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INTERNATIONAL CAPITAL MARKETS AND THE FINANCING OF U. S. FOREIGN TRADE AND INVESTMENT

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International Capital Markets and the Financing of U.S Foreign Trade and Investment

Almost exactly two years ago today, the President appealed to the American banking and business communities to help reduce the persistent deficit in the Nation's balance of payments. The response was immediate, and the effect on our international payments position was striking. But in achieving these results, striking changes were also brought about in the conduct of business abroad and in the structure and functioning of international capital markets. Moreover, these transformations were hastened and re-inforced by the policy of monetary restraint (also partly aimed at strengthening our balance of payments) pursued during most of last year.

To a considerable extent, the broad contours of this story are generally known. Yet, some aspects are less familiar while still others are again the subject of debate among those primarily responsible for the shaping and conduct of national economic policy. Thus, it appears both timely and appropriate to review a number of vital current issues relating to international finance and our balance of payments.

- First, I shall focus on the revival of a genuine international capital market outside New York. Despite the exigencies which stimulated this revival, this new market may prove far more viable and long-lasting than is generally appreciated.

- Secondly, I shall look at developments in the short-term Euro-dollar market. Here also efforts to adjust to temporary pressures (especially the efforts of U.S. banks with branches abroad) may have aided the emergence of a more efficient market mechanism. At the same time, however, bank participation in this market has complicated the tasks of domestic monetary management.

- Thirdly, the drive of U.S. corporations to expand their direct investments abroad, while minimizing the impact on the balance of payments, has generated the most dramatic changes in the international capital market. In fact, the very success of their efforts has attracted both praise and condemnation. Yet a strong case can be made for even greater -- rather than less -- reliance by U.S. companies on foreign sources to finance direct investment. This is particularly true with respect to equity financing.

- Finally, I shall summarize the latest information on the extension of foreign loans by U.S. banks. Trends in export financing and the status of the banks under the Voluntary Foreign Credit Restraint program may be of special interest.

Expansion of the International Capital Market

Since 1962, the volume of internationally-issued securities in non-U.S. markets has increased nearly four-fold. And, what is even more dramatic, dollar-denominated issues (which were virtually non-existent a few years ago) have become the most dominant market instrument. Foreign long-term bonds issued in major European markets amounted to the equivalent of $291 million in 1962, virtually all of which was denominated in a single national currency and floated in a particular national market. By 1964, the total volume of offerings had risen to $913 million of which $514 million were denominated in currencies other than that of the country where issued. Of this amount, $490 million (or 95 per cent) were dollar-denominated. Total flotations reached $1.2 billion in 1965, with $625 million denominated in U.S. dollars. Last year, issues in all currencies shrank somewhat to roughly $1.0 billion. However, dollar bonds climbed further to more than $800 million, accounting for a substantially larger proportion of the total market than in the previous year.

This rapid expansion in the volume of dollar-bond flotations has led to significant changes in the marketing mechanism itself. In the early 1960's, investment bankers in Europe (particularly in Belgium and Luxembourg) began to form multinational syndicates to market long-term bonds for non-resident borrowers in the key financial centers of Europe. However, the first dollar-denominated issues were through syndicates managed or co-managed by a few American investment banking firms. But the growing volume of issues drew into the market not only more money but more men as well. Thus, during the first ten months of last year, 58 firms served as managers or co-managers of these dollar issues; only 19 firms (or one-third) were North American and the rest European. Moreover, while American firms still account for the largest volume of dollar bonds underwritten, European firms are acquiring a rising share of the market. For instance, in the first ten months of 1966, one U.S. firm (associated with a volume of $261 million) held the lead position and accounted for about 30 per cent of the total. Second place was held by a British firm with 20 per cent, and an Italian firm was in third place with 17 per cent. An American underwriter with 16 per cent barely edged out a German firm for fourth place.

