FEDERAL RESERVE BANK OF ST. LOUIS

May 1967

CONTENTS

Review

Volume 49 Number 5

Bank Profits Rise Sharply

A Look at the 1966 Income and Expenses of Eighth Federal Reserve District Member Banks

PROFITS AT MOST Eighth District member banks rose sharply in 1966. Profits after taxes at these banks totaled $85 million last year, 14 per cent above 1965. Major factors influencing the rise were an increase in the volume of loans and a higher rate of return on both loans and securities.

Net profits after taxes at member banks in the nation rose less rapidly, increasing 5 per cent.[1] Gains in net current earnings (operating income less operating expenses) at banks in both the nation and district were similar, rising about 14 per cent in each case. The difference in the rates of gain in profits between district banks and banks in the country as a whole was almost entirely the result of a much larger increase in net losses, charge-offs, and transfers to valuation reserves at the latter banks.

During the past decade member bank profits in the district have risen at an 8.1 per cent rate and in the nation at a 7.9 per cent rate.

Relative to capital accounts, net profits after taxes in both the district and the nation have fluctuated in the comparatively narrow range of 8 to 10 per cent throughout the 1956-66 period. They hit a peak of 10.2 per cent at district banks in 1960. After declining to 8.0 per cent in 1963, the postwar low, net profits after taxes rebounded to 9.3 per cent of capital accounts in 1966.

Revenues

Operating revenues at district member banks totaled $503 million in 1966, an increase of 16 per cent from a year earlier (Table I). Revenues at these banks have risen at an average 9 per cent rate since 1956. This growth reflects largely an increase in total

Table I

REVENUES AND EXPENSES OF EIGHTH DISTRICT MEMBER BANKS

	Millions of Dollars			Per Cent Change	
					Annual Rate
	1966	1965	1956	1965-66	1956-66
Revenue on loans	334.7	287.4	130.4	16.5	9.9
Interest on securities					
U. S. Government	75.7	69.6	43.5	8.8	5.7
Other	43.6	36.7	11.6	18.8	14.2
All other revenues	48.8	41.7	23.6	17.0	7.5
Total operating revenues	**502.8**	**435.4**	**209.1**	**15.5**	**9.2**
Salaries, wages, and benefits	118.9	109.0	59.5	9.1	7.1
Interest on time deposits	138.6	114.2	16.9	21.4	23.4
Other expenses	102.9	87.1	46.3	18.1	8.3
Total operating expenses	**360.4**	**310.3**	**122.7**	**16.1**	**11.4**
Net current earnings	**142.3**	**125.1**	**86.4**	**13.7**	**5.1**
Recoveries, transfers from reserves, and profits	19.8	18.1	5.4		
Losses, charge-offs, and transfers to reserves	44.7	36.9	27.1		
Net income	**117.4**	**106.3**	**64.7**	**10.4**	**6.1**
Taxes on net income	32.1	31.3	25.7	2.6	4.6
Net income after taxes	**85.3**	**75.0**	**39.0**	**13.7**	**8.1**
Cash dividends on common stock	32.9	30.9	17.1	6.5	6.7
Interest on capital notes and debentures[1]	1.9	1.4	*		

[1] Includes small amount of cash dividends on preferred stock.

* Less than 0.05.

[1] Preliminary estimates. Income and expense data for all member banks in the nation are published annually in the Federal Reserve *Bulletin*. The 1965 data for all member banks may be found in the June 1966 *Bulletin* and for all insured banks in the July 1966 issue. Income and expense data for all national banks are published in the *Annual Report of the Comptroller of the Currency*, while data for all insured banks are contained in the *Annual Report of the Federal Deposit Insurance Corporation.*

assets, a shift from nonearning assets and relatively low yielding securities to higher earning assets, and a marked rise in the average level of interest rates.

Total resources of district member banks grew from \$6.5 billion in 1956 to \$11 billion in 1966, an average annual rate of 5.4 per cent. Earning assets of these banks grew somewhat more rapidly, from \$4.9 billion in 1956 to \$8.6 billion in 1966, a 5.7 per cent rate. The slightly faster growth in earning than total assets reflects the fact that member banks placed an increasing proportion of their available funds in loans and investments. Nonearning cash balances were reduced from 23 per cent of assets in 1956 to 19 per cent in 1966. Reductions in reserve requirements facilitated this move.

In addition to the growth in total earning assets, banks have enhanced operating revenues by adjusting their portfolios to higher earning types of assets. Over the past decade, holdings of U. S. Government securities dropped from 29 to 16 per cent of assets (Chart 1). In contrast, loans rose from 40 per cent to 50 per cent of assets during this period. Meanwhile, "other" securities (mostly tax exempt issues of state and local governments) rose from 8 to 13 per cent.

Another factor tending to increase revenues of banks during the past decade has been the upward trend of interest rates. The average return on bank loans increased from about 5 per cent in 1956 to 6.1 per cent in 1966 (Chart 2). The average return on Government securities rose from 2.3 per cent to 4.2 per cent.

