PROGRESS REPORT BY
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BEFORE THE SUBCOMMITTEE ON INTERNATIONAL FINANCE OF THE
SENATE BANKING AND CURRENCY COMMITTEE
ON THE PROGRAM FOR VOLUNTARY RESTRAINT OF FOREIGN CREDIT
BY BANKS AND OTHER FINANCIAL INSTITUTIONS

August 5, 1965

Mr. Chairman, I appear in response to your request for information on the voluntary foreign credit restraint program, under which financial institutions are taking part in the President's program to improve our payments balance, in accordance with guidelines issued by the Federal Reserve System. Copies of these guidelines and accompanying news releases have been furnished to your Committee.

This program includes two separate but interrelated parts. The first aims at reducing the expansion of bank credit to foreigners; the second seeks to limit the expansion of credits and investments abroad by other financial institutions, such as mutual funds, insurance companies, and pension and other trust funds.

Credits and investments of financial institutions played an increasingly important role among the factors responsible for last year's deficit in our payments balance. While it would be impossible to state that any special item of our payments balance "caused" the deficit to the exclusion of the others, it certainly should be considered significant if one item deteriorated while the others improved. And this is what happened last year in the case of capital flows.

The outflow of U.S. private capital, excluding direct investments of U.S. firms abroad and net purchases of foreign securities, averaged $1.4 billion annually in the years 1960 through 1963. In the same period, our payments deficit, as calculated by the Department of Commerce, averaged $3.5 billion per year. Hence, that outflow was equal to just about 40 per cent of the total payments deficit.

But in 1964, this ratio suddenly changed. The payments deficit declined slightly to $3.1 billion but the outflow of capital (again excluding direct investments and purchases of securities) rose to $3.4 billion. In 1964, therefore, that outflow was equal to 110 per cent of the total payments deficit and at least two-thirds of that outflow reflected transactions of banks and investment concerns.

These figures should not be interpreted as meaning that our payments balance would have improved in exact proportion to a decline in the capital outflow. No doubt, part of the bank credit expansion was connected with the rapid increase in our merchandise exports, which rose by $3.2 billion between 1963 and 1964. And the newly extended credits and investments also yielded some income in 1964. Nevertheless, a large part of the newly extended credits had no connection with exports of U.S. goods or services, and the increased returns attributable to the increased capital outflow obviously did not offset more than a small fraction of that outflow.

For these reasons, it seemed clear at the time of the President's message of February 10, 1965--and it seems even clearer today, when we have better statistics on the subject--that any decisive improvement in our payments balance would be impossible without a reduction in the outflow of capital provided by banks and other financial institutions. This reduction is the goal of the voluntary foreign credit restraint program.

Let me stress that our program is designed to limit, not to eliminate, the expansion of our credits to foreigners and of our investments abroad. We are fully aware of the need for a steady expansion of those credits and investments. Such expansion is needed to support expanding exports of U.S. goods and services; to make more private capital available for the development programs of less developed countries; and to help meet the financial needs of such nations as Canada and Japan, which have traditionally depended on the inflow of U.S. funds. Nothing in our program should be interpreted as indicating that we regard credits to foreigners or investments abroad as harmful in themselves; on the contrary, we know very well that the world-wide activities of our banks and other financial institutions are not only an important source of future income for our economy but also an important means of contributing to the expansion of international commerce and hence to the economic growth of the free world as a whole.

But just because the international activities of our banks and investment concerns are so important, it is necessary to avert the danger of excessive and unsustainable expansion, which would risk harming the international position of the dollar, with all its potential implications for our domestic as well as the international economy.

Under our bank guidelines, banks are requested to limit the increases in their foreign credits so that their outstanding credits to foreigners will not exceed 105 per cent of the amount outstanding at the end of 1964. Since the latter amount was approximately $10 billion, this means that the banks are requested to limit their net credit expansion in 1965 to approximately $500 million, as compared with an average expansion of about $1 billion annually in the years from 1960 through 1963, and a record expansion of more than $2 billion in 1964. Financial concerns other than banks are requested to limit similarly those credits and investments in which those concerns are likely to compete with banks; this means primarily credits with a maturity not exceeding ten years. While those concerns are not requested to limit credits or investments of more than ten years to any specific amount or percentage, they are requested to avoid any increase in the total of such credits or investments in foreign developed countries other than Canada, Britain, or Japan. Moreover, they are requested to reduce their holdings of liquid funds abroad to the 1963 level.

Within the limits of the expansion target, both banks and investment concerns are requested to give absolute priority to credits providing _bona fide_ financing for exports of U.S. goods and services. On the basis of data furnished by the banks themselves, we calculated that the target gave ample room for any foreseeable need to expand export financing.