The rush of both American and European investment bankers to this market is not hard to understand in view of the profit opportunities available. Data relating to the cost of securities sold abroad by companies participating in the voluntary program administered by the Department of Commerce provide a fairly good estimate of the profitability of the business. In general, issue costs (the difference between issue price and proceeds received by the borrower) seem to be about 2½ per cent of the amount of the bond issue. The division between underwriting and selling costs cannot be determined readily.

However, data from industry sources suggest that selling costs may be slightly more than 1¼ per cent and the underwriter's share slightly less than 1¼ per cent. In contrast, corporate flotations in this country normally entail underwriting and selling costs of only 1 per cent of the total issue -- compared with the 2½ per cent on international dollar bonds.

Impact of the Interest Equalization Tax

Although the principal focus in this discussion is on the influence of U.S. corporations and banks on the international bond and Euro-dollar markets, we should remember that the application of the Interest Equalization Tax (IET) to securities of most developed countries sold in the U.S. since mid-1963 had already given these markets a strong push in the direction they have taken in the last two years. For example, in 1962, countries which were later affected by the IET sold slightly more than $350 million of new issues to U.S. investors, and during the first half of 1963, roughly the same amount was sold here. In the second half of 1963, however, issues sold by IET-affected countries dropped to less than $200 million (which included some issues not subject to the tax at the start of the period).

As the tax increased the cost of borrowing in the United States, foreigners turned to the European market for accommodation. For example, in the last quarter of 1963, foreign securities floated by European underwriters jumped to the equivalent of $234 million; these issues had averaged only $93 million in each of the three previous quarters. Dollar-denominated bonds represented a substantial proportion of this increased volume -- amounting to $490 million in 1964, and the uptrend continued into 1965 -- well before U.S. companies began to sell securities under the stimulus of the voluntary program.

As far as access to the U.S. capital market is concerned, the IET has worked well. For example, in the 3½ years during which the IET has been in force, new issues sold in the United States by European countries, Australia, New Zealand, South Africa, and Japan have averaged slightly more than $100 million per year; this compares with an annual average of more than $450 million in the 2½ years just prior to mid-1963. In reality, the average volume of securities sold to U.S. residents since the tax became effective is even smaller than the above statistics suggest; this is particularly true if one does not count the Japanese issues floated in 1965 under a special exemption of up to $100 million (not all of which was used) granted for Japanese government and government-guaranteed long-term borrowings.

Currently, the Administration has asked Congress to extend the IET until July 31, 1969 -- rather than allowing it to terminate at the end of July this year. It was also requested that the tax be established on a flexible basis with authority vested in the President to vary the annual rate between 0 and 2 per cent. We in the Federal Reserve strongly support this proposal. The tax, even at its present level of 1 per cent, provides a degree of protection from too-ready access to our capital market by developed countries. Thus, it permits us greater scope to conduct monetary policy in a way best suited to meet the needs of the domestic economy while minimizing potential conflicts with the balance of payments -- which is also one of the Federal Reserve's major responsibilities.

This year, such a conflict may be far more probable than it was a year ago. As domestic economic pressures -- including pressures on prices -- began to ease late last year, the Federal Reserve shifted from a policy of substantial restraint to a policy of somewhat easier credit conditions. The results of this shift are clearly evident in the sharp decline in a variety of interest rates and the greater availability of credit at most types of financial institutions. However, if our interest rates decline compared with interest rates abroad, the widening differential may well induce an increasing number of foreigners -- even those subject to the IET -- to seek funds here. Thus, it is wise not only to extend the tax but -- equally important -- to provide flexibility in setting the rate to apply at any particular time to meet changing conditions in our domestic capital market.

Impact of Borrowing by U.S. Corporations

As mentioned above, U.S. corporations have been the pace-setters in the international capital market during the last two years. It will be recalled that, when the voluntary program to improve the U.S. balance of payments was launched in February,1965, companies were asked by the Secretary of Commerce to postpone marginal projects and to obtain abroad the maximum amount of funds required to finance direct investment. In response to that request, companies participating in the program administered by the Department of Commerce began to issue securities abroad during the Spring of 1965. By the end of January this year, they had raised over $1.0 billion through 43 issues offered publicly abroad. The greatest share of this borrowing (35 issues amounting to $865 million) has been through U.S. financing subsidiaries (mainly incorporated in Delaware), and the remainder has been through foreign (principally Luxembourg) financing subsidiaries.

