American venture capital from moving abroad for more than two decades, some of these postwar capital exports—especially direct investments and new foreign security issues in the United States—might be considered as part of a “catching up” phase. Once such pent-up for-

eign demand for investment funds is satisfied and the accumulated backlog of desirable investments worked off, some of the pressure to export capital from the United States could moderate.

Part of the postwar expansion of investment activity overseas thus can be attributed to the emergence of a propitious economic environment. However, a number of other factors — both of general applicability and of a more special nature — also encouraged American private capital exports. High economic growth rates abroad, especially in relation to the United States, helped attract American capital. Production under favorable wage, cost, and price conditions, particularly in the more advanced industrial countries, oftentimes permitted American companies to operate more profitably from foreign plants, while in many instances the establishment of facilities abroad gave these firms access to the European Common Market and other protected markets as well as a share in the gains from expanding national incomes. The prospects for capital appreciation of financial assets and for higher yields in prospering countries provided inducements for portfolio investments.

Another stimulus to American direct investments abroad has been the need to develop foreign sources of supply for industrial materials not available in the United States or available only in inadequate volume—or in order to take advantage of lower production costs. The petroleum and mining industries are prime examples of this type of investment.

At the same time, the easing of capital restrictions abroad has opened up additional investment outlets for American investors, permitting greater diversification of portfolios and oftentimes higher average yields. For example, some corporate treasurers—particularly those of the larger American firms with extensive overseas operations — now weigh the relative yield advantages and risks of for-

eign as well as domestic money market instruments in managing their cash position.

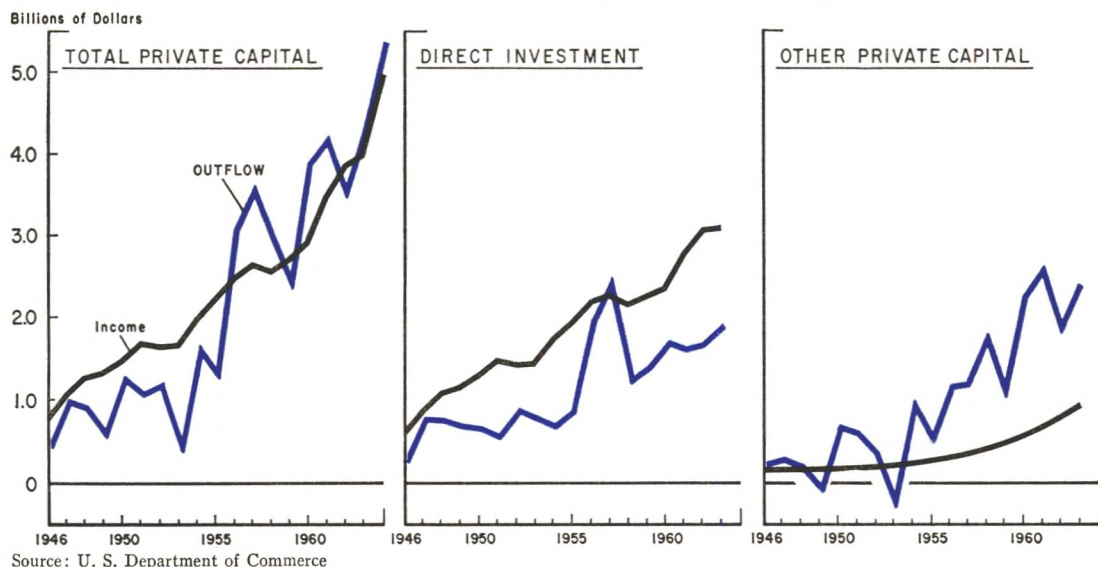
The initiative, however, has not always come from the American investor; foreigners in turn have come to this country to seek funds. The upsurge in foreign security offerings in the United States has been motivated primarily by the greater depth and breadth of the U. S. capital market and by its unrestricted access in comparison to capital markets abroad.

The cost of borrowing has been a less important consideration for foreign borrowers as a whole. The cost of long-term financing in the United States, for example, has seldom been a barrier to foreign security flotations. Interest rate differentials, however, occasionally have been significant for certain types of financing and are probably important to the timing of some individual offerings.

Several temporary factors have operated in varying degree over the postwar period to increase the outflow of private U. S. capital. Fluctuations in international confidence in the dollar have brought about capital movements to and from the United States, while anticipated revaluations of strong currencies — such as the German mark—have been responsible for substantial shifting of funds. Political and economic uncertainties have influenced capital flows. Balance of payments difficulties abroad have been reflected in the extension of international assistance in the form of private credits from the United States, particularly to the Latin American countries, Japan, and the Philippines. Relatively easy credit conditions in this country also may have played some part in the rising volume of bank credits to foreigners in the past year or two.

Several more permanent factors have also helped step up the volume of private capital outflow. These have included the development of the Euro-dollar market, the establish-

**Income from investments abroad matches private capital exports . . .
income on direct investments accounts for major share of receipts**



ment of an American system of export-credit insurance, and increasing private participation in United States Export-Import Bank and World Bank loans.

Are our investments profitable?

American private investments overseas have been profitable in the aggregate, notwithstanding losses incurred in individual projects or through expropriation. In the 18 years from 1946 through 1963, income from private capital investments abroad has totaled almost \$40 billion, or \$2.5 billion more than private capital exports. For direct investments alone, the gross income remitted by branches and affiliates of American companies abroad has totaled some \$33 billion, almost \$13 billion more than the dollar volume of funds placed abroad in these enterprises by American investors.

Naturally, there is wide variation in the rates of return on different types of investment. The returns from direct investment in manufacturing, for example, generally tend to be lower than the returns from petroleum

and mining. Consequently, the rate of return on direct investments in Europe and Canada tends to be lower than in other areas where manufacturing is less important. According to a Treasury Department study covering the 1953-60 period, petroleum investments in Latin America and the developing countries earned a 24-percent rate of return compared with a 13-percent rate of return on manufacturing investments in Canada and Western Europe. (The Study was prepared for Senate Finance Committee hearings on the Revenue Act of 1962.)

For portfolio investments, the return has been estimated at around 6 to 7 percent, but it has varied in accordance with economic conditions abroad and also in accordance with the degree of risk involved. For short-term foreign investments under conditions of currency convertibility, yield variations on different money market assets have reflected differences in the domestic credit situation in the borrowing and lending countries and conditions in the foreign exchange markets. As currency convertibility became more wide-

spread and capital transactions liberalized during recent years, the spread between short rates here and abroad tended to narrow, par-

ticularly with the assistance of the growing facilities of the Euro-dollar market.