Second only to that absolute priority, all institutions are requested to give priority to credits to less developed nations. Moreover, the exemption of credits and investments with a maturity of more than ten years granted to investment concerns removes any obstacle under the program to such long-term credits to, and investments in, less developed countries--the type of credits and investments which is considered most beneficial to these countries.

And thirdly, all institutions are requested to avoid restrictive actions that might embarrass Canada and Japan, which are traditionally dependent on financing from U.S. sources, and Britain, which is suffering from a serious balance-of-payments problem of its own. Again, the guideline provision regarding long-term credits and investments of institutions other than banks removes the danger of inhibiting the expansion of such credits to, and investments in, the Canadian economy.

The three categories of priorities, incidentally, broadly parallel the provisions of the Interest Equalization Tax, which generally exempt export credits and credits to less developed countries and which permit certain exemptions for countries such as Canada and Japan.

Our bank guidelines, including 14 specific points, were issued on March 5, 1965, after consultation with the Treasury and other interested government agencies and after obtaining the views of experts from the banking community; since then, two of these points have been amended in order to clarify their intent. In addition, requests received from banks for advice on controversial points have been answered by a set of interpretations, designed to help the banks to participate in the program in line with its purposes.

Formulation of guidelines for investment concerns was complicated by two factors. First, the Federal Reserve was less well acquainted with the practices of those concerns than with the activities of commercial banks; and second, the statistical material available on the international credit activities of those concerns was quite fragmentary, in contrast with the data regularly collected from banks by both the Treasury and the Federal Reserve. For these reasons, the Board of Governors felt compelled at first, on March 8, 1965, to issue only tentative guidelines for investment concerns. After consultation with experts in that field and after analysis of improved statistical material collected for that purpose, we issued revised guidelines for those concerns on June 21, 1965.

Both sets of guidelines are based on the principle of minimizing interference with the business of the participating institutions, and especially with individual business decisions. Within the broad targets, it is left to banks as well as to investment concerns to choose the best way to abide by the guidelines. In particular, the Board of Governors as well as the Federal Reserve Banks, through which we maintain close contact with participating institutions, have attempted to answer questions of interpretation in terms of general principles, and to avoid passing on individual cases. In this way, we have avoided the risk of letting the voluntary restraint program turn into a partial system of exchange controls.

Needless to say, we do not regard our guidelines as sacrosanct. We are constantly consulting with other government agencies and with experts from the participating banks and other institutions on the problems raised by the program, and are following closely the statistics collected under the President's program in order to evaluate the current status of our payments balance as well as the success of, and continuing need for, foreign credit restraint.

So far, the program has proved outstandingly successful. This success is due to the splendid cooperation of the participating banks and investment concerns. Each institution willingly cooperates because it knows the "rules of the game," and realizes that it receives exactly the same treatment as all other institutions of its kind, wherever located, with no individual exemptions or exceptions.

Adherence to the program has meant giving up many opportunities to engage in profitable business transactions, and it is truly voluntary. Nevertheless, the financial community has responded to the President's appeal with a spontaneity and unanimity that has not only astonished our foreign critics--who at the beginning had dismissed the idea of voluntary restraint at best as an utopian dream or at worst as fatuous make-believe--but even some of us here at home.

A few figures will show you what I mean. In the first two months of 1965, bank credits to foreigners rose at a monthly rate of nearly $200 million. In March, the first month under the voluntary restraint program, the expansion fell to less than $50 million--and presumably most of that outflow was the consequence of earlier binding commitments, which the institutions are, of course, obliged to honor. And in the second quarter, the net expansion was replaced by a net reduction in credits to foreigners, averaging more than $100 million per month. Consequently, at the end of June 1965, total bank credits to foreigners were only about $100 million higher than at the end of 1964.

Incidentally, these figures are based on special reports of the participating banks to the Federal Reserve, and are not strictly comparable to the data on capital flows generally used in the analysis of our payments balance. I am submitting for the record a statement presenting additional statistical information regarding the foreign lending activity of commercial banks under the program.

Financial institutions other than banks have also cooperated well in the restraint effort. In 1964, the concerns participating in the program had expanded their credits to foreigners and investments abroad by nearly $1 billion; in the first six months of 1965, according to preliminary and incomplete data, the expansion was on the order of $100 million. Liquid funds held abroad were reduced by more than $100 million; credits and investments with a maturity of not more than ten years rose very little; and long-term credits and investments expanded by nearly $200 million. The pattern of these changes fully conforms to the intent of the guidelines.

Needless to say, the gratifying results to date cannot entirely be attributed to the program itself. For instance, the dock strike of January-February 1965 inhibited the growth of exports and hence also of export credits during that period; and more recently, the measures taken by industrial countries to combat inflationary pressures and reduce payments deficits, as well as less favorable developments in the international trade position of less developed countries, have stemmed the rise in our exports and therefore the need for an expansion in export credits.