Initially, borrowing companies relied on straight bond issues with maturities of 15 to 20 years. The yields required to market these averaged about 5.75 per cent well into the Fall of 1965. However, as the volume of issues mounted, companies began to search for ways to reduce this relatively high cost of borrowing abroad. The first remedy was the offer by financing subsidiaries of debentures convertible into stock of the parent U.S. corporation. This potential opportunity to acquire "blue chip" equities in U.S. firms proved particularly attractive. The first convertible debentures were offered in October, 1965, at a yield of 4.50 per cent -- while companies with equally strong credit ratings had to pay 6 per cent or slightly more on straight bonds. Soon thereafter, bonds with the convertible option became the dominant form of borrowing, and the trend continued until the period of market congestion in the Spring of last year. In fact, through the end of 1966, funds raised through convertible issues ($425 million) were nearly twice as large as the amount ($231 million) raised through sales of straight bonds by U.S.-incorporated companies.

Yet, as the growing volume of borrowing exerted increasing pressure on the market in the Spring of 1966, even the convertible feature became less-and-less able to move long-term bonds except at substantially higher yields. For example, by last April, straight bonds with a 10-year maturity were being issued at 6.25 per cent and 20-year convertibles at 5.00 per cent. To attract a wider market, companies began to offer 5-year notes, but yields even on these shorter issues continued to advance -- reaching 6.38 per cent in May. Yields on convertible issues also continued to rise and reached 5.25 per cent in the same month.

This congestion in the market not only resulted in a considerable climb in yields and modifications in the mode of borrowing -- it also generated a sharp debate among foreign underwriters over the need for some form of regulation. It was felt in some quarters that borrowers (such as national governments) who could not resort to convertible and other features were being forced (unfairly) out of the market by U.S. corporations. Some European underwriters -- unaccustomed to the vigorous competition which U.S. investment bankers brought to the market -- began to call for a voluntary spacing of new issues. While a number of schemes were suggested, no real effort at regulation was undertaken -- perhaps primarily because no obvious basis exists, or can be readily foreseen, for control of the international capital market.

Perhaps another reason why most of the criticism subsided is that U.S. companies themselves began to back away from the market in the face of sharply rising rates. While U.S.-based and foreign subsidiaries floated a total of $281 million of securities abroad in the second quarter of last year, the volume amounted to only $35 million in the third quarter and to $101 million in the fourth. Part of this drop probably can be traced to the lessened attractiveness of convertible debentures as prices of U.S. stocks declined steadily through the rest of 1966.

But since the turn of the year, interest rates abroad have declined considerably, and stock prices in the U.S. have recovered much of the lost ground. In this improved environment, U.S. borrowers seem to be returning to the international capital market. In January, three issues, totaling $65 million, were offered for sale. Straight bonds, convertible debentures, and 5-year notes were equally represented. If the volume of borrowing continues to expand (as well it may in view of the continuing high level of direct investment abroad projected by U.S. companies), we may again hear criticism and a demand for regulation of the market.

But, whatever the course of events which may lie ahead, I am personally convinced that U.S. companies should continue to look to the international capital market for a sizable share of the funds required to finance their projects abroad. Not only will this lessen the burden on our balance of payments, but it will also help to hasten the development of a genuine international capital market.

Innovation in the Euro-Dollar Market

Just as the advent of the IET and the U.S. voluntary balance of payments program gave an extra stimulus to the Euro-bond market, these same factors accelerated the process of innovation in the market for short-term Euro-dollars. However, in the context of our balance of payments and monetary management in this country, one development outweighs all others -- that is, the sharply increased role played by U.S. commercial banks. But before examining their behavior more closely, we might reflect for a moment on the overall workings of this part of the international capital market.

