For Release on Delivery
Wednesday, February 11, 1970
6:00 p.m., C.S.T.

CAPITAL OUTFLOWS AND THE U.S. BALANCE OF PAYMENTS

Review and Outlook

A Paper Presented

by

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Member
Board of Governors of the
Federal Reserve System

At a Dinner Meeting

of

Bankers, Businessmen and the Board of Directors
of the Federal Reserve Bank of Dallas

Fairmont Hotel
Dallas, Texas

February 11, 1970

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Review and Outlook

By
Andrew F. Brimmer*

Yesterday, February 10, marked the fifth anniversary of a Federal Government program whose longevity was expected to be much shorter: on that day in 1965, President Johnson announced, with great urgency, the establishment of a series of programs to moderate capital outflow and improve our balance of payments. The main elements in the programs were both voluntary and temporary. Five years later, the balance of payments is still in substantial deficit, a major component of the programs is mandatory, and the restraints on capital outflow have acquired a look of permanency.

Clearly, this is an outcome that was unanticipated. The key parts of the programs -- administered separately by the U.S. Department of Commerce and the Federal Reserve Board -- were launched against the background of a dramatic rise in the movement of U.S. funds abroad. However, it was also generally assumed within the

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I am grateful to several members of the Board's Staff for assistance in the preparation of these remarks. Messrs. Bernard Norwood and Gordon B. Grimwood (who work closely with me in the administration of the Board's foreign credit restraint program) were mainly responsible for the review of program developments. Mr. Samuel Pizer was very helpful in the assessment of the outlook for the U.S. balance of payments. Mr. Lyle E. Gramley provided counsel on the possible use of reserve requirements to moderate bank acquisition of foreign assets, and Mr. James T. Lynch made the preliminary analysis to determine the legal basis of such a possibility.

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Federal Government that our external financial position was fundamentally strong and that restraints on capital outflows were required only to provide short-term assistance until the basic strength of our trade surplus, rising earnings on direct investment, and other favorable elements could coalesce to restore a lasting balance. To a considerable extent, the business and banking community accepted this view and cooperated with the Federal Government in an effort to achieve the stated objectives. But within six months after the programs were launched, U.S. military activity in Vietnam was accelerated, and the country became enmeshed in a web of inflation that is still with us. The detrimental effects of both developments for our balance of payments are also still with us. Thus, the present seems a particularly appropriate time to ask whether these programs have achieved their aims and whether -- five years later -- they are still needed.

Sadly, I have concluded personally that -- not only is some form of restraint on capital outflow required at this time -- but also that the need will exist for a number of years to come. In view of this prospect, I am also convinced that we should try to devise techniques for moderating capital outflow which can remain viable over the long haul. In my judgment, such techniques should be rooted firmly in the market place and should depend as little as possible on administrative decisions of Government officials.

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I have reached this conviction on the basis of an experience with the existing programs which extends back to the date of their inception. As Assistant Secretary for Economic Affairs in the Department of Commerce, I helped to fashion the voluntary version of the direct investment program and administered it until I was appointed to the Federal Reserve Board in March, 1966. Since June, 1968, on delegated authority from the Board, I have had administrative responsibility for the program (which is still voluntary) to restrain the extension of foreign credits by U.S. banks and other financial institutions. During all of this period, I have been ever conscious of the original goal of dismantling the restrictions as soon as possible. But I have been equally conscious of the continuing weakness in our balance of payments and of the pressing need to achieve -- and maintain -- an equilibrium in our international accounts. Consequently, in searching for a course which will permit lifting administrative restraints on capital movements, we must assure that this more fundamental target is not put in jeopardy. In the closing section of these remarks, I outline an approach which -- I believe -- would bring about a reconcliation of these competing goals.

At this point, let me stress that the views advanced here are my own. The Federal Reserve Board as a whole is obviously aware of -- and troubled by -- the continuing serious deficit in our balance of payments. The Board is also troubled by the inequities inherent

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in the present program and by its continued existence well beyond the point at which it was expected to be terminated. However, the review and assessment of the program -- and a possible alternative -- presented here should not be interpreted as representing a position already adopted by the Board.