Chart 1

Distribution of Assets

Eighth District Member Banks

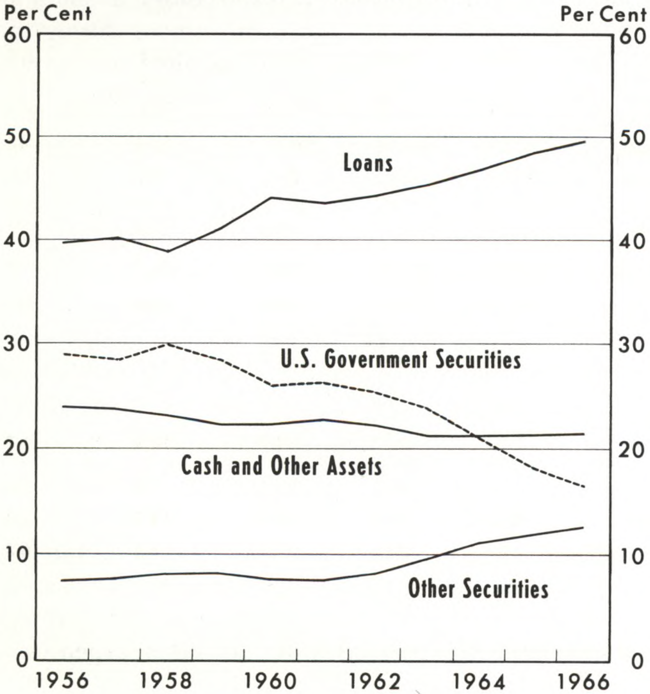
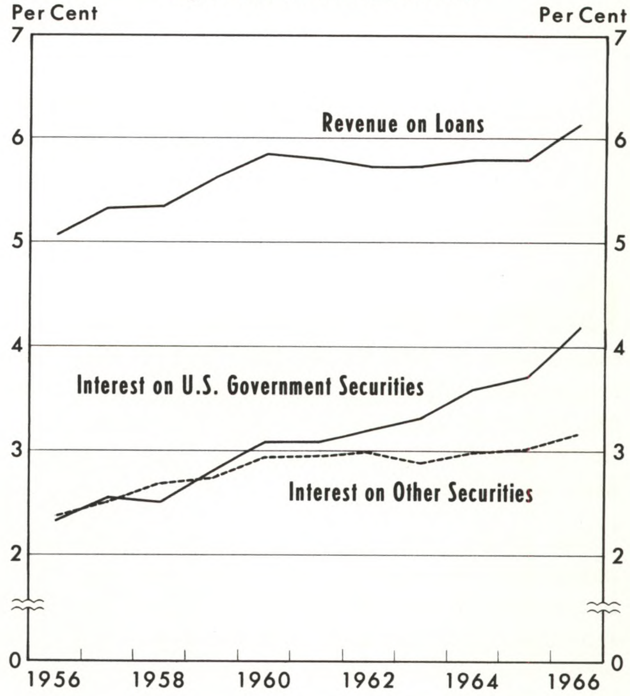


Chart 2

Average Return on Securities and Loans

Eighth District Member Banks



Growth in interest and charges on loans has accounted for a major portion of total bank revenue growth during the past decade. From \$130 million in 1956, or 62 per cent of the total, revenue from loans rose to \$335 million, or 67 per cent of the total in 1966. Returns on loans increased at an average rate of 10 per cent during the period.

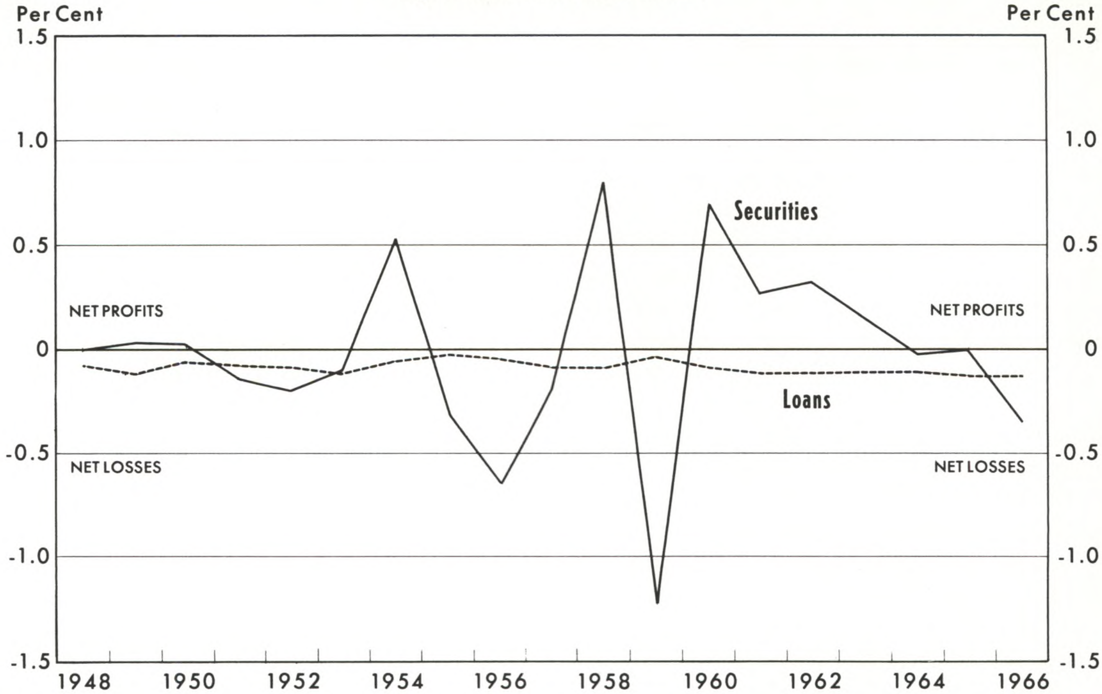
Although accounting for less than one-tenth of total revenues, interest on securities other than U. S. Governments has been the most rapidly growing revenue source. Interest on other securities rose from \$12 million in 1956 to \$44 million in 1966, an average annual increase of 14 per cent.