II. The Effects

Because the dollar income from private investments abroad has exceeded private capital exports in most postwar years, private capital exports are assumed to be of net benefit to our balance of payments position. But, when the payments accounts are examined more closely, it becomes clear that private capital exports can have an adverse effect on the payments balance in the short run. Thus, a sharp increase in foreign security flotations from \$1.1 billion in 1962 to almost a \$2.0 billion annual rate in the first half of 1963 contributed substantially to a deterioration in our payments deficit on regular transactions—from \$3.5 billion in 1962 to \$4.7 billion in the first half of 1963. (All data are seasonally adjusted annual rates.) The outflow of dollars to foreigners through this source does not necessarily measure the true net drain on our payments balance over the longer run; the dollar proceeds eventually might be respent in the United States. The balance of payments impact of private capital outflows therefore has both a short- and a long-run aspect.

Over an extended period of time, the transfer of capital should take the form of a real transfer of goods and services, but the transfer mechanism may work imperfectly. In certain types of private investment, the connection between the capital export and a rise in the current account surplus is direct and immediate, as the dollars are spent in the United States for goods and services. In other cases, the dollars may be spent in a third country and/or added to international reserves, in which case the real transfer is delayed or short-circuited. This can occur, for example, when the desired goods and services are not

obtainable from the capital-exporting country or are not competitively priced, or when a foreign country acquiring dollars desires to build its reserves to a higher level.

Impact of direct investments

To the extent that direct investments are transferred abroad in the form of American goods and services—and to the extent that they generate current investment income within the accounting period—the adverse impact on our payments balance is minimized. However, offsetting flows can develop in the form of increased imports from foreign subsidiaries or increased sales by subsidiaries abroad which displace direct exports.

The type of direct investment and the country or geographical area within which the investment is made also influence the balance of payments impact. Direct investments requiring the kinds of goods in which this country holds a technological advantage tend to create the strongest demand for U. S. exports; thus, investment in resource development and in technologically backward countries tends to create a strong demand for American goods and services. The Treasury Department study cited earlier estimated that \$1 invested in manufacturing in Europe and Canada generated net exports of only 4 cents a year, not including possible market displacement. The same dollar invested in Latin America, on the other hand, resulted in net exports of about 40 cents because of Latin America's greater dependence on the United States as a source of supply.

The method by which the investment is financed also affects the balance of payments impact of the capital export. Funds supplied

from the United States result in a recorded drain on our payments position, while reinvestment of earnings does not—under current reporting procedures.¹ If financing is arranged abroad, no capital moves out from the United States. Thus, by financing abroad more of our direct investments, the immediate impact on our payments position can be reduced. A recent Department of Commerce study indicates that U. S. funds in the past two years have financed a declining share of total direct investments abroad, particularly in Canada and Latin America. Funds from the United States for direct investments in Europe and in “all other areas,” however, show a rising trend.

From the viewpoint of the balance of payments impact, the fact that income from direct investments has substantially exceeded the outflow into direct investments should not be accepted without qualification. In the first place, there are marked differences in the relation of income to outflows among geographical areas. Income has surpassed outflows in most postwar years only for Latin America and “all other areas”; only occasionally for Europe; and even less frequently for Canada. Direct investment in Europe has been consistently larger than income from these investments since 1959.

In the second place, it is erroneous in this context to relate total income on investments in any one period with the private capital outflow within that same period. The balance of payments impact of any single investment should be measured in terms of the income (as well as exports and imports of goods and services) derived only from that investment—and not in terms of the income from other unrelated current and past investments. When income flows from both current and past investments are lumped together, the actual

dollar drain from any single investment is masked by income flows from earlier and possibly more profitable investment activity.

Over the longer run, of course, the earnings generated by any single investment will eventually equal and then surpass the original investment, assuming a profitable venture. Based on the average rates of return mentioned above, an initial investment in petroleum facilities could be recouped in about 5 years and for manufacturing facilities in about 8 years. But if the direct investments are in a continuously rising stream—as they have been in the postwar period—the net receipts would match the initial investment outflow only after a much longer period of time. On the basis of a 5 to 10 percent annual rate of increase in direct investments in Canada and Europe, it has been estimated that 10 to 15 years would be required for net receipts to match investments. Thus, if U. S. direct investments in the Common Market countries continued to rise, there would be no *net* contribution to our payments receipts before the early 1970's.

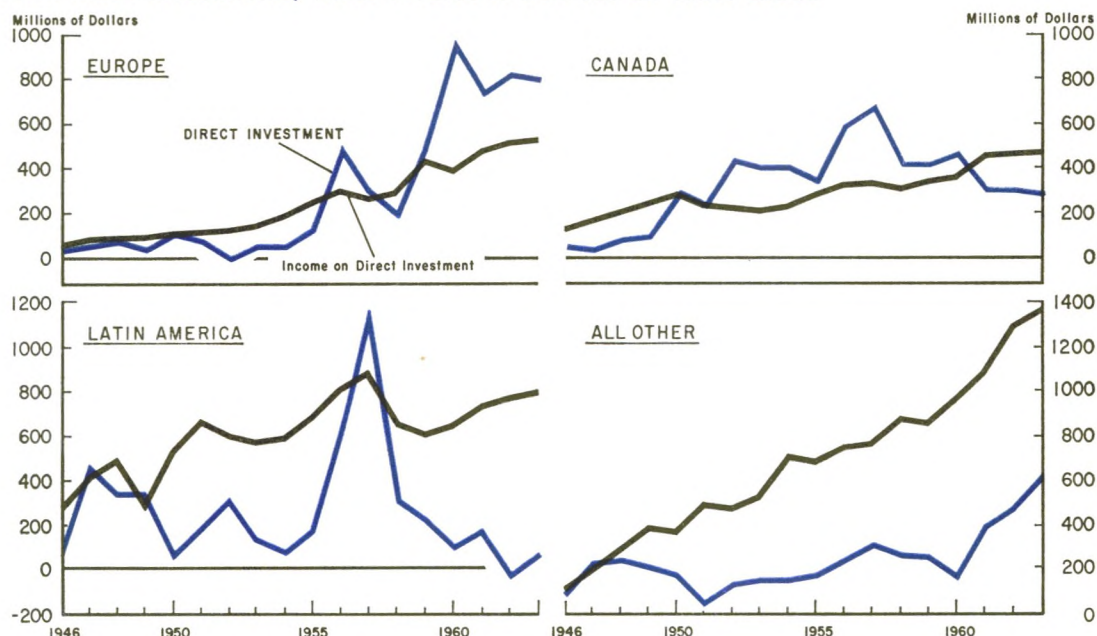
Impact of portfolio investments

Dollars transferred to foreigners through portfolio investments are less likely to result in expenditures in the United States than are the dollars transferred through direct investments, except for bank and trade credits used to finance exports from this country. Yet, if new foreign security issues offered in the U. S. capital market or portions of bank loans are sold to foreigners, the dollar drain is minimized. If the proceeds accrue to countries that tend to spend rather than accumulate dollars—such as the developing countries that traditionally obtain most of their imports from the United States—the adverse impact also tends to be weakened.