Before proceeding further, it might be well to summarize the salient conclusions emerging from this assessment of the Federal Reserve's voluntary foreign credit restraint program over the last five years:

- The major objective of the program, to restrain the growth in foreign lending and investment of U.S. financial institutions, has been achieved. In every year since 1965, the amount of foreign assets outstanding has been less than the amount that would have been permitted under the guidelines -- in most years by substantial amounts. Moreover, the total amount of such lending and investment is today lower than the targets set in the early years of the program.

  While achieving this main objective, the cooperating banks and other financial institutions have been mindful of two other important national goals: insuring that sufficient credit is available to finance U.S. exports and to help meet the needs of the developing countries.

  The basic design of the program has remained essentially unchanged over the years: it remains voluntary, and it establishes an overall ceiling within which interference with management decisions is minimized. However, during the last two years, the program has become somewhat more specific.

  The program has affected the pattern of U.S. international banking. Competitive inequities

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> among banks have developed, and a network of foreign branches has been stimulated whose long-run impact cannot be seen clearly.

Finally, as I mentioned above, in my judgment our balance of payments situation still requires some kind of restraint on the outflow of U.S. private capital. But I also believe that some other technique should be substituted for the existing quantitative and administrative controls:

> Thus, I think serious attention should be given to the possibility of replacing the present program with a system of graduated reserve requirements against foreign assets. Such a system would be closely allied to market forces, and it could be tailored to enhance -- or discourage -- any type of foreign lending or investment consistent with our overall balance of payments objectives.
>
> A preliminary review of the Federal Reserve Board's authority suggests that the Board may already have an adequate legal basis on which to rest such a system.

Origins of the Balance of Payments Programs

Before proceeding further, it might be well to remind ourselves briefly of the circumstances which necessitated the adoption of restrictions on capital outflow. It might be recalled that the first step in this direction was the proposal of the Interest Equalization Tax (IET) in mid-1963, and its adoption about a year later. The measure was designed to lessen the attractiveness of the U.S. capital market to borrowers in Europe and other developed countries.

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This first step itself was taken against the background of heavy balance of payments deficits to which a rising outflow of private capital was making an increasingly large contribution. For example, during the late 1950's, the movement of private capital from this country averaged about $2-1/2 billion per year; but in the 1960-64 period, the annual average was roughly $4-1/2 billion. In the single year 1964, the net outflow of private funds reached $6-1/2 billion. In contrast, during these years, the U.S. had the advantage of a large and growing surplus in exports of goods and services -- which exceeded $8-1/2 billion in 1964. Nevertheless, our total payments abroad greatly outweighed our receipts from abroad, so substantial deficits appeared in the late 1950's and persisted into the early 1960's.

The second move in the evolution of restrictions on private capital outflow was triggered by a sharp deterioration in our balance of payments in the closing months of 1964. When the IET was adopted, it did not cover long-term bank lending, and this exemption encouraged foreign borrowers to shift from the sale of bonds in the U.S. market to reliance on bank financing. Simultaneously, other types of capital outflows (particularly direct investments and short-term bank credits) which were not subject to the IET also rose rapidly. By the last quarter of 1964, the balance of payments (measured on the liquidity basis) was in deficit at an annual rate of $5 billion, and private capital outflows were at an annual rate in excess of $8 billion.

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Out of these developments came the voluntary balance of payments programs announced in February, 1965. At the time, it was fully realized that the voluntary restraint of capital outflows was an innovation. The classic solution to the balance of payments problem would have called for a substantially restrictive monetary policy, considerably reduced credit availability and higher domestic interest rates. This policy was avoided because it would have hampered efforts to encourage an expansion of output as a means of reducing the prevailing high level of unemployment and of shrinking the backlog of unused resources. Furthermore, there was reason to believe that higher interest rates in the United States would have been countered by higher rates abroad -- with no net benefit to our balance of payments. Under these circumstances, it was thought best to tackle the problem at its source -- that is, to limit our capital outflow to a figure more nearly equal to our current account surplus, while at the same time pressing vigorously toward achieving an optimum rate of economic growth.

