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FEDERAL RESERVE BANK OF ST. LOUIS

Review

Economic Outlook

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FEDERAL RESERVE BANK
OF ST. LOUIS

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ON JANUARY 20, the President presented his annual *Economic Report* to Congress. This report serves as a basic document, setting forth administration proposals designed to improve the economic well-being of the nation. As background, the document contains a report by the Council of Economic Advisers analyzing the economic state of the nation and the outlook for the coming year.

This article presents some background data and charts which may be helpful in placing in perspective the Council's projections for 1964. The current report projects an increase in the total expenditures for final goods and services (GNP) for the nation of about \$40 billion, 6.5 per cent, from 1963 to 1964. GNP averaged \$585 billion in 1963 and is expected to average about \$623 billion in 1964. The report suggests that most of the rise will be in actual production; price rises are likely to be moderate. According to the forecasts, real output (i.e., GNP after adjusting for price changes) is expected to rise about \$30 billion, or 5 per cent. The expansion in real output is expected to lower the unemployment rate from 5.5 per cent in December 1963 to 5.0 per cent a year later. These favorable forecasts were premised on a sharp reduction in personal and corporate income tax rates in early 1964. Subsequently, the reduction was provided in the tax bill signed February 26.

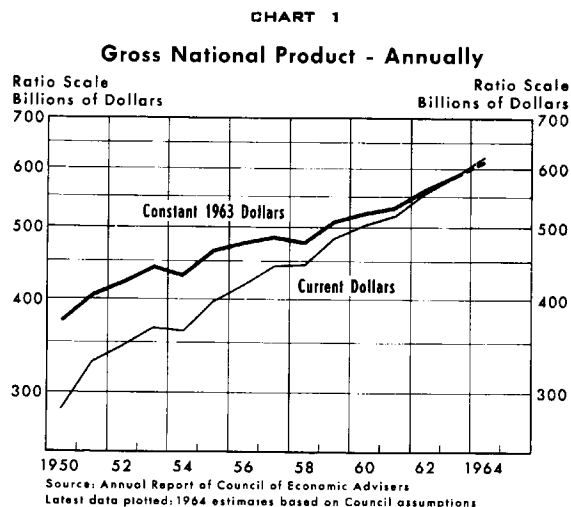
In this article the anticipated rise in GNP is compared with increases in some other periods, providing an indication of the relative magnitude of the projected movement of economic activity. Next, developments in business activity since early fall of 1963 are examined in order to set forth the underlying momentum

in activity at the beginning of this year. Finally, monetary and fiscal developments which have influenced the course of current economic activity are discussed.

Projected Large Rise in GNP for 1964

The *Economic Report* of the President predicted that 1964 gross national product will range between \$618 billion and \$628 billion (assuming a tax rate reduction). The midpoint of this range is \$623 billion. Thus, the anticipated rise in GNP from 1963's average of \$585 billion would most likely be between 5.6 per cent and 7.4 per cent.

The projected median gross national product (\$623 billion) would represent a continuation of approximately the same rate of expansion as has occurred since the last business cycle trough in the first quarter of 1961. Since then, GNP has risen at a 7 per cent rate. Gross national product increased 5.4 per cent from 1962 to 1963 (Chart 1) and has increased at an average annual rate of 4.9 per cent since 1951.

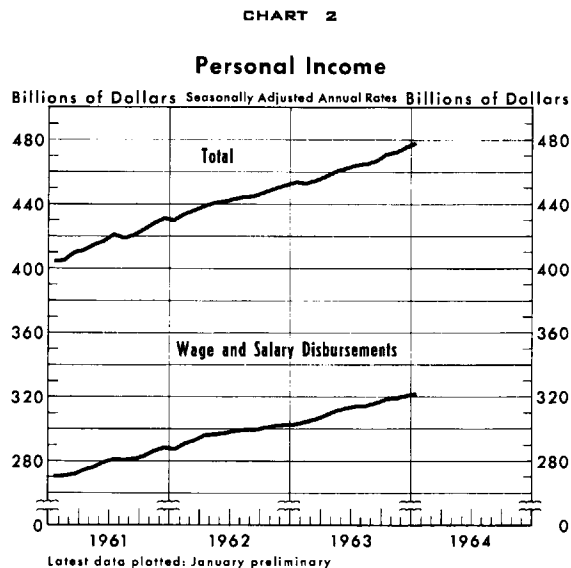


Real GNP is expected to rise less than dollar GNP, as the *Economic Report* assumes the price level will rise about 1.5 per cent from 1963 to 1964. The range of increase in real GNP is expected to be from 4 per cent to 6 per cent. Since the last business cycle trough, real GNP has risen at a 5.7 per cent rate. From 1962 to 1963, real GNP rose 3.8 per cent (Chart 1), and its longer run trend since 1951 has been an average annual increase of 3.1 per cent.

Rise in Economic Activity since Last Fall

The rise in GNP anticipated from 1963 to 1964 would be a continuation of the increase in economic activity during the last part of 1963. Since September, there have been pronounced increases in income, spending, production, and employment. Some price advances have accompanied these increases in economic activity.

The pace of expansion of income payments received by individuals has increased substantially since early fall. These payments rose from an annual rate of \$467 billion in September to a rate of \$479 billion in January, an annual rate of increase of 7.3 per cent (Chart 2). During the first nine months of 1963, incomes



rose at a 4.4 per cent rate. Major elements contributing to the late 1963 rise in personal income were wage and salary payments, dividends, and transfer payments.

Purchases of final goods and services by consumers, business, and government expanded markedly from the third to fourth quarter of 1963. Real gross national product increased at a 5.3 per cent annual rate (Chart 1) compared with a 3.8 per cent rate for the first three quarters of last year and a 3.1 per cent rate since 1951. Expenditures of consumers for durable goods, and of business firms for inventories provided a substantial part of the fourth quarter rise. Consumer spending during the first two months of 1964 continued large, as retail sales, after rising sharply from November to December, have remained at a high level (Chart 3).

