NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D. C. 20429

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FOR RELEASE TO A. M. PAPERS
TUESDAY, JULY 21, 1964

PR-62-64(7-15-64)

Administration proposals for an Interest Equalization Tax were sparked by an enormous increase in the outflow of portfolio capital, and by an Administration unwillingness to apply solutions which would have in effect either raised interest rates or thrust the Government into private investment decisions, Joseph W. Barr, Chairman of the Federal Deposit Insurance Corporation declared last night.

In a speech on "The Background of the Interest Equalization Tax Proposal," Mr. Barr reviewed the alternative approaches available to the Administration and concluded that the IET, as a temporary solution, was the best device available to the nation. Mr. Barr was addressing an evening seminar session at the Southwestern Graduate School of Banking at Southern Methodist University in Dallas, Texas.

Outlining the basic problems facing the Administration, Mr. Barr discussed the balance of payments problem confronting President Kennedy and Secretary of the Treasury Douglas Dillon and his team in January, 1961. Not only were American balances with other nations badly out of balance, but a tremendous drain on gold was pulling American stocks down drastically. In the next two years, Mr. Barr pointed out, this position was in large part corrected.

However, in the middle of 1963, Mr. Barr said, "a new phenomenon had appeared on the international scene that threatened to wipe out all the progress we had made in the past two years, and then some. In the words of Secretary

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Dillon 'this deterioration was due almost entirely to accelerating capital outflows, and particularly to an unprecedented outflow of portfolio capital. The rate at which new issues of foreign securities were being purchased in the United States had more than tripled in the previous eighteen months and the volume during the first six months of 1963 reached a total of one billion dollars.'"

Largely because of this outflow of capital, the deficit in international accounts, eliminating special inter-governmental transactions, jumped from the 1962 rate of 3.6 billion dollars to an annual rate of 5.3 billion dollars in the second quarter of 1963, Mr. Barr pointed out. Something had to be done.

Mr. Barr pointed out that some of the possible attacks on the problem were unrealistic and would have run strongly against American obligations overseas. Such proposals included withdrawal of troops from overseas, although the Administration has made determined efforts to ease balance of payments effects of military commitments without weakening American posture throughout the world. Secondly, cuts in foreign aid would not only have fallen short from providing the needed balance, but would have been damaging to American posture and commitments. A third possibility which had to be rejected as unwise and extremely difficult to enforce would have been to curb tourist spending abroad.

Two other proposals which merited more serious study, Mr. Barr said, were approaches to setting up a Government control of American investments overseas, through a Capital Issues Committee, or the more classic approach of the use of higher interest rates to keep investment funds home.

The former proposal, he said, was rejected because the Treasury "felt such a committee would be an extremely unusual intrusion into the competitive forces

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of the economy during peacetime. There was also a strong feeling that decisions by this committee would involve judgments that would do credit to a Solomon."

On the possibility of raising interest rates, on the order of 1 percent, to insure that the American capital market would no longer be attractive to foreign seekers of capital, Mr. Barr declared: "It would have been unwise for us to have adopted at this time a highly restrictive monetary policy, and thereby to have slowed down our domestic economy and growth to meet this limited problem. It would be unwise to do so today, as well as politically difficult."

For these reasons, senior Treasury officials developed the Interest Equalization Tax Proposal, and presented it to Congress. The Senate Finance Committee probably will consider the measure later this week. The IET, which is in the form of an excise tax levied on the American acquiring directly from a foreigner a foreign stock or debt issue maturing in more than three years, is proposed as a temporary measure, and would expire in December, 1965, Mr. Barr said.

He pointed out that the effect of the graduated tax would be to increase by about one percent the cost of capital to a foreigner raising money in the American money market and in effect would tend to equalize interest rates in the American market, and those in higher cost overseas markets.

The FDIC chairman declared "the advantages of this approach are that the tax, with limited exceptions, would apply broadly to all American purchases of securities from foreign sellers. It would not involve the discretionary intrusion of the Federal Government into the market place. It would not involve a highly restrictive monetary policy which could throw out of phase the painful economic progress that the nation had begun. Furthermore, it would give us additional time to continue our efforts to improve our balance of payments."

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THE BACKGROUND OF THE INTEREST EQUALIZATION TAX PROPOSAL

Address of

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at the

SOUTHWESTERN GRADUATE SCHOOL OF BANKING

at

SOUTHERN METHODIST UNIVERSITY

(Karcher Memorial Auditorium)

Dallas, Texas

Monday, July 20, 1964

7:30 P. M.