The Voluntary Foreign Credit Restraint Program: A Review

In appraising the performance of the Voluntary Foreign Credit Restraint Program (VFCR) relating to financial institutions, it is well to bear in mind that it is one component of a comprehensive set of restrictions which bear on capital outflow in varying degrees. At the time the VFCR was launched in February, 1965, the IET was extended

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to cover long-term bank loans to foreigners. As mentioned above, a voluntary program to moderate direct foreign investment by non-financial corporations (administered by the U.S. Department of Commerce) was part of the same announcement. (It will be recalled that the latter program was made mandatory by Executive Order as of January 1, 1968). Each part of this set of restraints reinforces the others, none of them would be effective without the others. Moreover, the administration of the parts (and this is especially true of the VFCR and the direct investment regulations) is coordinated as much as possible. In the rest of these remarks, however, most of my comments will be restricted to the VFCR.

The Federal Reserve program remains voluntary, although the Board has authority under the January 1, 1968, Executive Order to make it mandatory. The general structure has changed little: it involves an overall ceiling (which has been modified several times), based generally on the holding of foreign assets at the end of 1964. Within this ceiling managers of financial institutions are free to make their own decisions, but they are asked to give priority to credits to finance U.S. exports and to meeting the needs of developing countries. These priorities have recently been given more emphasis. The guidelines for 1968 contained a request that financial institutions refrain from making new nonexport term loans to developed countries of Continental Western Europe (and in the case of banks that they reduce their

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ceilings by the amount of repayment of such loans). The bank guidelines for 1970 established a separate ceiling for export term loans. Finally, on February 28, 1968, Canada was exempted from all the U.S. balance of payments programs and, on its side, undertook to ensure that Canada would not be used as a "pass through" for U.S. funds to flow to third countries. The general structure of the VFCR applies to both the bank and nonbank financial institution programs. However, because of key differences in the foreign investment portfolio of the two types of institutions, a few differences in treatment have been necessary. The major difference is that over 90 per cent of the $10.2 billion of the banks' foreign assets are covered by the guidelines, whereas nearly 90 per cent of the $14-1/2 billion of foreign assets of the nonbank financial institutions are exempted. For banks, the exceptions are more related to institutional arrangements than to types of assets. For the nonbank institutions, loans to Canada (nearly $10-1/2 billion), bonds of international institutions (about $1 billion), and around $1-1/2 billion in loans with maturities of ten years or longer and equity investments in the developing countries (and in Japan until a few weeks ago) are not subject to guideline ceilings. Other aspects of the nonbank guidelines -- the emphasis on export financing and the desirability of refraining from new nonexport loans or investments in the developed countries of Continental Western Europe -- parallel those for banks.

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The current guidelines for the banks, announced on December 17, 1969, include a major innovation: a separate ceiling for term credits financing exports of U.S. goods and services was added. The banks now have a General Ceiling of $10.1 billion -- equal to their adjusted ceilings under the 1969 guidelines. This can be used for any purpose, although they are requested to continue to observe the priorities in the use of this General Ceiling. In addition, they have a ceiling equal to one-half of one per cent of total assets as of December 31, 1968, to use for making export loans which have maturities of one year or longer and which are in amounts of $250,000 or more. This provision added about $1.5 billion to existing ceilings, bringing the aggregate to $11.6 billion.

Several troublesome issues (which at times have bordered on controversy) have surrounded the VFCR almost from its very beginning. Undoubtedly, the most vigorously debated of those (both in and out of Government) is the assertion that the program has hampered U.S. exports and thus reduced (if not erased) any benefits it may have yielded for the balance of payments. In fact, when the VFCR guidelines were first drafted, the Federal Reserve was urged to exclude export credits from the ceiling. This argument has never been accepted by the Board. Instead, we have always tried to allow ample room for necessary financing of an expansion in exports. Throughout the life of the VFCR, the banking system as a whole has

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maintained a substantial leeway under which credits could have been extended to meet the needs of U.S. exporters and their foreign customers. Moreover, no statistical study of the trends in exports since 1964 supports the proposition that additional amounts of bank credit extended to foreigners would have increased exports by a like amount. Yet, such a growth in bank lending abroad certainly would have added some amount to our balance of payments deficit. On the other hand, individual banks from time to time may have had to relinquish this credit business to other banks in easier positions under the guidelines.