I may say, incidentally, that the recent slowing down in our exports can by no means be attributed, even in part, to the voluntary restraint program: not only because the guidelines do not permit the participating institutions to take the program as an excuse for denying needed export credit accommodation to any creditworthy applicant; not only because all our inquiries so far have failed to unearth a single actual case in which an export transaction failed to materialize because of denial of credit to a creditworthy borrower under color of the restraint program; but also because the very fact that the banks as a whole are considerably below the suggested credit target proves that the banking system has, indeed, ample room for increasing its export credits without risking a violation of the suggested ceiling.

A second reason for the virtual cessation of credit expansion independent from the restraint program probably may be found in the unusually large rise in credits during the last quarter of 1964 and the first six weeks of 1965. Some foreign countries or individual borrowers may well have exhausted the credit lines envisaged by the managers of prudent banks and investment concerns.

A third factor--almost needless to say--was the extension of the Interest Equalization Tax to bank credits with a maturity of at least one year, together with the proposed subjection to the tax of nonbank credits with a maturity of at least one year but no more than three years. In recent months, however, some European and Japanese borrowers have been willing to reimburse the tax to U.S. lenders so that the tax alone would not have made credits to those borrowers unattractive. In these cases, the voluntary restraint program has served to supplement and reinforce the Interest Equalization Tax.

When the voluntary restraint program was started, we knew that in view of the large credit expansion of January and February quite a few banks already were above the target suggested for the entire year. We also knew that others would necessarily exceed that target sometime during the year because the guidelines requested banks not only to honor any binding commitments but also to extend bona fide export credits, even if such extension meant a temporary excess over the suggested ceiling. Subsequent statistics showed that, at the end of March, about 60 participating banks were above the suggested ceiling by a total of $275 million. Representatives of some of these banks assured us that it would be impossible for them to reduce outstanding credits fast enough to get below the suggested ceiling before the end of 1965, unless they were to violate the provisions in regard to binding commitments and priority credits. For this reason, the guidelines stated that a bank finding itself on those grounds in excess of the suggested ceiling would not be deemed to have failed to conform to the guidelines, provided it managed to get below the ceiling not later than one year from the issue of the guidelines, i.e., not later than in March 1966.

But by the end of June 1965, the aggregate amount by which banks exceeded the ceiling had dropped to $100 million; this means that these banks as a group have reduced their excess by two-thirds within as short a period as three months. Equally important, most banks now in excess are so by very small amounts or for clearly temporary, sometimes seasonal, reasons; not more than a handful still have substantial excesses that may pose some problem for bank management.

The most gratifying part of the program has been the compliance of banks and other institutions with the suggested credit priorities. I have already mentioned that, despite some rumblings about interference of the restraint program with the export drive, no concrete instance of unjustified refusal of export financing has been discovered--although export financing is often less profitable than other forms of credit and some banks might have been tempted to keep within the overall ceiling by means of curtailing export credits in favor of other more profitable transactions.

Bank credits to less developed countries also have been expanded in accordance with the guidelines. True, short-term credits to those countries have not risen, in line with the lag in the expansion of our exports to those countries; but in the first half year of 1965, the annual rates of commitments on, and actual disbursements of, bank loans to less developed countries with a maturity of one year or more compared favorably with those for 1964.

In the first half of 1965, again according to incomplete figures, investment concerns increased by $300 million their long-term credits to, and investments in, the less developed countries as well as Canada and Japan, while reducing them by $125 million in other industrial countries. The figures were roughly equivalent to the half-yearly 1964 averages for the less developed countries and Canada, and substantially more favorable for Japan, which suffered a reduction in long-term credits last year.

The restraint program has resulted in some withdrawal of American funds from the so-called Euro-dollar market, both directly and through the shift of liquid funds out of Canadian banks, which usually invest at least part of such funds in the Euro-dollar market. This withdrawal caused some stiffening of rates in that market. But this stiffening in turn has induced more European funds to flow into Euro-dollars, and by the end of June rates in that market had returned to their earlier levels, about 1/2 of 1 per cent above rates for certificates of deposit in New York.

The guidelines aimed at reducing the outflow of financial capital by curtailing these flows to Continental Europe. Continental Europe has a chronic surplus in its payments balance with the rest of the world. European central banks therefore have urged, and later welcomed, the reduction in the inflow of funds from the United States, which not only added to their payments imbalance but also, in their opinion, to domestic inflationary pressures in Europe. It is true that the success of our program may have curtailed that inflow more than they had thought possible. And the recent tendency of European subsidiaries of American firms to cooperate in the balance-of-payments program by seeking financing in Europe rather than in the United States may have added to the credit stringency in some European countries. But this development, although perhaps in some cases temporarily embarrassing for those countries, actually is contributing to the restoration of financial stability throughout the world. It induces and permits the central banks of the affected European countries to relax their credit restraints without risking domestic inflationary pressures--the mere substitution of domestic for foreign funds without a change in total domestic investment cannot have inflationary repercussions. And at the same time, the resulting narrowing of differences in credit conditions between Continental Europe and the United States will permanently help to reduce the payments surplus of Europe together with the payments deficit of the United States.