Output of the nation's factories, mines, and utilities rose from September to January at a 3.3 per cent annual rate (Chart 4). Steel and auto production remained strong in February. During the first nine months of 1963, industrial production rose at a 7.4 per cent rate. The longer run increase in industrial production has averaged 3.6 per cent since 1951.

Rising employment has accompanied the increases in spending and production. From September to February, total civilian employment increased at a 2.7 per cent annual rate; a large part of the rise occurred

CHART 3

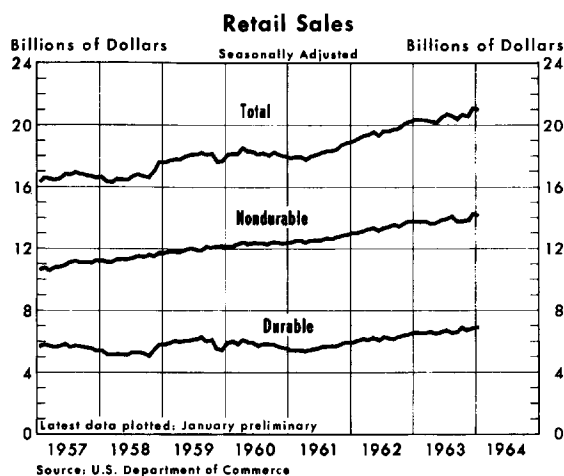


CHART 4

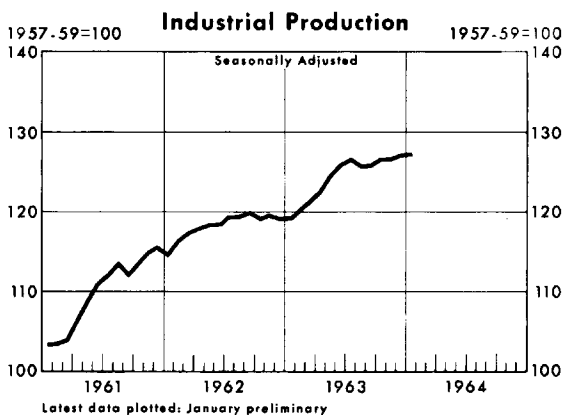
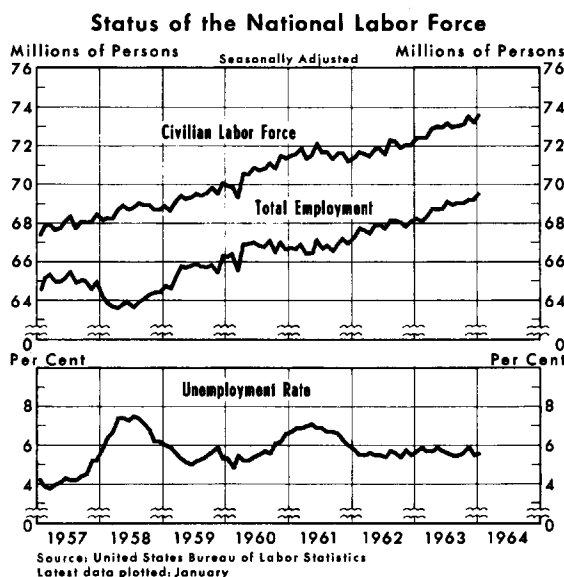


CHART 5



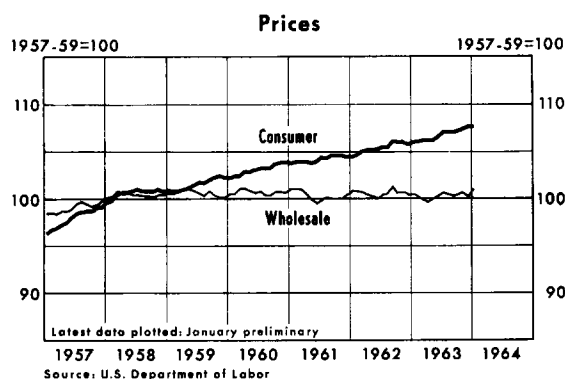
from December to February (Chart 5). Manufacturing employment since September has been little changed, and other employment has risen moderately. The September to February expansion in employment is somewhat greater than the 1.8 per cent rate that prevailed during the first nine months of last year. The

longer run increase in employment (1951-1963) has been at a 1 per cent average annual rate.

Despite rising economic activity, the unemployment rate has remained virtually unchanged since early autumn, averaging about 5.6 per cent of the civilian labor force (Chart 5). If the unemployment rate were to decrease to 5.0 per cent by the end of 1964, as projected in the report, output and employment would have to expand sufficiently for a net addition of approximately 1,500,000 jobs to reduce the number of unemployed by 500,000, while providing for about 1,000,000 new labor force entrants.

A moderate rise in consumer prices has accompanied the increased pace of economic activity since September (Chart 6). Consumer prices advanced at a 1.7 per cent annual rate from September to January,

CHART 6



compared with small price decreases during the same period of 1961 and 1962. Price increases occurred mainly in food, housing, transportation, and medical care. The average annual rate of increase in consumer prices since 1951 has been 1.5 per cent.¹

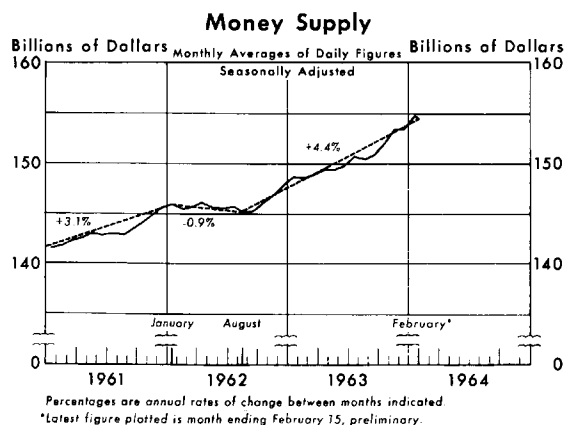
Wholesale prices in September were 100.3 per cent of the 1957-1959 average, and in January they were 101.0 per cent (Chart 6). In January 1963, the wholesale price index was 100.5. The wholesale price index has shown no trend upward or downward since 1958.