Nevertheless, we did provide a separate ceiling for export credits when we revised the program last December. In taking this step, we wanted to give renewed emphasis in the program to the importance that we attach to improving our balance of trade. The additional latitude for export financing within an overall ceiling should provide even more assurance that the restraint program will not cost the country export sales. On the other hand, to have exempted export credit entirely would have entailed a risk of capital outflows of unknown dimensions and thus would have made the restraints largely meaningless.

Another troublesome issue has arisen because of the inequities inherent in a program which rests so heavily on the

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relative position of individual banks in international finance as of December 31, 1964 -- the base date for most banks under the VFCR. Of the 13-1/2 thousand banks in the United States, about 160 (less than 2 per cent) have reported regularly under the program. The rest do not have even a token amount of foreign assets. However, given the relatively small size of the average bank -- and the complexities of foreign lending -- this situation is not surprising.

The real problem arose because the launching of the VFCR caught a number of banks of substantial size in the midst of starting new or expanding existing but modest international departments. For the most part, these institutions were essentially frozen out of participating in foreign lending because they had virtually no base. The high degree of concentration of foreign business among a few banks can be seen in the fact that 20 of the 160 banks reporting have consistently accounted for 75 to 80 per cent of the general ceiling fixed under the VFCR. Moreover, it is known that some of the banks with large ceilings (because they already had a substantial amount of foreign assets at the end of 1964) have used such ceilings as competitive levers in seeking the business (including purely domestic business) of firms that normally would be accommodated by their local banks.

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The Federal Reserve has always been troubled by these competitive inequalities that are directly related to the VFCR. Consequently, in November, 1967, an alternative method of computing the ceiling was provided. Under this change, a bank had the option of adopting a ceiling equal to 2 per cent of its total assets as of December 31, 1966. The change was intended to give more flexibility to banks with small- and medium-sized bases. Unfortunately, this newly granted leeway had to be shaved drastically when the deterioration in the balance of payments made it necessary to tighten the various programs on New Years Day of 1968. But each time the Board has had an opportunity, it has continued its efforts to reduce the inequities. In the spring of last year, it modified the VFCR by raising the ceiling by about $400 million, and proportionately more of the increase went to the smaller banks. The same was true of the Export Term loan ceiling established last December: while the 20 leading banks had about four-fifths of the general ceiling, they got only slightly more than one-half of the special export ceiling. But despite these changes, competitive inequities remain a serious problem -- and they provide another reason why a better alternative should be found.

<u>Contributions of the VFCR to the Balance of Payments</u>

There is no need to present here a detailed catalog of the contributions of the VFCR to the balance of payments.

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(Furthermore, it would be virtually impossible to identify such unique assistance -- if any -- because of the role played by other programs as well.) However, the broad contours can be sketched.

In 1965, banks' foreign assets subject to the guidelines increased by only \$150 million (compared with an increase of \$2-1/2 billion in bank lending to foreigners in 1964), whereas the guideline ceilings would have permitted an increase of \$500 million. This "swing" of about \$2.35 billion was greater than the improvement in that year's balance of payments, as measured on the liquidity basis. In 1966, when monetary policy became increasingly restrictive as domestic inflationary pressures intensified, the banks reduced their holdings of foreign assets by \$150 million. In absolute terms, this represented a balance of payments improvement of \$300 million. Nevertheless, the liquidity deficit was maintained at about \$1.3 billion for the year. Because of the decrease in covered assets and an increase in the ceiling, the banks ended the year with a leeway under the program of almost \$1 billion.