In contrast to the rising importance of revenue from loans and other securities, revenue from U. S. Government securities has declined relative to the total since 1956. At that time, interest on Government securities was \$44 million, 21 per cent of total revenues, while in 1966 such revenue was \$76 million, 15 per cent of the total. From 1956 to 1966 such revenue

Chart3

Net Losses or Profits on Securities and Loans

Eighth District Member Banks



rose at an annual rate of 5.7 per cent.

Income from sources other than loans and investments has also grown during the past decade but contributed less to total revenues in 1966 than in earlier years. Service charges on deposit accounts, trust department earnings, and other receipts have risen at an average annual rate of 7.5 per cent since 1956. These items accounted for 12 per cent of total revenue in 1956 compared with about 10 per cent in 1966.

Expenses

Operating expenses of district member banks totaled $360 million in 1966, up 16 per cent from the previous year (Table I). Interest paid on time and savings deposits, up 21 per cent, was the most rapidly rising major expense item. Wages, salaries, and employee benefits rose 9 per cent, and all other expenses increased 18 per cent.

Since 1956 operating expenses of member banks in the district have risen from $123 million to $360 million, an annual rate of 11.4 per cent. Reflecting both the sharply rising volume of time and savings deposits and the upward trend in interest rates on these accounts, interest expense was the major factor in the overall increase.

Interest expense rose from $17 million in 1956 to $139 million in 1966, an average annual rate of 23 per cent. This is in sharp contrast with the immediate postwar decade when such expense rose at a 10 per cent rate. In 1946 cash and Government securities accounted for almost three-fourths of assets at member banks in the district. This liquidity enabled banks to meet most of their loan demand through shifts in portfolio holdings and growth in reserves during the 1946 to 1956 period. Banks accepted time and savings deposits at relatively moderate interest rates.

Since 1956, however, with the opportunities for profitable lending and with a minimum of other assets for shifting into loans, banks have bid aggressively for time and savings deposits. Both the volume of such deposits and the average rate paid have increased rapidly. Time and savings deposits rose at a rate of 3.7 per cent per year from 1946 to 1956 compared with rates of 7 per cent from 1956 to 1960 and 15 per cent since 1960. The average rate of interest paid on time and savings deposits rose from 0.8 per cent in 1946 to 1.36 per cent in 1956, 2.37 per cent in 1960, and 3.77 per cent in 1966.

Other major expense items have increased but less rapidly than interest expense during the past decade. Salaries, wages, and fringe benefits rose at an average annual rate of 7 per cent, and all other expenses at an 8 per cent rate.

Net Losses on Loans and Securities

Net losses on loans (exclusive of transfers between undivided profits and valuation reserves) totaled $7 million in 1966, an increase of 8 per cent from the previous year. The ratio of net losses on loans to total loans was 0.13 per cent, unchanged from a year earlier. Although this is a reasonably low rate, it is slightly greater than the average level of the 1950's.

Net losses on securities at district member banks in 1966 totaled $11 million compared with net profits of $0.3 million in 1965. The large losses resulted from the combination of an exceptionally strong loan demand and depressed security prices during the past year. To meet the rapidly rising loan demand, banks found it profitable to liquidate some of their security holdings at the depressed price levels prevailing during most of the year. The sale of some securities may also have been motivated by tax considerations. Banks may deduct capital losses resulting from security sales from ordinary income taxed at a maximum rate of 48 per cent. By selling some of their securities when prices decline and simply buying others, banks obtain expected future capital gains which are taxed at a maximum 25 per cent rate. In this manner, banks trade ordinary income for future capital gains which are taxed at a much lower rate.

The ratio of net losses on securities to total securities was 0.35 per cent in 1966. The ratio of losses or gains on securities to total securities fluctuates considerably from year to year (Chart 3). During the past decade it has ranged from a net gain of 0.8 per cent in 1958 to a net loss of 1.2 per cent in 1959.

Although net losses on loans and securities combined were greater than in other recent years (except 1956 and 1959), banks were able to show a net addition to total valuation reserves. These reserves at the end of 1966 were $103 million, 4.4 per cent above a year earlier. In comparison, valuation reserves rose at a 10 per cent rate from 1956 to 1966. Such reserves, while not included in capital accounts, serve much the same purpose. They are in a sense a form of hidden capital in banks. Loan and security valuation reserves at district member banks are currently about 11 per cent of the volume of total capital accounts.