Monetary Developments since Early Fall

Monetary developments since last fall have been expansive. The money supply has risen at an advanced rate since September, and most interest rates have changed only moderately since November. The money supply (demand deposits adjusted plus cur-

¹ It is widely believed, however, that the price indexes are usually not able to take adequate account of quality changes and, hence, tend to overstate price increases.

CHART 7



rency) increased at a 6.4 per cent annual rate from September to the month ending February 15 (Chart 7). Since money also rose sharply in the previous two September-February periods (the average rate of increase for these periods was 4.7 per cent), some of the rise since last September may reflect some weakness in the seasonal adjustment process. Therefore, the 4.1 per cent rate of increase in money during 1963 may be a better indicator of the degree of recent monetary expansion. This rate of expansion, which appears to have continued into early 1964, is greater than the 3.1 per cent annual rate of increase since the February 1961 trough in economic activity and the average rate of 2.2 per cent since 1951.

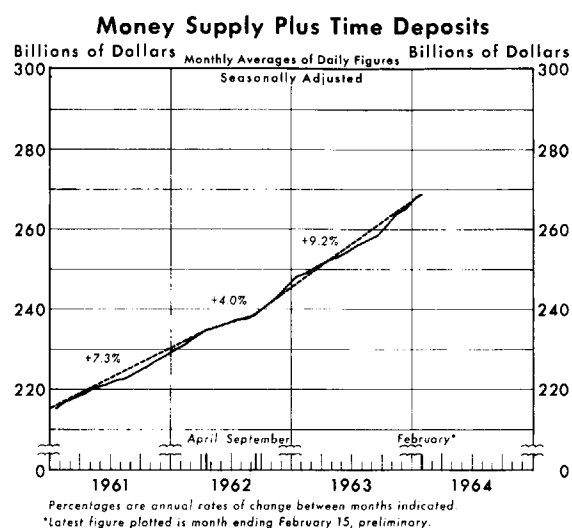
The money supply plus time deposits in commercial banks rose at a 10.6 per cent rate from September to the month ending February 15 (Chart 8) compared with an 8.2 per cent rate since February 1961. From 1951 to 1963, they rose at an average annual rate of 4.3 per cent. The rapid rate of increase in time deposits during the last four years may have largely resulted from a new competitive position of commercial banks vis-a-vis other financial intermediaries and probably did not represent a net addition to the money supply.

Some readers may be interested in the following publications:

The Quality of Bank Loans: A Study of Bank Examination Records, (Albert M. Wojnilower) Occasional Paper 82, National Bureau of Economic Research, 1962.

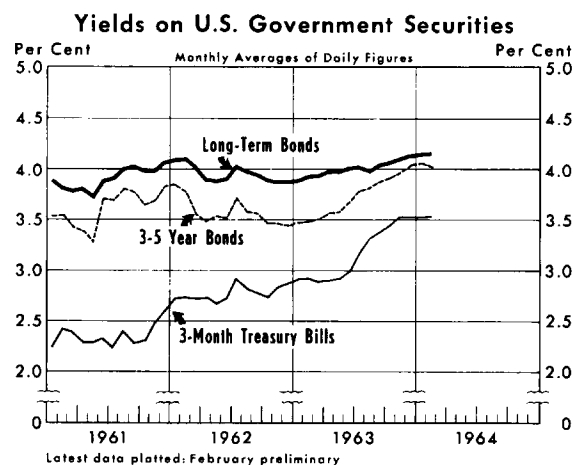
"The Stock of Money and Money Substitutes," (Richard H. Timberlake, Jr.) *The Southern Economic Journal*, XXX, No. 3 (January 1964), pp. 253-260.

CHART 8



Interest rates have changed little since early November. Yields on corporate and U. S. Government

CHART 9



securities (Chart 9) have increased slightly. State and local Aaa bond rates have drifted downward.

The relative stability in interest rates during the latter part of 1963 in contrast to the traditional seasonal rise prior to mid-1960 probably reflected a sharp rise in credit and money, matching a large rise in credit demands. Prior to 1960, rising seasonal demands for credit during the latter part of a year typically were accompanied by rising interest rates. The interest rate increases tended to moderate the quantity of credit demanded, thereby causing the outstanding quantity of credit to rise less than otherwise would have been the case. However, in each year since mid-1960, an exceptionally sharp rise in the quantity of credit outstanding has occurred from early fall to the year's end. Rather than being moderated by rising

interest rates as had been customary, rising credit needs have been met by increased supplies. Because changes in bank deposits are closely related to changes in bank credit, these increases in credit outstanding have been accompanied by sharper increases than formerly in the money supply during the last half of the year.

In contrast to the once customary seasonal declines in interest rates during the early part of the year, interest rates have been relatively stable in January and February of this year. Their stability may have been the result of rising demands for credit because of expanding economic activity, which about offset the usual seasonal decline in credit demand during these months. The Treasury also engaged in two major refundings of the Government's debt in January and February which led to some lengthening of the average maturity of the debt. When the maturity of debt is lengthened, downward pressure is applied on short-term interest rates and upward pressure on long-term rates.