In 1967, monetary policy eased, and banks increased their holdings of covered assets by \$370 million, contributing about \$500 million to the \$2.3 billion deterioration in the liquidity balance for that year. As mentioned above, when it became apparent that the balance of payments situation was worsening, the Administration

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reconsidered programs it had announced in November and set forth new, more restrictive programs on January 1, 1968.

Although the Federal Reserve program remained voluntary, for the first time the banks and nonbank financial institutions were asked to achieve an actual reduction in foreign claims during the year -- $400 million in the case of the banks, and $100 million for the nonbank financial institutions. The aggregate ceiling for banks was reduced from $11.1 billion to $10.1 billion, and bank leeway from $1.2 billion to about $200 million. Both the banks and the nonbank financial institutions exceeded the requested reductions. Bank holdings of covered foreign assets declined by more than $600 million, and the nonbank financial institutions by $240 million. Largely because of this good performance -- and because of other fortuitous developments in the capital accounts -- the United States ended the year with a small surplus on the liquidity basis. The trade surplus, however, declined to only $600 million.

With respect to 1969, preliminary figures indicate that banks increased their holdings of foreign assets last year by about $150 million. This figure includes a large outflow in December. It appears that much of that month's outflow may have been related to an extremely large volume of transactions which took place near the year-end, and it may have been temporary in nature. Prior to this year-end development, the banks were showing a modest net inflow of funds compared with the level of foreign credits outstanding at the end of 1968.

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Stimulation of Foreign Branches

One by-product of the VFCR program may not be as helpful to the long-run international position of the United States as it may appear at first glance. This is the enormous expansion of foreign branches of U.S. banks. Since the program began, there has been approximately a six-fold rise in number of banks with branches abroad. It may be recalled that, when the VFCR guidelines were formulated, assets on the books of foreign branches were not counted against the ceilings of parent institutions. Thus, shifting of foreign credits from the head offices to such branches became a convenient way for banks to keep within their ceilings. Before long, a number of banks applied for permission to open branches abroad -- usually in London. By the end of last September, the total dollar-denominated assets of foreign branches amounted to $28.9 billion. Just under half of this total had been placed with head offices in the U.S.; just over two-fifths had been lent abroad -- including loans to U.S. firms and their foreign affiliates to finance direct investment -- and the remaining 10 per cent represented claims on other foreigners. In terms of sources of funds, about two-thirds of the total had been derived from foreign banks -- acting primarily as vehicles for mobilizing and redistributing Euro-dollar deposits.

But the really dramatic story of the expansion of foreign branches in partial response to the restrictions imposed by the VFCR is to be found in the so-called "Nassau" branches. These are limited

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service or "shell" branches established in the Bahamas. At the end of last September, 22 U.S. banks (20 Federal Reserve members and 2 nonmembers) had opened such facilities -- and they had no branches in other foreign areas. Since early 1969 when the Board started approving the creation of Nassau branches (a policy which I have personally never supported), they have grown rapidly in both number and size -- and the growth is continuing. By the end of last September, the Nassau branches held just over $1 billion in total liabilities, about 80 per cent of which represented Euro-dollar deposits. Almost three-fifths of the funds had been placed with the branches' U.S. parents.

Thus, while the desire to escape the restrictions of the VFCR program was a major factor inducing some banks to open Nassau branches (and about one-third of their assets represented claims on non-U.S. borrowers), many of them now seem to be serving primarily as a means of providing their head offices with Euro-dollars. Because of the low cost of a typical Nassau branch (amounting to only a few thousand dollars and involving few if any full-time employees) compared with a full-scale branch in London or in Continental Western Europe (which may run to $400-$500 thousand), these banks have found the Bahamas an attractive location. This has been so despite the fact that the advantages of more traditional foreign financial centers -- particularly proximity to corporate clients -- cannot be found in Nassau. Nevertheless, the Nassau branches are likely to be maintained, perhaps on a minimum-level-of-operations basis, even

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if the VFCR disappears and the demand for Euro-dollars to avoid the pressures generated by domestic monetary restraint becomes less intense.