The exact dimension -- or even a definition -- of the Euro-dollar market is impossible to determine. However, for practical purposes, it consists of the borrowing and lending -- normally at short-term -- of dollars at banks in other countries. Just a few years ago, Euro-dollar deposits were of only minor importance. But the Bank for International Settlements in Basle, Switzerland, recently estimated the volume outstanding at more than $12 billion. While trading in these deposits is rather widespread, London apparently accounts for about one-half of the total.

As mentioned above, the Euro-dollar market had already experienced noticeable growth prior to mid-1963. Since then (and apart from the IET and the U.S. voluntary balance of payments program), new techniques have continued to appear. For example, even earlier, Italian monetary authorities had entered into a series of special arrangements with Italian commercial banks through which the latter were able to hold sizable dollar deposits. These they put to work in the Euro-dollar market -- thus greatly expanding the supply. Moreover, the growing financial requirements of foreign affiliates of U.S. corporations have induced many banks with Euro-dollar deposits to extend longer-term loans as well as short-term credits. This experience may lead to a major change in the ability of the market to meet foreign credit needs generally.

The appearance of the negotiable, dollar-denominated CD was another innovation which occurred last year. So far, the CD has not become an important factor in the market. Yet, in a period of declining interest rates, it may well become quite popular as a means of arbitraging among various short-term yields. It will be recalled that this is exactly what happened in the United States in the early 1960's.

While these institutional changes may have a lasting impact on the functioning of the market in the long-run, the most immediate significance must be attached to the part played by foreign branches of U.S. banks in mobilizing Euro-dollar funds for use in this country. About a dozen or so large U.S. banks maintain a network of branches abroad, and this is essentially their story.

During 1966, these foreign branches increased their claims on their head offices by $2½ billion. This inflow was obtained explicitly by the head offices as a means of easing the pressures on reserves resulting from a policy of domestic monetary restraint. The rise in branch claims represented virtually all of the expansion in their dollar assets last year. In contrast, during 1965, the gain in assets of the branches had consisted mainly of increased claims on commercial banks abroad and an expansion of loans to other foreigners -- including foreign subsidiaries of U.S. corporations. There was essentially no change in branch claims on head offices in the United States.

Most of the $2½ billion rise in branch claims on head offices last year was financed through the branches' bidding for relatively short-term Euro-dollar deposits. As a result, the amount outstanding at the end of last June was already roughly $800 million above the level at the close of 1965. But the truly spectacular rise occurred in the last half of 1966, the peak of about $4.3 billion outstanding being reached in mid-December.

Reflecting this bidding for funds, yields on 3-month Euro-dollar deposits rose from less than 5½ per cent at the end of 1965 to about 6 per cent at the end of last June. A further sharp rise occurred during the Summer and Fall, and a peak of 7 per cent was reached in October. Yields then declined slightly and stabilized around 6 3/4 per cent through November. Since then, they have fallen sharply to 5½ per cent.

The sources of the Euro-dollar deposits acquired by the foreign branches cannot be identified readily. However, there is no doubt that a good part represented funds shifted out of sterling because of the uncertainties facing that currency around mid-year. Shifts probably also occurred out of some continental currencies during the Summer and Fall. Moreover, some of the proceeds from Euro-bond issues sold by U.S. firms and not needed immediately for direct investment were placed in Euro-dollars.

On the basis of very fragmentary data publicly available, an attempt has been made to identify the main sources of the rise in the branches' claims on their head offices. But in interpreting these figures, their tentative nature must be kept fully in mind. During the first nine months of 1966, U.S. liabilities to commercial banks abroad (including foreign branches of domestic banks) rose by $1.9 billion. Of this amount, almost $500 million came through an increase in Euro-dollar deposits in London owned by U.S. residents (particularly non-financial corporations). It also appears that perhaps $200 million of the gain can be traced directly to switches out of sterling by London banks at the cost of a reduction in British reserves, and/ perhaps $600 million to net purchases of dollars by the commercial banks in seven continental Western European countries. The remainder came from other sources.