Recent Fiscal Developments

In February, Congress adopted a tax bill lowering the Federal income tax rate structure. The new rates for individuals range from 14 to 70 per cent; previously they ranged from 20 to 91 per cent. Corporate tax rates were reduced from 52 to 50 per cent in 1964, and then to 48 per cent in 1965. Based on 1963 levels of incomes, the new structure of rates is estimated to reduce Federal tax revenues about \$11 billion. In order to make the tax reduction effective as soon as possible, provision was made for reduction of withholding tax rates starting March 5.

A major portion of the projected rise in 1964 output, according to the *Economic Report*, is expected to result from the reduction in tax rates. The changes in income tax rates are estimated to add approximately \$800 million a month to spendable income, thereby expanding expenditures on goods and services. How-

THE Federal Reserve System PURPOSES AND FUNCTIONS

THE BOARD OF GOVERNORS recently released the fifth edition of *The Federal Reserve System: Purposes and Functions*. This booklet describes the System's organization, the range of its operations, and its role in the economy. In this latest edition, three new chapters have been added. One discusses international economic relationships and explains why and how Federal Reserve policy is modified to help deal with international payments problems. Another discusses how the Federal Reserve System is organized to make monetary decisions. The third goes into considerable detail concerning open market operations, from policy formulation to execution.

The fifth edition of *The Federal Reserve System: Purposes and Functions* is available without charge. Requests for copies may be sent to the nearest Federal Reserve Bank or the Board of Governors of the Federal Reserve System. Requests to this bank should be addressed to: Research Department, Federal Reserve Bank of St. Louis, Post Office Box 442, St. Louis, Missouri 63166.

ever, some of this impact on expenditures may be partially offset by a slower rate of increase in Government expenditures in the fiscal year starting July 1, 1964. The initial impact on total spending of the net between the tax measures and a reduced pace of Government expenditures is presumed to be multiplied several times by repeated rounds of spending. Therefore, according to the report, these fiscal actions will increase substantially total expenditures and output in the economy.

Summary

The course of economic activity and monetary and fiscal developments since early fall appear to be consistent with a marked increase in GNP during 1964. Income, spending, production, and employment were moving upward rapidly at the end of last year, and this momentum appears to have continued into the first quarter of 1964. The recent reduction in tax rates provides additional impetus to the present advance in activity. Finally, the 4.1 per cent annual rate of increase of the money supply, which has prevailed since early 1963, is conducive to further strength in economic activity.

New Member Bank

The Commercial National Bank of Texarkana Texarkana, Arkansas

a newly chartered institution, opened for business on February 5.

The bank's capital is \$250,000 and surplus is \$250,000. Officers are:

GEORGE PECK, *Chairman of the Board*

ERIC WADE, *President*

BOYCE LANIER, JR., *Vice President and Cashier*

Measurement of a Nation's Balance of Payments

Introduction

THERE HAS BEEN UNUSUAL CONCERN about the U. S. balance of payments since 1958. In recent years this account has been a vital consideration in the framing of both our domestic and our foreign economic policies. The state of our balance of payments has also affected the economic decisions of foreign governments and individuals.

Widespread attention has been focused on the nature of the balance of payments as an index of this country's international economic position. However, there are many ways of evaluating the balance of payments. A shorthand way is to select certain credit items (receipts) and certain debit items (payments) and to consider the difference between these payments and receipts as "surplus" or "deficit." The other debit and credit items can be considered as the means whereby the deficit or surplus is "settled" and the balance of payments "balanced." For example, in Table I, under the "liquidity" approach to the balance of payments,¹ only the net change in our liquid liabilities to foreigners (including convertible foreign currency securities held by foreign monetary authorities) and net change in United States monetary reserve assets are the balancing items.

The size of a deficit depends upon which items are selected to measure it. To understand the significance of a deficit, it is important to realize the way in which it may be computed. This article outlines several alternative ways of measuring the balance-of-payments "deficit."

Two features of the present international payments system²—fixed exchange rates and the use of the dollar as an international reserve currency—are especially relevant to the problem of evaluating the condition of the U. S. balance of payments. The United States as a

member of the International Monetary Fund has agreed to maintain the value of its currency relative to gold. The authorities must stand ready to stabilize the value of the dollar in terms of other currencies. To do this, they need an adequate reserve of internationally acceptable non-dollar means of payment. Under present international monetary arrangements, the principal means of payment for this purpose are gold and convertible foreign currencies.

The extensive holding of dollar claims by other nations is an important consideration in evaluating the U. S. balance of payments. Since the dollar is one of the principal currencies used as a means of payment in world trade, foreigners hold dollar claims as working balances for financing trade. Dollar claims are also widely held by foreign countries as part of their international reserves. In large measure, foreigners are willing to hold dollar claims because the U. S. Treasury stands ready to convert dollars held by official foreign holders into gold upon demand. In order to determine the external liquidity position of the United States, therefore, it is necessary to take into account both its stock of international means of payment and the liquid dollar claims which are held by foreigners.

The Balance-of-Payments Statement

A nation's balance of payments for a given period records the transactions between that nation and the rest of the world. As an accounting statement summarizing these transactions, and based on double-entry principles, the balance of payments always balances in the sense that debits always equal credits (Column I of Table I). However, even though a nation's balance of payments is continually in balance from an accounting viewpoint, the underlying economic relationships between that nation and others may be of an unsustainable character. It is in this latter sense that a "deficit" or "surplus" in the balance of payments may be a meaningful concept as part of an evaluation of the problems related to the balance

¹ This measure has been perhaps the one most popular, or "traditional," in public discussion of the U. S. balance of payments. See the *Survey of Current Business*, December 1963, p. 11, Table 2, line C.1., for this measure.

² See this *Review*, July, 1963, for a more complete discussion of the international payments system.

of payments. In this sense, the implication is that market forces or policy measures will ultimately have to be brought to bear on the underlying character of the balance of payments if the external value of the nation's currency is to be maintained. To evaluate the balance of payments for any particular period—and thereby provide a guideline to policy steps—is thus a step in an analytical process.