But aside from these considerations, the rapid growth in the number and scale of foreign branches of U.S. banks may hold serious implications for our balance of payments in the long-run. Undoubtedly, well-established branches of U.S. banks (particularly in Europe) could be expected to expand in any case to accommodate the rising activity of their clients abroad. Yet, the drastic shift in emphasis of the banks' foreign operations toward foreign branches could lead to a lessening of the incentive for banks in the U.S. to engage in activities that might promote exports. That was one of the considerations underlying the decision to provide more leeway under the VFCR for export financing.

Outlook for the U.S. Balance of Payments

As is generally known by now, the U.S. balance of payments registered an extremely large deficit on the liquidity basis in 1969. For the first three quarters of the year, on a seasonally adjusted basis, the deficit reached $8 billion, but large capital inflow in the last quarter reduced the total for the year somewhat. In the final quarter of the year, the trade surplus improved considerably -- rising to an annual rate of $1.7 billion. But for the year as a whole, the trade surplus was just over $1/2 billion, about the same as in the previous year.

Although the details on capital movements during the final quarter of 1969 will not be known for a month or so, we do have a rough

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idea about some of the main elements. The downtrend in stock prices in the U.S. market (in contrast to rising prices in some key equity markets abroad) and the continued high yields on Euro-dollar and other alternative investments undoubtedly dampened foreign acquisitions of U.S. corporate stocks. On the other hand, there was probably a large inflow of corporate funds around the year-end as U.S. firms sought to get under the targets set by the direct investment program. A similar inflow occurred at the end of 1968. There was also a return inflow of funds that had been placed in German mark assets prior to revaluation.

But, as mentioned above, there was an unexpected outflow of bank funds in December, amounting to more than \$1/2 billion, though part of this was seasonal, and was soon reversed. During the fourth quarter as a whole (and on a seasonally adjusted basis), the outflow was around \$350 million. In the full year 1969, the rise in bank-reported claims on foreigners amounted to over \$1/2 billion -- and this was accounted for entirely by types of claims not subject to the VFCR -- for instance, collections for customers or foreign assets of the agencies of foreign banks. However, as mentioned above, banks under the program did increase their own foreign lending in December (by almost \$320 million) and thus concluded the full year with a net outflow of about \$150 million.

If we pull together the various, incomplete threads of information, it is clear that the balance of payments deficit for

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1969 as a whole, on the liquidity basis, was well under the figure of nearly $8 billion recorded for the first three quarters. Yet, since a modest surplus had been achieved in 1968 (although partly because of a sizable amount of special Government-arranged transactions), the deterioration was obviously extremely large. On the official settlements basis, the balance of payments was in surplus by almost $2 billion during the first three quarters of last year, and by a somewhat larger amount for the full year.

Yet, if we look behind these short-run developments, little can be seen to encourage a feeling of confidence with respect to our balance of payments. On the contrary, it is clearly evident that we have made only limited progress toward the objectives set when the restraints on capital outflow were adopted in early 1965, although at least part of our difficulty relates to Vietnam and other military costs rather than underlying economic imbalances. It will be recalled that these programs were conceived with the expectation that they would be short-lived. They were generally looked upon as temporary measures designed to hold the size of the deficits in check while efforts were made to achieve a fundamental adjustment in our payments position. To achieve the latter, several intermediate goals were set:

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- The maintenance (and even expansion) of an already large trade surplus.
- Reductions wherever possible in Government outlays abroad.
- A reversal of the widening gap in travel expenditures.
- A rise in income from previous foreign investment.
- Encouragement of expansion of European capital markets.

Obviously, we have fallen considerably short of these objectives. Last year, our trade surplus was only $1/2 billion compared with a record of $6-1/2 billion in 1964. To a considerable extent, this poor performance is a reflection of our failures to check inflation at home. With our prices rising faster than those of our competitors since 1964, we have lost a sizable share of foreign markets. While some of this reduction in our relative shares of total exports may be attributed to barriers of various kinds (which our negotiators are struggling to lower), our basic problem is clearly one of cost and price competition. Some of our competitors (including foreign affiliates of U.S. firms) have become increasingly able to out-sell some of our firms in our own markets as well as abroad.