I should like to close on that optimistic note; but it is my duty also to point to some less reassuring consequences of the very success of the restraint program. According to present indications, the second quarter of 1965 has shown for the first time in many years a surplus in our payments balance. This is, of course, highly satisfactory. But the change in the flows of bank credits to foreigners, alone, is about as large as the entire probable improvement in our payments balance between either the first quarter of this year or the quarterly average of last year, and the second quarter of this year.

This is disquieting because our voluntary restraint program is meant to be a temporary expedient, and in fact cannot be expected to work smoothly except on a temporary basis. We may hope that it will lead to the better realignment of American and European capital markets, mentioned before. But it would probably be unrealistic to expect that this realignment alone will be sufficient to eliminate our payments deficit for good. To that end, we need renewed improvement in our current balance as well as further domestic economic expansion, to make investment at home more attractive than investment in foreign industrial countries and especially in Continental Europe.

Our monetary policies must be consistent with both these endeavors: firm enough to prevent price and cost increases from endangering our international competitiveness; but not so firm as to let a stringency of credit endanger the financing of continued domestic growth. The voluntary credit restraint program is no substitute for these general policies; but I hope that it will continue to supplement them until the improvement in our more basic international economic relations has led to payments equilibrium without the need for specifically restraining credits to foreigners. I am looking forward to the day when we shall be able to discontinue our voluntary credit restraint efforts--as eagerly as does the financial community itself.

Statistical Information Regarding the
Voluntary Foreign Credit Restraint Effort of
Commercial Banks

Submitted to the
Subcommittee on International Finance
of the
Senate Banking and Currency Committee
by
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Summary figures regarding the position of the banks at the end of each month since February are shown in Table 1. This tabulation includes only those banks with total foreign assets in excess of $500,000; the number of banks included varies somewhat from month to month.

Table 1. Foreign Credits of United States Banks
(Dollar amounts in millions)

	February	March	April	May	June
Number of banks	145	145	150	154	156
Total foreign claims subject to 105 per cent ceiling	9839	9883	9748	9663	9579
Target ceiling (105 per cent of December 1964 base)	9953	9953	9958	9972	9963
Net expansion of claims since December 1964	360	405	264	165	88
Net expansion of claims remaining within target ceiling	112	70	211	308	384

Tables 2 and 3 present certain data regarding banks having outstanding foreign credits in excess of 105 per cent of their base as of the end of each month. The specific banks included in this group vary from month to month. Many banks are relatively close to the 105 per cent ceiling, and a small change in outstanding credit may thus cause them to shift from a position of just under to just over the target, and vice versa.

Table 2. Foreign Claims of
Banks in Excess of Target Ceiling

	February	March	April	May	June
Number of banks	56	56	53	48	52
Net reduction in claims necessary to achieve target ($ million)	265	275	197	109	110

Table 3. Analysis of Foreign Credits of
Banks in Excess of Target Ceiling, June 1965

Number of Banks	"Excess" Credits of ($ million)	Amount of Credit in Excess of Target ($ million)	Credit Increase Jan.-June 1965 (per cent)
4	More than 4.9	56	8.9
10	2.0-4.9	28	17.4
8	1.0-1.9	11	6.3
30	Under 1.0	13	12.2

Reporting by commercial banks under the voluntary foreign credit restraint effort has also provided, for the first time, accurate information on the total foreign claims of U.S. banks. The following tabulation is based on foreign claims subject to the restraint effort; that is, it excludes credits guaranteed by or arranged through the Export-Import Bank as well as loans made by foreign branches, but it includes long-term securities, real assets, and the net investment in foreign branches and subsidiaries. It differs from the data on foreign assets reported by U.S. banks, as currently published in the Federal Reserve and Treasury Bulletins, mainly in that it does not include assets held for the account of customers nor does it include foreign assets of U.S. agencies of foreign banks.

Table 4. Foreign Claims of
United States Banks by Size Group, December 1964
(Amounts in billions of dollars)

Banks Ranked by Size of Foreign Claims	Total of Group	Cumulative Total	
		Amount	Per Cent
Total, 154 banks	9.5		
5 largest banks	5.0	5.0	53
Banks 6-10	2.1	7.1	75
Banks 11-15	0.6	7.7	81
Banks 16-20	0.35	8.05	85
Banks 21-25	0.25	8.3	87