Concepts of the Deficit

Two of the most widely used approaches to balance-of-payments analysis are the “liquidity” approach and the “basic balance” approach.³ A major purpose of analyzing the balance of payments is to appraise changes in the ability of a nation to maintain the external value of its currency in the face of potential and actual demands by holders of its currency for gold or other currencies. This ability will depend upon the state of the nation's external liquidity. For the United States, as a reserve currency country, the stock of internationally accepted means of payment

³ For a discussion of these various approaches to the balance of payments, see Hal B. Lary, *Problems of the United States as World Trader and Banker*, National Bureau of Economic Research, 1963; Walter S. Salant (and others), *The United States Balance of Payments in 1968*, Brookings Institution, 1963; Walther Lederer, *The Balance on Foreign Transactions: Problems of Definition and Measurement*, Princeton University, 1963.

relative to liquid claims held by foreigners against this stock define the state of external liquidity. For any given period, changes in external liquidity provide a measure of deficit or surplus in the balance of payments.

For other purposes, it is important for a nation to appraise its longer run competitive position, which is determined by underlying structural conditions in the world economy. In this basic approach, it is assumed that short-term flows of funds, which respond in large measure to relative interest rates and other short-run influences at home and abroad, are highly transitory. It is expected that these flows will largely reverse themselves in time, leaving the “basic balance” as the measure of deficit or surplus appropriate to evaluating the international performance of the economy.

The Liquidity Approach

The “overall” deficit in the balance of payments, measured according to the “liquidity” approach, is the sum of the decreases in liquid international assets and increases in liquid international liabilities (Column II, Table I). However, it is not a simple matter to determine which of our international resources and claims against them are “liquid” and thus relevant to

Table I
UNITED STATES' BALANCE OF PAYMENTS, 1963*
(In billions of dollars)

Transactions	I Balance of Payments		Types of Balance					
			II Overall (Liquidity)		III Regular		IV Basic	
	Receipts	Payments	Net Balance	Balancing Items	Net Balance	Balancing Items	Net Balance	Balancing Items
Merchandise Trade	21.7	16.9	+4.8		+4.8		+4.8	
Military Sales and Expenditures	0.8	2.9	—2.1		—2.1		—2.1	
Other Services	9.1	6.2	+2.9		+2.9		+2.9	
Remittances and Pensions		0.8	—0.8		—0.8		—0.8	
Government Grants and Capital	0.8	4.5	—3.7		—3.7		—3.7	
Private Long-term Capital	0.3	3.2	—2.9		—2.9		—2.9	
Private Short-term Capital	0.0	0.7	—0.7		—0.7			—0.7
Non-scheduled Receipts on Government Loans	0.3		+0.3			+0.3	+0.3	
Advances on Military Exports	0.2		+0.2			+0.2	+0.2	
Errors and Omissions		0.5	—0.5		—0.5			—0.5
Sales of Foreign Currency Securities	0.7			+0.7		+0.7		+0.7
Increase in Liquid Liabilities to Foreigners ..	1.5			+1.5		+1.5		+1.5
Decrease in U. S. Monetary Reserve Assets ...	0.4			+0.4		+0.4		+0.4
TOTAL	+35.8	—35.7	—2.5	+2.6	—3.0	+3.1	—1.3	+1.4

* Figures may not balance because of rounding.
Source: U. S. Department of Commerce.

the question of defending the gold convertibility of the dollar.

For the United States, liquid assets or resources are defined by the Department of Commerce to include gold, convertible foreign currencies held by U. S. authorities, and certain drawing rights on the International Monetary Fund to which the United States has more or less automatic access.⁴

The types of liabilities included in liquid liabilities to foreigners are short-term liabilities to foreigners reported by U. S. banks and all foreign holdings of marketable U. S. Government securities.⁵ Foreign holdings of certain nonmarketable U. S. Government securities, U. S. corporate and local government securities, and short-term liabilities to foreigners reported by nonfinancial U. S. concerns, are not considered to be liquid for this purpose.

The definitions of liquid resources and liabilities in the official U. S. balance-of-payments statistics have been criticized for being too conservative and hence overstating our deficit and the threat it poses to defending the dollar. Private U. S. holdings of liquid claims abroad are not included as part of our international liquidity. These resources are excluded because (1) they are generally not readily available to U. S. authorities as a support for the dollar, and (2) the present statistical reporting practices do not permit a distinction between those private claims against foreigners that might be available to U. S. authorities from those that are not.

While claims of U. S. citizens against foreigners are excluded from the nation's stock of external liquidity, the country's liquid liabilities to foreigners include both official and private holdings. Aside from the problem of statistically separating official and private holdings, the rationale for this procedure is that although the U. S. Treasury need provide gold only to official holders of dollars, an attempt by foreign private holders to dispose of their dollar assets could result in an increase in official holdings of dollar claims. Also, foreign authorities generally can exercise effective control over private holdings of dollar claims. Therefore, private foreign holdings of liquid dollar assets constitute a potential demand on our liquid resources.

The practices followed in measuring the U. S. international liquidity position are not free from criticism.

⁴ The so-called "gold-tranche" position, which is equivalent to our quota less the Fund's holdings of dollars.

⁵ Including nonmarketable, convertible foreign currency securities.

According to present methods of measurement, a movement of short-term dollar deposits to foreign banks by U. S. residents⁶ would give rise to an increase in liquid liabilities to foreigners and an increase in the deficit (since the private U. S. dollar claim against the foreign bank is not included as a liquid asset in measuring the deficit). However, in view of the foreign bank's outstanding liability to the U. S. depositor, it cannot permanently dispose of the dollars for assets denominated in foreign assets.