Thus, on the whole, it is evident that, through bidding aggressively in the Euro-dollar market, the foreign branches of U.S. banks kept a sizable volume of dollars from accumulating in central banks -- which may have been inclined to convert them into gold. Moreover,/ the inflow of these funds also contributed to a substantial reduction in our balance of payments deficit calculated on the basis of official reserve transactions.

On the other hand, these inflows also allowed a handful of large money market banks to obtain considerable relief from the policy of monetary restraint. Member banks of the Federal Reserve System are not required to hold reserves against amounts due to branches abroad. So -- despite the high costs of these funds -- banks here readily turned to the Euro-dollar market as an alternative to bidding for Federal funds in the domestic market. This became especially the case as the 5½ per cent ceiling on the rates payable on CD's made them less-and-less competitive while other market yields rose to historic levels. In one sense, then, the activities of the banks in the Euro-dollar market complicated the management of domestic credit policy. Because of this outside source of funds, greater effort had to be made to absorb reserves through open market operations. . Of course, this situation was known and fully appreciated. However, in view of the temporary aid to our balance of payments derived therefrom, it seemed preferable to allow the inflow to continue.

Since the turn of the year, a sizable reduction has occurred in the liabilities of U.S. banks to their foreign branches. As of February 1, the amount outstanding was about $3½ billion. This would represent a repayment of about half of the increase between last Spring and the December, 1966, peak. To some extent, this reflow may enlarge the volume of funds available in the Euro-dollar market -- and thus permit U.S. firms, among others, to make a lesser demand on domestic sources to meet their requirements abroad. But there is also the danger that a sizable share of the reflow may end up in some foreign central banks that are not anxious to hold dollars.

In fact, the appearance of this reflow has led a number of observers to suggest recently that it may be necessary to prevent any substantial reduction in domestic short-term interest rates -- because such a decline would worsen our balance of payments. Below I shall comment further on this issue.

Financing U.S. Direct Investment Abroad

As already indicated, the search for a larger volume of funds abroad to finance direct investment projects has cast American firms in the role of leading innovators in the international capital market. Their success in this effort cannot be disputed. However, the basic factor giving rise to the search in the first place still remains -- that is, the high rate of growth of U.S. business abroad which, in turn, exerts inevitable pressure on the companies to transfer funds from this country.

During 1966, U.S. direct investment may have been in the neighborhood of $2 3/4 billion, after allowing for the use of funds obtained abroad by parent companies. This would be a substantial reduction from the $3.3 billion registered in 1965. Last year, U.S. corporations borrowed abroad about $600 million to finance direct investment, compared with around $200 million of such borrowing in 1965. Since these borrowings were undertaken explicitly within the guidelines of the voluntary program, they are counted as an offset to the outflow from the United States when the funds are actually used for direct investment. In 1966, between $350 - $400 million of the proceeds may have been employed for this purpose (against roughly $60 million in 1965). As indicated above, the rest was added to the companies' bank deposits and other short-term assets abroad.

Income from direct investment apparently rose more slowly in 1966 than it did in the previous year, and the advance was substantially below the long-run trend. During the first three quarters, the inflow was at a seasonally adjusted annual rate of $4.1 billion, a gain of less than $200 million from the figure for the full year 1965. The slower advance in income last year reflected a number of factors, including the reduced pace of industrial activity in several foreign countries, higher tax payments by oil producing companies, and the absence of special dividend receipts recorded in the 1965 figures. On the other hand, the excess of direct investment income over direct investment outflow seems to have improved considerably. In 1965, the surplus amounted to only $590 million, compared with $1.3 billion in 1964. But in the first three quarters of 1966, it was at a seasonally adjusted annual rate of $940 million. Yet, when the current surplus is measured against the performance of 1964 and earlier years, one can see readily why there is so much concern about the direct investment outflow in relation to the balance of payments.