Net Earnings and Income

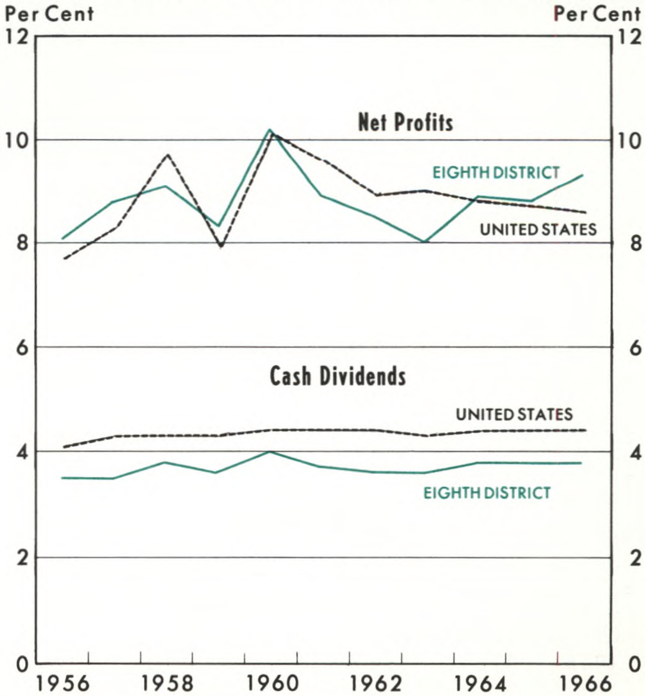
Net current earnings of member banks in the district totaled $142 million in 1966, an increase of 14 per cent from a year earlier (Table I). Since 1956 net current earnings have risen at a 5 per cent annual rate. The result of all adjustments for net losses, charge-offs, and transfers to valuation reserves was a reduction in net income before taxes of $25 million in 1966 compared with a reduction of $19 million in 1965.

Net income before taxes amounted to $117 million in 1966, 10 per cent above the previous year. Income taxes rose only 2.6 per cent, reflecting both the greater losses on security sales and the greater tax-exempt income on municipal securities.

Net profits after taxes totaled $85 million in 1966, an increase of 14 per cent from 1965. Since 1956, after-tax profits at district member banks has risen at an 8 per cent rate. Net profits relative to capital accounts in 1966 were 9.3 per cent, up from 8.8 per cent a year earlier. During the past decade the ratio of profits to capital at member banks in both the district and the nation has fluctuated from 8 to 10 per cent (Chart 4). Although average profits in other businesses over this period have generally been higher, profits at banks have shown greater stability. Comparisons of the rates of return on capital between banks and other businesses, however, may be somewhat misleading. The primary purpose of capital in a nonfinancial business is to provide physical plant and equipment. In banking these requirements are usually quite modest relative to total resources. The primary function of capital in banking is to provide safety, or protection against unexpected losses and shrinkage in value of assets.

Chart 4

Net Profits and Dividends as a Per Cent of Total Capital



Bank Capital

Determining the optimum amount of capital for a bank is not an easy task. Stockholders generally prefer to have as little as possible in order that profits on invested funds (which come primarily from investing deposits) will be maximized. Depositors, particularly those with large accounts, prefer to have as much capital cushion for protection as possible. With capital in banking designed to serve this somewhat unique function of protecting depositors, the amount of capital invested is heavily influenced by regulation and supervision. As a result, the adequate capital requirements set for banks for safety purposes may sometimes be at the expense of higher returns on capital.

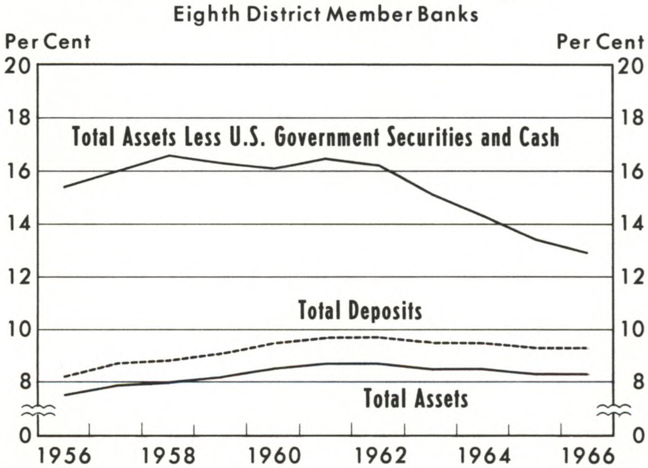
Total capital accounts of district member banks were $912 million in 1966, an increase of 6.8 per cent from 1965. Since 1956, capital of these banks has risen at a 6.5 per cent rate. In the late 1950's capital was rising somewhat more rapidly than either total deposits or total assets. As a result the capital-to-assets and capital-to-deposits ratios both rose (chart 5). Since 1960 these ratios have shown very little net change. In contrast the ratio of capital to risk assets (total assets less Government securities and cash) has declined from about 16 per cent, prevailing in the 1956-60 period, to 13 per cent in 1966.

Traditionally banks have raised nearly all of their capital through the issue of common stock and retained earnings. In several recent years a significant portion of new capital was raised through the sale of capital notes and debentures. During the 1963-66 period district member banks sold $42 million of such debt capital. This represented about 24 per cent of the net addition to capital accounts during these years.