Income from portfolio investments abroad apparently has been smaller than capital outflows into portfolio investment ever since

¹Sometimes, however, earnings are reinvested in a U.S.-controlled company abroad rather than remitted to the parent company because of a tax advantage. The existence of such differential tax treatment worsens our payments deficit by discouraging the transfer of funds back to the United States.

Direct investments in Europe now exceed income
from these investments, while reverse is true for all other areas



Source: U. S. Department of Commerce

1956, despite a steady growth in earnings from this source.¹ Estimates placing the average return on such investments at 6 to 7 percent would mean that an initial investment would not be recovered until about 15 years later. If the outflow of new capital into portfolio investment exceeds the 6 to 7 percent rate of return, receipts of interest and dividend income will never equal the capital outflow. The gap between other private capital exports and income from other than direct investments has widened in the past several years for Western Europe and for "other foreign countries" and is significantly larger than income flows derived from these investments for all areas combined.

Short-term capital exports, particularly bank credits, also widen our payments deficit as defined by the Department of Commerce, despite such lesser benefits as increased inter-

est receipts from abroad and increased business stemming from this nation's position as the leading international banker and trading nation. Exports of goods and services financed by U. S. short-term credits are obviously beneficial, although less advantageous from the standpoint of our payments balance than when the same transactions are financed abroad. Financing of trade and service transactions between other foreign countries, which is of growing importance because of the dollar's role as the leading international currency, probably is of least direct benefit to our payments balance.

Notwithstanding the immediate drain on our payments position caused by capital outflows larger than receipts, short-term loans (if not repeatedly renewed) tend to have a less adverse impact on our payments deficit and on our international reserve position than do longer term capital exports, because of the quicker feedback in the form of debt-service

¹ Income from portfolio investments is not separable from income from short-term investments in the balance of payments statistics and thus the two categories must be treated together.

payments. Other types of nonbank short-term claims on foreigners not matched by exports, such as the purchase of foreign money market assets, do tend, however, to increase our payments gap by adding to the dollar holdings of foreigners.

Other benefits and costs

U. S. private capital exports benefit both the United States and the international community. These capital exports help to strengthen the economies of the less developed countries by supplementing domestic capital resources, by providing the means to obtain the technological know-how and physical capital essential to economic development or diversification, and by supplying other services. These investments have helped to increase foreign exchange earnings by expanding the host country's export capacity or to conserve foreign exchange by replacing imports.

The consequent improvement in national income and output redounds to the benefit of the industrial countries through expanded trade and reduced military and economic assistance. Because U. S. direct investments tend to fluctuate over a business cycle, however, the capital-importing country may be subjected to sharp variations in the rate of foreign investment. Primary producing countries, for example, are particularly vulnerable during a recession because declining demand for their exports from industrial countries

may be accompanied by a cutback in capital inflow from abroad.

International capital flows, in addition, are an essential element in the mechanism of international adjustment; they help to finance temporary payments deficits, and they assist in mobilizing capital resources and in transferring them from areas of plentiful supply to areas of short supply. But private international investment carries both benefits and responsibilities. From the viewpoint of less-developed recipient countries, a steady flow of funds from the capital-exporting country is more desirable than larger, erratic flows.

Nonetheless, while U. S. private foreign investments may be both profitable and beneficial in other ways, they may also have adverse effects on this country's domestic economy. More attractive earning opportunities abroad may lure capital out of the country and create a stringency of funds to meet domestic requirements. Direct investments abroad, not surprisingly, exert less stimulation on American employment and incomes than does a similar volume of investment at home, because only a small portion of every dollar invested abroad is respent in this country. But, despite the greater overall expansionary effect of a dollar spent in this country, an individual firm still might prefer to invest abroad because of locational or supply advantages.

III. The Implications

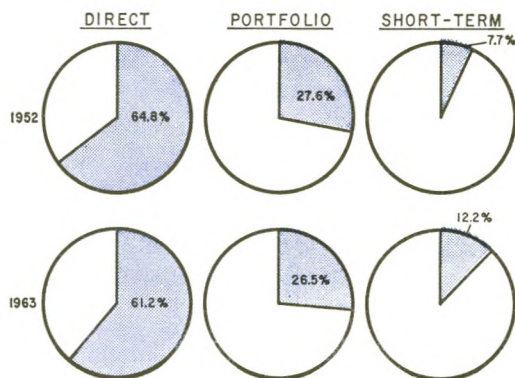
Over the longer run, U. S. private capital exports have contributed significantly to the strengthening of our international investment position, from a mere \$14 billion of overseas assets in 1946 to more than \$66 billion in 1963. Nevertheless, over even a fairly long period, the export of private capital by any country clearly can create a net drain on its balance of payments position in the sense that the aggregate of current private capital exports is much larger than receipts derived directly and indirectly in the same period from these exports. Offsetting inflows of investment income reflect largely payments of interest and dividends on past investments. The fact that money outflows are not matched simultaneously by the real transfer of goods and services can be ascribed partly to imperfections in the transfer mechanism (such as institutional and trade barriers) and partly to a weakening of an exporting country's competitive position. A net drain also may be due just to the time lag involved in receiving the full benefits of any investment.

Reasons for the drain

Shifts in the composition and direction of U. S. private capital exports have tended in recent years to increase the current drain of these exports on our balance of payments position. Income on private investments, moreover, has been rising more slowly than private capital investments abroad since the end of 1955, with the gap widening particularly for portfolio and short-term investments.

Even though income on direct investments has exceeded the annual outflow of U. S. direct investments abroad by substantial amounts ever since 1958, the excess stems mainly from previous investments in Latin America and in "all other countries." Direct investment outflows are larger than current income receipts in Western Europe, the area where our

Short-term investments grow relatively faster than other types



Source: U. S. Department of Commerce

investments have recently been expanding most rapidly.

Increased financing of U. S. direct investments abroad through funds obtained in the United States again has occurred mainly in connection with our rapidly expanding investments in Europe and "other areas" (principally Japan). Moreover, direct investments in manufacturing and in "miscellaneous" industries, which have a lower rate of return and thus constitute a more immediate drain on our payments position, have been increasing faster than other types of investment, such as investment in the extractive industries. In general, therefore, U. S. direct investments have been leveling off in those industries and areas that tend to produce the most favorable impact on our balance of payments — and they have been expanding most rapidly in industries and areas making the smallest contribution to our payments position currently in the form of either net exports or investment income.

At the same time, portfolio and short-term investments have been increasing in relative importance. These categories tend to be somewhat more interest-sensitive—and thus more

responsive to monetary policy actions—than direct investments, although they also tend to have a lower rate of return. As in the case of direct investments, the geographical distribution of income-and-outgo relationships for portfolio and short-term private capital outflows shows a large and growing gap for Western Europe and “other foreign countries,” the areas where our investments have been increasing the fastest.