In raising external funds abroad, foreign affiliates of U.S. companies have depended almost entirely on various kinds of debt -- rather than on sales of equities. In 1965, loans from foreign banks and other financial institutions rose by $600 million to $1.3 billion -- divided almost equally between short-term and long-term debt. This amount represented nearly two-fifths of total funds raised abroad compared with only one-quarter in 1964. Increases in other types of liabilities accounted for nearly half of the foreign sources.

In contrast, issues of equity securities abroad provided only $273 million for the foreign affiliates in 1965, or 7 per cent of their foreign sources. Such sales amounted to $436 million in 1964 and to $334 million in 1963.

This modest reliance on equity financing is one of the principal points of criticism of U.S. companies in many of the countries in which their affiliates are located. As is generally known, most U.S. firms maintain in their own hands both the ownership and control of their foreign operations. Just how closely these are held can be inferred from Commerce Department figures. In 1957 (the date of the last census of U.S. business abroad), three-quarters of the value of direct investment assets were held by firms in which U.S. ownership represented 95 per cent or more of the total, and one-fifth was held by firms in which U.S. ownership was between 50 and 95 per cent. While foreign participation in these enterprises has undoubtedly increased in the last decade, the gain apparently has been rather small. This is implied by the Commerce Department figures which indicate that in 1965 only 6 per cent of the undistributed earnings of U.S. subsidiaries abroad were assigned to foreign owners.

Here, then, is an area in which U.S. corporations could strengthen their foreign sources of funds -- and their positions in the host countries -- while simultaneously reducing the impact of the direct investment outflow on our balance of payments. It will be recalled that, under the Commerce Department's guidelines, companies in the voluntary program were urged to sell equities in their foreign subsidiaries where this seemed appropriate. So far, this appeal has been received with little warmth. Where a response has been forthcoming, most companies have stressed the management complications which might result from a wider sharing of ownership (and presumably control).

Nevertheless, while I obviously do not wish to comment explicitly on how the companies should conduct their business, in my personal opinion a greater reliance by U.S. firms on sales of equities in their foreign subsidiaries is a course well worth pursuing.

In the meantime, if the affiliates' needs for funds in 1966 expanded as much as they did in 1965, they would have found it necessary to make further heavy calls on foreign sources or on U.S.-source funds. However, the trend of direct investment in the first three quarters of last year and the volume of borrowing abroad suggest a substantially reduced reliance on the transfer of resources from this country in 1966. As far as the current year is concerned, some easing may occur with respect to the affiliates' total demand for funds and in their claims on foreign financial markets -- as well as in the outflow from the U.S. for direct investment. It now appears that plant and equipment outlays abroad by the affiliates will not rise appreciably over the level attained in 1966, and -- because of the slower pace of industrial activity in several foreign countries -- they may require only modest additions to working capital. Thus, the need of U.S. corporations to meet direct investment requirements should pose less of a burden on the balance of payments this year.

Bank Lending Abroad and the Financing of U.S. Exports

As announced a few days ago, U.S. commercial banks made a substantial reduction in their holdings of foreign loans and investments last year, when assets covered by the voluntary foreign credit restraint program declined by approximately $160 million. In 1965, they had risen by about the same amount.

On December 31, 1966, these banks had a net leeway of $864 million for further expansion of credit within the target ceiling applicable in 1967. They were however only, $144 million below the interim ceiling applicable through March 31, 1967.

It will be recalled that, under the guidelines for the 1967 voluntary balance of payments program, the Federal Reserve again asked commercial banks to keep their foreign claims within 109 per cent of the amount outstanding at the end of 1964. This gave them a leeway of $1.2 billion as of October 1, 1966. However, they were also asked to use no more than 20 per cent of the leeway each quarter and no more than 10 per cent (or $120 million) for nonexport credits to developed countries.

