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# The Multinational Corporation: A Controversial Force

By Sheldon W. Stahl

There appears to be a growing awareness on the part of many observers of the importance of the multinational corporation (MNC) as a force in world trade and commerce. In 1973, when the gross world product was estimated to be about \$3 trillion, approximately 15 per cent, or \$450 billion, was accounted for by MNC's. Of this amount, U. S. firms generated nearly one-half. An even more graphic means of illustrating the dimensions of the large multinational firms is to compare their gross annual sales with the gross national products of various countries. These data are presented in Table 1, and they serve to point out not only the heterogeneity of the multinational companies, but their massive size as well.<sup>1</sup> In addition, the table clearly demonstrates that while U. S. firms loomed large, the multinational phenomenon is not uniquely American—a factor which should be borne in mind in light of the many criticisms which have been directed at the multinationals.

In a recent, and generally critical book dealing with MNC's, the authors observed:

The global corporation is the most powerful human organization yet devised for colonizing the future. By scanning the entire planet for opportunities, by shifting its resources from industry to industry and country to country, and by keeping its overriding goal simple—worldwide profit maximization—it has become an institution of

unique power. . . . They (the managers) exploit the advantages of mobility while workers and governments are still tied to particular territories. . . . In making decisions today they are creating a politics for the next generation.<sup>2</sup>

At the same time, there are many who view the growing internationalization of production engendered by the MNC not only as a highly positive development, but perhaps on a par with the Industrial Revolution of the 18th century insofar as its ultimate impact is concerned. Thus, the investment and operations decisions of corporations come to be viewed in global dimensions with regard to resource allocation and maximization of welfare. And, in this scheme of things, the multinational company becomes the key vehicle for bringing about a world economic system in which the allocation of resources is rationalized to a far greater degree than had ever been the case in the past. Additionally, it is held that if the developing countries seize the opportunities for enhancing their economic growth that result from the activities of the multinational companies, there may be a significant rise in living standards for a vast, impoverished area of the world.

Yet, if this somewhat idealized view of the positive potential of the multinationals has considerable appeal to many, there also remains for many a far less flattering or beneficent view. For example, representatives of organized labor have charged that through the transfer of U.S. technol-

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<sup>1</sup>Since gross national product figures are calculated on a value-added basis—which counts only the value added at each successive stage of production—while gross annual sales of business are not so calculated, comparisons such as those offered in Table 1 should be interpreted with this qualification in mind. Nonetheless, even if one were to divide gross sales figures by two to compensate for double-counting, MNC's would still be massive compared with many nations.

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<sup>2</sup>Richard J. Barnet and Ronald E. Muller, "Global Reach: The Power of the Multinational Corporations" (New York: Simon and Schuster, 1974). p. 373.

**Table 1**  
**NATIONS AND CORPORATIONS**  
**Gross National Product or Gross Annual Sales**  
**in Billions of U.S. Dollars**

|                                      |          |  |         |
|--------------------------------------|----------|--|---------|
| 1. United States.....                | \$974.10 | 51. Egypt.....                         | \$ 6.58 |
| 2. Soviet Union.....                 | 504.70   | 52. Thailand .....                     | 6.51    |
| 3. Japan.....                        | 197.18   | 53. <b>ITT</b> .....                   | 6.36    |
| 4. West Germany.....                 | 186.35   | 54. <b>TEXACO</b> .....                | 6.35    |
| 5. France.....                       | 147.53   | 55. Portugal.....                      | 6.22    |
| 6. Britain.....                      | 121.02   | 56. New <b>Zealand</b> .....           | 6.08    |
| 7. <b>Italy</b> .....                | 93.19    | 57. <b>Peru</b> .....                  | 5.92    |
| 8. China.....                        | 82.50    | 58. <b>WESTERN ELECTRIC</b> .....      | 5.86    |
| 9. Canada.....                       | 80.38    | 59. Nigeria.....                       | 5.80    |
| 10. India.....                       | 52.92    | 60. Taiwan.....                        | 5.46    |
| 11. Poland.....                      | 42.32    | 61. <b>GULF OIL</b> .....              | 5.40    |
| 12. East Germany.....                | 37.61    | 62. U. S. <b>STEEL</b> .....           | 4.81    |
| 13. Australia.....                   | 36.10    | 63. Cuba.....                          | 4.80    |
| 14. Brazil.....                      | 34.60    | 64. Israel.....                        | 4.39    |
| 15. Mexico.....                      | 33.18    | 65. <b>VOLKSWAGENWERK</b> .....        | 4.31    |
| 16. Sweden.....                      | 32.58    | 66. <b>WESTINGHOUSE ELEC.</b> .....    | 4.31    |
| 17. Spain.....                       | 32.26    | 67. <b>STANDARD OIL (Calif.)</b> ..... | 4.19    |
| 18. Netherlands.....                 | 31.25    | 68. Algeria.....                       | 4.18    |
| 19. <b>Czechoslovakia</b> .....      | 28.84    | 69. <b>PHILIPS ELECTRIC</b> .....      | 4.16    |
| 20. Romania.....                     | 28.01    | 70. Ireland.....                       | 4.10    |
| 21. Belgium.....                     | 25.70    | 71. <b>BRITISH PETROLEUM</b> .....     | 4.06    |
| 22. Argentina.....                   | 25.42    | 72. Malaysia.....                      | 3.84    |
| 23. <b>GENERAL MOTORS</b> .....      | 24.30    | 73. <b>LING-TEMCO-VOUGHT</b> .....     | 3.77    |
| 24. Switzerland.....                 | 20.48    | 74. <b>STANDARD OIL (Ind.)</b> .....   | 3.73    |
| 25. Pakistan.....                    | 17.50    | 75. <b>BOEING</b> .....                | 3.68    |
| 26. South Africa.....                | 16.69    | 76. <b>DUPONT</b> .....                | 3.62    |
| 27. <b>STANDARD OIL (N.J.)</b> ..... | 16.55    | 77. Hong Kong.....                     | 3.62    |
| 28. Denmark.....                     | 15.57    | 78. <b>SHELL OIL</b> .....             | 3.59    |
| 29. <b>FORD MOTOR</b> .....          | 14.98    | 79. <b>IMPERIAL CHEMICAL</b> .....     | 3.51    |
| 30. Austria.....                     | 14.31    | 80. <b>BRITISH STEEL</b> .....         | 3.50    |
| 31. Yugoslavia.....                  | 14.02    | 81. North <b>Korea</b> .....           | 3.50    |
| 32. Indonesia.....                   | 12.60    | 82. <b>GENERAL TELEPHONE</b> .....     | 3.44    |
| 33. Bulgaria.....                    | 11.82    | 83. <b>NIPPON STEEL</b> .....          | 3.40    |
| 34. Norway.....                      | 11.39    | 84. Morocco.....                       | 3.34    |
| 35. Hungary.....                     | 11.33    | 85. <b>HITACHI</b> .....               | 3.33    |
| 36. <b>ROYAL DUTCH/SHELL</b> .....   | 10.80    | 86. <b>RCA</b> .....                   | 3.30    |
| 37. Philippines.....                 | 10.23    | 87. <b>GOODYEAR TIRE</b> .....         | 3.20    |
| 38. Finland.....                     | 10.20    | 88. <b>SIEMENS</b> .....               | 3.20    |
| 39. Iran.....                        | 10.18    | 89. South Vietnam.....                 | 3.20    |
| 40. Venezuela.....                   | 9.58     | 90. Libya.....                         | 3.14    |
| 41. Greece.....                      | 9.54     | 91. Saudi Arabia.....                  | 3.14    |
| 42. Turkey.....                      | 9.04     | 92. <b>SWIFT</b> .....                 | 3.08    |
| 43. <b>GENERAL ELECTRIC</b> .....    | 8.73     | 93. <b>FARBWERKE HOECHST</b> .....     | 3.03    |
| 44. South Korea.....                 | 8.21     | 94. <b>UNION CARBIDE</b> .....         | 3.03    |
| 45. <b>IBM</b> .....                 | 7.50     | 95. <b>DAIMLER-BENZ</b> .....          | 3.02    |
| 46. Chile.....                       | 7.39     | 96. <b>PROCTOR &amp; GAMBLE</b> .....  | 2.98    |
| 47. <b>MOBIL OIL</b> .....           | 7.26     | 97. <b>AUGUST THYSSENHUTTE</b> .....   | 2.96    |
| 48. <b>CHRYSLER</b> .....            | 7.00     | 98. <b>BETHLEHEM STEEL</b> .....       | 2.94    |
| 49. <b>UNILEVER</b> .....            | 6.88     | 99. <b>BASF</b> .....                  | 2.87    |
| 50. Colombia.....                    | 6.61     |  |         |