Conflicting developments

The prospects for a reduction in the rate of private capital outflow from the United States are dampened by the U. S. dollar's pre-eminent position as a medium of international finance—a position achieved through the postwar emergence of the dollar as the leading international currency and through the generally higher level of international trade and payments. The removal of restrictions on the international mobility of capital also tends to increase the volume of funds moving between countries in response to changes in profit opportunities. Capital outflows may also be stimulated because of the American need to get behind tariff walls or to penetrate otherwise protected markets, and finally, because of the continuing strong demand for capital from both the industrial and developing countries.

On the other hand, a number of developments suggest some leveling off in private capital exports. A higher domestic growth rate and more attractive investment opportunities at home than abroad may tend to slow the outflow of funds from the United States. Recent relative price stability and favorable cost-productivity relationships should strengthen the competitive position of American suppliers and stimulate the purchase of goods and services in the United States by foreigners.

Back into balance

The proposal advanced by President Kennedy in July 1963 for an interest equalization tax succeeded in arresting the sharp upward trend in U. S. portfolio investments abroad, partly because of the uncertainties surrounding the specific provisions of the tax. Now there will probably be some recovery in new foreign security activity in the U. S. capital market. By increasing the cost to the foreign borrower or reducing the yield to the American investor, the tax is designed to discourage temporarily security flotations by the industrialized countries. Where ease of access to the market and ready availability of funds—rather than cost—are the major factors, however, the tax is less of a deterrent. Nevertheless, the proposal and its enactment signal our firm commitment to measures that will bring our international payments into balance with minimum interference with the free play of market forces.

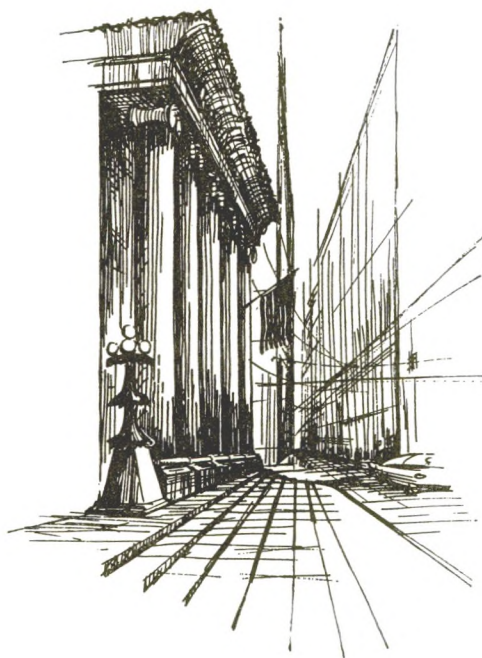
The lack of capital market facilities abroad comparable in breadth and depth to those in the United States—a factor in recent foreign borrowing—is a structural problem that will take time to solve. But there are encouraging signs of progress already in the industrialized countries: Capital transactions are being liberalized, alternative forms of capital financing are being developed, and freer foreign access to their capital markets is being granted. For some time to come, however, the United States will continue to be a leading source of private investment capital, since the development of efficient foreign capital markets is a slow process.

Private capital exports certainly do constitute an immediate net drain on the U. S. balance of payments. The fact must be recognized, but that does not imply that our balance of payments policy should necessarily be geared to private capital exports or that the determination of economic policy should be

subordinated solely to the requirements of our balance of payments. The longer term benefits of private capital exports for both the creditor and the debtor nations, as well as the broader goals of domestic and international economic policy, continue to be important considerations.

International capital flows are an essential element in the mechanism of international adjustment, with the American dollar playing a major part in fulfilling this function at the present time. Progress has been made toward

correcting international payments imbalances and checking undesirable capital flows through adjustments both in domestic economies and in international transactions. Once the basic adjustments are made, international flows of capital should be more consistent with overall payments balance. But, in view of the constant shifts in economic relationships, the process of adjustment must go on constantly to minimize possible conflicts between internal and external policies. The United States has been successful in working toward this goal—but progress is necessarily slow.



Changing Deposit Structure?

WESTERN banks frequently have been considered nonconformists by the rest of the banking fraternity. In addition to their widely publicized initiative in developing large-size branch systems, Twelfth District banks, historically, have been much more active than other banks in seeking savings and other time deposits and in acquiring mortgages. At the beginning of this decade, for example, District banks accounted for one-fifth of all time deposits and for one-fourth of all real estate loans at insured commercial banks, although they held only about one-seventh of the assets of those banks. In more recent years, however, major shifts have occurred in bank deposit flows and, as a result, the deposit and asset structure of banks outside the District has tended to swing in the direction of the long-prevailing District pattern. Consequently, District banks today might more appropriately be considered pacesetters rather than nonconformists.

What were the dimensions and characteristics of the deposit changes of the last three years? What were the effects of the deposit shifts on bank lending? on liquidity ratios? on profits? Moreover, what do these developments portend for the future trend of bank credit?

Time deposits crucial

Some light may be thrown on this subject by comparing the changes that occurred in the weekly reporting member bank series between June 1961 and June 1964—a period of strongly expanding business activity. District banks during that period increased their total time deposits by a substantial 38 percent, but other weekly reporting banks recorded a striking 69-percent gain and thus moved closer to a Western-style deposit structure.

the allocation of deposits between demand and time at District banks was strikingly different from the distribution elsewhere; just over one-half of District bank deposits were in the form of time and savings deposits, whereas such deposits constituted less than one-third of total deposits at other banks. This difference was historical, since District banks had consistently been more active than other banks in soliciting savings and other time deposits. (Prior to 1961, for example, some major banks outside the District would not accept corporate time deposits.)