THE BACKGROUND OF THE INTEREST EQUALIZATION TAX PROPOSAL

A cursory look at your program for the Southwestern School of Banking reveals that "the school utilizes lectures but emphasizes the case method." During these sessions of the Southwestern Graduate School of Banking, I will be delighted to leave to people more expert than I the responsibility for discussing with you the problems of operating a profitable and sound commercial banking institution! But it is my intention tonight to utilize the case method to describe to you how policy is developed by the United States in some of the perplexing areas of international finance. This will involve a rather personal approach, but I see no other way to develop my subject.

I am sure that as bankers you will agree with me that finance is no "dry as dust" affair. Finance to me has always been a dramatic flow of events, but in no place is the drama more intense than the area of international finance. The curtain for the last act of one of the most dramatic episodes in the recent financial history of the United States will be going up this week when the Senate Finance Committee, in executive session, begins consideration of the Interest Equalization Tax.

Tonight I want to set the stage for you so you can understand how the Treasury developed this tax proposal. My props will be very simple. All of you will have received by this time a series of four tables which place the overall balance of payments problem in perspective. The only other props that I intend to use are a few quotes from the Secretary of the Treasury, Douglas Dillon, and my own personal recollection of the events. When I have finished I hope you will agree with me that, although to a layman this part of history may lack some of the dramatic effect of "East Lynne", to a financier it is replete with excitement and suspense.

To implement my opening statement that my approach tonight would be via the case method, I want to make it abundantly clear that I intend to present the case but, after I have presented my side of the argument, I am perfectly willing to try to defend the case against any arguments that may come from the floor. I might add that I will be disappointed if there are no questions and no arguments. I do not think that any case is ever that good.

I suppose that if I were to continue with my analogy to the drama I should say that I came on the scene of this international drama in January of 1961 when I was sworn in as Assistant to the Secretary of the Treasury. Actually my entrance could date back to 1959 and 1960 when I served as a Member of Congress, assigned to the Banking and Currency Committee of the House of Representatives.

My interest in the international balance of payments came about in a rather unusual fashion. In 1959 the Banking and Currency Committee had reported legislation which would double the capitalization of the World Bank and International Monetary Fund. A portion of our subscription to the increased capitalization of the International Monetary Fund was to be in gold and the formula required that the United States transfer to the Fund approximately $400 million of our gold resources. I was assigned the responsibility of answering questions concerning this legislation on the floor of the House of Representatives. One Congressman asked me whether the United States could afford this transfer of approximately $400 million of our gold reserves, and the only honest answer I could give him was " I don't know." I promised this Congressman that I would try to give him a definite answer in a reasonable time and began an investigation of the whole issue of balance of payments with the Treasury Department and with the Federal Reserve Board. I never did give a report to that Congressman because by the end of 1959 after 3 or 4 months of study, I was almost completely confused. I did realize that I had stumbled on to a problem that was only dimly recognized five years ago.

In the fall of 1960 during the Presidential election of that year there was a considerable amount of tension in the international financial markets which exploded in a temporary rise in the price of gold on the London Market to $40 an ounce. This episode was merely the culmination of a trend that had been running through the years 1958, '59 and '60 --- years in which our gold stock had declined by an average of 1.7 billion dollars per year. When I was sworn in, in January of 1961, it seemed to me that the situation was deteriorating rather than improving. Our gold losses in January of that year had been running at the rate of about one hundred million dollars per week. To be perfectly candid, I was "scared to death." I felt that there was a run on the bank, and like most bankers in similar situations I wondered if we could stop the run.

President Kennedy halted this run by a flat assertion that all the energies of this nation would be dedicated to preserving the international stability of the dollar. Then Secretary Dillon and Under Secretary Roosa began attacking the basic problem of our imbalance in payments. They persuaded some of our foreign creditors to prepay their debts. They persuaded some of the nations where we had heavy troop concentrations to offset the exchange losses by military purchases in the United States. They intensified the efforts already begun to tie our foreign aid program to American goods. They began a careful and searching scrutiny of all government expenditures overseas. In cooperation with our allies they devised a gold pool to take the strain off the London market. They arranged to borrow back some of the funds which had accumulated in countries with a dollar surplus. They arranged for the Treasury to begin operations in the forward exchange market through the Exchange Stabilization Fund. They arranged with other industrialized countries to increase the usable resources of the International Monetary Fund through the "Paris agreement." And lastly, the Federal Reserve System entered the picture by setting up swap arrangements with other nations that would hold in check temporary disturbances to the international exchange markets.