NOTE This table uses 1970 figures for all except the centrally planned economies (excluding China) and General Motors Corp., for which 1969 figures are used.  
 SOURCE: Lester Brown, "The Interdependence of Nations" (New York: Foreign Policy Association, 1972), pp. 14-15.

ogy and productive facilities to foreign countries, the MNC's have not only exported American jobs, but have, at the same time, eroded our tax base and worsened our balance of payments problems. If it appears that many observers here in the United States are increasingly concerned about the economic impact of multinationals, it would appear equally true that there is rising uneasiness abroad with regard to the activities of U. S. MNC's. Many foreign countries have come to view these corporations as simply an extension of American influence and dominance in the economic sphere, with interests that may not necessarily coincide with what they perceive to be their own national interests. In their shrillest form, allegations have been made that multinational firms simply constitute a subtle form of economic imperialism. Reduced to a less emotional theme, the question of national control over the means of production is becoming a major issue of political debate in country after country. One need look no further than our neighbor to the north, Canada, to be made aware of the increasingly strict controls that have been imposed on the inflow of equity capital from abroad.

The rising tide of U. S. concern over the activities of the multinationals appears to coincide with two developments which have taken place within roughly the last 2 decades. One is the massive flow of U. S. capital into Western Europe—increasingly in the form of direct investment in manufacturing industries. The second factor is the deterioration—until quite recently—in the overall U. S. balance-of-payments position. Without question, the influx of U. S. capital into Western Europe contributed to the rebirth of Europe's economic infrastructure and brought with it a dramatic upsurge in production, employment, and incomes. But along with this rise in living standards, these countries have emerged in a relatively few years as very formidable competitors of the United States both here at home and in our foreign markets. In this regard, the MNC's through their successful foreign operations are alleged to have created the very export competition which, critics say, has undermined our export position, and which allegedly threatens U.S. living standards and job security.

In the analysis which follows, this charge, as well as a number of major problems which have emerged with the growth of MNC's, will be examined. Before looking at some of the economic areas of impact of the MNC's, however, it is helpful to try to clearly define the MNC, as well as to shed some light on the motives for investing abroad.

### **DEFINITIONS AND MOTIVES**

The term "corporation" can be defined precisely. However, there is no universal agreement on exactly what constitutes an MNC. In discussing firms which have international operations, the terms "multinational" and "international" are often used interchangeably. Initially, firms with a high percentage of foreign sales which represented principally exports from the home country were so designated. With the postwar growth in importance of foreign sales traceable to direct foreign investment rather than simply to home country exports, the terms became somewhat less precise. However, a look at some of the representative MNC's shown in Table 1 suggests that those firms have a number of readily identifiable characteristics. They operate in many countries; within those countries, in addition to production, they are quite likely to be engaged in research and development; their management is multinational in character; and stock ownership is typically multinational. The MNC's activities transcend national boundaries and their strategies are directed from a corporate center which may be far removed from where a particular activity takes place. Such corporations have large financial resources, and given their management capabilities, they are able to exploit profitable opportunities throughout the world. Although no precise quantitative frame of reference has been placed on MNC's, knowledgeable authorities suggest that the typical multinational company would have annual net sales of \$100 million to several billion dollars, with their foreign sales representing a significant share—some have suggested 25 per cent-of their total sales. Similarly, direct foreign investment in productive facilities in one or more foreign countries may approximate at least 15-20 per cent of the company's total investment outlays.

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In addition to defining and attaching some quantitative dimensions to the MNC, it is helpful to distinguish between two principal types, since their economic impact and their rationale for investment abroad are likely to vary according to type. MNC's may be either vertically or horizontally integrated. Vertical integration occurs when the various components used in some final product or products are produced by subsidiaries located in different countries. This might be the case where component part production requires a significant amount of either unskilled or semiskilled labor. Depending upon the number of stages in the fabrication process, the MNC might be highly vulnerable to interruptions in production at one or several steps along the way. Thus, the likelihood of **uninterrupted** production will be a primary factor in the choice of investment locations, as well as the relative costs of production.

The second type of MNC, the horizontally integrated company, typically is made up of a parent company and one or more foreign-based subsidiaries. These subsidiaries are independent units in their productive capacity, and are set up to produce and sell the company's products in the surrounding overseas region. Although the parent company may set up a branch firm abroad to produce for the American market, in the case of sales to foreign customers, the MNC will usually go the overseas subsidiary route in order to take advantage of the competitive edge afforded by a tariff structure which penalizes foreign imports. In addition, differences in national tastes and traditions frequently necessitate special designs for particular markets. In these instances, even in the absence of tariff or other cost considerations, MNC's will locate close to their potential customers and will therefore disperse their productive facilities.