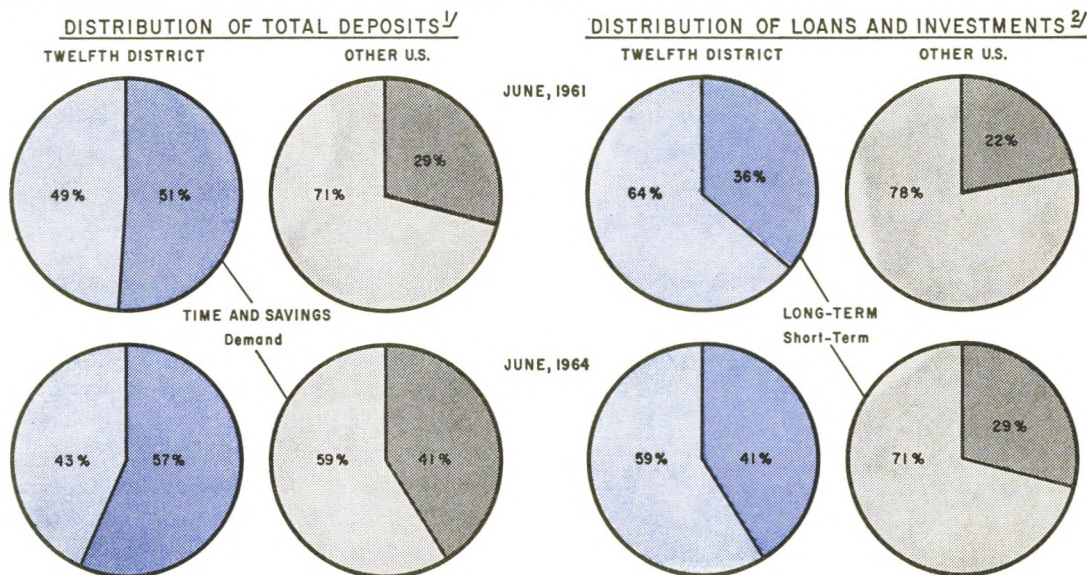
This difference was also crucial, because time deposits have certain characteristics that significantly affect bank investment decisions. Unlike demand deposits, savings and other time deposits are subject to interest payments. Therefore, as increases take place in total time deposits (including savings) or as increases occur in the effective rate of interest paid on such deposits, banks tend to allocate a greater proportion of their total investments to higher earning assets in order to cover the increased interest expense.

Then, in addition, savings and time deposits (particularly savings) generally are considered less volatile than demand deposits, and banks with a higher percentage of time deposits, therefore, expect to be subject to relatively less fluctuation in their total deposit base. Such institutions generally have held a larger proportion of their total loans and securities in higher-earning—though less liquid—long-term assets than banks with low ratios of time to total deposits. Not surprisingly, then, over one-third of total bank credit¹ at Twelfth District banks as of June 1961 was in real estate loans, U. S. Government securities maturing after 5 years, and

¹ Total loans (net of valuation reserves and less loans to domestic commercial banks) and securities.

Twelfth District pattern followed by banks elsewhere . . .

growth in time and savings deposits spurs growth in long-term assets



Notes: Long-term assets include real estate loans, U. S. Government securities (five years and over), and other securities. ¹ Less cash items in process of collection. ² Loans (net of valuation reserves and less loans to domestic commercial banks) and securities.

Sources: Federal Reserve Board; Federal Reserve Bank of San Francisco (weekly reporting member bank series)

"other" securities (mainly tax-exempt municipals) — assets which characteristically are longer term than other types of bank investments and which yield higher average rates of return. On that same date, however, banks outside the District held less than one-fourth of total bank credit in those categories.

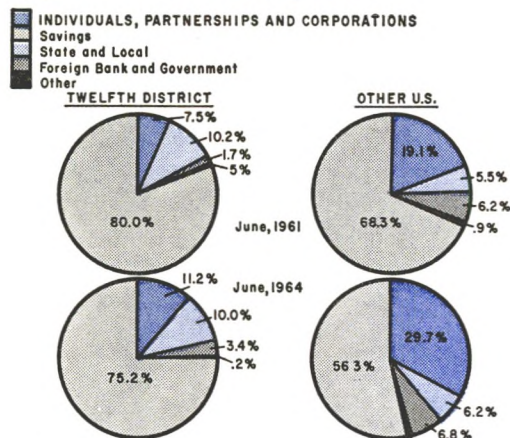
Tilt toward time categories

Now, how did these relationships change in the three years between June 1961 and June 1964? At weekly reporting member banks outside the District, total demand deposits increased only 2.5 percent in contrast to the District gain of 9.5 percent. Thus, at a time of expanding business activity with an attendant increase in demand for bank credit, these banks had to deal with a demand-deposit base that was only slowly expanding.

Consequently, since relatively high-earning investments were available to banks during this period, due to strength in demand for medium and long-term credit by households

and local governments, these banks began to show as much interest as District banks in attracting personal savings and idle corporate balances. Subject to the maximum ceilings of Federal Reserve Regulation Q, which were revised upward during this period, many banks increased the rate of interest on such deposits in order to meet competition for these funds from other sources. The success of their efforts was dramatically illustrated by the 69 percent increase in total time deposits recorded between June 1961 and June 1964. In comparison, the 38 percent District-bank increase appears almost modest. The rapid rate of expansion raised the non-District-bank ratio of total time deposits to total deposits from 29 to 41 percent. Although this percentage was still well below the District-bank ratio of 57 percent, the gap between the ratios for the two bank groups substantially narrowed over the three-year period.

Time-deposit structure altered by growth in I. P. C. deposits



Sources: Federal Reserve Board; Federal Reserve Bank of San Francisco (weekly reporting member bank series)

Over the three-year time span, both groups of banks recorded substantial gains in all time-deposit categories. Passbook savings increased at a slower rate than other categories, however, even though they accounted for more than half of total time deposits at non-District banks, and for three-fourths of the total at District banks at the end of the period. The fastest growth rate occurred in large-denomination negotiable time certificates of deposit, especially in other sections of the

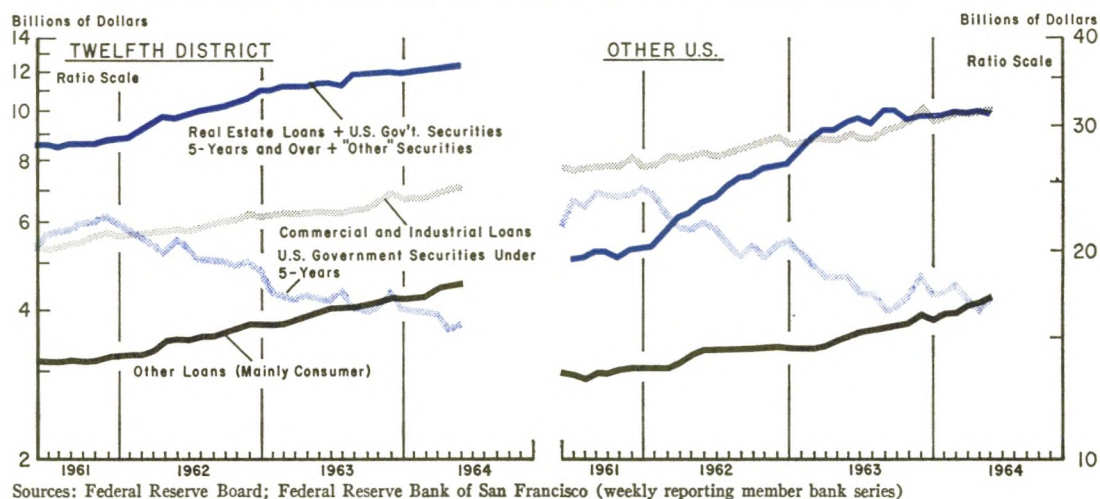
country. In June 1964, this potentially unstable deposit category accounted for almost 23 percent of total time deposits at non-District banks but for less than 7 percent of the total at District banks.