Other illustrations of the measurement problem may be cited: When short-term funds are invested abroad to take advantage of higher interest rates, the U. S. investor may choose to protect himself against exchange risk by "hedging." That is, he may buy foreign currencies for present delivery and at the same time sell the currency for future delivery of dollars. By the U. S. liquidity criterion, the increased dollar liabilities to foreigners would increase the deficit, since the claim of U. S. investors for dollars to be delivered in the future is not considered a liquid asset in measuring the deficit.

Loans extended to foreigners by U. S. banks increase liquid claims against the United States and hence the deficit, according to the liquidity measure. However, if foreigners are required to hold compensating balances in U. S. banks, then not all these dollar claims of foreigners represent a potential drain on our reserves. Another instance in which the deficit might be overstated is when "window dressing" (i.e., borrowings to improve balance sheet liquidity) operations of foreign commercial banks temporarily increase their dollar claims against the United States over the end of balance sheet periods. The U. S. deficit is thus overstated in one period, and then understated in the next period when the borrowings are repaid.

Aside from the criticism that the limitations of statistical reporting procedures may preclude a precise and appropriate measurement of net external liquid liabilities, there is the fundamental objection that any net external liquidity measure fails to provide an adequate measure of potential drain on our international reserves. Liquid liabilities to foreigners include those held by international organizations, foreign monetary authorities, and private foreigners. The motives for holding dollar claims vary considerably among these holders, and the potential drain on our reserves that these holdings represent is not the same for all

⁶ See this *Review*, December 1963, for an exposition of the "Euro-dollar" market.

holders. For example, that part of foreign dollar claims which constitute working balances for the finance of international trade is probably not as great a threat to liquidity position as those balances held for private investment purposes.⁷

More importantly, all liquid dollar assets, whether held by residents or foreigners, constitute a potential drain on our international liquidity as long as our residents may freely convert dollars to foreign currencies. In this sense, any liquidity approach overstates our capacity to defend the dollar.

The Basic Balance Approach

The deficit or surplus, viewed according to the basic balance approach, is the sum of the net transactions on goods and services, long-term capital movements, and government account (Column IV, Table I). This measure differs from the liquidity measure in that the net movements of short-term capital (including the "errors and omission" item which is considered to be largely unrecorded short-term capital flows) are regarded as a means of financing the deficit, rather than as part of the deficit. Thus, while a net outflow of U. S. short-term capital increases the "over-all" deficit, it has no effect on the "basic" deficit.

The rationale of this approach is that the transactions giving rise to the "basic" balance are considered to be "autonomous" whereas the other items are "accommodating." That is, trade in goods and services, long-term capital movements and government transactions are thought to be subject to longer run economic influences and political decisions. These "autonomous" items, which mainly reflect underlying competitive economic relationships, are the ones a country must balance if the external value of its currency is to be ultimately maintained.⁸ The "accommodating" movements of private liquid funds are considered to be temporary, reflecting such factors as changing conditions in international money markets.

To the extent that it may be valid to make a distinction between these "autonomous" and "accommodating" transactions, the policy implications are clear.

⁷ The emergence of various forms of central bank cooperation has been for the purpose of minimizing short-run speculative runs on the dollar and other currencies. To the extent that these arrangements are effective, the possibility of a "run on the dollar" is less likely.

⁸ For the United States, it is possible that net short-term capital outflows might exist over time and be sustainable insofar as the additional foreign dollar claims which arise are held for purposes of international liquidity. In this case, a continuing basic deficit could exist.

A nation should pursue those policies which will promote a reasonable basic balance over a longer period of time. Short-run policies which have their chief effect on short-term interest rates can quickly affect the accommodating transactions, but they will not directly redress the basic imbalance.

Unfortunately, in practice the forces affecting the basic balance are not clearly distinguishable from those affecting the accommodating transactions. Available evidence suggests that a major part of short-term capital movements are affected primarily by the level and pattern of international trade. It is also possible that basic transactions are to a significant extent affected by interest rates in the short run. For example, credit conditions may have a marked effect on inventory policy and hence imports.

Moreover, a reserve currency country such as the United States must consider the effect of short-term capital movements on the country's external liquidity position. While it is true that an increase in short-term investment abroad by U. S. residents gives rise to both a claim on and a liability to foreigners, for the period of the investment the foreign liability is a claim against the reserves of the United States. Because the dollar is a reserve currency, the aggregate volume of these claims could become a threat to our liquidity position.