Despite the allegations by some labor spokesmen that MNC's represent "runaway" firms which produce abroad in order to take advantage of lower foreign wage rates, more often than not, this simply is not true. For the process by which a firm becomes an MNC is an evolutionary one in response to a variety of motives and seldom involves an abrupt or dramatic reversal of previous corporate

policies or objectives. The development of an MNC will ordinarily proceed through a number of steps. Initially, the firm will export abroad, selling its products through overseas distributors. A second stage involves the establishment of overseas sales subsidiaries. This is followed by the building of plants abroad, and constitutes direct investment. These plants may be used either for local assembly or full production. Finally, the regional subsidiaries are given full operating authority, and at this point the role of the parent company becomes one of planning and coordination.

Except in the obvious case of the extractive industries which must, of necessity, place their direct investments in those countries where the raw materials are located, the reasons for the movement of direct investment capital abroad are more varied than those alleged by many critics of the MNC. The desire to get around tariff barriers has already been alluded to as a motive, and indeed this was a major consideration for U. S. companies wishing to do business in the **European** Economic Community. Similarly, where local taste and design differences exist, both production and transportation costs may be minimized by locating close to the markets to be served. Related to this, in part, is the desire to diversify product lines in order to guard against fluctuations in earnings either from cyclical movements in economic activity, labor strife, or interruptions to supply.

While all of the above, in varying degrees, serve to motivate direct foreign investment, perhaps the most important and the most fundamental motivation is simply to tap foreign markets. More than 90 per cent of the output of **U.S.-owned** firms abroad is absorbed by local rather than U. S. markets. Thus, corporate strategies are directed primarily at either preserving or preempting market shares from actual or potential competitors—U. S. and foreign based. Although a good deal of this direct investment activity may be basically defensive in nature, it can also take on a more aggressive tone when large firms seek to develop new markets outside their home base in order to sustain continued overall rapid growth rates. Where these markets have requirements which make it difficult to

service them efficiently via exports from domestic operations, investment capital will move abroad.

The above discussion stresses market motivation as a primary factor in explaining the flow of direct investment overseas. This is not to deny that cost considerations may be important as well. However, cost comparisons are seldom the predominant factor in reaching a basic decision as to whether to invest abroad or in the United States. There have been a number of highly controversial and well-documented cases in which U. S. firms have shifted their production abroad. Unlike most of our direct overseas investment, which is in relatively high-cost industrial countries, these went to the less-developed countries principally because of the large pool of low-wage labor, and involved mainly the consumer electronics, footwear, toy, and apparel industries. Not only do these examples constitute a relatively minor part of our total direct foreign investment, but even in these instances where cost factors are assumed to be of primary importance, there still remains a very strong element of market focus. But in contrast with the examples cited earlier, the market focus in these cases relates to the domestic rather than the foreign market. For all, or nearly all, of the output of the U.S.-owned plants abroad is returned for sale in the U. S. market. It should be noted that in these examples of "run-away" firms, the industries of which they are a part are generally labor-intensive with labor costs representing a high proportion both of the total cost and the value of the output. Within those industries affected, the negative impact on the U. S. work force has been significant and, as noted earlier, has generated heated discussion over the broader impact of multinational business on a number of facets of the American economy.

### **THE ECONOMIC IMPACT**

Perhaps one of the most comprehensive investigations of some of the more important implications of multinational firms was undertaken by the U. S. Tariff Commission at the behest of the Senate Finance Committee. The report is entitled "Implications of Multinational Firms for World Trade and Investment and for U. S. Trade and Labor," and

was released in February 1973. Much of the data was obtained from the Bureau of Economic Analysis of the U. S. Department of Commerce and was the result of a special census which encompassed all known U.S.-based MNC's, covering 3,400 U. S. parent companies and approximately 23,000 foreign affiliates. That survey was supplemented by a sample survey of MNC operations for the calendar year 1970. Comparison data were based on the benchmark years 1966 and 1970. Although those responsible for the report candidly acknowledge a number of technical shortfalls and urge further substantive research into the area, the report does provide a wealth of data as well as a number of important insights into both the operations and some of the implications of the MNC's. The observations which follow are drawn largely from the Tariff Commission report.

#### The Impact of **U.S.-Based MNC's** on World Trade

During the period covered in the study, the U.S.-based MNC's bulked large in overall world trade, but they did not dominate it. A basic reason was that the major share of their foreign output, particularly in the manufacturing sector which was the most dynamic in terms of MNC expansion, was sold in the countries where it was produced. The MNC's, including parents and affiliates, generated about 25 per cent of world exports of all commodities, but accounted for about one-fifth of world exports of manufactured goods. At the same time, it was observed that MNC worldwide exports, and in particular exports of manufactured goods, were growing faster than those of the world as a whole in the 1966-70 period.

#### The Impact of Multinational Firms on U. S. Trade

One of the more frequent allegations regarding MNC's is that they displace domestic production—hence jobs—by increased imports from their affiliates. At the same time, some charge that by using affiliate output to serve foreign markets, they tend to reduce our exports to those markets. Regarding these allegations, the Tariff Commission found a close association between U. S. foreign investment and U. S. exports, but a weak association between

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the level of foreign investment and the degree of import penetration. Those industries which were the larger direct investors abroad were also the industries generating the largest amount of U. S. industrial exports. With regard to trade levels, then, the evidence suggested that the MNC's played a larger role as exporters than as importers. However, a partial indication of the extent to which the U. S. trade balance may have suffered adversely from MNC activities may be discerned by examining changes in the U. S. trade position.

Changes in U. S. exports and imports may be affected by MNC's in two ways. By their shipments from and to the United States—their exports and imports—they exert a direct effect. Additionally, they may exert an indirect effect by substituting the production of their foreign affiliates for U. S. exports in foreign markets. From 1966-70, the Tariff Commission study showed that overall, U. S. MNC's generated \$3.4 billion more in new exports than in new imports, while at the same time non-MNC's in manufacturing generated an import surplus of \$3.6 billion, suggesting that the direct trade effects of MNC's were highly favorable to the United States. An estimation of the indirect effects also proved favorable, with U. S. exports showing a net gain of \$400 million over the same period.

Yet, it would not be wholly correct to infer from the existence of export balances for some firms or industries versus import balances for others, that the former were automatically more beneficial to the U. S. economy than the latter. The amount of imports used by a firm is quite obviously related to the kind of product it produces, and it would be clearly wrong to conclude that a firm which may be a heavy importer is, because of that fact, somehow damaging the U. S. economy. For many U. S. firms—among them a number of vertically integrated MNC's, as noted earlier—import large amounts of raw materials or other intermediate inputs and export little, if any, of their final product. To the extent that these imports contribute to the firm's overall productive efficiency, its sales of final products in the U. S. market might well substitute for those of would-be foreign exporters. Such a benefit to the overall U. S. trade balance,

though perhaps less visible than increased exports, is nonetheless equally real.