Chart 5

Total Capital as a Per Cent of Assets and Deposits

Eighth District Member Banks



Somewhat over $20 million of capital notes and debentures were sold by district member banks in 1963, the first year of sizable sales of such capital. During 1966 such sales totaled slightly under $1 million compared with $14.8 million in 1965 (Table II). The lower level of sales in 1966 is probably indicative of the unwillingness of banks to make long-term capital commitments of this type, given the relatively high market interest rates prevailing during the year.

Table II

CAPITAL NOTES AND DEBENTURES[1]

EIGHTH DISTRICT MEMBER BANKS

(Thousands of Dollars)

	Sold during year	Retired during year	Outstanding at end of year
1962	-	-	200
1963	20,250	-	20,450
1964	6,200	-	26,650
1965	14,750	50	41,350
1966	950	150	42,150

[1]Includes small amount of preferred stock.

Interest on capital notes and debentures at district member banks totaled $1.9 million in 1966, an increase of 35 per cent from a year earlier. The average rate of interest paid on debt capital was 4.6 per cent.

Conclusions

The year 1966 was a profitable one for most member banks in the Eighth District. Net operating earnings rose 14 per cent, nearly triple the average rate of the past decade (5 per cent per year). After adjustments for net losses, charge-offs, and transfers to valuation reserves, net income before taxes rose 10 per cent from the previous year. Despite the sharp drop in security prices and substantial losses on security sales, bank earnings were sufficient to provide small net additions to loan and security valuation reserves. The increase in capital and valuation reserves combined was 6.6 per cent last year compared with a 9 per cent increase during 1965 and a 7 per cent rate of increase from 1956 to 1966.

Net profits after taxes at district member banks rose 14 per cent from 1965 to 1966 compared with an average growth of 8 per cent per year during the past decade. Net profits relative to capital accounts in 1966 were 9.3 per cent, up from 8.8 per cent a year earlier and a postwar low of 8.0 per cent in 1963.

The Domestic Economy in Transition

Recent indications of growth follow stimulative monetary and fiscal actions

SINCE EARLY SPRING the economy has indicated a renewed strength in contrast to the weakness exhibited through the fall and winter. After slowing for several months, consumer spending on goods and services and business investment in plant and equipment apparently have started to rise again. This improvement in total spending follows stimulative monetary and fiscal actions taken during the winter.

The U.S. balance-of-payments deficit has shown little improvement thus far in 1967. There is some concern that the deficit will increase substantially this year over 1966, particularly in view of declining short-term interest rates in the United States. However, some foreign interest rates have also fallen, and this may reduce such concern.

Slowdown in Late 1966 and Early 1967

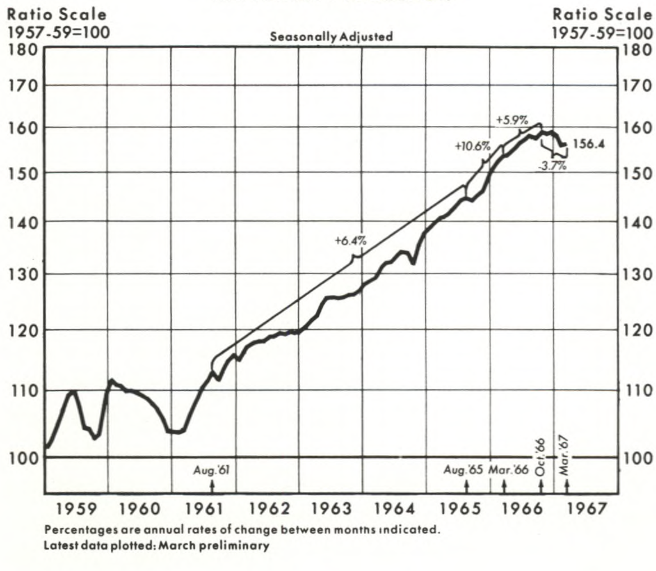
Total spending slowed markedly in late 1966 and early 1967, and real output showed no growth. Industrial production, which represents about one-third of real output, declined at a 4 per cent annual rate from October 1966 to March 1967.

A sharp increase in inventories held by businesses relative to their total sales was another indication of weakness in the fall and winter months. The inventory-sales ratio rose at a 12 per cent annual rate from August to February. This measure tends to rise as the pace of economic activity slows because production usually adjusts to weakness in sales with a lag of several months. As inventories build up relative to sales, they generally act as an additional drag on economic activity. Businesses reduce inventories to more efficient levels by slowing production. Final sales, which is measured by total spending minus inventory investment, showed some improvement in early 1967. From the fourth quarter of 1966 to the first quarter of 1967, these sales increased at a 9 per cent annual rate compared with a 7 per cent increase during last year.

The upward pressure on commodity prices moderated as spending slowed. Consumer prices increased at a 1.8 per cent rate from August to March compared with a 3.5 per cent rate of increase in the previous year. Wholesale prices declined at a 2 per cent rate from August to March, reflecting primarily a 15 per cent rate of decline in prices of farm products. Wholesale industrial prices increased at a 1.3 per cent annual rate, somewhat slower than the 2.4 per cent rise in the previous year.