You can see from Table 1 before you "U. S. Balance of Payments" the results of all these efforts. While there was some improvement in our balance on regular transactions, when special government transactions are included the results are much more impressive. The overall deficit dropped from a total of 3.8 billions in 1960 to 2.3 billions in 1961 and to 2.2 billions in 1962. The gold sales in this three year span dropped from a total of 1.7 billion in 1960 to 857 million in 1961 to 890 million in 1962 and to an annual rate of 227 million in the first half of 1963. It seemed to me and to all of us that we were definitely making progress.

During the years 1961 and 1962, although my primary responsibility was for legislation, still I spent a lot of time with the international people of the Treasury watching with fascinated awe as they tackled the problem. However by the early months of 1963, I felt that the problem was well on the way toward solution and turned most of my attention towards the tax section of the Treasury. You will remember that early in 1963 we went forward to the Congress with the largest tax cut in the history of the United States. The legislative problems involved in this proposal occupied practically all my attention, and I paid little heed to what was happening on the international side. I was frankly astounded to discover in June of 1963 that a new phenomenon had appeared on the international scene that threatened to wipe out all the progress we had made in the past two years, and then some.

In the words of Secretary Dillon "this deterioration was due almost entirely to accelerating capital outflows, and particularly to an unprecedented outflow of portfolio capital. The rate at which new issues of foreign securities were being purchased in the United States had more than tripled in the previous eighteen months and the volume during the first six months of 1963 reached a total of one billion dollars.

"As a result, the deficit in our international accounts --- apart from all special inter-governmental transactions --- jumped from the already high 1962 level of 3.6 billion dollars to an annual rate of 5.3 billion dollars in the second quarter of 1963. If allowed to continue, that deficit would have undermined the international stability of the dollar." You can trace the details of this long-term capital flow in Tables 2 and 3: "Long-Term

Capital Flows in the U. S. Balance of Payments," and "New Issues of Foreign Securities."

In June of 1963 the issue was clear --- something had to be done. What was not so clear was the question "what should be done?" John Kenneth Galbraith has remarked that in many questions of high national policy reasonable men will agree that there are no easy solutions. All too often there are choices only between almost equally dreary alternatives. Ambassador Galbraith's remarks seemed particularly pertinent to this problem. Of course there were alternatives, but let me list a few for you.

First of all, the President could have pulled back troops from their overseas stations. You can note from Table 1 that the exchange cost of military expenditures averaged about 2.5 billion dollars a year for the years 1960, '61, and '62. They were running at a slightly lower rate in the first half of 1963 reflecting Secretary McNamara's determined drive to ease the balance of payments impact of our military expenditures. However, such a move would obviously have undermined our international posture and commitments in the world, and it was doubtful whether anything could have been done quickly enough to meet the problem that was on top of us. Secondly, when these international crises arise, most critics invariably ask: "why not cut out foreign aid?" You can see from the statistics on Table 1 that eliminating foreign aid, with its annual exchange cost averaging approximately $1 billion, would not have solved our problem --- to say nothing again of the damage to our posture in the world. Thirdly, American tourists travelling overseas last year cost the United States about 3.2 billion dollars in exchange. I suppose that we could have clamped the lid on American tourists travelling overseas, but our friends in other countries who have tried this device have discovered that it is extremely difficult to enforce. To be perfectly candid, I doubt that any American government at this time could get by with a tourist restriction. When I use the term "get by" I am using it in a purely political sense. These first three alternatives that I have mentioned made little sense, and I do not believe that they were ever seriously considered. I mention them only to indicate to you that they could be classified as possible alternatives to the problem that was facing us at the time.

There were two other possible alternatives with respect to the urgent problem of portfolio capital that did merit more serious attention. The first was the foundation of a Capital Issues Committee. This in effect would have been a government committee which would have decided how much long-term capital could be exported from the United States. This committee would also have been forced into decisions on which loans or which purchases of securities fit our national guidelines. I am not going to belabor this idea too heavily tonight, because it might still have a certain attraction for the Senate Finance Committee and the Senate. However, the Treasury rejected this idea initially because we felt that such a committee would be an extremely unusual intrusion into the competitive forces of the economy during peacetime. There was also a strong feeling that decisions by this committee would involve judgments that would do credit to a Solomon.