The result overall, for manufacturing, shows that the impact of MNC's on changes in U. S. trade from 1966 through 1970 appeared to be highly favorable. As might be expected, however, on an industry-by-industry basis, there was a good deal of variance. Of the 24 industries in which comparisons could be made, 16 industries showed a net increase in U. S. exports of \$7.3 billion for the period, while 8 industries showed net new imports of \$3.4 billion. Despite the apparent favorable outcome overall, the wide variations in industry performance do lend some credence to the notion that for some groups of workers, the MNC development may have been costly.

### **The Impact of MNC's on U. S. Labor**

If some groups of workers have been clearly harmed as a result of the growth of MNC's, is it true, as has been alleged by many within organized labor, that the spread of multinational business has reduced overall employment in the United States? In order to measure the impact of U. S. direct investment abroad on domestic employment, for the period 1966-70, the Tariff Commission study attempted to estimate what would have happened if the multinationals had not invested abroad. It did this by making estimates based on three different sets of assumptions. The first, and most pessimistic estimate, assumes that in the absence of U. S. plants overseas, the foreign countries would not resort to local production to replace that lost output, but would import the entire output from plants within the United States. Given this assumption, the presence of U. S. plants abroad represents a net loss of 1.3 million U. S. jobs. The second estimate was arrived at by assuming that foreign countries would replace half of the output of the U. S. overseas plants with local production and import the remainder from the United States. Using this assumption, there is a net loss of 400,000 U. S. jobs. Finally, in order to incorporate more realism, the Commission assumed the following: in the absence of U. S. MNC's, foreigners would not have substituted their own plants, and U. S. exports to those

countries could reasonably have been expected to have maintained only the share of world exports of manufactures that they held in 1960-61, rather than to have taken completely the markets abroad served by the MNC's affiliate plants. With these more realistic assumptions, there is a net gain in U. S. manufacturing employment of roughly 500,000 jobs.

Ultimately, the kind of job loss or gain that may result depends upon the time scale involved. In the short run, a domestic job loss is a near certainty where production is shifted abroad. Over the longer run, however, if one expects our international accounts to tend toward equilibrium, some positive offset is likely to occur in some other industry. Perhaps the principal difficulty the MNC's pose is that, because they are typically in the technological forefront, they serve as a much quicker transmission belt for technological change than otherwise. The more rapid the change or the dispersion of production to new locations, the more rapidly adjustment problems arise for the work force in the short run, even though this same process might, in the longer run, benefit the general welfare.

An important point brought out by the analysis was that there was significant variation on an industry-by-industry basis. For example, even under the most pessimistic assumption, there are still some industries which show gains in employment. In the case of industries that are experiencing difficulties from foreign competition, the appropriate public policy response should be couched in terms of the broad U. S. national interest. For labor is not only a producer, but a consumer as well. From the perspective of the consumer, it seems reasonably clear that there have been sizable benefits in terms of a wider range of high quality, lower-priced goods as a result of the overseas production opportunities made possible by U. S. foreign investment and by our liberal trade policies. At the same time, this may be of little solace to those U. S. workers whose incomes have been terminated as a consequence of job loss to foreign competition. Yet, basically, high levels of production, employment, and income in the United States depend upon a

vigorous economy which is competitive and profitable in the world economy. Thus, advocacy by labor of restrictions on U. S. trade and investment appear to be not only ill-founded, but short-sighted as well. For such a course would generate retaliation by other nations and would lead ultimately to reduced levels of trade and investment with consequent reductions in income and employment both here and abroad. Rather, in those instances where U. S. industries have been adversely affected by foreign competition, a more forward-looking approach would involve adjustment assistance to domestic firms and adequate compensation and retraining opportunities for labor, plus a vigorous pursuit of more equitable trade and investment rules from our trading partners.

#### Technology and the **MNC's**

The U. S. based multinationals play a key role in the development of new domestic technology. At the same time, they are the principal vehicles for both exporting and importing technology. The study found that exports of technology exceeded imports by a factor of more than 10 to 1, for the 1966-70 period. In addition, the high technology industries tended to place more direct investment abroad—as compared to investment at home—than did either the medium or low technology industries. Thus, it might seem a foregone conclusion that, inasmuch as the high technology MNC's are both the major developers and exporters of U. S. technology as well as major investors abroad, they contributed significantly to the relative decline in our trade of high technology products. However, the study found that this was not the case. Over the 1966-70 period, the MNC's in the high technology industries generated about \$6.1 billion in net new exports, while the non-MNC's in the same industries generated about \$2.1 billion in net new imports. On balance, then, it would appear that the MNC's have aided rather than impeded the growth of U. S. export trade in high technology goods. It should be pointed out, though, that this observation would likely be just as true for those high technology firms which were not MNC's. Thus, our favorable export experience in high tech-

nology goods may not solely be a function of the unique character of MNC's, but rather may reflect the experience of high technology firms, some of which happen to be MNC's.

### **The U. S. Balance-of-Payments Impact**

In the second half of the 1960's, aggregate U. S. balance-of-payments performance was marked by considerable deterioration, traceable chiefly to transactions with Canada and Japan. The alleged negative payments role of the MNC's was alluded to earlier. In examining these allegations, the Commission found that in the period 1966-70, the position of the MNC's in terms of the "basic balance" (current account and long-term capital account combined) improved by \$2.8 billion, while non-MNC's in the private sector showed a decline of \$3.3 billion. The MNC's appeared to be a major factor in the adverse shift in the payments balance with Canada—primarily because of trade in automobiles. But this came about as a result of a treaty with Canada, rather than decisions by the MNC's involved. With respect to our payments balance with Japan, the MNC's were a positive force.

Despite the generally favorable payments impact of MNC's reported by the Tariff Commission, several qualifications should be borne in mind. Just as an examination of import versus export balances was not adequate to assess the impact of MNC's on U. S. trade, similarly, comparisons of MNC versus non-MNC basic balance positions provide only a very cursory and incomplete indication of the impact of MNC's on the overall U. S. payments balance. Moreover, to the extent that there is at work a long-run adjustment process toward equilibrium in our international accounts, generalizations based on fragmentary evidence for a short time period must be viewed with extreme caution as a guide to the future.

### **SOME FINAL OBSERVATIONS**

The subject of MNC's is charged with a good deal of emotion. At home, they are the object of a wide range of allegations, most of which do not

appear to be borne out under investigation. Yet, the evidence is not absolutely conclusive. For public policy then, until long-run benefit/cost ratios for MNC's can be more clearly determined, the appropriate policy stance would seem to be one of neutrality in either promoting or discouraging MNC development. Certainly, to the extent that public policies focus on ways of maintaining a vigorous and healthy American economy, any adjustments necessitated by MNC activities in particular industries can proceed more smoothly.