The decline in farm commodity prices since late summer has pertained both to crops and to livestock products. Of the crops, soybean prices have shown

Industrial Production



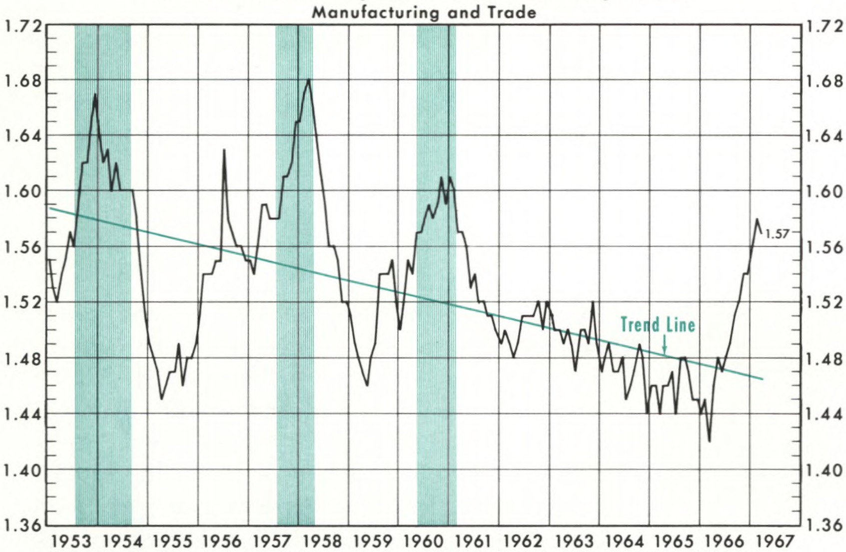
Percentages are annual rates of change between months indicated.
Latest data plotted: March preliminary

Farm Commodity Prices

Latest data plotted: April
Source: USDA

Inventories Compared With Monthly Sales*

Manufacturing and Trade



Shaded areas represent periods of business recession as defined by the National Bureau of Economic Research.

*Ratios based on seasonally adjusted data. Source: U.S. Department of Commerce

Latest data plotted: March preliminary

the sharpest drop, declining about 22 per cent. Hog prices have fallen 31 per cent. Eggs and wool have recorded large price declines, dropping 24 and 22 per cent respectively. Although prices of farm products have declined sharply since their peaks of last August, they remain somewhat above the average for most recent years.

Much of the change in farm commodity prices can be traced to the current phase of the livestock production cycle. Production has been in a rising phase since late 1965, tending to depress prices. Livestock marketing may now have already reached a peak and may be expected to slow in the coming months. As a consequence farm prices will probably become firmer and perhaps start rising by the fall of the year.

Private demands for credit declined relative to supply in late 1966 as total spending grew more slowly. Consequently some interest rates (the price of loan funds) also declined. The rate on short-term commercial paper declined from 6 per cent in October 1966 to 5⅜ per cent in February and to 4¾ per cent in early May. Yields on highest-grade long-term corporate bonds receded from the 5.5 per cent peak reached early last fall to 5 per cent in February. The average yield in early May was 5.15 per cent, up 15 basis points from the February low.

The excessive total demand and price inflation, which were of much concern during most of last year, have moderated. Whether this moderation is temporary or of a longer-run nature depends in considerable measure upon recent and forthcoming monetary and fiscal actions.

Stimulative Monetary and Fiscal Actions since Late 1966

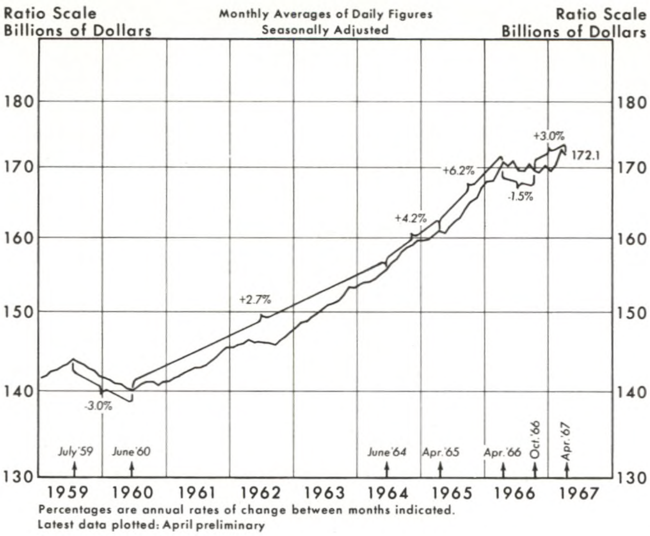
Government stabilization actions since late last year have been of a character generally regarded as stimulative. Monetary expansion has been rapid, and the Federal budget has become even more stimulative than in late 1966.

Monetary developments, which had been restrictive from last spring to late 1966, have since become quite expansionary. From October to April Federal Reserve open market operations added $3 billion to reserves of member banks, a 14 per cent annual rate of increase. March reductions in legal reserve requirements on certain time deposits of member banks had an effect similar to increasing reserves an additional $850 million. As a result of these actions, a measure of Federal Reserve credit which includes member bank borrowing from Federal Reserve Banks and which is adjusted for changes in reserve requirements increased $3.2 billion or at a 15 per cent annual rate from October to April. The interest rate at which Federal Reserve Banks lend to member banks was reduced from 4½ to 4 per cent in early April. This move was generally considered a further sign of easier monetary policy.