The rapid expansion in negotiable time certificates undoubtedly has been one of the most noteworthy banking developments of this decade. In 1961, a secondary market was established where large-denomination certificates could be traded when a certificate holder needed funds prior to maturity. The growth of this secondary market facilitated the acceptance of time CD's as a money market instrument and increased the attractiveness of this type of interest-bearing deposit among business firms, states and political subdivisions, foreign governments, and others. Revisions in Regulation Q in January 1961 and again in June 1963 increased the ceiling rates banks were permitted to pay on certificates with maturities of 90 days and over. In addition, effective October 1962, time certificates issued to foreign governments and central banks were exempted from rate ceilings for a period of three years.

These changes allowed banks to pay rates of interest that were competitive with yields on alternative forms of money market instru-

The analysis in this article is based on the weekly reporting member bank series, since this series presents detailed data on a current basis. This series includes banks in leading cities, and it thus reflects the behavior of the nation's major banks. In the Twelfth District, the series is highly representative of all District commercial banks; it accounts for a high percentage (80 percent) of their total assets and deposits, and it includes many banks which operate branch offices in "country" bank communities. Outside the District, the banks included in the series account for a smaller proportion of the banking universe (about 58 percent of assets and 53 percent of deposits), and they do not reflect "country" bank patterns to the same extent as in the District. Nevertheless, the comparison of District and other weekly reporting member banks does show the regional differences and similarities in the operation of the nation's major banks, and the comparison also reflects, in general, the trends followed by all commercial banks.

**Long-term assets show strongest gains, especially at non-District banks . . .
business and consumer loans rise, but short-term Governments decline**



ments. Time CD's are highly sensitive to rate changes in the money market and, in addition, their volume is subject to fairly wide fluctuations, particularly over corporate dividend and tax payment dates. Individual banks, therefore, must be prepared at any time to adjust their assets to balance possible deposit losses.

Asset side of ledger

The time-deposit shift, and especially the shift toward time CD's, has significantly affected the asset side of the ledger for banks throughout the nation. In particular, the large volume of time CD's held by non-District weekly reporting member banks has deterred them from achieving a high ratio of long-term assets (particularly real estate loans) to time deposits. This development has been most pronounced in the large money market centers, where the CD volume has been concentrated. Not surprisingly, then, the ratio of real estate loans to total time deposits for these banks, although rising in recent years, has remained below the District-bank ratio. (The comparative figures in June 1964 were 25 and 42 percent, respectively—and a wide differ-

ential was also evident for the ratio of real estate loans to savings deposits.) The higher ratio for District banks probably reflects a more aggressive policy in seeking mortgage loans, as well as a proportionately stronger demand for mortgage financing in the fast-growing Western states, but it undoubtedly also reflects the lesser reliance of District banks on the potentially unstable CD category of deposits.

The performance has been somewhat different in the field of municipal securities. During the three-year period, both groups of banks channeled funds into such securities to gain higher after-tax yields, but the rate of expansion was far greater at banks outside the District. By June 1964, over one-half of their long-term earning assets were in municipals and non-Federally guaranteed securities, as compared with less than one-third at District banks.

Relatively strong demand for consumer credit, particularly to finance record purchases of automobiles, stimulated broader bank participation in the consumer-loan area and, at the same time, reinforced bank efforts

to attract time deposits. Both groups of banks turned increasingly to consumer loans during the three-year period, and, as in the case of high-earning mortgage loans, the relatively high average rate of return on consumer loans helped banks to cover steeply rising interest costs. Outstandings in the "other loans" (mainly consumer) category rose 43 percent at District banks and by 30 percent elsewhere. At both groups of banks consumer-loan growth substantially exceeded the rate of growth in business loans.

Squeeze on liquidity

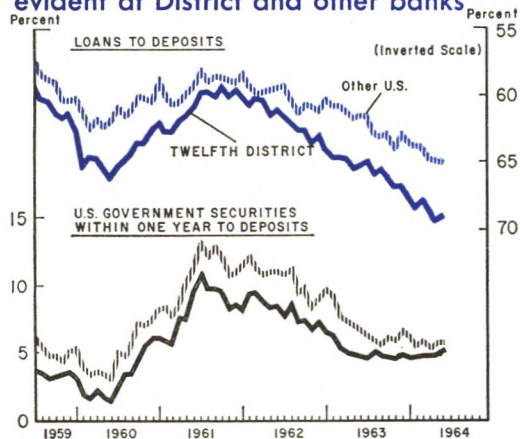
In addition to altering the earning-asset structure of banks, the rapid time-deposit increase has strongly affected bank liquidity—that is, the ratios of liquid assets and of loans to deposits. Bankers have been induced to operate with a lower level of liquidity, partly because of the relative stability of the savings component of time deposits, and partly because of a reserve-requirement effect. The reserves which member banks are required to hold against savings and other time deposits are substantially less than the reserves they are required to hold against demand deposits—currently 4 percent vs. 12 percent (for country banks) and 16½ percent (for Re-

serve city banks). For this reason, a given amount of time deposits provides a bank with more excess reserves than an equivalent amount of demand deposits and, therefore, provides a potentially larger base for loan expansion.

Whatever the reasons, a reduced margin of liquidity has been apparent in a recent rise in loan-deposit ratios. At District banks, the highest loan-deposit ratio—66 percent—reached in the 1958-60 business expansion was attained again in August 1963, but the ratio then rose to 68 percent in June 1964. Similarly, at weekly reporting member banks elsewhere, the 63-percent peak reached in the last cyclical expansion was exceeded by the 65-percent figure recorded in June of this year.

Other measures have also shown a tightening liquidity situation but not to the extent demonstrated in the last business cycle. So far, neither the ratio of short-term (under one year) U. S. Government securities to total deposits, nor the ratio of liquid assets to total deposits,¹ has fallen so low as during the 1958-60 period. This development reflects the fact that the present business expansion has been marked by a relatively easier monetary policy than existed in the previous cyclical upswing, and this policy, in turn, reflects the relative lack of inflationary pressures during the current expansion. Consequently, banks have been under relatively less reserve pressure and, therefore, have not had to draw down their short-term security holdings or other liquid assets to meet loan demand to the extent that they did during the last business expansion.

Reduced margin of liquidity evident at District and other banks



Sources: Federal Reserve Board; Federal Reserve Bank of San Francisco (weekly reporting member bank series)

Squeeze on profit margins

During the 1961-64 period, the deposit shift was also vitally important to bank prof-

¹ The numerator of the liquid assets-deposit ratio includes vault cash, balances with domestic banks, loans to banks, loans to brokers and dealers, and Government securities maturing within one year, less borrowings. The denominator includes total deposits, less cash items in process of collection and reserves held at the Federal Reserve Banks.