In a larger sense, the promise of the MNC in a world characterized by increasing economic interdependencies and a growing awareness of the need to maximize the efficiency with which resources are utilized should be apparent. As a force for breaking down national barriers and integrating economic relationships throughout the world, the MNC may be uniquely able to help create a true world economy. Yet, this promise of the MNC coincides with a growing wave of economic nationalism, particularly in many of the smaller and less affluent nations. Fears and resentment of the MNC run deep in the impoverished countries of the Third World, where paradoxically MNC's account for most of the employment in the advanced sectors of the economy. For frequently, the immediate interests of the MNC and the host government may not coincide and in such instances the issue of who is the boss becomes of paramount importance.

The MNC may represent one part of the practical answer to the question of how a truly viable world economic system can be created. But the conflicts which have arisen between the MNC with its supranational point of view, and the host of newly emerging and already existing nations with their narrower national economic concerns, will have to be resolved before the MNC can play its positive role. Whether the MNC will, in the future, be a positive force contributing to the uplifting and economic betterment of much of the world, or whether it will become a divisive force leading to distrust and hostility, depends to a large degree upon how those conflicts are resolved.

# Bank Profitability and Bank Size

By Edward C. Gallick

The earnings performance of commercial banks varies widely from one bank to another. Some banks earn quite high rates of return, while others turn in low rates of return. A number of factors are believed to contribute to the variability of bank profits. They include differences in bank size, location, and structure as well as differences in asset portfolios, liability composition, and quality of bank management.

This article examines the extent to which bank size is associated with bank profitability. In contrast to earlier studies on this subject, which have tended to focus on current profit disparities among selected individual banks or among well-defined bank subsamples, this study considers the profitability of all insured commercial banks in the United States during the 21-year period 1954-74.<sup>1</sup> Systematic differences in bank profitability by bank size, therefore, are examined from a long-run perspective. Also, to gain a better understanding of the variability of bank profits, the major components of bank profitability during the period are identified and their movements investigated. In addition, four subperiods within the 1954-74 period are considered to better evaluate the representative nature of long-run trends in profitability.

## AN OVERVIEW OF PROFITABILITY: 1954-74

The overall measure of bank profitability used in this study is the rate of return on capital, defined

<sup>1</sup>See William F. Ford, "Profitability: Why Do Some Banks Perform Better Than the Average? An In-Depth Analysis." *Banking*. Vol. 76, No. 16 (October 1974), pp. 29-33; Dennis A. Olson, "How High Profit Banks Get That Way." *Banking*. Vol. 67, No. 5 (May 1975), pp. 46-58; Jean L. Valerius, "Bank Profits in 1974," Federal Reserve Bank of Chicago *Business Conditions*, July 1975, pp. 13-15; Marvin M. Phaup, Jr., "Contrasts in 1974 Bank Profitability: Two Profiles." *Economic Commentary*, Federal Reserve Bank of Cleveland, August 18, 1975; and William C. Niblack, "Income and Expenses of Eighth District Member Banks," Federal Reserve Bank of St. Louis *Review*. Vol. 57, No. 8 (August 1975), pp. 20-23.

as the ratio of net income before taxes to total capital. Table 1 shows the rates of return on capital of all insured commercial banks in the United States by bank deposit size during the years 1954-74. As can be seen, there is considerable variability in the rates of return among deposit size groupings. Nonetheless, there is a distinct tendency for smaller banks to register lower rates of return on capital than larger banks, not only during particular years but also during the period as a whole.

Evidence of a positive association between bank size and bank profitability is depicted clearly in Chart 1. The chart shows the average rates of return on capital by banks classified according to deposit size for the entire 1954-74 period. Banks with deposits of less than \$5 million, for example, had an average rate of return of 11.43 per cent—the lowest ratio of any bank size group. Then, as the chart shows, the average rates of return tend to increase as bank size increases. Banks with deposits from \$5 to \$10 million, \$10 to \$25 million, \$25 to \$50 million, and \$50 to \$100 million averaged pretax rates of return on capital of 13.97, 14.98, 15.27, and 15.20 per cent, respectively. Banks with deposits of more than \$100 million, the largest banks, had an average rate of return of 15.71 per cent—the highest ratio of any group.

## Components of Bank Profitability

Given the clear tendency for bank profitability to rise as bank size increases, it is useful to examine the components of bank profitability that contribute to this positive relationship. The components can be identified by reference to the definition of the rate of return on capital, which is the ratio of net income before taxes to total capital, as shown by the following equation:

**Bank Profitability and Bank Size**

| <b>Table 1</b>   |                     |                   |                    |                    |                     |                       |
|--|---------------------|-------------------|--------------------|--------------------|---------------------|-----------------------|
| <b>RATE OF RETURN ON CAPITAL, ALL INSURED COMMERCIAL BANKS, BY BANK SIZE</b> |                     |                   |                    |                    |                     |                       |
| Year   | Millions of dollars |                   |                    |                    |                     |                       |
|  | Less<br>than<br>\$5 | \$5<br>to<br>\$10 | \$10<br>to<br>\$25 | \$25<br>to<br>\$50 | \$50<br>to<br>\$100 | More<br>than<br>\$100 |
| 1954   | 13.546              | 15.553            | 17.169             | 18.494             | 18.652              | 17.833                |
| 1955   | 12.495              | 13.868            | 14.374             | 14.721             | 14.854              | 14.757                |
| 1956   | 12.168              | 13.238            | 13.943             | 14.471             | 15.001              | 15.055                |
| 1957   | 11.996              | 13.239            | 14.277             | 14.699             | 15.450              | 16.409                |
| 1958   | 12.304              | 14.659            | 16.618             | 18.934             | 18.752              | 20.705                |
| 1959   | 11.983              | 12.486            | 12.973             | 12.581             | 12.678              | 13.128                |
| 1960   | 13.027              | 14.583            | 16.191             | 17.488             | 17.568              | 19.280                |
| 1961   | 11.900              | 13.864            | 15.179             | 16.577             | 16.996              | 19.535                |
| 1962   | 11.416              | 13.057            | 13.997             | 14.339             | 15.307              | 16.578                |
| 1963   | 10.686              | 12.528            | 13.211             | 13.473             | 14.294              | 15.625                |
| 1964   | 10.984              | 13.051            | 13.576             | 13.849             | 13.622              | 14.639                |
| 1965   | 10.233              | 12.371            | 13.044             | 13.534             | 13.268              | 13.845                |
| 1966   | 11.038              | 12.550            | 13.028             | 13.257             | 13.005              | 13.019                |
| 1967   | 11.508              | 12.808            | 13.387             | 13.968             | 13.599              | 14.449                |
| 1968   | 11.826              | 13.751            | 14.414             | 14.703             | 14.075              | 14.463                |
| 1969   | 11.719              | 15.243            | 16.380             | 16.256             | 16.033              | 15.910                |
| 1970   | 12.276              | 15.770            | 16.599             | 16.162             | 15.980              | 15.488                |
| 1971   | 11.046              | 14.986            | 16.216             | 15.560             | 15.470              | 14.486                |
| 1972   | 8.766               | 13.966            | 15.797             | 15.719             | 15.267              | 14.439                |
| 1973   | 9.713               | 16.118            | 17.265             | 16.839             | 15.281              | 15.069                |
| 1974   | 9.302               | 15.674            | 16.871             | 14.944             | 14.098              | 15.234                |
| 1954-59  | 12.415              | 13.841            | 14.892             | 15.650             | 15.898              | 16.315                |
| 1960-64  | 11.603              | 13.417            | 14.431             | 15.145             | 15.557              | 17.131                |
| 1965-69  | 11.265              | 13.345            | 14.051             | 14.344             | 13.996              | 14.337                |
| 1970-74  | 10.221              | 15.303            | 16.550             | 15.845             | 15.219              | 14.943                |
| 1954-74  | 11.425              | 13.970            | 14.977             | 15.265             | 15.202              | 15.712                |