In adopting these guidelines, we wanted to provide a stimulus to export credits beyond that afforded by the request in 1965 and 1966 that banks give an "absolute priority" to such credits. On the other hand, we felt that complete exemption of export credits from the program might well amount to the virtual absence of any ceiling whatsoever.

But after the program was announced, a number of banks suggested that it would be difficult -- if not impossible -- to meet the reporting requirements. They held that it would be particularly difficult and costly to segregate nonexport from export credits. Therefore, they reported that it was not feasible to comply with the request to impose a quantitative limit on nonexport credits to developed countries. Some banks also said that the limitation in the guidelines would make it difficult for them to meet large anticipated credit demands from Japanese banks in 1967, and, further, that it would be hard to refuse such demands if they materialized -- given the fact that large deposit balances are maintained by the prospective borrowers.

The Federal Reserve gave careful consideration to the banks' views. But, on balance, we have not felt it necessary to make any formal modification in the guidelines. On the contrary, banks have been requested explicitly to adhere as closely as possible to the original request. However, we did try to ameliorate the problems encountered by banks in reporting on their foreign lending activities. We are now asking only that they report their total credits, distinguishing simply between those to developed countries and those to less developed areas. Loans to Japan are still subject to the special limitation. However,banks can use run-offs of European loans to meet expanded credit demands from Japan -- should these materialize -- and the guideline encourages them to do so.

This change should in no way adversely affect the achievement of the objective of a greater stimulus for exports anticipated when the guidelines for 1967 were developed. Moreover, since we have never had any evidence that any significant amount of export credits was being turned down because of the program, I do not believe export financing will be hampered because of the modification in reporting requirements.

Concluding Remarks

In closing these comments, I want to turn again briefly to the question of whether short-term interest rates in the United States must remain relatively high in order to prevent an excessive outflow of short-term funds. Some observers have held that, to avoid such an adverse impact on the balance of payments, the Federal Reserve System should adopt a new version of the so-called "Operation Twist" policy launched in 1961 and followed during at least part of the next two years. That policy was aimed at producing a sizable decline in long-term interest rates while preventing a sharp reduction in short-term yields. The further twin objectives were to stimulate domestic real investment and faster economic growth while simultaneously checking the short-term capital outflow.

As indicated above, I do not believe that the adoption of an updated version of "Operation Twist" is called for at this time. In the first place, there is no evidence so far of any marked tendency for private short-term balances to move abroad in search of higher earnings. In fact, the only noticeable movement to date has involved the reflows associated with the repayment of funds which U.S. banks obtained from their branches abroad during the period of greatest credit stringency last year. As I stressed above, we have been fully aware all along that this reflow was almost certain to occur if we found it necessary to ease the availability of credit for domestic reasons. In my opinion, it would be a mistake to keep short-term interest rates in this country unduly high -- in a vain attempt to keep banks from reducing the high-cost balances obtained in the Euro-dollar market last year in order to escape some of the pressures of domestic monetary restraint.

Moreover, in the early 1960's many corporate treasurers in this country were just discovering the profit opportunities afforded by short-term investments in London and other foreign financial centers. To exploit these, they transferred sizable amounts of short-term funds abroad. In the present environment, there is little danger of a recurrence of this practice. Instead, under the voluntary program administered by the Department of Commerce, companiee have repatriated such holdings and have refrained from re-building them. They also seem fully prepared to continue their cooperation in this regard during the life of the program.

In emphasizing the lack of any need for a new version of "Operation Twist" -- at least under present circumstances -- I am by no means suggesting that currently prevailing interest rates (short-term or long-term) are inappropriate and should be reduced further. I am personally confident that the Federal Reserve System will pursue whatever monetary policy appears to be required in view of the actual future trend of economic developments, whether these relate to the domestic economy or the balance of payments. Rather, my purpose is to urge strongly that we do not conclude from the reflow of previous U.S. bank borrowings from the Euro-dollar market that we need to be diverted into following a policy which would offer no clear advantage to the balance of payments and which might be definitely ill-suited to our domestic requirements.

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