We have made significant strides in reducing some Government outlays abroad and in holding others. For example, dollar payments to foreigners under U.S. Government grant and credit programs were

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down to about $650 million in 1968, out of a total program of over $5 billion. However, such savings had been more than offset by the sharp rise in military outlays abroad -- especially in Vietnam. In 1964, military spending abroad amounted to $2.9 billion; by 1968, it had risen to $4-1/2 billion, and today it is close to a $5 billion rate.

Income receipts from investment abroad have climbed sharply since 1964. In the latter year, private foreign investment income was just under $5 billion; today the rate is approximately $8 billion. On the other hand, because interest rates here have risen dramatically since 1964 (reflecting to some extent the heavy reliance on monetary policy in the fight against inflation) and partly because we have been financing our balance of payments deficits by accumulating a huge volume of short-term debt -- there has also been a sizable increase in our payments of interest and other income to foreigners. Such payments rose from $1-1/2 billion in 1964 to a current rate of roughly $5 billion. This increase has more than matched the gain over the period in our receipts of income from abroad.

With respect to foreign travel, we seem to have made no progress in closing the gap. In 1968, Americans spent about $3.9 billion abroad, an increase of $800 million since 1964. Spending by foreigners here during the same years rose by only $560 million to $2.0 billion. Thus, the margin of travel expenditures abroad by Americans in excess

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of what foreigners spent here widened from about $1 billion to almost $1-1/2 billion. The gap probably widened further last year.

In the case of European capital markets, we have witnessed a development that has brought considerable benefits to our balance of payments. Even two years ago (when the mandatory regulation for direct investment was adopted) few -- if any -- observers clearly foresaw the enormous expansion which has occurred since then in the volume of funds raised by these markets. This has helped to lessen the financing problems of U.S. corporations whose efforts to carry out projects abroad would have generated even more pressures on capital outflow from this country. It has also contributed to a much greater flow of foreign capital into U.S. equities.

Nevertheless, since we are still a long way from achieving a viable equilibrium in our balance of payments, I think the time has come to search for a better way to achieve an adjustment.

An Alternative to the VFCR: Application of Reserve Requirements Against Foreign Assets

In broad terms, the alternative I have in mind to our present restraints on U.S. bank lending to foreigners would be the application of a cash reserve requirement against foreign assets. This reserve would be in addition to the customary reserve that a bank maintains against deposits. For convenient reference, it might be described as a supplemental reserve.

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The objective of this supplemental reserve would be to raise the cost of foreign lending by reducing the marginal rate of return to the bank making the foreign loan -- and thereby dampen the outflow of U.S. capital. The basic purpose of the supplemental reserve would not be to levy new reserve requirements on the banking system as a whole; nor would it be to raise the average level of reserves required for individual banks that do not choose to engage in foreign lending or investing. Thus, it would not be related directly to general domestic credit conditions -- as are regular reserve requirements applicable to all member banks of the Federal Reserve System.

In focusing on this approach, I put a market force technique at the top of my list of desirable characteristics. In administering the VFCR, I am keenly aware of the desirability of assuring that -- as much as possible -- it minimize interference with normal business decisions and the economic forces of the market place. The business community, within whatever outer limits are considered absolutely necessary, can best allocate financial and real resources. Business, therefore, should be assured as much freedom of choice as the basic objectives of an official program permit.

Since the object would continue to be to restrain the <u>growth</u> in foreign lending, rather than to burden the amount of lending achieved by some date in the past, the reserves might apply only to the amount of lending above some determined volume. That is, the cash reserves would constitute marginal, rather than average, required reserves.

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Solely for the sake of illustration, let us take $10 billion as the amount of U.S. bank lending existing at the inception of the program. Suppose further that a bank were required to set aside cash reserves equal to 20 per cent of the amount by which its outstanding loans to foreigners exceeded the amount of such loans outstanding just before the reserve program went into force.