NOTE: Rate of return on capital defined as net income before taxes divided by total capital account. Denominators for the 1969-74 period calculated from all commercial banks. Ratios computed from aggregate dollar amounts and expressed as percentages. Post-1968 figures not strictly comparable due to changes in reporting procedures introduced in 1969. The remaining discrepancies, however, are minimal.  
 SOURCE: Annual Report(s) of the Federal Deposit Insurance Corporation; Assets and Liabilities: Commercial and Mutual Savings Banks. FDIC, and report(s) of income and of condition submitted to the Federal Reserve System.

(1) Rate of return on capital =  $\frac{\text{net income}}{\text{capital}}$

Since net income is definitionally equal to total revenues minus total expenses, the rate of return on capital can also be shown as follows:<sup>2</sup>

(2) Rate of return on capital =  $\frac{\text{total revenues} - \text{total expenses}}{\text{capital}}$

To eliminate the effects of absolute bank size on revenue, expense, and capital measures, each is deflated by total bank assets. As a result, bank profitability can be analyzed in terms of its three major components:

<sup>2</sup>Total revenues are defined as total operating income. Total expenses equal total operating expenses plus actual net losses on loans and securities minus provision for loan losses and interest paid on capital notes and debentures. Capital includes total capital accounts.

(3) Rate of return on capital =  $\frac{\frac{\text{total revenues} - \text{total expenses}}{\text{assets}}}{\frac{\text{capital}}{\text{assets}}}$

This latter formulation implies that a higher rate of return on capital can result from a rise in the revenue-assets component or from a decline in either the expense-assets or the capital-assets components.

The average revenue, expense, and capital components of bank profitability during 1954-74, classified by bank size groups, are shown in Chart 1. In examining the relationship of these compo-

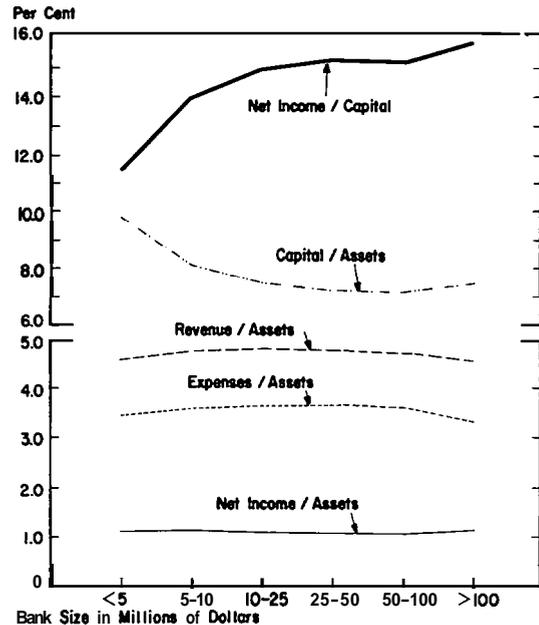
nents to bank profitability, it is quite evident from the chart that the **uptrend** in profitability across bank size is associated with the decline in the **capital-assets** ratio. The smallest banks—those with deposits of less than \$5 million—had an average capital to assets ratio as high as 9.80 per cent. As bank size increased, the ratio declined **quite** sharply, falling to 7.17 per cent for banks with deposits of \$50 to \$100 million. The only exception to this generally strong negative relationship between profitability and capital to assets-occurred in the largest size group. These banks with deposits of more than \$100 million increased their average return on capital relative to smaller sized banks despite an increase in their capital to assets.

The net income to assets component remained generally stable throughout the bank size distribution during the 1954-74 period. Banks with deposits of less than \$5 million averaged a net income to assets ratio of 1.12 per cent, while banks with deposits of \$50 to \$100 million had a ratio of 1.09 per cent. The largest banks, however, showed a noticeable rise in their net income component to 1.17 per cent.

The general stability in the net income to assets ratios shown in Chart 1 reveals a relatively constant spread between the revenue and expense ratios. Both revenue and expense ratios tend to increase across the smaller bank sizes and decline across the larger sizes. Banks with deposits over \$100 million were able to reduce expense ratios sufficiently to offset lower revenue ratios, so that their net income relative to assets posted a noticeable increase.

The rise in the net income to assets ratio of the largest banks serves to explain how they were able to increase their overall profitability despite a rise in their capital to assets ratio. As indicated by equation (3), other things equal, an increase in the capital to assets ratio would cause a decline in the rate of return on capital. In the case of the largest banks, however, the rise in the net income component more than offset the negative impact coming from the capital component. Specifically, the higher rate of return on capital shown by the largest banks, relative to banks with deposits of \$50 to \$100 million, was due to a larger percentage gain (7.8 per

**Chart 1**  
**BANK PROFITABILITY: 1954-74**



SOURCE: See Table 1.

cent) in the net income component than the percentage increase (4.1 per cent) in the capital component. The net effect of these two factors enabled banks with deposits over \$100 million to earn the highest average return on capital of any bank size group for the entire period.

To summarize, the average rates of return on capital of all insured banks in the United States during the 1954-74 period have displayed a marked tendency to increase as bank size increases. For all but the largest size bank category, this tendency reflects systematic movements of two factors. The capital component of bank profitability declines as bank size increases and the net income component remains relatively constant. In the case of the largest banks, the increase in the rate of return on capital is produced by an upward movement in the net income component and not by a decline in the capital component.