TIME AND SAVINGS DEPOSITS AT WEEKLY REPORTING MEMBER BANKS

	Net Change June 1961 - June 1964				Twelfth District as a Percent of All Weekly Reporting Member Banks	
	Twelfth District Banks		Banks Outside of Twelfth District			
	Dollars (in millions)	Percent	Dollars (in millions)	Percent	June 1961	June 1964
Total Time and Savings Deposits	+4,913	+ 38	+26,931	+ 69	32.2	28.0
Savings	+3,073	+ 30	+18,397	+ 39	35.7	34.2
Individuals, Partnerships, and Corporations	+1,019	+106	+ 5,141	+163	15.7	12.8
State and Local	+ 468	+ 36	+ 1,491	+ 89	46.7	38.6
Foreign Bank and Government	+ 374	+172	+ 1,656	+ 86	11.6	16.1

its. Increased interest expense — both from higher absolute rates of interest paid on time deposits and from a greater proportion of total deposits in the form of savings deposits and time certificates—was indeed a pivotal factor in the profit picture of this period. Because of this depressive factor, net operating earnings of all member banks in 1961 declined 4 percent below the 1960 level, and in 1962 fell about one percent more. Finally, in 1963, member banks showed a healthy year-to-year gain of over 4 percent. Thus, approximately three years passed before an increase in earning assets and a shift to loans and securities with higher rates of return could offset the sharp rise in bank expenses. By 1963, interest costs on time deposits replaced wage and salary payments as the largest single item of expense.

The rise in interest costs affected District member-bank profits even more, not only because of their proportionately larger volume of such deposits but also because of their higher average interest payments. In 1961, District net operating earnings declined 5 percent from the preceding year's level, and in 1962 they dropped another 3 percent. A turn-around occurred in 1963, however, with net operating earnings up over 9 percent from the preceding year. This recent achievement is especially striking in view of the fact that interest costs on time deposits by

1963 accounted for 41 percent of District banks' total expenses — compared with 35 percent elsewhere.

Implications of shift

Now, what do these structural developments portend for the future trend of bank credit? Assuming no major reversal of current deposit flows, both Twelfth District banks and other banks may well experience a further weighting of their deposit structure toward time-deposit categories. This trend, however, should be less pronounced at District banks than elsewhere. For one reason, time deposits already constitute over one-half of all District bank deposits, so a larger absolute increase in such deposits is necessary to bring about a percentage change equivalent to that at those banks which have a smaller proportion in time categories.

In the first six months of 1964, the rate of growth in *savings* deposits dropped substantially below the record rates of 1962 and 1963. Consequently, even if total *time* deposits continue to rise, the shift toward long-term earning assets, particularly mortgages, may abate somewhat at both bank groups. The considerably lower ratio of real estate loans to savings at non-District banks, however, may give these banks more leeway than District banks in adding to their mortgage portfolios at a time of reduced savings flow.

CD's present a challenge

Now that negotiable time CD's account for a significant, and increasing, proportion of total time deposits, banks face some new problems. The CD category's portion of their deposits—and, therefore, part of their reserves—has become increasingly sensitive to movements of money market rates. Since upward pressure on rates usually occurs at a time of accelerated economic activity, banks face the possibility of a loss of time deposits when demand for bank credit is rising. A reduction in CD's could occur if the rate banks pay on CD's becomes noncompetitive with other money market rates, either because of the maximum ceilings imposed by Regulation Q or because of banks' unwillingness to meet higher rates. At the same time, a substantial increase in capital expenditures or inventories could reduce corporate liquidity and result in a reduction in corporate demand for CD's.

For an individual bank a reduction in CD's could mean an absolute reduction in deposits—unless these funds were redeposited in the same bank as checking account balances. Even then the bank would have to obtain additional reserves, because the reserve requirements against demand deposits are much higher than those against time deposits.

To moderate the effect of such a deposit loss on their asset structure, banks must carefully schedule the maturities of their large-denomination time CD's. In addition, they are under pressure to maintain their liquid asset ratios at higher levels than might appear necessary on the basis of their time to total deposit ratios. As a consequence, holdings of both short-term securities and short-term loans, particularly at money market banks, may not be reduced too far below current levels in the near future.

The savings deposit component in the last few years has also become more responsive to

interest rates. This has been evidenced by shifts in savings flows among competing institutions following changes in rate differentials. Commercial banks have continued to attract savings even though paying lower rates of interest, but savings growth has varied widely, depending to a considerable extent upon the differential in each area between bank rates and the rates paid by savings and loan associations and mutual savings banks.

Successful shift?

In summary, District banks and banks elsewhere both experienced several basic changes in deposit structure between June 1961 and June 1964: 1) A substantial increase in the proportion of time to total deposits, and 2) a smaller share of total time deposits in the form of passbook savings. And, since time deposits have tended in the past to be less volatile than demand deposits, loan and investment portfolios in 1964 were more heavily weighted toward long-term assets than was the case in 1961. At banks outside the District, a 61-percent increase in the total of holdings of real estate loans, U. S. Government securities with maturities over 5 years, and municipals and Federal Agency securities pushed up the ratio of these long-term assets to total loans and investments.

Overall, banks have successfully met the challenge of a changing deposit structure. Through flexible handling of their loan and securities portfolios, banks have offset steeply rising expenses; in fact, judging from the evidence to date, they have been so successful at this that they may well attain record profits in 1964. What seems certain, at any rate, is that the rest of the nation has now followed the Western lead and adapted to the new structure. But only time will tell whether this is a permanent shift or simply a passing phase of this cyclical expansion.

Western Digest

Banking Developments

Since mid-year the performance of weekly reporting member banks in the Twelfth District has reflected the generally expanding pace of economic activity. Total bank credit increased by \$29 million in July and by \$50 million more in August—in contrast to a net decline of \$112 million in the corresponding months of 1963. Most of the gain since June was in loan portfolios, as banks reduced their holdings of U. S. Government securities to meet loan demand. . . . Business demand for bank credit (particularly from food and liquor processors and retail firms) strengthened in August, for a net monthly gain of \$166 million in business loans. This gain far offset a small decline in July. Banks added to their mortgage holdings in both July and August, but at a slower rate than in 1963. . . .

Despite an August decline, demand deposits adjusted recorded a net increase of \$177 million since June. Total time deposits rose \$169 million in the two-month period, despite substantial seasonal withdrawals by states and political subdivisions. Savings deposits in both months registered increases exceeding the year-ago gains—in contrast to the trend prevailing throughout most of the first half of 1964.