This formulation might be varied so that a cash reserve requirement might be applied against whatever new foreign loans the bank might extend rather than apply a marginal reserve against the amount of loans above the amount outstanding on a particular date.

To illustrate, a bank that extended a loan to a foreigner after, say, the end of February 1970, might be required to set aside cash reserves of 20 per cent of the amount of that loan. Loans to foreigners already outstanding as of that date would require no reserves nor be under any quantitative restraint. Any extension of those outstanding loans, as well as any drawdowns of then-existing lines of credit, would be treated as new loans and would be subject to the reserve requirement. This variant is especially attractive in being free of any relationship represented by differing volumes of foreign loans outstanding among individual banks at a given base date -- a weakness of the existing VFCR.

Under either variant of this alternative to our present system, the percentage reserve requirement would be set on the basis of an official determination of the degree of influence to be applied, for balance

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of payments reasons, against unlimited capital outflow. The restraint would be levied in proportion to the lending. Contrary to the present situation, it would not require immediate asset adjustments by each bank; instead it would leave the decision to individual banks to adapt their lending to the circumstances at the time.

The loans that would be subject to the supplemental reserve requirement could be defined in a way that would take account of the priorities and exemptions under today's program. For example: the present request that banks give priority to loans to meet the needs of developing countries could be given effect through a reserve ratio against such loans smaller than the ratio for other loans; loans to residents of Canada could be exempted, as they are from present restraints, by setting the requirement at zero. Export loans -- including export-term loans recently accorded a separate set of ceilings -- could be subjected to a cash reserve requirement only when they exceeded a stipulated percentage of a bank's end-of-1968 total assets, the basing point for the present ceiling for this category of loans.

Such a supplemental cash reserve requirement system sketched above would have the effect of restraining bank lending to foreigners, but it would do so in a more supple and economically justifiable way than is the case with our existing technique. The new reserve requirement for foreign assets of banks, being a very minor fraction of the reserves now required against deposit liabilities, would not cause a

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significant disturbance of domestic monetary policy. While there would be a modest impact on the required reserves of member banks, this could be easily offset by open-market operations.

From the point of administration, the system would have a lesser degree of certainty than the present system, because -- barring a shift to a prohibitive reserve ratio -- it would allow foreign loans to increase, whereas the present system provides a fairly rigid limit to the volume of foreign lending by U.S. banks. But the reduced certainty seems to me a reasonable price to pay for the many advantages such a system would offer.

As I mentioned earlier, the Federal Reserve System may already possess authority to establish a reserve program related to the amount of credit extended to particular categories of foreign borrowers. With respect to foreign loans by member banks of the Federal Reserve System (which hold over four-fifths of our banking resources but over 90 per cent of total foreign assets), it seems that the reserve provisions of the Federal Reserve Act provide such authority. For a broader-base program - one applying to all banks and other financial institutions-- Executive Order 11387, issued in January 1968, authorizes the Board to "regulate or prohibit any transaction by any bank or other financial institution" involving credit to foreigners, if the Board "determines such action to be necessary or desirable to strengthen the balance of payments position of the United States."

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A possible additional source of authority is the recently-enacted Credit Control Act, which empowers the Federal Reserve Board to prescribe maximum ratios of loans of particular types to assets of particular types (such as reserve balances), or to prohibit or limit such loans. However, this power can be exercised only after a Presidential determination that regulation and control of credit by the Board is called for to control "inflation generated by the extension of credit in an excessive volume."

In outlining a possible alternative to our five year old VFCR program, I do so to encourage an active quest for a more attractive -- and efficient -- means of limiting capital outflow. While I have not urged the Federal Reserve Board to adopt it (and in fact it is not even on the Board's agenda), it does indicate the direction of my own thoughts as the administrator of the VFCR -- and as a believer in market techniques.

In closing, we should note that a similar quest for market techniques to replace the direct investment regulations applying to nonfinancial corporations should also be encouraged.

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