How representative are these long-run trends in bank profitability, and components of profitability, for individual subperiods within the 1954-74 period? The next section of this article attempts to an-

## Bank Profitability and Bank Size

swer this question by examining movements in bank profitability by bank size for four distinct subperiods.

### **PROFITABILITY WITHIN THE 1954-74 PERIOD**

#### **Representative Subperiods**

The long-run systematic behavior of bank profitability across bank size is found to be representative of three subperiods: 1954-59, 1960-64, and 1965-69. To illustrate this similarity, Chart 2 contains average rates of return on capital for all insured commercial banks in the United States, grouped according to deposit size, for each of these subperiods. Also shown are the components of bank profitability for each of the subperiods.

A noticeable characteristic of each of the three representative subperiods is that the average rates of return on capital are positively associated with bank size. The smallest banks invariably record the lowest average rates of return; larger banks tend to show progressively higher rates of return; and the largest banks show the highest rates of profitability. Also clearly evident is that, for each representative subperiod, the capital to assets ratio falls across the size distribution, except in the case of the larger banks. There is, with the exception of the larger banks, a perceptible inverse relationship between bank profitability and the capital component in each of the three representative subperiods. The net income to assets ratio, and the underlying revenue and expense ratios, also behave in a similar fashion in each of the three subperiods. While little variability occurs in each of these ratios for most bank sizes, the net income to assets ratios of the largest banks rise noticeably due to a more rapid decline in the expense than in the revenue component. This rise in the net income component for the largest banks was sufficient to offset the increase in the capital component, producing a rise in the return on capital.<sup>3</sup>

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<sup>3</sup>/Chart 2 may appear to suggest that movements in capital are more important than movements in net income between the two largest bank sizes. Yet, in percentage terms, the increments in the net income component are larger. In the 1965-69 subperiod, for example, the capital to assets ratio increased from 7.28 per cent to 7.53 per cent, whereas the net income to assets ratio increased from 1.02 per cent to 1.08 per cent across the two largest bank sizes. In percentage terms, however, the movements in the capital and net income components are 3.43 per cent and 5.79 per cent, respectively.

#### **A Nonrepresentative Subperiod**

Movements in bank profitability are found to differ significantly in the 1970-74 subperiod from the long-run patterns evidenced for the entire 1954-74 period. Average rates of return for this non-representative subperiod are depicted in Chart 2. As seen from the chart, rates of return on capital are only positively associated with bank size over the smaller bank groups. Thereafter, as bank size increases, profitability falls. As a consequence, the highest average rate of return of 16.55 per cent is turned in by medium sized banks with deposits of from \$10 to \$25 million. And, the profitability ratio of the largest banks of 14.94 per cent is found to be next to the lowest of any size group. In the 1970-74 subperiod, therefore, the relationship between profitability and bank size becomes negative for bank sizes larger than \$25 million in deposits.

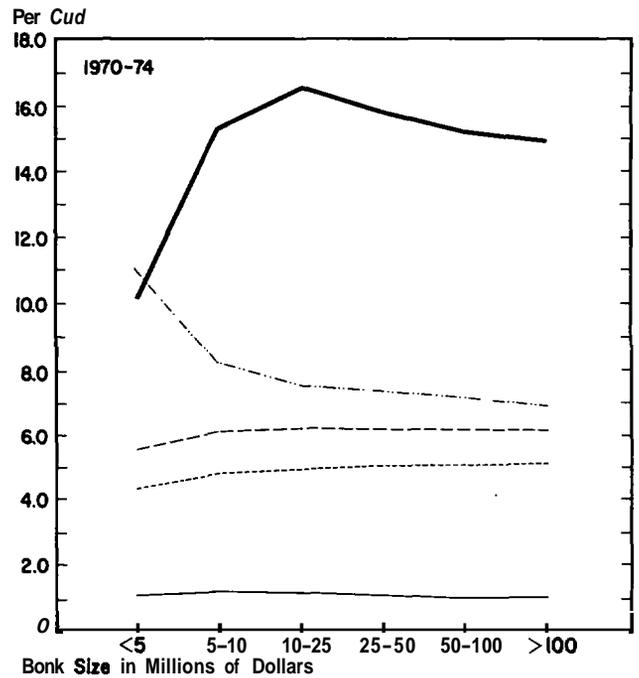
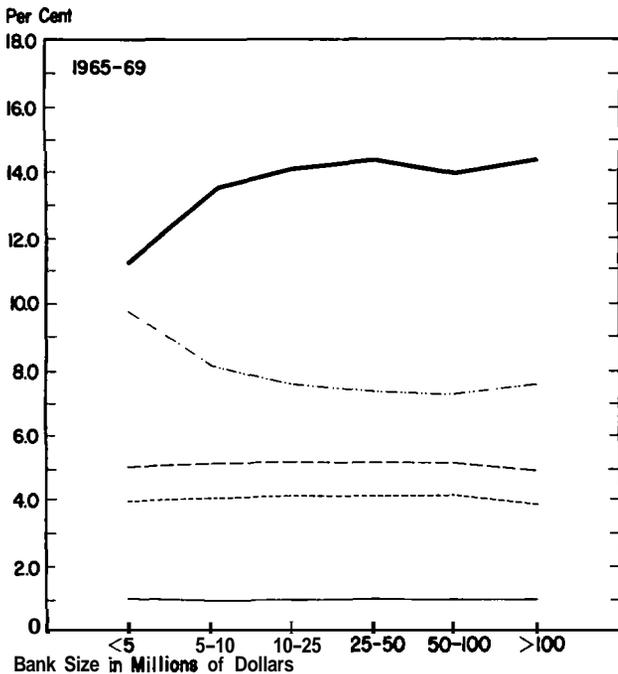
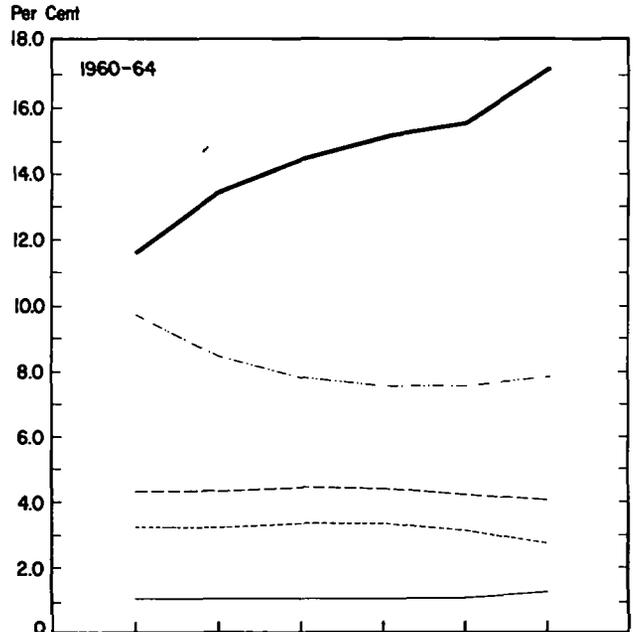
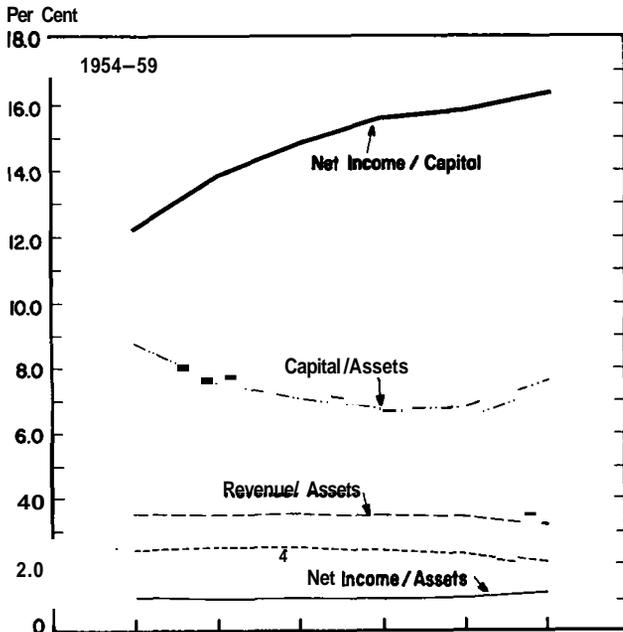
Movements in the capital to assets ratio in the most recent subperiod are generally similar to earlier periods for small and medium bank sizes. Unlike the 1954-74 period, however, the ratio falls across the larger bank sizes. Other things equal, declines in the capital component are associated with increases in bank profitability. Hence, declines in the capital to assets ratio across bank size offer no ready explanation for the relative decline in profitability experienced by the larger sized banks during the 1970-74 period.