To illustrate a possible dilemma facing the Capital Issues Committee, let us suppose that the Treasury on a given occasion felt it had $50 million to allocate in a capital outflow. Let us also suppose that at the same time there were requests from three countries for permission to borrow in the United States. To continue the hypothetical example, assume that Rome wanted to borrow $50 million to construct a subway system; there was a request for $50 million from Japan for funds to improve their shipyards, and a request from Sweden for $50 million to expand their hydroelectric system. The question arises as to who has sufficient wisdom to judge who should get the $50 million. I am not stating that such a Capital Issues Committee can not work; it has worked in other countries. I merely note that we rejected this approach in the Treasury because it appeared difficult and because it did not seem to fit the relative freedom for which we were striving in the American economy.

Lastly, there was still another alternative. That would have been for the monetary authorities to raise interest rates across the board to a level so high that our American capital market would no longer be attractive to foreigners. I am not certain what level of long-term interest rates would have slowed this outflow of capital. Certainly an increase on the order of one percent --- equivalent to the proposed tax --- would have been necessary. If such a step were possible at all it would have resulted in a drastic tightening of credit. It would have been unwise for us to have adopted at this time a highly restrictive monetary policy and thereby to have slowed down our domestic economy and growth to meet this limited problem. It would be unwise to do so today, as well as politically difficult. From my experience in the Congress I believe that there is a very strong aversion in this country to extremely high interest rates.

After discarding all these alternatives, Secretary Dillon, Under Secretary Roosa, and Under Secretary Fowler came to the conclusion that a rather novel approach was the most appropriate. They decided on a proposal which we termed the Interest Equalization Tax. This is merely an excise tax levied on the American acquiring directly from a foreigner a foreign stock or debt issue maturing in more than three years. While the tax is payable by the American purchaser, the impact will be effectively passed on to the foreign issuer in reduced prices for his securities. The rate of tax is graduated so that its net effect is to increase by about one percent the annual cost of capital to a foreigner raising money in our market, thus bringing this cost to a level more comparable to the cost he would face abroad. The advantages of this approach are that the tax, with limited exceptions, would apply broadly to all American purchases of securities from foreign sellers. It would not involve the discretionary intrusion of the Federal Government into the market place. It would not involve a highly restrictive monetary policy which could throw out of phase the painful economic progress that the nation had begun. Furthermore, it would give us additional time to continue our efforts to improve our balance of payments. The tax was clearly defined as a transitional measure and under the terms of our proposal is slated to expire in December, 1965.

This, then, sets the stage for the final act of the drama. In conformity with the case study method, you have before you all the statistical information and all the background considerations that were available to the Treasury and which have been placed before the United States Senate.

The Senate Finance Committee will probably begin its final deliberations on this proposal this week. The measure will then go to the floor of the United States Senate either later this month or early in August. Thus tonight each of you in the audience can take the role of a United States Senator and force me to defend a proposal in which I have had an extraordinary interest. I hope that you will do so, and I will look forward to an opportunity to answer any questions or to meet any arguments that you may wish to advance.

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U.S. Balance of Payments, 1960 - First Quarter 1964
(In Millions of Dollars)

	1960	1961	1962	1963 Seas. Adj. Ann. Rates 1st Half	1963 Seas. Adj. Ann. Rates 2nd. Half	1963 Total	1964 1st Qtr. (Seas. Adj. Ann. Rates)
Commercial Merchandise Exports	17,545	17,693	18,213	18,098	20,338	19,218	21,880
Commercial Merchandise Imports	-14,723	-14,497	-16,134	-16,428	-17,434	-16,931	-17,388
Commercial Trade Balance	2,822	3,196	2,079	1,670	2,904	2,287	4,492
Commercial services, remittances & pensions	856	1,583	1,739	1,200	1,484	1,342	2,460
Commercial Balance 2/	3,678	4,779	3,818	2,870	4,388	3,629	6,952
Military Expenditure (net) 3/	-2,712	-2,560	-2,375	-2,188	-2,360	-2,274	-1,988
Gov't grants and capital dollar payments	-1,110	-1,139	-1,077	-1,010	-762	-886	-560
Gov't capital receipts, excl. prepayments, borrowings & fundings	543	516	501	388	502	445	540
Private Capital:							
Transactions in foreign securities	-864	-910	-1,172	-2,112	-438	-1,275	8
Other long-term 4/	-1,243	-1,267	-1,437	-1,784	-2,042	-1,913	-2,716
Short-term	-1,438	-1,492	-752	-998	-454	-726	-2,528
Unrecorded Transactions	-772	-998	-1,111	-164	-408	-286	-432
Balance on Regular Transactions	-3,918	-3,071	-3,605	-4,998	-1,574	-3,286	-724
Special Government Transactions 5/	37	701	1,402	1,258	1,430	1,344	556
Overall Balance	-3,881	-2,370	-2,203	-3,740	-144	-1,942	-168
Memorandum: Gold Sales (not seas. adj.)	1,702	857	890	227 6/	234 6/	461	46 6/