Total bank reserves, reflecting the growth of Federal Reserve credit, increased $1.1 billion or at a 10 per cent annual rate from October to April. These reserves had declined at a 2.3 per cent rate during the previous six months. A major share of these additional reserves was used as reserves required for time deposits. These deposits rose rapidly when interest rates paid on time deposits became attractive relative to other market rates.

In addition to reserves supplied for time deposit expansion, reserves available for private demand deposits increased at a 2.7 per cent rate from October to April. By comparison these reserves decreased at a 3.9 per cent rate from April 1966 to last October. Demand deposits, which had declined at a 3 per cent rate from April to October 1966, subsequently have increased at a 2.1 per cent rate. Money stock (private demand deposits plus currency in the hands of the public) showed a similar pattern, decreasing at a 1.5 per cent rate from April 1966 to last October and then rising at

Money Stock



3 per cent rate. Since the first of the year this expansion has been at about a 5 per cent rate.

Fiscal developments have also been more expansionary in recent months. The Federal Government imparted an additional $4 billion annual rate stimulus to the economy from the fourth quarter of last year to the first quarter, according to the high-employment budget. This was about $3 billion more than was planned in the January budget, and reflected higher-than-expected Government expenditures. Defense spending, which has risen rapidly each quarter since mid-1965, continued its advance in the first quarter.

The deficit in the national income accounts budget is expected to exceed $9 billion in the first quarter. This measure of budget developments reflects the slowdown in economic activity and its associated effect on tax receipts, as well as increased Government expenditures.

Renewed Strength in the Domestic Economy

Some economic developments indicate that stimulative monetary and fiscal actions in the first few months of this year are now moving the economy upward from the plateau of late 1966 and early 1967. Such expansionary actions usually take some time to affect the economy. By now there is scattered evidence that some sectors of the economy are showing renewed strength. Retail sales in March increased sharply over February, and preliminary April figures indicate continuation of this strength. Construction outlays have risen since the first of the year. Capital market interest rates have firmed in recent months as new security offerings have been quite large.

A frequent topic of discussion among economic analysts at the present time is whether the upturn is now occurring or will be delayed to the third or fourth quarter. Some analysts have expressed concern that current Governmental actions, if continued much longer, may foster excessive demands and the renewal of inflation.

Effects of Policy Actions on the Balance of Payments

The recent expansionary monetary actions have stimulated an increase in the supply of credit. At the same time slower growth in total demand for goods and services contributed to a decline in the demand for credit. Both of these forces have contributed to lower interest rates. Some concern has been expressed that the decline in short-term interest rates will tend to aggravate the already serious U.S. balance-of-payments problem.

The rapid increase in interest rates in the summer of 1966 attracted a large amount of foreign funds into the United States and, to a lesser extent, encouraged some Americans to hold their dollar balances at home rather than depositing them abroad.[1] It is feared by some that the current easing in financial markets and decline in interest rates in the United States will induce a sharp short-term capital outflow in 1967.

Preliminary evidence indicates that the balance-of-payments deficit on the official settlements basis was at a faster rate in the first quarter of 1967 than in the last half of 1966. This was due chiefly to the outflow of a significant portion of the short-term funds which came into the United States during the summer of 1966. Continued easing of domestic financial markets and U.S. interest rate declines could lead to a continued weakening balance of payments during the rest of 1967.

Comparison with 1960. Increased concern about the balance of payments in 1967 may be in part based on the 1960 experience. That was a year of softness in the United States domestic economy and of sharply declining interest rates. The decline in the demand for credit caused Treasury bill rates to decline from a peak of close to 5 per cent in early 1960 to 3 per cent in early 1961. At the same time rates were rising abroad, especially in the United Kingdom, Germany, and Canada. The resulting spread between U.S. and foreign interest rates lead to a sizable short-

[1] Since American corporations have been cooperating in the President's voluntary program to strengthen the balance of payments, corporate short-term funds might not have been invested abroad even if U.S. short-term rates had not risen.

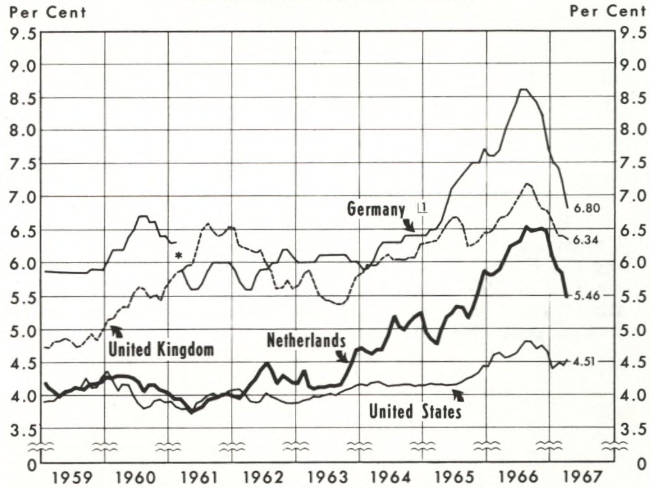
term capital outflow from the United States.[2]

This outflow of funds, combined with the Presidential election uncertainties, led to foreign speculation about devaluation of the dollar. As a result there was a heavy run on the London gold market which pushed the free market price of gold from its normal range of around $35 per ounce to close to $40 per ounce. This speculative attack was subdued by the strong statement of President-elect Kennedy assuring maintenance of the international value of the dollar at $35 per ounce of gold and by the development of institutional arrangements among central banks to stabilize the London gold market.