The dominant factor contributing to the falloff in profitability at larger sized banks is that—unlike earlier periods—the net income to assets ratio drops almost steadily as bank size increases.<sup>4</sup> In particular, the ratio falls for the largest banks, which is in marked contrast to earlier subperiods when the ratio at these banks increased. Underlying the downward movement of the net income ratio, as seen in Chart 2, is the fact that the revenue component remains generally flat for all but the smaller bank sizes while the expense component steadily rises as bank size increases. This pattern is particularly evident for banks with deposits over \$100 million. In brief, the decline in relative profit-

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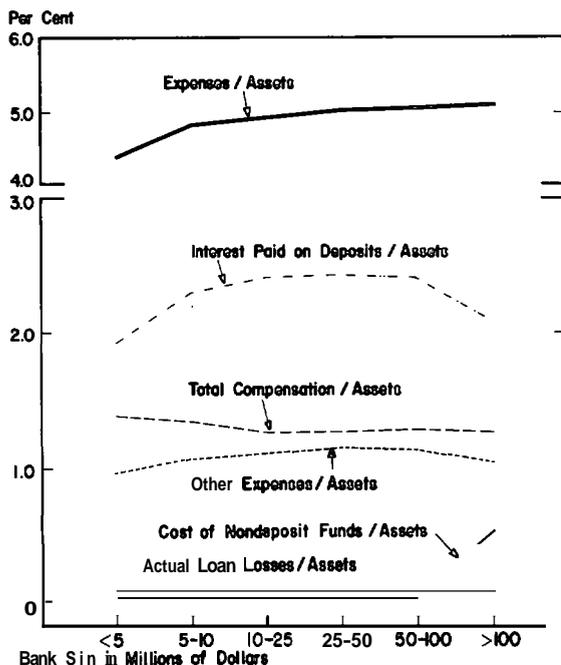
<sup>4</sup>/From equation (3), other things equal, a decline in the capital component produces an increase in the rate of return on capital. Thus, the downturn in net income was sufficient to reduce the rate of return on capital, despite the reduction in the capital to assets ratio.

Chart 2  
BANK PROFITABILITY IN SUBPERIODS



SOURCE: See Table 1.

Chart 3  
EXPENSE COMPONENT: 1970-74



SOURCE: See Table 1.

ability of the larger banks in the 1970-74 period is traceable to a rise in the expense component relative to the revenue component.

But what caused the expense component of bank profitability to rise at larger banks during the 1970-74 period? To examine this question, Chart 3 depicts the major items of expense relative to total assets of all commercial banks classified by deposit size during the recent period. The chart shows that all except one of the major expense items either declined or remained relatively constant over the larger bank size groups. The one expense item that increased noticeably was the cost of nondeposit sources of funds, defined as the expense of Federal funds purchased plus the interest cost on other borrowed money. In other words, the rise in the expense to assets ratio at the larger banks appears to be attributable mainly to an increase in the cost of nondeposit funds. Underlying this phenomenon is that the larger banks have relied increasingly during recent years on short-term borrowed money

to accommodate loan demand in the short run and to maintain valuable customer relationships in the long run. These bank practices, however, at times of rising interest rates and unexpectedly severe inflationary pressures — such as prevailed in the 1970-74 period — undoubtedly have served to reduce the relative profitability of the larger sized banks.<sup>5</sup>

### SUMMARY

An examination of bank profitability according to bank deposit size reveals that during the 1954-74 period there is a clear tendency for the rate of return on capital to increase as bank size increases. Small banks show the lowest average rates of return; larger banks show progressively higher rates of return; and the largest banks post the highest rates of profitability. Except for the largest bank sizes, this tendency reflects the sharp downward movement in the capital component of bank profitability as bank size increases. The net income component of bank profitability tends on average to vary little across small and medium sized banks. Across the two largest bank sizes, however, the income component increased sufficiently to offset an upward movement in the capital component, producing a rise in the rate of return on capital.

The general pattern of bank profitability observed in the 1954-74 period was found not to hold true in the most recent subperiod of 1970-74. Rates of return on capital were positively related to bank size only over the small to medium size groups. Thereafter, as bank size increased, bank profitability decreased. Consequently, medium sized banks turned in the highest average rate of return of any size group during the recent subperiod. Contributing to this pattern of bank profitability is that the expense component — particularly for short-term borrowed money — moved up quite noticeably at larger banks. As a result, the average profitability ratio of the largest banks was found to be next to the lowest of any size group during the recent 5-year period.

<sup>5</sup>A mild and relatively stable inflation rate averaging 1.99 per cent per annum characterized the 1954-69 period; it more than tripled to 6.14 per cent during 1970-74. It is precisely in this time interval that rates of return on capital peak over the medium sized banks and steadily decline throughout the remainder of the bank size distribution.