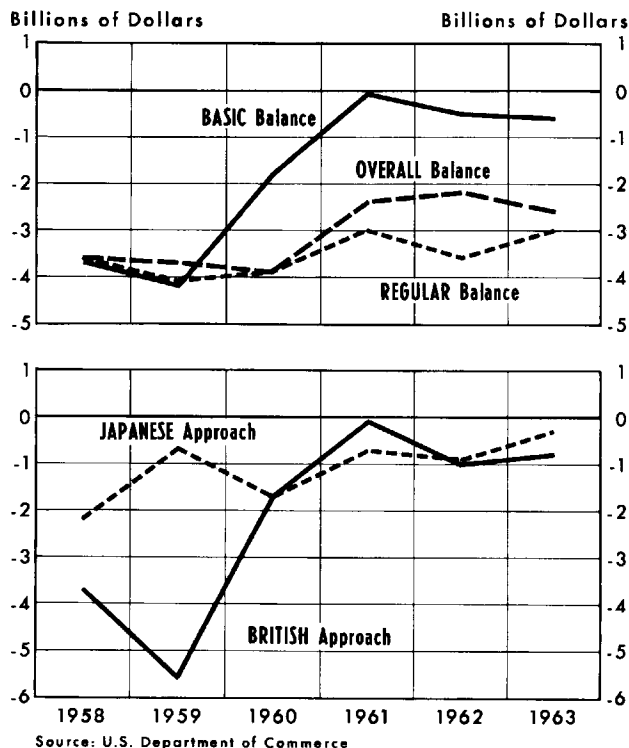
Other Measures

Another widely used measure of the U. S. deficit is the "gross deficit" or balance on "regular" transactions (Column III, Table I).⁹ This measure is equivalent to the "overall" balance (i.e., the "liquidity" measure) adjusted to exclude net receipts from "special" government transactions. Certain transactions between the United States and other governments—such as prepayment of foreign official debt to the United States, advances on military purchases from this country by foreign governments, and sales of certain types of U. S. Government nonmarketable securities to foreign governments—are undertaken *ad hoc* primarily as a means of improving the U. S. external liquidity position. These special transactions cannot be considered responsive to market forces or policy measures in the same sense as can "regular" transactions. Hence, the "regular" balance is a useful policy guideline indicating the magnitude of correction that is required in the balance of payments.

⁹ See the *Survey of Current Business*, December 1963, p. 11, Table 1, line A.13.

The chart below presents the U. S. balance-of-payments deficits for 1958-63, defined by "overall," "basic,"

Alternative Measures of the U.S. Balance-of-Payments Deficit



and "regular" measures. Table I illustrates the computation of each of these deficit measures for the year 1963. The chart also shows what the U. S. deficit for 1958-63 would have been, using an approximation to the established practices of the United Kingdom and Japan. The U. K. measure is essentially similar to the basic balance outlined above, whereas the Japanese definition of surplus or deficit is a liquidity approach, comprising only changes in gross official holdings of gold and foreign currency assets. Table II shows what effect the use of alternative measures has on the magnitude of the U. S. deficit.

Table II
Average U. S. Deficit, 1958-1963
by Alternative Measures
(Billions of dollars)

Overall	3.1
Basic	1.8
Regular	3.5
British Approach	2.1
Japanese Approach	1.1

Source: Basic data, U. S. Department of Commerce.

Summary

The U. S. balance-of-payments deficit has been presented under several alternative methods. No method is definitive. Institutional differences may justify different approaches. For the United States, a reserve currency country, it may be appropriate to focus upon its external liquidity position. In establishing economic policies to deal with a deficit, the "regular" balance may frequently be more meaningful for indicating the size of correction needed. On the other hand, if short-term capital flows tend to net out over time, then the basic balance provides a good long-run policy guideline.¹⁰

The approach employed by a country in measuring its balance of payments may have an impact on its national policies and may greatly affect its reactions to policies of other countries. For example, suppose that both the United States and the United Kingdom are in balance-of-payments equilibrium. Suppose then that the British experience a deficit in their basic balance and that policy measures are taken to raise interest rates. If higher rates caused an inflow of short-term funds from the United States, it would be recorded as a U. S. deficit, using a "liquidity" measure. Everything else equal, the recorded U. S. deficit might be interpreted as requiring higher U. S. interest rates, and the effect of higher British rates attracting U. S. funds would be offset. If, on the other hand, the U. S. policy actions were guided by its "basic" balance, no remedial steps would be indicated. Thus, when different measures are used, the asymmetrical treatment of certain items can give rises to "surpluses" and "deficits" which might tend to serve as guidelines for conflicting national policies.

In conclusion, the measurement of a deficit is part of a larger analytical process in which the past is reviewed in order to shed light on a nation's international economic position. Many other factors must enter into the analysis—comparisons of national income levels, changes in costs and prices at home and abroad, conditions in international capital markets, and political decisions affecting government expenditures abroad. Public understanding may best be served by not attempting to evaluate the position of a nation in the world economy on the basis of one arbitrary figure.

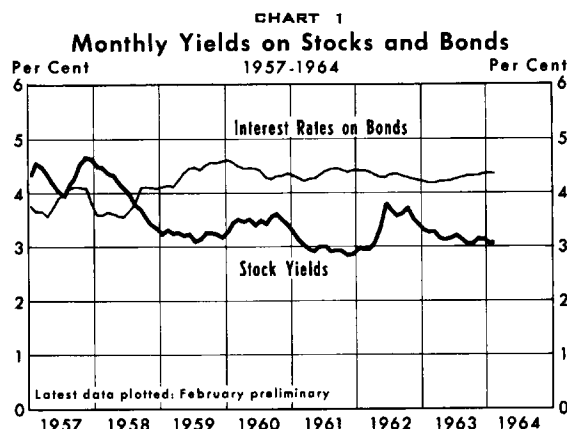
¹⁰ Cf., footnote 8, p. 9.

Decline in Stock Yields

YIELDS ON COMMON STOCKS have been generally declining for well over a decade. By 1959, stock yields were low relative to their historic levels and to interest rates on bonds, and this situation has continued for five years. The lower returns available on equities developed despite a substantial rise in corporate earnings and dividends. Lower yields resulted from a sharp increase in stock prices.

Trend of Stock Yields

Yields on common stocks have trended downward since mid-1962 and are near the low level of late 1961 and early 1962. The dividend/price ratio for Standard and Poor's 500 stocks averaged 3.05 per cent in February 1964. By comparison, in the June-October



1962 period, the yield on common stocks averaged 3.67 per cent (see Chart 1). Over the same period, the earnings/price ratio on common stocks declined similarly from 6.10 per cent (June-October 1962) to about 5.24 per cent (February 1964).

The current dividend yield on stocks is one of the lowest on record (going back to 1912). For brief periods in 1929 and in 1933, the dividend/price yield dipped below 3.00 per cent, but the averages for those years were 3.48 per cent and 4.05 per cent. Then, again, between April 1961 and March 1962, yields were low, averaging 2.93 per cent for the period.