Production Developments

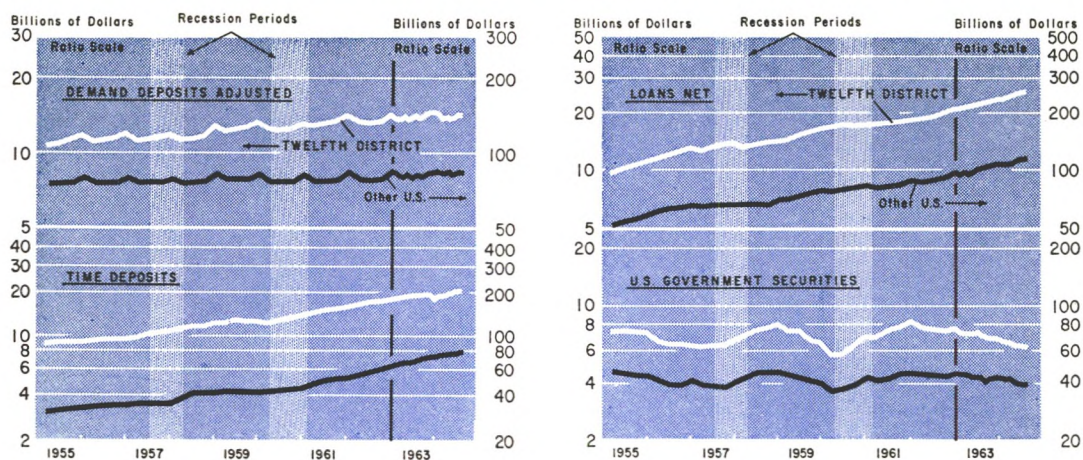
Steel production during August registered smaller gains in the District than in the nation. Even so, District production at month-end was 123 percent of the 1957-59 average—31 percent higher than a year ago. . . . Crop production prospects in the District improved during August, as compared with a 2-percent decline nationally. Frost damage reduced the production forecast for the District's fall potato crop. Nevertheless, if current prospects for other products are realized, District farmers will harvest a record crop volume in 1964. . . . Fat cattle prices edged up to year-ago levels in early September. However, the price of animals moving into feed lots continues considerably below last year's prices. Financial losses experienced by cattle feeders during the year-long price decline have discouraged a resurgence of cattle feeding activity. On September 1, there were about 10 percent fewer cattle in the feed lots of California and Arizona than a year ago.

Employment and Unemployment

In California and Washington, total employment declined slightly from July to August, on a seasonally adjusted basis. Both agricultural and nonagricultural employment shared in the decline. . . . The California unemployment rate rose from 6.0 percent in July to 6.2 percent in August, while the Washington rate declined slightly from 6.4 to 6.3 percent in the same period. Meanwhile, the jobless rate for the nation as a whole rose to 5.1 percent in August from July's 4.9-percent rate—the lowest figure for the year. Defense employment in California continued its downward trend, but in Washington defense employment gained slightly in August.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Condition Items of All Member Banks — Twelfth District and Other U. S.



Source: Federal Reserve Bank of San Francisco. (End-of-quarter data shown through 1962, and end-of-month data thereafter; data not adjusted for seasonal variation.)

BANKING AND CREDIT STATISTICS AND BUSINESS INDEXES—TWELFTH DISTRICT¹

(Indexes: 1957-1959 = 100. Dollar amounts in millions of dollars)

Year and Month	Condition items of all member banks ² Seasonally Adjusted				Bank debits Index 31 cities ^{5, 6}	Bank rates on short-term business loans ^{7, 8}	Total nonagri- cultural employ- ment	Dep't. store sales (value) ⁶	Industrial production (physical volume) ⁶		
	Loans and discounts ³	U.S. Gov't. securities	Demand deposits adjusted ⁴	Total time deposits					Lumber	Refined ⁸ Petroleum	Steel ⁸
1951	7,751	6,370	9,512	6,713	57	3.66	80	68	99	87	97
1952	8,703	6,468	10,052	7,498	59	3.95	84	73	101	90	92
1953	9,090	6,577	10,129	7,978	69	4.14	86	74	102	95	105
1954	9,264	7,833	10,194	8,680	71	4.09	85	74	101	92	85
1955	10,827	7,162	11,408	9,130	80	4.10	90	82	107	96	102
1956	12,295	6,295	11,580	9,413	88	4.50	95	91	104	100	109
1957	12,845	6,468	11,351	10,572	94	4.97	98	93	93	103	114
1958	13,441	7,870	12,460	12,099	96	4.88	98	98	98	96	94
1959	15,908	6,495	12,811	12,465	109	5.36	104	109	99	101	92
1960	16,628	6,764	12,486	13,047	117	5.62	106	110	98	104	102
1961	17,839	8,002	13,676	15,146	125	5.46	108	115	95	108	111
1962	20,344	7,336	13,836	17,144	141	5.50	113	123	98	111	100
1963	22,915	6,651	14,179	18,942	157	...	117	129	102	112	117
1963											
August	21,890	6,958	13,990	18,334	162	...	117	132	102	116	105
September	22,236	6,968	14,102	18,409	166	5.47	117	125	105	113	105
October	22,387	6,698	14,106	18,727	167	...	118	127	108	112	104p
November	22,673	6,730	14,272	18,923	170	...	118	130	106	110	114p
December	22,915	6,651	14,179	18,942	167	5.47	118	136	111	110	112p
1964											
January	23,256	6,575	14,332	19,342	163	...	119	135	115	111	116p
February	23,544	6,832	14,222	19,520	168	...	119	137	114	115	123p
March	23,763	6,893	14,287	19,685	166	5.47	119	133	114	113	136p
April	23,953	6,559	14,243	19,773	170	...	119	134	101	111	143p
May	24,102	6,541	14,170	19,813	167	...	119	139	105	112	142p
June	24,394	6,489	14,347	19,876	167	5.46	119	137	...	114	131p
July	24,836p	6,215p	14,369p	20,152p	166	...	119p	141	121p
August	24,865	6,170	14,362	20,195	175

¹ Adjusted for seasonal variation, except where indicated. Except for banking and credit and department store statistics, all indexes are based upon data from outside sources, as follows: lumber, National Lumber Manufacturers' Association, West Coast Lumberman's Association, and Western Pine Association; petroleum, U.S. Bureau of Mines; steel, U.S. Department of Commerce and American Iron and Steel Institute; nonagricultural employment, U.S. Bureau of Labor Statistics and cooperating state agencies.

² Figures as of last Wednesday in year or month. ³ Total loans, less valuation reserves, and adjusted to exclude interbank loans. ⁴ Total demand deposits less U.S. Government deposits and interbank deposits, and less cash items in process of collections. ⁵ Debits to demand deposits of individuals, partnerships, and corporations and states and political subdivisions. Debits to total deposits except interbank prior 1942. ⁶ Daily average. ⁷ Average rates on loans made in five major cities, weighted by loan size category. ⁸ Not adjusted for seasonal variation. p—Preliminary. r—Revised.