1/ Excludes military transfers under grants.
2/ Excluding exports and services financed by Government grants and capital.
3/ Excludes advances on military exports.
4/ Including direct investment.
5/ Includes nonscheduled receipts on Gov't. loans, advances on military exports, and sales of nonmarketable medium-term securities, including convertible securities of $502 million, 1st half 1963; $200 million, 2nd half 1963.
6/ Not at annual rates.

Source: Survey of Current Business

June 29, 1964

Table 2

Long-Term Capital Flows in the U.S. Balance of Payments, 1960 - First Quarter 1964
(In Millions of Dollars)

	1960	1961	1962	1963 Seas.Adj.Ann.Rates 1st Half	1963 Seas.Adj.Ann.Rates 2nd Half	1963 Total	1964 1st Qtr. (Seas.Adj Ann.Rates
Direct investment:							
U.S. direct investment abroad	-1,674	-1,599	-1,654	-2,064	-1,660	-1,862	-1,852
Foreign direct investment in U.S.	141	73	132	88	-54	17	96
Net direct investment	-1,533	-1,526	-1,522	-1,976	-1,714	-1,845	-1,756
Portfolio investment:							
U.S. purchases of new issues of foreign securities	-555	-523	-1,076	-1,858	-680	-1,269	-388
U.S. net purchases of outstanding foreign securities	-309	-387	-96	-254	242	-6	396
Total purchases foreign securities	-864	-910	-1,172	-2,112	-438	-1,275	8
Redemptions of U.S. held foreign securities	201	148	203	186	204	195	176
Other U.S. long term, net 1/	-200	-263	-258	-312	-816	-564	-1,088
Foreign long-term portfolio investments in U.S.	289	374	140	318	284	301	-48
Net portfolio investment	-574	-651	-1,087	-1,920	-766	-1,343	-952
Net long-term capital	-2,107	-2,177	-2,609	-3,896	-2,480	-3,188	-2,708

1/ Mainly long-term bank loans.

Source: Survey of Current Business and Department of Commerce

June 29, 1964

Table 3

New Issues of Foreign Securities Purchased by U.S. Residents by Area 1960 - First Quarter 1964
(Millions of Dollars)

	1960	1961	1962	1963 1st Half	1963 2nd Half	1963 Total	1964 1st Qtr.
Canada	221	237	457	632	105	737	91
Western Europe	24	57	195	219	53	272	-
Japan	15	61	101	83	57	140	-
Other Developed 1/	27	43	60	17	-	17	-
Latin American Republics	107	18	102 2/	13	23	36	13
Other Less Developed	64	95	77	35	32	67	24
International Institutions	97	12	84	-	-	-	4
Total New Issues	555	523	1,076	999	270	1,269	132

1/ Australia, New Zealand, South Africa
2/ Includes $75 million issues by Inter-American Development Bank.

Source: Survey of Current Business and Department of Commerce.

June 29, 1964

Table 4

U.S. Transactions in Foreign Securities
Nine Months Before and After Interest Equalization Tax
(Millions of Dollars)

	Seasonally Adjusted Annual Rates: Oct. 1962 to June 1963	Seasonally Adjusted Annual Rates: July 1963 to March 1964	Improvement
U. S. Net Purchases of Foreign Securities:			
New Issues	-1,853	-583	+1,270
Outstandings	-132	+293	+425
Total	-1,985	-290	+1,695

Source: Department of Commerce

June 29, 1964