In the last 14 years, yields on common stocks have trended down-

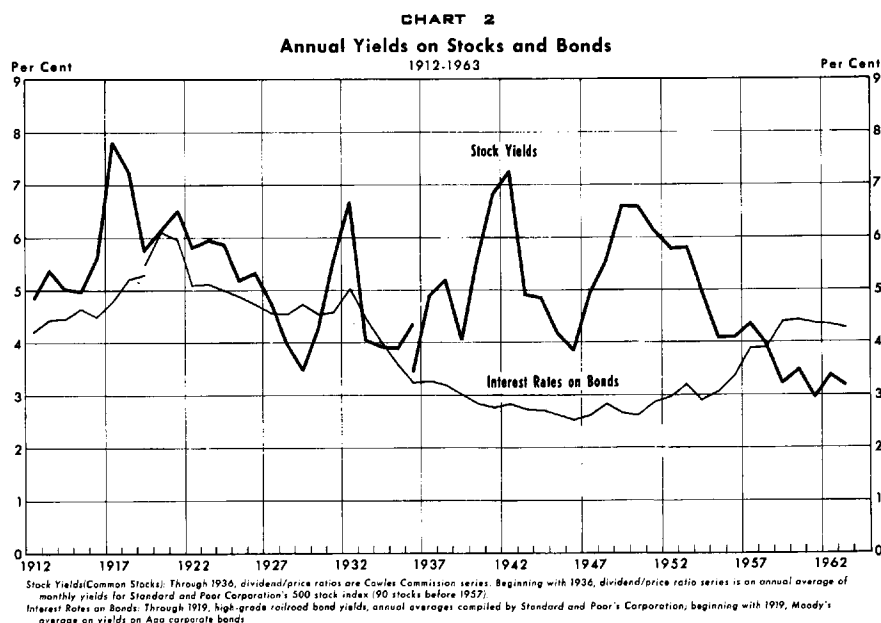
ward. In 1949, the dividend/price ratio averaged 6.59 per cent, more than double the current ratio.

The decline in stock yields since the late forties resembles one that took place earlier. In 1917, the dividend/price ratio reached a peak of 7.82 per cent (see Chart 2). Yields then worked down to an average of 3.48 per cent in 1929. Similarly, the earnings/price ratio on common stocks dropped from roughly 15 per cent in 1917 to about 5 per cent in 1929 and decreased from 15 per cent in 1949 to 5.6 per cent in 1963. In both periods the amount of corporate profits and dividends rose, but stock prices rose much faster.

Comparison with Interest Rates

The decline in stock yields since the late forties has been in marked contrast to the trend in interest rates on bonds. In 1949, bond rates were only slightly above their lows of this century. During that year rates averaged 2.66 per cent on highest-grade (Aaa) corporate bonds and 3.42 on medium-grade (Baa) corporate bonds. Since then, bond rates have generally moved upward (see Chart 2). During the twenties, on the other hand, when stock yields were declining, interest rates on bonds also drifted lower.

In the late fifties, high grade bond rates rose above stock yields. In 1959, Aaa corporate bond rates averaged 4.38 per cent and Baa corporate bonds 5.05 per cent, while stock yields averaged 3.23 per cent. Since



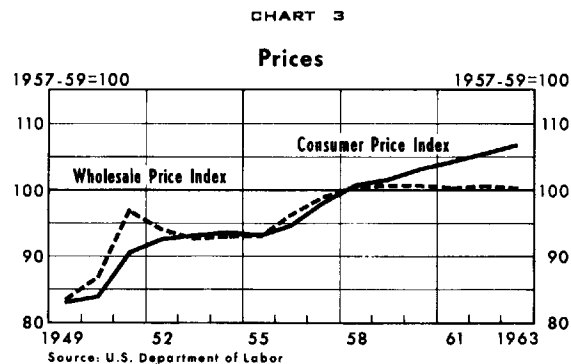
1959, bond yields have remained significantly higher than stock yields. In February 1964, the average yield on Aaa corporate bonds was 4.36 per cent and on Baa corporate bonds was 4.83 per cent. By comparison, the dividend/stock ratio averaged 3.05 per cent.

Such an excess of bond rates above common stocks is the reverse of the historic relation; bond rates have usually been considerably below stock yields. Bonds of a corporation, which are debtor instruments, have generally been considered less risky than common stocks, which are equity instruments. In order to attract capital into an investment judged to carry greater risk, it has traditionally been expected that yields must be greater.

Some Factors in the Decline in Yields

Investors have advanced several reasons to explain their willingness to invest in common stocks despite relatively low yields (high prices). Some investors believe common stocks provide a good hedge against price inflation. Presumably, as commodity prices rise, the assets and earnings of corporations would also increase. Since shareholders are residual owners, the purchasing power of their investment would be protected. When expectations of price rises become stronger, it might be expected that common stocks would become a more attractive investment. A question concerning the relevance of this point might be raised because wholesale prices have been essentially constant since 1958 (see Chart 3). While the consumer price index has risen moderately, many observers believe these prices have actually been essentially stable because of compensating improvements in the quality of goods.

Since 1949, there has been a considerable expansion in the volume of investment funds. Personal income and savings have grown consistently during this period. In addition, there has been a substantial growth in such institutions as pension funds, trust funds, insurance companies, and mutual funds, which place a portion of their portfolios in common stocks. Many investors were attracted into the



stock market by the relatively high yields on common stocks which were obtainable in the early 1950's. As the demand for this investment medium increased, yields fell and stock prices rose. In 1949, stock prices (Standard and Poor's 500 Stocks) averaged 15.23. In 1963 the average had risen to 69.87 and by February 1964 to 77.39 (see Chart 4). Although there have been several setbacks during the past decade, expectations of higher stock prices have generally been fulfilled. The higher prices brought profits, thereby attracting additional investment funds seeking to participate in the gains. These new funds, reinforced by tax laws which discourage the withdrawals of capital gains, have likely been a major factor in driving stock yields to historic low levels.