Contrast with 1960. Although conditions in the United States in 1967 with respect to the decline in short-term interest rates are similar to those in 1960, conditions abroad are not the same. The United Kingdom, Germany, and Canada, instead of having booming domestic economies and high interest rates, have recently been experiencing some economic weakness and softening in their interest rates. This is also true of the Netherlands, Belgium, Switzerland, and Sweden. Thus the incentive for moving short-term funds from the United States to these financial markets is not so strong this year as in 1960.

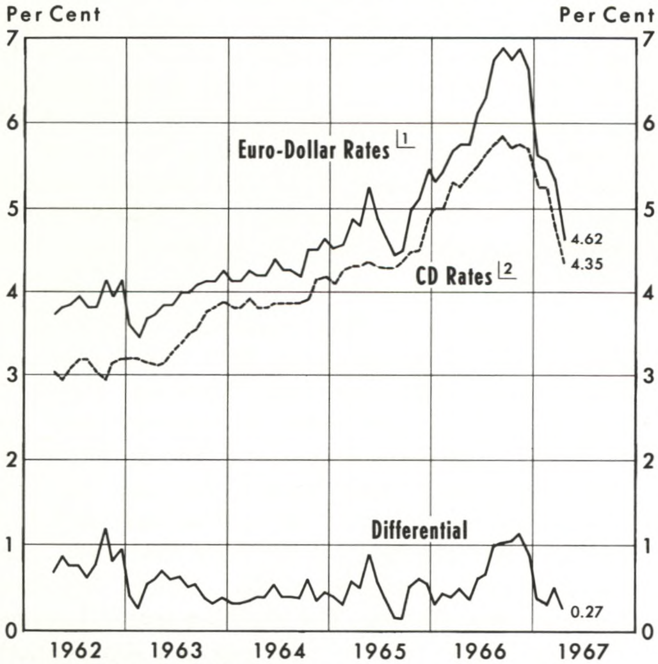
[2]A large share of the recorded short-term outflow in 1960 was in the form of bank loans to Japan. This not only was due to high rates in Japan but also to a change in Japanese government policy in July 1960, which made it much easier for Japanese banks to borrow short-term funds abroad.

Government Bond Yields



1 Mortgage bond yield through March 1961; Public Authorities bond yield thereafter.
*New series.
Source: IMF
Latest data plotted: U.S.-April; Others-April estimated

Yields on Euro-Dollar Deposits and Certificates of Deposit



Data for the last Friday of the month.
1 Rates on three-month deposits.
2 Secondary market rates for negotiable three-month CD's.
Sources: Board of Governors of the Federal Reserve System and Salomon Brothers and Hutzler
Latest data plotted: April

Financial markets in France, Italy, and Japan also do not now provide attractive interest rate incentives for moving funds from the United States. Although the economies of these countries are relatively buoyant and their interest rates are rising, the absolute level of their rates is still not unusually favorable relative to rates in the United States.

Other important differences between the current situation and 1960 are the President's voluntary program initiated in February 1965 to support the balance of payments and the interest equalization tax (IET) initiated in July 1963. The voluntary program is designed to discourage banks from making loans and investments in developed countries and to encourage corporations to finance their foreign investments with funds obtained abroad. The IET on foreign securities is designed to discourage portfolio managers from investing abroad.

The different conditions existing in 1967 compared with 1960 are illustrated by developments in the Euro-dollar market in the two periods. Since this market is sensitive to changes in international financial conditions, it tends to reflect net demand and supply conditions of many countries. In 1960 U.S. short-term rates declined as they are doing now, but the Euro-dollar rates did not decline. Therefore, an unfavorable interest rate differential against the United States was created, and short-term funds flowed from the

United States to Europe. By comparison, Euro-dollar rates have fallen even more rapidly in recent months than U.S. short-term rates on instruments of comparable liquidity.[3] The reduced spread between these rates has thus provided less incentive for U.S. funds to move abroad.

[3] The Euro-dollar market is much larger now than in 1960, and U.S. banks are participating more actively in it. The United States probably plays an important part in determining the Euro-dollar rate. Heavy bidding by U.S. banks in the summer of 1966 probably helped push this rate up, and the runoff of a large share of these funds since January has helped push this rate down.

Summary

Stimulative monetary and fiscal actions since late 1966 are probably contributing to improvement in economic activity. Acceleration of total demand may be expected to develop as the full effect of these actions takes hold. The general decline in interest rates in late 1966 and early 1967 in most leading countries may enable the United States to continue to pursue a monetary policy directed at domestic considerations without seriously aggravating the balance-of-payments problem.